WHY A TAX-FREE SAVINGS ACCOUNT MAY BE BETTER THAN AN RRSP

Three key considerations before you invest

With a Tax-Free Savings Account, your money can grow tax free, and you can withdraw the money at any time without penalty, and without paying income tax. With a deposit into your RRSP account, you can get a tax refund and your money can grow tax-free. However, when you withdraw your money, you will have to pay income tax. It is not always obvious which account will actually result in more money in your pocket.

There are three key factors that may help investors decide what is best:

1) Marginal tax rates when contributing vs. marginal tax rates when withdrawing.
2) Your use of the RRSP tax refund.
3) Other considerations of personal circumstances.

Marginal tax rates when contributing vs. marginal tax rates when withdrawing

Most people assume that they will be in a lower tax bracket when they retire, since they will be making less income than while they were working. If this is true, it seems that investors would be better off with RRSP's. However, upon further examination this is often not true because of government clawbacks on benefits to seniors. The main clawbacks on seniors are on the Guaranteed Income Supplement and Old Age Security and they have a significant impact on income for many seniors. Unlike RRSPs, TFSAs do not mature into RRIFs whose forced withdrawals raise income.

If, for example, your marginal tax rate is 35 per cent today and 30 per cent in retirement then the clawback of your Old Age Security benefits alone would have the same impact as adding 10% to your tax rate. Effectively your marginal tax rate increases to 40 per cent in retirement from 35 per cent in your working years. OAS payments start to be clawed back when your annual retirement income reaches about $67,000 in today's dollars. Investors may use TFSAs as a way to stay below this threshold during retirement. There are no forced taxable withdrawals as is the case with RRIFs.

Money withdrawn from a TFSA is tax-free, so it won't add to your other sources of retirement income and increase your taxable income to a level where the OAS clawback is a factor. RRSP withdrawals represent taxable income, so they have just the opposite effect.

Your use of the RRSP tax refund

Getting a tax refund is the main reason many Canadians contribute to an RRSP. However, if you spend the tax refund and do not use it as a contribution then you would be far better off with a TFSA. The TFSA is also a better choice because it can be invested January 1, whereas, the RRSP refund will be received then invested only after your tax filing date and has less time to grow as a result.

	Investment	Refund 40%	Growth 5%/20 yrs	Withdrawal tax 40%	Net cash
RRSP	$5500	$2200	$14593	$5837	**$8756**
TFSA	$5500	$0	$14593	$0	**$14593**

The table above shows that spending a $2200 RRSP refund results in a future tax penalty as opposed to investing the same $5500 in a TFSA. The investor is better off with the TFSA.

Other considerations of personal circumstances

Canadians have a wide variety of personal circumstances which may influence if they are better off in a TFSA than an RRSP. Each investor has individual objectives, plans and a unique financial situation. Young investors may plan to purchase a car or their first home. Others may require a source of emergency funds for unexpected expenses. High income investors may need to shelter returns on investments. Some may need to reduce income to avoid government clawbacks such as Old Age Security, GST Credit and Canada Child Tax Benefit.

Summary

RRSP can be better for investors with...	TFSA can be better for investors with...
• Reasonable working income and modest retirement savings or pension. • High working income (over $120,000). • Impulsive spending habits that want to curb their temptation to withdraw. • High RRSP unused contribution room and a corresponding high level of income.	• Reasonable or high working income with generous retirement savings or pension. • Low working income (under $37,000/year). • Reasonable or high working income with very little retirement savings or pension. • A habit of spending their RRSP refund. • Need the flexibility to access funds. • No additional RRSP contribution room and a need to shelter further investment gains. • A need to reduce the chance of clawback of government benefits.

Ideally most Canadians should have both an RRSP and a TFSA and the plan you contribute to may change from time to time depending on your income or purpose for building wealth. If you have money to invest on which you are earning investment income, then maximize your TFSA, subject to your decision about RRSPs. If you can maximize your RRSP and still fund your TFSA, then do both.

For more detailed information on TFSA investing and how it can help you reach your financial goals please contact:

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