

TFSA vs. RRSP

The TFSA (Tax Free Savings Account) is here, but the biggest question, besides what is it (Please refer to our October article) is what should an investor do with it. A quick calculation can show the obvious advantages to having money grow tax sheltered. http://www.budget.gc.ca/2008/mm/calc_e.html However, how does this new account compare to the RRSP and which one should a client invest in? There are obvious and not-so-obvious similarities and differences between the two and this column will evaluate the comparative advantages and disadvantages of TFSAs as well as show an example of how they can be combined effectively to provide your portfolio with the greatest degree of investment and tax planning flexibility.

TFSAs (Current annual limit of \$5,000.00) and RRSPs (Current annual limit of 18% of "earned income" for the preceding year to an annual maximum of \$20,000.00 for 2008) are directly comparable in four ways:

- 1) They do not impose a tax on annual investment income
- 2) There are penalties of 1% per month for over-contributions
- 3) Carrying charges (borrowing costs) are not deductible
- 4) They both require holders to include only eligible investments.

In all other respects, they are quite different financial vehicles, starting with age limitations. While TFSA holders have to be at least 18, there is no minimum age requirement for an RRSP.

An important distinction is the ability for TFSA holders to carry forward contribution room indefinitely following withdrawals which is not replicated with RRSPs. With a few exceptions (notably the Home Buyers' Plan and Lifelong Learning Plan), when a withdrawal is made from an RRSP, the contribution room it represents is lost forever. Another important difference is the upper age limit. TFSAs can last the holder's lifetime, but an RRSP matures when the holder reaches age 71, at which time the proceeds are commonly rolled into annuities or Registered Retirement Income Funds (RRIFs).

The differences between the two accounts are more pronounced when it comes to taxes. Unlike TFSAs, RRSPs provide appealing tax deductions for contributions. It is difficult to overlook the instant gratification of the tax deduction from the RRSP contribution. But looking ahead, it helps to keep in mind that withdrawals from an RRSP are taxed as ordinary income whereas withdrawals from a TFSA are tax free. Also, unlike the TFSA, withdrawals from RRSPs may reduce the holder's income-tested benefits, including Old Age Security, the Guaranteed Income Supplement and the age credit.

TFSAs appear to have an advantage on the issue of contributions from spouses or common-law partners. The taxation for this situation is best explained in the scenario where one spouse earns all the family income. Where the working spouse provides the funds to contribute to a TFSA in the name of the non-working spouse, the income earned

in and/or withdrawals from the TFSA are not subject to tax. Therefore attribution rules would not require the working spouse to report any income or gains from the TFSA.

In comparison, with an RRSP, it is unlikely that the non-working spouse would have RRSP contribution room; however, the working spouse could make RRSP contributions to a spousal RRSP. In this case, the working spouse gets the RRSP deduction, but when the funds are withdrawn, the withdrawal is included in the non-working spouse's taxable income. This is a good income splitting technique (although the benefits are somewhat diminished by the new pension splitting rules). However, in certain situations, the attribution rules could apply and require that a withdrawal be included in the working spouse's income (note that RRSP attribution rules can be complex). We should also point out that, in the first year, this couple could contribute \$5,000 each to a TFSA, whereas the RRSP contribution is limited to the working spouse's RRSP contribution limit.

Both accounts face a deemed disposition on death, but while TFSAs have no tax on the disposition, the fair market value of an RRSP balance will be subject to tax. Both types of accounts allow for transfers to surviving spouses. A transfer of a TFSA to a surviving spouse is on a tax-free basis, whereas a transfer of an RRSP to a surviving spouse is on a tax-deferred basis, since on the death of a surviving RRSP holder, there will be tax owing on the remaining RRSP balance.

Deciding which best suits your financial needs:

Given the similarities and differences, how do you choose where to put your money to create the right balance? Using one or the other, or both, depends on your specific goals. TFSAs are flexible and can be used to meet either short-term savings objectives or long-term objectives like retirement savings. RRSPs are clearly designed for retirement savings with limited exceptions — allowable tax-free withdrawals (and subsequent repayment) for the Home Buyer's Plan (<http://www.cra-arc.gc.ca/E/pub/tg/rc4135/>) or the Lifelong Learning Plan (<http://www.cra-arc.gc.ca/tx/ndvds/tpcs/rrsp-reer/llp-reep/menu-eng.html>).

Your income levels both now and expected in the future are also important in choosing between the TFSA and the RRSP. If a client's marginal tax rate is higher at the time of contribution than it's likely to be when withdrawals are made (i.e. working income is higher than expected retirement income) an RRSP is preferable for its tax-saving qualities. If the reverse is true, and retirement income (and hence marginal tax rate) is expected to be greater than during the client's working life, then a TFSA might be the better choice because of those tax-free withdrawals.

For most people, it won't necessarily be an either/or situation. Those who consistently save and invest throughout their working lives—and there are such people—may well be in higher income brackets at retirement. Over the course of their working lives, they may juggle the utility of both types of accounts. RRSPs can be used to build savings that will generate retirement income while TFSAs can be used to top up savings, reach short term savings goals, and serve as emergency funds.

Along the way, you may need to juggle the need to contribute to savings while paying off your mortgage, a debate that gains a new layer of complexity with the arrival of TFSAs.

Previously, the debate focused on the pros and cons between contributing to an RRSP (gaining a tax deduction and a deferral) and paying down the mortgage on an asset that can generate a tax-free profit. (Please refer to our February article) The decision depended on many factors, including the mortgage rate, the expected rate of return on the RRSP investment and the tax rate on the RRSP deduction. Now, TFSAs add a third choice to the debate. Like mortgage repayments, TFSA contributions are in after-tax dollars, and investment gains will not be taxed. In choosing between the two, you have to estimate the future cost of mortgage rates and the possible investment return on the TFSA.

Most likely, an effective and balanced approach will fit an average scenario. In effect continuing to contribute to your RRSPs and then using the tax refunds to both reduce mortgages and build TFSA savings.

To demonstrate this lets look at a fairly typical scenario in Calgary; an individual whose annual income is \$62,237.00 and contributes close to the annual maximum at \$10,000.00 into RRSPs. The tax refund in that year will be approximately \$3,200.00. The average home buyer in Calgary is 36 (which we use in this scenario) and the average mortgage amount is 203,401.38 with an interest rate of 5.5%. If the investments grow at the same rate of 5.5% and you split the tax return each year by putting \$2,000.00 into the TFSA and an additional \$1,200.00 onto your mortgage you will pay the mortgage off in 21.58 years saving \$26,549.00 in interest (Based on a 25 year amortization). At the end of that 22 year period you will have saved \$431,118.47 in your RRSP and \$83,946.00 in your TFSA. In addition you have allowed a savings account that gives you flexibility for accessing emergency funds as well as large purchases.

Let's compare this with the two alternatives using the same cash flow into the investments:

- 1) Putting \$10,000.00 per year on the mortgage until it's paid off and then putting \$10,000.00 into an RRSP and the tax refund into a TFSA. This scenario would pay the mortgage off in 11 years and saving \$99,226.00 in interest. However, the investments would be greatly reduced (RRSP value in year 22 would be \$153,855.91 and the TFSA would be \$47,933.00). Keep in mind that there would have been an 11 year period of no savings for emergencies and/or large purchases which could have resulted in taking on more debt.
- 2) Putting \$10,000.00 per year into an RRSP and putting the refund towards the mortgage. This would have also resulted in a substantial savings of interest of \$55,094.00 and the mortgage would be paid off in 17.67 years. However, the risk of no savings would be extended to 17 years from 11 years. The investments at the end of the 22 year period would be greatly reduced (RRSP value: \$45,810.91 and TFSA Value: \$18,344.00)

It sounds complicated, but it isn't. The important thing to remember is that the TFSA is another weapon in your savings arsenal. Combining the RRSP, TFSA, and additional deposits on your mortgage can be a powerful, flexible, and balanced approach to your long term planning.

A complete analysis of your financial planning needs with a qualified and experienced professional, will help you to determine what your needs may be.

For a no obligation analysis of your financial planning needs, please contact us to discuss and review your options for your unique situation.