RRSP or TFSA? Consider Your Tax Rate!

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Answering the old questions of when and how much to contribute to a Registered Retirement Savings Plan (RRSP) will never be the same following the recent introduction of the Tax-Free Savings Account (TFSA). To answer these questions, you must now consider the option of contributing to a TFSA. The TFSA is almost exactly the same as the RRSP, except that there is no tax refund for a contribution and no tax payable upon a withdrawal.

Is the RRSP or the TFSA a better option when confronted with limited funds? Unfortunately, as with most questions dealing with retirement planning, the answer depends on your personal tax position. Let's explore some common scenarios to reveal whether the choice of an RRSP or a TFSA is preferable for you.

The Choice May Be Irrelevant

Though the investment income earned within either an RRSP or a TFSA is not subject to income tax, it is important to understand that the RRSP and the TFSA may also be tax neutral in other respects. Essentially, there is no difference between an RRSP and a TFSA if you are able to earn the same rate of return investing the funds within a TFSA as you would investing the funds within an RRSP and there is no difference between your respective marginal tax rate at the time of any contribution to, and any withdrawal from, the RRSP.

For example, assume that you earn $1,452 in taxable income and you are confronted with the choice of a contribution to an RRSP or a TFSA. If you opt for the RRSP, you can contribute the entire gross (pre-tax) amount to generate investment income. Assuming that you earn a rate of return of 4%, the funds within the RRSP would equal $2,149 in 10 years. This amount will, of course, be subject to tax upon withdrawal from the RRSP. Assuming a 31.15% marginal tax rate at the time of the withdrawal from the RRSP, you would pay $669 to the government, which would leave $1,480 in after-tax dollars.

How does this example compare to the use of a TFSA? If you opt for the TFSA, you must first pay tax on the $1,452 in taxable income prior to any contribution to the TFSA. Assuming the same marginal tax rate of 31.15%, this would leave you with after-tax income of $1,000 with which to contribute to, and to generate investment income within, the TFSA. Assuming further the same 4% rate of return, the funds within the TFSA would equal $1,480 in 10 years. This amount is not, however, subject to tax upon withdrawal from the TFSA, which would leave $1,480 in after-tax dollars.

Therefore, similar rates of return earned by the funds invested within the RRSP or the TFSA, when combined with similarities between the respective marginal tax rate at the time of any contribution to, and any withdrawal from, the RRSP will make irrelevant the choice of either the RRSP or the TFSA. This relationship holds true after 10, 20, 25, 30, etc. years. Table 1 illustrates this point.

Different Marginal Tax Rates

As Table 1 reveals, the choice between a contribution to an RRSP or to a TFSA should be based on comparative marginal tax rates. A preferred choice will exist only when

TABLE 1 - COMPARISON OF RRSP AND TFSA IN A TAX-NEUTRAL SCENARIO

Initial Contribution	$1,452 RRSP Annual return	Taxes at 31.15% (Withdrawal)	After-tax dollars	$1,000 TFSA Total after-tax dollars	Difference
Value of contribution in					
10 years	$2,149.96	$669.71	$1,480.24	$1,480.24	–
20 years	3,182.46	991.34	2,191.12	2,191.12	–
25 years	3,871.95	1,206.11	2,665.84	2,665.84	–
30 years	4,710.82	1,467.42	3,243.40	3,243.40	–

your current marginal tax rate at the time of the contribution is different than your marginal tax rate at the time of the withdrawal.

For example, assume the same facts as in Table 1, except that the marginal tax rate upon the withdrawal of the funds from the RRSP is not 31.15%, but 21.05%. Table 2 indicates that the contribution to an RRSP is preferable if your marginal tax rate at the time of the contribution is greater than your marginal tax rate at the time of the withdrawal.

TABLE 2 - COMPARISON OF RRSP AND TFSA WITH DIFFERENT MARGINAL TAX RATES

	Annual Return	RRSP Taxes at 21.05% (Withdrawal)	After-tax dollars	TFSA Total After-tax dollars	Difference
Value of contribution in					
10 years	$2,149.96	$452.57	$1,697.39	$1,480.24	$217.15
20 years	3,182.46	669.91	2,512.55	2,191.12	321.43
25 years	3,871.95	815.05	3,056.90	2,665.84	391.07
30 years	4,710.82	991.63	3,719.19	3,243.40	475.79

Conversely, the contribution to a TFSA is preferable if your marginal tax rate at the time of the contribution is less than your marginal tax rate at the time of the withdrawal. The latter marginal tax rate is affected by other income sources at that time, such as RRSP withdrawals, Old Age Security Act pension benefits ("OAS"), federal Guaranteed Income Supplement payments ("GIS"), and the related potential clawbacks, which are discussed below.

The greater the difference in the respective marginal tax rate, the more effective the choice of a contribution to an RRSP. Figure 1 presents this relationship graphically by plotting the difference in after-tax cash flows after 25 years between the RRSP and the TFSA, assuming different possible combinations of the respective marginal tax rate at the time of a contribution to, and a withdrawal from, the RRSP. Note that a positive number indicates that the choice of a contribution to the RRSP is preferable, whereas a negative number indicates that a contribution to the TFSA is the better option.

FIGURE 1 - COMPARISON OF RRSP AND TFSA WITH DIFFERENT MARGINAL TAX RATES

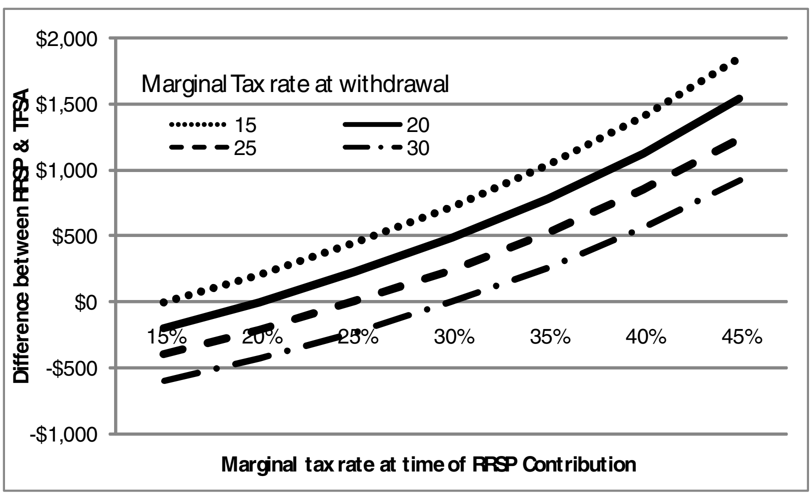

Figure 1 illustrates two important implications. First, the choice of a contribution to an RRSP is far superior as the difference between the respective marginal tax rate at contribution and at withdrawal increases. Second, the lines are not perfectly linear. Therefore, it is not the difference in the respective marginal tax rate alone that will determine the preferred choice of the RRSP or the TFSA. Rather, the difference at higher marginal tax rates provides a greater incentive to utilize an RRSP (e.g., a 40% marginal tax rate at the time of a contribution with a 25% marginal tax rate at the time of a withdrawal will lead to larger after-tax cash flows from an RRSP than will a 35% marginal tax rate and a 20% marginal tax rate, respectively).

Considerations For Determining a Marginal Tax Rate At Retirement

A common assumption made during retirement planning is that an individual will be subject to a lower marginal income tax rate upon retirement than he or she will be beforehand. If this is the case, then the choice of a contribution to an RRSP is far superior to the choice of a contribution to a TFSA. This may sound logical, but it is often not true when considering income-based clawbacks that apply to several programs for seniors.

The three main clawbacks that affect seniors apply to the OAS, the GIS, and the age tax credit. The tax policy associated with the clawbacks is that those individuals who enjoy higher levels of taxable income do not need the benefit of this tax relief. Accordingly, higher tax rates are imposed on those seniors who earn significant taxable income.

- The OAS is $6,203.52, which is reduced by 15% of net income in excess of $66,335. The OAS is eliminated when net income is equal to or greater than $107,692.

- The GIS is a tax-free amount that does not exceed $7,830.12, which is paid to a senior with a net income of less than $15,672, excluding the OAS and the GIS. For a senior who is single or widowed, $1.00 of GIS is subject to a clawback for every $2.00 of non-OAS income received.

• The age tax credit is a non-refundable tax credit available to a senior in an amount equal to 15% of $6,408, which is reduced by 15% of net income in excess of $32,312. The age tax credit is eliminated when net income is equal to or greater than $75,032.

Table 3 presents the 2009 combined marginal tax rates for the province of Ontario for retirees when the clawbacks that affect seniors are considered. The marginal tax rates apply to everyone, while the tax rates with clawbacks apply specifically to anyone who is 65 years of age or older. You can determine the marginal tax rates applicable to your province on Canada Revenue Agency's website at http://www.cra-arc.gc.ca/tx/ndvdls/fq/txrts-eng.html.

TABLE 3 - MARGINAL TAX RATES CONSIDERATIONS AT RETIREMENT (AGE 65+)

Marginal tax rate			Senior Clawbacks			Tax rate with clawback	
Income Brackets		Pension/ Interest	GIS	Age	OAS	Pension/ Interest	Capital Gains
–	8,881	0%	50%			50%	25%
8,882	10,100	15%	50%			65%	33%
10,101	15,600	21%	50%			71%	36%
15,601	32,000	21%				21%	11%
32,001	40,000	21%		2.25%		23.25%	12%
40,001	66,000	31%		2.25%		33.25%	16%
66,001	74,000	33%		2.25%	15%	50.25%	25%
74,001	81,000	35%			15%	50%	25%
81,001	107,700	43%			15%	58%	29%
107,701	126,000	43%				43%	22%
126,001		46%				46%	23%
Average tax rate		28%				46%	23%

For example, a non-senior earning $8,882 will pay taxes of 15% on each additional dollar earned up to $10,100, at which point the marginal tax rate will increase to 21%. However, a senior earning $8,882 will pay taxes of 65% on each additional dollar earned: 15% for income taxes and 50% for the GIS clawback (i.e., the GIS benefit will be reduced by 50 cents for the additional dollar). Or, a non-senior earning $66,001 will pay 33% taxes on each additional dollar earned up to $74,000. Whereas, a senior in the same tax bracket will pay taxes of 50.25%, which represents the 33% income tax rate, plus a 15% clawback on OAS (i.e., the OAS is reduced by 15 cents for each dollar earned in excess of $66,325), and an additional 2.25% for the age tax credit reduction (i.e., the 15% age tax credit is reduced by 15% for each dollar earned after $32,312).

It is interesting and, perhaps, surprising to many to note that, when considering the various clawbacks, a senior with a taxable income less than $15,000 or in excess of $66,000 to $107,700 will be subject to tax at a rate that is higher than the top tax bracket of 46% for a non-senior. Given that a withdrawal from an RRSP is included in taxable income, it rarely makes sense to contribute to an RRSP unless you are currently in a high tax bracket. Accordingly, a contribution to a TFSA is preferable, given that a withdrawal is not included in income and, thus, is not a factor in any of the three (i.e., OAS, GIS, and age tax credit) income-based clawbacks.

Deciding Which is Right For You

In summary, the question of whether to invest in an RRSP or a TFSA is really a question of today's marginal tax rate versus tomorrow's marginal tax rate. It makes more sense, and results in more after-tax dollars, to contribute to an RRSP only when your current marginal tax rate is higher than your marginal tax rate upon retirement.

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