MACKENZIE Investments

CONFIDENCE IN A CHANGING WORLD

RRSP or TFSA?

Mackenzie Tax & Estate Planning

The Registered Retirement Savings Plan (RRSP) was introduced in the 1950s as a means for Canadians to save for retirement. Since that time, the RRSP has become a staple of retirement savings largely because of the tax-deferral opportunities it provides. Given that tax-efficiency continues to be a key factor in the accumulation of savings, the federal government introduced the Tax-Free Savings Account (TFSA) as a complement to RRSPs in an effort to improve incentives for Canadians to save.

With its introduction in 2009, the TFSA was described by the federal government as a flexible, general-purpose savings vehicle designed to earn tax-free investment income. It is also considered by many to be "the single most important savings vehicle for Canadians since the launch of the Registered Retirement Savings Plan."

Given these characteristics, many Canadians have been wondering if their savings should be invested in an RRSP or TFSA. In order to address this question, a review of the basic features of each plan is worthwhile.

	RRSP	TFSA
Contribution limit	18% of previous year's earned income subject to a maximum amount[1] plus carry forward of unused room (previous years) plus current year pension adjustment reversal (PAR) less pension adjustments (PAs and PSPAs)	$5,500[2] plus carry forward of unused room (previous years) plus withdrawals from previous year
Unused contribution room	carries forward to future year	carries forward to future year
Taxation	contributions tax-deductible	contributions not tax-deductible
	income tax-deferred	income tax-free[3]
	withdrawals taxable	withdrawals tax-free[3]
Impact on income-sensitive benefits[4]	withdrawals impact benefits	withdrawals do not impact benefits
Withdrawals that are re-contributed require new contribution room	yes	no
Age restrictions	available to age 71; contributions to spousal RRSP allowed after 71 if spouse or common-law partner is younger than 72	available beyond age 17
Eligible investments	cash, mutual funds, stocks, bonds, deposits, GICs, certain small business corporation shares	cash, mutual funds, stocks, bonds, deposits, GICs, certain small business corporation shares

[1] Maximum amount defined by the government each year [2] Increases with inflation periodically
[3] Refers to income tax [4] Federally-sponsored benefits

Recommendation

Do both! If you are able to maximize both RRSP and TFSA, it is generally a good idea to do so. Monies invested would benefit from tax-efficient growth, which generally leads to enhanced portfolios in the future. But what if you can't afford to contribute maximum amounts to your RRSP and TFSA? How do you determine which plan is best for you?

One size doesn't fit all

It is important to understand that there is no one solution that suits every Canadian. Many factors play a role in determining the optimal allocation between RRSPs and TFSAs. Factors to consider include:

Are you investing for the short-term or long-term?

If you are investing for the short-term (eg. saving for a car, vacation, etc.), the TFSA is generally considered the better option. Tax-free withdrawals and the ability to re-contribute withdrawals in a future year without requiring new TFSA contribution room speak to the flexibility of the TFSA. Because RRSP withdrawals are taxable (which serves as a psychological barrier to many when considering access to these plans), and because RRSP contribution room cannot be recovered when amounts are withdrawn, RRSPs are generally used for long-term needs or short-term needs where special access is provided (eg. Home Buyers' Plan or Lifelong Learning Plan).

What is your current tax rate, and what do you expect your rate to be when you need the money?

Tax rates at the time of contribution and withdrawal make a difference. For example, if you are currently taxed at a 45% tax rate and intend to withdraw your RRSP or TFSA while still at a 45% rate, the after-tax amount from each plan would be the same assuming identical rates of return. In other words, from a tax perspective, there is no difference between investing in an RRSP and TFSA when rates of return are the same and tax rates are consistent at the time of contribution and withdrawal.

However, many Canadians expect their tax rate to decrease in the future (eg. retirement), and there are also many Canadians who expect their tax rate to increase in the future (eg. young adults starting out in the workforce). When your tax rate at the time of contribution exceeds your tax rate at the time of withdrawal, RRSPs produce the greater after-tax amount. On the other hand, where your tax rate at the time of contribution is lower than your tax rate at the time of withdrawal, TFSAs provide the greater benefit. The following chart illustrates this concept.

	Same Tax Rate		Low to High		High to Low	
	RRSP	TFSA	RRSP	TFSA	RRSP	TFSA
Pre-tax income	$5,500	$5,500	$5,500	$5,500	$5,500	$5,500
Tax rate at contribution	–	45%	–	20%	–	45%
Tax payable	–	$2,475	–	$1,100	–	$2,475
Net contribution	$5,500	$3,025	$5,500	$4,400	$5,500	$3,025
Growth – 6% over 20 years	$17,639	$9,701	$17,639	$14,111	$17,639	$9,701
Tax rate at withdrawal	45%	–	45%	–	20%	–
Tax payable	$7,938	–	$7,938	–	$3,528	–
Net cash	**$9,701**	**$9,701**	**$9,701**	**$14,111**	**$14,111**	**$9,701**

Worried about income-sensitive benefits?

Benefits such as Old Age Security (OAS), Guaranteed Income Supplement (GIS), Canada Child Tax Benefit (CCTB) and the Age Credit are income-sensitive. This means, as your taxable income grows, you are less likely to receive these benefits. This reduction of benefits (or "clawback") can be considered an added tax for those subject to the clawbacks. While RRSP and RRIF withdrawals are income that can reduce federally sponsored income-sensitive benefits, TFSA withdrawals do not. If you anticipate that your future income might hover near clawback thresholds at a time when withdrawals are likely, it may be better to withdraw from a TFSA.

Can't contribute to an RRSP?

There are many Canadians who simply cannot contribute to an RRSP. A lack of RRSP contribution room may be the result of insufficient earned income, contributions to an employer pension plan (which creates a pension adjustment that reduces RRSP contribution room) or reaching age 71, the year RRSPs must be converted to RRIFs. Other Canadians seek additional tax saving opportunities once RRSP contributions are maximized. TFSAs are a solution. Regardless of employment status, age (other than a requirement to be at least 18), or contributions to employment pension plans or RRSPs, Canadians are currently granted $5,500 of TFSA contribution room each year, subject to inflation.

RRSP better for you? Try this strategy

If you determine that the RRSP is better for you, the TFSA might still help. Because RRSP contributions typically produce a tax refund at tax filing time, the opportunity exists to get a head start on RRSP contributions for the current year, or invest the refund in a TFSA. While both solutions are beneficial, investing in a TFSA allows you to benefit from tax-free (as opposed to tax-deferred) growth that much sooner.

Want more information?

There are many considerations to think about when deciding whether to invest in an RRSP or TFSA. Because each situation is unique, it is generally best to speak with a financial advisor to help with this decision. A financial advisor can help you understand the features and benefits of each plan, and work with you to customize a strategy that is best for you. Work with a financial advisor today to take advantage of tax-efficient investment options available to you.

GENERAL INQUIRIES

For all of your general inquiries and account information please call:

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