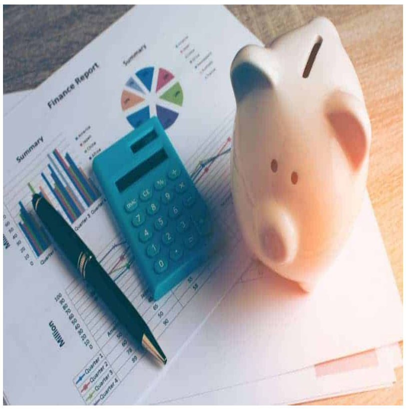

1 Important Reason You Shouldn't Be Saving With an RRSP

Description

We here at Motley Fool Canada spend a lot of time talking about retirement. Whether we're helping folks pick growth stocks with huge capital gains potential for their portfolio — which helps to maximize retirement savings — or telling people about excellent dividend payers that can help turn that capital into steady income, we've got you covered.

So, yeah, it's obvious helping investors save for retirement is important to us.

But not everyone should be saving for retirement — at least not in the traditional way. Let's take a closer look at who shouldn't be putting cash aside in RRSPs and a strategy these folks should embrace instead.

The high achiever

Like music skills or the ability to hit a baseball, some savers are just naturals at personal finance. They breeze through life collecting assets the whole way.

It starts out with no debt after university, either through a full scholarship or from parental assistance. Next is a great first job, which is then leveraged into a six-figure income in no time. These folks are in middle-management jobs by the time they hit their 30s and inevitably get promoted early, too.

Or perhaps these high achievers follow a different path. Maybe they start a successful blue-collar business. Or they create and maintain a massive savings rate, trying to chase early retirement. They could even be regular folks who are sitting on a huge inheritance from wealthy parents.

The point is this: if you're somebody with significant assets outside registered accounts, then it's time to stop RRSP contributions. The traditional method of saving for retirement no longer applies to you, and a different strategy must be embraced. Here's what you should do instead.

Think taxes today

Let’s run a little hypothetical scenario. You’re 35 today with a $1 million net worth. You expect to generate an 8% return going forward and want to retire at 60. Saving isn’t difficult, so you’ll put away $50,000 per year on top of any investment gains. How much would this person be worth at 60?

The answer will probably shock you. We’re looking at a net worth of $10.8 million. If our imaginary saver continues squirreling money away until a traditional retirement age, they’ll be sitting on a net worth of more than $16 million.

Think about the tax situation of somebody with a net worth of $5 million, $10 million, or even $16 million. A dividend portfolio yielding 4% would generate $200,000 per year in income on a $5 million portfolio. This immediately puts them in a situation where they’re paying a lot of taxes.

Now think about a scenario where much of that capital is locked up in RRSPs. This cash must slowly be converted back into regular income, with taxes owed each time it’s withdrawn from the RRSP account. This can be delayed for a little while, but it must eventually happen.

The end result is a retiree paying huge tax bills in their golden years, all because their affairs weren’t properly planned out. Nobody wants that.

The solution

The solution is simple. If you’re already sitting on a big net worth that you expect to get much larger come retirement time, avoid RRSPs for other types of accounts.

Maximizing your TFSA is a no-brainer, of course. That account will be tax free forever, provided greedy politicians don’t start taxing them at some point in the future.

Then I’d put the rest of my assets into regular, ol’ taxable accounts. Yes, you’ll have to pay taxes on dividends, but capital gains can be deferred by loading up on great stocks and holding them for decades.

Remember, RRSPs only work if you expect to make less during retirement than you do today. That’s why they’re the perfect savings vehicle for average people. High achievers with already significant RRSP assets should do the opposite and keep their capital in taxable accounts. It doesn’t make sense for them to defer taxes to retirement when they’ll likely be in a higher bracket.

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