7 things you need to know about RRSPs

People know they need to put money in their RRSPs, but how much do they really know about them?

It's been 62 years since the registered retirement savings plan (RRSP) was introduced and it's since become the go-to investment account for many Canadian savers.

While a lot has changed since 1957, the RRSP has mostly stayed the same. Canadians put money into the plan, receive a tax deduction, and then pay tax on their savings when they withdraw. It's that simple.

However, with a January 2018 Angus Reid poll finding that only 51% of people consider the RRSP among their top sources of retirement income, investors could use a refresher on how this account works and why it's a powerful savings tool.

Money grows tax-free

The main reason people use RRSPs is that any money inside the account can grow tax-free. While you will have to pay the Canada Revenue Agency when you withdraw, decades of tax deferral can provide a significant boost to your savings.

Essentially, your dollars are able to compound unabated year after year at a potentially higher rate than if you invested in a non-registered account. Since there's no tax hit, you can sell, say, a high-flying security and then reinvest the full amount into something else.

Here's how that might look for someone who has $150,000 in taxable income and lives in Alberta. If the current value of your RRSP is $100,000 and you increase that by $5,000 every year for the next 25 years and receive a 5% rate of return in your investments, you'll have $589,203, pre-tax, by 2044. If you do the same in a non-registered account and have 30% of your funds in income-bearing securities, 30% in dividend securities, and the rest in capital gains-producing equity, you'll wind up with $450,086.

Clearly, there are big benefits to deferring tax and compounding your returns tax free.

Reduce your taxable income

The other advantage is that contributions reduce your taxable income. That's why you may receive a tax refund—since you now owe less, you'll get back some of the money you've already paid through your workplace. (Or if you're a business owner, you'll have to pay less than you otherwise would.)

However, RRSPs work best when you contribute in your high-earning years and then withdraw in retirement, when you're in a lower tax bracket. If you'll be in as high a bracket in retirement as you are when you contribute, you'll want to talk to an advisor about how you can minimize your tax hit.

Save more in an RRSP

Still, even if you're destined for a lifetime of higher taxes, RRSPs remain worth it. The alternative is a tax-free savings account (TFSA) which allows you to contribute up to the maximum allowed no matter how much money you make. The TFSA program began in 2009 with a $5,000 per year

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contribution limit for each year from 2009 to 2012; $5,500 for 2013 and 2014, $10,000 for 2015, and $5,500 for each year from 2016 to 2018. The 2019 contribution limit is $6,000. Those earning more than $150,000 per year will be able to put away $26,500 in an RRSP in 2019—in this case, that's still four times as much room in an RRSP than a TFSA.

Avoid withholding taxes

Here's something else to know: investors are exempt from the 15% withholding tax on U.S. and foreign dividends and interest. That's not the case with TFSAs, which aren't recognized as tax-sheltered accounts by foreign countries. In other words, there may be an advantage to holding your U.S. securities in a RRSP rather than a TFSA or taxable account.

Remember the RRIF

When it comes to withdrawing, you'll need to convert your RRSP into an income product in the year you turn 71. While you can turn it into cash, most people choose to convert their RRSP into a registered retirement income fund (RRIF). Once you convert, you'll have to take a certain percentage of money out of your account every year. For instance, at 72, the first year you must withdraw, you'll have to take out at least 5.28% of what you have saved.

Consider clawbacks

Another thing to keep in mind is that RRSP and RRIF withdrawals are recognized as income. If your total income, including RRIF withdrawals, falls between $77,580 and $125,696, your Old Age Security (OAS) benefits will start getting clawed back.

Your Guaranteed Income Supplement (GIS) payments could be impacted too. If you're a single senior and receive a full OAS pension and make more than $18,240 a year, you may not receive any GIS payments. If you're married and your spouse receives a full OAS pension, then your GIS payments could get cut off if you earn more than $24,096 a year. If you're a high-net-worth individual then that may be fine, but it's something to think about.

One way to avoid clawbacks is to spread out your withdrawals over time in an attempt to stay in lower income tax bracket. However, if you convert a large RRSP into a RRIF, your high minimum withdrawals may prevent you from using this strategy.

Rebalance tax-free

It's always a good idea to rebalance your assets periodically—market movements might push your equity allocation higher than you'd like, or vice versa. Fortunately, with an RRSP, you can adjust your asset mix without having to worry about paying capital gains on the sale of any holdings, which makes rebalancing easy to do. However, remember that you can't claim capital losses if you sell underperforming securities.

As easy-to-use as RRSPs may be, there's still a lot more you can do with them from an investing and financial planning perspective, so it's always good to get professional advice. Still, six decades on, the RRSP continues to be one of the best savings vehicles around.
