

## Tax-Free Savings Accounts versus Registered Retirement Savings Plans

In January 2009, the federal government created an additional tax-effective vehicle for Canadians to save called the Tax-Free Savings Account (TFSA). This registered savings account is available to all Canadian residents age 18 and over from all income levels.

In some ways, the TFSA is similar to a Registered Retirement Savings Plan (RRSP) in that investment earnings grow within the account tax-free.

But unlike an RRSP, contributions are made on an “after-tax” basis so you can’t claim these contributions as a tax deduction. On the other hand, withdrawals from a TFSA are tax-free whereas withdrawals from an RRSP are taxable.

Let's compare the details of a TFSA to an RRSP.

	TFSA	RRSP
<b>Contributions</b>	<p>Contributions are made with “after” tax dollars.</p> <p>They aren’t deductible and don’t reduce your income for tax purposes.</p>	<p>Contributions can be made with “before-tax” dollars in an employer-sponsored plan or with “after-tax” dollars when you make a contribution to your RRSP with a financial institution.</p> <p>They are deductible and reduce your income for tax purposes.</p>
	<p>You don’t need to have employment earnings to contribute.</p>	<p>Contributions are made based on your employment earnings or your spouse’s or common-law partner’s employment earnings if they are contributing to a spousal RRSP in your name.</p>
	<p>You can contribute to your spouse’s or common-law partner’s TFSA as long as they have enough contribution room to do so.</p>	<p>You can contribute to your spouse’s or common-law partner’s spousal RRSP as long as you have enough contribution room to do so.</p>
	<p>Your contributions will not impact your net income and so will not impact any Federal income-tested benefits.</p>	<p>Contributions to your RRSP will reduce your current net income.</p> <p>Depending on your income level, this could <i>increase</i> amounts you receive from Federal income-tested benefits and income tax credits such as the Canada Child Tax Benefit (CCTB) and the GST Credit.</p>

	TFSA	RRSP
<b>Contribution Limits</b>	<p>You can contribute to a maximum of \$5,000 per year. This amount is scheduled to increase in the future to take inflation into account.</p> <p>If you don't contribute your maximum amount allowable, you can "carry forward" that amount and it is added to your limit.</p>	<p>Your allowable contribution is the lesser of:</p> <ul style="list-style-type: none"> <li>• 18% of your earned income from the previous year, or</li> <li>• the maximum annual contribution limit for the taxation year (it is \$21,000 in 2009), or</li> <li>• your remaining limit after any company-sponsored pension plan contributions</li> </ul> <p>If you don't contribute your maximum amount allowable, you can "carry forward" that amount and it is added to your limit.</p>
<b>Withdrawals</b>	<p>Both the contributions and the investment earnings are exempt from tax upon withdrawal.</p> <hr/> <p>Amounts withdrawn create an equal amount of contribution room so you can re-contribute them back to your TFSA at a later date.</p> <p>You need to wait until the next year to re-contribute the money.</p> <hr/> <p>Withdrawals aren't considered taxable income.</p> <p>As such, Federal income-tested benefits and income tax credits such as the GST Credit, Old Age Security (OAS) and the Guaranteed Income Supplement (GIS) aren't affected by any TFSA withdrawals.</p> <p>Withdrawals don't reduce these benefits.</p>	<p>Both the contributions and the investment earnings are taxable upon withdrawal. They are added to your income and taxed at current rates.</p> <hr/> <p>If you make a withdrawal from your RRSP, this contribution room is lost.</p> <hr/> <p>Withdrawals are considered taxable income.</p> <p>They could reduce amounts you receive from Federal income-tested benefits and income tax credits such as the GST Credit, Old Age Security (OAS) and the Guaranteed Income Supplement (GIS).</p> <p>So RRSP withdrawals could reduce your post-retirement government benefits.</p>

	TFSA	RRSP
<b>Home Buyers' Plan (HBP)</b>	<p>You can withdraw an unlimited amount of funds at any time to buy or build a house.</p> <p>There is no requirement for you to repay it to your TFSA and withdrawals aren't considered taxable income.</p> <p>Amounts withdrawn will create an equal amount of contribution room so you can re-contribute them back to your TFSA at a later date.</p>	<p>The HBP is a program that allows you to withdraw up to \$20,000 in a calendar year from your RRSP(s) to buy or build a home. No tax is payable on withdrawal.</p> <p>You have to repay all withdrawals to your RRSP(s) within a period of no more than 15 years.</p> <p>Any amount that you don't repay when it is due will be included in your income for the year it was due.</p>
<b>Lifelong Learning Plan (LLP)</b>	<p>You can withdraw funds at any time to finance full-time training or education.</p> <p>There is no requirement for you to repay it to your TFSA and withdrawals aren't considered taxable income.</p> <p>Amounts withdrawn create an equal amount of contribution room so you can re-contribute them back to your TFSA at a later date.</p>	<p>The LLP allows you to withdraw up to \$10,000 in a calendar year (to a maximum of \$20,000 in total) from your RRSP(s) to finance full-time training or education for you, your spouse or common-law partner. No tax is payable on withdrawal.</p> <p>You have to repay these withdrawals to your RRSP(s) over a period of no more than 10 years.</p> <p>Any amount that you don't repay when it is due will be included in your income for the year it was due.</p>
<b>Eligible Assets</b>	A TFSA can generally hold the same assets as an RRSP, including bonds, publicly traded stocks, mutual funds and GICs.	An RRSP can hold bonds, publicly traded stocks, mutual funds and GICs.
<b>Collateral for a loan</b>	You can assign the assets of a TFSA as collateral for a loan.	You can't assign the assets of an RRSP as collateral for a loan.
<b>Maximum Age</b>	You can contribute to a TFSA after the age of 71.	You can't contribute to an RRSP after the age of 71. Accounts must be collapsed at the end of your 71st year.

## So which is the better choice? A TFSA or an RRSP?

Let's meet Peter. Peter is single, lives in Saskatchewan and currently earns \$40,000 per year. He expects to have 70% of his current income (adjusted for inflation) during retirement. Given his income level and the broad tax brackets in his province, he can expect to face a 26% tax rate both now and during his retirement.

	TFSA	RRSP	
Amount saved	\$1,000	\$1,000	RRSP is deposited with "before" tax dollars
Tax to pay now (26%)	<u>260</u>	<u>0</u>	
Net amount deposited	\$740	\$1,000	Value of both increases by 5% per year with investment return
Value in 25 years	\$2,506	\$3,386	
Tax to pay on withdrawal	<u>0</u>	<u>880</u>	26% tax is payable on the RRSP withdrawal
After tax value	<b>\$2,506</b>	<b>\$2,506</b>	

### Assumptions:

- Income is not in the range where RRSP contributions or withdrawals impact any government benefits.
- Investment rate of return is 5% per year from year of contribution to year of withdrawal.

✓ So for Peter, using a TFSA or RRSP would result in the same income in retirement.

Now let's meet Sonia. Sonia lives in Alberta where she earns \$94,000 each year. She plans to replace 80% of her current income in retirement (adjusted for inflation). Her current tax rate is 36% and that tax rate expected to fall to 32% with her reduced income in retirement. Her income during retirement falls in the range where the Old Age Security (OAS) clawback can be expected to apply.

	TFSA	RRSP	
Amount saved	\$3,000	\$3,000	RRSP is deposited with "before" tax dollars
Tax to pay now (36%)	<u>1,080</u>	<u>0</u>	
Net amount deposited	\$1,920	\$3,000	Value of both increases by 5% per year with investment return
Value in 10 years	\$3,127	\$4,887	
Tax to pay on withdrawal	<u>0</u>	<u>1,564</u>	32% tax is payable on the RRSP withdrawal
Value after income tax	\$3,127	\$3,323	The RRSP withdrawal attracts the OAS clawback
Old Age Security (OAS) clawback	<u>0</u>	<u>498</u>	
Value after tax and benefit clawbacks	<b>\$3,127</b>	<b>\$2,825</b>	

### Assumptions:

- OAS clawback applies to RRSP withdrawal of \$4,887 at a clawback rate of 15% which is \$733 before tax or \$498 after tax.
- Investment rate of return is 5% per year from year of contribution to year of withdrawal.

✓ For Sonia, she will receive more income in retirement by using a TFSA.

And finally here is Marc. Marc and Susan are married and live in Ontario. He earns \$45,000 and she earns \$40,000. They both plan to have 60% of their respective current income (adjusted for inflation) during retirement. Their children are now grown. He currently faces a tax rate of 31.1% but during retirement, the tax rate can be expected to be approximately 21% due to his lower income at that time.

	TFSA	RRSP	
Amount Marc saved	\$2,000	\$2,000	RRSP is deposited with "before" tax dollars
Tax to pay now (31.1%)	<u>622</u>	<u>0</u>	
Net amount deposited	\$1,378	\$2,000	Value of both increases by 5% per year with investment return
Value in 15 years	\$2,865	\$4,158	
Tax to pay on withdrawal	<u>0</u>	<u>873</u>	21% tax is payable on the RRSP withdrawal
Value after income tax	\$2,865	<b>\$3,285</b>	

**Assumptions:**

- Marc will receive the full OAS benefit since his income is well below the level where he might attract the OAS clawback seen in the previous example.
- His combined family income with Susan leaves them above the level where they might expect to receive any government paid GST benefit or Guaranteed Income Supplement (GIS) benefit during retirement. As such, use of RRSPs will not impact Marc's income-tested benefits.
- Investment rate of return is 5% per year from year of contribution to year of withdrawal.

Marc will be better off if he invests in an RRSP for retirement.

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Ideally, it would be great if you could make full use of both your RRSP and TFSA! But most Canadians can't afford to.

If you have to choose, you should consider your tax rate when contributions are made and your tax rate when you make your withdrawal(s) as well as the impact on any government income-tested benefits.








**TFSA vs. RRSP calculator**

Considering the appropriate tax rate for your province and the appropriate benefit clawback rules requires gathering figures from several sources and then doing the calculations.

RetirementAdvisor.ca has developed a TFSA vs. RRSP calculator which can be found at [www.retirementadvisor.ca/tfsa-rrsp](http://www.retirementadvisor.ca/tfsa-rrsp). The calculator takes into account your individual circumstances including your province, income and family situation and then tells you whether a TFSA or RRSP works out better for you financially.

## TFSA vs. RRSP by Income Range

Here is a summary of income ranges when a TFSA and/or an RRSP is more financially beneficial. This table assumes that your retirement income will be approximately 70% of your income during working years, after adjusting for inflation.

Income Level	TFSA Advantage	Equal	RRSP Advantage	Explanation
Now: over \$180,000 Retired: over \$126,000				When you are in the top tax bracket through the end of retirement, TFSA and RRSP are financially equivalent.
Now: \$150,000 - \$180,000 Retired: \$107,000 - \$126,000				When retirement income is in this range and all OAS will be clawed back, the small drop in tax rate on retirement gives RRSP the advantage.
Now: \$95,000 - \$150,000 Retired: \$66,000 - \$107,000				When retirement income is in the OAS clawback range (\$66,000 to \$107,000), the heavy clawback rate on RRSP withdrawals gives TFSA the advantage.
<i>With 2 or more dependent children:</i>  <i>Single</i> Now: \$25,000 - \$95,000 Retired: \$15,700 - \$95,000  <i>Married</i> Now: \$30,000 - \$95,000 Retired: \$20,700 - \$95,000				For those with two or more dependent children at the time of contribution, the RRSP has the advantage for most or all of the \$25,000-\$95,000 income range with some variations by province. The reason is the enriched Child Tax Benefits for which you will be eligible.
<i>With 0 or 1 dependent children:</i>  <i>Single</i> Now: \$25,000 - \$95,000 Retired: \$15,700 - \$95,000  <i>Married</i> Now: \$30,000 - \$95,000 Retired: \$20,700 - \$95,000				If you have no dependent children or only one at the time of contribution, then the results are mixed in the \$25,000-\$95,000 income range. The TFSA vs. RRSP calculator mentioned earlier is the best way to determine which choice is more financially advantageous in your circumstances.
<i>Single</i> Now: under \$25,000 Retired: under \$15,700  <i>Married (combined income)</i> Now: under \$30,000 Retired: under \$20,700				If you will be eligible for GIS during retirement (single is under \$15,700 and married is under \$20,700 combined) then avoiding GIS clawbacks by saving in a TFSA is the best choice.

## Conclusion

This article has outlined the respective rules for a TFSA and an RRSP. The two differ in many important ways. It's worth emphasizing that a financial comparison of TFSA versus RRSP is one important consideration when making a choice between the two. It is also important to remember that the TFSA is a very flexible tool with fewer restrictions than an RRSP.