

Five tax drivers of RRSPs

Taking full advantage of registered plan features

A registered retirement savings plan (RRSP) helps you save towards retirement in a tax-effective way. Through five key features, an RRSP encourages you to save, lets you defer tax so you can accumulate more, and paves the way for you to ultimately reduce tax on your retirement income.

1. Tax-deductible contributions

For every dollar you place into an RRSP, you can take a deduction against your income.

In a sense you are declining to receive that income in the current year, in favour of taking it as income some time later. Though that income is yours to keep, you are setting it aside in an RRSP where it can be invested until you draw on it, generally meaning your retirement.

There are limits to how much deduction can be taken, based on historical income and past contributions, but it's the mechanics of the procedure we're focused on presently.

2. Investing pre-tax dollars

Had you not made an RRSP contribution, you would have been taxed on that amount. That would have left you with less money to be invested in your hands directly as compared what you have available in your RRSP. Put another way, you are investing pre-tax dollars as opposed to after-tax dollars.

We'll discuss the tax applying on RRSP withdrawals below, but for now the result is that there is more available to earn investment income.

3. Tax-sheltered earnings and growth

With the benefit of those larger pre-tax dollars, the next step in using an RRSP is to start investing your money. As those investments grow and earn income, there is no tax to be paid, or as is commonly stated, an RRSP is 'tax-sheltered'.

Some people prefer the term 'tax-deferred', given that eventual withdrawals are taxable, as we'll cover in a moment. Until withdrawal though, there is more to be reinvested, which leads into the next feature – compounding.

4. Tax-efficient reinvestment and compounding

Just as using pre-tax money gives you more to start with, reinvesting tax-sheltered income can accelerate your growth. This is obviously helpful at first instance, and gets even better over time through the effect of compounding.

Initially only your own principal is being invested, but as you earn income then that income is invested, which generates income-on-income. Year after year, this repeated reinvestment is responsible for an increasing portion of your returns, in time possibly exceeding what you earn on your own contributions.

This compounding effect is not at all exclusive to RRSPs, but it will be accentuated in an RRSP where the full amount of all earnings can be put to work without being reduced by taxes.

5. Tax deferral until withdrawal, likely at lower tax bracket

The features covered to this point have helped you build your investments with the benefit of tax deferral on both contributions and earnings. Now on withdrawal, tax is due. Even so, you will pay less tax by using an RRSP, assuming your tax rate is lower on withdrawal in your later years than it was on contribution in your working years when you contributed.

But what if you are early in your career at a fairly low-income level? Most people will make the RRSP contribution and claim the deduction. That's a smart savings habit, but you can also be strategic with the taxes. Instead of taking the deduction that same year, you can carry it forward to claim in a year when you're at a higher tax bracket, making the deduction worth more.

Your financial advisor can help you decide whether deferring the deduction makes sense for you, and how you can take best advantage of all the tax features of RRSPs.

For more information, please consult your advisor and tax professional.

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