RRSP vs TFSA: What's the Difference, and Which one is Right for you?

Both RRSPs and TFSAs have been around for some time now, since 1957 and 2009 respectively. Yet many Canadians are still confused by what they are, how they differ and what they have in common.

Both of them were created by the federal government as registered accounts to encourage Canadians to save. With only a third or so of Canadians having a company pension, and with CPP and OAS barely covering basic expenses, the onus is on most of us to save enough so that we have the kind of retirement we want. RRSPs and TFSAs can help us to achieve that.

So, what are RRSPs and how do they work?

A registered retirement savings plan (RRSP) is a tax-deferred saving/investment plan. Any money you put into your RRSP is deducted from your gross income, which means that you pay less tax. If you pay tax at source, like most employed Canadians, you may get a considerable tax refund.

Also, any increases in the investments within your RRSP — in the form of interest, dividends and capital gains — are tax free. There's a maximum amount you can invest in your RRSP each year: it's the lower of 18% of your gross income or $27,230 in 2020. However, if you didn't contribute the maximum amount in any year that you worked, this amount can be rolled over to subsequent years. Your most recent tax return will show how much your unused contribution room is.

You don't need to hold just cash in an RRSP — and it doesn't make sense to do that. You can have guaranteed investment certificates (GICs), stocks, mutual funds, exchange traded funds (ETFs), real estate investment trusts (REITs) and bonds within an RRSP.

In the year you turn 71, you have to close your RRSP. You can either withdraw all the cash (but you would pay a hefty amount of tax on this), transfer it into an annuity (which will provide you with regular payments) or convert it into a registered retirement income fund (RRIF). Any payments you receive from your RRIF or annuity are counted as income and taxed.

If you withdraw money from your RRSP for reasons other than your education or as a down payment on a new home, you will pay a withholding tax and it will also be included as income for tax purposes.

RRSPs are most effective if you can get tax breaks when you are working and in a higher tax bracket, then pay tax in retirement when you are in a much lower tax bracket.

How do TFSAs work?

A tax-free savings account (TFSA) is similar to an RRSP in that it allows your investments to grow tax free. Contributions are not tax-deductible, however, but you can withdraw money from it at any time without paying tax on it.

The pros and cons of RRSPs

The main advantages of RRSPs are:

- You get an immediate tax break when you contribute to it
- Your money grows (and compounds) tax free
- Your unused contribution room can be carried forward to subsequent years
- Your investments within RRSPs are protected from creditors

Disadvantages of RRSPs include:

- Withdrawals are counted as income and taxable
- You could be heavily penalized when drawing directly from an RRSP rather than a RRIF or annuity
- You have to start withdrawing a set amount from age 71 onwards

- Withdrawals can have a negative impact on old age security (OAS) and guaranteed income supplement (GIS) benefits
- Allowable contribution limits are based on income – if you don't earn much, you can't contribute much

The pros and cons of TFSAs

TFSAs have several key benefits:

- Your investments grow tax-free
- You can withdraw funds at any time, with no penalties or income tax
- You can recontribute any withdrawn amounts in the following year
- Any unused contributions can be made in subsequent years
- Withdrawals don't have any impact on OAS or GIS

There are only two main drawbacks to TFSAs:

Contributions are not tax-deductible
Investments can be taken by creditors in the case of bankruptcy

So, which is better for you, a TFSA or an RRSP?

For many working Canadians, contributing to both accounts would be ideal. This would maximize savings and provide a more comfortable retirement. However, people on low income and/or a low tax rate may do better saving within a TFSA.

You certainly don't want to be in a higher tax bracket when you retire than when you were making contributions, because you could end up paying more tax. If you have a great company pension plan, taking out an RRSP may not make sense. And if you're over 71, a TFSA is your only option of the two.

Making an informed decision

A Cornerstone financial advisor can take a look at your overall financial situation and advise you on whether an RRSP, TFSA or both would be the best option for you. Call us on 1.855.875.2255 to set up a meeting.