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# TFSAS OR RRSPS: TIPS, TRAPS & OPPORTUNITIES

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QUBE WHITEPAPER

# TFSAs or RRSPs: Tips, Traps & Opportunities

Saving for retirement is a daunting task, but Canadians have help. Tax-advantaged options include Tax Free Savings Accounts (TFSAs) and Registered Retirement Savings Plans (RRSPs). Some, blinded by the RRSP tax credit, assume that the RRSP is better, but the decision on which to utilize first could have significant implications. To illustrate, we will follow Joan and her evaluation of each of these accounts.

## Who is Joan?

Joan, almost 30 years old, has been successful in her career so far. She now wants to start saving more for retirement and, maybe, buy a home. She currently earns $85,000 a year and has a 31% marginal tax rate. She didn't study finance in school and needs help to determine where to start. **An RRSP or TFSA?**

- "How do TFSAs and RRSPs differ?"
- "Are RRSPs better than TFSAs?"
- "Can I use RRSPs or TFSAs to buy a home?"

## "How do TFSAs and RRSPs differ?"

**RRSPs:** 2021 contribution limit is the lower of 18% of your previous years gross income up to $27,780, plus any unused contribution room.

**TFSAs:** $6,000 plus any unused contribution room from previous years

*TFSA and RRSP limits are subject to change annually

**Tax Free Savings Accounts** were introduced in 2009 and were designed to be flexible, general purpose savings accounts. These tax-sheltered accounts allow individuals, like Joan, to invest her after-tax income free of tax. One of the major benefits of TFSAs is that Joan would have the flexibility to withdraw her investments without incurring tax (e.g., a down payment on a house), then redeposit the funds in a future year.

**RRSPs** have been around since 1957. They allow Joan a way to deposit and invest "pre-tax". This gives Joan the opportunity to invest more in the account today. Like TFSAs, RRSP accounts are also tax-sheltered, but if Joan were to withdraw investments from her RRSP, the withdrawal amount would be taxable. Further, she cannot redeposit the funds in a future year as the contribution room is lost permanently.

## An Example: TFSA vs. RRSP

### TFSA

Joan could decide to invest $1000 of her employment income in a TFSA.

**$690** → **TFSA**

**$310** → **Taxes**

She would have first paid tax (we'll assume at her marginal rate) on the $1,000 of employment income, leaving her with $690 to invest in her TFSA.

In a future year, when she decides to withdrawal the investments from the TFSA, the growth and capital can be accessed free of tax as the entire withdrawal is tax-free.

### RRSP

Joan could decide to invest the $1000 of employment income into an RRSP. The deposit creates a refundable **tax credit** that eliminates the taxe on the income.

**$1000** → **RRSP**

In other words, Joan can fully invest the $1,000 of employment income in the RRSP account (compared to the $690 that went into the TFSA).

Unlike the TFSA, when she withdraws the RRSP funds, the entire amount is taxable.

**Age of 71**

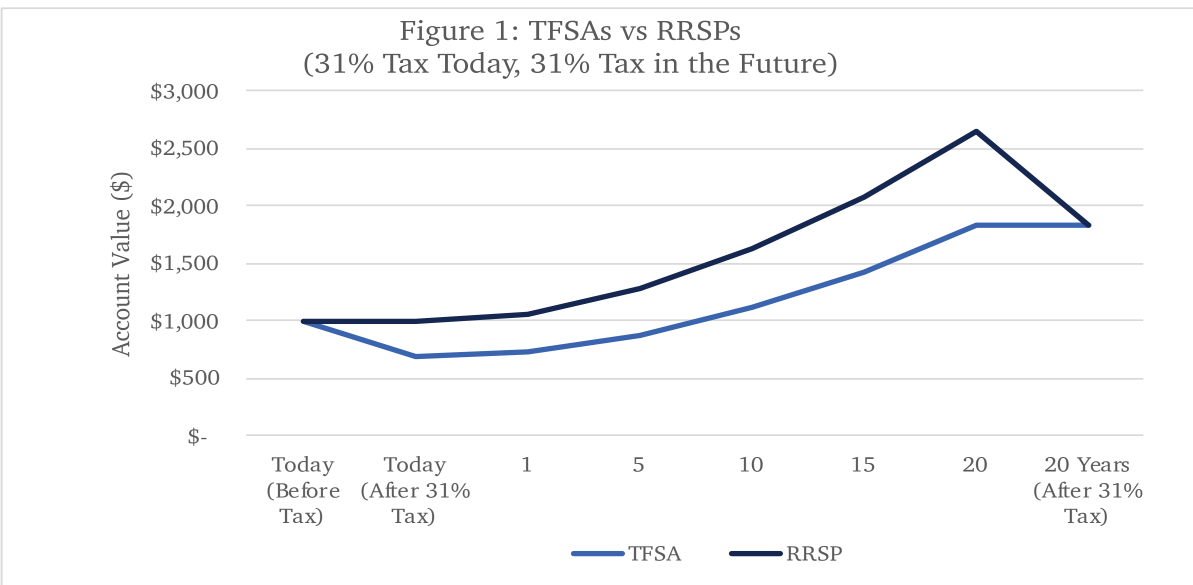
After 71, RRSP contributions are no longer allowed and funds have to be withdrawn, transferred to a Registered Retirement Income Fund (RRIF) or purchase an annuity.

## “Are RRSPs better than TFSAs?”

Many Canadians don’t realize that when an RRSP and TFSA have the same investment time frame, annual returns and tax rates (entering and exiting the accounts), they produce equivalent results. Joan, therefore, needs to first focus on her tax situation when evaluating which account to use. A couple of scenarios with a $1,000 contribution can help illustrate this.

### Scenario 1 – Joan has no change in tax rate!

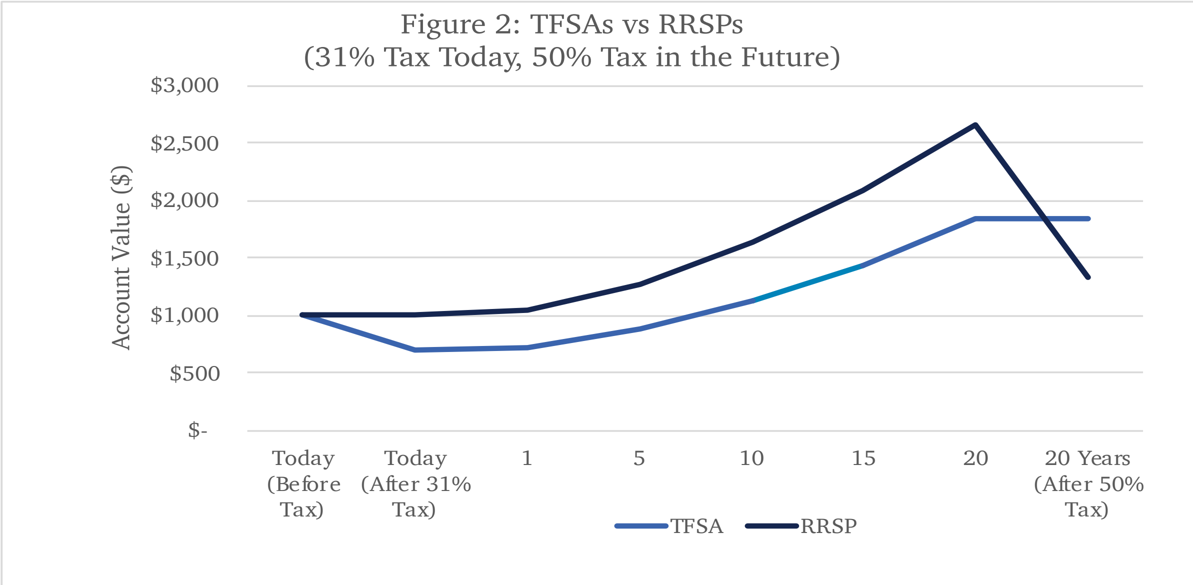
Joan is currently paying 31% in taxes on decisions like this (called the marginal rate). If in retirement she expects to be paying the same tax rate, there will be no difference between choosing a TFSA or RRSP (Figure 1). By depositing into the TFSA after-tax, the depositor has less to start with and less to grow tax-free. Overall, RRSPs appear to outgrow TFSAs. However, upon withdrawal, taxes will reduce the RRSP balance leaving Joan with the same amount as the TFSA after-tax.




*Assumptions: 5% ROI every year on both TFSAs and RRSPs

### Scenario 2 – Joan’s successful career increases her tax rate! (Proceed with caution!!!)

Joan is early in her career and has high earnings potential. It is possible that she may draw her retirement income at a higher tax rate than at this point in her career. This situation would not affect her use of TFSAs but it would harm her when using an RRSP.




*Assumptions: 5% return each year on both TFSAs and RRSPs

## The Bottom Line

If Joan projects a higher tax rate in retirement, TFSAs are her better option. Relative to the TFSA, the RRSP could actually harm her wealth. However, if she expects to be in a lower tax bracket in retirement (like most Canadians), RRSPs will outperform TFSA accounts and boost her after-tax wealth. To be safe, she could start with the TFSA early in her career and then transfer the investments to an RRSP when her tax bracket is higher.

## "Can I use RRSPs or TFSAs to buy a home?"

Buying a home is part of our culture and a major financial decision for any Canadian. Both TFSA or RRSP accounts can facilitate this decision, but in different ways. TFSAs allow flexible withdrawals, for example, permitting a down payment on a home. RRSPs offer a Home Buyer Plan (HBP) benefit in addition to a Life-Long Learning Plan (LLP)

## Home Buyer Plan (HBP) & Life-Long Learning Plan (LLP)

For Joan, if she's planning on purchasing a home, or going back to school, she can borrow funds from her RRSP account under the HBP or LLP programs.

### Home Buyer Plan (HBP)

The HBP is designed to give Canadians access to upwards of **$35,000** from their RRSPs, tax and interest free, if put towards a first home.

In Joan’s case, if she were to save $35,000 into her RRSP (at a 31% tax rate), she could save $10,850 in taxes when using these funds towards a first home.


If she had a partner and they were also eligible as a first-time home buyer, both could withdraw $35,000 from their RRSPs, giving them a total of $70,000 towards the home purchase. Withdrawals from the HBP have to be paid back within 15 years (1/15 of the loan each year), or the missed payment becomes taxable income. Sometimes we see parents assisting children, like Joan, by gifting funds that are first placed in an RRSP and then used for the HBP. Joan then pays back her RRSP instead of her parents. By doing this it will help her in buying a house today while also setting her future retirement as a priority.

### Life-Long Learning Plan (LLP)

The LLP plan is similar to the HBP, where if Joan decided to go back to school, she could withdraw up to $10,000 per year to a maximum of $20,000 from her RRSP and then repay it within 10 years (1/10 of the loan each year).


### The Bottom Line

The HBP and LLP will help Joan not only save on taxes today but also save on any interest payments made on a larger mortgage. Here with the LLP, parents have gifted funds to their child or grandchild for schooling, with the funds first being placed into the RRSP and then utilizing the LLP to pay for skill upgrades. It helps today, while setting the long-term priority of retirement saving.

## "Once I decide between a TFSA or RRSP, what should I be aware of?"

There are a few things that should be taken into consideration when making the TFSA or RRSP decision. For instance, Joan needs to monitor how much she is contributing to an RRSP or TFSA. Contributions over her limit can be costly, often attracting a 1% penalty per month.When investing, Joan could work with an advisor to ensure her investment choices are permitted in the RRSP or TFSA. For instance, if she were to hold a foreign stock in her TFSA, she could be subject to a foreign withholding tax. Below is a useful "Cheat Sheet" that can assist with TFSA and RRSP planning:

## TFSA vs. RRSP Cheat Sheet

| | TFSA | RRSP |
|---|---|---|
| Age Limit | 18+ | 0-71 (income must be earned) |
| 2021 Contribution Limit (Annual) | $6,000 (2021) plus any unused contribution room | Lesser of 18% of earned gross income or $27,780, plus unused contribution room from previous years |
| Indexing of Contribution Limit | Based off the Consumer Price Index, increments of $500 | Based on the average wage increase in Canada |
| Tax-deductible contribution | No | Yes |
| Tax payable on investment growth | No | No |
| Taxable Withdrawal | No | Yes – Pay at marginal tax rate |
| Ability to Re-deposit withdraws | Yes, but only in the next or future calendar year | No. Except for the HBP and LLP programs |
| Withdraw Limit | None | None |
| Excess Contributions | 1% penalty/ month | 1% penalty/ month with a $2,000 buffer |
| Tax on Death | No | Yes, if no rollover to a spouse or disabled dependent child |
| Other | Need to be aware of Foreign Withholding tax | Need to be aware of OAS and GIS Claw backs when timing withdrawls |
| Expiration | No Expiry | Must be converted to RRIF by Dec 31 in the year you turn 71 |

## Why do we do this?

At Qube, we are passionate about many great topics focusing on Canadians' investment needs. With our passion for financial planning, we promote financial literacy to anyone within our reach. The whitepapers we create aim to bring awareness of the benefits that working with a wealth manager provides. After reading the papers, our objective is to have the opportunity to prepare an investment proposal for potential clients. While the topics we write about are applicable for Canadians, Qube specifically services clients anywhere in Alberta and British Columbia.

## Next Steps

Your goals, whether they are focused on ensuring a comfortable retirement, growing a business, taking care of later generations or something more intangible, we are here to make it matter. We want you to reach out to see how we can help. You can contact Qube at info@qubeinvest.ca or by phone: 1.866.463.7939.

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