RRSP vs TFSA: Which Is Right for You?

Description

Tax efficiency is one of the most overlooked aspects of investing. Every dollar you earn on a trade has capital gains tax applied to it, and if you're investing in dividend stocks, those payouts are taxed too. Currently, half of your capital gains are taxed at your marginal tax rate, while dividends are taxed anywhere from 25% to 47% based on a number of factors. So when you invest money, it pays to consider the tax consequences–and minimize them as much as you can.

Two of the most popular instruments for minimizing taxes are RRSPs and TFSAs. An RRSP is a retirement account that provides several tax benefits, but also some potential drawbacks. A TFSA is a savings account that exempts holdings from the usual dividend and capital gains taxes. Deciding which one you'll put your assets in is one of the biggest financial decisions you'll ever make. In this article, I'll be reviewing the benefits of each while providing investing strategies appropriate for either one.

Tax benefits

RRSPs and TFSAs both provide considerable tax benefits. In the case of RRSPs, your holdings are tax deferred for as long as they remain in the RRSP account. While TFSA holdings aren't taxed, even when they're withdrawn.

RRSP holdings may be taxed as income when you withdraw them to a RRIF at the age of 71; the idea is that you will be retired by then, so the overall tax rate will be lower than it would otherwise be. However, if you never withdraw more than the minimum 'lump sum' amount from a RRIF, the income is not taxed.

If you want to withdraw money from an RRSP while you're still earning income from a job, the tax consequences are negative: the withdrawal will be treated as income and taxed at your marginal rate. For this reason, if you're going to invest in an RRSP, you should be committed to holding until either age 71 (when holdings are transferred to a RRIF) or when you're not earning taxable income.

TFSA tax rules are simpler: the holdings are not subject to capital gains or dividend taxes when they are in the account, nor when they are withdrawn.

Long-term vs. short-term investing

Because RRSPs only have tax benefits if you hold to retirement, it's to your advantage when using them to invest long term. Remember, if you withdraw early, you'll be taxed as if the withdrawal was income, so this is not the place to pocket quick gains that you may be tempted to spend immediately. Good RRSP picks include long-term dividend stocks like **Fortis Inc** (TSX:FTS)(NYSE:FTS) that can be relied on to generate income for decades, and index funds like the **iShares S&P/TSX 60 Index** (TSX:XIU), which give you the average market return and the lower risk that comes with that.

With a TFSA, short-term trading makes more sense. Because you can withdraw from a TFSA at any time, you may enjoy the proceeds of high-risk/high-return trading in one if you wish. A stock like **Shopify Inc** (TSX:SHOP)(NYSE:SHOP) may be a good choice for a TFSA: it comes with a level of risk/volatility that's not appropriate for retirement accounts, but also the potential for high returns that can be tax-exempted by trading it in a TFSA.

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2. NYSE:SHOP (Shopify Inc.)
3. TSX:FTS (Fortis Inc.)
4. TSX:SHOP (Shopify Inc.)
5. TSX:XIU (iShares S&P/TSX 60 Index ETF)

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Date
2025/07/22
Date Created
2019/01/10
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