Tax-free Savings Account (TFSA) vs. Registered Retirement Savings Account (RRSP)

WHO SAID COUNTING PENNIES WAS EASY?

Hitting the happy holiday party circuit for Christmas and New Year's is always interesting on so many fronts. People inevitably ask what you do and when you answer that you are a Certified Financial Planner, they ask *the* question. This year, again, it sounded like a lot of, "Should I invest in a TFSA or a RRSP?" This question gets louder and is asked more frequently as we hit February/March, and ultimately closer to tax filing time.

My blanket response is usually to suggest doing the maximum for both if possible. In truth this only applies to a small percentage of our population - the high-income couple or individual with very low monthly expenses. Why do I offer a blanket response – because (as I stand with my glass of celebratory wine – remember, I'm at a party) I have no evidence or information about their circumstances such as income, debt, assets, retirement planning goals, or estate planning goals.

In exchange for my opinion, I receive their reasons or justifications as to which one they think is better. The more common reason given for selecting the RRSP is related to the tax deduction - to reduce the income tax that is paid. However, a comparison of RRSP & TFSA is not so simple and can be shown using other factors.

SHOP TALK

The number one criterion to decide which (RRSP or TFSA) gets preference is the answer to "what are your goals?" If you are saving for retirement the RRSP allows for a larger contribution. If you are not a member of a registered pension plan (RPP) or a deferred profit sharing plan (DPSP), you'll be able to contribute 18% of your 2014 earned income to an RRSP in 2015 to a maximum of $24,930. However, if you did not use your entire RRSP deduction limit for the years 1991-2014, you can carry forward the unused room to 2015 resulting in a deduction limit greater than $24,930.

If your savings goal is short-term like a new car, new house, or emergency fund, the TFSA is a better choice as you will be able to access your funds quickly without incurring a tax penalty. You can only put $5500 into a TFSA for 2016, however if you are age 18 or older and a resident of Canada since 2009, and haven't previously contributed to a TFSA, you can put a maximum of $46,500 into a TFSA in 2016.

MIXED NUTS

TFSA contributions are based on after-tax income dollars. The funds are invested and are not subject to taxation while growing. When the funds are withdrawn there are no taxes to be paid. The RRSP works in reverse with an immediate tax deduction for the amount contributed however all the funds in a RRSP are subject to tax when you take them out later.

Age is also a very important factor in deciding TFSA vs. RRSP. If you are younger than 18 and have earned income you can only contribute to an RRSP. If you are older than 71 you can only contribute to a TFSA. Also, if you are older and you expect to need government support as a low-income taxpayer, a TFSA may be a better option. Old Age Security (OAS) and Guaranteed Income Supplement (GIS) payments are income tested. RRSP withdrawals count as income for OAS and GIS calculations and can reduce the amount you qualify for. Effective February, 2016, you can withdraw money from the TFSA at any time, for any reason, with no tax consequences, and without affecting your eligibility for federal income-tested benefits and credits.

Another important factor is the tax rate that prevails while employed versus when retired. For most people their marginal tax rate as working adults is greater than their expected marginal tax rate when they retire, so the RRSP is the more obvious choice. While fully employed our incomes are usually greater than our retirement income. Sometimes however individuals are part of a stellar pension plan that projects to pay high retirement benefits. Coupled with Canada Pension Plan (CPP) benefits and OAS benefits, any RRSP withdrawals can push them into a tax bracket where their retired marginal tax rate is greater than when they were working. In this case the TFSA is a better bet. Bear in mind this is a simplified illustration that will require more qualified analysis in a real life situation.

ENDING ON A HIGH NOTE

Generally an RRSP is intended for retirement savings. A TFSA is flexible and can be used for any type of savings goal. You need earned income to contribute to an RRSP but not a TFSA. RRSP contributions are tax-deductible but the whole RRSP is then subject to tax upon withdrawal. TFSA contributions are not tax deductible and withdrawals are tax free.

As you can see from the examples given above there are many factors and variables that go into the decision to contribute to a TFSA or a RRSP. The illustrations provided have been simplified for comparison purposes. The best way is always through a proper financial or retirement plan that can assess the importance of the client's goals. We always recommend retaining a Certified Financial Planner to help assess the differences as per your unique situation.

Both TFSAs and RRSPs are wonderful financial instruments that give amazing opportunities for saving. Utilized with proper planning and strategies they should be an essential part to most financial plans.

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To have a deeper conversation about how this subject will affect your business, please contact:

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