WARNING: The RRSP Myth That Could Wreck Your Retirement

Description

Who doesn't love RRSPs?

Giving you the ability to grow your investments tax-free until retirement, they're a Canadian investor's best friend, especially if your annual investment capital is below your RRSP deduction limit.

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The reasons being is that you can really save a lot by putting money in RRSPs, not only on capital gains/dividend taxes, but also on income taxes.

However, there is a commonly believed myth about RRSPs that could get you in trouble if you subscribe to it, particularly if you plan to continue working past the age of 71, as it could wreck your retirement.

It's a myth that's easy to believe–because it's not exactly a galaxy away from the truth–but devastating for those who don't understand the nuances that make it false.

So without further ado, here's the #1 RRSP myth that could wreck your retirement:

That RRSPs are tax-exempt

If you're like most people, you're probably aware that investments can *grow* in an RRSP tax free. That's technically true. However, an RRSP isn't the type of 'no strings attached tax shelter many people imagine.

In truth, RRSP holdings *are* taxed eventually. And if you're still earning an income when that day comes, they could be taxed quite a bit. To understand why that is so, we first need to understand the difference between tax deferment and tax exemption.

Tax deferment vs. tax exemption

Tax deferment and tax exemption are related but non-identical concepts. A tax exemption means you don't pay any tax on a particular thing: TFSA holdings fit this description. Tax deferment means you don't pay any taxes until you withdraw. This is the category that RRSPs are in.

When you withdraw money from your RRSP, it's taxed at your marginal rate plus any applicable withholding taxes. What this means is that RRSP withdrawal taxes should be fairly low if you're retired, but could be devastating if you're still working, particularly if you're a high earner.

A great example to illustrate this point would be a hypothetical person, let's say Bob, who held **Aurora Cannabis Inc** (TSX:ACB)(NYSE:ACB) stock in an RRSP and withdrew it before retiring.

Imagine that Bob is a lawyer earning $250,000 a year. At that income, his marginal tax rate (federal) is 33%.

Now imagine that Bob had bought $100,000 worth of Aurora stock in October 2017 and held it until January 2018. With perfect timing, he could have pocketed a 372% gain, which would have resulted in a $100,000 position in Aurora growing to $372,000.

However, if he wanted to withdraw that sum from his RRSP while still earning a $250,000 income, he'd pay a 33% tax on it.

The above hypothetical illustrates the difference between tax exemption and tax deferment. When your holdings are tax-exempt, such as in a TFSA, you can withdraw at any time without worrying about taxes.

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So if you had held $100,000 worth of Aurora stock in such an account, you'd have been able to pocket all the gains once you cashed out. But in an RRSP, you only enjoy tax-free status as long as your stocks are in the account.

This makes it imperative to wait until you actually retire before you withdraw from your RRSP. For this reason, if you're gambling on risky stocks like Aurora in hopes of cashing out early, it may be better to hold in a TFSA.

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