



TFSA Vs. RRSP

Which is the right savings vehicle for you?

The introduction of the Tax-Free Savings Accounts (TFSA) in 2009 has given investors another savings vehicle to the Registered Retirement Savings Plans (RRSP). However, TFSA's and RRSP's are not meant to be competing products. The primary objective of the RRSP is to set aside funds for retirement, although many of us have found alternative uses for this savings vehicle, for example, funding the purchase of a principal residence, education or supplementing income at times of need. These other savings goals can now be met with the use of a TFSA - it allows individuals to save for those things that the RRSP was not intended for.

Although both plans allow the holder to invest in similar financial instruments and grow the investments tax-free, there are some key differences between an RRSP and a TFSA:

- Contributions to an RRSP are tax-deductible and withdrawals are fully taxable, unless made under the Home Buyer's Plan (HBP) or Lifelong Learning Plan (LLP). Contributions to a TFSA, which are on an after tax basis, do not generate a tax deduction and the withdrawals, including accumulated earnings, are never taxable.
- Once an amount is withdrawn from an RRSP, it cannot be re-contributed to the account unless the individual generates earned income or sufficient carry-forward room is available. There are no such limitations to a TFSA – withdrawals from the account can typically be re-contributed to the plan in the following calendar year.

In a perfect world, individuals would maximize their contributions to both plans, realizing the tax advantages that come with each. The reality is, however, that most Canadians don't have the means to contribute to both an RRSP and a TFSA. For those individuals with financial constraints, the question of where to put their money comes up – TFSA or RRSP?

The short answer is it depends. Consider the following example. It illustrates the difference of a \$1,000 contribution to an RRSP, TFSA and unregistered account for an individual subject to a 40% marginal tax rate. The assumed rate of return is 5.5% (a conservative portfolio) over a 20 year period, at which point the funds are withdrawn.

	TFSA	RRSP	Unregistered savings
Pre –tax income	1,000	1,000	1,000
Tax (40% rate)	400	0	400
Net contribution	600	1,000	600
Investment income (20 years at 5.5%)	1,151	1,918	707
Gross proceeds (net contribution plus investment income)	1,751	2,918	1,307
Tax (40% rate)	0	1,167	0
Net proceeds	1,751	1,751	1,307
Net annual after-tax rate of return (%)	5.5	5.5	*4.0

Source: Morningstar

* assumes a tax rate of 28% on investment income, composed of 30% capital gains, 30% Canadian dividends and 40% interest.

As you can see, at the end of 20 years, the RRSP and TFSA yield identical results. This will always be the case when the marginal tax bracket is the same at the time of withdrawal as with the time of contribution. From a purely financial perspective, the investor in this example should be indifferent as to savings vehicle; however, the flexibility of a TFSA gives it an edge.

Based solely on financial considerations, there are three possible scenarios that could influence one's choice of investment vehicle over the other:

- **Marginal Tax Rate at Contribution is equal to Marginal Tax Rate at Withdrawal**

As already demonstrated, if the individual's marginal tax rate is expected to stay the same for the foreseeable future, there is no clear advantage to choosing an RRSP over a TFSA, or vice versa.

- **Marginal Tax Rate at Contribution is greater than Marginal Tax Rate at Withdrawal**

If we assume that the marginal tax rate at the time of withdrawal is less than the contribution date's, the advantage goes to the RRSP. An example of this situation would be an individual nearing retirement or one who is contemplating a leave of absence from work.

- **Marginal Tax Rate at Contribution is less than Marginal Tax Rate at Withdrawal**

Alternatively, if the marginal tax rate is higher at the time of withdrawal, the TFSA becomes the obvious choice because the RRSP withdrawal would further increase taxable income. A young professional who has yet to realize his/her earnings potential would fall into this category.

The question of investment vehicle superiority is really not the right question to be asking. Both the RRSP and TFSA are excellent savings vehicles and each has its advantages.

A more appropriate question might be – how does either investment vehicle fit into one's short and long-term financial goals? As one progresses through the various stages of the life cycle, there may be strategies that are better suited to his/her situation.

Before implementing a financial strategy, be sure to speak with a financial advisor for an assessment of your individual needs.

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