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GROWN UP MONEY

A millennial primer on RRSPs. Should you contribute to one?

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Right now, you are probably hearing a whole lot about RRSP season. It's a tax-saving frenzy out there, with loads of pressure to contribute. Here are four important questions to ask before you put money into a registered retirement savings plan.

Question 1: How does an RRSP work?
RRSP season is the first two months of the year. If you put money into an RRSP during this time, you can use the deduction against last year's taxes owing.

When you make a contribution to your RRSP, the government will deduct this from your income so you get taxed at a lower rate. The higher your income, the bigger bang for your buck because your tax rate is higher. (You can learn more about that here.)
If, for example, you make $40,000 and you live in Ontario, your marginal tax rate is 20.05 per cent. A $1,000 contribution will give you a refund of $200.50. If you make $90,000 in the same province, your tax rate is 43.41 per cent. So a $1,000 contribution would give you a refund of $434.10. Each province has different tax rates so you need to take that into consideration when you're calculating your RRSP savings. More on that here.
Sounds great, right? Free money! Hold the phone: This isn't new money; this is a refund of what you've already paid (if you're employed) or it reduces the amount of tax owing (if you're self-employed).

Question 2: **Do you need the money for something else?**
Money going into an RRSP should be earmarked for three financial goals only. First, retirement. Second, the first-time homebuyers plan. (You can read more about that here.) Lastly, full-time school tuition. (You can read about the Life Long Learning Plan here.) If you are saving for anything else, such as children, wedding, trip, home reno or debt repayment, the RRSP doesn't support these goals. When you put money into an RRSP, the government will deduct it from your income. If you earn $40,000 a year and make a $1,000 contribution, you get taxed like you made $39,000. So, you owe less at tax time. This is the refund mechanism.

Here's the catch: When you take money out of the RRSP, it gets added back to your income. If you need that $1,000 contribution to fix your roof, the $1,000 is added back on to your income, and you get taxed like you made $41,000. Bummer. So, ensure that you don't need money that goes into an RRSP in the short-run, unless it's for a first-time homebuyer down payment or for full-time school.

Special note to the self-employed: You only get a percentage of what you contribute back, so don't put all your savings into your RRSP. If you do, you will only reduce a portion of your taxes owing, and will still be facing a doozy tax bill.

Question 3: Do you make enough money to make it worth it?
The higher your income, the bigger bang for your buck with RRSP contributions. So, if you're in a low tax bracket, contributing money to "save taxes" doesn't make as much sense as it does for someone who has a higher income. You've got the rest of your life to increase your income and tax rate. Maybe 10 years from now, you'll be dominating in your career and sleeping on a bed of money.

The nice thing about RRSP room is that it never goes away, so you don't have to use it now. If you're making peanuts now, don't feel compelled to dump a bunch of money into an RRSP to save taxes. You're not paying that much tax anyways. Wait my friend … wait until you really are paying high rates and then dump all the money in.

Question 4: What happens if you don't contribute to an RRSP?
Don't worry, you're not a financial criminal and you're not going to go to debtor's prison. If you've got extra savings, you may want to consider the tax-free savings account. The TFSA is like the sexy best friend of the RRSP. If your savings are earmarked for goals that aren't aligned with the RRSP or you don't earn enough (yet) to really get a big bang for your buck on RRSP tax savings, put your savings into a TFSA.

The TFSA doesn't offer the tax deduction (that fun refund thing that the RRSP has), but it is also tax-sheltered, like the RRSP, so it's a great place to save money. Plus, when you take money out of the TFSA, it doesn't get taxed. Ever. Period, full stop. So, it doesn't matter what you're saving for, the TFSA can support those goals.

If five years from now, you're a total high-roller and your income tax bracket is 43 per cent, you can take all of the money you saved in the TFSA over the years and dump it into the RRSP (assuming you've got the room) and save boat loads of tax money at that point when you're getting back 43 per cent of everything you put in. Clever.

Contributing to your RRSP is never a "bad thing" but it makes more sense for some people than others. Ensure that it makes sense for your income and your goals before you get caught up in the RRSP frenzy. Don't forget, the TFSA is relatively new in town, but boy, are we glad that it's here.