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RRSP or capital gains? Why not both?

Now that only half of a capital gain gets taxed, some people wonder if it's better to skip their RRSP contributions and invest instead in an "open" account that is not part of the tax-sheltered retirement savings system.

Open account investing offers more flexibility than an RRSP given that you have full control over the timing and amount of withdrawals from your open account.

Your RRSP must be turned into a taxable income stream after you turn 69 – even if you don't need the money for spending. This RRSP income creates an extra tax bill and could reduce income-tested government benefits. Therefore, open account investing may be advantageous in certain specialized cases that involve income-tested government benefits. This added flexibility combined with the capital gains tax break may seem compelling, but read on.

OAS claw back – is this really a concern?

The most commonly cited case involves retirees with net income over the $62,144 threshold limit at which the Old Age Security benefits begin to be clawed back. But is this really a concern for most people? Tax statistics show the clawback hits only about 5% of OAS recipients and fewer than 2% lose the full benefit. You will need annual income of about $100,914 to lose all of the OAS and that amount is individual – as opposed to joint income. Very few retirees make that much.

How much of your investment really goes to work?

If the same amount is invested, an open account that follows a tax-efficient capital gains strategy will produce more after-tax income than an RRSP. But the assumption that the *same* amount is invested ignores a key element – the RRSP tax refund.

RRSP contributions are made with pre-tax dollars. Many people don't realize this. They see tax being deducted from their paycheques and later see a tax refund from their RRSP contribution, but don't link the two. Suppose there is a 40% tax bite on your top $10,000 of income. You will pay $4,000 in tax. If you contribute $10,000 to your RRSP, the associated deduction will reduce your taxable income by $10,000 and refund the $4,000 in tax you previously paid. This means you can take the full $10,000 you earned and put it to work in your retirement fund. (Your financial advisor can help you muster the cash for your RRSP contribution and speed up your tax refund.)

Open account investments are made with after-tax dollars. So, in this scenario, your $10,000 of earnings would leave just $6,000 available for investment.

Suppose both investments average 8% in compound annual growth for 20 years. You then withdraw the money for spending. Your $10,000 RRSP contribution will have grown to $46,610. After tax at 40%, you will have $27,966 to spend. Assuming it has used tax-efficient holdings, your $6,000 capital gains investment will be worth $27,966 before tax and $23,573 after tax. In this case, the RRSP won because more money was put to work.

	RRSP	Open Account
Earnings	$10,000	$10,000
Tax deducted at 40%	-4,000	-4,000
Net amount	6,000	6,000
Tax refund on $10,000*	4,000	0
Amount put to work	10,000	6,000
Value after 20 years	46,610	27,966
Less adjusted cost base	0	-6000
	46,610	21,966
Tax-free portion of capital gains	0	-10,983
Taxable amount	46,610	10,983
Tax due at 40%	18,644	4,393
Available for spending	$27,966	$23,573
*RRSP contribution		

Notice that we used the value of the RRSP tax refund to maximize our investment. Unfortunately, many people don't do that. Often, they spend this money without thinking. It's only natural to view a tax refund as a bonanza!

So, an open account offers more flexibility and future tax savings while an RRSP lets you put more money to work now. Is it possible to get the added growth from investing the upfront RRSP tax deduction plus the benefits of open account investing?

Yes.

The advantages of both an open account and a RRSP

Make your RRSP contribution and then put the related tax refund into an open account and invest in tax-efficient holdings (see below) for capital gains. As the chart shows, this RRSP+ open strategy is a definite winner.

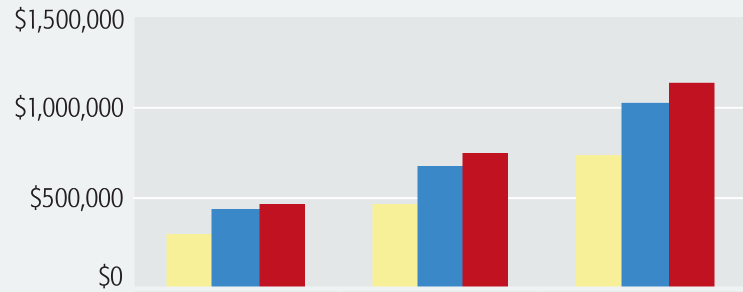
We assumed that a person has $10,000 in cash to invest every year. The first (yellow) bar in each time frame shows the after-tax value if this money is used for an RRSP contribution without investing the tax refund it generates. For example, after 20 years there would be $296,538 available after tax. That's if the investments averaged 8% in compound annual growth and the plan was cashed out all at once, getting taxed at 40%.

The second (blue) bar shows the after-tax value if $10,000 is put into an open account each year and invested for capital gains. After 20 years there would be $435,383 available after tax – 47% more than in the previous case. We assumed 100% tax efficiency during those 20 years – no taxable distributions and no capital gains tax when switching from one fund to another. As in the first case, the investments averaged 8% in compound annual growth and were all cashed out at once when the investor was in the 40% tax bracket.

The third (red) bar shows the after-tax value if $10,000 is contributed to an RRSP each year and the $4,000 tax refund is not spent, but put into an open account for tax-efficient capital gains investing. After 20 years there would be $470,691 available after tax. That's 8% more than the second case and 59% more than the first.

Notice that the out-of-pocket investment was still $10,000 each year, but using the RRSP tax refund put a total of $14,000 to work. Meanwhile, the open account – worth nearly $200,000 just before the cash-out at the end of year-20 – enjoyed total flexibility with no concerns about mandatory withdrawals in the future.

Invest tax refund to boost after-tax value



	20 yrs	25 yrs	30 yrs
RRSP - refund spent	$296,538	$473,726	$734,075
Open account	$435,383	$681,635	$1,038,767
RRSP + open account	$470,691	$746,381	$1,149,582

*The rate of return is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of Mackenzie Mutual Funds or returns on investments on Mackenzie Mutual Funds.

It is important to measure the tax efficiency of your taxable investments – in other words how much of the income after tax you get to keep. The more tax efficient an investment, the more money you put in your pocket. **Mackenzie Capital Class Funds** are a major financial development in our effort to help you secure wealth. Our capital class mutual funds are set up within a corporate class structure, which allows you to formulate an effective asset allocation strategy. Whenever rebalancing is necessary or you simply want to switch mutual funds, our capital class funds allow you to switch among more than 40 mutual funds without triggering capital gains tax. The long term compounding of that extra money that you would normally have paid tax on can have a dramatic effect on your long term wealth. In addition, Mackenzie's corporate class structure can reduce and possibly eliminate year-end taxable distributions that negatively impact your long-term growth.

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