What is a Registered Retirement Savings Plan (RRSP)?

Description

A Registered Retirement Savings Plan (RRSP) is an investing and savings account that allows you to grow your money with tremendous tax benefits. RRSPs can hold numerous qualifying investments, including stocks, bonds, and mutual funds. And because your money grows tax-free, it can be a powerful way to take advantage of compound growth.

Though they have contribution limits and withdrawal rules, RRSPs are simple to understand and use. If you're considering opening one for your investments, here's what you need to know.

What is a Registered Retirement Savings Plan (RRSP)?

A Registered Retirement Savings Plan (RRSP) is a government-sponsored retirement account that allows you to save money for the long term, while also taking advantage of certain tax breaks.

You can open an RRSP at most financial institutions, including banks, credit unions, trusts, and insurance companies, or your employer may offer a company-sponsored RRSP (called a "Group RRSP"), often with a contribution match.

Tax benefits of an RRSP

With an RRSP, you save on taxes in two big ways. First, any contributions you make can be deducted off your taxable income, up to your contribution limits. For instance, if you make $60,000, and you contribute $5,000 to your RRSP during the year, then you can deduct $5,000 from your taxable income and pay taxes on $55,000.

Second, your investment gains are tax-deferred. That means, no matter how much your investments grow, you won't pay capital or dividend gains to the Canada Revenue Agency (CRA), at least not for now. The only time you pay taxes is when you withdraw money from your RRSP in retirement. At that point, each withdrawal you make will be taxed at your marginal tax rate which, if you're retired, willmost likely be lower than the tax rate you have now.

How does an RRSP work?

Every year, income-earning Canadians between the ages of 18 and 71 can contribute to their RRSPs up to the maximum amount. The contribution limit is either 18% of the previous year's earned income or an amount specified by the CRA, whichever is less (for 2022, that amount is $30,780)[(1).]

For example, if you made $100,000 last year, you can contribute up to $18,000. On the other hand, if you made $250,000 last year, then you would only be able to contribute the CRA's imposed maximum for that year. Since18% of $250,000 would be $45,000, you would be able to deduct the $30,780 limit.

Contributions are taken directly from your paycheque pre-tax (without being taxed) and added to your RRSP. Once you have funding in your account, you can hold it in savings accounts and bank products (like GICs), or invest it in certain qualifying securities like stocks and mutual funds.

Benefits of investing in an RRSP

- **Savings grow tax-free.** You don't have to pay interest or capital gains taxes for investment earnings made inside an RRSP.
- **Contributions are tax-deductible.** This can be an effective way to reduce how much you owe to the CRA.
- **Lifetime taxes for high-income earners are reduced.** Those in a higher tax bracket can contribute at their highest tax rate and withdraw in retirement at their lowest.
- **Withdrawals can be flexible.** You can withdraw early from an RRSP without penalty to fund the downpayment of a house or pay for continued education.

Who's eligible for an RRSP?

RRSPs have no minimum age requirement. If you're earning income and filing a tax return—and you're a Canadian citizen—you or your guardian can open an RRSP.

That said, RRSPs *do* have an age maximum. You can open and contribute to your RRSP until the year in which you turn 71. By the end of that year, you have to convert your RRSP into a [Registered Retirement Income Fund] (RRIF) or an income annuity. Failure to do so will result in a very, very hefty tax bill: the CRA will treat your RRSP as income for that year and tax you according to whatever tax bracket your RRSP puts you in.

How much can you contribute to your RRSP?

You can contribute a maximum of 18% of last year's income, up to an annual limit. For 2023, the annual contribution limit is $30,780.

What happens if you over-contribute to an RRSP?

The Canadian government frowns upon over-contributions, though they're not extremely harsh with punishments.

You can typically contribute $2,000 over your maximum limit with no penalties. After $2,000, you'll get several notices from the CRA asking you to withdraw your excess contribution. If you fail to withdraw the appropriate amount, the CRA will charge a 1% penalty per month on the excess.

For instance, if you're $5,000 over your maximum, you'll pay $50 per month ($600 per year) until you withdraw the $5,000.

What happens if you don't contribute the maximum within a given year?

If you can't contribute the maximum for any given year, the extra space rolls over into the next year.

For example, let's say your maximum contribution for both 2021 and 2022 is $18,000. Let's also say you contributed $6,000 in 2021, leaving you with $12,000 of unused space. That $12,000 will roll over into 2022. That means, during 2022, you can contribute $30,000 ($18,000 plus the unused $12,000). Unused contribution space will keep carrying forward like this until you turn 71.

At 71, you have to cash out your RRSP, turn it into an annuity, or convert it into a Registered Retirement Income Fund (RRIF). An RRIF is basically an annuity contract that will give you periodic payments until you run out of RRSP funding or you pass away.

What is the penalty for an early withdrawal?

RRSPs can be a great savings vehicle. But, if you withdraw before you turn 71, you could get hit with several taxes.

For one, you'll pay a withholding tax on the amount you're withdrawing. More than likely, you won't pay this directly: your RRSP provider will deduct the necessary portion from your withdrawal and pay the government on your behalf. Unless you live in Quebec, here's what you can expect to pay for the following withdrawal amounts:

- **Up to $5,000**: 10% tax rate
- **Between $5,000.01 and $15,000**: 20% tax rate
- **Greater than $15,000**: 30% tax rate

On top of this withholding tax, you'll also need to report your withdrawals as income on your tax filings.

The more you withdraw, the higher your taxable income and the more you'll pay in taxes for that year.

As if that wasn't enough, you'll also lose contribution room equal to the amount you withdraw. While you can still make the maximum contribution to your RRSP, you won't be able to recontribute any early withdrawals. This is different from a TFSA, which allows you to replace what you withdraw.

Finally, keep in mind: withdrawing money means missing out on compound growth. The best way to build substantial wealth is to leave your retirement money invested for the long term. Even a small withdrawal could come back to haunt you. For instance, if you withdrew $5,000 from an account that had an 8% return, then after 20 years you'd lose out on $19,634 in earnings.

How to withdraw from an RRSP without paying taxes

Fortunately, the Canadian government isn't completely merciless on early withdrawals. While you can't withdraw from an RRSP for just anything, you can withdraw for two very important expenses: buying your first home (the Home Buyer's Plan) and paying for continued education (Lifelong Learning Plan).

The Home Buyer's Plan

Under the Home Buyer's Plan, you and your spouse can withdraw up to $35,000 each from an RRSP without paying taxes. As long as you use the RRSP money as the down payment on your *first* home, you won't be penalized for making an early withdrawal.

But there's a catch — you and your spouse must repay what you borrow within 15 years. Typically, each year the government will require you to repay 1/15th of what you borrowed. If you don't repay it, the CRA will include it as RRSP income on your taxes (they'll squeeze the money out of you one way or another).

So long as you can repay what you borrow, you can use $70,000 from multiple RRSPs to help buy your first home.

Lifelong Learning Plan (LLP)

The Canadian government will also allow you to withdraw money tax-free if you're using it to pay for full-time education or training.

Yes — in order to be eligible for the LLP, you must be enrolled full time (unless you're disabled, in which case you can be enrolled part-time).

Under the LLP, you can withdraw up to $10,000 per year for a maximum of $20,000. You can withdraw money for a maximum of four years, but anything you withdraw must be repaid in 10 years. Like the Home Buyer's Plan, the Canadian government will require you to pay at least a tenth of what you borrow each year, though you can pay more than that without penalty.

How many RRSP accounts can you have?

You can have as many RRSP accounts as you want: there is no limit. But no matter how many RRSP accounts you have, your annual contribution limits won't change. Whether you have one RRSP or nine, you can contribute a maximum of 18% of last year's income, up to an annual cap.

How to open an RRSP

1. **Shop around for an RRSP provider.** Even though nearly every financial institution provides RRSPs, you should compare different providers first. Some RRSP providers charge administrative fees, while others might allow you to invest in different types of securities. **Note**: If you don't want a bank to hold your RRSP, you can open an RRSP within a brokerage account. This is known as a "self-directed" RRSP.

- **Complete an RRSP application.** You'll need your Social Insurance Number (SIN) and your most recent Notice of Assessment (NOA) from the CRA. At this time, you should also add a beneficiary to your account, someone who will receive the money in your RRSP if you pass before you turn 71.

- **Decide how you'll contribute.** Once your account is open, you'll need to figure out how you'll make contributions. Most Canadians set up regular contributions through payroll deductions, but you can contribute in several ways, including a lump sum payment or a pre-authorized contribution (PAC).

What's the difference between an RRSP and TFSA?

RRSPs are only one type of government-sponsored retirement account. The other most popular account is the Tax-Free Savings Account (TFSA), which works similarly to RRSPs: each year, you have certain contribution limits, and any contributions can grow tax-free within the account. But, beyond that, TFSAs and RRSPs have some key differences.

1. **TFSAs have more flexible withdrawal options.** Whereas an RRSP only lets you make tax-free early withdrawals for buying your first home or paying for full-time education, a TFSA allows you to make early withdrawals for, well, pretty much anything. Your TFSA is a *savings account*, which means you can use it to save up for a car, a vacation, a new laptop, or, yes, even your retirement.

- **With a TFSA, you don't pay taxes on withdrawals.** Again, this is different than an RRSP, which uses pre-tax money (money in your paycheque that hasn't been taxed), then taxes you later. A TFSA, on the contrary, uses after-tax dollars: you've already paid taxes on your contributions, so the CRA won't tax you again later.

- **The contribution limits on TFSAs are typically much lower than an RRSP**. For example, the maximum contribution limit for a TFSA in 2021 is $6,000 which, depending on how much you make, can be significantly less than the 18% limit on RRSPs.

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Is an RRSP right for you?

RRSPs are great for Canadians who want to save money for retirement in a tax-sheltered account.

That said, Canadians who earn a high income will likely benefit from RRSPs the most.

For one, high income earners can potentially lower their annual taxable income by contributing the maximum each year. Depending on how much you earn, this could be substantial enough to knock you into a lower tax bracket.

Secondly, high income earners can defer paying taxes until a time when they're making less income—thus putting them in a lower tax bracket. The idea behind an RRSP is that you can contribute pre-tax dollars at your highest tax rate, then withdraw and pay taxes when your rate is lower.

For example, let's say your household brings in more than $222,000 per year. You'd be in the highest tax bracket and your tax rate would be 33%. But let's say you expect to earn less than $90,000 in retirement. At that time, your tax bracket would be substantially lower—20.5% or less by today's standards. By contributing to your RRSP now (and withdrawing in retirement), you could pay substantially less in taxes over your lifetime.

For Canadians who want a more flexible savings account, or who don't earn a substantial amount of income, a TFSA might be a better option. Be sure to compare both accounts before you sign up for one, as one or the other may be more favourable to your unique situation.

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