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TFSA vs RRSP: which should I contribute to?

Investment Insight

With the tax-free savings account (TFSA) available for saving in a tax-free environment, does it still make sense to contribute to a registered retirement savings plan (RRSP)?

RRSPs can work well if you contribute while you're in a high tax bracket and withdraw when in a lower tax bracket. You can generate a higher net rate of return with an RRSP when the effective tax rate at the time of withdrawal is lower than the effective tax rate at the time of contribution. A TFSA can provide a higher return if the reverse occurs.

For example, if you contribute $1,000 to an RRSP when you are in a 20 per cent tax bracket, your net cost is $800 after tax savings. If you're in the same tax bracket when you make a withdrawal from your RRSP, your net withdrawal will be equal to your net cost after paying the taxes ($800). However, if you're in a higher tax bracket when you make the withdrawal, say 40 per cent, then your net withdrawal will only be $600 after the taxes are paid.[1]

Should I use a TFSA, RRSP, or both?

Low income

A TFSA can be an ideal savings vehicle if you're in a low-income tax bracket. RRSPs may not be well suited to low-income Canadians. The RRSP tax savings are insignificant and you may be in a higher tax bracket when you make withdrawals, as the earlier example demonstrates. You may also want to consider that TFSA withdrawals don't impact income tested benefits and credits, such as child tax benefits and credits, Old Age Security, or Guaranteed Income Supplement.

If you now find yourself in a lower tax bracket, such as when on maternity leave, and made RRSP contributions in the past, you may want to consider withdrawing from your RRSP to make a TFSA contribution. However, remember that funds withdrawn from your RRSP can't be re-contributed later.

Middle income

One strategy would be to contribute to your TFSA now and accumulate RRSP room to be used later when in a higher tax bracket to optimize the tax benefits.

High income

This is a situation where you may want to maximize both your RRSP and TFSA contributions. In fact, the tax savings or refund received from the RRSP contribution could be used to fund the TFSA.

Which option is better with a HBP and LLP?

If you're saving for a down payment on a house, a TFSA might be a better option than saving in an RRSP and withdrawing under the Home Buyers Plan (HBP) for several reasons:

- You have the flexibility to recontribute the TFSA withdrawal without time limits.[2] If HBP repayments aren't made on time, the annual repayment amount is added into your income and any missed repayment amount means the RRSP room is lost forever.
- There's no restriction on how much you can withdraw from your TFSA, while the HBP restricts you to $35,000 from each of your RRSP and your spouse's RRSP. Alternatively, you could each contribute $5,000 a year for seven years to a TFSA and then withdraw $35,000 plus any investment earnings tax free and with no required repayments.
- There are no conditions on TFSA withdrawals, whereas the HBP requires you to be a first-time home buyer.

Similar logic could be applied to the Lifelong Learning Plan (LLP). By using a TFSA to save and fund continuing education, contributors can gain increased withdrawal flexibility while eliminating any enrollment requirements or repayment conditions.

Whether to save in a TFSA, RRSP, or both depends on your savings needs, your eligibility for income tested benefits, and your current and expected future financial situation and income level.

Important disclosures

1 To simplify the illustration, we're assuming that the market is flat and there's no return. **2** Amounts withdrawn in a taxation year will be reflected in contribution room in the following year.

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