Blinded by the “refund”: Why TFSAs may beat RRSPs as better retirement savings vehicles for some Canadians

August 2020

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A Tax Free Savings Account (TFSA) can be a powerful retirement savings tool, yet some individuals 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.

The basics of TFSAs

TFSAs are “tax pre-paid” savings plans, the term “pre-paid” referring to the fact that you pay tax in advance on funds that you earn, and then use after-tax funds to make the TFSA contribution, unlike a Registered Retirement Savings Plan (RRSP) on which you only pay tax when the funds are withdrawn.

The TFSA rules are relatively straightforward. If you are at least 18 years old, you are permitted to open a TFSA if you have a social insurance number.

The amount you can contribute to a TFSA is based on your “TFSA contribution room.” You automatically accumulate TFSA contribution room for each year after 2008 in which you are at least 18 years old and resident in Canada. Your TFSA contribution room is cumulative and unused room is carried forward indefinitely to future years. If you have been resident in Canada and at least 18 years old since 2009 and, as of 2020, have not yet opened up a TFSA, you can immediately contribute $69,500 to a TFSA.[1]

You can invest the funds inside your TFSA in everything from savings accounts, GICs and mutual funds to individual stocks and bonds. In fact, you can hold nearly any investment that’s eligible for other registered plans, such as a RRSP or Registered Retirement Income Fund (RRIF), inside your TFSA.

Perhaps one of the biggest differences between a TFSA and an RRSP is that, unlike the RRSP, any amounts you withdraw from your TFSA in a year, other than amounts withdrawn to correct over-contributions, referred to here as “regular withdrawals”, will be automatically added to your TFSA contribution room for the following year. You can re-contribute an amount equal to the total of your current year’s regular withdrawals in a future year. Note that the amount added to TFSA contribution room is the full amount of your regular withdrawals, which can include not only amounts you originally contributed but also income and / or growth on your initial contributions.

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[1] 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, 2017 and 2018 and $6,000 for 2019 and 2020

Secondly, unlike RRSPs, your contributions to a TFSA are made from after-tax funds (hence the term tax “pre-paid”) and, therefore, are not tax deductible and do not result in a “refund” come tax season. The big advantage, however, is that you pay no tax on income and gains on your TFSA investments or on any amounts you withdraw from your TFSA, as long as you follow the rules.

Finally, as will be discussed in greater detail below, since TFSA withdrawals are tax-free, you do not have to include them in your “net income” so they won’t negatively impact your federal income-tested federal government benefits and tax credits, which could be otherwise reduced if you withdrew funds from your RRSP or 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 many 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 if your tax rate is the same on the date you contribute to a TFSA or RRSP and on the date you ultimately withdraw funds from the plans, the amount of after-tax cash that you could accumulate over time with an RRSP or TFSA is identical.

Figure 1 compares the after-tax cash that you would have after 20 years with a 5% rate of return if you initially earned $5,000 of income and then invested through either a TFSA or an RRSP, assuming your tax rate is 40% both at the time of contribution and withdrawal.

Figure 1: After-tax cash after 20 years when $5,000 of income is invested at 5% in TFSA & RRSP, assuming tax rates are 40% upon contribution and withdrawal

Description	TFSA	RRSP
Pre-tax income	$5,000	$5,000
Tax upon contribution at 40%	(2,000)	n/a
Net contribution	**$3,000**	**$5,000**
Growth at 5% after 20 years	4,960	8,266
Total after 20 years	**$7,960**	**$13,266**
Tax upon withdrawal at 40%	0	(5,306)
Net cash	**$7,960**	**$7,960**

In the TFSA scenario, when you earn the $5,000 of income, you would pay tax of $2,000 ($5,000 times 40%), so you would have $3,000 ($5,000 minus $2,000) to invest in your TFSA. Since the tax is literally “pre-paid” and since the 5% earnings and growth inside your TFSA are neither taxed during the accumulation phase nor upon withdrawal, the after-tax value you would after 20 years is $7,960.

If, instead, you earn $5,000 of income and put it into your RRSP, you don’t have to pay tax on the income currently because you can claim a deduction for your $5,000 contribution. Thus, you could invest the full $5,000, which would grow to $13,266 in 20 years’ time. Upon withdrawal, you would pay tax of $5,306 ($13,266 times 40%), also netting you $7,960 ($13,266 minus $5,306).

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, would 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 that you don’t pay on the funds you contribute to an RRSP is merely being deferred to a later point in time when you ultimately pay tax, either when you withdraw funds from your RRSP or RRIF (or ultimately, upon death).

For example, it is often suggested that you put the tax “refund” from your RRSP contribution into your TFSA, rather than simply spending it on personal expenses. Assuming your TFSA grows at the same rate of return as your RRSP and your tax rate is the same upon contribution and withdrawal, the fair market value of your TFSA would equal your future tax payable on your RRSP withdrawal.

Figure 2: When $5,000 is contributed to an RRSP and the $2,000 tax “refund” is invested in a TFSA, the amount from the TFSA would equal the tax on withdrawal from an RRSP, assuming a 5% rate of return and 40% tax rate

Description	RRSP	TFSA
RRSP contribution	$5,000	n/a
Amount of tax "refund" (at 40%) available for TFSA contribution	n/a	$2,000
FMV of RRSP / TFSA after 20 years, with a 5% rate of return	$13,266	**$5,306**
Tax on RRSP withdrawal at 40%	**$5,306**	n/a

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!

An example

With this in mind, consider the case of Zach and Ali, who live in Alberta. Each earns $60,000 per year, so taxes payable would be about $11,700.[2] Each requires about $45,000 after-tax annually to meet current consumption needs. As Figure 3 shows, if Zach chooses to contribute $5,000 to his RRSP, he gets the benefit of a tax refund, which reduces his tax payable by about $1,500[3] and leaves him with $44,800 to spend.

Ali, on the other hand, doesn’t get a tax refund but instead chooses to contribute to a TFSA. If Ali also spends $44,800 currently, only $3,500 is available for a TFSA contribution.

[2] Source: *Tax Templates Inc.,* June 2020, assuming only the basic personal amount is claimed, with amounts rounded to the nearest $100.

[3] At a marginal tax rate of 30.5%, with amounts rounded to the nearest $100.

Figure 3: How Zach and Ali could use after-tax funds for an RRSP or TFSA contribution, respectively

Description	Zach (RRSP)	Ali (TFSA)
Income	60,000	60,000
RRSP contribution	(5,000)	n/a
Taxable income	**55,000**	**60,000**
Tax payable	(10,200)	(11,700)
After-tax cash	**44,800**	**48,300**
Expenses	(44,800)	44,800
Available for TFSA contribution	**0**	**3,500**

So, ultimately, who is better off, Zach or Ali?

While clearly Zach will have $1,500 more money in an RRSP than Ali will have in a TFSA, that’s only true on a pre-tax basis. Suppose Zach contributes $5,000 to an RRSP and Ali contributes $3,500 to a TFSA each year for 20 years and earn a 5% rate of return on investments. Figure 4 shows that after 20 years, just before retirement, Zach will indeed have nearly 50% more money on a pre-tax basis than Ali.

Now suppose they each withdraw equal amounts annually over the course of the next 20 years during retirement. Zach would receive $13,266 of annual taxable RRSP (or ultimately RRIF) withdrawals while Ali would receive $9,287 annually from the TFSA. If we assume that Zach continues to be taxed at a marginal tax rate of approximately 30% at the time of withdrawals, you can see that both Zach and Ali end up with the identical after-tax annual cash flows of $9,287.

Figure 4 — Zach and Ali — Withdrawals

Description	Zach (RRSP)	Ali (TFSA)
Future value of savings at the end of 20 years, just before retirement	**$173,596**	**$121,517**
Annual withdrawals for each of 20 years during retirement	13,266	9,287
Tax on withdrawals at 30%	(3,980)	n/a
Annual after-tax cashflow from retirement savings	**$9,287**	**$9,287**

Tax rates – working vs. retirement

As the example of Zach and Ali 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. But what if you have different tax rates at the time you make a contribution to an RRSP or TFSA and the time you withdraw funds from the plan?

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.

The first column in Figure 5, which is reproduced from Figure 1, illustrates that with constant tax rates you should generally be indifferent between investing in a TFSA or an RRSP because you’d receive the same amount after-tax either way. The second column shows that RRSPs will produce a better result when the tax rate upon contribution is higher than the tax rate upon withdrawal. Conversely, the third column demonstrates that TFSAs will provide more after-tax cash if your tax rate is lower when you make a contribution than the tax rate upon ultimate withdrawal.

Figure 5: After-tax cash in TFSA & RRSP with same tax rates, high / low tax rates and low / high tax rates

Description	TFSA with same tax rates (40% on contribution / 40% on withdrawal)	RRSP with same tax rates (40% on contribution / 40% on withdrawal)	TFSA with high / low tax rates (40% on contribution / 20% on withdrawal)	RRSP with high / low tax rates (40% on contribution / 20% on withdrawal)	TFSA with low / high tax rates (20% on contribution / 40% on withdrawal)	RRSP with low / high tax rates (20% on contribution / 40% on withdrawal)
Pre-tax income	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Tax on contribution	(2,000)	0	(2,000)	0	(1,000)	0
Net contribution	**$3,000**	**$5,000**	**$3,000**	**$5,000**	**$4,000**	**$5,000**
Growth at 5% after 20 years	4,960	8,266	4,960	8,266	6,613	8,266
Total after 20 years	**$7,960**	**$13,266**	**$7,960**	**$13,266**	**$10,613**	**$13,266**
Tax on withdrawal	0	(5,307)	0	(2,653)	0	(5,307)
After-tax cash	**$7,960**	**$7,960**	**$7,960**	**$10,613**	**$10,613**	**$7,960**

One C.D. Howe Institute study[4] 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[5] 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 may find that even modest withdrawals from these plans upon retirement affect the retiree's eligibility for income-tested government benefits and credits. Figure 6 shows four income-tested federal benefits and credits, what they're worth and at what income levels they are recovered.

Figure 6 — A Sample of Various 2020 Federal Income Tested Benefits and Credits

Benefit	Maximum value ($)	Income at which benefit reduction begins ($)	Income at which benefit is fully eliminated ($)
Old Age Security	7,362	79,054	128,137
Guaranteed Income Supplement – Single	10,997	0	18,600
Age credit (federal)	1,146	38,508	89,421
GST / HST credit – Single	443	37,789	46,649

[4] Shillington, Richard. "New Poverty Traps: Means-Testing and Modest-Income Seniors" — C.D. Howe Institute Backgrounder No. 65, April 2003, available online at cdhowe.org/sites/default/files/attachments/research_papers/mixed//backgrounder_65.pdf

[5] 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 cdhowe.org/sites/default/files/attachments/research_papers/mixed/ebrief_91.pdf

Since withdrawals from a TFSA are not considered to be “income,” they have no impact on income-tested benefits.

The Institute 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 recovery tax on 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 the regular withdrawal amount 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 and the Canada Workers 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 federal 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 it might be better to maximize contributions to a TFSA or RRSP, TFSAs may become the retirement vehicle of choice for many more Canadians going forward.

According to the most recent statistics, over 14 million Canadians had opened a TFSA, with more than $276 billion growing tax-free.[6] This represents an estimated take up rate of about 50 per cent,[7] 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 plans may turn out to be the ideal retirement savings vehicle for many Canadians.

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6 Tax-Free Savings Account statistics (2017 tax year), Table 1 and Table 3, available online at canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/tax-free-savings-account-statistics/tax-free-savings-account-statistics-2017-tax-year.html#toc12.

7 Per Statistics Canada “Population estimates on July 1st, by age and sex” for 2017, which are available at 150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1710000501, there were approximately 28.5 million Canadians over age 19. This approximates, to some extent, the population that is eligible to make TFSA contributions. If 14 million Canadians have contributed to a TFSA out of an eligible population of 28.5 million, that represents a take up rate of about 50 per cent.

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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