Welcome to RRSP Season !

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It is that time of year again when attention turns to RRSPs and tax planning. This year's contribution deadline is March 3rd, 2014 if you want to deduct the contribution against your 2013 income tax return.

The purpose for making an RRSP contribution, from a financial planning perspective, is to build savings and assets over time so that you can replace earned employment income with passive or investment income for your retirement years. In other words you can sleep in and still have the lifestyle you want without going to work!

The Canadian Government assists you with that objective. It does this by giving you a tax deduction for contributions so that you can save more money on a pre-tax basis than you would if the money was taxed and then saved. Secondly, it allows for the tax-free growth (tax deferral) on your RRSP so that the capital amount will be much greater than it would be if you were taxed annually on the growth or income.

Most people focus on the tax deduction only while ignoring the significant benefits of the compounding effects and growth on the money that is not paid out as taxes. The theory is that you are contributing money while in a higher income tax bracket during your working years and withdrawing it in your retirement years while you are in a lower tax bracket. The reality is higher income earners may find themselves in the same tax bracket in retirement!

This leads many people, including some accountants, to challenge the effectiveness of RRSP by saying: Why bother with an RRSP if you have to pay taxes on the withdrawal!? This viewpoint ignores the real power of tax-deferred compounded growth and the effects of compound growth that you can achieve in an RRSP, especially on the capital that would have otherwise been lost to income taxes.

The math works something like this. If you took the assumed future capital value of your RRSP at age 65 or 70 and then collapsed the RRSP (not recommended) and paid 50% of the capital as income taxes, the remaining capital would still be higher than if you had been building your savings outside the RRSP in a fully taxable environment.

Impossible you say! Take a calculator while watching TV and invest, say $10,000 a year, minus your annual income taxes, say 30%, then invest the balance of $7,000 at an assumed rate of growth, pick 5% to keep it simple, then subtract the taxes on the earned income $105. The net amount at the end of Year One is $7,245. Then do this another 39 times assuming the person is age 25.

[1]

Compare this with the RRSP with $10,500 at the end of Year One. The gap only gets bigger over time!

[2]

There are situations where RRSP contributions may not be the right thing for some people some of the time. For example, young people at the start of their careers or low income earners nearing retirement. A TFSA may be the better solution!

These are just two alternatives for building savings and assets something which you would still need to do even if RRSPs didn't exist. RRSPs just make it easier to build savings. Call us today to discuss more savings and tax planning strategies!

Have questions about RRSP's?
Contact our office today ! [3]

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