The Best Way to Use RRSPs

Description

Registered Retirement Savings Plans (RRSPs) are intended for saving for retirement. Generally, you'll be heavily taxed if you withdraw from RRSPs before you retire (except if you withdraw for the Home Buyers' Plan or the Lifelong Learning Plan). This ensures that you have a good chance to save up some serious money before you retire if you consistently contribute to RRSPs over many years.

Reduce taxes

When you contribute to RRSPs, your taxable income for the year will be reduced. If you earn the average Canadian annual salary of $50,000 and contribute $2,000 to RRSPs this year, your taxable income will be $48,000 for the year.

You can imagine that the more you contribute, the more taxes you'll save. The higher the tax bracket you're in, the more taxes you'll save from your RRSP contributions. So, if you foresee that you'll be in a higher tax bracket in the future as you advance in your career or grow your investments, it may be wise to save your RRSP contribution room for the future.

Earn U.S. dividends

If you earn U.S. dividends, you should consider earning them inside an RRSP. If you earn them in a Tax-Free Savings Account, there will be a 15% withholding tax.

If you earn them in a non-registered account, there will be a 15% withholding tax, but you'll get a foreign tax credit deduction, which means that the foreign income will essentially be taxed at your marginal tax rate.

American Hotel Income Properties REIT LP (TSX:HOT.UN) is a decent income investment for an RRSP. The company focuses its operations in secondary U.S. markets. It has 115 hotels across 33 states, including 48 hotels, which primarily serve the rail crew lodging sector, and 67 branded hotels. Its branded portfolio contributed 81% of its net operating income in Q3.

American Hotel pays a U.S. dollar-denominated distribution, which equates to a yield of 9.1% at $9.16 per unit (based on the recent foreign exchange rate between the U.S. and Canadian dollar). The company's payout ratio has reduced from over 100% in 2013 to ~76% recently, which makes its distribution safer than before.

There will be no withholding tax on the distribution if you hold American Hotel in an RRSP or RRIF. In other words, Canadians can get the full distribution by holding its units in an RRSP or RRIF.

Maximize total returns

When you withdraw from your RRSP/RRIF in retirement, the full amount will be taxed as income. So, some investors argue that one should focus on maximizing total returns when investing in RRSPs.

We're talking about an investment horizon of decades. A 12% rate of return and 8% rate of return, for example, makes a huge difference depending on how much you ultimately invest in the long run.

For instance, if you invest $250 every month in an RRSP for 8% per year for 30 years, you'll accumulate $372,590. If you get 12% per year on the investment, you'll accumulate $873,741 — a difference of +$500,000!

Investor takeaway

Investing in RRSPs is a great way to save for retirement. Ideally, you want to contribute more to it when you're in a higher tax bracket. Focus on investing U.S. dividends or total returns in your RRSPs. Also, be careful not to over-contribute to your RRSPs.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:HOT.UN (American Hotel Income Properties REIT LP)

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