Should You Contribute to Your TFSA or RRSP in 2023?

Description

The Canadian retirement account landscape offers investors two main options when it comes to investing their hard-earned money: the Tax-Free Savings Account (TFSA) and the Registered Retirement Savings Plan (RRSP). The question is, which one should you prioritize?

Like many questions in investing, the answer is, "it depends." There's no hard and fast answer, and even if you get it wrong, it's not the end of the world. However, optimizing this decision can help some investors save more money down the line. Here's the run-down on the TFSA vs. RRSP debate.

When to choose the TFSA

In most cases, the TFSA should be prioritized. Income and capital gains generated in this account grow tax free, as its name suggests, which is important for maximizing returns.

Each year, your TFSA contribution room grows. In 2023, the contribution limit was increased to $6,500. If you turned 18 before 2009 and have yet to open a TFSA, you can contribute up to $88,000 in 2023 to catch up, assuming you have the money on hand.

The other reason to prioritize a TFSA over an RRSP is because any unused RRSP contribution room can be carried forward indefinitely. If you find yourself in a higher income bracket a few years down the line, the deferred RRSP contribution room can be a lifesaver.

Finally, if you have a work-sponsored retirement plan like a defined benefits (DB) pension, your RRSP room will be reduced by your pension adjustment. In this case, you won't have much RRSP contribution room altogether. The TFSA can come in handy here.

The TFSA is a great place to hold high-yielding investments, such as domestic Canadian stocks. A good set-it-and-forget-it option is i**Shares Core S&P/TSX Capped Composite Index ETF**, which provides exposure to the entire Canadian stock market.

When to choose the RRSP

In contrast, the RRSP is tax deferred. You make contributions to this account with pre-tax income, with contributions reducing your taxable income. Any capital gains or income in an RRSP is tax deferred, meaning you only pay taxes on it once you withdraw at retirement.

Your RRSP contributions in 2023 are limited to 18% of your annual income, subject to a maximum limit of $30,780. In general, investors in a high tax bracket who expect to earn less in retirement should prioritize the RRSP. If you earn more than $100,392, consider making enough of an RRSP contribution to bring your taxable income down to a lower bracket.

Remember that even if you don't use it, RRSP contributions can be carried forward perpetually, so don't worry if you have leftover space. Here are other valid reasons to prioritize RRSP contributions:

- Your employer is matching any RRSP contributions, which is literally free money.
- You are a dual citizen of the U.S. and thus a U.S. taxpayer (the TFSA is not recognized by the IRS).
- You have reasons to shield your savings from creditors.

If you plan on investing in U.S. stocks that pay dividends, the RRSP is the ideal place to hold them. This is because the IRS's 15% foreign withholding tax on dividends does not apply to U.S. stocks and ETFs in a RRSP. A good ETF to hold is **Vanguard Total Stock Market ETF**, which invests in over 4,000 U.S. stocks representing the entire U.S. market.

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