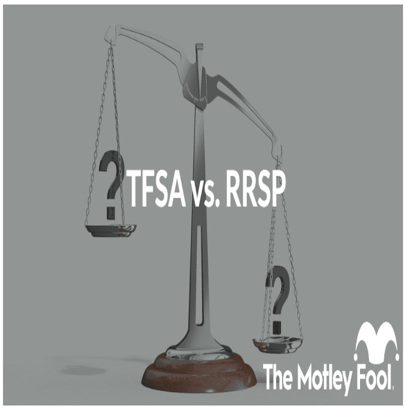

TFSA vs. RRSP: Which is Right for You?

Description

TFSAs and RRSPs are both retirement accounts that offer immense tax benefits and can help you save for long-term goals. They are both sponsored by the government, have clear limits on how much you can contribute per year, and give you the option to grow your money through stocks, exchange-traded funds (ETFs), mutual funds, and other investments.

But beyond these similarities, TFSAs and RRSPs have some notable differences, which could make one more appropriate for you over the other.

What are those differences? And how do you know which one is right for you? Let's look at the TFSA v. RRSP debate and find out.

What is a TFSA?

A Tax-Free Savings Account (TFSA) is a tax-advantaged savings account that can help you save for, well, pretty much anything. Whether you're saving for a car, a house, or retirement, TFSAs allow you to save money without having to pay taxes on interest or investment earnings gained. You can use your TFSA contributions to invest in a wide variety of securities, including stocks, funds, GICs, mutual funds, or bonds.

The biggest advantage of TFSAs is their tax-free withdrawals. Unlike the RRSP, which requires you to pay taxes on any money withdrawn in retirement, you won't have to worry about reporting your TFSA withdrawals on your tax filings. In addition to that, you can withdraw from your TFSA at any time, whether you're retired or not.

With a TFSA, you have a yearly contribution limit. Contributing more than the limit could result in a penalty. But if you contribute less, your unused space rolls over into the next year.

What is an RRSP?

Like a TFSA, a Registered Retirement Savings Plan (RRSP) is a government-sponsored retirement account that helps you grow your retirement savings, while also taking advantage of some exciting tax breaks.

Perhaps the RRSP's most exciting tax advantage is the ability to deduct contributions from your taxable income. For high-income earners, this could mean the difference between paying taxes in one tax bracket versus paying them in a lower one. In addition, you won't pay taxes on your RRSP earnings. That means, whether you have your money invested in stocks, an exchange-traded fund, or a GIC, you don't have to report gains on your tax filings.

Though you won't pay taxes on earnings, you will pay taxes on whatever you withdraw. These taxes depend entirely on your marginal tax rate *when you make the withdrawal.* If you withdraw money from your RRSP when you're not earning income (say, at 70), your marginal tax rate will be much lower than the tax rate you have now, helping you save more money on taxes.

Like the TFSA, your RRSP has contribution limits. The limits are either 18% of the previous year's earned income or an amount specified by the CRA, whichever is less. Again, if you contribute more than the limit, you could pay a penalty, though if you contribute less, your unused contribution space rolls over into the next year.

TFSAs vs. RRSPs: At a glance

	TFSA	RRSP
How much can you contribute?	For 2023, you can contribute $6,500 (for a lifetime maximum of $88,000).	For 2023, you can contribute 18% of last year's income up to $30,780.
What tax benefits does it come with?	Tax deferral.	Tax deferral and a tax deduction for contributions.
Are there any penalties for early withdrawals?	No. You can withdraw at any time.	No penalties, but if you withdraw before retirement, you'll pay a withholding tax.
Do you pay taxes on withdrawals?	No.	Yes, your withdrawals are taxed at your marginal tax rate.
When does it expire?	Never. You can keep a TFSA for as long as you live.	You must convert your RRSP into an RRIF before December 31 of the year you turn 71.

When should you use an RRSP?

In general, you'll enjoy the tax advantages of an RRSP if you're a high-income earner in a high tax bracket, and you want to save for retirement. For one, you can deduct annual contributions from each year's taxable income, which can lower your overall tax bill. Depending on how much you contribute, you could even put yourself in a lower tax bracket, helping you save even more on taxes.

Then there's the future. With RRSP contributions, you're essentially deferring income taxes. The idea is that by the time you turn 71, your income will be far lower than it is now. If that's the case, you'll find yourself in a much lower tax bracket, and you'll pay less in taxes on your withdrawals in retirement.

Finally, you should consider using an RRSP if your employer offers you an account — especially if there's a match. If you don't take the match, you're essentially leaving money on the table. But contribute at least up to the match and you'll take full advantage of the benefit.

When should you use a TFSA?

A TFSA is well-suited for low-income earners, especially those who believe they will earn significantly more in the future. If you're earning less right now, you might find yourself in a similar tax situation in retirement, or worse — in a higher tax bracket. In that case, you're better off paying taxes now while your tax rate is lower.

TFSAs are also well-suited for those who want more flexibility with their withdrawals. If your savings goals are mushy, if you want to save simultaneously for a house, a car, maybe a wedding — hopefully retirement — you're better off with a TFSA. You won't pay taxes on your money's growth, and you won't pay taxes on your withdrawals.

Finally, a TFSA comes in handy if you've maxed out your RRSP contribution space, and you still want to contribute towards your retirement. With a TFSA, you can also withdraw money before you turn 71, which could help those Canadians who want to retire before their RRSP expires.

How to decide if an RRSP or TFSA is best for you

Here are some scenarios wherein one account may be a better fit for you than the other.

An RRSP is best for you if ….

- **You're a high-income earner now.** When you start withdrawing from your RRSP in retirement, you'll be in a lower tax bracket (assuming you're earning less income). That means, you'll pay less income taxes than if you had let the money be taxed at your current rate.
- **RRSP contributions could knock you in a lower tax bracket.** With an RRSP, you can deduct your contributions from your taxable income. For high-income earners, this could make tax bills significantly lower.

- **Your employer offers a group RRSP with a match.** Many RRSPs are offered by employers as an employee benefit. If your employer offers to match your contributions, don't hesitate to takethe match.
- **You have a long-time horizon.** There's no doubt about it: RRSPs were designed for retirement savings. If your goal is to save money for retirement, an RRSP can help you achieve that.

A TFSA is best for you if ….

- **You want a flexible savings account.** You can withdraw from your TFSA at any time, for any purpose, without paying additional taxes. For some Canadians, that gives the TFSA a major leg-up in the TFSA vs. RRSP debate.
- **You don't want to pay taxes in retirement.** With a TFSA, you contribute "after-tax" dollars, that is, money you've already paid taxes on. That money will then grow tax-free within your TFSA account, and when it comes time to withdraw it, you won't have to pay income taxes.
- **You've maxed out your RRSP.** No one says you can't have *both* an RRSP and TFSA. If you've contributed the maximum to your RRSP, you can use your TFSA to continue saving for retirement.
- **You want a retirement account that doesn't expire.** Every RRSP has an expiration date — the year you turn 71. TFSAs, however, don't have an expiration date. You could have your TFSA for as long as you live, even long past your 100th birthday.

Foolish bottom line on a TFSA vs. RRSP

While, yes, there are some key differences between TFSAs and RRSPs, savvy Canadians should aspire to have both accounts.

When you're starting out, a TFSA could help you save for *any* financial goal, not just retirement. You'll dodge paying taxes on investment gains, and you can withdraw money for any purpose. As you get older, and as you start to earn more income, the RRSP will start to make more sense. You'll take advantage of the RRSP's tax deductions, and you could pay less income tax on withdrawals when your income is lower in retirement.

And, of course, both accounts give you a tax-sheltered vehicle to hold your investments. In this regard, the RRSP does have a slight advantage over the TFSA, as you can hold many foreign stocks in an RRSP without paying additional taxes. Other countries, such as the United States, don't view the TFSA as a retirement account, and you'll have to pay a non-resident withholding tax on any income you earn. But if you're using both accounts — the TFSA for domestic stocks and the RRSP for domestic and foreign — you can maximize contribution space for investments, while also minimizing your tax liabilities.

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