Is It Better to Invest in RRSPs or TFSAs?

Description

Both the registered retirement savings plan (RRSP) and tax-free savings account (TFSA) can help you to save taxes, but depending on your situation, investing your hard-earned money in one or the other may be a better way to go.

Save taxes in your TFSA

Generally, the TFSA is well-suited for all investors. Almost everything earned inside is tax free, including interest, dividends, and capital gains. The one exception is tax withheld on foreign dividends.

For example, if you invest in a U.S. dividend stock that yields 3% in your TFSA, there will be a 15% withholding tax, which will be lost. Your effective yield for the investment would be 2.55%. Therefore, it makes more sense to invest in foreign stocks with high growth inside your TFSA.

Any withdrawals you make from your TFSA are free of taxes. So, your TFSA can also act as a secondary emergency fund. Ideally, though, you'd want to leave your money in the account to compound for tax-free returns for a long, long time.

If you do end up withdrawing money, make sure to remember that the withdrawal amount can only be recontributed to your TFSA in the following year or later.

Save taxes in your RRSP

Whereas it makes sense to maximize your TFSA contribution every year, it doesn't make sense for all investors to contribute to their RRSPs.

Making RRSP contributions reduces your taxable income for the year. Therefore, the higher your tax bracket, the more you'll benefit from your RRSP contributions.

It follows that if you're in a relatively low tax bracket, it'd make more sense to contribute to your TFSA first so that you can save more RRSP contribution room for future years when you're at a higher tax bracket.

In RRSPs, you can invest in U.S. corporations and get the full dividends from them. Yes, there's no 15% withholding tax on U.S. dividends. So, if you buy **Coca-Cola** stock for a 3% yield, you'll get the full 3% yield.

Foolish takeaway

In summary, consider investing in your TFSA first unless you're in a high tax bracket, which generally means that you're earning $60,000 or more each year.

Ideally, you want to invest your money for decades inside your TFSA or RRSP so that you'll benefit from long-term compounded returns in a tax-favourable environment.

Since stocks offer the best long-term returns among a range of investments, you should aim to buy quality businesses and hold their stocks for a long time.

If you're a more active investor, you can also shelter your capital gains inside your TFSA or RRSP when you make short-term trades.

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