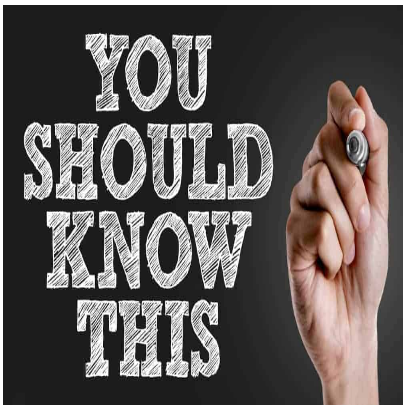

Maxing Out Your RRSP Could Lead to Higher CPP Taxes: Do This Instead!

Description

When people contribute to RRSPs, they usually do so to lower their taxes. If you get an immediate tax break followed by years of tax-free compounding, it's easy to think you're saving money. And you are — today. The downside is that you have to *pay* taxes tomorrow. Not only do you pay taxes on RRSP withdrawals, but you could end up paying higher taxes than normal on other income sources. That includes CPP.

How maxing out your RRSP today could lead to higher CPP taxes tomorrow

The more taxable income you have, the more tax you pay on it. Your total taxable income is all your income sources combined. That includes employment income, CPP payments and — yes — RRSP withdrawals. So if, when you retire, an extra benefit pushes you into a higher tax bracket, you could end up paying higher taxes on your CPP payouts.

That's oversimplifying a little, because your marginal tax rate is really your tax rate on an extra dollar of income, not on a specific type of income. The income sources aren't broken down and taxed separately, they're added up giving you a total net income figure. However, the net effect of higher RRSP withdrawals — assuming they're big enough to push your marginal tax rate up — would be higher taxes. That means less money you can take home from your total income, including CPP.

Do this instead

If you want to avoid paying extra taxes in retirement, a good idea would be to invest in a TFSA instead of an RRSP. This is because TFSA withdrawals aren't treated as taxable income. So, you don't pay tax on TFSA withdrawals themselves, nor do such withdrawals risk pushing you into a higher tax bracket.

This can be illustrated by imagining that you held $69,500 worth of the **iShares S&P/TSX 60 Index Fund** (TSX:XIU) in a TFSA. If you had that much money invested in XIU, you could withdraw it, pay no taxes on it, and pay no extra taxes on CPP. TFSA withdrawals aren't considered taxable income one way or the other.

It would be quite different if you withdrew that money from an RRSP. $69,500 is a nice chunk of change, and withdrawing it all at once would almost certainly push your marginal tax rate higher. First, even if you had no other income, you'd pay taxes on the withdrawal itself. Second, the large amount would push you into a higher tax bracket than you'd normally be in. Third, even if the amount was much smaller, you could be pushed into a higher tax bracket if you were close to the margin. Fourth and finally, the end result would be higher taxes on your total income.

By holding ETFs like XIU in a TFSA, you avoid all these pitfalls. Not only can you cash out such ETFs tax free, you can also withdraw them without a penalty. In fact, there's more to the equation than just cashing out and withdrawing gains. XIU pays a dividend yielding about 3.4%, so you'd avoid the taxes on those as well. Overall, it's just best to hold these types of investments in TFSAs, assuming you have the contribution room.

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