

RRSP Account versus the Tax Free Savings Account. The RRSP Account Wins!

The RRSP account gets less love than it should these days. For most, I think this is wrong headed and this article's purpose is to prove it.

I compare the account progressions of two individuals who are exactly the same except one individual hates the RRSP and does all his saving into TFSA. The other saves into an RRSP and takes the annual tax reduction generated from the annual RRSP contribution and contributes it to the TFSA. So, Individual A has an RRSP and a TFSA. Individual B has a TFSA only.

They are the same in all other aspects. So, they are both the same age, save the same amount, earn the same rate of return, have the same disposable income in the working years and the same after-tax income in retirement. Then we compare the account progressions.

Here is what the first two years of contributions and account balances look like:

		\$60,000 Employment Income 6% Rate of Return											
		Individual A - RRSP and Refund Contributed to TFSA								Individual B - TFSA Only			
		RRSP				TFSA							
Work Year	Balance	Contribute	Growth	End of Yr. Balance	Tax Reduction	Balance	Contribute	Growth	End of Yr. Balance	Balance	Contribute	Growth	End of Yr. Balance
1	\$ -	\$ 5,000	\$ 300	\$ 5,300	\$ 1,482	\$ -	\$ 1,482	\$ 89	\$ 1,571	\$ -	\$ 5,000	\$ 300	\$ 5,300
2	\$ 5,300	\$ 5,000	\$ 618	\$ 10,918	\$ 1,482	\$ 1,571	\$ 1,482	\$ 183	\$ 3,236	\$ 5,300	\$ 5,000	\$ 618	\$ 10,918

Here is what the last five years of contributions and account balances look like:

		Individual A - RRSP and Refund Contributed to TFSA								Individual B - TFSA Only			
		RRSP				TFSA							
Work Year	Balance	Contribute	Growth	End of Yr. Balance	Tax Reduction	Balance	Contribute	Growth	End of Yr. Balance	Balance	Contribute	Growth	End of Yr. Balance
26	\$ 290,799	\$ 5,006	\$ 17,748	\$ 313,553	\$ 1,482	\$ 86,188	\$ 1,482	\$ 5,260	\$ 92,930	\$ 290,799	\$ 5,006	\$ 17,748	\$ 313,553
27	\$ 313,553	\$ 5,007	\$ 19,114	\$ 337,674	\$ 1,482	\$ 92,930	\$ 1,482	\$ 5,665	\$ 100,077	\$ 313,553	\$ 5,007	\$ 19,114	\$ 337,674
28	\$ 337,674	\$ 5,008	\$ 20,561	\$ 363,243	\$ 1,482	\$ 100,077	\$ 1,482	\$ 6,094	\$ 107,652	\$ 337,674	\$ 5,008	\$ 20,561	\$ 363,243
29	\$ 363,243	\$ 5,009	\$ 22,095	\$ 390,347	\$ 1,482	\$ 107,652	\$ 1,482	\$ 6,548	\$ 115,682	\$ 363,243	\$ 5,009	\$ 22,095	\$ 390,347
30	\$ 390,347	\$ 5,010	\$ 23,721	\$ 419,079	\$ 1,482	\$ 115,682	\$ 1,482	\$ 7,030	\$ 124,194	\$ 390,347	\$ 5,010	\$ 23,721	\$ 419,079

The RRSP of Individual A and the TFSA of Individual B grow to the same amount. This makes sense. They contribute the same and earn the same rate of return.

It is important to note that Individual A pays less tax than Individual B in the working years by \$1,482 per year. RRSP contributions reduce taxable income and therefore tax. They both have the same disposable income, because Individual A contributes all \$1,482 into the TFSA account.

Now we look at retirement and the account progressions. We set it up so that both individuals have the same after-tax income in retirement.

Annual Income in Retirement													
Individual A - RRSP & TFSA							Individual B - TFSA Only						
Taxable Income	Tax	After-Tax Income	RRSP Withdraw	Tax on RRSP Withdraw	TFSA Withdraw	After-Tax Income	Taxable Income	Tax	After-Tax Income	TFSA Withdraw	After-Tax Income		
\$ 33,670	-\$ 3,670	\$ 30,000	\$ 30,000	\$ 7,355	-\$ 7,355	\$ 60,000	\$ 33,670	-\$ 3,670	\$ 30,000	\$ 30,000	\$ 60,000		

They both have the same CPP, OAS and a small company pension that brings taxable income to \$33,660. They qualify for the age and pension income credit. They both want more income. Individual B redeems \$30,000 per year from the TFSA. After-tax income is \$60,000. Individual A wants the same after-tax

income and redeems from his RRSP (or RRIF). This generates \$7,355 of tax. Individual A offsets the tax by redeeming \$7,355 from his TFSA. They both have an after-tax income of \$60,000.

Individual A is paying \$7,355 per year more in tax than Individual B in the retirement years.

Here are the account progressions in the first couple of years in retirement:

RRSP / RRIF TFSA Combination - TFSA from tax reduction of RRSP Contributions										No RRSP Contributions.			
RRSP / RRIF					TFSA From Contribution Refund					TFSA Only			
Retirement				New				New				New	
Year	Balance	Withdraw	Growth	Balance	Balance	Withdraw	Growth	Balance	Balance	Withdraw	Growth	Balance	
1	\$ 419,079	-\$30,000	\$ 23,345	\$ 412,423	\$ 124,194	-\$ 7,355	\$ 7,010	\$ 123,849	\$ 419,079	-\$ 30,000	\$ 23,345	\$ 412,423	
2	\$ 412,423	-\$30,000	\$ 22,945	\$ 405,369	\$ 123,849	-\$ 7,355	\$ 6,990	\$ 123,484	\$ 412,423	-\$ 30,000	\$ 22,945	\$ 405,369	
3	\$ 405,369	-\$30,000	\$ 22,522	\$ 397,891	\$ 123,484	-\$ 7,355	\$ 6,968	\$ 123,097	\$ 405,369	-\$ 30,000	\$ 22,522	\$ 397,891	

Now we prove that the RRSP is superior to the TFSA for saving for retirement. Who runs out of money sooner?

RRSP / RRIF TFSA Combination - TFSA from tax reduction of RRSP Contributions										No RRSP Contributions.			
RRSP / RRIF					TFSA From Contribution Refund					TFSA Only			
Retirement				New				New				New	
Year	Balance	Withdraw	Growth	Balance	Balance	Withdraw	Growth	Balance	Balance	Withdraw	Growth	Balance	
25	\$ 80,886	-\$30,000	\$ 3,053	\$ 53,939	\$ 106,680	-\$ 7,355	\$ 5,960	\$ 105,285	\$ 80,886	-\$ 30,000	\$ 3,053	\$ 53,939	
26	\$ 53,939	-\$30,000	\$ 1,436	\$ 25,376	\$ 105,285	-\$ 7,355	\$ 5,876	\$ 103,806	\$ 53,939	-\$ 30,000	\$ 1,436	\$ 25,376	
27	\$ 25,376	-\$30,000	-\$ 277	\$ 4,902	\$ 103,806	-\$ 7,355	\$ 5,787	\$ 102,238	\$ 25,376	-\$ 30,000	-\$ 277	\$ 4,902	

By the end of the 27th year of retirement, Individual A is clearly richer than individual B and can finance at least 3 more years of life.

So, what happened here? They both contributed the same amount and had the same disposable income in the working years. They both had the same after-tax income in the retirement years. They earned the same rate of return on their investments.

Individual A paid less tax than individual B in the working years and more tax than individual B in the retirement years. Clearly the benefit of lower tax in the working years overwhelms the burden of higher tax in the retirement years.

RRSP Wins!

A few side notes:

If individual A did not contribute the tax reduction from the RRSP contribution to the TFSA account, his retirement would've been worse than individual B, but his working years would've been more fun.

Note that, also, I am ignoring the more severe constraint on TFSA contributions. If Individual B gets a raise and wants to contribute more per year to the TFSA, he can't go past \$6,000 assuming he has no past accumulation room.