RRSPs vs. TFSAs

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The Benefits and Implications

When it comes to choosing a way to save, the RRSP versus TFSA debate is always at the forefront of conversation. Both plans offer tax advantages as well as opportunities for growth. Deepening your understanding of each plan will allow you to analyze the differences between the two and learn how to use them in tandem to make the most of your savings.

What is an RRSP?

In the simplest form, Registered Retirement Savings Plans (RRSPs) are tax-deferred savings accounts. These plans are typically set up to save for long term goals such as retirement, but they also offer benefits for purchasing a first home or enhancing your education. RRSPs offer a tax deduction on contributions, meaning you pay on pre-tax dollars as opposed to after-tax. They also offer tax-free growth on investments in the account until you start withdrawing for retirement.

The intention of an RRSP is to incentivize retirement saving by allowing an individual to save money on taxes in their current higher-income years and pay the taxes in retirement, when taxes typically decrease.

What is a TFSA?

On the other hand, Tax-Free Savings Accounts (TFSAs) are not specifically geared towards retirement savings, although people often use the account to decrease tax rates further in retirement. **They can be used for any goal.** TFSAs are tax sheltering savings accounts. This means that there are no tax breaks during contributions—you pay from the after-tax income—however, you are not subject to any tax on withdrawals.

TFSAs are only useful if the funds contributed are invested and expected to grow. If not, it is essentially a plain savings account, with the potential of coming with higher account fees.

The selection of an efficient savings account depends on each individual's financial situation. There are a number of elements to consider that will influence these investment decisions such as time horizon, goals, and future and current tax rates. You may find that the decision between the two is not binary. In fact, utilizing both in a way that aligns with your separate goals is the best course of action.

So, what factors are important to consider when understanding the implications of each savings account?

The 3 Differences Between RRSPs and TFSAs

1. Contribution Room
2. Tax Implications
3. Outcomes of Withdrawals

1. Contribution Room

The total amount that you can contribute to your RRSP each year is composed of the contribution maximum for the current year plus any remaining room from previous years. If you do not contribute the maximum allowable dollar amount in a given year, the CRA allows the unused amount to be carried forward indefinitely and added on as contribution room for future years.

It is important to mention here that this is assuming you have no prior contribution room. If you had $10,000 of contribution room from previous years, you would be able to contribute $10,000 over the annual maximum.

As of 2022, an RRSP allows you to invest **up to 18% of your reported earned income** in the previous year—up to a maximum of $29,210. For example, if you earned $80,000 in 2021, your maximum contribution for the year would be $14,400.

However, if you earned $200,000 in 2021, you would not get to contribute 18% of your income (in this case, $36,000) because it would be more than the annual limit of $29,210.

If you have an employer-sponsored pension plan, this plan will take up most—if not all—of your yearly RRSP contribution room. This pension adjustment is reported to the CRA and posted on your T4 each year.

Alternatively, TFSA contribution room is not dependent on earned income. Rather, contribution room is accumulated by age. If you were 18 or older in 2009, your TFSA contribution room for 2022 is $81,500 and grows $6,000 each year, even if you do not have an account yet.

However, for everyone who turned 18 after 2009, your contribution room starts the year you become eligible (i.e., the year you turn 18) and accumulates every year after in increments of $6000.

2. Tax Implications

The main difference between RRSPs and TFSAs is how your income is taxed when you contribute or withdraw from the account.

RRSPs are **tax-deferred**, which means you contribute to them with pre-tax dollars and pay income taxes on withdrawals.

For example, if your paycheque comes out to $1000 and payroll automatically contributes $50 of your gross earnings into your RRSP, your taxable income will not include the $50 and will total $950. Instead of paying income tax on the $1,000, you will pay it on the $950. This would give you tax savings today equal to $12.50 monthly.

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How do I get the RRSP refund then?

Great question! Even if you contribute from your pay stub, you are still having income taxes withheld as if you never contributed. This all gets reconciled when you do your income taxes for the year, resulting in a refund.

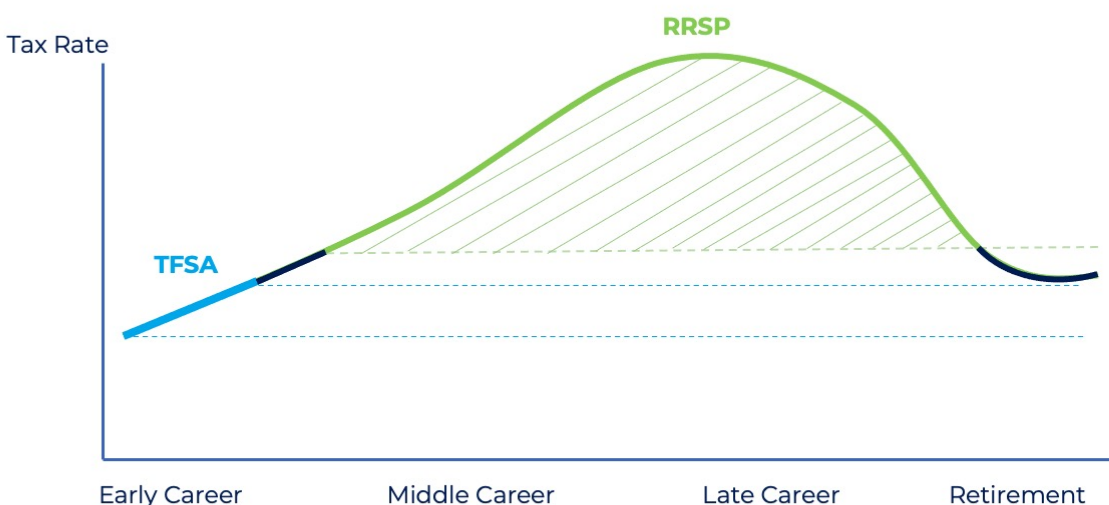
Imagine your gross pay is $1000. You get taxed $250 which results in net income of $750. Of that $750, you choose to contribute $50 towards your RRSP. In this example, you already paid tax on the $1,000 when you should only be paying tax on $950. Therefore, you will be entitled to an RRSP refund equal to the tax you paid on the $50 contribution into your RRSP.

Automatic RRSP Contribution from Payroll		RRSP Contribution Made Personally From Paycheck	
Gross Income	$1,000	Gross Income	$1,000
RRSP Cont.	$50	--------------	
Taxable Income	$950	Taxable Income	$1,000
Taxes to Pay 25%	$238	Taxes to Pay 25%	$250
--------------		After-Tax RRSP Cont.	$50
--------------		RRSP Refund 25%	$13
Overall Taxes Paid	$238	Overall Taxes Paid	$238

On the contrary, TFSAs are tax-sheltering accounts, meaning that you contribute to the account using after-tax income and do not pay taxes at the time of withdrawal. Using the example above, you would use the amount of net income after tax ($750) for contributions and, as a result, would not be subject to a tax deduction at the time of withdrawal.

Ultimately, when considering whether to utilize a RRSP or TFSA, it is important to compare your current tax rate to your expected tax rate in retirement. If the goal is to continuously invest funds until retirement, then it is best to contribute into a TFSA in your early career and then contribute to an RRSP in your later career.

Why? Since RRSPs are taxed later (in low-tax retirement years), you should contribute to this account when you are in the highest tax bracket of your career. Using the same logic, since TFSA contributions are made with your after-tax earnings, it is more beneficial to contribute in your early career as your tax bracket will be lower.



3. Outcomes of Withdrawals

Although withdrawals from both RRSPs and TFSAs are possible at any time for any purpose, there are a few caveats of each account to keep in mind.

RRSP withdrawals are taxed as income (therefore subject to withholding taxes) immediately at the time of withdrawal. Additionally, once you withdraw funds from your RRSP, you lose that contribution room indefinitely. Simply put, the total amount of funds withdrawn cannot be redeposited into the account unless you generate additional contribution room through earned income. Because RRSPs were created to **incentivize saving for retirement**, the rules of withdrawing before retirement are understandably harsh.

It is important to note here that withdrawals related to the Home Buyers' Plan or the Lifelong Learning Plan are not subject to a withholding tax and do not cause you to lose any contribution room. Withdrawals made for these purposes can be—and must be—redeposited into your RRSP. You can read more about utilizing an RRSP in conjunction with the Home Buyers' Plan here.

Alternatively, since TFSAs use after-tax dollars, all withdrawals are tax free. As well, if you withdraw out of your TFSA, you receive that TFSA contribution room back in the following calendar year—on top of the automatic $6,000.

For example, if an 18-year-old decides to contribute $6,000 into their TFSA, but then decides to withdraw the funds in the same year, they will not be able to replace that $6,000 until the next calendar year. In the next calendar year, they will have $12,000 in contribution room as a result of the $6,000 from the prior year and the $6,000 from the new year.

In Conclusion...

As you can see, there are quite a few differences between TFSAs and RRSPs, but these can be used to your advantage with the right planning. Understanding the various types of savings accounts is a complex and important financial topic. Individuals who are feeling overwhelmed in managing their wealth via financial planning techniques or are seeking active investment management will benefit from the services of a portfolio manager.

Unencumbered by alternative motivations, your portfolio manager will work with you to make sense of your unique circumstances and investment preferences, considering your specific financial goals, risk tolerance, and ongoing needs. Our team at Qube is committed to providing you with a holistic, diversified, and personalized investment experience. If you would like to learn more, please contact us using the details below.

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