

## TFSA's and RRSP's — Making the Annual Choice

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, which falls this year on Monday, March 1, 2010. The introduction of tax-free savings accounts (TFSA's) as part of the 2008 federal Budget gave taxpayers an additional choice, beginning with 2009, when it came to tax-assisted savings, and this year, for the first time, both options also involve the possibility of contributing carryforward amounts.

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 the lingering effects of the recession that began in the fall of 2008), let alone in the same month. That said, what are the considerations that apply in determining which savings/investment vehicle is preferable for 2010?

There are some similarities between TFSA's and RRSP's. 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 that contribution. Many taxpayers, when presented with an option that will reduce current-year taxes, find that the most attractive choice. However, over the long term, the tax consequences of choosing an RRSP over a TFSA can erode that benefit. When funds contributed (along with investment income earned on those funds) are withdrawn from a TFSA or an RRSP, the tax consequences are very different. Funds withdrawn from an RRSP (or 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 2009 must be made by March 1, 2010, 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 subsequent year by the amount of that withdrawal.

The minority of working taxpayers who are members of registered pension plans will likely find the TFSA option particularly attractive. The maximum amount that can be contributed to an RRSP for the 2009 tax year is calculated as 18% of earned income for 2008, to a maximum contribution of \$21,000. However, that maximum contribution is reduced, for members of RPPs,

by the amount of benefits accrued during the year under the pension plan. Where the RPP is a particularly generous one, RRSP contribution room may be minimal, and a TFSA contribution may be the logical alternative.

In a similar way, for taxpayers over the age of 71, the RRSP v. TFSA question is simply irrelevant. Taxpayers over that age are not eligible to make contributions to an RRSP, making TFSA the only tax-free savings vehicle to which they can make contributions. In fact, the federal government estimated, when it introduced TFSA, that, based on current savings patterns, half of the savings that will be realized through the use of TFSA 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. And, unlike RRIF or RRSP withdrawals, 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. And, 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 or training 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 withdrawing 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 tax-free TFSA withdrawal can always be made.

Similarly, taxpayers who experienced a temporary drop in income during 2009 – perhaps through job loss or even a short-term layoff or reduction in hours resulting from the recession – may not be likely to gain a great deal from the tax deduction provided by an RRSP contribution. In such circumstances, the taxpayer would likely be better off contributing available funds to a TFSA for the short term to benefit from the tax-sheltered growth of those funds inside the plan. When the taxpayer's income is back to pre-recession levels – perhaps at this time next year or the year after - consideration can be given to withdrawing the funds from the TFSA and contributing them to an RRSP to offset the tax payable on that higher income.

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. That question has become more complicated now that the TFSA option has been added to the mix. There is, however, 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 it to a TFSA or use it to pay down the mortgage or other debt, or split it between the two.

The Canada Revenue Agency has created a section of its Web site to deal with the need for information and taxpayers' questions about TFSAs, and that information can be found at <http://www.cra-arc.gc.ca/tx/tfsa-celi/menu-eng.html>.