

Just do it: The case for tax-free investing

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Whether you choose an RRSP or TFSA, most Canadians would be well served by simply making a contribution to either plan. That's because, no matter which plan you choose, you have the ability to earn tax-free investment income for life - an opportunity that no one should pass up.

While Canadians often ponder whether it would be better, given limited resources, to contribute to a Tax Free Savings Account (TFSA) or a Registered Retirement Savings Plan (RRSP), it's important not to lose track of the major benefit of each plan - the tax-free growth.

Tax-free growth

While all investors will openly acknowledge the fact that investment income, be it interest, dividends or capital gains, is 100% tax-free when earned inside a TFSA, only a handful will assert the same assumption when it comes to income earned inside an RRSP. In fact, many individuals consider investment income earned within an RRSP to be merely "tax deferred." This is simply incorrect.

To prove that income and growth inside an RRSP (or its successor, a RRIF) is indeed completely tax free,¹ let's take a look at an example.

On January 1st, Dan, whose marginal effective tax rate (METR)² is 33.33%, can afford to invest \$2,000 of his net after-tax cash flow in an RRSP. As a result, he actually contributes \$3,000³ to his RRSP, which generates a tax refund of \$1,000 netting him the \$2,000 he has budgeted for retirement savings.

So where does Dan get that extra \$1,000 to fund the \$3,000 RRSP contribution? He either takes it temporarily from other non-registered funds or he borrows it at a favourable rate under an RRSP Loan Program and pays it back as soon as he gets his tax refund.⁴ While the interest on such a loan is not tax deductible, if timed properly, the duration of such a loan can be as short as nine days - the time it can take to file your tax return electronically and have your refund directly deposited into your account. This minimizes the amount of non-deductible interest paid.

Now, let's assume Dan invests the funds on January 1st and earns a five per cent return this year so that by December 31st, his RRSP has grown in value to \$3,150 from his initial \$3,000 RRSP contribution. If Dan pulls out the \$3,150 from his RRSP at the end of the year and he's still in a 33.33% tax bracket, he would pay \$1,050 of tax on his RRSP withdrawal and net \$2,100. As Chart 1 shows, when you compare the \$100 he has netted with the \$2,000 it cost him to contribute, he has realized a 5% tax-free rate of return. In other words, the income he earned was not simply tax-deferred, but it was indeed completely tax-free.

Chart 1 – Tax-free growth in an RRSP

	Cash Flow	RRSP Account
RRSP Contribution - January 1 st	\$3,000	\$3,000
Tax Refund (33.33%)	(1,000)	
Net cost of RRSP contribution (A)	\$2,000	
Growth (5%)		150
Value of RRSP - December 31 st		\$3,150
Tax (33.33%)		(1,050)
Net after-tax proceeds of RRSP (B)	\$2,100	\$2,100
After-tax growth (B - A)	\$ 100	
Tax free rate of return (B-A)/A	5.00%	

Effect of changing tax rates

Of course the above example assumed that Dan's initial METR at the time of contribution was identical to his METR at the time of ultimate withdrawal. This is the easiest to model in that there is no additional tax rate benefit (disadvantage) associated with contributing to an RRSP. The sole benefit of RRSP investing is the ability to earn tax-free investment income over time.

Chart 2 – RRSP vs. Non-Registered - Same rate

	Cashflow	RRSP Account	Non-Registered Account
RRSP Contribution	\$3,000	\$3,000	
Tax Refund (33.33%)	(1,000)		
Net after-tax savings	\$2,000		\$2,000
Total amount contributed		\$3,000	\$2,000
Ending Value		21,120	14,080
Tax (33.33% on RRSP / 16.67% on capital gain)		(7,040)	(2,013)
Net after-tax proceeds		\$14,080	\$12,067

Chart 2 shows the after-tax value of Dan's RRSP, invested over 40 years at 5%, as compared to the after-tax value of an equivalent investment had Dan gone the non-registered route. The non-registered investment assumes no income or gains are realized during the accumulation period and, when the entire amount is cashed in at the end of

40 years, a capital gain is realized, taxed at 50% of Dan's METR, assumed to be constant.

Clearly, the RRSP beats the non-registered account when Dan's METR stays the same upon ultimate withdrawal, due to the tax-free investment income earned in the RRSP. The RRSP account would show an even greater advantage over the non-registered account if the non-registered account assumption was more realistic in that annual interest or dividend income was earned and taxed annually or gains were realized occasionally during the accumulation phase and taxed throughout the period rather than merely at the end.

It goes without saying that if Dan's METR was lower upon retirement than it was upon contribution, the relative advantage of the RRSP over non-registered savings would be that much greater.

But what if your METR actually increases between now and retirement?

Some commentators⁵ have suggested that building up too much money in an RRSP or its successor, a RRIF, could very well be a bad thing because of the potentially high METR associated with RRIF withdrawals.⁶

But depending on the rate of return assumption, the number of years of tax-free compounding available, as well as the types of investment income you might otherwise earn by saving an equivalent amount in a non-registered account, the benefits of the tax-free compounding can actually outweigh the additional tax cost of a higher withdrawal METR.

Let's model this by using the same assumptions as above but this time we'll assume that Dan's METR increases by a full 10% from 33.33% to 43.33% upon retirement. Chart 3 shows that with a 5% return over time and a pure deferral of tax on the non-registered side, it would take 25 years for the after-tax value of the RRSP to beat out the non-registered account. The chart also shows that in this situation, contributing to a TFSA provides

higher after-tax values throughout the entire period.

Chart 3 – After-tax values of RRSP, TFSA and Non-Registered Account; 5% Return; METR 33.33% at contribution, 43.33% at withdrawal

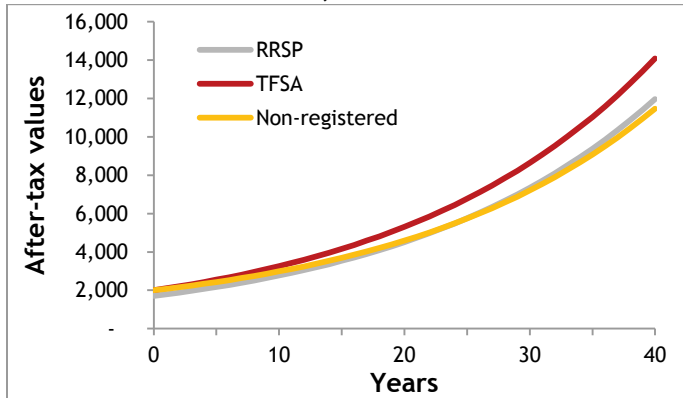
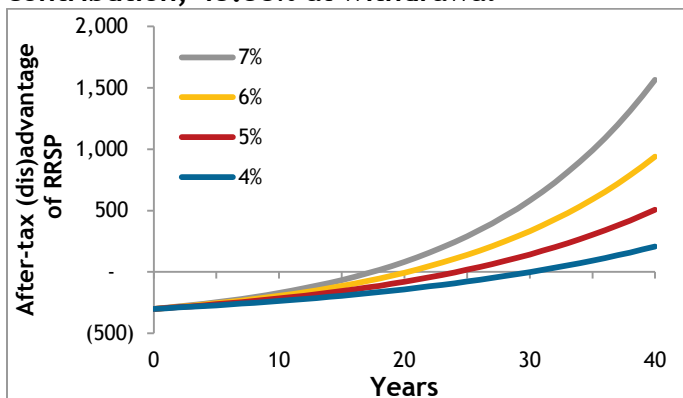


Chart 4 shows that the break-even point at which the relative advantage of registered plan investing over non-registered investing, when Dan’s METR is 10% higher upon withdrawal, comes earlier the higher the rate of return assumption.

To reiterate, both Charts 3 and 4 paint an extreme picture whereby the non-registered account grows free of any tax during the accumulation period and is fully taxed as capital gains at the end of 40 years. In a more realistic world, the breakeven points illustrated in Chart 4 would come much sooner if the non-registered savings were taxed throughout the accumulation period and at rates less favourable than that of capital gains.

Chart 4 – Relative (Dis)Advantage of RRSP vs. Non-Registered Investing; METR 33.33% at contribution, 43.33% at withdrawal



The role of TFSAs

Finally, a quick word about TFSA investing is warranted. The TFSA can also play an important role in retirement savings accumulation in that all investment income earned inside a TFSA is never taxed. For taxpayers nearing retirement whose time horizons are shorter and whose METRs upon ultimate retirement savings withdrawal are expected to be higher than they were during the period of contribution, saving within a TFSA may provide additional tax savings beyond the tax-free investment accumulation.

TFSAs also play an important role in retirement savings for low-income Canadians. A low income earner would be best advised to maximize his or her TFSA to the extent possible. Any additional savings, however, should be directed to non-registered savings instead of RRSPs due to the potential loss of the Guaranteed Income Supplement (GIS) upon retirement. In this case, even a full and immediate taxation of investment income annually in a non-registered account is preferable to an RRSP because those in the lowest tax bracket are facing a 20% or so METR when they contribute but a 50% to 70% estimated METR when they withdraw.⁷

In a nutshell, if you think that your post-retirement METR will be materially larger than your pre-retirement METR (as would happen if you were expecting to be subject to the GIS or OAS clawbacks), TFSAs are the best choice. If you think that your post-retirement METR will be materially smaller than your pre-retirement METR (as might happen if you plan to split pension income with a lower-income spouse or partner) then RRSPs work best. If you are not expecting your post-retirement METR to differ materially from your preretirement METR, then it doesn't really matter which plan you choose. This is discussed in detail in our earlier report titled Blinded by the Refund: Why TFSAs may beat RRSPs as better retirement savings vehicle for some Canadians.⁸

Conclusion

For Canadians expecting to have a similar or lower METR upon retirement, there is no doubt that RRSP investing beats non-registered investing, no matter the type of income earned and the rate of return assumption. For those saving for retirement who expect to face a higher retirement METR, depending on the time horizon, rate of return assumption and investment mix (i.e. interest, dividends or capital gains), the benefit of tax-free accumulation of investment income inside an RRSP can still outweigh non-registered investing, once the TFSA is maximized.

In other words, in nearly all cases, no matter your tax rate now or in the future, RRSP or TFSA investing should be an integral part of your retirement plan.

So, what are you waiting for? Just do it!

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- ¹ The equivalent of a tax-free rate of return is earned in an RRSP when tax rates are the same constant at the time of contribution and withdrawal.
- ² The marginal effective tax rate (METR) takes into account not only an individual's statutory income tax brackets but also considers the impact of the loss of various income-tested benefits, such as Old Age Security or the Age Credit, which are "clawed back" once income reaches various annually-indexed, preset thresholds.
- ³ The simple formula used to optimize the ideal RRSP contribution given an individual's cash contribution = Cash on hand / (1 - METR).
- ⁴ Following from the formula above, the additional amount an individual needs to borrow to optimize the RRSP contribution = Cash on hand X [1 / (1 - METR) - 1].
- ⁵ See, for example, Michael Nairne, "The dark side of RRSPs," *Financial Post*, January 19, 2011 and John Newell, "Were RRSPs a major mistake?" *Financial Post*, January 19, 2011 available online at <http://business.financialpost.com/2011/01/18/counterpoint-were-rrsps-a-major-mistake/>.
- ⁶ Of particular concern to some higher income seniors is the potential "claw back" of Old Age Security (OAS) benefits, which can effectively add 15% to some retirees' METR.
- ⁷ As Richard Shillington wrote in his 2003 Report, "(F)or many lower-income Canadians RRSPs are a terrible investment." See: "New Poverty Traps: Means-Testing and Modest-Income Seniors" - C.D. Howe Institute Backgrounder No. 65, April 2003, which is available online at <https://www.cdhowe.org/public-policy-research/new-poverty-traps-means-testing-and-modest-income-seniors>.
- ⁸ The report *Blinded by the Refund: Why TFSAs may beat RRSPs as better retirement savings vehicle for some Canadians* is available online at <http://www.cibc.com/ca/pdf/rrsp-versus-tfisa-report-en.pdf>.



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