RRSP vs. TFSA: Which One Is Better for You?

Description

If you have to choose whether to invest money in a TFSA or in an RRSP because you don't have the money to have both, you may wonder which registered account is better for your situation. Before choosing between an RRSP and a TFSA, you need to understand the characteristics and the differences between the two.

What's the difference between a TFSA and an RRSP?

Contributing to an RRSP will give you a tax deduction and allow you to defer the payment of taxes on your investments until you make a withdrawal. Contributing to a TFSA won't give you a tax deduction, but you'll never have to pay any taxes on the income you earn in your account.

So, deciding which registered account is the best for you depends partly on what you earn now versus what you anticipate to earn in the future.

How much do you earn and what are your investment goals?

If you're young and earn a low income, you might prefer the TFSA because you are in a lower tax bracket and don't have much taxes to pay. If you contribute to an RRSP, you won't benefit as much from the tax deduction as someone who earn a high income and is thus in a higher tax bracket.

If you earn a high salary and think that you will earn less during your retirement, the RRSP is a better choice. You will have to pay taxes on your RRSP when you withdraw funds when you retire, but hopefully you'll then have fewer expenses and will be in a better position financially. Your house should be fully paid, and you don't have to pay for your children anymore.

However, if your goal is to invest for your retirement, the RRSP might be a better choice regardless of your salary. Indeed, as withdrawals from an RRSP are taxable, you'll have to think twice before withdrawing money from it.

On the other hand, you can withdraw money from a TFSA whenever you want without having to pay any kind of penalties or taxes, so it may be tempting to withdraw money for something else than retirement.

A TFSA is best suited for less long-term savings goals like the purchase of a car or a house.

What do you want to invest in?

There is another thing you should consider before making your choice between a TFSA and an RRSP. You should pay attention to the stocks you want to invest in.

If you want to buy U.S. stocks that pay dividends, you should buy them in an RRSP. Indeed, if you hold U.S. stocks into your TFSA, you may have to pay a non-residents' withholding tax of 15% on the dividends you receive. You cannot claim a foreign tax credit on your Canadian tax return.

For example, if you hold 100 shares of **AT&T** (NYSE:T) in a TFSA, that gives you US$204 in dividend income annually. But you'll only receive US$173.40 in your account because a 15% tax will be removed from your gross income.

You don't have that problem with Canadian dividends. For example, if you buy 100 shares of **Laurentian Bank** (TSX:LB) in your TFSA, you'll receive $260 in dividend income annually. You don't have to pay any tax on this amount, so you keep the whole $260.

On the other hand, U.S. dividends paid in an RRSP are not subject to a withholding tax, so you keep the entire dividend. Like in the TFSA, Canadian dividends are not subject to taxes, but keep in mind that all the money you're making in an RRSP will be taxed one day when you withdraw funds.

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1. NYSE:T (AT&T)
2. TSX:LB (Laurentian Bank of Canada)

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