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TAX MATTERS

Your mortgage, RRSP or TFSA: What's the priority?

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If you won the lottery, what would you do with the money?

A low-income couple from Guernsey who had been collecting government housing and other benefits won about $90,000 in the Channel Islands Christmas lottery in December, 2014. The problem? They're now broke, faced eviction earlier this year and want to collect government benefits again.

After winning the money, Jamie and Abbie Hort spent it over the next eight months. "We bought a sofa, chest of drawers, fridge, televisions and cutlery. We bought a few bits of clothing – my husband likes designer clothing so [he] bought some Diesel, Ralph Lauren and Franklin & Marshall items. But we won the lottery so we deserved to buy nice stuff," Ms. Hort said. At last report, the government is refusing to help them again.

You don't have to win the lottery to be faced with the problem of what to do with cash you might have available to you. Perhaps you still have a tax refund to deal with. Maybe an inheritance has just come your way. Or perhaps you're spending less than you earn and are trying to prioritize what to do with the difference.

The options

At the most basic level, your options for available cash include spending it, investing it, paying down debt, or giving it away. If you want to narrow the options further, many people will debate paying down the mortgage, contributing to their registered retirement savings plan (RRSP) or contributing to their tax-free savings account (TFSA).

RRSP vs. mortgage

The time-tested advice that most financial advisers give to clients, who are wondering whether to bolster RRSP savings or pay down the mortgage, is to contribute to your RRSP. This will provide tax savings that, in most cases, come back to you as a tax refund. You can then use that refund to pay down your mortgage. This way, you get the best of both worlds.

If you want to examine the numbers more closely, you need to compare the rate of return in your RRSP with the interest rate on your mortgage. You'll find that you're generally better off to pay off your mortgage first if your mortgage rate is equal to or higher than the rate of return in your RRSP. Given today's low mortgage rates, chances are that investing in your RRSP at reasonable rates of return today will leave you better off. You can always change your strategy as interest rates and expected returns change.

A couple of thoughts here: Paying down your mortgage gives rise to guaranteed savings while generating meaningful returns in your RRSP is not guaranteed. Also, it's a good objective to have your mortgage paid off before your kids head to university (paying for that education will be easier). Finally, it's a no-brainer to pay off your credit cards or other high-interest debt before contributing to an RRSP.

RRSP vs. TFSA

The key factor when deciding between your RRSP or TFSA is your marginal tax rate (MTR) today, and your expected MTR in retirement. If your MTR today is higher than you expect in retirement, you'll be better off contributing to your RRSP. You'll enjoy the tax savings at a higher rate today and will pay a lower rate later when making taxable withdrawals. In addition, you're pushing the tax bill to a future year (when you make the withdrawals), resulting in a deferral of tax in addition to absolute tax savings.

If your MTR is low today and is expected to become higher in retirement, a TFSA probably makes more sense. While you'll forgo a tax deduction today, the taxes saved in retirement could be much higher.

TFSA vs. mortgage

Paying down your mortgage and contributing to your TFSA are very similar options in that both provide a tax-free rate of return. If your mortgage rate is, say, 3 per cent, then paying down your mortgage provides a 3-per-cent guaranteed, after-tax, rate of return. If you can achieve a higher rate of return in your TFSA than the interest rate on your mortgage, the numbers work in favour of your TFSA.

But there are other factors, too. Will you invest your mortgage payment after the mortgage is gone? The "pay down-your mortgage first" idea works best when you invest an amount equal to your payments after the mortgage is paid off. If you don't think you're likely to do this, paying down the mortgage first may not make sense.

So, behavioural and emotional factors need to be considered in addition to the number crunching.

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