



NUMBER CRUNCHING BY TALBOT STEVENS

RRSPs vs paying capital gains tax

Unsheltered investments may prove more profitable in certain situations

ONE OF YOUR "A" CLIENTS, nearing retirement, asks if she should keep her equities outside RRSPs to take advantage of the lower tax rate on capital gains. Her son wonders the same thing for his situation.

There is a minimum holding period needed for RRSPs to be better than unsheltered investments, especially for equity investments that are mostly deferred capital gains. Whether the RRSP refund is spent or reinvested can be the most important, yet often overlooked, part of the analysis. And, to compare apples with oranges in terms of retirement goals, we need to calculate the net after-tax income produced by each strategy over the desired retirement period.

Like many aspects of financial planning, there is no answer that applies to all clients. Some factors affecting whether investments should be sheltered inside RRSPs include:

■ **CLIENT BEHAVIOUR.** If clients spend the RRSP-generated refund, that makes a smaller after-tax commitment to retirement goals than investing the amount unregistered.

■ **CLOSENESS TO RETIREMENT.** The real benefit of RRSPs is deferral of tax on investment growth. As clients approach retirement, the time investments have to compound decreases. Less growth means less benefit from tax deferral. Thus, younger clients benefit most from RRSPs.

■ **MAGNITUDE OF RETURNS.** Deferring tax on growth is more important when returns are higher. Thus, RRSPs are more valuable when returns average 12% than when they average 4%, regardless of the type of investment.

■ **TAX EFFICIENCY.** RRSPs are valuable for deferring tax on highly taxed fixed-income investments such as GICs. There is less benefit from sheltering equities if most of the return is a deferred capital gain and is only 50% taxable. With all unregistered investments, only growth is taxed; the adjusted cost base, representing the after-tax amount invested, is withdrawn tax-free.

■ **TAX RATE WHEN WITHDRAWN.** Deferring any expense, including taxes, makes sense if the cost (tax rate) does not increase later. Most clients will withdraw their funds at a

20-year after-tax Income from \$1,000 Investment					
Strategy	Before-tax retirement value	%		20-year after-tax income	% diff. from RRSP1
		diff. from RRSP1	diff. from RRSP1		
Case 1: Five years to retirement, 40% tax, 8% returns					
RRSP1	1,469	---	---	83	---
RRSP2	2,057	40	---	116	40
RRSP3	2,449	67	---	139	67
Equities1	1,435	-2	---	120	45
Equities2, 8.5%	1,467	0	---	126	52
Equities3, 8.5%	1,504	2	---	129	55
Interest	1,264	-14	---	95	14
Case 2: 25 years to retirement, 40% tax, 10% returns					
RRSP1	10,835	---	---	694	---
RRSP2	15,169	40	---	972	40
RRSP3	18,058	67	---	1,157	67
Equities1	9,378	-13	---	829	19
Equities2, 10.5%	10,436	-4	---	948	37
Equities3, 10.5%	12,135	12	---	1,081	56
Interest	4,292	-60	---	353	-49

RRSP1: refund is spent, RRSP2: refund is reinvested, RRSP3: refund is "grossed up." Equities1 and 2 assume 30% of returns are distributed annually. Equities3 assumes 100% deferred capital gains, 50% of capital gains taxable.

SOURCE: TALBOT STEVENS' ATI PROFESSIONAL SOFTWARE FROM WWW.TALBOTSTEVENS.COM INVESTMENT EXECUTIVE CHART

lower tax rate than they faced when contributing, increasing the benefit of RRSPs. Effective use of spousal RRSPs can reduce the tax rate of a couple's RRSP withdrawals even more. This benefit can't be reproduced outside of RRSPs.

But, if the tax rate when RRSPs are withdrawn increases, tax deferral can become a negative, even after accounting for the time value of money. Clawback of government benefits is a "hidden" form of taxation that can produce very high tax levels for retirees.

■ **RESTRICTIONS REDUCING RRSP RETURNS.** Foreign-content limits reduce potential returns, especially for equities. Historically, global equity funds have outperformed Canadian equities by 2%-3% a year, putting RRSPs at a big disadvantage. Now, clone funds allow RRSP-eligible global investments for an extra cost of about 0.5% a year. Clients end up with 0.5% lower returns with RRSP-eligible clone versions of their funds.

■ **CAPITAL LOSSES.** The ability to deduct capital losses does not exist inside a registered plan.

■ **TRUSTEE FEES.** RRSP trustee fees reduce net benefits, especially in smaller accounts.

We can now crunch the numbers for a few client cases to illustrate some possibilities. Let's assume the client has \$1,000 to invest, and his or her goal is to generate the maximum after-tax income over 20 years.

Let's say Sue Smith is five years from retirement, and her son, Bob, is 25 years from retirement. Both are in the 40% tax bracket and hope to retire in the same 40% bracket.

Let's look at Sue's case first. She is a conservative investor and is comfortable with 8% projected returns. She invests \$1,000 today, lets it grow for five years, then draws from it for the next 20 years (see the table, above).

RRSP1 through RRSP3 refer to the different RRSP refund strategies, and account for the important client behaviour parameter of what happens to RRSP refunds. RRSP1 occurs if the client spends the refund. RRSP2 occurs if all of the refund is reinvested back into RRSPs, resulting in a \$1,400 contribution from \$1,000 for Sue in the 40% tax bracket. RRSP3 occurs if the refund is grossed up. With \$1,000 available, a client could borrow \$667 and contribute a total of \$1,667. The 40% refund is \$667, almost enough to repay the loan. This is the most effective of the three approaches, resulting in a \$1,667 contribution from \$1,000.

Equities1 refers to \$1,000 invested in unregistered equities if 30% of returns are distributed and taxable annually. Equities2 shows 0.5% higher returns, reflecting the higher potential of global equity funds without the extra clone-fund cost. Equities3 illustrates 0.5% higher returns with no distributions, showing the best possible equities case, for which all the return is a deferred capital gain.

Notice how the after-tax retirement income evaluation leads to conclusions different than the simpler approach of comparing before-tax values. Case 1 shows Sue's situation, with five years until retirement. If Sue is disciplined and reinvests 100% of her refund in RRSPs, \$1,000 will result in an initial contribution of \$1,400, which will grow to a

before-tax value of \$2,057 in five years, as shown in RRSP2. But if she invests \$1,000 in unregistered equity funds averaging the same 8% return, she would have a before-tax retirement fund worth only \$1,435.

But this approach compares apples with oranges using the wrong scale. When the two strategies are compared in terms of the real retirement goal of producing net after-tax retirement income, we get a different picture. Because capital gains are taxed less and grow mostly deferred, the smaller retirement fund from the unregistered strategy pro-

duces more after-tax income (ATI) over 20 years.

Bob has more time to benefit from the tax-deferral of RRSPs. He thinks 10% equity returns are achievable. After 25 years, \$1,000 in RRSPs produces a 20-year ATI of \$694. If Bob is disciplined, he'll produce \$972 a year for 20 years after tax by reinvesting his refund (RRSP2). Unregistered equities at the same 10% returns produce a 20-year ATI of only \$829. Even with global equities with slightly higher 10.5% returns, avoiding additional clone-fund costs (Equities2), Bob would be

wise to stay with RRSPs.

Equities3 shows the best case of the most tax-efficient global equity fund with no distributions. Bob might produce a 20-year ATI of \$1,081 from a single \$1,000 investment. Whether Bob is better off sheltering his global equity fund inside RRSPs depends on the tax-efficiency of the fund he chooses. **IE**

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