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An RRSP strategy to ‘liberate your losers’ in order to save tax

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In a recent article, I described the "nice problem" of million-dollar RRSPs and drawing them down early while in lower tax brackets. But sometimes the market does the job of "melting down" a registered retirement savings plan on our behalf, as can our own poor investment choices.

Enter an eclectic strategy a broker friend of mine calls "liberating your losers."

There's a possible bright side to crystallizing RRSP losses by "withdrawing them in-kind" to non-registered status. That is, you keep the position but in effect move it outside the RRSP.

This is an alternative to the more typical RRSP drawdown tactic of first selling your stocks inside the RRSP, then withdrawing the cash. Either way, you are "deregistering" some of your RRSP, which means paying withholding taxes.

Liberating your losers can make sense under three circumstances, according to my broker friend: when you have had bad timing in your RRSP/RRIF investment choices; when you're confident your investment will return to its previous higher value; and if you prefer to pay tax on 50 per cent of a capital gain rather than 100 per cent of income.

As I draw down my own RRSP, I've implemented traditional cash withdrawals as well as experimenting with withdrawals-in-kind. In the former case, you're generating some post-tax cash to live on; while in the latter, you still pay the tax but instead of having some spending money you have increased your non-registered investments, holding on to losers in the hope they'll recover some day.

What does this accomplish? The Canada Revenue Agency is in effect sharing the pain of your paper loss. Remember you got a tax refund when you contributed to the RRSP years ago. Once non-registered, if the loser bounces back, only 50 per cent of the gain will be taxed when you sell; had it remained in the RRSP and gained in value, it would eventually be withdrawn as 100 per cent taxable income.

Here's an example. Say you contributed $25,000 to your RRSP and invested in a stock that plummets to $5,000. That's a $20,000 paper loss. But if you're in the 46-per-cent tax bracket in Ontario (combined federal/provincial on income above $220,000), you originally had a tax refund of $11,500 on the $25,000 contribution. You may have hoped the $25,000 would double in a few years to $50,000, but eventually that RRSP money has to be withdrawn, probably in the form of a Registered Retirement Income Fund (RRIF) starting the end of the year you turn 71 (albeit the compulsory withdrawal is only in the subsequent year). If you're in the same tax bracket when you pull out the money, that $50,000 would eventually result in taxes payable of $23,000 when withdrawn (hopefully less if you're in a lower tax bracket in retirement).

It's sad to see a $25,000 RRSP investment fall to $5,000, but at least when it comes time to pull it out of your RRSP, the tax payable will be a fraction of what you would have had to send the CRA had you doubled your money on the original investment. On a $5,000 net in-kind withdrawal, you'd pay $1,250 – 20 per cent – as mandatory withholding tax from cash held within the RRSP, explains Aaron Hector, vice-president of Calgary-based Doherty and Bryant Financial Strategists. On your tax return the following year, you'd pay tax on $6,250 of gross RRSP income at your top marginal rate: If you're at the 46-per-cent tax rate, that is $2,875 of tax, of which you have paid $1,250 and $1,625 remains owing, for a total of $5,750. (But the adjusted cost base for the withdrawal-in-kind remains $5,000.)

But once you have the $5,000 post-tax outside your RRSP, if the former loser starts to rise in value, only 50 per cent of the resulting capital gains will be taxable. Alternatively, once outside the RRSP, you could contribute the $5,000 to a tax-free savings account, and avoid paying the CRA any further tax at all on future gains.

Despite the possible upside, several advisers were less enthusiastic than my broker friend about this gambit.

The "liberating losers" strategy is simply a variation of the age-old practice of contributing to an RRSP when you're at a higher tax rate and withdrawing at a low rate, says Jamie Golombek, managing director of tax and estate planning for CIBC Wealth Strategies. "But you then lose your tax-free compounding indefinitely, which is why I don't like it."

Of course, no RRSP investment will be tax-free forever: It's only tax-deferred and ultimately taxed at 100 per cent. Withdrawing money from an RRSP, whether large or small amounts, is primarily a "tax decision" and should be done with more in mind than simply trying to move losers to another account, Mr. Hector says.

He agrees that high-growth stocks can be held in non-registered accounts (or better yet, TFSAs), but you could sell the RRSP loser and buy something else, and if you were that keen on the original trade, simply purchase it in a non-registered account or in a TFSA. "For an RRSP, the only time I would see the merit in this strategy is if you were tapped out everywhere else with no liquidity, and you still wanted to own the shares but didn't want them in the RRSP because of the escalating tax cost later on if they were to increase in value."

However, if it were a RRIF rather than an RRSP, Mr. Hector says you could consider a transfer-out-in-kind strategy instead of a cash withdrawal if you didn't need the cash to fund your lifestyle costs. "Both alternatives would satisfy the required annual minimum deregistration for the RRIF."

Finally, cutting your losses is one of three best practices for investment success, but the "liberating your losers" strategy "is the opposite," says Adrian Mastracci, portfolio manager with Vancouver-based Lycos Asset Management Inc.

"When you have a losing stock, you shouldn't get attached to it." So in the example cited earlier, "I wouldn't deregister the last $5,000. I'd just leave it in the RRSP and if I had extra money buy something else that makes sense."

When I blogged about this a year ago, as an experiment, I "liberated" five losing Canadian and U.S. stocks from my RRSP to a non-registered account. I use a discount broker, but it was easier to call the financial institution and let them walk me through it. It's less complicated than it seems and you can do it in a matter of minutes. It's not that uncommon, the representative at the discount broker told me. And some of those positions that are now non-registered have indeed recovered in the past year.

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