3 Reasons to Open a TFSA Instead of an RRSP

Description

One of the biggest things for any investor to keep in mind is tax efficiency. Capital gains and dividends are both taxed, so the more you shelter your holdings, the better your long-term result will be. In Canada, 50% of your capital gains are taxed at your marginal tax rate, while dividends are taxed at a variable rate depending on a number of factors. Sheltering both capital gains and dividends should therefore be a top priority for any investor.

In Canada, there are two tax-preferred accounts that investors rely on to keep their investments safe: TFSAs and RRSPs. TFSAs are accounts that keep your investments tax-free as long as they're in the account and *after* they're withdrawn; RRSPs are retirement accounts that give an income tax deduction and defer taxes on the holdings until later in life. Each of these accounts has its positives and negatives. However, if you're investing for any purpose other than retirement, it makes sense to opt for a TFSA instead of an RRSP. The following are three reasons why.

TFSA withdrawals are tax-free

The big advantage of TFSAs is their holdings are neither taxed in the account nor when they're withdrawn. This means you that if you hold a growth stock like **Shopify** (TSX:SHOP)(NYSE:SHOP) in a TFSA and pocket a huge return, sell a portion of it, withdraw the cash to your chequing account, and pay no taxes. This is in stark contrast to an RRSP, where you pay an immediate tax on any withdrawal — potentially a huge tax if you're still earning an income.

TFSAs are better for short-term investing

The fact that TFSA withdrawals are tax-free makes TFSAs better short-term investment accounts than RRSPs. In a TFSA, you can buy a stock, watch it go up and sell it immediately for any purpose youlike. With an RRSP, if you make a big gain and take the cash out, the taxes will likely be greater thanthe gain. Of course, that doesn't mean you can't make short-term growth plays in an RRSP; it's justthat you can't enjoy the proceeds in the near term.

TFSAs can be handy in financial emergencies

A final advantage of TFSAs is that they can be handy in financial emergencies. Because you can withdraw TFSA funds at any time without worrying about tax penalties, you can use investments in your TFSA to deal with financial emergencies. Let's say, for example, that you get a call from a credit agency about money you owed that you had long since forgotten about. If you've been holding growth stocks like Shopify in your TFSA, you could simply sell a portion of your holdings and use the money to pay the bill. If you had those same shares in an RRSP, you'd need to seriously weigh the tax cost of cashing out against the benefit of dealing with the delinquent bill. So, TFSAs can be used to provide liquidity much more easily than RRSPs can.

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Date
2025/09/18

Date Created
2019/04/03
Author
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