Can you have too much money in an RRSP?

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Registered Retirement Savings Plans (RRSPs) have been around since 1957 and, at one point, were clearly the best retirement saving vehicle there was. However, with consistently increasing tax rates and the introduction of the Tax Free Savings Account (TFSA) in 2009, you now should to take a closer look at your retirement savings options to determine what works best for you and your personal situation.

There are two main advantages the RRSP has over the TFSA. The first being the higher contribution limit, for anyone whose income is above $33,334, that is. The RRSP limit is 18% of your earned income from the previous year up to a maximum annual limit of $27,230 for 2020, plus any amount that has been carried forward from previous years. The second advantage is the fact that an RRSP contribution will reduce your taxable income in the year the contribution is claimed.

Both your unused TFSA and RRSP contribution limits carry forward and can be used in future years.

While the TFSA plans do not offer you any current tax savings, any funds withdrawn from a TFSA are totally tax-free. TFSA withdrawals can happen any time and do not just have to be used for short term savings or retirement. In fact, TFSAs are a great estate planning tool.

Also, funds withdrawn from a TFSA can be re-contributed in the following calendar year or later. Just don't do it in the same calendar year, or you could get hit with a penalty tax. Ideally, you don't want to take money out of your TFSA if you have investment losses, as the amount that you can re-contributed is based on the amount you took out. So, if you contributed $10,000 to your TFSA and it grew to $20,000 and you withdraw the funds, you could contribute the $20,000 back to your TFSA. However, if you had a loss and the $10,000 was only worth $5,000 and you withdraw those funds you can only contribute back the $5,000. This re-contributed amount is a large advantage over RRSPs, where withdrawals cannot be re-contributed.

In general, RRSPs work best for long term money, and when your marginal tax rate while making contributions is higher than it will be when you are retired and drawing taxable money out of these plans. While years of tax-free compounding can make up for some increase in your marginal tax rates, if you feel your income in retirement will be taxed at a higher rate then it is currently, you may wish to look at other retirement savings options.

Excess taxable income in retirement not only costs you more in income tax, but it can also cause you to lose benefits from two government programs. The Old Age Security (OAS) recovery tax and the Guaranteed Income Supplement (GIS) payment are both reduced or totally “clawed back” if your taxable income exceeds a certain income threshold.

The OAS clawback affects high-income earners, while the GIS affects low-income earners. So, if you are going to be eligible for either of these two plans in retirement, you might be better off to skip the RRSP tax deduction and focus on your TFSA or other tax-preferred investments, such as deferred capital gains or eligible dividends.

Conclusion

So, can you have too much in your RRSP? Well, like most financial questions that depends on your personal situation, so be sure to consult with your financial planner to determine your best course of action.

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