Can you have too much invested in RRSPs?

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At this time of year, investors are bombarded with reminders to load up their registered retirement savings plans (RRSPs) for the tax deduction and deferral benefits – and, of course, to save for retirement.

But is it possible to have too much in your RRSPs?

Many older investors are asking this question after being forced to take out more money than they may want or need from their RRSPs, especially when they're converted into registered retirement income funds (RRIFs) and the mandatory withdrawal rates kick in.

Issues include the tax hit when taking money out of the RRSP or RRIF later in life and the potential clawback of Old Age Security (OAS) benefits if your income exceeds the annual threshold, which was $81,761 for 2022. Dying with too much money in your RRSP or RRIF can also trigger a huge tax bill on an estate.

Having too much money in an RRSP may sound like a good problem to have, especially for younger investors scraping together funds to make their annual contributions. Still, it raises the question of whether so much financial sacrifice is necessary during a person's younger, working years when they have other major expenses to worry about, such as a mortgage, daycare fees and saving for a child's post-secondary education.

"RRSPs aren't a one-size-fits-all solution, even though marketing from financial institutions during RRSP season may make you think otherwise," says Morgan Ulmer, certified financial planner with fee-for-service financial planning firm Caring for Clients in Calgary.

While she's an advocate of RRSPs, Ms. Ulmer says they tend to work best when someone is in a lower tax bracket when they withdraw the funds than when they contribute.

Many retirees today are pulling in more income than during their working years thanks to steadily rising markets over the past few decades and a combination of sources, including RRSPs or RRIFs, tax-free saving accounts (TFSAs), company pension plans, non-registered investments and business income, as well as Canada Pension Plan (CPP) and OAS benefits.

"Some Canadians in retirement can actually find themselves in the same or an even higher tax bracket," Ms. Ulmer says.

Benefit of tax savings in working years

Mark Chan, vice-president of wealth planning at Gluskin Sheff in Toronto, sees an oversized RRSP or RRIF as a "tax-optimization issue."

"It's not necessarily a dire situation if you have too much," he says.

Mr. Chan notes that many investors don't know how long their careers last or how long they'll live in retirement, "so having the financial discipline to start saving money early in your life should always be commended."

He also points to the tax benefits when contributing to an RRSP, including the deduction from your income in any given tax year and the deferral of taxes while it grows in the registered account until withdrawn.

"The ability to achieve compound growth over a long period of time, without paying taxes every year on that growth, can result in significant tax savings," he says.

Some investors also benefit more from the tax deduction in their working years, adds Ms. Ulmer of Caring for Clients.

"For many, it's a time in their life when they're financially strapped – maybe they're paying down a mortgage or student loans, paying for daycare and trying to save for a child's education – so cash flow is really important," she says. "So, delaying the tax on those RRSP contributions frees up the precious cash that they need during this time in their life."

There's tax when they withdraw, but presumably, those other obligations have ended, and clients are in a better position to pay that tax, she adds.

How to reduce an RRSP or RRIF tax hit

There are ways to reduce the tax liability from an RRSP or RRIF withdrawal and prevent or reduce an OAS clawback.

Ms. Ulmer says investors can work with advisors on “income-averaging” strategies, such as withdrawing funds from RRSPs even before they retire. An example is if someone takes a year or more off from work, maybe for parental leave, or if they’ve been laid off or decide to step away from work for a while. The strategy is to take some money out of the RRSP while in a lower tax bracket.

Another option is to convert RRSPs to RRIFs earlier than is mandatory, which is the year a person turns age 71, Ms. Ulmer says. She also notes that some people age 65 and older may be able to split RRIF income with a spouse, which is another way to spread it out and reduce the tax liability. Canadians with existing RRSP contribution room, even when not working, can also contribute to bringing down their taxable income, she adds.

Mr. Chan says Canadians may also wish to take funds out earlier in retirement before the RRSP has to be converted to a RRIF at the end of the year someone turns 71.

“That’s one common strategy we look at,” he says, “particularly, for those in a lower tax bracket than they would be in once they factor in the minimum RRIF withdrawals that begin in the year they turn age 72.”

He says the strategy would have to be weighed against the loss of the tax-deferred growth within the RRSP over time.

Investors could also delay taking their CPP and OAS payments until age 70 to keep their income low and stay below OAS clawback threshold, he adds.

John De Goey, senior investment advisor and portfolio manager at Wellington-Altus Private Wealth Inc. in Toronto, says retirees who are forced to withdraw more from a RRIF than they need to live on could turn around and use some or all of the excess to contribute to their TSFA.

“While a tax bill is triggered on the minimum withdrawal, the deferral is extended on the after-tax money up to $6,500 thereafter,” he says, citing the current annual TFSA contribution limit.

In general, putting too much money into RRSPs could pose a problem for high-income earners down the line, but is still advised, Mr. De Goey says.

"As long as your cash flow allows for it, you should contribute as much as you can afford to," he says, adding that it should be part of a broader financial planning strategy.

"Diversify. Incorporate your RRSP planning and asset mix with other accounts (i.e., pensions, TFSAs, corporate accounts, personal cash accounts) to improve tax effectiveness while still reflecting your long-term goals and risk tolerance," he says.

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