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Choosing between RRSPs and TFSAs

The great debate for investors

A frequent financial planning question is whether to contribute to a Registered Retirement Savings Plan (RRSP) or a Tax Free Savings Plan (TFSA). With the ratio of Canadian household debt to annual disposable income at a new high, limited resources are forcing many to choose one over the other. Making the decision begins with a basic understanding of each.

RRSPs are designed to promote long-term retirement savings. The maximum annual contribution limit for 2012 is $22,970, with individual amounts varying based on factors such as unused past contribution room. RRSP contributions are tax deductible, and that deductibility offers the greatest benefit when the tax refund is re-invested. Withdrawals are subject to withholding taxes and fees.

TFSAs are savings vehicles that allow contributions up to $5,500 per year (effective 2013) in cash and investments. Unused contribution room can be carried forward indefinitely and never expires. Withdrawals can be made anytime in any amount, without being taxed, and can be fully re-contributed the following calendar year. An individual can fund a spouse's TFSA and the income earned is not attributed back to the partner who provided the funds.

TFSAs make a lot of sense for many young people beginning to save for retirement, as they are still in lower income tax brackets and won't benefit much from the tax deductibility of RRSPs. It may be better to accumulate RRSP headroom until their marginal tax rate is higher.

The funds in TFSAs are also accessed more easily, providing a source of emergency funds. The emphasis is on emergency because the convenience of TFSA withdrawals is a downside for those tempted to withdraw on whimsy rather than absolute necessity.

For investors in higher income tax brackets, RRSPs make sense because their tax deduction is likely at a higher marginal rate than it will be when withdrawals are taxed in retirement. And, RRSP contributions may be used to drop their current taxable income to a lower bracket. Higher income earners are also less likely to have to choose between the TFSA and the RRSP, and may wish to contribute to both and link the benefits.

Assuming the RRSP contribution is fully deductible, a BC investor with an annual income of $100,000 who contributes $22,970 to an RRSP would get a tax savings of approximately $8,317. The refund could be placed into a TFSA, up to allowable limits, to be invested and grow without fear of taxation either now or in retirement, multiplying the positive impact of the original RRSP contribution.

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Both RRSPs and TFSAs can act in an investor's favor, not just as savings vehicles but also from a tax planning perspective. Unfortunately, there isn't a one-size-fits-all answer as to which is best, and the choice really boils down to individual circumstances and time horizons. Whether you have a lot or a little to invest, do your homework and begin as soon as possible to ensure you get the most in tax-free or tax-deferred benefits.

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