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Five reasons an RRSP might not be right for you

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Mulling over an RRSP contribution? If you're scrambling to come up with the cash before the March 3 deadline, take some time to consider your options first. While investing in a registered retirement savings plan can be a fantastic financial strategy for some, it's not the right move for everyone.

Carl Spiess, director of wealth management for ScotiaMcLeod, says he prefers to call this time of year "contribution season" instead of "RRSP season," because it shouldn't just be about one savings vehicle.

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"Before having the conversation about whether [your investment] should be in cash or last year's hot fund, decide whether the RRSP is the right account," he says. "Let's talk about your marginal tax rate, and start thinking about, 'Is the RESP better? Is the TSFA better?' And it's our job to know our client and make sure that they are putting the right amounts in the right account."

Here are five reasons why you might want to pass on an RRSP this year:

1. You will have a higher income next year (or the year after that)

Much of the allure of the RRSP contribution comes from the promise of a tax deduction, and hopefully a refund.

However, if you are in a lower income year and expect to be making more money next year, you might be better off holding off on that RRSP contribution, says Ian Black, a registered financial planner at Macdonald, Shymko and Co. Ltd., a fee-only financial planning firm in Vancouver. The higher your tax bracket, the bigger the tax break you're going be rewarded with.

"Maybe you've just started out in a job, you're in your 20s, just got out of university but don't have any debt, and you can foresee within a year or two, you'll have higher income," Mr. Black says. "Say you're at the 30 per cent tax bracket now, but you'll be at the 48 per cent a year from now. You can pick up an 18-per-cent return just by delaying a year."

If you have money for your RRSP and worry you might be tempted to spend it before next year, you can always make the contribution now and claim it a year or two down the road.

2. You have high-interest debt

When it comes to credit-card debt or other high-interest debt, you're better off paying it down than springing for an RRSP, Mr. Black says, because you are unlikely to make enough on your investments to counteract the hefty interest rates you will be paying.

"If you have credit-card debt at 18- to 22-per-cent rates, if you're paying that with after-tax dollars, it's conceivable that you will have to earn two dollars to pay a dollar," Mr. Black says. "Maybe not quite that, if you're in a lower tax bracket it's not quite as bad, but you're paying a fairly high penalty to carry that debt."

"So if you've got $1,000 in your pocket and you've got $1,000 on a credit card or you have an opportunity to make an RRSP contribution, I would pick the credit card," he says.

If you are in a higher tax bracket though, says Allen Church, a partner at MNP LLP accounting firm in Toronto, an RRSP could be of benefit when it comes to paying down credit-card debt.

"If I'm in the top tax bracket, say 50 per cent as a round number, if I put money in my RRSP, I cut my tax bill by half of that," he says. "And if I'm really disciplined, I can take that tax savings and turn around and pay down the debt, the best of both worlds."

Mr. Church points out that strategy works only if you actually pay the debt.

"If you're the type of person who, when the cheque comes, you say, 'It's been a long cold winter, a vacation down south would be nice,' next thing you know, the debt's still there and maybe it's even gone up because you used credit card on the vacation."

3. You will be overcontributing

Most of us can only dream of being able to max out their RRSP contributions every year. But if you are someone who frequently contributes close to your limit, it's important to ensure you don't overcontribute, Mr. Church says.

"Overcontributing is a big no-no, and the penalty for doing that is quite severe," he says. "It's 1 per cent per month of the overcontribution amount, which can be quite substantial. In the past they didn't police this very closely, but we've seen a significant increase in the number of situations where they're identifying these excess contributions and making the RRSP holders pay the penalty."

To avoid penalties, check your notice of assessment each year and make sure that it is correct.

"Sometimes there are mistakes," he says, "So compare it to your tax return."

4. You might be better off with an RESP or TFSA

As Mr. Spiess points out, sometimes a tax-free savings account (TFSA) or registered education savings plan (RESP) are better options if you've got some money burning a hole in your wallet and you're eager to invest it.

If you have children and you also have RESP room, you may want to max that out before opting for an RRSP, Mr. Spiess says. The federal government will pay you a Canada education savings grant of 20 per cent of your annual contributions every year (up to $500 a year, to a lifetime limit of $7,200), possibly more, depending on your income.

Another factor to consider is what kind of investment you plan on putting in your RRSP, Mr. Church says. If your investment results in a capital gain or yields dividends, an RRSP might not be the best choice from a tax perspective, he says.

"The one big drawback of an RRSP is if I invest and generate dividends or capital gains within the RRSP, when I pull the money out, I pay normal tax on it instead of the lower rate of tax that applies to dividends and capital gains," he says.

"So, for example, if I get a dividend today from a public company, I would pay roughly 30-per-cent tax. But if I got that dividend in the RRSP and then pulled it out of the RRSP, I'd pay at the top rate about 46 per cent," Mr. Church says.

When deciding where to park a capital gains or dividend-yielding investment, the client's age may come into play, he adds.

"If I'm 20 years old, having that money grow tax deferred would probably make up for [the tax difference] over time, but if I'm 60 or 69 years old, I'll probably never make that up because I have to pull that RRSP out when I turn 70."

5. You are very uncomfortable with debt

Mr. Church says some of his clients, in particular the ones nearing retirement, tell him they would rather pay down even their low-interest debt, rather than invest in an RRSP.

"The analysis shows them, 'Make the investment, it's a good move,'" Mr. Church says. "But they say, 'I'm not comfortable having debt, it keeps me awake at night. I want to pay off all my debt. In terms of my overall welfare, it will put me in a better place holistically.'"

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