

Should I contribute to a TFSA, RRSP or both?

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INVESTMENT INSIGHT

With the Tax-Free Savings Account (TFSA) available for saving in a tax-free environment, does it still make sense to contribute to a Registered Retirement Savings Plan (RRSP)?

RRSPs can work well if you contribute while you are in a high tax bracket and withdraw when in a lower tax bracket. You can generate a higher net rate of return with an RRSP when the effective tax rate at the time of withdrawal is lower than the effective tax rate at the time of contribution. A TFSA can provide a higher return if the reverse occurs.

For example, if you contribute \$1,000 to an RRSP when you are in a 20 per cent tax bracket, your net cost is \$800 after the tax savings. If you are in the same tax bracket when you make a withdrawal from your RRSP, your net withdrawal will be equal to your net cost after paying the taxes (\$800). However, if you are in a higher tax bracket when you make the withdrawal, say 40 per cent, then your net withdrawal will only be \$600 after the taxes are paid.¹

TFSA, RRSP OR BOTH?

LOW INCOME

A TFSA can be an ideal savings vehicle if you are in a low income tax bracket. RRSPs may not be well suited to low income Canadians. The RRSP tax savings are insignificant and you may be in a higher tax bracket when you make withdrawals, as the earlier example demonstrates. You may also want to consider that TFSA withdrawals do not impact income tested benefits and credits, such as child tax benefits and credits, Old Age Security (OAS) or Guaranteed Income Supplement (GIS).

If you now find yourself in a lower tax bracket, such as when on maternity leave, and have made RRSP contributions in the past, you may want to consider withdrawing from your RRSP to make a TFSA contribution. However, remember that funds withdrawn from your RRSP cannot be re-contributed at a later date.

¹ To simplify the illustration, we are assuming that the market is flat and there is no return.

MIDDLE INCOME

One strategy would be to contribute to your TFSA now and accumulate RRSP room to be used later when in a higher tax bracket to optimize the tax benefits.

HIGH INCOME

This is a situation where you may want to maximize both your RRSP and TFSA contributions. In fact, the tax savings or refund received from the RRSP contribution could be used to fund the TFSA.

YOU MAY WANT TO RETHINK YOUR HOME BUYERS PLAN SAVINGS

If you are saving for a down payment on a house, a TFSA might be a better option than saving in an RRSP and withdrawing under the Home Buyers Plan (HBP). There are several reasons for this.

- The flexibility to recontribute the TFSA withdrawal without time limits.² If HBP repayments are not made on time, the annual repayment amount is added into your income and any missed repayment amount means the RRSP room is lost forever

- There is no restriction on how much you can withdraw from your TFSA while the HBP restricts you to \$25,000 from each your RRSP and your spouse's RRSP. Alternatively, you could each contribute \$5,000 a year for 5 years to a TFSA and then withdraw \$25,000 plus any investment earnings tax free and with no required repayments
- There are no conditions on TFSA withdrawals, whereas the HBP requires you to be a first time home buyer

Similar logic could be applied to the Life Long Learning Plan. By using a TFSA to save and fund continuing education, contributors can gain increased withdrawal flexibility while eliminating any enrollment requirements or repayment conditions.

Whether to save in a TFSA, RRSP or both may depend on your savings needs, your eligibility for income tested benefits and your current and expected future financial situation and income level.

² Amounts withdrawn in a taxation year will be reflected in contribution room in the following year.

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