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For boomers the RRSP decision was easy, but for millennials things are a little more complicated

By Jonathan Chevreau

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As a baby boomer, I've always believed in maximizing contributions to the Registered Retirement Savings Plan (RRSP). Introduced in 1957, it has been the investment vehicle of choice for my generation, and for good reason.

As KCM Wealth Management president Adrian Mastracci notes, there are three solid reasons to contribute to RRSPs. The first is the one newcomers first think of: You generate immediate tax savings by reducing your taxable income, something that typically results in a welcome tax refund come filing time.

As time moves on, regular users of RRSPs come to appreciate the second compelling feature: the long-term tax-deferred investment growth. RRSPs are a tax-optimized wealth-creating machine: because interest, dividends and capital gains are not taxed while securities are held there your RRSP should grow like topsy, reinvesting the income without the taxman biting into your investment growth.

The third solid reason is the opportunity to make RRSP withdrawals at lower tax rates than when the contributions were originally made. If you contribute while in the top 53 per cent bracket in some provinces and pull money out when you're in a lower tax bracket (perhaps post-employment sometime between 60 and 71), you may be taxed at just 20 per cent or so on withdrawal. Add to that the initial tax deduction and decades of tax-sheltered growth, and that's a triple win.

But there are generational differences to consider. If I were to succumb to the deadly sin of envy, I might envy millennials for two things the boomers did not have. One is the Tax-free Savings Account or TFSA, which arrived only in 2009. TFSAs are the mirror image of RRSPs: They have no upfront tax deduction and shelter ongoing investment income (like RRSPs) but unlike RRSPs, are not taxable when you withdraw funds.

The second thing millennials will enjoy is the new expanded Canada Pension Plan, once the expansion announced the past summer comes into full implementation mode. I'd argue the combination of the TFSA *and* the expanded CPP makes the RRSP relatively less compelling for millennials than it was for the boomers. With decent growth from equities, it's conceivable a millennial who puts $5,500 into a TFSA every year from age 18 on will have $1 million or more by the time he or she reaches retirement age. Even at a conservative 4 per cent return, a $1 million TFSA will spin off $40,000 of tax-free income every year, and you will have the annuity of expanded CPP benefits that will be considerably more generous than they were for the boomers.

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By the time the expanded CPP fully kicks in around the year 2065, someone who qualifies for maximum benefits *and* waits till 70 to receive them could get as much as $2,356 per month just from CPP, or $4,712 for a qualifying couple. Add in a giant untaxed TFSA and that might be all they'd need in retirement.

While CPP and OAS will be taxed TFSA income will not be, so our future retired millennial will likely not suffer OAS clawbacks, which is probable for retired boomers with large RRSPs.

Matthew Ardrey, a wealth advisor with Toronto-based Tridelta Financial, says all else being equal, if your tax rate is higher now than it will be in retirement, choose the RRSP. If your tax rate is expected to be higher later, choose the TFSA over the RRSP.

So millennials not yet in a top tax bracket should prioritize the TFSA. They can always carry forward their RRSP contribution room to future years. Once in the higher tax brackets, they can "catch up" on their unused RRSP contribution room. Ironically, you may not need to borrow (the interest isn't deductible anyway for this purpose) to catch up once you're making the big bucks: you can always use the money in the TFSA, assuming you did the right thing and maximized it from day one.

To summarize, the RRSP was the only game in town for the boomers so it was a no-brainer. For millennials, the TFSA is a no-brainer for those in low tax brackets. If you're in higher brackets, the RRSP becomes a compelling tax incentive, but, by definition, if you're in a top tax bracket, you also have enough money to maximize contributions to a TFSA as well as the RRSP. High-earning dual-income couples have no excuse not to do both. In fact, the tax refund generated *by* the RRSP contributions can be used to fund the TFSA, making it a double win.

Jonathan Chevreau is founder of the Financial Independence Hub[1] *and co-author of Victory Lap Retirement. He can be reached at jonathan@findependencehub.com*[2]

References

1. findependencehub.com
2. jonathan@findependencehub.com