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

Determining the best approach.

THE DEBATE OVER WHETHER TO INVEST in a Registered Retirement Saving Plan (RRSP) or a Tax-Free Savings Account (TFSA) comes up every year. Both are excellent tools that allow you to shelter investments from taxes, and both have their place in a well-defined financial plan. Here are some factors to consider as you decide which type of account to save in.

Registered Retirement Saving Plan

RRSPs are generally used for saving for retirement. Contributions are tax-deductible and investments grow tax-free within the account. Both the contributions and investment earnings are taxable upon withdrawal, but the idea is that these withdrawals will happen after retirement, when your income and tax rate are expected to be lower than when you contributed. Withdrawals are included in income and affect eligibility for federal income-tested benefits and tax credits, such as child tax benefits and Old Age Security. Once you withdraw funds from your RRSP, the contribution room is gone for good, unless you do so through a program such as the Home Buyers' Plan or Lifelong Learning Plan.

Tax-Free Savings Account

TFSAs can be used to save for both retirement and shorter-term needs. Contributions are not tax-deductible, but investments grow tax-free inside the account. Amounts withdrawn from a TFSA are not subject to tax and will not affect eligibility for federal income-tested benefits and tax credits. Withdrawals are added back to your available TFSA contribution room in the following calendar year, so there is very little downside to using TFSA savings for mid-sized to large purchases.

Which is right for you?

Lower income

If you are in a low income tax bracket (for example, if you are a student or are on maternity leave), saving in a TFSA may be more advantageous than saving in an RRSP. The RRSP tax savings are less significant, and you may be in a higher tax bracket when you make withdrawals.

Middle income

If you are in a middle income tax bracket, there may not be a clear advantage to using one plan over the other. One strategy would be to contribute to your TFSA now and accumulate RRSP room to be used later, when you're in a higher tax bracket and can optimize the advantage of the tax benefits.

Higher income

If you are in a high tax bracket, you may want to consider using both types of plans. An RRSP may be a better option if your current tax rate is higher than you expect it to be when you withdraw your savings. You'll benefit from a tax deduction when you make your contribution, and withdrawals will be taxed at your lower future rate. You can also use the refund from your RRSP contribution to fund your TFSA.

Talk to your advisor

Whether to save in a TFSA, an RRSP or both may depend on your savings needs, your eligibility for income-tested benefits, and your current and expected future financial situation and income level. Your advisor can help determine the best tax-advantaged investment strategy to help you achieve your goals. ■

COMPARISON OF SAVINGS OPTIONS

	Registered Retirement Saving Plan	Tax-Free Savings Account
Minimum age to own	No	Yes – age 18
Maximum age to own	Yes – end of year you turn age 71	No
Annual contribution limit	18% of your earned income from the previous year, up to a maximum amount (adjusted for certain pension amounts)	Dollar amount per year, indexed to inflation
Carry-forward of unused contribution room	Yes	Yes
Tax-deductible contribution	Yes	No
Monthly penalty on excess contributions	Yes – on excess at month-end. If excess is removed by the end of the month, penalty will not apply for that month	Yes – on the highest amount of excess at any time during the month[1]
Investment options	A variety of investments, such as stocks, bonds, GICs, mutual funds, segregated fund contracts, cash	A variety of investments, such as stocks, bonds, GICs, mutual funds, segregated fund contracts, cash
Tax-deferred/tax-free investment growth	Yes – tax-deferred	Yes – tax-free
Taxable on withdrawal	Yes – fully taxable	No – tax-free, except for growth after death if no successor holder
Withdrawals added to contribution room	No	Yes – but not until the following calendar year[2]
Withdrawals affect federal income-tested benefits and tax credits	Yes	No
Tax-deferred/tax-free transfer to spouse on death	Yes	Yes – if successor holder. Otherwise, value at date of death
Tax-deferred/tax-free transfer to second generation on death	No – fully taxable unless financially dependent	Yes – only investment income after date of death is taxable

[1] Any income attributed to deliberate overcontributions will be taxed at 100 per cent. [2] The withdrawal of amounts in respect of deliberate overcontributions, prohibited investments, non-qualified investments, asset transfer transactions and income related to those amounts does not create additional TFSA contribution room.

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