

Inside or OUTSIDE

Should Canadians contribute to their RRSP or a non-registered account?

By Barry R. Carson

For nearly 50 years, RRSPs have been touted as the best vehicle for Canadians to save for retirement. Now that the capital gains inclusion rate has been reduced to 50% outside an RRSP, is it time to challenge this traditional wisdom? Usually, the debate is between investing inside versus outside an RRSP when it really should be about how much to put in each plan type.

Many articles have been written comparing investments inside and outside an RRSP and most try to convince the reader that one is superior to the other, using assumptions that support their case. This article intends to present three very different scenarios to demonstrate that under certain circumstances the investor is better off inside an RRSP while under a different scenario it is better to invest outside an RRSP. The following three scenarios will illustrate this point as follows:

- › Scenario A: \$10,000 contribution allocated 100% to GICs.
- › Scenario B: \$10,000 contribution allocated 100% to equities.
- › Scenario C: \$10,000 borrowed to contribute 100% to equities.

Tables for each scenario begin on page 8.

SCENARIO A:

It is assumed the RRSP contribution generates a full tax refund one year after the contribution, which is reinvested. That generates an additional refund, which is also reinvested and so on. The money within the RRSP grows tax-free at a rate of 5% while the money outside the RRSP grows at a lower rate since tax is payable on the interest each year. The marginal rate of tax at the time of contribution equals the marginal rate of tax upon withdrawal.

Scenario A summary: The highest tax bracket over a 30-year time horizon results in a total of \$41,238 inside the RRSP (after tax) versus \$22,239 outside the RRSP. The value of the RRSP is more than 85% higher, so obviously there is no comparison. A higher marginal tax rate produces a better result in favour of the RRSP. A longer time horizon also produces a better result. This scenario is often utilized in marketing campaigns to convince the investor to contribute to their RRSP. However, do Canadians put 100% of their RRSP contributions into GICs at today's historically low interest rates?

SCENARIO A: 100% GICs

	Outside RRSP	Inside RRSP	Outside RRSP	Inside RRSP
Tax Rate	22%	22%	46%	46%
GIC Return	5%	5%	5%	5%
Accumulation	3.9%	5%	2.7%	5%
Value in 10 yrs	\$14,661	\$16,289	\$13,053	\$16,289
Refund	\$0	\$4,309	\$0	\$12,689
Tax	\$0	(\$4,512)	\$0	(\$13,330)
Net	\$14,661	\$16,086	\$13,053	\$15,648
Difference		+9.7%		+19.9%
Value in 20 yrs	\$21,494	\$26,533	\$17,038	\$26,533
Refund	\$0	\$7,019	\$0	\$20,680
Tax	\$0	(\$7,381)	\$0	(\$21,717)
Net	\$21,494	\$26,171	\$17,038	\$25,496
Difference		+21.8%		+49.7%

SCENARIO B: 100% EQUITIES

	Outside RRSP	Inside RRSP	Outside RRSP	Inside RRSP
Tax Rate	22%	22%	46%	46%
Equity Return	8%	7.9%	8%	7.9%
Accumulation	8%	7.9%	8%	7.9%
Value in 10 yrs	\$21,589	\$21,390	\$21,589	\$21,390
Refund	\$0	\$5,474	\$0	\$15,884
Admin. Fee	\$1,956	\$0	\$1,956	\$0
Tax	(\$1,352)	(\$5,910)	(\$2,828)	(\$17,146)
Net	\$22,193	\$20,954	\$20,717	\$20,128
Difference	+5.9%		+2.9%	
Value in 20 yrs	\$46,610	\$45,754	\$46,610	\$45,754
Refund	\$0	\$11,714	\$0	\$33,979
Admin. Fee	\$6,178	\$0	\$6,178	\$0
Tax	(\$4,432)	(\$12,643)	(\$11,336)	(\$36,677)
Net	\$48,356	\$44,825	\$41,452	\$43,056
Difference	+7.9%		+3.9%	

SCENARIO B:

Assume 100% of the money is invested in equities. Taxes are only payable when the gains are realized. However, fund companies have developed corporate-class funds whereby you

can switch between funds and not realize any gains. This new class of funds was developed specifically for non-RRSP equity investors who want 100% tax-sheltered growth. Once a gain is realized, only 50% is subject to taxation thanks to the preferential tax treatment of capital gains.

Equity investments outside an RRSP are not subject to foreign-content rules so it is not necessary to buy RRSP clone funds to bypass the foreign content. It is assumed the management fees on these clone funds is 10 basis points higher so the corresponding return should be 10 basis points lower. Since Canada represents approximately 2% to 3% of the world's equity markets, investors should invest outside of Canada for proper diversification and potential for higher returns.

As a general rule, RRSPs charge an annual administration fee of approximately \$125. However, banks don't charge annual administration fees and some advisors will pay these fees on behalf of valued clients. The \$125 saved by investing outside the RRSP is reinvested in equities outside the RRSP for illustration purposes.

Scenario B summary: Incorporating the \$125 annual RRSP administration fee produces comparable results or slightly favours investing outside an RRSP. However, if the RRSP administration fee is waived, this changes the benefit

in favour of the RRSP. In addition, the impact of this administration fee is reduced as the value of the portfolio increases. It is unlikely an investor would be disciplined to reinvest all the RRSP tax savings, but for comparative purposes we assume they do. The results are really too close to call and can be interpreted in favour of investing inside or outside the RRSP. The tax savings upon disposition outside the RRSP using the 50% inclusion rate are equivalent to the accumulated wealth due to reinvested tax savings within the RRSP.

The traditional wisdom that Canadians should always invest inside their RRSP is not necessarily true under this scenario. Although they are only a small percentage, many Canadians have utilized all their RRSP contribution room and would love to have additional RRSP contribution room. Investing in equities is almost the same as having unlimited RRSP room.

SCENARIO C:

Assume at an annual interest rate of 5%, it would cost \$500 annually in interest on a \$10,000 interest-only loan (e.g., secured line of credit). This interest expense is fully deductible outside an RRSP and not deductible if the money is used to make an RRSP contribution.

The non-RRSP investor will use the tax savings to invest in equities outside the RRSP. In addition, the administration fee savings are invested in equities outside the RRSP.

Scenario C summary: An investor who borrows to invest in equities should achieve better results outside their RRSP. How many Canadians take out an RRSP loan for their RRSP contribution and invest it in equities? Do they realize the accumulated growth is taxed at their full rate whereas growth outside their RRSP is taxed at half the rate? Realistically, how many people actually reinvest their

SCENARIO C: 100% EQUITIES WITH BORROWED MONEY

	Outside RRSP	Inside RRSP	Outside RRSP	Inside RRSP
Tax Rate	22%	22%	46%	46%
Equity Return	8%	7.9%	8%	7.9%
Accumulation	8%	7.9%	8%	7.9%
Value in 10 yrs	\$21,589	\$21,390	\$21,589	\$21,390
Refund	\$0	\$5,474	\$0	\$15,884
Savings	\$3,677	\$0	\$5,554	\$0
Tax	(\$1,420)	(\$5,910)	(\$3,126)	(\$17,146)
Net	\$23,846	\$20,954	\$24,017	\$20,128
Difference	+13.8%		+19.3%	
Value in 20 yrs	\$46,610	\$45,754	\$46,610	\$45,754
Refund	\$0	\$11,714	\$0	\$33,979
Savings	\$11,614	\$0	\$17,545	\$0
Tax	(\$4,787)	(\$12,643)	(\$10,822)	(\$36,677)
Net	\$53,547	\$44,825	\$53,333	\$43,056
Difference	+19.2%		+23.8%	

RRSP refund diligently each year?

Overall, each Canadian investor's situation is unique and should be reviewed with the assistance of an advisor. The numbers are important but equally important is the investor's risk tolerance. For example, it might make financial sense to borrow outside your RRSP with equities but some investors do not like the thought of taking out a loan and would prefer to pay down their mortgage. This study demonstrates that equity investors should consider investing some of their money outside their RRSP while GIC investors should remain inside their RRSP. Since most investors have an equity component in their portfolio they should really consider investing outside their RRSP. Should you invest inside or outside your RRSP? Why not do both!

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