TFSAs and RRSPs—making the annual choice (February 2011)

It's that time of year again, when advertisements about the wisdom of contributing to your RRSP (and usually about the benefits of borrowing to do so) fills the airwaves and Web sites. And, since the introduction of tax-free savings accounts in 2009, February is now also the month in which Canadians wrestle with the question of whether to put any available funds into an RRSP before the contribution deadline of March 1, 2011, or whether to deposit those funds instead into a TFSA.

It is important to be clear, at the outset, that it is 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 is often not possible to fund contributions to both an RRSP and a TFSA in the same year, let alone in the same month. That said, what are the considerations that apply in determining which savings/investment vehicle is preferable for 2011?

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 which 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 to be 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 When funds contributed (along with investment income earned on those funds) are withdrawn from a TFSA or an RRSP, the tax consequences are very different. Funds withdrawn from an RRSP (or a RRIF into which the RRSP has been converted) are fully taxable, without exception, at whatever tax rate applies to the taxpayer at the time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 in income for the purpose of determining eligibility for such benefits, while TFSA funds will not. Finally, while RRSP contributions for 2010 must be made by March 1, 2011, 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. Funds withdrawn from an

RRSP cannot be re-contributed, unless the withdrawal was made as part of government-sanctioned withdrawal plans like the Home Buyers' Plan or the Lifelong Learning Plan.

The minority of working taxpayers who are members of registered pension plans will likely find the TFSA option particularly attractive. The maximum amount which can be contributed to an RRSP for the 2010 tax year is calculated as 18% of earned income for 2009, to a maximum contribution of $22,000. 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, making a TFSA contribution 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 TFSAs the only tax-free savings vehicle to which they can make contributions. 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 which 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 are 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.

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 which 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.