Should You Contribute to Your RRSP or TFSA in 2020 and 2021?

Description

Some Canadians have set goals to save a set amount, such as $500, every month. Investing this money in tax-advantaged accounts, including Registered Retirement Savings Plans (RRSPs) and Tax Free Savings Accounts (TFSAs) for compounded returns will do greater wonders the longer you stay invested.

If you are able to invest $500 a month for a 10% annualized return over three decades, you'll be a millionaire with $1,085,660.55 to be exact. This scenario assumes no taxation, which would apply to investments in TFSAs.

The pandemic has disrupted the income of millions of Canadians this year. Many people are therefore forced to postpone their financial plans. If you still somehow managed to save some money for investing, should you contribute to your RRSP or TFSA?

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The benefits of the RRSP and TFSA still stay the same with or without a pandemic. The RRSP is a great tool for reducing your taxable income, while the returns in your TFSA are tax free.

If your income is miraculously not impacted this year and you fall in a tax bracket with a tax rate that's meaningfully greater than the previous bracket, it may make sense to contribute to an RRSP first over a TFSA.

For example, if you're in Ontario and you earn $50,000 from your job this year, the first $44,740 you earn has a tax rate of 20.05%. The next bracket from over $44,740 to $48,535 has a tax rate of 24.15%. The subsequent bracket from over $48,535 up to $78,783 has a tax rate of 29.65%.

If you reduce your taxable income to $48,535 by contributing $1,465 to your RRSP, you'd save about $434 of income tax. If you contribute $5,260 to your RRSP, you'd save roughly $1,351 of income tax.

Many years of investment returns from these saved taxes could add up to a hefty amount. For instance, $1,351 invested for returns of 10% per year will transform to $244,454 in 30 years!

If your income reduces meaningfully this year but you still have some money to contribute towards your investments, it might make sense to contribute to your TFSA first. In doing so, you can save your RRSP contribution room for future years in which you'd earn substantially more income.

The pandemic situation can continue through 2021. You can apply the same thinking process illustrated above to help you decide if it's better for you to contribute to an RRSP or TFSA.

Where can you get 10% rates of returns?

Enbridge (TSX:ENB)(NYSE:ENB) stock has become increasingly attractive over the last couple of months. It has corrected about 15% since its August high. In turn, its yield has been pushed up to a whopping 8.7%!

In other words, investors only need 1.3% of returns from price appreciation, which is a low bar to achieve for the energy infrastructure leader that has a track record of stable growth.

The dividend stock can actually deliver total returns closer to 17% per year, over the next five years, due to its attractive valuation.

The pandemic has disrupted the energy sector; this has gotten investors worried about Enbridge. Last quarter, the company reaffirmed its cash distribution guidance that places its payout ratio at about 70%, which would keep its dividend safe.

If you're not 100% comfortable with Enbridge, you can wait for its third-quarter results that are set to be released next Friday before making a decision.

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Date
2025/07/08
Date Created
2020/10/28
Author
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