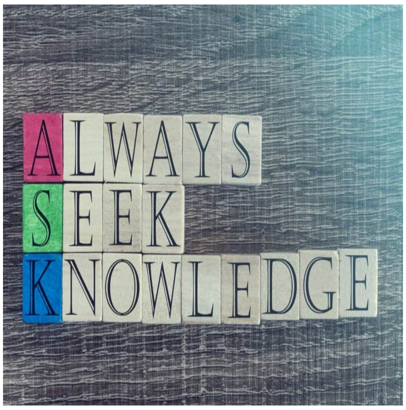

Warning: Taxes Could Rise Soon. Pick a TFSA Contribution Over the RRSP

Description

Canada's Tax-Free Savings Account (TFSA) and the Registered Retirement Savings Plan (RRSP) are both well-crafted tax shields for the average investor. However, most investors can't practically maximize their tax savings in both vehicles. They must pick between exhausting the TFSA contribution limit or deploying funds in the RRSP.

Usually, your personal circumstances and investing objectives should guide your decision between one or the other. However, a major macroeconomic shift occurred this year, and I believe this shift makes the TFSA more favourable than the RRSP for long-term investors. Let me explain.

A landmark year

2020 has been an interesting year to say the least. A global pandemic confined everyone to their homes and destroyed millions of jobs. In response, the government has unleashed an unprecedented stimulus package.

The government is currently spending billions of dollars on unemployment benefits, medical research, business loans, corporate bailouts and mortgage support. This spending spree will balloon Canada's sovereign debt and the fiscal deficit in 2020.

Meanwhile, the amount of taxes collected has declined. Sales taxes won't be collected, as the economy remains shut down. Income tax receipts will decline, as unemployment has surged. Corporate taxes could be hit as companies go bankrupt.

In other words, the government is spending more and earning less. To plug the gap, the government could be compelled to raise taxes in the future.

Tax today or tax tomorrow

Since taxes are likely to rise over the next few years, it might be better to pay taxes upfront and maximize the TFSA contribution limit right away. Deferring taxes and contributing to a RRSP means you'll end up paying potentially higher taxes on your wealth in later years.

In short, it might be better to pay today's lower rate of taxes on your income than to pay a higher rate on accumulated capital 10 or 20 years from now.

TFSA contribution limit

The TFSA contribution limit is controlled by the government. This year, the limit is $6,000. That limit has steadily expanded since the TFSA program was introduced in 2009.

However, the government could hold the limit steady for the next few years. Expanding the TFSA limit will simply magnify the government's deficit woes. So, investors shouldn't expect this tax-saving program to become more generous over time.

Nevertheless, the current TFSA contribution limit is adequate for most investors. $6,000 could represent nearly 20% of the annual median individual income in Canada. Most earners never reach that level of saving.

Foolish takeaway

Maximizing your RRSP or TFSA contribution limit is a question of when you prefer to pay taxes. You can defer taxes and contribute to the RRSP or pay taxes right away and contribute to your TFSA.

Considering the government's expanding debt burden and diminishing tax returns, I expect taxes to rise over the next few years. With that in mind, it may be better to pay today's lower taxes and max out the TFSA contribution limit rather than pay higher taxes on the RRSP later.

Planning for retirement should take into account the structure of taxes in the future, not just today.

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