January 23, 2018

In Defense of RRSPs: Dispelling common myths

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For over 60 years, the Registered Retirement Savings Plan (RRSP) has been available to build savings for retirement.[1] *In recent years, these plans seem to be falling out of favour, with fewer Canadians contributing to RRSPs and a significant number of pre-retirees withdrawing funds from these plans. This report looks at this surprising trend and debunks some of the myths that may be keeping Canadians from saving in an RRSP.*

The role of RRSPs in retirement funding

When it comes to retirement planning, how much Canadians need to save is a touchy subject. While some Canadians may spend less in retirement due to a reduction in work-related and other expenses, like paying down their mortgage, others find that retirement expenses stay the same or may even increase, perhaps due to increased costs for travel, entertainment, hobbies, or health expenses.

Government plans may be a primary source of retirement funds for many Canadians. In a CIBC Poll ("Poll")[2] conducted in January 2018, 57% of respondents (and 77% of respondents ages 55 and older) expected that government pensions would be a main source of retirement income. In 2018, the maximum annual Canada Pension Plan (CPP) retirement benefit is $13,610;[3] however, payment depends on contributions to the plan and the average recipient will only get about $7,700,[4] far less than the full amount. The maximum annual Old Age Security (OAS) pension is $7,040[5] and, for low-income individuals, the Guaranteed Income Supplement (GIS) may add a non-taxable benefit of up to $10,515 annually.[6] When combined, the maximum total of these benefits is slightly more than $30,000 per individual or $60,000 per couple, before tax. As noted, however, many retirees receive significantly less than the maximum.

Private pension plans may be another source of funds for your retirement; however, less than four in ten Canadian employees are members in these plans.[7] Consequently, private pensions may add little or no value for many employees, and self-employed individuals generally have no private pensions at all.

Another possible source of retirement funds may be from gifts or windfalls, and 15% of Poll respondents expected an inheritance or lottery winnings to be a main source of retirement income; however, these are generally not reliable sources of funding.

Given these realities, you may find that you need to draw on personal savings to supplement your pension income in retirement. In fact, according to the Poll, Canadians estimate they need to save about $756,000 on average to have a comfortable retirement life, yet 35% of respondents age 55 and older hadn't started saving for retirement. RRSPs, along with their newer cousin, the Tax Free Savings Account (TFSA), were specifically designed to help you with your retirement savings goal.

Saving with RRSPs

You can claim a deduction on your income tax return for RRSP contributions up to 18% of your "earned income" for the prior year to a maximum of $26,230 for 2018 ($26,010 for 2017), minus any pension adjustment, plus any unused contribution room from prior years. Contributions in excess of this amount could be subject to penalties and interest.

You generally will pay tax on funds you withdraw from an RRSP[8] at federal/provincial combined marginal tax rates that range from about 20% to 54%, depending on your level of income and province of residence.

Trends in RRSP savings

RRSP contributions have declined in recent years. From 2000 to 2013, the total value of annual RRSP contributions by individuals aged 25 to 54 dropped by approximately 26%.[9] More recently, RRSP contribution rates have remained surprisingly low. In 2015, just 35% of Canadian households made a contribution to an RRSP[10] and unused RRSP contribution room topped $1 trillion.[11]

Worse yet, Canadians may be jeopardizing their retirement savings by withdrawing funds from RRSPs before retirement. From 2000 to 2013, RRSP withdrawals increased by 30%.[12] In 2015, 28% of individuals who were 20 to 54 years of age claimed RRSP deductions, with an average amount of about $5,500; yet 8% of individuals from this same age group reported RRSP income, with an average amount of about $4,200.[13] It seems some pre-retirees are withdrawing from RRSPs almost as quickly as others are contributing.

Debunking the myths: Why saving in an RRSP still makes sense

Canadians cite various reasons why they do not save in RRSPs. Let's look at some of the myths and show why RRSPs are, for many individuals, the best way to save for retirement.

Myth 1: There's no point investing in an RRSP — you pay all the savings back in taxes when you retire anyway

While this is a fairly popular myth, with 39% of Poll respondents believing that RRSPs are pointless because you'll pay tax in the future, it is completely inaccurate.

Although you do pay tax on RRSP withdrawals, don't forget that you also got a tax deduction upon contribution. If your tax rate is the same in the year of contribution that it is in the year of withdrawal, an RRSP provides a completely tax-free rate of return.[14]

If your tax rate is lower in the year of withdrawal, you'll get an even *better* after-tax rate of return on your RRSP investment. In fact, even if your tax rate is higher in the year of withdrawal, we've demonstrated that in most cases, you are still better off with an RRSP than non-registered investments due to effectively tax-free compounding. For further details, see our report "Just Do It: The Case for Tax-free Investing".[15]

Figure 1 (on page 3) provides an example showing the after-tax amount from an RRSP, TFSA or non-registered investments after one year, assuming that you would start with $3,000 of income, perhaps from (self-)employment or rental income, have a 33.33% tax rate, and your investments grow at 5% over the course of the year.

If you invest in an RRSP, you would not pay tax on your income, so you would have the full $3,000 to invest. With a TFSA or non-registered account, you would pay tax of $1,000 ($3,000 x 33.33%), leaving $2,000 to invest.

Growth of 5% would increase the value of your investments by $150 ($3,000 x 5%) in your RRSP, or $100 ($2,000 x 5%) in your TFSA or non-registered account.

Figure 1 — RRSP vs. TFSA vs. Non-Registered Investments, Constant tax rate

	RRSP	TFSA	Non-Registered Investments
Pre-tax income	$3,000	$3,000	$3,000
Tax (33.33%)	n/a[16]	(1,000)	(1,000)
Total amount invested, January 1	$3,000	$2,000	$2,000
Growth (5%)	150	100	100
Total pre-tax, December 31	$3,150	$2,100	$2,100
Tax (33.33% / 16.67%)	(1,050)	n/a[17]	(17)
Net after-tax proceeds	$2,100	$2,100	$2,083

When you withdraw funds from your RRSP, you would pay tax of $1,050 (33.33% on the full $3,150 withdrawn from the RRSP), leaving you with $2,100. When you withdraw funds from your TFSA, you would pay no tax, so you would have $2,100. When you withdraw funds from your non-registered investments, you would pay tax of $17, ($100 capital gain x 33.33% x 50% taxable capital gain), yielding $2,083.

The non-registered investments leave you with the least amount, since you would pay tax on your $100 of investment income. Notice that investing in your RRSP or TFSA both leave you with the exact same amount of $2,100, meaning your RRSP provides the equivalent of a tax-free rate of return.

Myth 2: It's better to invest in a TFSA than in an RRSP

Just over half (57%) of Canadians believe that it is better to invest in a TFSA than in a RRSP, and two-thirds (67%) believe that TFSAs are better tax saving vehicles because they are completely tax-free.

In reality, an RRSP is generally a better choice than a TFSA if you expect to have a lower tax rate in retirement. This is particularly likely if you are a baby boomer in your peak earning years and expect lower income when you are no longer working.

It is true that a TFSA may be a better choice than an RRSP in some cases, such as if you expect a higher tax rate upon withdrawal or will face clawback (repayment) of OAS or GIS benefits (see our report, *Blinded by the "Refund"*).[18] Even so, you may not be able to save enough in a TFSA alone and may also need to save in an RRSP.[19]

Myth 3: It's better to pay off debt

A December 2017 CIBC poll revealed that for the eighth straight year, debt repayment was a top priority for Canadians.[20] Paying off high-interest debt may certainly make sense; however, the decision to pay down debt, at the expense of retirement savings, is often an emotional one that isn't driven by the numbers. With mortgage interest rates at near 60-year lows, neglecting your long-term savings in favour of debt repayment may result in sacrificing the quality of your retirement.

For factors to consider when deciding whether to pay down debt or save for retirement, see our report "Mortgages or Margaritas: Is paying down debt putting your retirement at risk?".[21]

Myth 4: I don't have enough money to save in an RRSP

The top reason given in the Poll for not contributing to an RRSP was "I do not have enough money to save" (mentioned by 40% of respondents), especially among those 35 to 54 years of age (mentioned by 49% of those respondents).

The fact is, you don't have to make a huge investment in an RRSP. Making modest contributions on a regular basis can really add up. Suppose you were to invest just $100 each month in an RRSP from ages 30 to 65 and could obtain a rate of return of 5% on your investments. In 35 years, you would build up over $114,000 in your RRSP to use for your retirement. Your savings could provide over $9,100 of pre-tax income annually for 20 years to top up your retirement income.

It's easy to set up an automatic savings plan to make regular contributions. Your employer may offer this option, and may even make matching contributions on your behalf, with the added benefit that there will be no tax withheld on the earnings that are contributed.

Myth 5: I don't need an RRSP because I'll have other sources of funds for retirement

The Poll showed that almost one-half (49%) of respondents did not expect to use RRSPs as a main source of income in retirement and 40% of the respondents (including 33% of respondents age 55 and older) currently do not have an RRSP. Respondents listed other assets that would likely provide retirement income, including equity in a home (19%), non-registered savings (18%) and real estate or rental properties (15%). Notably, 13% of respondents (including 6% of those ages 75 and older) did not know what their major source of retirement income would be.

Moreover, 57% of respondents said they wished they knew what retirement savings strategy was best for them. Yet among those who were currently not retired or only semi-retired, only 10% had a formal and detailed plan that describes the lifestyle they want in retirement, the income they will need, and take measures to save regularly to achieve their goals.

Your financial advisor can help you determine what expenses you might expect in retirement and the amount of income that you may receive from government and private pensions. If you project a shortfall of income to cover your expenses, you may need to use personal investments to fill the retirement funding gap. For many Canadians, the RRSP should be top on the list for retirement savings.

Myth 6: If I save too much in an RRSP or RRIF, there will be a large tax bill when I die

The tax rules require the fair market value of your RRSP or Registered Retirement Income Fund (RRIF) as of the date of death to be included in income on your terminal tax return, with tax payable at your marginal tax rate for the year.

There are exceptions, however, which may allow a tax-free rollover to certain beneficiaries. The income inclusion can be deferred if the RRSP or RRIF is left to your surviving spouse or common-law partner. If certain steps are taken, including that your spouse or common-law partner puts the proceeds into his or her own RRSP or RRIF, tax will be payable by your surviving spouse or common-law partner at his or her marginal tax rate in the year in which funds are withdrawn from his or her RRSP or RRIF.

Alternatively, an RRSP or RRIF may be left to your financially dependent child or grandchild and used to purchase a registered annuity that must end by the time your child or grandchild reaches age 18. The benefit of doing this is to spread the tax on the RRSP or RRIF proceeds over several years, allowing the child or grandchild to take advantage of personal tax credits as well as graduated marginal tax rates each year until he or she reaches the age of 18.

If the financially dependent child or grandchild (of any age) was dependent on you because of physical or mental disability, then the RRSP or RRIF proceeds can instead be rolled to his or her own RRSP and effectively only taxed when withdrawn.

While these tax-free rollover options may be available whether eligible family members are named as beneficiaries in your will or in the RRSP or RRIF contract itself,[22] the latter option may avoid provincial probate fees (where applicable).

As another option, proceeds of a deceased individual's RRSP or RRIF may be transferred to the Registered Disability Savings Plan (RDSP) of the deceased individual's financially dependent child or grandchild who qualifies for the disability tax credit, if the RDSP holder and beneficiary consent.

More than half (54 per cent) of Poll respondents said they didn't understand the tax consequences upon their deaths or if their spouses predecease them. It's important to know about, and plan for, any available rollovers during your lifetime to maximize tax deferral that may be available upon your death. You should consider designating beneficiaries for your RRSP or RRIF, making sure beneficiary designations in your RRSP or RRIF documents are consistent with beneficiaries named in your will, and ensure that designations are kept up-to-date.

Another strategy to minimize income taxes on your RRSP or RRIF at death is to take annual withdrawals from your plan during your lifetime to maximize the income that will be taxed at low rates by forcing additional withdrawals in years you are in the lowest tax bracket. For example, in 2018, income up to about $46,000 is taxed at the lowest federal rate of 15%. Provincial taxes would also apply.

Conclusion

If you are like many Canadians, you will need to supplement your retirement income with personal savings and an RRSP may be the best choice to build your retirement fund. Don't let unfounded myths keep you from maximizing your RRSP savings opportunity!

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[1] The RRSP was introduced in 1957. Funds from an RRSP can also be used for a first-time home purchase under the federal Home Buyers' Plan (available since 1992) and for education under the Lifelong Learning Plan (available since 1999).

[2] From January 12th to January 14th, 2018, an online survey was conducted among 1,523 randomly selected Canadian adults who are Angus Reid Forum panelists.

[3] *Quarterly report of Canada Pension Plan and Old Age Security monthly amounts and related figures - January to March 2018* is available online at https://www.canada.ca/en/employment-social-development/programs/pensions/pension/statistics/2018-quarterly-january-march.html.

[4] The average CPP retirement benefit for new beneficiaries in October 2017 was $641.63 monthly, per https://www.canada.ca/en/services/benefits/publicpensions/cpp/cpp-benefit/amount.html.

[5] *Quarterly report of Canada Pension Plan and Old Age Security monthly amounts and related figures - January to March 2018, Op. cit.*

[6] Ibid.

[7] In 2015, 37.8% of employees were members of a registered pension plan (RPP) and defined benefit plans accounted for 67.1% of employees with an RPP. Source: http://www.statcan.gc.ca/daily-quotidien/170721/dq170721d-eng.pdf (July 2017).

[8] You will not pay tax on funds withdrawn under the Home Buyers' Plan or Lifelong Learning Plan if you meet repayment requirements.

[9] Per *Study: Trends in pre-retirement RRSP contributions and withdrawals,* Statistics Canada, February 23, 2017, available at http://www.statcan.gc.ca/daily-quotidien/170213/dq170213a-eng.htm.

[10] *Household contribution rates for selected registered savings accounts*, Census in Brief, Census of Population, 2016, Statistics Canada, released September 13, 2017. Available at http://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016013/98-200-x2016013-eng.pdf.

[11] CANSIM *Table 111-0040 - Registered Retirement Savings Plan (RRSP) room*, Statistics Canada, is available at http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=1110040.

[12] *Study: Trends in pre-retirement RRSP contributions and withdrawals,* Op. cit.

[13] Calculated by CIBC, based on information in *T1 Preliminary Statistics 2017 edition (for the 2015 tax year). Op. cit.*

[14] 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.

[15] The report, *Just Do It: The Case for Tax-free Investing*, is available online at www.cibc.com/ca/pdf/case-for-taxfree-en.pdf.

[16] No tax is owing on this income since the RRSP deduction offsets it completely.

[17] No taxes are payable on TFSA withdrawals.

[18] The report, *Blinded by the "Refund"*, is available online at https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/rrsp-versus-tfsa-report-en.pdf.

[19] In 2018, the TFSA dollar limit is only $5,500 while the RRSP dollar limit is $26,230.

[20] See the CIBC news release dated December 28, 2017 at http://cibc.mediaroom.com/2017-12-28-CIBC-Poll-For-eighth-straight-year-Canadians-say-paying-down-debt-is-their-top-financial-priority-in-the-coming-year.

[21] The report *Mortgages or Margaritas: Is paying down debt putting your retirement at risk?* is available online at https://www.cibc.com/ca/pdf/mortgages-or-margaritas-en.pdf.

[22] In Quebec, an RRSP must qualify as an annuity to take advantage of a valid beneficiary designation.