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

Key Points:

- When choosing between an RRSP or TFSA, remember to take into account your unique circumstances as well as your short and long-term goals.
- Consider RRSPs for long-term investments, and if you're in a lower tax bracket after retirement.
- TFSAs may be a better option for short-term goals, and can be more tax-efficient if you're in a higher tax bracket.

If you have any questions about choosing between contributing to an RRSP or TFSA, I would be happy to help.

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. But the big question on many people's minds is whether they should contribute to a TFSA, the tried-and-tested RRSP, or possibly even both?

Before shedding some light on this question, let's first understand some of the key differences and similarities between the two investment vehicles.

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But unlike an RRSP, contributions to a TFSA are not tax-deductible, amounts can be withdrawn tax-free at any time, and withdrawn amounts are added back into your TFSA contribution room the following year.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

Hold on; not so fast.

Although it's tempting to settle on a simple rule-of-thumb, the decision to use a TFSA or RRSP is not that simple – your Investors Group Consultant can help you to determine what's best for you.

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 benefit 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, and thus qualifies 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.

So where does this leave us?

Generally speaking, a TFSA may be better suited for shorter-term goals, such as an emergency fund or saving for a major purchase, since there is no tax on withdrawals and withdrawn amounts are added back

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COMPARING THE TFSA TO THE RRSP

REGISTERED 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

* except for repayments of withdrawals under the home buyers' plan or the lifelong learning plan

into your TFSA contribution room the following year. An RRSP is 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. The TFSA can also be a powerful retirement savings tool. However due to the ease with which TFSA savings can be accessed (no taxes on withdrawals or loss of contribution room), only a disciplined investor who can resist the temptation to dip into their savings prior to retirement will 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.

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