To RRSP or to not RRSP? ... that *is* the Question

When it comes to contributing to an RRSP, for most, it's not a question of "If", it's simply a question of "How much?" and perhaps "When?" But the question of contributing to an RRSP is far more complicated because the truth is that RRSP contributions are not for everyone. Considering that RRSP investments often account for the second largest asset in many people's lives (next to their house), the importance of creating a thoughtful and strategic approach cannot be understated.

Let us guide you through the important questions and issues you should consider before you make your next RRSP contribution …

Maximizing the Tax Advantage

The lure of RRSP contributions is obvious – you get an immediate benefit by using the contribution as a deduction to your taxable income and receive a refund cheque from the Government. You also defer paying taxes on that RRSP investment account until such time as you withdraw that money. But the reality is that some day, you will have to pay the piper – RRSP withdrawals are taxed like income, at your full marginal tax rate.

The ideal RRSP scenario is to make your contributions when you are in a high marginal tax rate and take the money out when you are in a lower marginal tax rate. If you can achieve this objective, you come out ahead. But in order to understand if you will be able to take advantage of this tax trade, you need to look into the future …

Projecting Your Retirement Income

This isn't necessarily an easy exercise to undertake when you are 30 years old – life's journey may yet take you in many different directions. But as you get into your 40's and beyond, you start to get a clearer picture of whether you will have income above and beyond what you will draw from your RRSP.

The four most common scenarios in which an individual might have an income stream into their retirement years that will need to be factored into their future RRSP planning:

1. You are or have been a member of a defined benefit pension plan and have a guaranteed lifetime pension income;
2. You have purchased, or plan to invest in, income-paying real estate (Note: *income from real estate investments is taxed at your full marginal rate*);
3. You are incorporated and either your income is flowing into this entity (e.g. medical, dental or legal professional), or your shares in a private business are held by the corporation. Some day, this money must be paid out to you;
4. You work at or own a business for which you will be on the payroll even when you won't really be going into the office any more.

In any of these four scenarios, every dollar that you withdraw from your RRSP is only going to elevate your taxable income, either pushing you into a higher tax bracket, or simply adding onto your existing income at that wonderfully-Canadian 50% top tax rate! It sure takes the lustre off that RRSP statement knowing that only 50 cents on the dollar actually belong to you – the other 50 cents is on its way to Ottawa.

But even if your personal situation does not fall into the above-listed scenarios, there can be other situations where you will push yourself into the highest tax bracket in retirement …

Creating an RRSP "Balloon"

It's hard to believe, but there is such a thing as having too much money in your RRSP. Imagine, looking at your RRSP statement at 71 years of age, proud of the $2.5 million you have accumulated through disciplined annual contributions and some fantastic investment returns generated by STYLUS Asset Management (!) – and thinking 'Oops!' Why 'Oops'? Consider these two scenarios:

Scenario #1

Our successful RRSP investor above is 71 years old, which means it's time to convert their RRSP to a RRIF. Remember, you don't have to liquidate your investments to convert your RRSP to a RRIF. You are really just creating a new account type, but the rules change such that you are forced to start taking money out. The Federal Government has a schedule for minimum annual RRIF withdrawals. Currently, in the year in which you turn 72, you have to take out around 5.3%, and that percentage gradually increases every year. So what happens to our RRSP superstar? They now have $132,500 (5.3% x $2.5 million) in fully-taxable income at age 72. Which also means that every other source of income, including CPP payments, are taxed at that rate.

Solution: take a look at your current RRSP account statement and factor in your age. If you are 50 years old with an RRSP of $500,000 and plan to generate a 10% return with STYLUS investments over the next 21 years, what will that account be worth at RRIF time? $3,700,000! Which means your first RRIF payment at 72 years old is almost $200,000. Welcome to max tax for the rest of your life! *Perhaps you should have stopped making RRSP contributions earlier.*

Scenario #2

Our successful RRSP investor above has paid off their $1.5 million house, owns a mortgage-free beautiful cottage worth $1 million, and lives debt free. Unfortunately, this RRSP superstar has no other income or cash, and now wants to do a $100,000 renovation to the cottage. Where is the only place they can draw money for that project (assuming they decide not to borrow the money)? The RRSP is the only source of cash. So what's it going to cost to get that $100,000 net of taxes? $200,000 from the RRSP at the max tax rate. Ouch.

Solution: consider other ways to invest and save outside of an RRSP …

RRSP Alternative: TFSA

(Tax Free Savings Account)

This investment vehicle, introduced by the late Federal Minister of Finance Jim Flaherty in 2009, has grown to be an important and incredibly beneficial program for Canadians. What started out as a $5,000 per year opportunity to grow your investments tax-free, has now blossomed into $46,500 in cumulative contribution room through 2016.

Simply put, everyone should be maxing out their TFSA contributions, no matter what their age, personal tax circumstances, or future income. The first $5,500 (based on 2016 contribution limit) that you allocate to your long-term investment plan every year should go into a TFSA.

Who can *really* benefit from the TFSA? Consider a 25 year old, whose parents suggest he "better get started on RRSP contributions" so he deposits his hard-earned $2,000 into an RRSP account. This fine young citizen's annual salary is $28,000, and so he receives a whopping $400 tax refund due to his approximately 20% tax rate. Fast forward 45 years, and this RRSP (plus future contributions) has grown to $2 million. Since we have already seen the negative impact of an over-grown RRSP, the strategy should have been to put that $2,000 initially into a TFSA.

Solution: tell your children to start with TFSAs and as their income goes up, switch to RRSPs. They will build up lots of extra RRSP contribution room from the years they were contributing to a TFSA, and then take advantage of larger tax breaks.

How can I lower my taxable income in retirement?

This one is a slam dunk. Our Canadian tax code stipulates that only 50% of capital gains are taxable. The difference between withdrawing money from an RRSP versus a non-registered taxable account with capital gains can be significant – which means more NET money in your pocket.

RRSP: You're Not As Rich As You Think

Your RRSP account statement can be deceiving. That $1,000,000 might only be $600k after taxes. It is crucial to create a plan to contribute strategically, and then exit from your RRSP plan in a tax efficient manner.

Key RRSP Points to Remember:

1) Contribute to an RRSP only when your income is higher than when you expect to take it out
2) Anticipate other future sources of retirement income
3) Project your future RRSP to understand whether you should still contribute
4) TFSAs are a great alternative
5) Tax on capital gains are lower than tax on RRSP withdrawals

It's time to call STYLUS to talk about effective RRSP planning:

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This is the first article of a Special Series dealing with issues related to Registered Investment Plans (RRSP, Locked-In RRSP, RRIF, Corporate/Group RRSP)