RRSP or TFSA?

Your default choice depends on a number of factors

Since its introduction in 2009, the TFSA has proven to be a powerful tool that opens up countless possibilities for improving our finances. However, when it comes to retirement savings, the RRSP should be the default choice for most of us. Here are some important considerations to help you decide.

Tax treatment IN, tax treatment OUT

The key difference between the TFSA and RRSP is what happens on the front and back end:

- RRSP deposits are pre-tax, income within is sheltered, and withdrawals are taxable
- TFSA deposits are after-tax, income within is sheltered, but withdrawals are not taxed

If you're depositing to an individual RRSP, any associated refund must also go into your RRSP to keep it intact as 'pre-tax'. For workplace group RRSPs, your employer does this for you through withholding tax.

Base comparison

If your income is taxed at the same rate when contributing to and withdrawing from the investment, your spendable cash will be the same either way.

Example: Using $100 deposit at a 40% tax rate and a 10% return:

	Deposit amount	Return amount	Taxable amount	Net spendable amount
RRSP	$100	$10	$110	$66
TFSA	$60	$6	n/a	$66

However, if the withdrawal tax rate is reduced to 30%, the RRSP nets $77, or if it is increased to 50% it nets $55. So, if you expect your tax rate to be lower when you will be taking withdrawals from this investment, choose RRSP. But if you expect a higher rate later on, choose TFSA.

'Same rate' – Marginal or average?

As our tax system is progressive, higher income is taxed at a higher rate. An RRSP contribution gives you a tax deduction at your marginal tax rate. It comes off the top.

Upon eventual withdrawal, the appropriate comparison is average rate, which is total tax divided by income. As average rate is mathematically lower than marginal rate, RRSP is usually the default choice.

What's your own average rate?

Your RRSP (in the form of a RRIF or annuity draw) will not be your only income source in retirement. Other sources include the Canada Pension Plan and Old Age Security, and possibly a pension from past employment. These all add up to form your foundation income. This means that the average rate on your RRIF/annuity will be higher than your overall average.

And if you expect your retirement income to exceed the OAS clawback level, that will raise your effective marginal tax rate – that's when it's time to run the numbers through a financial planning spreadsheet or speak to your financial advisor to understand all your options.

Default choice, but with flexibility

While RRSP is the default choice, it could be displaced. Think of the choice in terms of proportionally allocating savings between an RRSP or a TFSA, not an either-or decision. Consider these factors:

Favouring RRSP – Most people live on a lower income in retirement. Spousal pension income splitting can reduce seniors' household tax rate. The pension credit can reduce tax on $2,000 of RRIF/annuity income.

Favouring TFSA – Savings timeframe is shorter term, not retirement. Contributor is at a low tax bracket when saving. There are already significant RRSP assets. A large inheritance/windfall is confidently expected.

For more information about RRSPs or TFSAs, please consult your financial advisor and tax professional.