RRSP VS TFSA

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Now that the pain of income tax is over, it's time to start saving again, or, if you're lucky, to figure out what to do with your tax refund. Canadians have two programs that protect their savings from the tax man: Registered Retirement Savings Plan (RRSP) and Tax-free Savings Account (TFSA).

RRSPs reduce the amount of tax you'll have to pay, often resulting in a refund. TFSAs allow your savings to grow tax free. Is one better than the other if you're saving for a home?

There is no right or wrong answer, according to Diane McCurdy, a well-respected financial planner and author of How Much is Enough? (Wiley, 2013)

Under the federal government's Home Buyers' Plan, first-time home buyers are allowed to withdraw up to $25,000 from their RRSP plan to help with a down payment. (That's $50,000 per couple.)

"In the past, I didn't advocate that people use their RRSP to buy a home," says McCurdy. "However, because homes are so expensive in BC it's more difficult to avoid using your RRSP."

There are some rules to remember.

First, contributions must remain in the RRSP for at least 90 days before you can withdraw them under the HBP. Second, you must pay back the money within 15 years. So that's money that won't go toward paying down your mortgage.

On the upside, you can use your tax refund from your RRSP contribution toward your down payment. McCurdy suggests contributing the tax refund to your TFSA. One step better is to top up your TFSA to the maximum since it allows money to grow into a bigger down payment with no payback penalty. The limit is now $5,500 annually, but unused contribution room is carried forward. If you have never contributed, your contribution room has grown to $31,000 since the program's inception in 2009.

"If you withdraw from your TFSA, you must wait until the next calendar date to re-contribute into the plan, but you may still make the following year's contribution. It is a wonderful saving tool designed to help you save money for emergencies and large-ticket items," says McCurdy.

However, she cautions that you must track your contributions and be careful because any over-contributions will be hit with a one per cent penalty per month. There is currently no method to track your eligible TFSA room.

When it's time to choose between RRSP and TFSA, McCurdy has this rule of thumb: If you're in a higher tax bracket when you put the money in than when you take it out, then it's better to use an RRSP. When you contribute to your RRSP you receive a tax rebate now, and Revenue Canada takes less tax on withdrawal.

However, if you take the money out when you're in a higher tax bracket than you're in now, it's better to go with a TFSA.

"If your tax rate is the same when the money goes in and out, then your options are the same," adds McCurdy.

A financial advisor can help you find the most effective savings plan for your future home.

For more information, visit the Canada Revenue Agency website.

"Which is the better way to save for a home?