RRSP OR TFSA?

As the RRSP deadline approaches, some Canadians wonder whether they should use a TFSA instead. Here's how to find out

Saving for retirement used to be simple. If you wanted to save on taxes, there was only one choice: the Registered Retirement Savings Plan (RRSP). It offers savers a great deal. You not only get a juicy tax rebate when you contribute, but your money grows tax-free until it's withdrawn. Then in 2009 the RRSP got a little brother—the Tax-Free Savings Account (TFSA)—and suddenly long-term saving got more complicated. As of this year, the TFSA contribution room for most Canadians has grown to $20,000, so TFSAs are becoming a significant savings tool. In many respects they are similar to RRSPs, but in other ways, they're very different. So picking the right account for the right savings goal isn't easy.

Both the TFSA and the RRSP help shelter your investment returns from taxes, so both can help you grow your wealth faster. But there is a crucial difference, and it's the key to deciding which account to use: With an RRSP, taxes are deferred on the money you contribute, which is why you usually receive a tax refund. However many people don't realize that RRSP withdrawals are considered income, and you have to pay taxes on them. On the other hand, with a TFSA you do pay taxes on the money you contribute (so you don't get a tax refund), but you do not have to pay taxes on the money you withdraw.

Because of that difference, a TFSA generally works best in situations where you expect your income to be higher in the year you withdraw the money than in the year you put it in. Conversely, an RRSP works best if your income is high when you contribute, and lower when you make a withdrawal.

When should you use a TFSA?

TFSAs are more flexible than RRSPs, so they tend to be better for younger Canadians and short-term saving, such as when you're saving up to buy a house, or a car. But in some cases, they can also be a better choice for retirement savings too.

For instance, many advisers recommend TFSAs as a retirement savings vehicle for savers who have a lower marginal tax rate. As a general rule, says Marc Lamontagne, a fee-only adviser with Ryan Lamontagne in Ottawa, if you're making less than $41,000 a year, you'll likely come out ahead over the long run with a TFSA. The best part ➤

HOW MUCH WILL YOU NEED FOR YOUR DREAM RETIREMENT?

It's one of the most common retirement questions out there—and one of the most difficult to answer: How much will you need to save? The answer is different for everyone but even a rough estimate can help. "When I do this calculation for clients, it always surprises them," says Rona Birenbaum, a certified financial planner with Caring for Clients in Toronto. Below, we price out two levels of retirement, assuming you retire at age 65.

A COMFORTABLE RETIREMENT

According to Statistics Canada, the average amount spent each year by couples aged 65 and higher is $51,000—but if you'd like to enjoy some extras, such as travel, you may want to aim for a retirement income of $60,000 a year. Assuming that you are a couple who have contributed to the Canada Pension Plan for your entire working lives, you will receive about $30,000 a year from CPP and OAS combined starting at age 65. Research suggests that your nest egg should amount to roughly 25 times your annual retirement spending (not including CPP and OAS), so you will need to save an amount between $500,000 and $750,000 to make up the difference.

A DELUXE RETIREMENT

If you want to do more in retirement—for instance, if you want to travel to exotic locations, take up a hobby such as sailing or golf, or enjoy a larger home or nicer car—then you'll have to save more. Such a retirement might see you spending $100,000 a year or more after age 65. If that's the case you will need a much larger nest egg of roughly $1.75 million or higher. You'll have to save even more if you want to retire before age 65. To get a more accurate picture of how much you'll need for the retirement you want, ask a good adviser to run several different scenarios for you.

THE BIG EVENTS

WHENEVER YOU RUN INTO ONE OF THESE MAJOR LIFE EVENTS, IT'S TIME TO CHECK IN WITH YOUR ADVISER

GETTING MARRIED

The average cost of a wedding in Canada is $27,000. Make sure to plan for that expense by drawing up a budget as a couple. Will you be pooling all your assets or have separate accounts? What debt do each of you bring into the relationship? "Have this conversation before you walk down the aisle," says Rona Birenbaum, a certified financial planner with Caring for Clients in Toronto. "It's essential to getting your finances off on the right foot."

HAVING KIDS

When you have kids it's time to review your life and disability insurance. Also, consider opening an RESP account for your little one's education. Finally, run the numbers to see what it will cost in terms of future savings if one spouse decides to stay home.

BUYING YOUR FIRST HOME

Find out what you can afford to spend on a mortgage and set limits that will prevent you from overspending. Then shop around to get the best mortgage rate.

APPROACHING RETIREMENT

As you near retirement, it's time to review your investments and dial down the risk. Look at different retirement spending scenarios with your adviser to see which one is right for you. You may find that making small changes, such as downsizing, selling one of your cars, or renting out the basement, could mean retiring earlier.

UNEXPECTED EXPENSES

Save throughout the year in a separate account for unexpected expenses like home or car repairs. It can also be a good idea to set up a line of credit in advance that you can access in case of an emergency.

CHANGES IN INCOME

If your household income changes—due to a job loss, a maternity leave, or a return to school—find out how this will affect your financial plan and what changes will have to be made. It could be as easy as skipping the family vacation or cutting back on luxuries to stay on track.

is that when you take the money out in retirement, it doesn't count as income, so you don't have to worry about clawbacks to government retirement benefits, such as Old Age Security (OAS) or the Guaranteed Income Supplement (GIS).

Let's look at the fictional example of Molly Reynolds, a 30-year-old child care worker in Ontario, to illustrate. In order to build up a nest egg for retirement, Reynolds wants to save $5,000 a year until she reaches age 65. She makes $35,000 a year, so she is in the 20% tax bracket while contributing.

Should she use a TFSA or an RRSP? Because she's in a lower tax bracket during the years she contributes, she would come out ahead with a TFSA. If we assume a 6% annual return on her investments, her nest egg would be worth $395,290 after taxes if she uses a TFSA versus $383,270 in an RRSP (if she reinvests her RRSP tax refund each year). So she'll be $12,000 ahead with a TFSA.

TFSAs also make great sense for those who have a good defined benefit pension plan at work, no matter how much they make. "In this case, it's almost always best to contribute to a TFSA instead of an RRSP," says Al Feth, a fee-only adviser in Waterloo, Ont. "Mandatory withdrawals required by RRSPs at age 72 could boost you into a higher tax bracket and result in clawbacks to your Canada Pension Plan (CPP) and OAS payments in retirement. You won't have that problem with TFSAs because when you take money out during retirement, you will never be taxed."

Finally, if you're a high-income earner and you expect to max out your RRSP contribution limits, a TFSA makes a great second savings vehicle.

When should you use an RRSP?

Despite the flexibility in TFSAs, RRSPs are still the best long-term retirement savings vehicle for many Canadians earning an income of $50,000 or more, especially as they reach their peak earning years in their 40s and 50s.

> Higher income earners will likely want to use both an RRSP and TFSA

But keep in mind that one of the key advantages of using an RRSP is that you don't pay taxes on the contribution—and that only works if you reinvest the refund. Talbot Stevens, a financial educator in London, Ont., notes that sadly, many Canadians mentally spend the refund even before receiving it. "That's a negative, especially if it's spent on non-productive expenses, such as travel and electronics," says Stevens. "You have to reinvest the refund every year back into RRSPs to get the full benefit of these plans."

Another benefit to using an RRSP for retirement savings is mainly psychological: Because you have to pay taxes on RRSP withdrawals, you're less likely to take the money out unless you really need it. "For a lot of people TFSAs don't feel like retirement savings," says Stevens. "They're more liquid and more vulnerable. So you have to be disciplined to really make TFSAs work as a retirement savings vehicle."

Keep in mind that while these rules usually work, there are always exceptions. A good adviser can help by taking you through the options to ensure you make the right decision for your particular situation.

For more great tips, visit: www.moneysense.ca/powerofadvice

HOW MUCH CAN YOU CONTRIBUTE?

With an RRSP, you can contribute up to 18% of your pre-tax income each year, to a maximum of $22,450 (as of the 2011 tax year). With a TFSA, as long as you're over 18 you earn a contribution allowance of $5,000 per year. TFSAs are now four years old, so as of 2012, people who have not yet contributed have $20,000 in contribution room.