RRSPs and TFSAs

February is usually the month in which Canadians wrestle with the question of whether and in what amount to make an RRSP contribution before the contribution deadline. This year, for the first time, the annual question is complicated by the additional choice of contributing to the new tax-free savings account (TFSA).

It's important to be clear, at the outset, that it's not an either-or choice. Taxpayers can (and probably should) utilize both the RRSP and TFSA options in planning their financial affairs. Realistically, however, for most taxpayers the limitation is one of resources and cash flow, and it's often not possible to fund contributions to both an RRSP and a TFSA in the same year (particularly given current economic conditions), let alone in the same month. That said, what are the considerations that apply in determining which savings or investment vehicle is preferable for 2009?

There are some similarities between TFSAs and RRSPs. Both allow savings to grow and compound free of current tax, and for both, contributions not made in a year can be carried forward and made in any subsequent year. As well, the types of investments that can be made with RRSP or TFSA contributions are, for all intents and purposes, the same, meaning that one's choice of investment (i.e., GICs, mutual funds, bonds etc.) should be irrelevant to the choice of RRSP vs. TFSA. However, the differences between the two savings vehicles are at least as significant as their similarities.

Perhaps most important to taxpayers, contributions made to an RRSP are deductible from income, resulting in a lower tax bill for the year of contribution and, for many taxpayers, a tax refund. Contributions to a TFSA are, on the other hand, made with after-tax funds, meaning that tax will already have been paid on the income used to make those contributions. However, when funds contributed (along with investment income earned on those funds) are withdrawn from the plan, the tax consequences are very different. Funds withdrawn from an RRSP (or from an RRIF into which the RRSP has been converted) are fully taxable, without exception, at whatever tax rate applies to the taxpayer at the time of withdrawal. TFSA funds (including accumulated investment income) are withdrawn from the plan free of tax, regardless of when the withdrawal is made or the purpose to which the funds are put. And for taxpayers who are receiving Old Age Security benefits (or any other means-tested benefits) from the federal government, it's important to note that RRSP or RRIF funds withdrawn will be included income for the purpose of determining eligibility for such benefits, while TFSA funds will not be. Finally, while RRSP contributions for 2008 must be made by March 2, 2009, there is no similar deadline for TFSA contributions – they can be made at any time during the calendar year. Finally, when funds are withdrawn from a TFSA, the planholder can "top up" the TFSA in any following year by the amount of the withdrawal.

For taxpayers over the age of 71, the RRSP vs. TFSA question is simply irrelevant. Taxpayers over that age are not eligible to make contributions to an RRSP, making TFSAs the only tax-free savings vehicle to which they can make contributions. In fact, the federal government estimated, when it introduced TFSAs in the 2008 federal Budget, that based on current savings patterns, half of the savings that will be realized through the use of TFSAs will be received by seniors.

The benefit is greatest for older taxpayers whose required RRIF withdrawals are greater than their current needs. While such RRIF withdrawals must be included in income and taxed in the year of withdrawal, transferring the funds to a TFSA will allow them to continue compounding free of tax, and no additional tax will be payable when and if the funds are withdrawn. In addition, monies withdrawn from a TFSA will not affect the planholder's eligibility for Old Age Security benefits or for the federal age credit.

For younger taxpayers, where the savings goal is short term – for example, a down payment on a home or paying for next year's vacation – the TFSA is clearly the better choice. While choosing to save through an RRSP will provide a deduction on that year's return and probably a tax refund, tax will still have to be paid when the funds are withdrawn from the RRSP a year or two later. More significantly from a long-term point of view, using an RRSP in this way will eventually erode one's ability to save for retirement, as RRSP contributions that are withdrawn from the plan cannot be replaced. While the amounts involved may seem small, the loss of compounding on even a small amount over 25 or 30 years can make a significant dent in one's ability to save for retirement.

Taxpayers who are expecting their income to rise significantly within a few years – for example, students in post-secondary- or professional-education programs – can save some tax by contributing to a TFSA while they are in school and their income (and therefore their tax rate) is low, and then withdraw the funds tax free once they're working, when their tax rate will be higher. At that time, the withdrawn funds can be used to make an RRSP contribution, which will be deducted against income that would be taxed at the much higher rate, generating a tax savings. And if a need for the funds should arise in the meantime, a TFSA withdrawal can always be made.

Financial planners and tax advisers are accustomed to being asked by clients at this time of year whether it makes more sense to pay down the mortgage (or other debt) or to contribute to an RRSP. This year, the question is likely to be, RRSP or TFSA? As with the mortgage vs. RRSP question, there is a solution that allows you to do both. Assuming a marginal tax rate of 45%, an RRSP contribution of $11,000 will generate a tax refund of $4,950. Contribute that $11,000 (or as much as you can) to your RRSP, and when the resulting tax refund lands in your bank account, move $5,000 of that refund (or, again, as much as you can) to a TFSA.

The Canada Revenue Agency has prepared a number of publications and Web pages devoted to answering taxpayers' questions about TFSAs. Some of those can be found on the CRA Web site at http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/tfsa-celi/menu-eng.html and http://www.cra-arc.gc.ca/E/pub/tg/rc4466/rc4466-08e.pdf.