Retirees: Here's when TFSAs beat RRSPs

Description

For retirees, few things are more important than tax efficiency. When you're retired, every dollar of income counts. And you can't afford to gamble with your retirement money.

For this reason, many retirees like to invest in RRSPs and Tax-Free Savings Accounts (TFSAs). Offering a way to lower the taxes payable on investments, they help retirees keep more of their money.

Historically, RRSPs have been the most popular savings vehicle for retirees. They've been around much longer than TFSAs have, and generally offer much more annual contribution room. However, TFSAs are gaining in popularity. Today, there is about 20% as much money in TFSAs as in RRSPs nation-wide. That's remarkable when you consider that RRSPs have been around since 1957, while TFSAs have only been around since 2008. Clearly, savers are beginning to move from RRSPs to TFSAs.

Whether they're right to do so is beyond the scope of this article. It is, however, worth exploring *one* scenario where it is unambiguously better for *retirees* to invest in TFSAs rather than RRSPs. This scenario doesn't apply to *most* people. But if it does apply to you, then you're far better off with a TFSA than an RRSP. In this article I will explore this potential scenario and why you should always go for the TFSA if you find yourself in it.

TFSAs beat RRSPs when you have a lot of income coming in retirement

A big part of the RRSP's tax benefit comes from having a lower tax rate in retirement than when you're working. If your tax rate is going to be just as high in retirement as when you were working, it makes less sense to invest in an RRSP. RRSP withdrawals are taxed at your marginal tax rate. If your marginal tax rate is just as high in retirement as when working, that results in a higher tax.

Let's imagine that, at some point in the past, you bought $90,000 worth of **Fortis Inc** (TSX:FTS)(NYSE:FTS) stock, then sold it for $100,000. Let's also imagine that, when you bought it, you had a

33% tax rate, and will still have a 33% tax rate in retirement. In this scenario, if you withdraw your entire $10,000 gain, you pay less tax in a *taxable* account than in the RRSP!

That sounds incredible, but it's actually quite straightforward. The RRSP withdrawal is simply taxed at 33%, no questions asked. In a taxable account, you'd pay taxes on only half the capital gain. So your real tax rate would be 16.5%. The only tax benefit you'd get from the RRSP would be the initial tax deduction on contribution. You would actually pay more tax on the withdrawal itself.

Retirement doesn't always mean lower income

If all of the above seems farfetched to you, remember that it's quite possible to pay just as much tax in retirement as when working. The following are just a few things that can cause that to happen:

- Having a very generous pension.
- Having a large taxable investment portfolio that pays regular dividends.
- Owning a business that generates substantial annual profits whether you're actively working in it or not.

Any of the above situations could cause a person to pay over 30% a year in taxes in retirement. If you think you could find yourself in one of these situations, then the TFSA is probably better for you than the RRSP.

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Date
2025/09/12
Date Created

2021/03/31
Author
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