Jason Reed, CFA, FCIA

QV Investors Inc.

Retirement Savings Vehicles

The purpose of this QV Update is to articulate some of the similarities and differences between the RRSP and the TFSA from a tax perspective.

Contributions to a TFSA are made with after-tax dollars. Investment returns inside a TFSA are not taxed, and neither are withdrawals. This tax-free compounding feature of a TFSA makes it an excellent investment vehicle for retirement, despite its name suggesting it might function merely as a savings account for short-term needs.

Contributions to an RRSP are deducted from taxable income, but future withdrawals are fully taxable. RRSPs provide two distinct benefits to investors, which we will explore:

1) If there is no change in marginal tax rates between contribution and withdrawal, RRSPs produce the same result as TFSAs. In both cases, investment returns on contributions are tax free. This may cause confusion as RRSPs are often communicated as a tax deferral, not an outright elimination of tax. As demonstrated below, the tax on RRSP withdrawals should be interpreted as the repayment of a loan from the government, with interest.

2) The tax deduction from an RRSP contribution does not in itself create wealth but will mature into a benefit if the tax rate in retirement is lower than when a contribution is made.

Let's illustrate with an example. Suppose that 35-year-old Lynn saves $1,000 of pre-tax employment income and is contemplating whether to contribute to a TFSA or an RRSP. Her marginal tax rate (MTR) is currently 40%. Lynn will remove the funds for spending at age 65. We have assumed a 5% rate of return.

	TFSA	RRSP 40% MTR at age 65	RRSP 30% MTR at age 65
A. Savings	$1,000	$1,000	$1,000
B. Tax (40% marginal rate)	($400)	($400)	($400)
C. Tax deduction	$0	$400	$400
D. Net contribution	$600	$1,000	$1,000
E. Value at age 65	$2,593	$4,322	$4,322
F. Tax on withdrawal	$0	($1,729)	($1,297)
G. Value, after tax	$2,593	$2,593	$3,025

Lynn's pre-tax savings will be reduced by her income tax bill of $400, resulting in a net TFSA contribution of $600. Lynn's TFSA will grow to $2,593 by age 65.

If instead Lynn opts to use her RRSP, she will get an up-front tax deduction of $400, meaning the full $1,000 is available for investment in her RRSP. By age 65, Lynn's RRSP grows to $4,322. If her marginal tax rate upon withdrawal is unchanged from 40%, then $1,729 of tax will be payable to the CRA, leaving Lynn with $2,593 for spending, identical to the TFSA.

Following the arrow in the example, we can see that Lynn's original tax deduction of $400 grew into a tax liability of $1,729 at age 65, at the rate of 5% per year. It is helpful for Lynn to conceptualize the up-front tax deduction of $400 as a loan from the CRA, which accrues interest at the rate of return on her RRSP. By viewing the up-front deduction as a loan from the CRA, Lynn hopefully sees through the illusion of "free money" from the tax refund, avoiding the temptation to use her refund to increase discretionary spending.

If Lynn's marginal tax rate declines in retirement to 30%, her tax liability to the CRA is reduced to $1,297, leaving $3,025 for spending. In this case, she realizes the second benefit of her RRSP, making it a superior vehicle to the TFSA. However, keep in mind, the opposite could be true if Lynn's marginal tax rate were to increase in retirement. For this reason, people with a relatively low income (and especially those who expect to earn much more in the future) should consider saving first with the TFSA rather than the RRSP. Those with relatively high income and high savings rates would benefit from using both vehicles, to the extent possible.

Unfortunately, the tax complexities of RRSPs versus TFSAs are much greater than described here. For example, the fact that RRSP withdrawals might reduce one's eligibility for benefits such as OAS and other supplements. In light of these complexities, and others, a tax expert might help optimize your situation.

The RRSP contribution deadline for 2019 is March 1st. Please contact us immediately if you wish to contribute.

Sources: QV Investors, The Wealthy Barber, retailinvestor.org