Canada Revenue Agency: Retire Rich With Your RRSP and TFSA

Description

You don't want to spend your retirement years working in the office making the ends meet. You would prefer retiring rich and start the second-innings of your life in luxury. The Canada Revenue Agency wants the same for you. Hence, it has put in place two types of accounts the Tax-Free Savings Account (TFSA) and the Registered Retirement Savings Plan (RRSP). Both accounts allow your money to grow tax-free.

What differs is the payment of tax and the contribution limit. You can leverage both the accounts to reduce your tax burden and maximize your investment earnings.

RRSP vs. TFSA

The basic idea behind RRSP is to allow you to delay your tax payment until retirement when your tax rate is lower. The RRSP allows you to contribute 18% of your earned income, up to a maximum of $27,230. This maximum limit is for the 2019 tax year and is revised annually. You can deduct your RRSP contribution from your taxable income. Your money will grow tax-free in RRSP and you will pay tax only on your withdrawals.

The TFSA is the exact opposite. The idea behind it is to allow you to pay your taxes upfront and enjoy tax-free investment income. You can contribute a maximum of $6,000 a year and these contributions offer no tax benefit. Here again, the maximum limit is revised annually. The TFSA allows your money to grow tax-free and your withdrawals are also exempted from taxable income.

Both accounts have their advantages and disadvantages. Your income depends on how well you play on the advantages.

How to invest in a TFSA

A TFSA is an ideal investment platform for millennials with a low tax bill. Always use your TFSA to invest in high-growth and high-dividend stocks as your investment income will grow nine to tenfold in a decade. The TFSA will exclude all this money from your taxable income.

Jane is a 25-year old web developer earning $40,000 a year. She is also pursuing other courses to enhance her technical skill and move up the corporate ladder. The CRA offers her several tax breaks, significantly reducing her tax bill. She has a long-term investment horizon. Hence, Jane should max out her TFSA by investing $6,000 in high-growth stocks like **Kinaxis**, which has grown 84% year to date and 931% in five years.

If Jane started investing $5,000 every year in Kinaxis from January 2015, she would have around $124,000 in her TFSA. Even if she has an effective tax rate of 20%, she only paid $6,000 on her $30,000 contribution and earned $124,000.

Kinaxis is in the growth stage and has outperformed its rival **Descartes Systems**. Kinaxis offers supply chain planning solutions to large enterprises. The nature of its business helps it generate stable cash flows. It will continue to generate double-digit revenue growth for the coming few years.

You can consider other growth stocks like **Lightspeed POS** and **Shopify**. You can also invest in the **iShares S&P/TSX Capped Information Technology Index ETF**, which gives you exposure to the top tech stocks.

How to invest in RRSP

When you invest in RRSP, it's largely to reduce your current tax bill. Use RRSP for defense stocks that give stable returns and dividends as you don't want to put your retirement money at risk.

Going back to the previous example, when Jane turned 35, she was promoted to the role of senior manager and was earning $150,000 a year. At this income range, her effective tax rate is 29%, or $43,500. She is no longer eligible for most of the tax breaks the CRA offers. She can save $8,000 in her tax bill by investing $27,000 (18% of her income) in RRSP.

If you invested $27,000 in a dividend stock like the **Canadian Imperial Bank of Commerce**, you will earn more than $1,600 per year in dividend income. The bank has a 20-year history of paying regular dividends and increasing them at an average annual rate of 4.9% in the last five years.

Retire rich and tax-free

When you retire, use your RRSP to fund your basic living expenses as the withdrawals are taxable. Use your TFSA to fund your luxury as the withdrawals are tax-free. Make the maximum of your TFSA and RRSP to retire rich and tax-free.

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