TFSA vs. RRSP: Don't Be Tricked by the RRSP Refund!

Description

Since 1957, Canadians have had the Registered Retirement Savings Plan (RRSP) as their retirement savings tool. The Tax-Free Savings Account (TFSA) came in during 2009, or 52 years later. Now, people have two powerful investment accounts to choose from to build wealth or achieve retirement goals.

However, when the tax season comes, preference tilts toward the RRSP. Users contend the older account is better, because it offers a windfall, particularly a tax refund. If you're familiar with the tax mechanics behind both accounts, you will maximize the TFSA instead of the RRSP.

Misplaced fixation on tax refund

The fixation on the RRSP because of the tax refund associated with it is misplaced. Understand that the RRSP is a tax-deferred account, while the TFSA is a tax-free account. Thus, TFSA users argue that it isn't a windfall after all, but only the present value of your future tax payment when you withdraw from the RRSP later on.

Simply put, money growth in an RRSP is tax-free until withdrawn. You merely defer taxes payment but would still pay them upon withdrawal. In your TFSA, everything is tax-free, unless you break the rules or mismanage the account.

While you can claim a tax deduction when you contribute pre-tax dollars to your RRSP, the advice is to re-invest the tax refund instead of spending it. Otherwise, you forfeit the pre-tax advantages.

Furthermore, when the contribution amount and dates as well as the tax rate, rate of return, and withdrawal dates are all the same, the after-tax cash you'll generate in TFSA or RRSP is the same.

Eligible RRSP and TFSA investment

Whether you're an RRSP or TFSA user, dividend investing is the way to go. You can benefit from the price appreciation and generate a recurring income stream from dividends. An ideal holding in either account is **Canadian Utilities** (TSX:CU). This dividend stock boasts the longest dividend-growth streak on the TSX.

Canadian Utilities provides integrated business solutions in utilities, energy infrastructure, and retail energy to commercial and industrial customers in Canada, Australia, and Latin America. Its cash flows are stable and predictable, as 95% of total earnings come from regulated sources. Long-term contracted assets comprise the remaining 5%.

Besides the stable cash flow, the balance sheet and credit rating are strong. Expect further growth in the utility assets due to the $3.5 billion capital-investment plan and high-quality earnings.

The $9.5 billion diversified utility company has raised its dividends for 49 consecutive years. At $35.03 per share, the dividend yield is 5.04% dividend. Let's use Canadian Utilities to illustrate the result of the assumptions above.

Pre-tax income:	$ 5,000 (TFSA)	$5,000 (RRSP)
Tax rate at contribution – 40%:	$ -2,000	$0
Net contribution:	$3,000	$5,000
Growth at 5.04% after 20 years:	$8,020.76	$13,367.93
Tax upon withdrawal:	$0	–$5,347.17
Net cash:	$8,026.76	$8,020.76

Advantages

Canadians above 18 need the RRSP and TFSA to secure their financial future. The TFSA is more flexible and has no maturity like the RRSP. However, the RRSP works best as a tax-saving tool if you're in the high-income bracket. If not, there's no sense chasing after a tax refund. Moreover, TFSA withdrawals have no impact on income-tested government benefits.

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cliew