Retirement: Converting an RRSP to a TFSA

Converting an RRSP to a TFSA Before Retirement

By: Joe the Investor

Registered Retirement Savings Plans (RRSPs) have been around for some time, but the Tax Free Savings Account (TFSA) is relatively new. This means that retirement strategies are possible today that were not thought about 5 years ago. One of these strategies is to address the issue of “how do I access my RRSP when I retire without paying a huge tax bill?” There are solutions to this question which are conversion to a Registered Retirement Income Fund (RRIF), buying an annuity, or perhaps withdrawing the money earlier and over a longer period of time. The TFSA creates another strategy which may be useful for certain situations.

What is wrong with the current strategies?

The answer is nothing, but the limitations may not be suitable for some people. In the case of a RRIF, once you turn 71 years old, how much you withdraw is now prescribed to you and there are few options.(2) Once you reach 94 years old, you will have to withdraw 20% of your RRIF with the intention of removal of all of the funds in a short time. You can withdraw more than the prescribed amount, but you will be penalized with taxes. If you buy an annuity, you are bound by the rules of the annuity contract. Like any complicated contract, you will need guidance on the best terms and it is not assured that your interests will be looked after in retirement. Other solutions may be more convoluted, which usually means more cost and expertise to implement.

What is the new strategy?

Under the current RRSP rules, you contribute money and get a tax refund upon contribution. You will pay taxes later however upon withdrawal. The TFSA is the reverse. You don’t get the tax benefit upfront, but you will not pay taxes later upon withdrawal. The strategy is to slowly withdraw money from your RRSP, pay the taxes when you do this, and then shelter that money in a TFSA. The theory is that if you do this in your 50’s or 60’s, you will likely have another 20 or 30 more years to invest this money. If you can pay taxes upfront, and then let money grow within the TFSA, you can have an investment portfolio that is tax free and no surprises later on. If the power of compounding can work to grow your money in an RRSP, it can do the same thing in the TFSA. More money generated from investments would mean more taxes are usually paid. In the case of the TFSA however, this would not be the case. There is no tax bill at the end of the compounding period. The catch is that you paying the taxes upon the original withdrawal from the RRSP, but that would be more than made up for within the TFSA at a later time. This is assuming that the current tax rules stay the way they are. If they change and TFSA withdrawals are limited or taxed in some way, this strategy would not be useful. Rules for any registered account can change at any time, so this risk exists for RRIFs, RRSPs or any other registered account.

How do you actually implement this idea?

Each year, you can withdraw money from the RRSP. You will pay taxes upon the withdrawal. You then take this money and deposit it into the TFSA account and invest it in the same way. As an example, if someone is 55 years old, they are paid $50,000 per year in their job, and they have $300,000 accumulated in their RRSPs. They have about 15 years before the money they have has to be converted into a RRIF. Since the TFSA limit is only $25,500 per person, and is rising by about $5000 per year, we will use these as the maximum amounts that can be transferred. In this example, it is assumed that the $25,500 has already been used up, so only future transfers will be considered. If this person leaves the money in the RRSP and then transfers in into a RRIF, they will be forced to withdraw about 7% of the money each year in retirement. (1)(2) This percentage will increase each year, but we will use this as a conservative estimate. It will also be assumed that in retirement, the lowest tax bracket will be used – which likely means they are receiving CPP, OAS, RRIF income and maybe a small pension payment but not much more. Their income would be under $35,000 per year combined. This means their tax bracket is around 30% when they are working, and 20% in retirement. Their investment return throughout the life of the RRSP and TFSA will be assumed to be 5%.

Note that 7% of the RRSP account withdrawn would amount to $21,000 in income per year. Since the TFSA limit is currently $5000 per year, we will use $5000 per year as the amount of the transfer. The remainder of this RRIF withdrawal would add considerable income to the person in retirement, as a $300,000 RRSP would be close to $600,000 by age 71. The withdrawal rate of 7% of this amount would mean an additional $42,000 in extra income, resulting in a higher tax bracket. It is assumed that the total income after age 71 would be in excess of $70,000 with an assumed tax rate of 40%.

If this person leaves the money in the RRSP, and then withdraws the money as a RRIF, they will be taxed at 40% each and every year that they have the RRIF. For $5000 per year at 40%, they will be paying $2000 per year in taxes until death. If this person lives until 85 years old, which is around the average life expectancy, they will be paying $30,000 in taxes. If they withdraw $5000 from their RRSP before retirement, starting at age 55, they will be paying around $1500 in taxes each year that they do this, and then $2000 per year after age 71. This would total $1500x16 years plus $2000x15 years or $54,000 in taxes. However, the money in the TFSA is now tax free for the rest of their life. If they invest this money in the TFSA at $5000 per year, and earn 5% each year for 30 years (85 years old less 55 years old), they will earn in excess of $147,000 in extra money. The taxes saved on this extra money would be in excess of $52,000, which would almost nullify the extra taxes paid upfront for the RRSP withdrawals. This would be a net savings of about $28,000 in taxes over their lifetime assuming they live to at least 85 years old. The reinvestment return on the taxes paid upfront is also accounted for in this calculation.

What are the advantages?

If you have various sources of income, this strategy may allow you to tax shelter part of your income in retirement, thereby lowering your income thresholds. If you are receiving Old Age Security, this may allow you to increase what you are getting. If you are receiving a private pension or RRIF payments, this strategy may lower your overall tax bill by lowering your total income in any given year. The specifics of this timing would have to be addressed with your tax professional, as it will differ with every person and for each year in some cases.

Who can benefit from the strategy?

If you receive CPP and OAS only in retirement and a very large RRSP which would translate into a large RRIF income in retirement, this idea may be enough to lower your income and increase your OAS payments. If your income drops as you reach retirement, or you take early retirement, this strategy can be used in the years between your retirement age and age 65, or age 71 depending on which accounts you have.

What are the limitations?

Currently, you can only contribute $25,500 per person into a TFSA. However, if the government continues on increasing the limit each year, it will rise by at least $5000 per year, which in 10 years would be an additional $50,000 available. If you have a spouse, these amounts can be doubled. This is potentially $150,000 that can be subject to this strategy which will have a tax impact. If inflation picks up, these numbers may be higher as the government seems keen or keeping these limits in line with inflation. The extra $500 added for 2012 is consistent with this argument. You can also continue with this methodology into retirement. If you don't need the income, you can defer it indefinitely until you do need it, and lower your taxes gradually each year as future income from investments will be increasingly more tax sheltered.

The money in your RRSP is assumed to be for retirement, meaning it is money that you do not need except for retirement purposes. If you withdraw from your RRSP, transfer to a TFSA and then spend it because it is easy to do, this strategy will not be of benefit. You can use the TFSA as an emergency account as well, which is good, but you will have to choose what your intention is to get the most benefit from what you want to accomplish. Leaving money in the TFSA account over a long period of time will overcome the taxes you have to pay upfront and will avoid future taxes. The conventional wisdom says you should defer taxes as long as possible, but you will always have to pay taxes somewhere, so the ideal scenario would be to weigh the options and optimize what is best for you given your lifestyle, income needs and preferences. If the wisdom of paying taxes later is always true, there would not be an issue of paying large taxes on RRSP withdrawals, or large estate taxes upon transition to the next generation.

From an investment standpoint, a TFSA can hold most of the same investments than an RRSP can hold, so nothing is lost from an investment point of view. Whatever was sold in the RRSP, can be repurchased in the TFSA. The difference here is strictly for the timing of paying taxes. The TFSA can be used in conjunction with the RRSP and RRIF account to save taxes if it is implemented in the right situation and at the right time. As can be seen in this article, there are many assumptions to examine and the best way to do this calculation would be to do several scenarios to see which one fits you the closest. Even if you do this, things can change, so the calculation should be revisited whenever an assumption changes: tax rates, investment returns, income earned or RRSP amounts to name a few.

Sources:

1) http://www.getsmarteraboutmoney.ca/en/managing-your-money/investing/rrifs-and-annuities/Pages/Making-withdrawals-from-your-RRIF.aspx#.Ud8Hi6wUXYc
2) http://cef.lccabc.ca/wp-content/uploads/2010/07/Registered-Retirement-Income-Fund-Withdrawal-Rules1.pdf

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