Young Investors: Should Your Investments Be Held in a TFSA or RRSP?

Description

The greatest of advantages of being investors in Canada are the Tax-Free Savings Account (TFSA) and Registered Retirement Savings Plan (RRSP) investment accounts. Both accounts allow Canadians to accumulate their investments' earnings on a tax-free basis. Therefore, Canadians don't pay taxes on any capital gains, dividends, or other income generated from the investments held in these accounts.

Although both accounts offer tax-free growth from buying and holding great companies such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Fortis Inc.** (TSX:FTS)(NYSE:FTS), the characteristics of each investment account are quite different. Therefore, young investors need to understand what both accounts offer and determine which one caters to their lifestyle and investing needs.

Here are some main characteristics of both accounts.

RRSP

The primary advantage of the RRSP is that it allows you to defer the taxes paid each year you make a contribution. Each contribution made to the RRSP is deducted from your taxable income, resulting in fewer taxes being paid today. This is advantageous for individuals in higher tax brackets now who will be in lower tax brackets once they retire and withdraw the funds from the RRSP.

However, there are strict limitations on withdrawing funds. Unless you are a first-time home buyer or need to pay for additional schooling, you can't withdraw the funds without unfavourable tax implications. Therefore, if you make a contribution, it probably won't come out until you retire.

TFSA

The TSFA provides young investors with flexibility. The funds from a TFSA can be withdrawn at any time without sacrificing your contribution limit. Therefore, if you're saving for a trip, a new car, or even making an emergency fund, you know you'll be able to access the funds at any time without tax consequences.

Unlike an RRSP, however, the contributions to a TFSA cannot be deducted from your taxable income. Therefore, contributions to your TFSA won't help defer the payment of taxes. However, this is irrelevant if you're in the lowest tax bracket since you'd essentially be paying the same amount in taxes now as you would in retirement.

Foolish bottom line

Both the TFSA and RRSP offer unique advantages and investors should be contributing to both if possible. However, the trick is determining which one suits your needs at this time.

Unless you are in a higher tax bracket, it doesn't make sense to contribute to an RRSP. Therefore, I recommend that young investors open their first brokerage account through a TFSA. Once they earn income in a higher tax bracket, they should start contributing to their RRSP as well.

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