Should New Investors Open a TFSA or an RRSP First?

Description

Canadians have the chance to contribute to two of the best retirement accounts in North America or, dare I say, the world: the Tax-Free Savings Account (TFSA) and the Registered Retirement Savings Plan (RRSP). Do you think I'm exaggerating? Well, consider this: Canada is the only country in the Americas (North and South) that has made the world's top 10 pension systems several years in a row.

Our retirement accounts are so good, in fact, that it can be incredibly difficult to choose between them, especially if you're a new investor. Both accounts hold relatively the same investments, such as stocks and funds. But, hypothetically speaking, if you had to choose one over the other, which would make the better choice for a new investor: a TFSA or an RRSP?

When you should open an RRSP

When choosing between a TFSA and an RRSP, it comes down to one thing: taxes.

While both RRSPs and TFSAs have tax advantages, the RRSP is typically more advantageous. That's because your RRSP contributions are tax deductible, meaning you can take them off your taxable income. Depending on your annual income, your RRSP contributions could knock you into a lower tax bracket, helping you save on overall taxes.

But don't get me wrong: you will pay taxes on RRSP withdrawals. Because you contribute with "pre-tax" dollars — that is, money that hasn't been taxed — the CRA will tax you later. To calculate taxes owed, the CRA will use your marginal tax rate *at the time of withdrawal.*

Ideally, your marginal tax rate will be lower in retirement than it is now. For instance, if your household income is $160,000, your marginal tax rate will be much higher than a retired person who lives off $70,000 a year.

Bottom line: if your household income is high right now, then you might want to open an RRSP first.

When you should open a TFSA first

RRSPs have great tax benefits. But they're not ideal for short-term goals, like saving for a car or a vacation. While you can withdraw from an RRSP at any time (unless it's locked in), you'll likely pay extra taxes if you withdraw before you convert it into a RRIF. You'll have to include your withdrawal in your taxable income, and you'll have to pay a withholding tax, which could be fairly hefty depending on your withdrawal.

So, if you're saving for short-term goals, a TFSA would better serve you. You don't have to pay a withholding tax when you withdraw from your TFSA. And because you've already paid taxes on your TFSA contributions, you don't have to include TFSA withdrawals in your taxable income.

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