Inside Out: RRSPs and Asset Location

Rethinking the Traditional Rule of Thumb

TAX AND ESTATE

Managing your investments involves two important decisions: asset allocation and asset location. For many investors, the primary one is how your investment portfolio should be diversified among the various asset classes such as stocks and bonds, which is often referred to as asset allocation. An equally important decision, asset location, is whether a particular asset should be held in your taxable non-registered account or your registered account. (See our report entitled *"Just do it: The case for tax-free investing"* issued in February 2011.)

For Canadians who save for their retirement exclusively through registered plans such as the Registered Retirement Savings Plan (RRSP) or Tax-Free Savings Account (TFSA), the question of asset location is moot since both plans allow an investor to earn tax-free income. For investors who have maximized their RRSP and TFSA contributions and, therefore, must hold additional savings in a taxable non-registered account, the question of asset location between taxable and non-taxable accounts has taken on a new importance in our continuing low interest rate environment, especially in light of the traditional rule of thumb when it comes to fixed income investing.

Traditional Rule of Thumb

The traditional rule of thumb holds that fixed income assets such as bonds, GICs or money market mutual funds should always be held in RRSPs. This is because they generate interest income, which is the most highly taxed form of investment income and is fully taxable at the investor's marginal tax rate when it is earned.

The corollary, therefore, is that equities are best suited to non-registered accounts since they have their own inherent, unique tax advantages. Firstly, capital gains on the sale of equities can generally be deferred until the asset is sold. Secondly, when equities are sold for a profit, the resultant capital gain is only 50 percent taxable. Finally, if you hold dividend-paying Canadian equities, then the dividends received are taxed favourably due to the dividend tax credit that, in most provinces, means tax rates similar to capital gains.

But in this current low interest rate environment, does it still make sense to keep our fixed income investments inside our RRSP and our equities outside?

Reconsidering the Traditional Rule

The primary advantage of holding investments in an RRSP (or, for that matter, a TFSA) is that any income and/or gains accrue tax-free. Consider the case in which a portfolio that contains more than one asset, and there is a finite amount of RRSP funds that is insufficient to hold one's entire retirement portfolio. It should follow that an investor would choose the asset with the highest potential rate of return to put inside the RRSP, which accumulates tax-free, rather than simply the asset with the highest potential tax rate associated with it.

After all, if fixed income investments are paying a mere one percent, the potential tax savings of holding such an investment in an RRSP, even at a top marginal rate of 50 percent, is only 0.5 percent. Alternatively, if we assume that equities could generate, over similar terms, significantly higher rates of return, then it would appear that equities may be more suited to our non-taxable RRSP account than the low-rate fixed income alternative.

Jamie Golombek is Managing Director, Tax and Estate Planning with CIBC Private Wealth Management. He works closely with advisors to help them provide integrated financial planning solutions for their high-net-worth clients. Jamie is frequently quoted in the media as an expert on taxation.

Follow @JamieGolombek

www.advisor.ca/togo
Podcast > Rethinking Asset Allocation

www.renaissanceinvestments.ca/en/jamie_golombek/