Avoid the CRA With TFSAs and RRSPs: Which One Should You Invest in First?

Description

About a year ago, roughly a third of Canadians didn't know the difference between a Tax-Free Savings Account (TFSA) and a Registered Retirement Savings Plan (RRSP). That's an alarming fact. The TFSA has been available since 2009, and it's about time Canadians take full advantage of both types of accounts.

TFSA and RRSP: What's the difference?

Here are some key differences. First, TFSAs allow you to grow your savings or investment tax free, while RRSPs allow for tax-deferred growth. When you withdraw from an RRSP (or RRSP turned RRIF), the amount will be counted as taxable income.

Second, contributing to RRSPs will reduce your taxable income for the year. The higher the tax bracket, the greater the tax rate becomes. So, RRSP contributions work wonders for people in high tax brackets.

For example, if you were a British Columbia resident who earned $113,506 in 2019 from your job, you'd land in the sixth tax bracket and end up paying $30,575 of income taxes for an effective tax rate of almost 27%.

However, if you have sufficient RRSP contribution room, you can contribute $20,030 to your RRSP, reduce to the fourth tax bracket and save $7,571 of taxes. You can then smartly invest the taxes saved, including contributing $6,000 to your TFSA.

For the 2019 tax year, the deadline to contribute to RRSPs is March 2, 2020. So, high-income earners still have time to contribute to their RRSPs to reduce the income taxes for 2019.

All Canadians should use TFSAs

As January 1, 2020 rolled around, investors got $6,000 of new TFSA contribution room. All Canadians can benefit from TFSAs.

If you'd been eligible for the TFSA since 2009, your TFSA contribution room for this year would be $69,500 unless you've made withdrawals that you haven't contributed back.

$69,500 is a lot of investment dollars for amazing tax-free growth. Even if you just earn average stock market returns of 7% per year and continue to contribute $6,000 every year, you'll still end up with a hefty amount of $508,916 in 20 years. Even better, if you can earn 10% total returns, you'll end up with $805,211 at the end of the period!

It's all about having disciplined regular TFSA contributions and making strategic investments.

Which investments can deliver 10% returns?

Look for dividend stocks like **Enbridge** and **Brookfield Property Partners**, which have juicy yields and growth components.

Enbridge yields 6.3%, so it only needs to grow by 3.7% per year to hit the 10% total return target. However, it actually aims to increase its distributable cash flow per share by 5-7% per year.

The distributable cash flow is the key metric that management uses to determine how much to grow the dividend.

Brookfield Property Partners yields 7.3%, so it only needs to grow by 2.7% annually to achieve the 10% target. However, it actually aims to increase its cash distribution by 5-8% per year, which would be supported by the stable cash flows generated from its globally diversified real estate portfolio.

Using the conservative assumption of 5% dividend growth per year in the foreseeable future, the estimated total returns would be in the range of 11% for Enbridge and 12% for Brookfield Property!

Investor takeaway

All Canadians can benefit from contributing and investing for high, tax-free returns in their TFSAs. However, if you're in a high tax bracket, it makes more sense to invest in an RRSP first. The taxes you save from RRSP contributions can then be used as TFSA contributions!

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