The Canada Revenue Agency Taxes CPP, OAS and RRSPs… But Not This Alternative!

Description

Most Canadian workers look forward to the day when they retire — and finally begin *drawing* the pension benefits they've been paying into for years. Unfortunately, some are getting a rude awakening in the form of taxes.

Currently all three of the main retirement income sources that Canadians rely on–CPP, OAS and RRSPs–are taxable. CPP and OAS count as taxable income, while tax-deferred RRSPs *become* taxable upon withdrawal of funds.

Collectively, the taxes paid can be a significant burden. The taxing of CPP payments is a particularly hard reality for some retirees to swallow, as the premiums to pay for the program came directly out of their pay cheques when they were working.

If you're a Canadian soon-to-be retiree, getting taxed on your retirement money may appear unfortunate but inevitable. However, you still have one trick up your sleeve. It's a relatively new savings vehicle designed for Canadian investors that can provide tax-free investment income.

Similar to RRSPs, it spares you dividend and capital gains taxes. Unlike RRSPs, however, it's not taxable on withdrawal. The amount of money you can contribute to this account increases every year. Best of all, you can hold any approved investment you like in it.

Tax-free savings account

Tax-Free Savings Accounts (TFSAs) are pretty much what their name implies: tax-free accounts that let you hold investments. Any dividends or capital gains realized in these accounts are exempt from taxes, as are any funds you withdraw. TFSAs let you hold the same kinds of investments that RRSPs do; stocks, ETFs and bonds are therefore all fair game.

What makes TFSAs so great for retirees is the tax-free withdrawals. Almost any kind of income you earn in Canada is taxable in one way or another. TFSA investments are the one exception.

Capital gain/dividend taxes are notorious for eating into investment returns, and RRSP withdrawal taxes ultimately have the same effect. TFSAs are exempt from both taxes so they can protect your returns much more than RRSPs over the long run.

An example to illustrate the point

Consider the case of an investor holding **Enbridge Inc** (TSX:ENB)(NYSE:ENB) stock in a TFSA versus an investor holding the same stock in an RRSP. Enbridge shares pay dividends, making the stock a perfect example to use for our purposes.

Inside a TFSA, the investor would pay no tax on either the capital gains or dividends realized on their ENB shares. Because ENB has a massive 6% dividend yield, that could save the investor quite a bit of money. If you held $69,500 worth of Enbridge shares, you'd get $2780 worth of dividends a year.

Outside of a registered account, you'd pay tax on that–specifically on the "grossed up" value minus a tax credit. Inside a TFSA, you wouldn't pay *any taxes* on those dividends–nor would you pay any taxes on withdrawing the funds.

Now let's turn to the investor holding ENB in an RRSP. Like the TFSA investor, he or she wouldn't pay tax on the capital gains or dividends directly.

However, upon withdrawing the funds, the investor would be subject to taxes–up to 30% in withholding taxes, then additional income taxes if your marginal rate exceeds the rate paid in withholding tax.

Clearly, the TFSA investor comes out better overall, realizing a higher after-tax return. Just one reason you should consider opening a TFSA, in addition to any RRSPs or other registered accounts you already have.

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