

TFSA vs. RRSP

There has been much written about the uses, differences, and benefits of Tax Free Savings Accounts (TFSAs) and Registered Retirement Savings Plans (RRSPs), but the reality is that each of these investment vehicles is unique in structure, and each personal situation needs to be analyzed to determine which way to invest your hard earned investment dollars.

The major difference between TFSAs and RRSPs is their tax consequences. An investor needs to pay attention to their own marginal tax rate when contributing and the marginal tax rate when withdrawing the funds.

The other main issue that should be addressed is how an RRSP investor plans to use their tax refund. If the refund is to be used to pay down debt, purchase a vacation, or reinvest, then the difference in accumulation will be different at the end of the planning session.

The other question that must be addressed is what is the overall purpose for the investment dollars? If it's for short term, to buy a new vehicle, then hands down use a TFSA. But if it is for short term to buy a house, an RRSP may be the better option under the Home Buyers Plan that allows a first time home buyer to withdraw up to \$20,000 tax free from an RRSP, with a 15 year repayment schedule.

Regulations also allow RRSP money to be withdrawn from an RRSP to go back to post-secondary education under the Life Long Learning plan. Therefore length of time to invest, and potential uses of those investment dollars will also have a determining factor into what product would suit the situation best.

Over the last 25 years, I have had many retirement planning sessions with clients where RRSP assets are projected to create potential future tax liabilities that can be substantial.

These tax liabilities are the result of Canadians focusing on accumulating RRSP assets (\$33.3 billion in contributions last year, and 6.2 million Canadians currently hold \$631 billion in RRSP's) but not being so diligent in accumulating (tax paid) non registered investments for retirement.

Investors need to realize that having a large RRSP at retirement could potentially mean substantial income tax on retirement income and especially upon death. Having a modest RRSP and the rest of their investment dollars in a TFSA would dramatically increase the planning opportunities for the client and in effect dramatically lower the tax paid in their retirement years.

Being forced under the current RRIF legislation to withdraw percentages every year from their RRIF makes clawbacks on Guaranteed Income Supplement, and Old Age Security, a harsh reality that needs to be looked at as additional tax on retirement income.

By having a modest RRSP portfolio and keeping the retirement income down at around \$30,000, and supplementing the income with tax paid TFSA dollars should be the goal for most investors.

Having built up a large TFSA means flexibility, choice, and lower taxes in the future. Take for example the retired couple who need \$4,000 per month in living expenses, but want to take a major vacation every two years, costing \$15,000. That in effect would mean, if they withdrew that from their RRSP, they would have to withdraw \$23,000 before tax, to have \$15,000 after tax for the vacation.

Also as a result of the higher income that year, the next year's Old Age Security could face some clawback, forcing the retired couple to withdraw more from their RRSPs to pay next years living expenses.



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Dale Berg, CLU, Ch.F.C., CFP is a Senior Financial Advisor with Regency Advisory Corporation.

	TFSA	RSP
New contribution room created each year	\$5,000*	18% of previous year's earned income, less any pension adjustment, up to the maximum annual RSP contribution limit for the year
Carry-forward of unused contribution room	Unused contribution room carried forward indefinitely	Unused contribution room carried forward until the year in which you turn 71
Need earned income to contribute?	No	Yes
Ability to make contributions	No maximum age	Until the end of the year in which you turn 71
Are contributions tax-deductible?	No	Yes, reduces taxable income
Do savings grow tax-free or tax-deferred?	Tax-free (never taxed)	Tax-deferred (not taxed until withdrawn)
Tax implications of withdrawals	Withdrawals are tax-free	Withdrawals are added to your taxable income in the same year the funds are withdrawn
Can I withdraw savings for any reason?	Yes, at any time (depending on what you invest in)	Yes, although the amount of withdrawal is considered earned income and taxes are withheld at the time of the withdrawal (unless participating in the Home Buyer's Plan or Lifelong Learning Plan)
Do withdrawals affect contribution room?	Amount of withdrawals are added to contribution room starting the following calendar year	No, as contributions are based on previous year's earned income
Do withdrawals affect government benefits?	Income earned and withdrawals will not affect eligibility for income-tested government benefits and tax credits.	Withdrawals could affect eligibility for income-tested federal government benefits and tax credits since withdrawals are considered taxable income
Are there over-contribution penalty tax?	Yes; excess contributions subject to a penalty tax of 1% per month.	Yes; excess contributions are subject to a penalty tax of 1% per month. Penalty tax only applies if you exceed the \$2,000 lifetime over-contribution amount
Am I required to convert my plan at a certain age?	No	Yes — must convert an RSP to a maturity option such as a RIF or an annuity by the end of the year you turn age 71 or choose to close the plan.

Take the same retired couple with a TFSA. They could easily access the cash every two years without affecting their tax situation and not jeopardize their Old Age Security payments. Again, TFSA will provide flexibility and choice at retirement. Many financial professionals have regarded the TFSA as the best improvement in retirement planning for at least 50 years, and in the first six months of 2009, about 3.6 million people set up TFSAs totaling about \$12.4 billion. Enclosed is a detailed chart that should help readers better understand the differences and similarities between the registered plans.

To summarize, the majority of Canadians should not get caught in a trap of which investment vehicle will be "better." The reality is 80% of investors should be using a combination of a TFSA and RRSP to give them financial security, choices and options.

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