TFSA vs. RRSP's

The question is: are TFSAs better than Registered Retirement Savings Plans (RRSPs) when it comes to retirement savings?

First, let's recap how the RRSP works: you can contribute 18 per cent of your earned income up to the year's maximum (currently $20,000 for 2008, and $21,000 for 2009). If you don't maximize your contribution in any one year, the unused portion carries forward and gets added to your maximum for the subsequent year.

The amount you contribute to an RRSP can be deducted from your income when you fill out your tax return form, saving you the marginal taxes you would have paid on your contribution amount. If you withdraw money from your RRSP, that amount will be added to your income in the year of withdrawal but won't pay tax on the return you earn while your money remains in your RRSP. Therefore the main characteristic of the RRSP is that it gives you a tax deduction for contributions, but you'll have to pay tax later when you take the money out.

On the other hand, the TFSA allows you to contribute up to $5,000 per year regardless of income, starting in 2009. You will NOT get a tax deduction for the contribution you make BUT there will not be any tax to be paid when your take your money out either. In very simple term, it is the complete opposite of an RRSP: no deduction and no tax.

So which is best for your retirement needs? In general, most Canadian earnings place them in a higher tax bracket now than they will be after retiring. That makes the RRSP a better choice for most Canadian to build up their retirement savings.

Let's look at this with actual numbers. You currently have an income of $45,000 a year and do not have a pension plan. Would you be better off putting $5,000 in to a TFSA or more than $7,000 in an RRSP?

You see, when evaluating both options, you must compare apples to apples. Your $5,000 contribution to a TFSA will cost you $5,000. However, that same amount of after-tax money invested in an RRSP will get you a much larger contribution, slightly over $7,000!

Almost anywhere in Canada, an annual salary of $45,000 will put you in the 29 per cent tax bracket which means that you can make an RRSP contribution of between $7,000 and $8,000 for a total cost of $5,000 after tax saving. Assuming that you save regularly for 20 years, and that you purchase the exact same investments within the TFSA or the RRSP with an average return of 6 percent, which will be more profitable: depositing $5,000 annually in the TFSA or $7,000 in an RRSP?

With the TFSA, you could end up with tax-free money worth almost $184,000. Meanwhile, with the RRSP, your savings would amount closer to $259,000. The fact that you would have to pay taxes when you withdraw money from your RRSP would be offset by the more than 41 per cent more capital you would have gained along the way. What you need to remember here is that the TFSA is perfect for emergency savings or expenses planned for the near future. But for the average Canadian earning $45,000 a year and qualified for the maximum benefits, the monthly Canada Pension Plan payment at age 65 will be only slightly above $900 with the monthly Old Age Security cheque totaling $516.96. Deductible contributions to an RRSP are what you need to ensure the best retirement savings strategy.

Keep in mind that this scenario applies to a person earning $45,000 per year. For higher income earners that are able to max out their RRSP contribution and for lower income earners it is a different story. I will discuss this in later postings.

If you have any questions about this topic or wish to find out how this would apply to your personal investment plan, call me toll free at 1-866-860-4190 with your questions.

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