CESTNICK

TAX MATTERS

The importance and benefit of contributing to your RRSP earlier than later

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I was visiting with my good friend Mike the other day and we started talking about our kids. “Tim, I told my wife that I want our kids every other weekend, and on Christmas Day,” he said.

“But Mike, you’re still happily married and living with your wife. You’re going to have to see your kids every day,” I replied.

We had a good laugh, then talked about how quickly our kids grow up and the conversation turned to the benefits of investing money earlier in life than later. In fact, delaying contributions to an RRSP by just a few years can make a huge difference. If you’re a millennial or part of Gen Z, you’ll want to check out the numbers I’m going to share.

Let me tell you a tale about two sisters, then one about two brothers.

Two sisters

Sarah and Ella are twin sisters, both age 25 today. Sarah has always been smart with her money and has decided to start setting aside $4,000 each year in her RRSP. Sarah does this for 10 years, from age 25 to 35. So, Sarah will contribute a total of $40,000 to her RRSP ($4,000 a year times 10 years).

Suppose Sarah then stops contributing to her plan at age 35 and simply allows the funds to continue to grow for 30 more years until she is 65. Let’s assume she can earn 6 per cent annually in her RRSP. When Sarah reaches 65, she’ll have $302,815 sitting in her plan.

Now consider Ella, who is more of a procrastinator. Ella decides not to start contributing to her RRSP today, but instead waits until she is 35. At that time, Ella starts contributing the same $4,000 a year for 30 years, until she is 65. So, Ella will contribute a total of $120,000 to her RRSP ($4,000 a year times 30 years). At age 65, Ella will have $316,230 in her RRSP, assuming the same 6-per-cent annual return.

Even though Ella has contributed $120,000 to her RRSP compared with Sarah's $40,000, she'd end up with about the same amount in her plan at age 65. And if Sarah were to contribute $4,000 for just one additional year – a total of 11 years rather than 10 years – she'd have $8,260 more in her plan than Ella.

Two brothers

Michael and Joe are brothers. Both are 25 today. Michael has decided to contribute $4,000 to his RRSP each year starting now. He's going to contribute every year until he reaches 65 – a total of 40 years. If we assume a 6-per-cent return in his plan over the years, he will have $619,050 in his RRSP at age 65.

Joe, on the other hand, waits just five years and then contributes the same $4,000 a year to his RRSP, starting at age 30. He also contributes to age 65 – a total of 35 years – and earns the same 6 per cent annually. When Joe reaches 65, he'll have $445,740 in his plan.

The extra five years that Michael contributes to his RRSP result in him having $173,310, or 39 per cent, more in his plan than Joe. That's huge.

The moral

The key lesson from these stories is simple: Time matters more than almost anything else when investing for the future. This doesn't mean that if you're late getting started, you should just give up. Even Ella in the first story above is able to accumulate about the same amount as her sister Sarah, although Ella starts 10 years later. If you happen to start late, it just means you'll have to save more each year, or save for a longer time, to reach your goals.

Now, if you're wondering whether it makes more sense to contribute to an RRSP or TFSA when investing for the future, there are a number of things to consider, which I've talked about before. As a general rule, an RRSP is not for short-term savings, while a TFSA can be.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached at tim@ourfamilyoffice.ca