What Is an RRSP and How Does It Work?

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Maybe you can't drive stick shift. Maybe you don't know the name of your local representative. Or maybe you're still unclear on what, exactly, gluten actually is.

We all have holes in our knowledge that we're embarrassed to admit. If you still aren't sure what an RRSP is, or how it actually works — don't worry.

Using an RRSP doesn't have to be complicated or intimidating. In fact, once you break it down, they're pretty straightforward. Even better? Learn how RRSPs work, open one, start contributing, and your future self will benefit.

So grab a coffee refill and carve out ten minutes. Here's what you need to know about RRSPs.

What is an RRSP?

RRSP stands for Registered Retirement Savings Plan. An RRSP is an investment account you contribute to each year in order to build up long term savings, most often for retirement (as the name suggests).

How an RRSP works

The most important way an RRSP differs from a regular (non-registered) account or a TFSA (Tax-Free Savings Account) is how it's taxed. Your RRSP contributions are tax deductible. So, when you contribute to an RRSP, you pay less in income taxes than you would otherwise. And while the money is in the account, it grows tax free. Later, when you withdraw that money again — typically in retirement — you pay taxes on it as though it's income.

Step 1: Earning money

Chances are, you're already completing this step. If you work for someone else, your employment income tax is taken off your paycheque automatically. If you work for yourself, you'll pay those taxes either annually, or on a quarterly basis, depending on how much money you make.

Step 2: Opening an RRSP

Once you open an RRSP, you'll be ready to contribute assets. Think of your RRSP as a box you can put cash and different types of investments into. These can include publicly traded stocks, bonds, ETFs, mutual funds, or GICS — just about any financial product that holds value.

Because you're almost certainly saving for the long-term, (retirement being the end-game), it's wise to take advantage of the opportunity to grow the value of your account by investing the money in the account. Working with an advisor helps you choose appropriate investments and products that meet your unique needs.

Step 3: Contributing money

Each year, you can contribute 18% of your previous year's earned income, or the year's maximum contribution rate, to your RRSP — whichever is less. For the 2021 tax year, the RRSP contribution limit is $27,830. Also, if you didn't max out your contribution room in previous years, that amount carries forward to the present.

To maximize your savings, consider setting up automatic contributions so the money is automatically taken out of your chequing account on a recurring basis.

Step 4: Using your RRSP money

You have the option to withdraw money from your RRSP before you retire. Generally, we strongly advise against making early RRSP withdrawals because you'll be hit with a tax liability — unless you plan to take advantage of the Home Buyer's Plan or Lifelong Learner Plan. Even then, there may be better ways to get funding.

Step 5: Converting your RRSP to a RRIF

Once you retire, the money in your RRSP becomes retirement income. To make these withdrawals, you'll need to convert your account into a RRIF (Registered Retirement Income Fund). You have to do this by the end of the year that you turn 71, but you have the option to do so sooner.

Any money you take out at this stage will be taxed as income when you withdraw it.

One Extra Step: Managing your estate

When you pass away, your spouse can inherit your RRSP on a tax-deferred basis. If you don't have a spouse, any beneficiaries you name receive it as cash but the value of the RRSP is subject to tax in your final tax return. If you haven't named beneficiaries, it gets rolled into your estate and would be subject to probate fees so its important to name a beneficiary.

RRSP tax benefits

You'll see the benefits of contributing to your RRSP in the form of tax savings. When people talk about RRSP contributions being "tax-deferred," they mean that you save on taxes now, and pay them later.

marginal tax rate which is determined by income level and differs by province. When you withdraw that money in the future, you'll pay taxes on it equivalent to your tax bracket at that time. Generally, you can expect your income in retirement to be lower, so you'll pay less taxes.

RRSP vs. TFSA: Which is right for you?

RRSPs and TFSAs (Tax-Free Savings Accounts) are both excellent options for long-term investing, and both offer tax advantages.

Like the name suggests, the RRSP is typically going to be the best option if you're investing specifically for retirement. That's especially true if you're in your peak earning years.

With a TFSA, you don't benefit from any income tax savings upfront, but when it comes time to withdraw the money from your account, you won't pay any taxes, even on interest and investment growth. If you think your income will be higher in retirement than it is now, or if you want to ensure that the money's available for any purpose, not locked away until retirement, then a TFSA might be your best bet.

Check out our detailed comparison of TFSA vs. RRSP.

Spousal RRSPs

If you're married, you can set up a joint RRSP for you and your spouse. This can come with several benefits. If one of you earns more than the other, they can make a larger contribution and benefit from the tax break — while you're both able to withdraw the money later.

In that case, if the spouse with the lower income withdraws the money, it will be taxed at their tax rate. This maximizes savings for both spouses. However, there are some requirements you have to meet — such as making sure the spouse with the higher income doesn't make a contribution the year before the withdrawal.

The ABCs of Spousal RRSPs will help explain how you and your partner can make the most of a spousal RRSP.

The 2022 RRSP contribution deadline

The deadline to contribute to your RRSP for the 2021 tax year is March 1, 2022.

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