Tangerine guides to personal finance

Understanding
(and choosing between)
RSPs & TFSAs

A guide for Canadians

Tangerine
Forward Banking

While RSPs have been around for a long time, TFSAs are relatively new and not always well understood

Boosting the power of saving

If you're already a disciplined saver, you're probably also aware that the ability of your savings to grow in real value over time is undercut by two big forces:

- Inflation, which steadily reduces the real value of your savings over time
- Taxes, which reduce the amount of money you can save from your paycheque and also reduce the effective returns from your savings

Retirement Savings Plans (RSPs) and Tax-Free Savings Accounts (TFSAs) help you battle both of these forces. Not only are they designed to help your money grow, but they also both provide different ways of easing your income tax burden.

But while RSPs have been around for a long time — more than half a century, in fact — TFSAs are relatively new and not always well understood. We've written this guide to help clarify how they both work, and how to choose between them.

All about RSPs

What they are:

Many of us are already familiar with the concept of how RSPs work. By putting money into an RSP account this year, you'll reduce your taxable income by the same amount. For many taxpayers, that will mean getting money back when they file their tax returns. (For example, if you make $40,000/year and contribute $2,500 to an RSP, your actual taxable income for the year becomes $37,500.) This "cash back" effect was intended by the government as an incentive for Canadians to save for their own retirement.

The money you place in your RSP will remain protected from income tax until you withdraw it — which, according to plan, will be during your retirement. This means the money in your RSP will increase in value through interest or investment returns without its growth being hindered by taxes. By the end of the year in which you turn 71, you'll need to convert your RSP into something that is designed to pay you retirement income, such as a Retirement Income Fund (RIF) or an annuity. Since you'll be retired, this stream of income will probably be taxed at a much lower rate (if at all) than it would have been when you first earned it. For this reason it's important to think of an RSP as a "tax-deferred" account rather than a "tax-free" account. Essentially, RSPs shift income from your higher-tax present to your (hopefully) lower-tax future. If you are in a high tax bracket (i.e. your top earning years) and don't plan on using the money until retirement, you should contribute to an RSP.

RSP vs. RRSP: What's the difference?

RRSP stands for Registered Retirement Savings Plan, and RSP stands for Retirement Savings Plan. Both are registered plans. Many financial institutions prefer the term RSP because it's less wordy (and less letter-y).

Why it makes sense to save in an RSP:

- You get a tax deduction, which can make a big difference on your tax return — and the refund gives you another opportunity to save.
- You can choose the investments held in your RSP, such as Guaranteed Investment Certificates (GICs), stocks, or mutual funds. Your RSP savings can also be held in a savings account. Each option will carry different risks and returns, so you can decide what you're most comfortable with, and what would best suit your saving objectives.
- You can contribute to a spousal RSP, which can be a good strategy if you're making more money than your spouse — you can reduce your taxable income, and at the same time, you can both build nest eggs.
- If you're planning to buy your first home, you can save in an RSP and take advantage of the Home Buyer's Plan. Under this program, you can withdraw up to $25,000 in a calendar year from your RSP without a tax penalty, as long as you pay it back within 15 years. It's like lending money to yourself.*

** Other restrictions and conditions apply. Consult the Canada Revenue Agency for more details.*

RSP rules to remember:

- *There's a maximum amount you can contribute to an RSP each year. Your contribution limit will appear in the Notice of Assessment you receive from the Canada Revenue Agency (CRA) after your tax return is processed.*
- *You can contribute to your RSP until December 31st of the year you turn 71. After that, it's time to start taking an income by converting the RSP to a Retirement Income Fund (RIF) or an annuity, or by withdrawing the money completely.*

What happens if you withdraw from an RSP early:

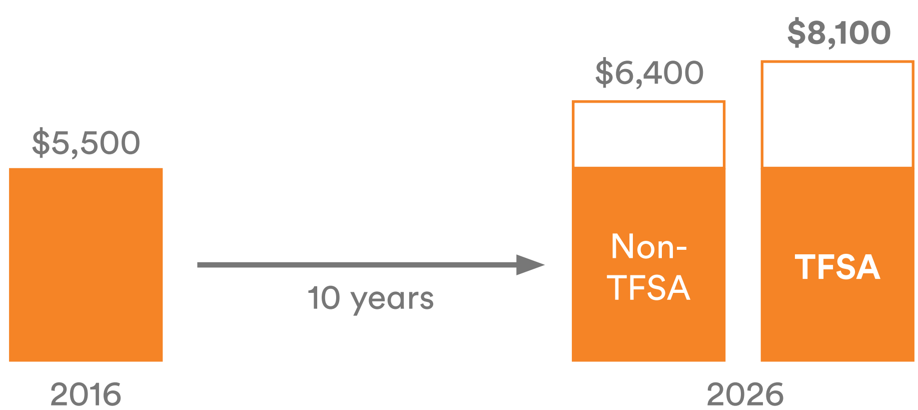
Hopefully you'll never have to: RSPs are meant to secure your retirement, and are far better left to grow until converted into RIFs or annuities at that time. If you simply can't avoid the need to make an early withdrawal, you'll need to report it on your tax return and pay income tax on the amount withdrawn. It's also important to remember that your contribution limit doesn't change if you withdraw money from your RSP.

All about TFSAs

What they are:

When your savings earn a return, whether through interest or investments, that return normally counts as taxable income — and of course, the tax you pay can significantly reduce the rate of growth of your savings. But if your savings are in a TFSA, you don't have to pay tax on returns they earn — not even when you withdraw money. That's what makes a TFSA "tax-free," and not "tax-deferred."

Imagine you have $5,500 to invest at a return rate of 4% a year. Outside of a TFSA, that 4% return will get taxed, reducing it from $220 to, say, $120. Keep the $5,500 saved over ten years at the same rate of return and rate of tax, and you'll have roughly $6,400 by the end. But invest this same amount of money inside a TFSA and you'll keep (and compound) the full $220 return — and after ten years you'll have about $8,100, $1,700 of additional growth on your original $5,500.



Why it makes sense to invest in a TFSA:

- You don't pay tax on your interest or investment returns.
- Unlike an RSP you don't have to pay tax when you withdraw money from your TFSA. This means you have more flexibility in a TFSA.

- You can use a TFSA to save for whatever you want, whether your goals are short-term or long-term.
- A TFSA is a good place to build an emergency fund.
- A TFSA is a good place to save if you're in a lower tax bracket and the tax deduction from RSP contributions wouldn't make much of a difference.
- Just like in an RSP, your TFSA savings can be held in a savings account, or it can consist of investments such as Guaranteed Investment Certificates (GICs), stocks, or mutual funds.
- You can give your spouse or common-law partner money to put in their TFSA and it doesn't affect your own TFSA contribution limits.

When you contribute to an RSP, thanks to the associated tax deduction, you protect a portion of your annual income from tax — a significant impact up front because of the amount of money you can protect this way.

A TFSA protects your interest or earnings on the after-tax money you set aside — a smaller immediate impact but one that can become significant over time as compounding does its work.

What happens when you withdraw from a TFSA:

Unlike an RSP you can withdraw funds from your TFSA at any time without paying tax or a penalty. But like an RSP, you have only a certain amount of contribution room available each year. Since withdrawing money doesn't change that amount, you won't be able to put your money back in if doing so would take you above your contribution limit. (You'll pay a 1% monthly tax penalty on any over-contributions.) However, money you withdraw can be re-contributed in the following year, and the amount you withdraw will get added onto the next year's contribution limit.

TFSA rules to remember:

- *You can save a certain amount tax-free in your TFSA every year. The annual dollar limit for 2017 is 5,500*. This is the total amount for all TFSAs you have — since you can have more than one.*
- *Any unused contribution room from previous years accumulates, so if you've never contributed to a TFSA your contribution room has been growing steadily. You can carry over up to $5,000 per year of unused contributions from 2009-2012, $5,500 from 2013 -2014 , $10,000 from 2015 and $5,500 from 2016.*
- *If you go over your TFSA contribution room, you'll pay a tax penalty on the excess amount.*
- *You can find out your TFSA contribution room online at cra-arc.gc.ca or by calling 1-800-267-6999.*

**As of June 1, 2017, the annual TFSA contribution limit for 2017 is $5,500.*

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How to choose

There's a lot of good general financial advice out there, but the best financial strategies are always about what's best for you — right now, and for building the future you want. Deciding whether to save your money in an RSP, a TFSA, or both, will take some up-front thinking. Here are a few questions for you to consider before making the choice:

What do I need short-term and what do I need long-term?

Throughout our lives and careers, our priorities are constantly shifting — and there are often many competing demands on our time and our resources. We can't always do everything we want to right away, so it's important to figure out what's most important to do right now, and what can be worked towards over time.

How should I think about debt?

Since the interest rates you pay on debt are typically higher than the returns you can earn on savings — the water flows out of the bathtub faster than you can pour it in — it often makes sense to reduce or eliminate your debts first and then redirect the amounts you're no longer paying in debt interest into a monthly savings program. But smart strategy is also about comfort level — you may feel better building an emergency cash fund first, particularly if your debt is at manageable levels.

Where am I in my career?

The amount of money you're making now will determine the size of the tax deduction you will receive with an RSP contribution. The difference between the money you're making now and the income you expect in retirement will also affect how valuable an RSP will be for you.

Career stage is another factor — if you're starting out in the work force, you'll have more years to save for retirement than someone already at mid-career, and where and how much to save will be a different calculation.

What is my personal financial style?

Are you disciplined? Do you reward yourself frequently? Are you prone to spending your windfalls? Do you have a high tolerance for risk? Understanding your traits will help you make better judgements about the mix of products you should consider to help you reach your goals.

What's my plan for the unplanned?

Life is full of unforeseen events — and your plan for paying for a severe roof leak or for surviving the loss of your job shouldn't consist of pulling money out of your RSP. Think about the kind of contingencies you should be prepared for, and the proportion of savings you'll need to set aside for them.

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Making the choice

That's a lot of considerations to juggle. But there are some easy rules of thumb to help guide you. Think of it as a simple matter of comparing now and then (i.e. after retirement).

- If you're in a high tax bracket now, and think you'll be in a lower tax bracket then, fill up your RSPs first — that's exactly what they were designed for, and when used this way they can't be beat.
- If you're in a low tax bracket now, and think you'll be in a higher tax bracket then (e.g. if you expect a big pension), then with an RSP, the tax you pay then may outweigh any tax deduction now — so consider a TFSA instead.
- If you think your tax bracket now will still be the same then, there will be little difference between the results you get from an RSP and from a TFSA. Other factors may well be the decision-makers in this case.

There are no cut and dried solutions here; no one has only one need in life, after all, or only one goal. Your personal situation in combination with your financial strategy will determine whether and when it's appropriate to put money into an RSP, a TFSA, or a combination of the two. If you're just starting your first job, for example, you might find that a TFSA today helps you build a cash fund for contingencies — and for a vacation later if the contingency never happens — and that an RSP becomes a sensible addition once your income and job security increases in a year or two.

Sample savings strategies

Dmitri	Newly graduated from university, working as an entry-level software developer. **Plan:** Paying off his student loan as quickly as possible, and saving a small portion of each paycheque in a TFSA.
Farida	Self-employed consultant in a busy, but volatile industry. **Plan:** Saving a portion of her earnings each month in a TFSA to build an emergency fund, and a larger portion of earnings each month in an RSP for the tax deduction (and retirement).
Eva & Nathan	Both working full-time, saving for their first home. **Plan:** Saving each month in an RSP to take advantage of the Home Buyer's Plan and tax deduction. Eva is also saving her bonuses in a TFSA towards a vacation.
Steve	Five years away from retirement and cutting back on his consulting hours. **Plan:** Still contributing regularly to his RSP for the tax deduction, but also saving in a TFSA (AKA his golf fund).

RSP and TFSA do's and don'ts

Whether you decide to save your money in a TSFA or an RSP — or both — there are a few important things to keep in mind:

Don't be reluctant to start saving: Sometimes people are hesitant to start because they feel like they won't have "enough" money to save. Get started with whatever makes sense for you — even small amounts add up over time.

Do save on a regular basis: Don't wait for a windfall to start saving. Commit to saving a certain amount of money each month, stay committed — having the money automatically transferred can help here — and watch your savings grow.

Don't treat your TFSA or RSP like a regular savings account: Savings accounts are helpful for everyday financial management, but TFSAs and RSPs are meant for specific savings goals. Remember there are rules about when you can re-contribute to your TFSA after you've pulled money out, and there are tax implications when you take money out of an RSP.

Do know your money personality: Your spending style and habits are an important part of your savings success. Think about what kind of savings suits you best. If you don't normally think long-term, and run the risk of needing to access your savings sooner rather than later, for instance, an RSP might not be the best choice for you right now.

Do save an emergency fund outside your RSP: You never know when you'll need accessible cash in reserve for unforeseen events like a job loss or illness. You may also want to consider building a "fun fund" for unexpected opportunities, like a family reunion trip you don't want to miss.

About

This publication is part of Tangerine's series of guides for Canadians on important personal finance topics.

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