TFSA or RRSP
Take your pick

WELLINGTON FINANCIAL

Executive summary

Whether you should invest in a Tax Free Savings Account (TFSA) or a Registered Retirement Savings Plan (RRSP) is a question that affects almost every investor, regardless of age or amount of savings. Registered Retirement Income Fund (RRIF) holders cannot also hold RRSPs, but everyone else with income should consider the tradeoffs of these two accounts.

For most, the answer is a bit of both. If you have a looming short or medium-term need (under five years) that will require funds, the untaxed TFSA withdrawals is likely the right choice. For longer term, retirement needs, you'll want to also invest in an RRSP.

What is the difference?

Both RRSPs and TFSAs can contain the same basket of investments whose growth and income are sheltered from taxes. This includes cash and cash-like instruments, GICs, stocks, mutual funds, exchange-traded funds (ETFs), and bonds. However, the two investment options act very differently when it comes time to withdraw funds; RRSP withdrawals are taxed, TFSA withdrawals are not.

Tax Free Savings Account

When you open a first-time, TFSA account you can contribute all of your allowed contribution room at once or disperse contributions throughout the year. Anyone over eighteen years old with a valid Social Insurance Number can open a TFSA.

For Canadians who have become non-residents, or for non-residents who pay Canadian tax, there are additional rules that you should be aware of. If you have foreign citizenship or ties to another country, contact CRA to verify the country's contribution room before making a deposit to your TFSA.

Allowed deposit amounts is readily available from CRA, and avoiding over-contributions is very important as the penalty of one percent of over-contribution per month can prove significant.

An important distinction between TFSAs and RRSPs is that upon a TFSA withdrawal the allowed contribution room is not lost; rather, it remains available in the next calendar year. Many investors will incur over contribution penalties because they innocently payback the withdrawal in the same calendar year, creating to an over contribution. Just wait until after New Years Eve, and you will get your contribution room back.

As of 2016 the lifetime cumulative limit for TFSA contribution was $46,500 per person, and expected to be $52,000 by 2017. Therefore a couple could contribute a total up to $104,000 to TFSAs, and if they earned 5% returns, they could leave them inside the TFSA to grow further, or withdraw them with no tax obligation on the approximately $5,000 in income.

If the $5,000 was earned outside a TFSA in a regular, non-registered account that $5,000 could be subject to a combined Federal and Provincial income tax of 45% or $2,250, leaving only $2.750 free-and-clear (provincial income tax rates and brackets vary by province).

Ideally, the TFSA's inaccessibility through a debit card or online banking, help you end up with a higher account balance and some tax sheltered growth even though there isn't a tax penalty to spending the contents of a TFSA.

Registered Retirement Savings Plan

Each year you can make an RRSP contribution up to eighteen percent of earned income from the previous year, less any pension adjustments. Maximum contributions do exist. For the 2016 tax year, for example, the maximum allowed contribution is $25,370, up from $24,930 in 2015. Unused contribution room can be carried forward to the following year.

Your allowed amount is available from the CRA; you can also find this information on your Notice of Assessment or Notice of Reassessment which the CRA sends after reviewing your annual tax return. In order to be eligible for RRSP contributions, an individual must earn an income and file a tax return.

How do they compare?

RRSPs and TFSAs were created with different goals in mind which explains their different behavior in relation to taxes.

Moneysense.ca explains nicely:

> "With an RRSP, you can deduct the contribution from your income, which earns you a tax refund, but the money becomes fully taxable when you take it out. The TFSA is the reverse: you don't get a tax break on contributions, but you don't pay tax on withdrawals either.
>
> So if you're deciding between the two options, the question boils down to whether you should pay the taxman now or later."[1]

A good guideline to follow is: "If your income (and therefore your tax rate) is greater now than you expect it to be during retirement, go with the RRSP; if it's lower, go with the TFSA."[2]

Most people with a high salary and secure pension plan find more benefit from the TFSA because the pension joined with Old Age Security (OAS) and the Canada Pension Plan (CPP) could potentially increase their income high enough to prompt a claw-back of OAS when they withdraw from RRSPs.

RRSPs however, are the most sensible for the majority of people. Those who don't have large incomes when they retire, can immediately invest the tax refund received and benefit in the long-term from compound interest.

---

[1] http://www.moneysense.ca/retire/the-savings-struggle

[2] http://www.theglobeandmail.com/globe-investor/personal-finance/retirement-rrsps/tfsa-or-rrsp-it-depends/article16792559/

Pros of RRSPs

- Immediate tax benefit
- Funds can be deposited in a Spousal RRSP
- Enforces discipline because tax implications limit when funds can be withdrawn (Only for school or for a first time home purchase)
- At death, RRSPs can be transferred to the surviving spouse, but this election is best made directly with the institution and in a will. Both the institution and the will should contain clear and consistent elections and wording.

Pros of TFSAs

- Funds can be withdrawn from a TFSA at any time without any tax penalties
- TFSA spans a lifetime, does not present any tax liability at death like an RRSP
- Unlike an RRSP, the TFSA cannot be converted to an income plan like an RRIF

Cons of RRSPs

- The investor will have to pay tax upon withdrawal, and a minimum, ten percent withholding at source is required with a maximum thirty percent for larger amounts
- If a withdrawal is made before retirement (and not for a first time house or you or your spouse attending school), the amount will be added to employment income and the increased amount will be subject to income tax
- Withdrawals result in permanent loss of contribution room
- Upon death, the entire balance of an RRSP, valued on the date of death, is considered to be withdrawn converting the entire amount within the RRSP into income on the deceased terminal return (deceased's last tax return for the tax year in which death occurred). If the balance is large enough, it can generate significant tax liability for the surviving spouse

Cons of TFSAs

- Funds can be withdrawn from a TFSA at any time making withdrawals tempting; investors must rely on self-discipline
- Repayments of withdrawals that put an individual over the maximum contribution must wait until the following year or are subject to severe penalties

The bottom line

With so many different options available to us, choosing where to invest your hard earned money can be troublesome. We all know diversity is key for a successful investment portfolio and strategy, and the same holds true for RRSP versus a TFSA; both have important functions within different investment strategies. In an ideal situation, you'll want to utilize both within your portfolio.

If you would like to discuss your options further or clear some confusion, I encourage you to get in touch with me.

For more information contact:

Wellington Financial

350 Speedvale Ave. W. Guelph, ON
519-763-4007

info@wellingtonfinancial.com