This One RRSP Mistake Could Destroy Your Retirement

Description

Do you want to build up a retirement nest egg by letting your investments grow tax-free?

If so, an RRSP is just what the doctor ordered.

However, if you want to get the most out of your RRSP, you'll need to mind the rules that govern it. You may already be aware of the tax penalties that come from drawing on your RRSP early, or withdrawing too much all at once. But you might be surprised to learn that there are other RRSP tax mistakes that aren't so well publicized. One of them can result in you paying a 15% tax that you may have never even heard about. In this article I'll explore what that mistake is and how to avoid it.

Buying ETFs without knowing the special tax rules that govern them

ETFs are extremely popular with non-professional investors who want to get average returns without too much effort. Index ETFs are among the most popular ETFs, as they aim to give you the average return of all the stocks on a particular index with low fees. It's true that index ETFs are among the safest and most reliable investments on earth. It's also true that RRSPs spare you some of the withholding taxes you have to pay on ETF dividends.

However, if you hold a Canadian ETF with U.S. holdings in your RRSP, you could end up with a lower dividend payout than you expect. Although the RRSP technically spares you the *personal* withholding tax, the stocks that make up the ETF have their dividends taxed before they're paid to the ETF itself, so you end up with a lower yield than a U.S. investor would with a comparable U.S. fund.

Why this is such a big mistake

Getting hit with withholding taxes is a big mistake for two reasons: one, it's avoidable; and two, it cankill your returns.

Index funds are not known for producing stellar capital gains. The **S&P 500** typically returns 8-10% a year–and that figure includes dividends. To realistically get a solid return from the **Vanguard S&P 500 Index Fund** (TSX:VFV), you'll need not only price appreciation, but also dividend payouts. But if 15% of your dividends are being withheld, that's a huge chunk of your income you're missing out on. And as VFV only yields a little over 1% anyway, you'll want to hold onto as much of the payout as possible.

What to do instead

If you don't want to get hit in the pocketbook by U.S. withholding taxes, you have two options.

First, you could buy Canadian ETFs that hold Canadian stocks like the **iShares S&P/TSX 60 index fund.** Funds like these only deal in Canadian stocks, so there's no withholding tax to contend with at all.

Another option, if you want to invest in U.S. equities, is to simply buy the U.S. ETF directly. For example, if you want to buy the aforementioned Vanguard S&P 500 fund, you could simply buy it on the U.S. markets under the ticker symbol VOO. Although this does come with currency conversion costs, those are typically much smaller than the cost of paying withholding tax.

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