Six things you need to know about RRSPs

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The concept seems simple enough. Open up a registered retirement savings plan account when you're in a higher tax bracket. Then, when you're finally – blissfully – retired and in a lower bracket, you withdraw the money and pay less overall tax.

While the basics are pretty straightforward, here are a few misconceptions and little-known facts about the RRSP that might surprise you.

1. An RRSP is not a type of investment.
Want to stop giving your financial planner hives? Stop calling your mutual fund your "RRSP."

Judith Cane, a money coach in Ottawa with Money Coaches Canada, says she often talks to clients who are in the dark about the RRSP's true nature.

"People tell me, 'I have GICs, RRSPs and mutual funds.' I still don't think many people know what it is," she says.

So, for the record: An RRSP is simply a savings or investment account that has tax-savings characteristics. Your bank might offer an investment package that includes mutual funds, exchange traded funds (ETFs) or other options, but you can also open an RRSP account and fill it with the investments of your choice – and pretty much anything is up for grabs. Think gold, cash, Canadian and foreign equities, bonds, income trusts and even a mortgage.

You can also open more than one RRSP account at different financial institutions. But be warned, too many accounts may prove unwieldy and hard to monitor.

2. Yes, you can add investments to your 2014 RRSP right now.
Although we're in the middle of the run-up to the RRSP 2013 tax deadline, you've still got a choice as to where your money goes.

If you make RRSP contributions in the first two months of the year, you can declare them for either the current or previous year. How to choose? Take a look at how much money you made last year versus what you expect to make this year. If there is a large discrepancy, that fact will guide your decision.

For instance, if you were out of work in 2013 but have a well-paying job today and are in a higher tax bracket, it might make sense to allocate the contribution to 2014. Just hold off on including the funds on your 2013 tax form.

3. You're not the only one missing out on RRSP tax savings.
According to Statistics Canada, fewer than 25 per cent of Canadian tax filers contributed to an RRSP in 2011. Of those who did, they socked away, on average, 4.5 per cent of their employment income.

The good news? Even though the RRSP contribution rate runs low, people are also investing outside of their RRSP accounts. Sounds positive, but that can be seen as an indication of lost opportunity and funds, says Sam Sivarajan, head of investments for Manulife Private Wealth in Toronto.

"Non-pension financial assets are growing almost as fast as registered assets across all income groups, suggesting that Canadians are leaving tax savings on the table," he says.

4. The Home Buyers' Plan is fantastic, but better pay up.
First-time home buyers can withdraw up to $25,000 from their RRSP and apply the money toward a down payment or to fund the building of their dream home. The money is not taxable when it's withdrawn, although it must be paid back within 15 years. Sounds great, but according to the Canada Revenue Agency, 47 per cent of the people who used the plan didn't repay the amount they were required to for the 2011 tax year. Failure to pay the full amount results in tax penalties and lost potential for tax-deferred investment gains.

Suddenly, that new semi-detached house in a great neighbourhood just got pricier.

5. Death plus taxes can result in a rude shock.
Everybody dies. But do you know what happens to your RRSP when you're gone? Although some get squeamish talking about death, it's important to know what you – or at least your heirs – are financially in for.

For starters, if one spouse dies the RRSP simply rolls over to the surviving spouse. It functions the same as before. Just remember to tick the box on the RRSP beneficiary form stating that the money goes to the spouse upon your death.

Unfortunately, if both spouses die, children and grandchildren can say goodbye to inheriting the complete amount in the RRSP. Its contents are fully taxable, says Howard Kabot, vice-president of financial planning at RBC Wealth Management Services in Toronto. The funds are included on the deceased's tax return the year they die. That means if there was still $150,000 kicking around in the RRSP, it will likely be taxed at 40 per cent.

"If there are children and grandchildren, it doesn't go to them tax-free," says Mr. Kabot. "They're going to lose a significant portion of it."

6. You really can get ahead by reinvesting your refund.
That $1,200 tax refund may seem like a mini-windfall when it arrives a few weeks after filing tax returns, but spend it on a new sofa or a weekend getaway and you're missing

out on big money later. That refund is considered pre-tax income and packs a bigger wallop if it's allowed to compound over years. Think of it as prepaying taxes you would normally have to shell out for when you retire.

"Most people don't fully understand the impact of after-tax dollars versus before-tax dollars when investing in RRSPs," says Talbot Stevens, the London, Ont.-based author of *The Smart Debt Coach*.

He goes on to explain that if you're in a 40-per-cent tax bracket, spending a $1,200 refund means you've really only invested $1,800 rather than the $3,000 you intended. But plow it back into the RRSP and it results in a $4,200 total contribution.

"Unfortunately, I would say 80 to 90 per cent of people spend their RRSP refund," Mr. Stevens says.