

RRSP or TFSA

Your decision depends on many factors

Since its introduction in 2009, the TFSA has proven to be a powerful tool that opens up countless possibilities for improving our finances. However, when it comes to retirement savings, the RRSP should be the default choice for most of us.

Here are some important considerations to help you decide what's best for you.

Tax treatment IN – Tax treatment OUT

The key difference between these plans is what happens on front and back end:

- RRSP deposits are pre-tax, income within is sheltered, and withdrawals are taxable
- TFSA deposits are after-tax, income within is sheltered, but withdrawals are not taxed

If you're depositing to an individual RRSP, any associated refund must also go into your RRSP to keep it intact as 'pre-tax'. For workplace group RRSPs, your employer does this for you through withholding tax.

Base comparison

If your income is taxed at the same rate when contributing to and withdrawing from the investment, your spendable cash will be the same either way.

Using \$100 at a 40% tax rate and a 10% return (to allow for simple arithmetic):

	Deposit amount	Return amount	Taxable amount	Net spendable amount
RRSP	\$100	\$10	\$110	\$66
TFSA	\$60	\$6	n/a	\$66

However, if the withdrawal tax rate is reduced to 30%, the tax on the \$110 in the RRSP will be reduced from \$44 to \$33, netting \$77. On the other hand, if the withdrawal tax rate is 50%, the tax will be \$55, netting to \$55.

So, if you expect your tax rate to be lower when you will be taking withdrawals from this investment, choose RRSP. But if you expect a higher rate later on, choose TFSA.

'Same rate' – Marginal or average?

To assist in comparing rates, keep in mind we have a progressive tax system. That means higher income is taxed at a higher rate. An RRSP contribution gives you a tax deduction at your top marginal tax rate.

On withdrawal in your later years, the appropriate comparison is average rate, which is total tax divided by income. As average rate is mathematically lower than marginal rate, RRSP is usually the default choice.

What's your own expected average rate?

In truth, your RRSP (in the form of a RRIF or annuity draw) will not be your only retirement income. You will have Canada Pension Plan and Old Age Security, and may have a pension, all together forming your foundation income. Thus, the average rate on your RRIF/annuity will be higher than your overall average.

And if you expect your retirement income to exceed the OAS clawback level, that will raise your effective marginal tax rate – that's when it's time to run the numbers through a financial planning spreadsheet!

Default choice, but with flexibility

To repeat, the point here is that RRSP is the default choice, but it could be displaced. Think of it in terms of proportionally allocating savings between them, not an either-or decision. Consider these factors:

Favouring RRSP

Most people live on a lower income in retirement. Spousal pension income splitting can reduce seniors' household tax rate. The pension credit can reduce tax on \$2,000 of RRIF/annuity income.

Favouring TFSA

Savings timeframe is shorter term, not retirement. Contributor is at low bracket at saving age. There are already significant RRSP assets. A large inheritance/winfall is confidently expected

For more information, please consult your financial advisor and tax professional.

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