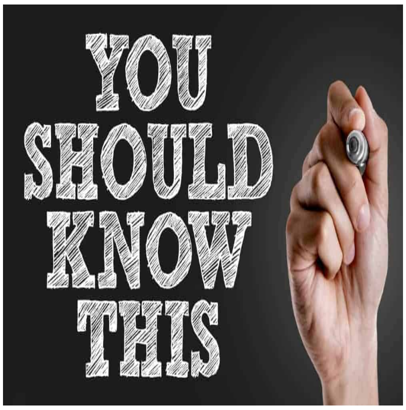

Where Should You Be Parking Extra Cash This Year: TFSA or RRSP?

Description

One of the classic debates in Canadian personal finance circles is the relative benefits of Tax-Free Savings Accounts (TFSAs) versus Registered Retirement Savings Plans (RRSPs). Those with additional contribution room in their TFSAs or RRSPs might be wondering which one they should be contributing to right now. Individuals facing an additional tax hit from Canada Emergency Response Benefit (CERB) or Canada Emergency Student Benefit (CESB) payments should also be considering whether they can use contributions to either type of account to help lower their tax bill next year.

TFSA contributions provide relatively few immediate tax benefits

TFSAs do not allow you to deduct contributions against current income taxes. However, the future withdrawals from the account are similarly tax exempt. This makes them ideal for those contributing in low tax brackets and withdrawing later in higher brackets. Those starting out their careers or still in their post-secondary education would likely fall into this group.

There is one key problem with TFSAs. While you can hold U.S. stocks in them, dividends from U.S. stocks receive an immediate 15% haircut from Uncle Sam. This is thanks to U.S. withholding tax. This is because the U.S. doesn't recognize TFSAs as registered accounts. This ultimately means that Canadians lose 15% on dividends received from U.S. stocks held in a TFSA. I prefer to try to stick to U.S. growth stocks in my TFSA for this reason.

However, Canadians who hold U.S. shares in Canadian dividend paying companies, like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), will be happy to know that they are safe from the 15% withholding tax.

The determination is based on the location of the company's headquarters. TD's headquarters is in Toronto. This means that Canadian investors in its U.S. shares receive the full annual dividend. TD has seen high dividend yields since its inception, with yields hovering around 4% in the past three years. Additionally, TD approximately quadrupled in value from its sub-$20 depths of the 2009 financial crisis to almost $80 in less than 10 years. Holding TD in a TFSA would have allowed investors to avoid incurring taxes on the generous dividends, as well as allowed them to potentially sell their shares without a crippling capital gains tax. Canadian investors would have enjoyed these benefits whether they owned the Canadian or U.S. shares in their TFSA and would have been free from the 15% withholding tax in both cases.

RRSP contributions have more immediate tax benefits

U.S. stocks held in RRSPs are not subject to the 15% U.S. withholding tax. This is a major benefit of RRSPs and makes RRSPs much more suitable for holding U.S. dividend stocks.

Additionally, RRSP contributions are deductible against income in the year that the contribution is made. However, RRSP withdrawals are taxed at the holder's tax rate at the time of withdrawal. Therefore, it makes the most sense to contribute to RRSPs when in a high tax bracket, and withdraw when in a low tax bracket. This results in the tax deductions from the RRSP contributions accomplishing the most tax savings.

If you're currently in a high tax bracket, RRSP contributions could be more beneficial than TFSA contributions. If you have taxes from other sources that you're looking to offset, this is especially so. Those additional taxes could be related to CERB or CESB payments, which the Government of Canada has said will be taxable. RRSP contributions are a great way to offset the taxes arising from these payments.

Takeaway

There are a host of considerations that go into deciding between contributing to your TFSA or RRSP. However, those in simple tax situations will likely benefit more from TFSA contributions if they will be withdrawing from the TFSA when they are in a higher tax bracket than they are currently in. RRSP contributions could be ideal for those with significant expected taxes in the 2020 tax year or who expect to be in a lower tax bracket when they will be withdrawing from the RRSP.

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