January 2016

Blinded by the "Refund": Why TFSAs may beat RRSPs as better retirement savings vehicles for some Canadians

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With the introduction of Tax Free Savings Accounts (TFSAs) in 2009, Canadians have a powerful retirement savings tool in their quiver, yet some may be reluctant to use it. Canadians who are fixated on the immediate gratification of the "tax refund" associated with Registered Retirement Savings Plan (RRSP) contributions often sock money away in their RRSPs at the expense of TFSA contributions and may be shortchanging themselves come retirement time.

TFSAs — The Basics

TFSAs first became available to Canadians in 2009. TFSAs are "tax pre-paid" savings plans, the term "pre-paid" referring to the fact that tax was paid in advance (by someone) on earned funds that are then used to make the TFSA contribution, unlike an RRSP on which tax is paid when the funds are withdrawn.

The TFSA rules are relatively straightforward. Any Canadian resident who is at least 18 years old is permitted to open a TFSA, provided they have a social insurance number. The amount you can contribute to a TFSA is based on your "TFSA contribution room."

Starting in 2009, each Canadian resident who reached aged 18 automatically began to accumulate $5,000 of TFSA contribution room annually. This TFSA contribution room is cumulative and unused room is carried forward indefinitely to future years. Canadians who were at least 18 in 2009 and, as of 2016, have not yet opened up a TFSA can immediately contribute $46,500 to a TFSA, consisting of $5,000 of accumulated room for each of 2009 through 2012, $5,500 for 2013 and 2014, $10,000 for 2015, and $5,500 for 2016.

Funds inside a TFSA can be invested in everything from savings accounts, GICs and mutual funds to individual stocks and bonds. In fact, nearly any investment that is eligible for other registered plans, such as RRSPs or RRIFs, can be held inside a TFSA.

Perhaps one of the most significant differences between a TFSA and an RRSP is that, unlike the RRSP, any amounts withdrawn from a TFSA in a particular year will be automatically added to your TFSA contribution room for the following year, allowing individuals who withdraw TFSA funds to re-contribute an equivalent amount in a future year.[1] Note that the amount added to TFSA contribution room is the full amount of the withdrawal, which can include not only amounts originally contributed but income and / or growth on those initial contributions.

Secondly, unlike RRSPs, contributions to a TFSA are from after-tax funds (hence the term tax "pre-paid") and therefore are not tax deductible from income and do not result in a "refund" come tax season. The big advantage, however, is that not only are income and gains on investments held within a TFSA not taxed annually while inside the TFSA but they can be subsequently withdrawn tax-free at any time.

Finally, as will be discussed in greater detail below, since TFSA withdrawals are tax-free, they are not included in "net income" and as a result, do not negatively impact federal government benefits and tax credits that are income tested and could be otherwise reduced if funds were withdrawn from an RRSP or a RRIF.

RRSPs vs TFSAs — The Myth of the "Refund"

It goes without saying that Canadians who can afford to maximize both RRSP contributions as well as make their annual TFSA contributions would generally be well-advised to do both. But the reality is that most Canadians simply don't have enough available cash annually to afford to contribute the maximum to both plans and as a result, must make an important decision, namely, which savings vehicle should take priority: the RRSP or the TFSA?

Conventional thinking seems to have steered most Canadians towards the tried and trusted plan, the RRSP, at the expense of the TFSA. But what is driving this decision? It seems that both a misunderstanding of the tax refund associated with an RRSP contribution combined with an unfamiliarity of the tax mechanics behind RRSP and TFSA contributions and withdrawals may be to blame.

The fact is that with the same rate of return assumption, the same compounding period and constant tax rates at the date of contribution and the date of ultimate withdrawal, the amount of after-tax cash that can be accumulated with an RRSP or TFSA is identical.

Chart 1 compares the after-tax accumulation over 20 years of $5,000 of income earned by an individual that's subsequently invested through either a TFSA or an RRSP. In the TFSA scenario, $5,000 is taxed up front, when earned, at the individual's marginal tax rate (assumed to be 40%) and the after-tax amount of $3,000 is invested in the TFSA.

Since this tax is literally "pre-paid" and since the earnings and growth inside the TFSA are neither taxed during the accumulation phase nor upon withdrawal, the after-tax value after 20 years is $7,960, assuming a 5% growth rate.

Now, assume that instead you earn $5,000 of income but you don't have to pay tax on it currently because you put it into your RRSP and claim a deduction for it. Thus, the full $5,000 is invested, grows to $13,266 and is ultimately taxed in 20 years' time at 40%, netting you exactly the same amount after-tax or $7,960.

Chart 1: After-tax cash in TFSA & RRSP

	TFSA	RRSP
Pre-tax income	$ 5,000	$ 5,000
Tax (40%)	(2,000)	n/a
Net Contribution	$ 3,000	$ 5,000
Growth at 5% / 20 years	7,960	13,266
Tax upon withdrawal (40%)	-	(5,306)
Net cash	**$7,960**	**$ 7,960**

It's only when your tax rate upon ultimate withdrawal is either lower or higher than your current tax rate that either the TFSA or RRSP wins out. This is discussed in detail below.

But what concerns many a prospective TFSA contributor is that if you make a contribution to your TFSA by forgoing a contribution that otherwise would have gone into an RRSP, you won't get as a large a tax refund and therefore have less money to meet current consumption needs.

But what is this tax refund anyway?

The refund associated with an RRSP contribution should not be considered a windfall but rather the present value of the future tax payment that will have to be made on the ultimate RRSP withdrawal (assuming tax rates are constant). In other words, the tax unpaid on the funds contributed to an RRSP is merely being deferred to a later point in time when the funds are ultimately withdrawn and taxed, either through an RRSP or RRIF withdrawal (or ultimately, upon death).

For example, if you put your tax "refund" into your TFSA, as many have suggested you do, and assuming your TFSA grows at the same rate of return as your RRSP, then the fair market value of your TFSA will equal your future tax payable on your RRSP withdrawal, assuming your tax rate is the same. (Chart 2).

Chart 2 — Contribute RRSP "Refund" into a TFSA

	RRSP	TFSA
RRSP Contribution	$ 5,000	
Contribute Tax "Refund" to TFSA (@40%)		$2,000
FMV of RRSP/TFSA (Growth @5%, 20 years)	$13,266	$5,306
Tax on RRSP withdrawal (@40%)	$ 5,306	

Spending the refund now is the equivalent of borrowing money against your future income at a rate of interest equal to the expected rate of return on your RRSP!

The case of Dick and Jane

With this in mind, consider the case of Dick and Jane who are both 45 years old. Each of them earns $60,000 per year and each requires just over $44,000 after-tax annually to meet current consumption needs. As Chart 3 shows, because Dick chooses to contribute $5,000 to his RRSP instead of a TFSA, he gets the benefit of a tax refund, which reduces his tax payable and leaves him with $44,500 to spend.

Jane, on the other hand, doesn't get a tax refund but instead chooses to contribute to a TFSA. But, because she requires the same after-tax amount of spending money currently, she can only afford to put $3,500 into her TFSA to achieve the same $44,500 in after-tax spending money.

Chart 3 — Dick and Jane — RRSP vs TFSA contribution

	Dick	Jane
Income	$ 60,000	$ 60,000
RRSP Contribution	(5,000)	n/a
Taxable Income	$ 55,000	$ 60,000
TFSA Contribution	n/a	(3,500)
Net Cash — Pre-Tax	$ 55,000	$ 56,500
Total Tax (Note 1)	10,500	12,000
Net Cash to Spend	**$44,500**	**$44,500**

Note 1:

The following assumptions are used in the calculations:

- A 20% tax rate applies to taxable income up to $40,000
- A 30% tax rate applies to taxable income exceeding $40,000
- The basic personal amount of $10,000 yields a credit that is calculated at a rate of 20%. No other personal tax credits may be claimed

So, ultimately, who is better off, Dick or Jane?

While clearly Dick will have more money in his RRSP than Jane will have in her TFSA, that's only true on a pre-tax basis. As Chart 4 shows, if we assume that both Dick and Jane contribute $5,000 and $3,500 annually to their RRSP and TFSA respectively, and do so for twenty years, at a tax-deferred growth rate of 5%, Dick will indeed have nearly 50% more money on a pre-tax basis than Jane.

But if we then assume that both Dick and Jane withdraw the balances in their RRSP and TFSA beginning at age 65, over the course of the next twenty years, allowing for continued tax sheltered growth on the remaining RRSP and TFSA balances at 5%, Dick would receive $13,266 of annual taxable RRSP (or ultimately RRIF) withdrawals while Jane would receive $9,287 after-tax. If we assume that Dick is taxed at the same marginal tax rate during retirement as he was when he contributed to his RRSP (30%), you can see that both Dick and Jane end up with the identical after-tax annual cash flows.

Chart 4 — Dick and Jane — Withdrawals

	Dick (RRSP)	Jane (TFSA)
Future value of savings — age 45 to 65	$173,596	$121,517
Annual withdrawals — age 65 to 85	13,266	9,287
Tax on withdrawals	(3,980)	n/a
Annual after-tax cashflow from retirement savings	$ 9,287	$ 9,287

Note:

Assumes beginning of year contributions, 5% growth rate, equal end of year annual withdrawals, zero balance left at end of 20 years and 30% marginal tax rate for Dick.

Of course the big assumption equating the annual retirement cash flows is that both Dick and Jane remain in the same tax bracket when they access their funds upon retirement as they were in when the initial contributions were made to the RRSP or TFSA. Let's explore the accuracy of this assumption and its applicability to Canadians in more detail.

Tax Rates — Working vs Retirement

As the example of Dick and Jane illustrated, whether one invests in an RRSP or a TFSA is nearly irrelevant if you're in the same tax bracket when you withdraw the funds as you were in when you made your contribution.

Many Canadians, however, believe that they may be in a lower bracket upon retirement making the argument for contributing to RRSPs over TFSAs.

Let's take a closer look at this by exploring the three possible scenarios side-by-side: the constant tax rate assumption, the high rate to low rate assumption that favours the RRSP over the TFSA, and the low rate to high rate assumption that reaches the opposite conclusion. (Chart 5)

The first column, reproduced from Chart 1 above, illustrates the constant tax rate assumption, which shows that with constant tax rates you should generally be indifferent between investing in a TFSA or an RRSP. The second column shows that RRSPs will produce a better result when the tax rate upon withdrawal is expected to be lower than the tax rate upon original contribution. Conversely, the third column demonstrates that TFSAs will provide more after-tax cash if your tax rate will be higher upon ultimate withdrawal than it was when you contributed.

Chart 5

	Same Tax Rate		High / Low		Low / High	
	TFSA	RRSP	TFSA	RRSP	TFSA	RRSP
Pre-Tax income	$5,000	$ 5,000	$5,000	$ 5,000	$ 5,000	$ 5,000
Tax rate — contribution	*40%*		*40%*		*20%*	
Tax	(2,000)	–	(2,000)	–	(1,000)	–
Net contribution	$3,000	$ 5,000	$3,000	$ 5,000	$ 4,000	$ 5,000
Growth at 5% / 20 years	$7,960	$13,266	$7,960	$13,266	$10,613	$13,266
Tax rate — withdrawal		*40%*		*20%*		*40%*
Tax	–	(5,306)	–	(2,653)	–	(5,306)
Net cash	$7,960	$ 7,960	$7,960	$10,613	$10,613	$ 7,960

One C.D. Howe Institute study[2] concluded that "for many lower-income Canadians, RRSPs are a terrible investment." That's because many government benefits, credits and programs are based on net income and are substantially or even totally reduced as your income gets higher.

Another study[3] released by the Institute explored Canadians' marginal effective tax rates (METRs) upon retirement. The METR reflects not only an individual's marginal personal income tax rate on an incremental dollar of income but also takes into account the potential loss of federal and provincial income-tested benefits and credits.

Seniors currently living on RRSP or RRIF withdrawals find that even modest withdrawals from these plans upon retirement affect the retiree's eligibility for income-tested government benefits and credits, such as the Guaranteed Income Supplement (GIS), Old Age Security (OAS) benefits and the Age Credit. Since withdrawals from a TFSA are not considered to be "income," they have no impact on the amount of GIS or OAS received nor will such withdrawals reduce the Age Credit.

Similarly, Canadians with low and modest income who receive the GST/HST Credit may find RRSP or RRIF withdrawals reducing their quarterly cheques. By being able to pull retirement funds from a TFSA rather than an RRSP or RRIF, the Credit may be preserved.

The study concluded that for many people, METRs upon retirement, which take into account the loss of government benefits and credits, will be higher than working METRs, suggesting that these individuals, given limited funds, may be better off saving in TFSAs than RRSPs.

Not to be ignored in this analysis, however, is the possibility of pension income splitting. Canadians age 65 or older who convert all or a portion of their RRSP into a RRIF are able to split the subsequent RRIF withdrawals with their spouse or partner. If the spouse or partner is in a lower tax bracket or is not otherwise subject to clawbacks of government benefits or credits, the RRSP route may indeed be preferable to the TFSA if the effective METR upon retirement is lowered sufficiently through pension splitting of RRIF withdrawals.

Accessibility of Funds

What doesn't show up in the numbers above, of course, is the added accessibility associated with TFSAs as compared to RRSPs. TFSA funds can be withdrawn at any time, tax-free and can then be re-contributed in a future year, while RRSP withdrawals are taxable in the year of withdrawal and cannot be re-contributed.

Perhaps the psychological barrier of knowing that tax must be paid on RRSP monies withdrawn, even for emergencies, has led at least some Canadians to favour contributing to their RRSP over a TFSA as a way of preventing themselves from easily accessing what should be retirement money. The TFSA, with its flexibility and tax-free nature, provides no such obstacle.

When cash-strapped Canadians do access funds in their RRSPs before retirement to supplement income, this has two consequences. First, funds withdrawn, even for an emergency, cannot be replaced later on, perhaps when financial circumstances improve and the ability to save is greater. Admittedly, however, this may not be much of a concern to lower income Canadians who have more RRSP carry-forward room than they could possibly afford to use.

Secondly, withdrawals of RRSP funds are taxable, meaning that current withdrawals could push the RRSP annuitant into a higher tax bracket and could reduce income-tested benefits, including the GST/HST Credit, the Canada Child Tax Benefit and the Working Income Tax Benefit.

TFSA withdrawals, on the other hand, avoid both these problems since the funds can be re-contributed at any time following the year of withdrawal and the withdrawals, being non-taxable, cannot trigger the loss of government benefits.

Other Considerations

For Canadians who can't contribute to an RRSP, TFSAs may be the only viable option for tax-deferred retirement savings. These can include employees who are members of registered pension plans (RPPs) through their employers and find their ability to contribute to an RRSP severely limited by the pension adjustment. Similarly, Canadians who don't have any earned income or who are over 71 may find the TFSA a useful way to sock away extra funds for retirement on a tax-free basis.

Finally, keep in mind that there is no one ideal solution for every Canadian. Even two individuals in the same tax bracket today may come to different conclusions as to the optimal retirement savings allocation between an RRSP and the TFSA. Factors that need to be considered include: family structure, which could permit pension splitting of RRIF payments at age 65, projected sources of retirement income, including access to non-registered savings, as well as assumptions about retirement income replacement ratios and a willingness to encroach on capital.

While the average Canadian is unlikely to be able to determine, with any certainty whatsoever, whether to maximize his or her TFSA or RRSP, perhaps with some financial guidance and a better understanding of how these new savings vehicles work, TFSAs may become the retirement vehicle of choice for many more Canadians going forward.

As of 2012, over 9.5 million Canadians had opened a TFSA, with more than $87 billion growing tax-free.[4] This represents an estimated take up rate of about 40 per cent,[5] which seems to suggest that Canadians are perhaps still not embracing this new savings vehicle as wholeheartedly as they should as a means to funding a comfortable retirement.

This can be explained by the many competing financial priorities that Canadians face, such as debt reduction, education savings or caring for elderly family members. With limited resources and many options, Canadians must prioritize where their money goes. But, with a better understanding and appreciation of how TFSAs work, these new plans may turn out to be the ideal retirement savings vehicle for many Canadians.

For example, Chart 6 shows four income-tested federal benefits and credits, what they're worth and at what income levels they are "clawed back."

Chart 6 — A Sample of Various Federal Income Tested Benefits & Credits

	Value	Income Threshold	
		Begins	Ends
Guaranteed Income Supplement — Single	$ 9,283	$ 24	$17,304
Old Age Security	$ 6,846	$73,756	$119,398
Age credit (federal)	$ 1,069	$35,927	$ 83,427
GST / HST Credit — Single	$ 272	$35,475	$43,765

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1 Withdrawals to correct over-contributions do not count and are not added to contribution room the next year.

2 Shillington, Richard. "New Poverty Traps: Means-Testing and Modest-Income Seniors" — C.D. Howe Institute Backgrounder No. 65, April 2003, available online at http://www.cdhowe.org/pdf/backgrounder_65.pdf

3 Laurin, Alexandre and Poschmann, Finn. "Saver's Choice: Comparing the Marginal Effective Tax Burdens on RRSPs and TFSAs" C.D. Howe Institute e-brief no. 91, January 2010, available online at http://www.cdhowe.org/pdf/ebrief_91.pdf

4 CRA Tax-Free Savings Account statistics (2012 tax year), Table 1-A and Table 3, available online at http://www.cra-arc.gc.ca/gncy/stts/tfsa-celi/2012/menu-eng.html#h12.

5 CRA Preliminary Income Statistics 2014 (2012 tax year) — Summary of Basic Table 4. Of the 25 million tax returns filed, 96% of them (24.4 million) were for those aged 20 and over. This approximates, to some extent, the TFSA contribution-eligible population. If 9.5 million Canadians have contributed to a TFSA out of an eligible population of 24.4 million, that represents a take up rate of almost 40 per cent.