IG PRIVATE WEALTH MANAGEMENT

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

The introduction of the Tax-Free Savings Account (TFSA) in 2009 represented the most important change to the way Canadians save money since Registered Retirement Savings Plans (RRSPs) were launched in the 1950s. Now, the question today is: Should you contribute to a TFSA, an RRSP, or both?

01 When choosing between an RRSP or TFSA, you need to understand your personal financial situation and your short- and long-term goals.

02 Consider RRSPs for long-term investments and if you expect to be in a lower tax bracket after retirement.

03 TFSAs may be a better option for short-term goals and can be more tax-efficient if your pre-retirement tax rate is no more than your retirement tax rate.

Both RRSPs and TFSAs provide investors with the opportunity for tax-efficient investment growth. But unlike an RRSP, contributions to a TFSA are not tax-deductible, amounts can be withdrawn tax-free at any time, and withdrawn amounts are added back into your TFSA contribution room the following year.

Which is best?

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

Hold on; not so fast

If only things were that simple! There are a few more factors you should consider. 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 (OAS) pension and the age credit.

On the other hand, if your expected marginal tax rate in retirement is equal to or higher than during your accumulation years, contributing to your TFSA is not always the best approach. 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, thus qualifying for pension income-splitting with your spouse. Other income-splitting strategies such as spousal RRSPs

could 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.

COMPARING THE TFSA TO THE RRSP

REGISTERERED 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 per cent tax-free
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

* Subject to available contribution room.
** Except for repayments of withdrawals under the home buyers' plan or the lifelong learning plan.

So where does this leave us?

An RRSP is definitely a long-term investment vehicle. The taxes and lost contribution room associated with early withdrawals are strong incentives to keep your money invested until retirement.

A TFSA, generally speaking, may be better suited for shorter-term goals, such as an emergency fund or saving for a major purchase, since you pay no tax on withdrawals, and withdrawn amounts are added back into your TFSA contribution room the following year. Although a TFSA can also be a retirement savings tool, because you can easily withdraw those savings (no taxes on withdrawals or loss of contribution room), you must resist the temptation to dip into it prior to retirement to fully benefit from its potential as a source of retirement income.

Remember, there is no one-size-fits-all solution. Your personal savings strategy needs to take into account your unique circumstances as well as your short- and long-term objectives.

Your IG Consultant can help determine what's best for you.

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