Planning for Retirement? Here Are 3 RRSP Tax Rules You Urgently Need to Know

Description

Tax efficiency is one of the most overlooked aspects of investing. If you don't take steps to actively reduce your tax burden, you're missing out on proceeds that could easily be kept. This is doubly true for retirement planners, who have many tax-deferred accounts at their disposal.

Most Canadian retirement planners are aware of RRSPs and the tax benefits that come with them. What most investors don't know is that RRSPs come with a lot of potential "gotchas" as well. In addition to the penalties for withdrawing early or while still earning an income, there are little-known RRSP rules that could punish you come tax time. The following are three such rules that you urgently need to know about if you want to make it to retirement in good shape.

U.S. withholding tax rules

Think holding U.S. assets in an RRSP saves you from paying U.S. withholding tax? Think again. Although RRSPs will spare you the 15% dividend withholding tax if you're buying stocks directly, the same isn't exactly true if you own Canadian funds with U.S. assets. U.S./Canada tax treaties allow you to recover withholding tax on dividends paid directly into your account.

However, if you own the Canadian version of a U.S. ETF like the **Vanguard S&P 500 Index Fund** (TSX:VFV), dividends paid to the fund will be taxed before they even hit your RRSP. This portion of the dividend tax is not recoverable, because it is technically paid to the ETF, not to you. For this reason, if you're going to be buying funds that hold U.S. assets in an RRSP, it pays to convert your currency to U.S. dollars and buy the fund directly in the U.S.

Mandatory minimum withdrawal rules

Most investors know that they need to withdraw their RRSP funds to a RRIF or annuity when they turn 71. What many don't know is that once the funds enter the RRIF, they then need to be withdrawn incrementally each year. The minimum withdrawals start at 4% and eventually reach as high as 20%.

If you own dividend stocks, you can pay for your first few years of withdrawals with dividend payouts — saving you from having to sell stock. It's generally hard to find dividend stocks that yield far north of 4% without insane payout ratios but remember that dividends can grow over time. If you invest diligently from, say, age 30, you could end up with a yield on cost that's much higher than the yield on shares purchased at that time.

Beneficiary rules

Want to leave part of your RRSP proceeds to your next of kin, so they can live off your nest egg tax-free? That's a worthy goal. However, if you plan on transferring your RRSP assets to a beneficiary, you'll need to name them as a "successor annuitant" to keep the payouts coming at a low tax rate.

If you simply transfer your RRSP assets to your spouse or next of kin in one lump sum, they'll be taxed as your RRSP is liquidated. As you might expect, the tax cost here can be very high and can result in your beneficiary receiving much less than they expected. For this reason, you'll want to make sure your beneficiary has an RRSP or RRIF of their own before designating them in your will.

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