Should You Save in an RRSP or a TFSA?

Description

People are often confused by the differences between the tax free savings account (TFSA) and the registered retirement savings plan (RRSP). They're not sure which one to use to build their savings.

Here are the differences between the two.

Contribution room

The amount that you can contribute to your RRSP account depends on how much contribution room you have accumulated. Your contribution room for the year is the lower of either 18% of your earned income from the previous year or up to a certain limit for each year. For 2015, the upper limit is $24,930. Any unused contribution room is accumulated. Further, when you contribute to an RRSP, you reduce the income taxes for the year.

On the other hand, the amount that you can contribute to your TFSA account is set for each year no matter how much you earn in income.

- From 2009 to 2012, the contribution limit was $5,000 each year.
- From 2013 to 2014, it was $5,500.
- In 2015, it was $10,000.

This year, it's back to $5,500. If you were at least 18 years old in 2009 and you never contributed to or withdrew from a TFSA, you've have accumulated $46,500 of contribution room.

Withdrawals

Typically, you have to pay taxes on RRSP withdrawals. However, there are two situations in which you can withdraw from an RRSP without penalty.

First-time home buyers can withdraw up to $25,000 from their RRSP, and that amount must be paid back periodically within 15 years.

The Lifelong Learning Plan allows Canadians to withdraw up to $10,000 in a calendar year and up to $20,000 in total. You have to pay back the amount periodically within 10 years.

You can withdraw from a TFSA any time. The withdrawal amount is added to the next calendar year's contribution room.

Which is better for saving?

Both accounts can hold the same types of investments, including GICs, bonds, and securities listed on designated stock exchanges in Canada and other countries, such as the Toronto Stock Exchange, the New York Stock Exchange, and the Australian Securities Exchange.

Both accounts can be used for saving for retirement. TFSAs provide the flexibility to withdraw without penalty, so they are great for saving for a big purchase, a trip, or an emergency.

If you're in a high tax bracket, you should consider contributing to an RRSP to reduce your income tax. If you get a tax refund, you can then contribute to a TFSA for further savings.

Conclusion

If you're saving for short-term goals, it's better to invest in a GIC or savings account within a TFSA. If you're saving for the long term, consider dividend stocks, such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY), which are trading at reasonable valuations. Royal Bank yields 4.5% and has increased its dividend for five consecutive years.

If you're investing in U.S. dividend stocks, such as **Welltower Inc.** (NYSE:HCN), you'll want to buy it in an RRSP to avoid the 15% withholding tax that would otherwise be deducted and lost forever in a TFSA.

Also, let's not forget that whatever is earned in a TFSA grows tax free, and whatever is earned in an RRSP grows tax deferred. You'll eventually have to pay taxes when you withdraw from an RRSP.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. TSX:RY (Royal Bank of Canada)

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