Should I contribute to an RRSP, a TFSA or both?

The introduction of the Tax-Free Savings Account (TFSA) represents the most important change to the way Canadians save money since RRSPs were launched in the late '50s. But the big question on many people's minds is whether they should contribute to a TFSA, the tried-and tested RRSP or possibly even both?

Before shedding some light on their question, let's first get a firm grasp on some of the innate differences and similarities. First and foremost, both RRSPs and TFSAs provide investors with the opportunity of tax-sheltered compound growth for investments held inside each plan. But unlike an RRSP, contributions to a TFSA are not tax deductible, amounts can be withdrawn tax free at any time and withdrawn amounts are added back into your TFSA contribution room the following year.

Now that we've established their unique characteristics, let's get back to our original question:

Which is best?

On a very basic level, looking at your pre-retirement and expected post-retirement marginal tax rates can provide you with an idea how to best allocate your investments. If you expect to be in a lower tax bracket during retirement, contribute to an RRSP is generally more beneficial. However if in retirement you anticipate being in a tax bracket that is equal or higher than your pre-retirement tax rate, the TFSA may be more tax-efficient.

Comparing the TFSA to the RRSP

Registered Retirement Savings Plan (RRSP)	Tax-Free Savings Account (TFSA)
Contributions are fully tax-deductible	Contributions are not tax-deductible
Contributions can be made until the end of the year in which you turn 71 years of age	Contributions can be made at any time with no age limit (for those 18 years of age and over)
Withdrawals are taxed at your marginal tax rate	Withdrawals are 100% tax-free
1% monthly penalty for over contributions	1% monthly penalty for over contributions
Withdrawals could affect eligibility for income-tested government benefits and credits	Withdrawals will not affect eligibility for federal income-tested government benefits and credits
Unused contribution room is carried forward indefinitely	Unused contribution room is carried forward indefinitely
Withdrawals cannot be returned to the RRSP without using contribution room*	Withdrawals will be added to contribution room in the following year.

** except for repayments of withdrawals under the home buyers' plan or the lifelong learning plan*

Hold on; not so fast.

Although it's tempting to settle on a simple rule-of-thumb, the decision on whether you should use a TFSA or RRSP is not that simple – your advisor needs to work with you to consider the entire spectrum of financial strategies at your disposal that could ultimately impact your approach.

Even if you anticipate having a lower marginal tax rate in retirement, maximizing your RRSP contributions may not always be the most tax-efficient long-term strategy. Since RRSP withdrawals (directly or through your Registered Retirement Income Fund (RRIF) or an annuity) increase your taxable income, those withdrawals may affect certain government income-tested benefits and credits such as the Old Age Security benefit and the Age Credit.

On the other hand, if your expected marginal tax rate in retirement is equal or higher than during your accumulation years, contributing to your TFSA may not be the best approach either. For example, RRSPs that are converted to a RRIF or an annuity after age 65 can produce income that is eligible for the pension income tax credit, and thus qualifies for pension income splitting with your spouse. Other income splitting strategies such as the use of spousal RRSPs could effectively

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distribute a portion of your taxable income to a spouse with a lower marginal tax rate in retirement, further reducing your tax bill and reducing the claw-back effect on your income-tested benefits and credits.

So where does this leave us?

Generally speaking, a TFSA may be better suited for shorter-term goals, such as an emergency fund or saving for a major purchase, since there is no tax on withdrawals and these plan withdrawals are added back into your TFSA contribution room the following year. However, for long-term objectives, RRSPs are generally the vehicle of choice since there are strong incentives to keep your money invested, in the form of taxes and lost contribution room on the withdrawals from an RRSP. The TFSA can also be a powerful retirement savings tool. However due to the ease with which TFSA savings can be accessed (no taxes on withdrawals or loss of contribution room) only a disciplined investor who can resist the temptation to dip into their savings prior to retirement will fully benefit from its potential as a source of retirement income.

Remember, there is no one-size-fits-all solution. In fact, there is a multitude of variables that must be taken into consideration. In many cases, the TFSA should be used as a complementary product, along with your RRSPs, as they both have their own advantages. Your personal savings strategy needs to take into account your unique circumstances as well as your short and long-term objectives.

To discover which approach is best for you, contact your Investors Group Consultant.

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