RRSPs

The Registered Retirement Savings Plan was developed by the federal government back in 1957 as a way of encouraging Canadians to save more for their retirement. Its key benefit is the immediate tax reduction it provides —up to 18% of your taxable income in the previous year (to a maximum of $25,370 in 2016) can be contributed to an RRSP, effectively reducing the amount of taxes you pay for that tax year.

UNUSED RRSP CONTRIBUTION ROOM

For many Canadians, saving 18% of their taxable income each year is difficult. So the majority of people have unused RRSP contribution room (you can find out how much RRSP contribution room you have by checking your last Notice of Assessment from the Canada Revenue Agency (CRA)). For example, if you earned $100,000 per year, and didn't contribute to an RRSP for ten years, the unused contribution room would have accumulated to $180,000 (10 years X $18,000 per year).

For those in this position, additional contributions can be made according to the availability of cash you have access to (i.e. you may receive an unexpected inheritance, or sell a property, etc), as well as other tax implications (i.e. you may pay less taxes by dividing a large contribution over two or more years).

Example

A person who earns $100,000 would normally pay combined federal and provincial taxes of $29,949 in Nova Scotia.

Let's say this person makes the maximum RRSP contribution of 18% or $18,000.

The RRSP contribution reduces the individual's taxable income at their top marginal tax rate, which in this case is 43.5%. Therefore the $18,000 RRSP contribution creates a tax savings of $7,268, reducing their overall tax payable to $22,681.

The immediate tax reduction is a great incentive for investing early and often, which creates great opportunities for your savings to grow through compound interest.

RRSP INVESTMENT OPTIONS

You can contribute to RRSPs in a variety of investment vehicles, including stocks, bonds, mutual funds, annuities, cash and precious metals. This lets you save and invest in the way that is most effective for you, while being as tax efficient as possible.

TAKING THE MONEY OUT

Although you can withdraw your funds at any time, it's smart to leave them in as long as you can to take advantage of the growth potential and defer any taxes. But RRSPs have a lifespan; you must convert your RRSPs to Registered Retirement Income Funds (RRIFs) by December 31st of the year you turn 71. At that time, you are also obliged to withdraw a minimum annual amount. RRIFs still have the growth potential they did as RRSPs. They don't move from the investments they are in (unless you want to move them). They are simply subject to annual minimum withdrawals.

TAXES UPON WITHDRAWAL

RRSPs provide tax incentives when you contribute to them. But it's important to note that when you withdraw from them (either before or after you retire), they are treated as taxable income. If you withdraw $20,000 to take a trip or fix a roof, that amount is added to your overall income for that year, and you are taxed at your marginal tax rates.

However, most people have lower incomes in retirement, putting them in a lower tax bracket. This means that the amount of tax you pay on the withdrawals from your RRSP/RRIF in retirement will typically be lower than the tax you would have paid on it when you earned it.

TRANSFERRING YOUR RRSP/RRIF

Upon your death, RRSPs and RRIFs can be transferred on a tax deferred basis to your spouse without immediate tax consequences. The same is not true for other beneficiaries such as children or other family members. In these cases, the funds within the RRSP/ RRIF would be taxable as income on your terminal (after-death) tax filing. (See more on this topic in the Taxes and Probate chapter.)

SPOUSAL RRSPS

Many couples aim to reduce the taxes associated with drawing an income from their RRSP by creating a spousal RRSP. This effectively lets each spouse withdraw similar amounts of income in retirement, which helps to equalize their overall household tax burden vs one spouse withdrawing a disproportionately high amount of income, which would be taxed at a higher rate.

Spouses who contribute to a spousal RRSP will receive the tax deduction in the year they contribute. And they cannot contribute more than their personal contribution limit.

Spousal RRSPs are meant to provide tax advantages during retirement, not during the working years. For that reason, there is a limitation built into the program that requires that contributions stay in the fund for three calendar years from the time they are contributed. If funds are withdrawn within that period, they will be taxed in the hands of the contributor.

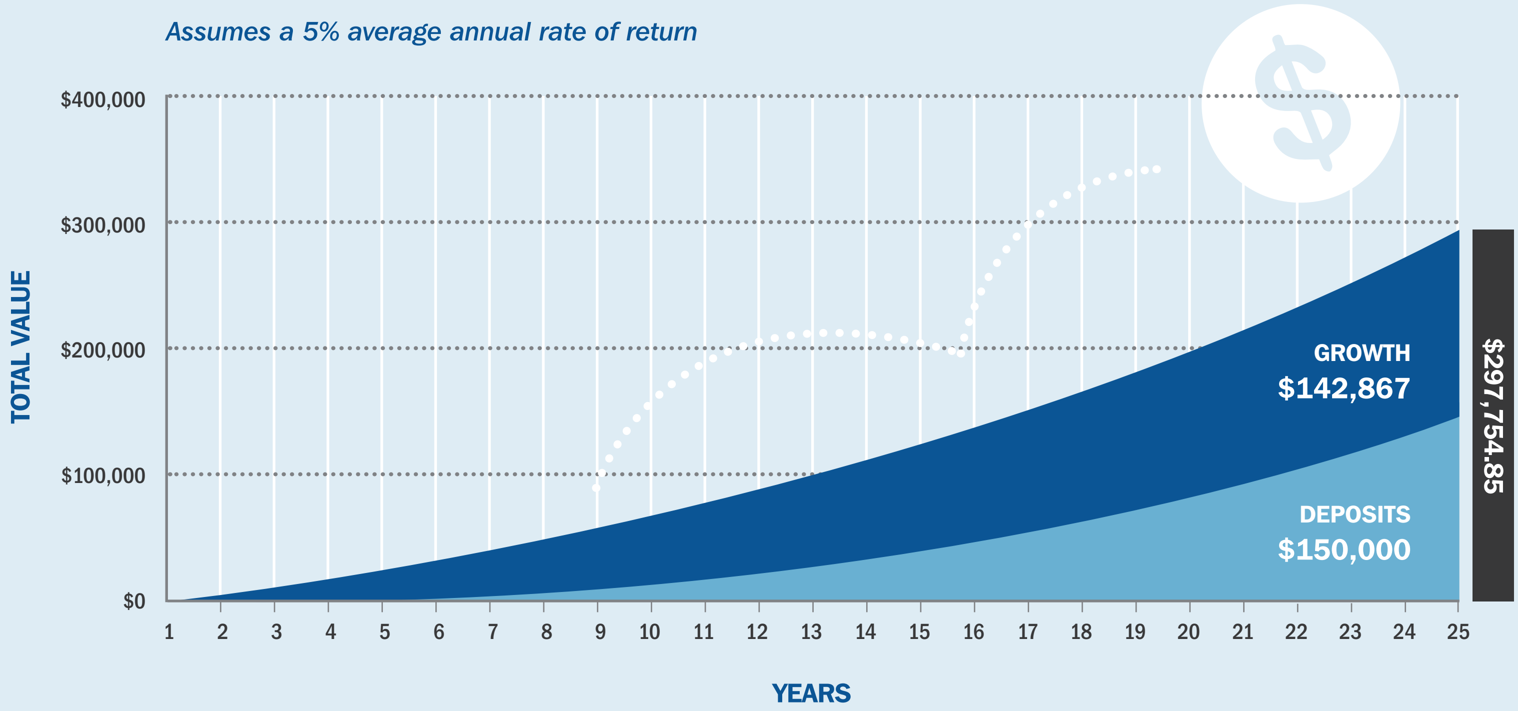
For example, if you contributed $10,000 annually to a spousal RRSP in 2013, 2014 and 2015, you would have a total amount of $30,000 plus any growth on your investment. If your spouse withdraws $15,000 in 2016, they would be taxed for $10,000 for the contribution that was made in 2013, and you would be taxed for $5000 for the part of the contribution that was made in 2014.

Finally, it's important to remember that once both spouses reach 65, all RRSPs are eligible for income-splitting. This makes spousal RRSPs less important for those who only plan to withdraw income after the age of 65.

Compound Growth

It's tough to argue with the benefits of compound growth. Let's assume Beth, age 40, starts saving $500 a month with a plan to retire at the age of 65. After 25 years, she will have saved $150,000 ($500 x 12 months x 25 years), with an impressive amount of growth of $142,867, for a grand total of $297,754.85.

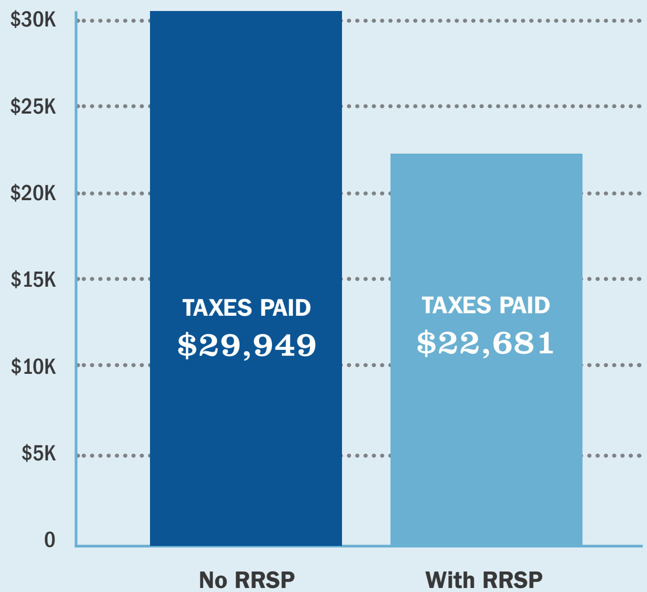
Assumes a 5% average annual rate of return



The Immediate Tax Benefits of Contributing to an RRSP

Based on Nova Scotia and federal tax rates.

TAX PAYABLE ON INCOME OF $100,000



Without RRSP contribution
Tax payable on $100,000
without RRSP contribution: **$29,949**

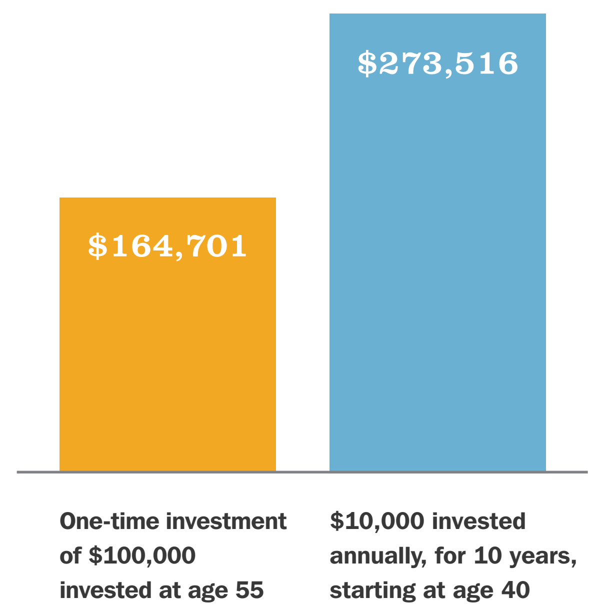
With 18% RRSP contribution
Tax payable on $100,000 with
18% RRSP contribution: **$22,681**

Taxes saved by contributing
18% to RRSP: **$7,268**

Slow and Steady Wins the Race

With saving and investing, starting earlier can have big benefits. Below, two people save $100,000 to retire at age 65.

TOTAL RETURN OF $100K INVESTMENT



(Assumes a return of 5%)