Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Comparing saving options

RRSP, TFSA or paying down debt

There are a number of tax-efficient options for Canadians when it comes to saving for the future. For those who don't have enough excess cash to maximize all of the forms of saving available to them, the question regularly becomes: Where do I save first or should I pay down my debt instead? This article examines some of the considerations you may want to think about when deciding between allocating money towards a registered retirement savings plan (RRSP) or a tax-free savings account (TFSA) or paying down debt.

RRSP and TFSA basics

RRSPs and TFSAs are registered accounts created by the government to encourage saving. The table below summarizes some of the key attributes of these accounts to give you a starting point for the comparison. If you'd like more information, please ask your RBC advisor for additional articles on each of these accounts.

RRSP and TFSA basics

	RRSP	TFSA
Contribution room	Determined annually based on 18% of earned income up to a prescribed maximum.	Prescribed annual limit for those ages 18 or older starting in 2009.
Impact of withdrawals on contribution room	Not added back to contribution room.	Added back to your available contribution room in the next calendar year.
Type of contribution	Before-tax dollars lowering taxable income through a deduction.	After-tax dollars.
Tax treatment within the plan	Income and capital gains not taxable.	Income and capital gains not taxable.
Tax treatment on withdrawal	Income, growth and original contributions taxable as income when withdrawn.	Not taxable.
Maturity requirement	Minimum withdrawal requirement by December 31 in the year annuitant turns age 71.	None.
Impact on income-tested benefits	Withdrawals impact federal income-tested benefits such as Old Age Security (OAS).	Withdrawals do not impact federal income-tested benefits.
Creditor protection	Creditor protected in the case of bankruptcy under the federal Bankruptcy and Insolvency Act.	No creditor protection under the federal Bankruptcy and Insolvency Act.
Tax treatment on death	Deemed deregistration at fair market value (FMV) on date of death and taxable to the deceased. Growth between date of death and date of distribution taxable to beneficiaries. Exceptions available where plan is transferred to a qualified beneficiary.	Deemed deregistration at FMV on date of death, FMV not taxable. Growth between date of death and date of distribution taxable to beneficiaries. Exceptions available where plan is transferred to a surviving spouse.

Evaluating your options

When examining your saving choices, it's important to note there is no single or absolute answer. Instead, there are many considerations that may make a particular savings vehicle more suitable for you.

The following sections outline some typical considerations you may want to take into account, which include:

- Interest rates and rates of return on investments;
- Risk tolerance;
- Marginal tax rates;
- Flexibility;
- Personal habits; and
- Income-tested retirement benefits.

In making a decision about where to save, give some thought to your personal goals and objectives to determine the best savings vehicle for you. Questions to consider could include, what are these savings for and when will you need them? Do you want to minimize tax today or smooth tax over your lifetime? Where do your priorities lie? Once you've determined your goals and objectives, you can look at which considerations are the most important to you. For example, if you need funds in the short-term (e.g. for vacation), investing in a TFSA may make sense, as it provides you with the flexibility to withdraw funds with minimal tax consequences.

Interest rates and rates of return on investments

RRSP	• Contributions made with pre-tax dollars (for every $1 you earn, you can invest the full $1). • Tax-deferred return on investment. • Ability to invest pre-tax dollars increases the power of compound growth. • Rate of return is subject to market risk. Losses realized in the RRSP cannot be used to offset gains realized in your non-registered account.
TFSA	• Contributions are made with after-tax dollars (for every $1 you earn, you can only invest $1 less the tax paid). • Tax-free return on investment increases the power of compound growth. • Rate of return is subject to market risk. Losses realized in the TFSA cannot be used to offset gains realized in your non-registered account.
Debt repayment	• If debt has fixed interest rate, you avoid the future interest payments by paying off the debt. In a sense, the debt has a guaranteed rate of return for each dollar of principal repayment at that fixed interest rate. • Rate of return can be more predictable depending on debt structure (fixed vs. variable) and term of the loan.

Once you've determined the potential rate of return on your RRSP/TFSA, you can compare the rate of return to the interest you'll be saving on the early debt repayment. For example, if you have locked in a very low interest rate on your debt and expect market returns to be higher, it may be more beneficial for you to invest rather than paying down that debt.

Risk tolerance

RRSP & TFSA	• Portfolio generally determined based on risk tolerance and may be subject to volatility in line with market movements. • Returns are generally not guaranteed.
Debt	• Savings are guaranteed to be the interest you avoid paying by repaying your debt. • Comfort level with debt needs to be assessed. Keep in mind that interest and principal payments will generally need to be made, typically according to a set schedule. • You will want to ensure you have sufficient cash flow to meet your debt obligations, otherwise, you may want to lower your debt.

Marginal tax rates

RRSP	• **At the time of contribution:** Tax savings from your deduction may provide you with more capital up front, on which you can earn additional income (assuming a 40% tax rate, if you invest $1,000 in an RRSP, you may receive up to $400 in tax savings to add to your investment). • The higher your marginal tax rate at the time of contribution, the larger your tax savings will be. • **At the time of withdrawal:** Full amount is included in income. • RRSPs work well where marginal tax rates are expected to be lower at the time of withdrawal versus time of contribution.
TFSA	• **At the time of contribution:** Contributions are made with after-tax dollars (a contribution of $1 to your TFSA at a 40% tax rate will require $1.67 pre-tax)as such, the lower your marginal tax rate at the time of the contribution, the less after-tax funds it will cost you. • **At the time of withdrawal:** There is no tax on withdrawals. • Can be a good source of cash flow if you need to withdraw when you are in a higher tax bracket.
Debt	• **At the time of principal repayment:** Payments are made with after-tax funds. • If you expect your tax rate to drop in the future, it may make sense to pay off debt when your tax rate is lower. However, the decision should factor in any additional interest paid. • If you expect your tax rate to increase, you may want to pay off more debt today, as this will cost you less and minimize future interest payments.

Flexibility

RRSP	• Thought more of as “retirement funds.” • When you withdraw, the amount is taxable, thus reducing the amount you’ll keep in your hands. • Consider also the inability to recontribute any withdrawals to an RRSP.
TFSA	• Withdrawals are tax-free. • Flexibility to recontribute withdrawals in the following calendar year. • Can be an ideal place to grow an emergency fund.
Debt	• Depending on the type of debt, you may not be able to, or it may be difficult to, re-borrow. For example, refinancing a mortgage to access equity in a principal residence can be slow and costly. • Consider cash flow in the event of job loss, leave or illness.

Personal habits – know yourself

RRSP	• Punitive consequences of a withdrawal can work to curb an early withdrawal. • Tax savings may be generated on the initial contribution to the RRSP, which may result in a tax refund. • Consider how best to use this refund. For example, you can make a lump-sum payment towards your debt, contribute to your TFSA or top up your RRSP again. If you spend your refund, you give up the opportunity to leverage this tax-favoured vehicle to boost your savings power.
TFSA	• Funds are easy to access, as there are no negative tax consequences on withdrawal.
Debt	• Paying debt earlier will reduce your cash flow for the short-term, which can be seen as forced saving. • Plan for the increase in cash flow as a result of repayment in the future.

Income-tested retirement benefits

RRSP	• Withdrawals are included in income and could impact income-tested benefits such as old age security (OAS).
TFSA	• Withdrawals have no impact on income-tested benefits.
Debt	• Repayments have no impact on income-tested benefits.

Other considerations

Time horizon: How long you plan to invest for should be considered when determining your saving strategy. As an example, RRSPs are generally better-suited for long-term savings, whereas TFSAs, debt repayment and non-registered investments may be better solutions for short-term. This is because withdrawals from an RRSP are fully taxable while the initial contribution is tax-deductible. As such, you'll generally want to keep the pre-tax dollars invested in the RRSP for as long as possible.

Employer matching: Does your employer match TFSA or RRSP contributions?
If so, to the extent your excess cash provides, it may make sense to contribute to one or both savings vehicles up to the maximum employer match. This allows you to increase your annual compensation, by getting more from your employer that would not otherwise be available. You'll also be able to grow these plans more quickly, as your contribution will be topped up by your employer.

Home Buyers' Plan/Lifelong Learning Plan:
While the RRSP isn't as flexible as the TFSA, there are two unique programs for the RRSP. They are the ability to access $35,000 for a home under the Home Buyers' Plan or withdrawing up to $20,000 for qualifying post-secondary education under the Lifelong Learning Plan. If you're interested in learning more, please ask your RBC advisor for additional articles on these specific programs.

Debt terms: Not all debt is created equally. Some lenders will set limits on the quantum and means of prepaying a debt, specifically with mortgages. Typically, accelerated monthly payments or annual lump-sum payments up to a pre-determined amount will be allowed, or some combination of the two. Before deciding on making any early repayments, make sure you understand the terms of the loan and determine if there are any additional fees associated with an early repayment if possible.

Conclusion

There's no one correct answer in deciding how to save. It's a personal decision that should be made based on your goals, circumstances, tax rates and personal habits. To help with the decision-making process, please speak with your RBC advisor, who can help you examine your options.

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