TD Bank (TSX:TD): A Quarter of Canadians Are Unaware of TFSA vs. RRSP Differences … Are You?

Description

In a research report from the **Toronto-Dominion Bank**, a shocking and deeply worrying claim has been made that a quarter of Canadians don't know the differences between Tax-Free Savings Accounts (TFSAs) and Registered Retirement Savings Plans (RRSPs).

While more than half of 1,600 survey respondents agreed that the TFSA (59%) and RRSPs (57%) are a crucial part of their savings strategy, more than a quarter (27%) "admitted that they don't know the differences between the two financial products," claims the January 27, 2020, press report from the chartered bank.

Considering how important the knowledge of savings and investment products is for one to efficiently craft financial and wealth-planning strategies while growing their net wealth and building their retirement nest egg, the bank's research findings are a cause for concern.

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

The Canadian RRSP account offers one the opportunity to delay income taxes to a much later stage. One can contribute as much as 18% (up to $27,230 for 2020) of their income into an RRSP and get exempted for income taxes on the amount. However, withdrawals made from this tax-deferred account will be taxed at your marginal tax rate for that tax year.

A TFSA is another tax-advantaged account that allows one to make tax-free withdrawals that the CRA will never touch ever, irrespective of when the withdrawal is made, but the tax man will levy taxes on whatever you deposit into the account.

The TFSA therefore loads all income taxes upfront to the year the contribution is made, but never on the wealth created within that account, as long as you don't overtrade (at which point the contributions are deemed as income from a trading business, which should be taxed), stick to allowable annual contribution limits ($6,000 for 2020), and you remain a resident of Canada during the year the contribution is made.

Which account is better?

The answer to which savings account is better will differ for every individual depending on personal circumstances like expected income level changes (which trigger migrations from one income tax bracket to the other), short-term goals like buying a home and saving for full-time education.

If one is a first-time home buyer, the best option would be to contribute into an RRSP first, up to a maximum of $35,000 for 2019. This amount can be withdrawn tax-free when making a down payment on a first home, and one has up to 15 years to return the money. The limit is usually increased with the rise in average home prices, so it could be much higher in the future.

The same goes for someone who intends to study on a full-time basis with an approved educational institution. A tax-free withdrawal of up to $20,000 can be made from an RRSP during the study period, and a couple could even double dip. One has up to 10 years to repay the "loan."

Generally, if one expects to migrate to a higher income tax bracket in the future, making TFSA contributions today (and paying lower taxes) could make sense, but investments is taxable accounts should be ideally be made when both accounts have been maxed out.

Heavily taxable income streams like REIT distributions should ideally be located in a TFSA, while tax-advantaged incomes like eligible Canadian dividends can be located in an ordinary taxable account.

Basically, you should use both tax-advantaged accounts to efficiently manage annual taxes and optimize net wealth. It's the after-tax wealth that actually matters at an individual level, and thanks to TD Bank's survey, I suspect not everyone is taking full advantage of these legal tools to save on taxes.

One more thing: the best way to get the best returns out of investments and savings accounts, especially in ordinary taxable accounts, is to delay realizing capital gains and postponing withdrawals by as long as practically possible. A long-term holding philosophy is what we believe in at The Motley Fool.

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Date
2025/08/26
Date Created
2020/02/03
Author
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