RSP vs. Non-RSP

Each year a number of Canadians ask themselves whether it is worthwhile to contribute to their registered retirement savings plans (RSPs). They are concerned because all withdrawals from RSPs are fully taxable and therefore those who have accumulated significant amounts in their RSP may increase their exposure to Old Age Security (OAS) clawback when they start to receive payments from their RSPs and/or RIFs (registered retirement income funds).

Individuals are also concerned that a significant portion of their RSPs or RIFs could be subject to tax at the highest marginal tax rate in the event of their death since the entire value of their RSPs or RIFs is brought into income in the year of death unless these plans can be transferred to a spouse or common-law partner (hereinafter collectively referred to as the "Partner") or qualified child or grandchild, on a tax deferred basis.

It is these concerns, coupled with the reduction in the taxable capital gains inclusion rate to 50% and, more recently, a reduction in Canadian dividend tax rates that have Canadians questioning whether they would be better off investing outside of their RSP.

To determine whether or not investing in an RSP makes sense, a number of factors should be considered including:

1) an individual's marginal tax rate;
2) an individual's ability to pension income split;
3) the investment time horizon;
4) the type of investment; and
5) the investment rate of return.

Marginal Tax Rate

Your marginal tax rate in the taxation year you make your RSP contributions is perhaps the most important factor in determining whether you should contribute to your RSP. Your marginal tax rate represents the amount of tax you can save if you contribute to an RSP. The higher your marginal tax rate, the greater the tax savings, and the more upfront capital you will have to invest.

As an example, assume you had $1,000 to invest and your marginal tax rate is 45%. By contributing to your RSP, you will save $450 in taxes which you can then invest outside of your RSP for a total investment amount of $1,450 versus $1,000 if you had invested outside of your RSP.

The extra capital that can be invested as a result of the tax savings generally makes investing in an RSP a better choice than investing outside an RSP provided your marginal tax rate does not increase in the future when you withdraw funds from your RSP.

Many Canadians contribute to their RSPs during their working years when they have high income (and a high marginal tax rate), and withdraw from their RSPs during their retirement years when their incomes (and marginal tax rates) are presumably lower. By making RSP contributions now, they will benefit not only from the ability to defer tax on the income earned inside the RSP, but also pay less tax on the amount of the RSP contribution.

If you anticipate that your marginal tax rate will be higher in the future than it is today, then the advantage of investing in an RSP today becomes less clear. If this is the case, you will need to evaluate the factors discussed below to determine whether the tax deferral benefits of an RSP will outweigh the potential higher taxation in the future.

Bear in mind that even with a large RSP, you may be able to remain in a relatively low tax bracket at retirement by splitting your RIF income with your Partner by opting to pension income split.

Pension Income Splitting

As a result of legislative changes in 2007 under the Tax Fairness Plan, the government permits a Canadian resident who receives eligible pension income to allocate up to one-half of such income to his or her Partner, thereby reducing total household taxes.

Income from an RSP annuity or a RIF is eligible to be split if the recipient is 65 years of age or older. Individuals who have been saving in their RSP can therefore take advantage of pension income splitting during retirement.

No such income splitting opportunity is accorded for income from a non-registered account. If you try to split non-registered income with your Partner, the income attribution rules in the Income Tax Act will attribute all income back to you.

Investment Time Horizon

Aside from tax savings, another benefit associated with investing in an RSP is the ability to defer tax on the income earned within the RSP. The longer your investment time horizon, the longer you will be able to enjoy the tax deferral benefit which increases exponentially with time.

The following table illustrates the compounding growth effect of investing in an RSP assuming a $1,000 initial investment and 5% rate of return.

Years	RSP Value	Growth in 10 Years
0	$1,000	-
10	$1,629	$629
20	$2,653	$1,024
30	$4,322	$1,669

If you have a sufficiently long time horizon, you may still be better off investing in an RSP even if you suspect you will be in a higher marginal tax rate in the future as the tax deferral benefits you enjoy over this period may outweigh the potentially higher taxation costs in the future.

Type of Investment

Different tax rates are applied to different types of investment. Interest income is taxed most onerously while capital gains income is only taxed at one-half the tax rate of interest income. Canadian dividend income receives the most favourable tax treatment at lower income levels but is taxed at a higher rate than capital gains in some provinces.

If you are looking to invest in interest income producing investments such as bonds, bond mutual funds, or GICs, you should consider investing within an RSP to take maximum advantage of its tax sheltering capabilities. Common shares and preferred shares also benefit from the tax sheltering capabilities of an RSP but to a lesser extent.

Some analysts have suggested purchasing common shares as an alternative to investing in an RSP. They reason that common shares can provide similar tax deferral benefits as an RSP in that the shares are not subject to tax until they are sold. But unlike RSP income, which is fully taxable (when withdrawn), only 50% of the gains from the sale of common stocks are subject to tax.

An aspect that is not mentioned in this strategy is the tax savings derived from investing in an RSP which provides more capital upfront to invest versus not investing in an RSP. Nevertheless, assuming that investing in 100% common shares is consistent with an individual's investment objective and risk tolerance, this strategy may make sense for certain individuals.

These individuals should ideally be in a low marginal tax rate today, have a short to medium investment time horizon, and expect to be in a significantly higher marginal tax rate in the future.

Investment Rate of Return

Generally speaking, the greater the investment rate of return, the greater the amount of income you will be able to tax shelter inside an RSP, and hence the greater the benefits of investing in an RSP.

Conclusion

As with most financial planning questions, the individual's specific situation will determine if it is better to invest inside or outside of an RSP. You should consult with your financial advisor to discuss what is right for you. However, the following general observations can be noted:

- If you expect your marginal tax rate to remain the same or decrease in the future, you are likely better off to invest in an RSP regardless of the type of investment or the rate of return on the investment.

- If you are considering investing in common stocks and you have a short investment time horizon, and you expect that you will be in a much higher marginal tax rate in the near future, then investing outside of an RSP may make sense.

- For all other situations, the decision to invest inside or outside of an RSP will depend on your current and future marginal tax rate, the type of income at retirement, the investment horizon, and also the type of investment.

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