It is that time of year again – RRSP season and more and more people are questioning should they be prioritizing their RRSPs, or their TFSAs? The article for this month's edition of the Monthly Compass comes to us from Money Sense Magazine and seeks to help answer this very question.

The article suggests that the answer generally comes down to will you be paying more or less tax in retirement than you are today. If you will be paying less tax later, prioritize your RRSP. If you will be paying the same or more tax later, prioritize the TFSA.

Practically, as we look to create a tax-efficient income for your retirement, having investments in a TFSA account are highly valuable for many reasons, including:

- Income from the TFSA is tax free, and it doesn't count towards the OAS Clawback

- Periodically larger expenses do happen in life – a new roof, car replacements etc. If you have to fund large onetime expenses through taking money from your RRIF, that expense is actually much larger due to the tax burden of the additional withdrawal. It would be most beneficial to instead fund these expenses by a tax free withdrawal from your TFSA

At Farwell Wealth Management we advocate both the RRSP and TSFA as being valuable tools to providing a comfortable retirement. Ideally you will retire with both – RRSP and TFSA assets. Your personal RoadMap to *Retire on Your Own Terms*™ helps you determine the right mix of both accounts as we look to tax effectively save for retirement and provide a tax efficient income during your retirement.

As always, your team of retirement specialists at Farwell Wealth Management are here to help you *Retire on Your Own Terms*™ – including starting Your Personal RoadMap.

The RRSP advantage

With the government hinting it will double contribution room, everyone's talking TFSAs. But the good old RRSP is still a better choice for most of us

by David Hodges

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These days you'd be hard-pressed to find a Canadian who isn't clamouring for Prime Minister Stephen Harper to just get on with it and finally give us more TFSA room. The PM has hinted—strongly—that the annual contribution limit on Tax-Free Savings Accounts will soon be almost doubled, from $5,500 to at least $10,000, which could make the TFSA a serious player as a retirement savings tool. But John Storjohann, for one, just yawns at the news. Sure, the 58-year-old Calgary project manager likes TFSAs just fine, but for him, RRSPs will always come first when he puts money aside for retirement.

"I know my income when I'm retired is going to be a lot less than what I'm making now, and I don't have a workplace pension plan," he says. "I'm trying to max out my RRSP, but I've still got lots of contribution room left. After that, I'd start thinking more about the TFSA."

Storjohann is keenly aware of the two main advantages of RRSPs: the tax refund when you make a contribution, and the tax-deferred growth until you make withdrawals in retirement. These make RRSPs ideal for those who expect to be in a lower tax bracket when they stop working—which will be the case for most Canadians. For those in the highest tax bracket today, the RRSP is a no-brainer. That's why Storjohann's always surprised when he meets people pulling in good incomes who think TFSAs stack up better than RRSPs. "People just don't understand how these accounts work."

While TFSAs let you earn a lifetime of tax-free growth, it's fair to say that many Canadians are contributing to TFSAs when they shouldn't be—a decision that may result in them paying higher taxes and having less income in retirement. Indeed, there are only a few instances when it makes sense to prioritize a TFSA over an RRSP. Read on and we'll show you why RRSPs are still the best way for most people to build their wealth.

Lower taxes, bigger savings

Like many Canadians, Jessica Foster and her husband Jason are unsure whether they should invest in RRSPs or TFSAs. "We have lots of room left in both, but we aren't sure what we should be contributing to first," says Jessica, a 29-year-old lawyer in Toronto's legal publishing industry. "We make decent money, but I don't think we're saving enough, and I am constantly worried about our ability to retire."

Between paying off their mortgage and other living expenses, the Fosters can't afford to max out both their RRSP and TFSA. But they're concerned that building up substantial RRSPs might be "a tax time bomb" waiting to detonate in retirement, and think they could minimize future taxes by using a TFSA instead.

This is the most common objection to RRSPs: people simply hate the idea of paying taxes on the withdrawals. Money taken out of a TFSA, by contrast, is tax-free, which sounds far more appealing. But that logic ignores the fact that you receive a tax refund when you put money in an RRSP, while TFSA contributions are made with after-tax dollars. So for the Fosters and other Canadians weighing this decision, it comes down to whether it's better to pay tax now or later. And that's not an easy question to answer.

Pension expert Malcolm Hamilton, a senior fellow at the C.D. Howe Institute, sympathizes with the confusion over the matter. "It's an annoyingly complicated question, and in a well-designed system it would be easy to answer it."

Eric Kirzner, a professor at the University of Toronto's Rotman School of Management, agrees. "Some financial planners get too deep in the weeds on this question, and the math associated with distinguishing the tax benefits are way too speculative," he says.

Both Hamilton and Kirzner say that anyone earning more than $50,000 is usually better off prioritizing RRSPs over TFSAs. While both accounts allow your investments to grow tax-free, the tax refund makes the RRSP more attractive for high-income earners. You can contribute up to 18% of your previous year's income—to a maximum of $24,930 for the 2015 tax year—and deduct that amount from your current income. You'll eventually have to pay taxes on RRSP withdrawals in retirement, but if you earn less income in your post-working years, you will be taxed at a lower rate.

That, in a nutshell, is what makes RRSPs better than TFSAs for higher earners: Not only are you taxed on your money years later, but because you're in a lower bracket when you retire, you'll pay less tax too.

Reinvesting your tax refund also helps to supercharge your savings, thanks to the magic of compounding. That's precisely what appeals to Jamie Kotlewski, a 26-year-old hospital pharmacist in Calgary. "Right now, I prefer my RRSP over my TFSA. It provides an instant tax refund that allows me to gross up my RRSP," he says.

Say you're contributing $5,000 to your RRSP each year and your marginal tax rate is 30%. If you reinvest your refund every time you get one, after 10 years your RRSP will be worth $90,000. If you don't reinvest your refund, your RRSP will be worth just over $66,000—almost one-third less.

Better behaviour

When your income is between $35,000 and $50,000, the long-term tax differences between RRSPs and TFSAs become negligible, says Malcolm Hamilton. In that salary range, "just being able to put money aside in either an RRSP or a TFSA is great."

But RRSPs can still be a better choice for reasons that don't involve tax deferral or refunds. In his new book, Wealthing Like Rabbits, author Robert Brown makes the case for favouring RRSPs over TFSAs most of the time because the former usually means less temptation to access your retirement savings early.

Because money in a TFSA has already been taxed and any earnings on contributions are completely tax-free, Brown says it can be tempting to dig into your retirement fund for indulgences like a new car or a vacation. Even Jessica Foster admits one reason she's averse to RRSPs is that she wouldn't be able to access the money easily, perhaps for a home renovation. Brown says that's precisely why she should use RRSPs: "If you take money out of your RRSP early, the tax man is going to nail you. Hard. Painfully. He will take up to 30% of your money at source, before you even see it," he says. "It will cost you $4,500 in taxes on a $15,000 withdrawal."

Jason Heath, a fee-only financial planner at Objective Financial Partners in Toronto, sees TFSAs being used unwisely all the time—particularly among the middle-class. "People have this idea that they should be using TFSAs because of the hype, and because planners tell them they should. But a lot of times TFSAs are promoted as a short-term savings tool, or an emergency fund. I'm not a fan of those kind of approaches." Heath would rather see middle-income earners who are saving for retirement max out their RRSP first, and then use any additional disposable income to pay off their home more quickly. That's precisely what Jamie Kotlewski does. "When I have finished maxing out my RRSPs I will pay down my mortgage and reinvest before I use a TFSA."

Borrowing from yourself

As Robert Brown points out, withdrawals from an RRSP are usually taxable immediately. But there are a couple of federal government programs that allow you to tap your RRSP in special circumstances without paying tax on the withdrawals.

The Home Buyers' Plan (HBP), introduced in 1992, allows first-time home buyers to withdraw up to $25,000 from their RRSP to put towards a down payment. In the case of a married or common-law couple, the combined tax-free withdrawal amount increases to $50,000, as both can pull $25,000 from their accounts.

Taking a big dent out of your home loan does more than just reduce the amount of interest you'll pay. Banks don't require mortgage insurance for buyers making a 20% down payment. So if borrowing from your RRSP allows you to get over that threshold, you'll save thousands in mortgage insurance premiums.

The only catch with the HBP is that you will have to pay the money back, but you have up to 15 years to do so, starting the second year after the money was withdrawn. You need to report the repayments on your tax return each year—and you don't get a tax break, because you got a refund when you made the original contribution.

If you're returning to school as an adult, you can also take advantage of the Lifelong Learning Plan, which works in a similar way. The LLP allows you to withdraw up to $20,000 (no more than $10,000 in any year) from your RRSP if either you or your spouse is attending school. You have 10 years to pay it back, and the first repayment isn't due until the fourth year after the first withdrawal.

Pension income splitting

No one relishes the idea of getting older, but one of the advantages of using an RRSP is that when you draw it down after age 65 you're entitled to split up to 50% of the income with your partner. (Note that to qualify for income splitting the RRSP needs to be converted to a Registered Retirement Income Fund, or RRIF.) For senior couples in different tax brackets, this strategy can dramatically reduce their overall tax bill. Not only does it allow some of the RRIF income to be taxed in the hands of the lower-earning spouse, it can also reduce clawbacks on your Old Age Security (OAS) benefits. "That's a valuable thing for some people," says Malcolm Hamilton. "This makes the RRSP look more attractive compared to the TFSA, where income splitting is a non-issue."

To use a simplified example, consider a fictional couple, Scott and Stefania, who are both 67. Stefania has little income or retirement savings, while Scott receives $60,000 a year from his RRIF and $30,000 from consulting work, in addition to his OAS and Canada Pension Plan benefits. Because Scott's income is high, his marginal tax rate is 43% and his OAS is clawed back. But by splitting his RRIF income with Stefania, Scott can reduce his taxable income by $30,000, which lowers his tax bill and allows him to keep all of his OAS. Meanwhile, that $30,000 will be taxed in Stefania's hands at a much lower rate, saving the family thousands of dollars.

As you can see, understanding the differences between the RRSP and TFSA retirement investing can save you a bundle in your post-working years. Both of these tax-sheltered accounts are useful tools that can help you hold onto more of your income—but only once you've determined which one works best for you.