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RETIREMENT***WATCH***

Proper planning will help you minimize tax and achieve the retirement lifestyle you want

TFSA, RRSP, or both?

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Ever since tax-free savings accounts were introduced, there has been a debate about which is the best for retirement: TFSAs, or RRSPs?

To fully understand this debate, you need to consider your tax rates before and after retirement, including the clawbacks on seniors discussed in the September issue of *The TaxLetter*. In this issue, I will take an in-depth look at the effective uses for TFSAs and RRSPs.

The first key point is that TFSAs are usually best used as a retirement investment vehicle. With the last two words being "savings account," most people are using them primarily for short term savings.

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However, the tax you save by investing your TFSA in a high-interest savings account for a couple of years is tiny compared to the tax you can save over your life by investing your TFSA in an effective, long-term investment portfolio – and let the growth compound over the years.

TFSA vs. RRSP – Deciding Factors

Should you be using TFSAs or RRSPs to invest for retirement? The short answer is that there is no definite answer. It all depends on your circumstances. Since the real difference between them is the tax consequences, your choice depends on two key factors:

✓ your marginal tax rates when you contribute vs. when you withdraw, including the clawbacks; and,

✓ how you use the tax refund.

Tax Brackets: Contributing vs. Withdrawing

What is the most significant difference between TFSAs and RRSPs? RRSP contributions are tax deductible and withdrawals are taxable, while TFSA transactions are all tax free.

Therefore, if your tax bracket will be higher when you are contributing than when you withdraw, there is an advantage for RRSPs (see Table 1 on the following page).

Most people assume they will be in a lower tax bracket when they retire, since they will be making less income than when they were working. If this is true, there should be an advantage to investing in your RRSP.

However, in my previous articles about clawbacks and how they affect seniors, we saw that this is often not the case.

Clawbacks are costs that everyone must pay to the government based on their taxable income, so it's best to view them as a tax.

When you look at tax brackets that include those individuals most affected, they may be better off with TFSAs.

We do not have accurate statistics on how many Canadians will be in lower-vs.-higher tax brackets in retirement compared to their working life. Despite the common belief

Table 1 Investing in an RRSP or TFSA – different tax rates before and after retirement

	Same Tax Bracket		High-Low		Low-High	
	TFSA	RRSP	TFSA	RRSP	TFSA	RRSP
Pre-tax income to invest	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Contribution rate	33%		46%		33%	
Tax	$3,300		$4,600		$3,300	
Net contribution	$6,700	$10,000	$5,400	$10,000	$6,700	$10,000
Growth(7% for 30 years)	$51,002	$76,123	$41,106	$76,123	$51,002	$76,123
Withdrawal tax rate		33%		33%		46%
Tax		$25,120		$25,120		$35,016
Net Withdrawal	$51,002	$51,002	$41,106	$51,002	$51,002	$41,106

that most Canadians are in higher tax brackets during their careers, I would estimate that in reality:

- 20 per cent of Canadians retire in the same tax bracket;
- 40 per cent of Canadians retire in a lower tax bracket; and,
- 40 per cent of Canadians retire in a higher tax bracket.

Surprised? Note that: RRSPs win in one large category that includes perhaps one-third to one-half of Canadians that are working: those with a reasonable working income and relatively small (but not insignificant) retirement savings.

TFSAs usually win for anyone with a low working income. They also generally prevail for anyone with little or no retirement investments or pension.

Uses for your tax refund

What do you do with your RRSP refund? Getting a refund is the main reason many Canadians contribute to a registered retirement savings plan. How you use it is critical to the TFSA vs. RRSP debate.

In fact, there is an inherent

Table 2 RRSP and TFSA Investment Strategies – A Comparison

	With 0% Return				With 10% Return			
Year	RRSP Spend Refund	RRSP Invest Refund	RRSP with Gross-up	TFSA	RRSP Spend Refund	RRSP Invest Refund	RRSP with Gross-up	TFSA
0	$1,000	$1,000	$2,000	$1,000	$1,000	$1,000	$2,000	$1,000
1		$1,500			$1,100	$1,600	$2,200	$1,100
2		$1,750			$1,210	$2,010	$2,420	$1,210
3		$1,875			$1,331	$2,336	$2,662	$1,331
4		$1,938			$1,464	$2,632	$2,928	$1,464
5		$1,969			$1,611	$2,927	$3,221	$1,611
6		$1,985			$1,772	$3,235	$3,543	$1,772
7		$1,993			$1,949	$3,566	$3,897	$1,949
8		$1,997			$2,144	$3,927	$4,287	$2,144
9		$1,999			$2,358	$4,321	$4,716	$2,358
10		$2,000			$2,594	$4,754	$5,187	$2,594
Before Tax	$1,000	$2,000	$2,000	$1,000				
After Tax	$500	$1,000	$1,000	$1,000	$1,297	$2,377	$2,594	$2,594

advantage for TFSAs over RRSPs, unless you use your RRSP tax refund effectively every year.

Three options for your tax refund are to spend the refund, reinvest the refund to your RRSP, or "gross-up" the tax refund.

To understand "gross-up," let's look at an example. If you have $10,000 to invest in your RRSP and are in a 50 per cent tax bracket, you could gross-up your contribution to $20,000. Your tax refund would be $10,000, so you are net out-of-pocket $10,000, which was the cash you had available.

How could you do this? You could contribute $10,000, plus take a short RRSP loan for $10,000 (or use a line of credit), then use the tax refund to pay off the loan.

If you are contributing monthly and have reduced your tax at source (or are contributing to a group RRSP), then you are essentially doing the gross-up.

Let's look at how these three options affect the TFSA vs. RRSP debate. Here, the point is most clearly shown when we ignore investment return (assume zero per cent) and look at only one contribution. For simplicity, we assumed a 50 per cent tax bracket before and after retirement.

If you have $1,000 of available cash, here are your refund options: spend it, invest it each year, or gross it up to make a larger contribution.

Note that in Table 2 there is an advantage for TFSAs, unless you gross up your tax refund every single year.

Only in those cases where you consistently gross-up all of your RRSP contributions does the RRSP match the TFSA. Few Canadians do this. If you spend the tax refund, you would be farther ahead with a TFSA. Even if you regularly contribute your tax refund, the TFSA wins – but not by a wide margin.

Note that you end up contributing the same amount over time if you always reinvest the refunds, but with the RRSP you are always behind, because you invested later. However, with a 10 per cent return, you are only about 10 per cent behind the TFSA at retirement.

The winner: TFSA or RRSP?

Overall, we believe TFSAs are the best choice for about 60 to 70 per cent of Canadians.

Based on tax brackets before and after retiring, we estimate that TFSAs win for roughly the same number of Canadians as RRSPs. If you will be spending your tax refund, then the TFSA clearly wins in almost any scenario.

Now that we have declared TFSAs as a better retirement choice for more than half of Canadians, do we consider TFSAs to be the best retirement vehicle?

Not necessarily. First, TFSA contribution limits are too low. Most Canadians will need to invest more than the $5,000-per-year TFSA limit to have the retirement they want. Second, RRSPs are more likely to be better for those saving for retirement.

Roughly one-third of Canadians have no retirement savings at all. With no retirement investments or pension, they may qualify for some GIS (Guaranteed Income Supplement) so TFSAs are probably better for them – if they saved.

Third, effective retirement planning often makes RRSPs more beneficial. If you build up a reasonable retirement nest egg, then you probably will not be impacted by the GIS clawback. And there are a variety of ways to plan around the OAS clawback; effective planning may change your situation so that RRSPs become a better option.

Examples of typical Canadians

In the table 3 on the following page, I have shown examples of typical Canadians, and whether an RRSP or TFSA is more advantageous based on income and existing pension or RRSP.

What you should know:

If you invest in a TFSA, don't spend the TFSA. It is easy to withdraw from a TFSA because there are no tax consequences or withholding tax, and you get your TFSA room back the next year. If you might be tempted to withdraw money from a TFSA, then the RRSP may be better for you. (A common argument for choosing RRSPs over TFSAs is that there is a withdrawal deterrent.)

If you invest in an RRSP, don't spend the refund. How you use your tax refund is a huge factor in determining whether to use an RRSP or TFSA. If you spend your tax refund, then it is probably better for you to invest in a TFSA.

By this I mean that your TFSA will provide you with a

better retirement income. Of course, this may be different depending on how you spend your refund. Many people invest their RRSP refund in their kids' RESP, which is clearly an excellent use. If you spend your refund on a vacation or a renovation, only you can compare the lasting memories to the lower lifestyle you will have in retirement.

Planning around the clawbacks

Guaranteed Income Supplement (GIS):

The largest clawback is the GIS clawback, which is 50 per cent of your income in addition to income tax. Assuming you will get the maximum OAS (by living in Canada 40 years by the time you turn 65), you receive GIS income if:

✓ you are single and making less than $23,053; or,

✓ married making less than $17,543 each per year in retirement.

If you are married, and both you and your spouse have earned the maximum CPP, the CPP and OAS alone will disqualify you for the GIS.

However, if you are single and receiving maximum CPP and OAS of $18,380, you still qualify for up to $2,339 per year of GIS income (as long as your other taxable income is less than $4,673). You would be able to achieve this if all your retirement investments were in a TFSA. If you or your spouse do not qualify for the maximum CPP and you have no other retirement income, then you can qualify for GIS income if you have all of your investments in TFSAs.

Old Age Security (OAS):

The other significant clawback is OAS, which applies to taxable retirement incomes of $69,563 to $113,160. The average Canadian lives 22 years after age 65, and will receive $143,000 OAS during this time (plus inflation).

If you are affected by this 15 per cent clawback, you are in a tax bracket between 50 to 58 per cent – which is definitely a higher tax bracket than while you were working. In addition to maximum government pensions, you can make $50,000 of taxable income each year before this affects you. There are many ways to plan around this, the most obvious being limiting the size of your RRSP.

After you retire and convert your RRSP to a RRIF, you will be required to withdraw a minimum of four per cent each year at age 65 and 10 per cent at age 85. Therefore, if you limit the size of your RRSP to $500,000 to $750,000 at retirement (depending on how you invest) and invest the rest in a TFSA, then you can probably avoid the OAS clawback.

The exception to this is if your RRSP will be very large, say over $1.5 million. In that case, you will likely have your entire OAS clawed back (unless you plan creatively), so limiting the size of your RRSP will not matter.

Table 3 RRSP and TFSA for retirement savings?

Type of Income, Pension	While Working		In Retirement		TFSA or RRSP?
	Taxable Income	Tax Rate	Taxable Income	Tax Rate	
Low Income, no RRSP	$35,000	20%	$15,000	50%	TFSA Only!
Low income with Pension	$35,000	20%	$25,000	20%	TFSA preferred
Moderate Income, minimal RRSP	$70,000	33%	$30,000	20%	RRSP
Moderate Income, moderate RRSP	$70,000	33%	$35,000	28%	TFSA Preferred
Good Income, minimal RRSP	$100,000	43%	$40,000	32%	RRSP
Good Income, large RRSP	$100,000	43%	$75,000	50%	TFSA Preferred
High Income, minimal RRSP	$200,000	46%	$50,000	34%	RRSP
High Income, large RRSP	$200,000	46%	$100,000	58%	TFSA
High Income, before and after retirement	$200,000	46%	$150,000	46%	TFSA Preferred

Marginal tax rates include clawbacks on seniors

Planning strategies:

If you are affected by a clawback, you can plan around it in several ways, such as:

☛ Plan how much to withdraw from your RRIF vs. your TFSA or non-registered investments each year. You can plan to have a target taxable retirement income each year at the top of a specific tax bracket (such as $43,000 per year which is at the top of the 20 per cent bracket) or just before the OAS clawback at $68,000.

Your cash income can be much higher than your taxable income because you may withdraw the difference from your TFSA, or partly from non-registered investments.

☛ Make a large withdrawal every few years, so that you can take less for all the years in between. If you do this right, you may be affected by the clawback only one year out of every five or 10 years.

Importance of a retirement plan

Clearly, having a detailed, written retirement plan is very helpful. It should give you a very good idea of what your tax bracket will be after you retire. In addition, you can plan to have your investments in the right type of accounts to minimize your tax. ❑

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