Which Will Save You More in Taxes: An RRSP or TFSA?

Description

When you're saving in the long term for retirement, you have two excellent retirement accounts at your disposal: the RRSP and the TFSA. Both accounts come with some hefty contribution space; both allow you to invest in numerous securities; and both can help you save a tremendous amount of money on taxes.

Though both accounts should have a place in your retirement plan, one might be better than the other in terms of saving you money on taxes. Which one should you choose to save for retirement? Let's take a closer look and see which might be right for you.

When the RRSP beats the TFSA

When it comes to the RRSP vs. TFSA debate, a good rule of thumb is this: an RRSP will most likely beat a TFSA when you expect your tax rate to be **lower** in retirement than it is now.

To understand why, let's recall how RRSPs and TFSAs are taxed. For your TFSA, it's fairly simple: you contribute after-tax dollars. You'll pay taxes at your current tax rate and then use that money to fund your account. Your money grows within the TFSA tax-free, and when you withdraw it, you don't have to pay taxes again.

With the RRSP, it's the opposite. You contribute with before-tax dollars. You won't pay taxes at your current tax rate: you *defer* them. When it comes time to withdraw money in retirement, you'll pay taxes at your tax rate *then*, whatever that may be.

So, here's the rub: if your tax rate is higher now than it will be in retirement, you'll pay more tax money to contribute to your TFSA then you will to withdraw from an RRSP.

Let's look at an example.

Let's say we have two retirement savers, Bob and Lynn. Bob's tax rate is 33%, and he contributes to his TFSA. Lynn's tax rate is also 33%, but she contributes to her RRSP. In retirement, Lynn's tax rate falls to 20.5%, and she'll pay 20.5% on her RRSP withdrawals. Bob doesn't pay anything to withdraw from his TFSA, but he paid 33% to *contribute* to it. Whose tax bill would be higher? Without specifics here, we can assume the 33% tax bill on the TFSA contributions would be higher than the 20.5% RRSP withdrawals.

When it doesn't matter which you contribute to

That said, if you expect your tax rate to be the same in retirement as it is now, then it doesn't matter which one you contribute to.

For instance, let's say Lynn's tax rate is 20.5% before retirement. If she expects her retirement income to completely replace her income, then she would most likely pay the same 20.5% tax rate. In this case, it doesn't matter if she contributes to an RRSP or TFSA. She's going to pay the same 20.5% rate on contributions, as well as the same rate on her withdrawals.

Rules are made to be broken…

When it comes to taxes, rules are always meant to be broken. And the same goes for TFSAs and RRSPs. The examples above are admittedly a bit oversimplified. You could, for instance, invest in some killer stocks within your TFSA, ones that grow 100-fold over your working years. If you keep that money invested in your TFSA, you could withdraw a significant amount of money without paying taxes, perhaps more than a RRSP could ever promise.

For that reason, it's always best to consult a tax advisor before you make investing decisions with significant tax consequences. They can help you make a tax plan that works for you as well as help you prepare your taxes when the time comes to calculate capital gains.

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