RRSPs and TFSAs: What's the difference when it comes to income tax rates?

Have you heard of registered retirement savings plans (RRSPs) and tax-free savings accounts (TFSAs) but aren't sure what the difference is? Are you trying to figure out which is best for you and your financial security plan?

We can help – let's take a closer look.

Before you decide whether to contribute to an RRSP or a TFSA, you'll want to consider your goals and your current and future tax rate.

One main consideration is what your marginal income tax rate is now versus what you expect it to be when you plan to make a withdrawal. Here are two scenarios to consider:

Scenario one

Your tax rate is expected to be **lower** when you're withdrawing money than it was when you were contributing money.

Your initial contribution (40% tax rate)	
TFSA **$600**	RRSP **$1,000**
Grows to **$1,592**	Grows to **$2,653**
Your withdrawal in 20 years (30% tax rate)	
After tax **$1,592**	**After tax $1,857** ☑

Recommendation: RRSP first, then TFSA

Scenario two

Your tax rate is expected to be **higher** when you're withdrawing money than it was when you were contributing money.

Your initial contribution (30% tax bracket)	
TFSA **$700**	RRSP **$1,000**
Grows to **$1857**	Grows to **$2,653**
Your withdrawal in 20 years (40% tax rate)	
After tax **$1,857** ☑	After tax **$1,592**

Recommendation: TFSA first, then RRSP

Ultimately, one isn't better than the other. There can be a place for both an RRSP and a TFSA in your financial plan.

An RRSP can be more beneficial if you're currently earning a high income because it helps you defer taxes until later in life when you may have a lower tax rate and pay less tax overall.

On the other hand, your TFSA can be more tax-effective if you expect your tax rate to be higher when you withdraw money than it is when you contribute money. This makes a TFSA suitable if you're in a lower income bracket but expect to be in a higher tax bracket later.

Your advisor and investment representative can help you decide whether it's more beneficial to pay taxes on your income now or in the future, based on your unique situation.

Assumptions: $1,000 pre-tax income in an RRSP, an equivalent after-tax amount contributed to a TFSA based on 30 and 40 per cent tax rates. Growth assumes a five per cent annual rate of return for 20 years.

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