

RRSPs versus non-registered accounts

Favourable capital gains tax treatment has resulted in non-registered accounts becoming an attractive option for investors. Investors want to know when they should invest in RRSPs and when they should invest in non-registered accounts. The following highlights the advantages and disadvantages of both.

The advantages of investing in RRSPs

RRSPs and RRIFs offer tax deferral until funds are withdrawn. When withdrawn, funds are treated as income and taxed at the taxpayers marginal rate at the time of withdrawal. In addition, any withdrawals are taxed as straight income notwithstanding the fact that they may have been the result of Canadian dividends or capital gains earned inside the registered plan.

With RRSPs and RRIFs, the annuitant can choose to rebalance his or her portfolio as appropriate. If gains have been realized on some of the investments inside the registered plan, they remain tax sheltered as assets are reallocated from one asset class (e.g., equities) to another (e.g., bonds).

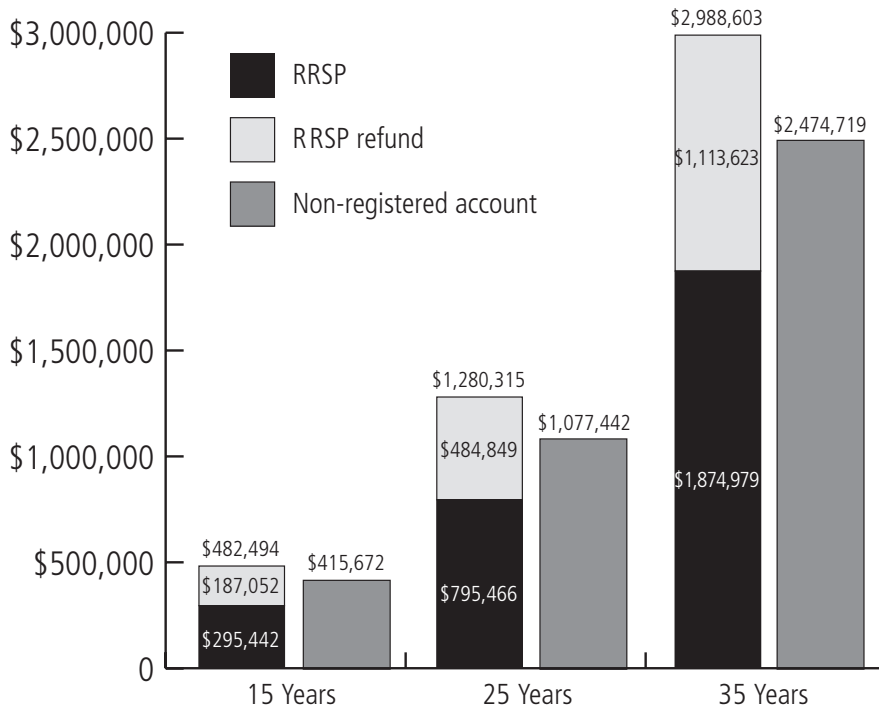
With a non-registered equity investment, generally, no tax is payable until the investment is sold. However, not many investors buy and hold an individual security or mutual fund in a non-registered account for 20 or 30 years. Also, an investor may be reluctant to dispose of a property that has increased in value because of the potential for large capital gains tax on such rebalancing. This may have the added effect of discouraging a reallocation of the investment mix where such a reallocation may be the appropriate choice for the investor as he or she approaches retirement age.

Most importantly, RRSPs offer a tax deduction in respect of contributions made. For example, a \$15,500 RRSP contribution would result in a tax savings of \$6,975 for an individual with a marginal tax rate of 45%. The tax refund received from making a contribution can be invested into a non-registered account. Let's see what happens over 15, 25 and 35 years if the investor consistently reinvests the refund into a non-registered account, assuming 8% annual returns.

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Reinvesting tax refunds into a non-registered account



This chart shows the after-tax values in 15, 25 or 35 years of the two options. It assumes a \$15,500 annual contribution; 8% annual market appreciation; 45% marginal tax rate (MTR) during contribution and 35% MTR upon redemption.

Over time, the combined after-tax value of the registered and non-registered accounts with reinvested tax refunds will generally surpass the after-tax value of a non-registered account alone, even though income from the registered account is fully taxable. Even if not reinvested, the money would at the very least contribute to a better quality of life at some level, whether the investor pays off debts or buys something new with it.

Finally, the RRSP offers many Canadians a psychological motivation to invest for their retirement on a regular basis. If someone invests the legal maximum RRSP contribution limit (18% of their prior year’s earned income – generally employment income, etc. – up to a maximum of \$15,500 for 2004 (\$16,500 for 2005) less any pension adjustment), then they will be going a long way towards a financially healthy and secure retirement.

The advantages of investing in a non-registered account

Now, let’s assume that instead of contributing funds to an RRSP each year, the investor deposits the same amount in a non-registered account that holds a mix of equity investments. Upon ultimate disposition, any profits earned on these investments will result in capital gains to the investor, taxable at only 50% of the investor’s marginal tax rate.

There are a few specific situations where ceasing to make RRSP contributions may make sense. This may be the case for investors who:

- Have already accumulated a significant amount of assets inside their registered plans
- Are approaching the age at which they will begin withdrawing from the plan
- Expect to be in a higher tax bracket when withdrawing the funds than they were when the RRSP deduction was taken

It's important that investors review their personal situations to determine how much of their assets should be in registered plans and what portion should be in non-registered accounts. The appropriate allocation will depend to a large extent on the factors discussed above.

Next steps

The preceding is a general overview of some of the issues that need to be considered when choosing between registered and non-registered accounts. All cases should be dealt with on an individual basis and investors should review their portfolio with their advisor and/or professional tax specialist when dealing with specific situations.

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