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Investing - RRSPs or TFSAs - Which is 'Best'?

In 2009, the federal government introduced the Tax Free Savings Account or TFSA to great fanfare. The TFSA is a welcome addition to the savings landscape and joins the traditional RRSP as a tax-effective way of saving for the future. A reasonable question being asked by many investors is which is 'better' and right for them? The subjective term 'better' is not really appropriate since the two investment vehicles are quite different and those differences must be appreciated before you can determine which is best.

TFSAs and RRSPs both allow tax-free growth for investments, but with an RRSP you get a tax break up front through tax deductions and pay full tax on withdrawals. With the TSFA, you contribute after-tax funds but pay no tax on withdrawals. If your Marginal Tax Rate (MTR) remains the same at the time of contribution as at the time of withdrawal, it can be mathematically shown that there is no difference between the plans. In a simple example:

	RRSP	**TFSA**
Amount Contributed *	$1,818	$1,000
Reinvested Refund (45% MTR)	($ 818)	
After-Tax Contribution	$1,000	$1,000
Compound Growth over 20 years @ 6% annual return	$5,831	$3,207
Tax on Withdrawal @ 45%	($2,624)	
Net Return	**$3,207**	**$3,207**

This example makes the assumption that an additional amount is contributed initially but when the investor receives the refund of $818, their after tax cash contribution is $1,000.

While the example above assumes a constant Marginal Tax Rate (MTR) of 45% for both the tax effect of the RRSP and the TFSA withdrawal, it follows that if your MTR is lower at the time of withdrawal than at the time of contribution then the RRSP will result in a higher net return. If the MTR at the time of the RRSP contribution remains at 45% and the MTR at the time of withdrawal is 35% then the following occurs:

	RRSP	TFSA
Amount Contributed *	$1,818	$1,000
Reinvested Refund (45% MTR)	($ 818)	
After-Tax Contribution	$1,000	$1,000
Compound Growth over 20 years @ 6% annual return	$5,831	$3,207
Tax on Withdrawal @ 35%	($2,041)	
Net Return	**$3,790**	**$3,207**

However, there are other considerations:

Reinvestment of RRSP Refund

In the table above, it is assumed that you will use the tax refund received to make an additional contribution to the RRSP. In many (perhaps most) cases this will not happen since tax refunds received are often viewed as a bonus and used to pay for a vacation, flat screen television, etc.

Psychological Factors

RRSPs are viewed as long-term investment vehicles and are subject to full taxation which makes people hesitant to draw on those funds. TFSA withdrawals, on the other hand, are not subject to tax which makes withdrawals far easier to contemplate. Consequently, RRSP contributions are probably more likely to be left intact to be available in retirement.

Clawbacks of Government Benefits

RRSP withdrawals are treated as earned income for tax purposes which may negatively impact government benefits such as Old Age Security and the Guaranteed Income Supplement. This is not the case with TFSA withdrawals which may have a bearing on the amount of money an investor would want in a particular plan when planning for future withdrawals.

As you can see, various factors must be considered when looking at RRSPs and TFSAs to determine which is ‘best’. In an ideal situation, the prudent investor with the financial means would contribute the maximum to both plans and hopefully you are one of those lucky people. Others may not be able to make RRSP contributions. This would apply to those over the age of 71 or those who do not have available RRSP contribution room due to tax-sheltered contributions to other plans such as registered pensions. For these people, TFSAs are the obvious choice.

Ask your Advisor whether an RRSP or a TFSA is better for your situation.

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