



Canada Revenue Agency: What's More Tax-Friendly, the TFSA or RRSP?

Description

We are fast approaching the [RRSP contribution deadline](#) for the 2019 tax year. There is no better time to revisit the tax benefits offered by the TFSA and the RRSP.

Without too much consideration, the differences may seem negligible or up to personal preference. There are cases where one account holds the advantage, however.

Benefits of the TFSA

The benefits of the tax-free savings account are enticing and easy to understand. It stands to reason that it has become an [extremely popular account](#) for Canadian investors.

All capital gains and dividend income within the TFSA are tax free, though some exceptions do exist. For example, dividend income from a foreign listed stock is taxable.

Flexibility is one of the biggest advantages of the TFSA. Money can be withdrawn from your TFSA without penalty at any time. However, if you look to recontribute in the same calendar year you need to be careful not to go over your total contribution room.

Fortunately, you can simply wait for the next calendar year for the base contribution to reset to its current maximum.

One example where the TFSA beats out the RSRP is if an investor starts with a lower marginal tax rate when contributing and possesses a higher marginal tax rate at the date of withdrawal.

In this case, we will assume an annual investment return of 5%. Because of the higher marginal rate at withdrawal, the net proceeds from the TFSA would beat out the RRSP.

Perks of the RRSP

Although the TFSA boasts attractive flexibility, the RRSP is a fantastic option for long-term investors.

Contributions are tax deductible, which means investors are rewarded for betting on their future.

While the savings in an RRSP also grow tax-free, they can't be withdrawn without a penalty. A spousal RRSP can reduce the tax burden of a Canadian couple, and new homebuyers can borrow from their RRSP to pay for their first home purchase.

What the RRSP gives up in flexibility it makes up in other areas. When an investor reaches retirement, the RRSP can be converted to provide regular payments. Young investors should get comfortable with the RRSP, especially in an environment that has seen the decline of defined-benefit pensions plans in the private sector. Many investors will be solely responsible for saving for retirement in the decades to come.

In a reversal of our TFSA scenario, the RRSP can also beat out its registered peer. If an RRSP investor contributes with a higher marginal tax rate that lowers later, the RRSP offers the tax advantage over the TFSA.

This is a typical retirement scenario, as Canadians should expect to see their earning potential slashed significantly when they enter retirement.

Settling the debate

Both registered accounts are extremely effective when used to their full potential. Ideally, investors will be able to maximize both in the long term. As it stands today, investors should do everything they can to contribute to their RRSP to make the 2019 tax year deadline.

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