FINANCIAL POST

January 16, 2017

Timing is everything: The long and the short of the TFSA vs RRSP decision

By Garry Marr

RRSP have had a big head start when it comes to personal financial planning in Canada, but the TFSA appears to making up ground fast

The registered retirement savings plan, 60 years running as of 2017, has had a big head start when it comes to personal financial planning in Canada, but after eight years of existence, the tax-free savings account appears to making up ground fast.

As they now both do battle for your hard-earned savings, the right vehicle for you can come down to a number of factors, not the least of which might be your plans for the money and whether you'll be accessing it in the short-term, medium term or long-term.

Short term

"The short-term is usually one-to-five years," says Carol Bezaire, vice-president tax, estate and strategic philanthropy of Mackenzie Investments. "If you are going to invest in the short-term, it always depends on your lifestyle and the kind of money you are putting away - pre-tax money or after tax money. You need to know your tax picture."

If you're in a high bracket, she says you probably do want to max out on your RRSP contribution to get a deduction and produce more after tax money.

"I think when we talk about saving for more short-term things like vacations or cars, the TFSA makes sense," said Bezaire. "You'll be taxed on any money you take out of your RRSP, unless it's under the Home Buyers' or Lifelong Learning Plan."

One short-term problem becoming increasingly more common for savers could be sudden employment and a need for cash fast. A withdraw from your RRSP would face a withholding tax plus it would count as income in the year you had employment.

"People do have significant savings in their TFSAs and the advantage is if you withdraw that money, you can pay it back in the next year," she says.

Brian Burlacoff, an advisor with Sun Life Financial, points out the Lifelong Learning Plan allows you to access some of your money to get more education, a short-term financial situation with long-term goals.

Under the lifelong learning plan you can withdraw up to $20,000 from your RRSP - $10,000 in each calendar year - as long as you or your spouse or common law partner is in enrolled in a designated education program defined by the government. The money has to be repaid over 10 years, one-tenth each year.

He says saving for something as simple as a vacation clearly falls into the TFSA category. The problem with RRSP withdrawal, in addition to being taxed, is the contribution room is gone forever.

Michael Allen, a portfolio manager at Wealthsimple, which focuses on millennials and counts 87 per cent of its clientele as under 45, says the liquidity benefits of the TFSA have become very popular for younger Canadians.

"We think of one to three years as short-term and we don't recommend in investing in the market at all," he says. "We don't want people risking something that's important for an extra few percentage points."

Medium Term

Your time horizon depends on how you define it but a house leans more towards that medium term and the RRSP has a plan to, at least partially, address housing prices.

Up to $25,000 can be withdrawn from RRSP under the first-time home buyers' plan without affecting your future contribution room. Your repayment period starts the second year after the year you withdrew funds from your RRSP and then you must repay the loan over the next 15 years, one-fifteenth each year.

The problem with RRSP withdrawal is the contribution room is gone forever

"I think the TFSA is good as well (for buying a house) but (annual) limits are smaller and if you have steady employment you want to get those deductions," said Bezaire.

Burlacoff recommends making a one-time $25,000 contributions into your RRSP, if you have the room, and deduct that amount off your taxable income, before using the money to buy a home. "Someone in a 20 per cent marginal tax rate in Ontario, that person who has $25,000 in their pocket could put it towards their home and that's great or they could put in their RRSP and get $5,000 in income tax savings back," he says.

Long term

On the long-term front, one of the problems for the RRSP has become that people are still working well past 65. The whole idea of an RRSP is being in lower income tax bracket in retirement, when you withdraw the money.

"It's just not the case anymore. We have a lot of business owners and they're making a lot of money and they don't retire at 65," said Bezaire."I'd say even if you are at the same tax bracket in 15-20 years, you've still had those years of deferred no-tax growth. It still makes a lot of sense."

In your retirement, TFSA withdrawals will have the advantage of not counting towards as income in terms of clawback of Old Age Security which in 2016 started at about $76,000 in income.

Burlacoff says if client tells him they will be in the first marginal tax bracket for the majority of their career and near retirement, there is a strong argument to be made for saving first in the TFSA and then the RRSP.

Allen says the soft benefit to the RRSP is that you are really hit hard on withdrawals and that forces clients "to be disciplined," removing any incentive to touch that money.

"What are finding with millennials is retirement is an option (they are looking at) but the more important goal seems to be financial independence," says Allen, adding 30-40 years just isn't a perspective they can handle. "We set some 10 and 20 year goals. We think of it as a roadmap with stops on way."

twitter.com/dustywallet.com

gmarr@nationalpost.com[1]

References

1. gmarr@nationalpost.com