1 Hugely Important Reason to Prioritize RRSPs Over TFSAs

Description

It seems like most Canadian investors are prioritizing their TFSAs over their RRSPs.

I don't blame these folks one bit. TFSAs come with all sorts of interesting advantages, especially for long-term investors. You can withdraw cash anytime you'd like, which will never be taxed. And the $6,000 annual limit is a reasonable savings goal in a world where everything relentlessly gets more expensive.

Compare that to an RRSP, which isn't quite so black and white. Your contribution limit moves around every year based on last year's income. The cash must be withdrawn starting at age 71 and then you're subject to taxes on it, while a TFSA can continue to grow forever. And there are a number of other rules that govern RRSP usage that make it more complex than TFSAs.

However, there's one important variable that TFSA lovers miss, something that makes a RRSP a very compelling investment choice. Let's take a closer look at how this forgotten wrinkle can really make a difference over the long term.

Remember taxes

I know, nobody likes to talk about taxes. But don't worry. This conversation will involve how to use taxes to your advantage.

One of the things people forget about RRSPs is that any amount contributed automatically comes off your income, creating an immediate tax refund that can then be invested as well.

It's probably easier if we look at an example. Say you make $100,000 per year and you're in the 33% tax bracket. If you contribute $10,000 to your RRSP, your taxable income immediately goes down to $90,000. The contribution will ultimately give you a $3,333 tax refund.

If you take that tax refund and immediately apply it again to your RRSP, it’s like getting an immediate 33% return guaranteed. I don’t care what you invest in: you won’t do better than that.

It gets even better. That $3,333 will then generate its own tax refund of $1,100, which can then be reinvested again. It’s actually better than another 33% guaranteed return though, as that cash was generated from free money in the first place. You didn’t have to put up a nickel of your own money.

Now there is the risk of this plan backfiring, but it’s not very likely. The only way it can really go wrong is if your earnings are higher in retirement than they are now. But if that happens, is that such a disaster? A high tax bracket in retirement means you did many things right as a worker.

The difference in action

Let’s assume you and your spouse save a total of $12,000 annually. How much extra will you end up with if you go the RRSP route?

If you save consistently for 30 years and get a return of 8%, $12,000 saved each year in a TFSA will end up being worth a hair over $1.5 million. That’s the basis of a great retirement right there, and you won’t have to worry about paying any taxes on the proceeds.

Let’s compare that to a RRSP. We’ll assume both our earners are in the 25% tax bracket, which increases their $12,000 contribution to $15,000 including tax refunds. This move alone increases our nest egg to $1.95 million, which is about 30% more money.

Yes, taxes must be paid on RRSP withdrawals. But if you and your spouse withdraw a total of 4% of the account annually, you’ll be each making a hair under $40,000. There won’t be much tax owing on that.

The bottom line

By strategically utilizing their RRSPs and the tax refund that comes from contributing to the account, Canadian savers can end up significantly richer than if they stick with TFSAs.

Yes, RRSPs do come with some other disadvantages, but they are an important savings tool that many folks are ignoring at their own peril.

CATEGORY

1. Investing

PARTNER-FEEDS

1. Business Insider
2. Msn
3. Newscred
4. Sharewise
5. Yahoo CA

Category

1. Investing

Date
2025/09/09
Date Created
2019/11/29
Author
nelsonpsmith