TFSA or RRSP, What's the Difference?

Two questions clients commonly ask are how exactly a Tax-Free Savings Account (TFSA) differs from a Registered Retirement Savings Plan (RRSP) and, more importantly, which one they should prioritize. With the similarities between them, we can understand the confusion that arises when discussing their merits.

Both plans can offer tax advantages and opportunities for growth when used *correctly*. The downside many fail to recognize is that if they are misused, there's a chance you may end up paying more in taxes. This probably goes without saying, but whittling down your retirement savings and cracking your nest egg is the last thing we suggest.

Today we'll be going over some of the basics: how to best use both options and which pitfalls to avoid.

What is a TFSA?

Originally introduced in 2009 near the tail end of the recession, the TFSA is intended for you to save and invest on a tax-free basis – it is in the name, after all. What is often forgotten (or outright unknown to most) is that the TFSA's second use is as a flexible account that can be used as an investment vehicle to grow your wealth.

Unlike the RRSP, there are no initial tax breaks for contributing to a Tax-Free Savings Account. Funds can be withdrawn at any point, and no matter how much it grows you will almost never be put in a position where it will be taxed. One caveat to consider is that if your day trading activity scales to the point of being labelled as a business, typical tax regulations will be applicable.

There are a few drawbacks to consider, which we're hesitant to refer to as such. You cannot go over your annual contribution limit, and should you choose to withdraw from the account, those funds cannot be replaced until January 1st of the following year. In other words, your annual TFSA contribution room is exclusively additive, not cumulative.

For any Canadian resident 18 years of age or older, the maximum lifetime contribution limit is $81,500 in 2022, which is growing at an annual rate of $6,000.

What is a RRSP?

Introduced in 1957 as part of the Canadian Income Tax Act to help citizens save for retirement, this plan exhibits different contours than the TFSA.

At first glance, one of the major draws is the fact that you can claim a tax deduction for contributions made. As a rule of thumb, there's a direct relationship between your total income and the size of the tax break in question.

To flesh this concept out, if you earn $175,000 annually, your marginal tax rate should be close to 50%. If you were to put $10,000 towards your RRSP in a situation like this, it would reduce your overall taxes for the year by around $5,000 – a tidy sum to stow away.

At a different income level, if your annual income was around $70,000 that tax rate would drop to around 30%. That same contribution of $10,000 would then only qualify for a tax deduction of $3,000. While not as impressive as the previous example, it's still nothing to scoff at.

Total Income	Marginal Tax Rate	Contribution	Tax Break
$175,000	~50%	$10,000	$5,000
$70,000	~30%	$10,000	$3,000
SOURCE: https://www.taxtips.ca/taxrates/on.htm			

Similarly, a Registered Retirement Savings Plan can also be used as an investment account – albeit not as efficiently as the TFSA. The downside is that an RRSP can be invested in on a deferred basis, but at the end of the line, any withdrawals made are subject to taxes in the year they are made.

Typically, this plan is meant to be built up throughout your working years. It encourages taking advantage of being in a higher tax bracket and withdrawing from it once your income slows to a lower bracket. You can think of it as a form of deferred self-payment.

Which one is the better option for you?

Although it would be difficult to provide a cut-and-dry answer to this question, there seems to be consensus on the RRSP being the better option for individuals with an income north of $50,000 a year. The reason is that it grants the ability to take advantage of tax brackets as you shift through them in life. With an annual income of $50,000 and a marginal tax rate of 30% when setting capital aside, it becomes increasingly more attractive to withdraw during retirement when the marginal rate has dropped to 20%. In this situation, you have theoretically saved 10% in taxes.

As a simpler way to conceptualize this idea – the larger your income is *now* should be compared to what your expectations of it are when you want to make withdrawals in the *future*. The bigger that difference, the more efficient the RRSP becomes in terms of tax management.

Mind you, it is largely circumstantial to decide which route is most suitable. Here are a few to consider:

- If you anticipate needing the funds in the near future (more specifically, something *not* for retirement) then a TFSA may be a better fit for your needs. Bear in mind that first-time home buyers don't necessarily fall into this category.
- If you anticipate an increase in your annual income in the next few years, it could be beneficial to defer contributing to your RRSP in the meantime. Doing so will allow you to carryover the contribution limit to your high-earning years and maximize your tax reductions.
- If you own real estate investment properties that you're looking to sell, they could incur capital gains. Keeping some space in your contribution limits may help mitigate these taxable events.

One of our personal favourite strategies to grow your retirement savings is to move your capital between accounts effectively. One of these tactics involves maximizing your RRSP contribution, receiving a large refund, and then pushing that break right into your TFSA. A move like this can let your money work for you on both ends: your RRSP is set aside for your retirement down the line, and you still have access to the more flexible TFSA funds.

Many people struggle to map out exactly when they plan on pulling from their savings accounts. Thankfully, a Family Wealth Advisor can help you establish a financial plan custom-tailored for you, your current needs, and your future aspirations to get the most mileage out of your RRSP and TFSA options. If you're interested in learning more – or to reassess how you can best manage these two incredible options – you can always reach out to our office for a free portfolio review.

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