Millennial Investors: Why Maxing Out Your RRSP This Year Might Not Actually Be the Smartest Move

Description

The deadline for Canadians to contribute to their Registered Retirement Savings Plan (RRSP) account is a little more than one month away: March 1, 2019.

If you're anything like me, you've probably been bombarded in recent weeks with advertisements and promotions about why you should be maxing out your RRSP contribution room as a young person.

In this post, I'll explain why in some cases, maxing out your RRSP while you are still in the early stages of your career might not actually be the right decision in helping you to optimize your investment returns.

To recap briefly, when you contribute funds to your RRSP account, the money you deposit is counted as a tax-deductible expense when you file your income taxes, meaning that if you earned $50,000 this year and contributed $10,000 to your RRSP, then the taxes you had already paid on that $10,000 of income will come back to you in the form of a tax rebate from the federal government.

But the "catch" with RRPSs (using the term loosely), is that when you retire and begin making withdrawals from your retirement account, you are going to get taxes on those investment returns. This is why RRSPs are referred to as "tax-deferral" plans.

Ok, so what if you contribute to your Tax-Free-Savings Account (TFSA) instead?

In this case, contributions to TFSA aren't tax deductible, so if you earned $50,000 of income this year and contributed $10,000 to your TFSA, you're still going to have to pay taxes on the full amount of your $50,000 in earnings this year.

But the good news is that the money you earn from those investments in your TFSA is going accumulate tax free. You'll never have to pay taxes on that money again. If your goal is to minimize your tax bill, the decision of whether to contribute to your RRSP over your TFSA – or vice versa — will come down to the outlook you hold for your future earnings.

For example, if you end up having a successful investing career over the next thirty years or so, it could just be that you wind up in a higher marginal tax bracket when you retire than where you find yourself today.

So if you're in one of the lower tax brackets today, you might arguably be better off delaying the bulk of your RRSP contributions until you get into one of the higher marginal tax brackets.

You should still save in the meantime, but throw those savings into your TFSA instead.

In an earlier post, I talked about how young investors, if they invest carefully, could turn a $26,500 investment in their RRSP this year into $1 million by the time they reached retirement.

In that post I used the example of **Canadian National Railway** (TSX:CNR)(NYSE:CNI) as a quintessential blue chip buy and hold investment that should be expected to pay investors dividends (both figuratively and literally) over the long term.

I love CNR as a prospective investment for those just starting out in the markets because the business is relatively straightforward and easy to understand, the stock pays a dividend (albeit a modest one at that, yielding just 1.65% as of this writing) and moreover the company plays a vital role in our nation's infrastructure.

But while that $26,500 investment, if it earned an average of 11% annually over a 35-year period, could turn into $1 million by the time you retired, if it was held in your RRSP account, you are going to be facing a nasty capital gains tax when those funds eventually get withdrawn from your account.

Meanwhile. if that same CNR stock had been invested in your TFSA instead, it has the potential to appreciate just the same – but without the burden of that looming tax liability.

In matters like these, readers are going to want to do their own due diligence to help them decide which investment strategy is most suitable for them but this – at least for me – is why I'll be favouring contributions to my TFSA rather than my RRSP for the current tax year.

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