The Navigator

RRSP Loans

Who benefits the most from them?

Determining whether an RRSP loan is right for you requires a look at several variables. You may have to look beyond the interest costs and the potential rate of return on the investments you choose. It is important to note that interest payments on RRSP loans are not deductible on your tax return. Since you will not generate an "immediate" taxable income and therefore revenue for Canada Revenue Agency (CRA), there is no incentive for the government to give you a tax break beyond the RRSP deduction. Therefore, a deduction on loan interest is not allowed. Also, given the fact that your RRSP contribution room can be carried forward indefinitely, you may question if it makes sense to borrow funds to contribute to an RRSP now, or are you better off waiting until you have the available funds in a future year. Let's take a look at some variables you should consider when deciding if an RRSP loan is beneficial for you.

Key variables to consider for your ultimate decision

The following key variables must be considered in order to determine if borrowing to invest in your RRSP makes sense for you:

a) Your cost of financing the RRSP loan versus the potential return in your RRSP

b) Your applicable tax rates (during the year of contribution and the year in which funds are withdrawn from the RRSP)

c) Your repayment timeline and the tax-deferred growth during the life of the outstanding loan

d) Qualitative factors

e) Risk Factors

(A) Cost vs. benefit

Assuming that your applicable tax rates remain the same (before and after retirement) and your after-tax return on the RRSP is the same as the (non-deductible) interest expenses of the RRSP loan, you should be indifferent as to whether you borrow or not. Basically, if the after-tax rate of return (ROR) on your RRSP is equal to the cost of financing the loan, then in theory you should be neutral in regards to this borrowing strategy. If your after-tax rate of return on your RRSP is greater than your loan rate, then you probably should borrow to invest since you will be ahead. However, if your after-tax rate of return on your RRSP is less than your loan rate, then, in theory, an RRSP loan does not make sense for you.

Keep in mind that you will not know what the after-tax rate of return on your RRSP is until you have already made the decision to borrow; therefore, there's an element of risk involved.

RBC Wealth Management

Basically, if the after-tax rate of return (ROR) on your RRSP is equal to the cost of financing the loan, then in theory you should be neutral in regards to this borrowing strategy.

Example

Sylvie has $300 per month to dedicate to her RRSP. Based on her investor profile she estimates her ROR will be 6%. She can borrow funds at a 4% interest rate, and her marginal tax rate is 40%.

If Sylvie invests the $300 in after-tax dollars per month in her RRSP, at the end of three years, her RRSP will be approximately $19,926. This assumes she also invests the tax savings back into her RRSP. Sylvie does not have to wait for a tax refund as she has requested her employer to reduce her withholding taxes at source by filing Form T1213 - Request to Reduce Tax Deductions at Source with the CRA. If Sylvie does not reinvest the tax savings into her RRSP and instead spends the savings, her RRSP will be worth only $11,827 after 3 years.

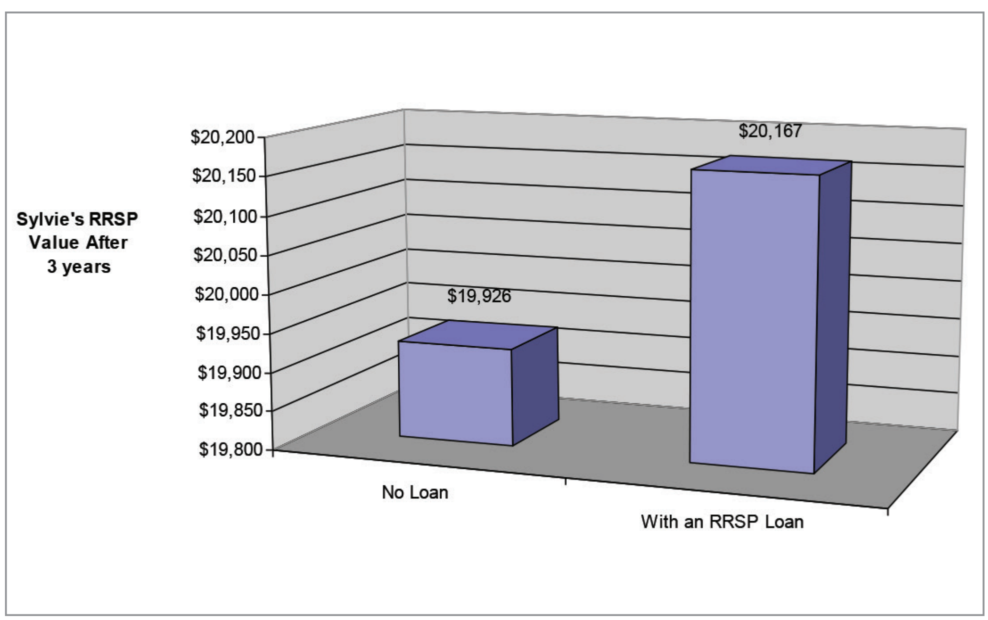
However, Sylvie's advisor shows her a better way of spending the same $300 a month. Based on her advisor's plan, Sylvie borrows $16,933 and makes an RRSP contribution. This provides her with a $6,797 tax refund, which she uses towards paying off her loan. Her remaining loan balance is $10,160*, which at $300 payments per month will be paid off in three years, when her RRSP will be worth $20,167. The $300 monthly payment essentially acts as a method of forced savings.

For Sylvie, using an RRSP loan is beneficial. At the end of three years, her RRSP will be worth $241 more by using an RRSP loan than making the same monthly payments directly into her RRSP. And by the time she retires in another 20 years, this $241 difference will grow into $798 in her RRSP — all this without changing her out-of-pocket cash outlay.

(B) Income tax rates

In general, most working people expect their marginal income tax rate to be lower during their retirement years than during their working years. This,

With and Without RRSP Loan



* Time required to receive the refund has not been factored into the calculation. Assumes the refund is received immediately and used towards paying off the loan.

Clearly, the higher your current marginal tax rate and the lower your future marginal income tax rate (at the time of the anticipated withdrawals), the more it makes sense to invest in an RRSP and the more appropriate an RRSP loan may be.

along with the up-front tax deduction and the tax-deferred growth an RRSP offers, is a key benefit of an RRSP since you may expect that the rate at which you will be taxed on the withdrawal will be lower than the rate at which you received your tax deduction.

Clearly, the higher your current marginal tax rate and the lower your future marginal income tax rate (at the time of the anticipated withdrawals), the more it makes sense to invest in an RRSP and the more appropriate an RRSP loan may be.

If, however, you are currently in a low marginal tax bracket, or expect to be in a higher marginal tax bracket when you withdraw the RRSP funds, then an RRSP and an RRSP loan may not be for you.

(C) Rapid repayment of loan and tax-deferred growth

If you can repay your RRSP loan within a short period of time, should you simply save up the cash for your contribution, even if it means receiving the deduction for the next year? Or, is it still beneficial to use the RRSP loan to get the deduction this year? Worded another way, is it beneficial for you to incur some financing costs in order to get the benefit of the tax deduction this year versus next year? If you do take a loan and make the contribution this year, you will have an additional year of tax-deferred growth in your RRSP. In order to make the decision, you should look at the following factors:

a) Interest rate on the RRSP loan

b) Term or duration of the loan

c) Years before retirement

d) Rate of return within the RRSP

e) Marginal tax rates now and at retirement

Generally, if you can pay off the loan rapidly, there seems to be an advantage because you are getting an immediate tax deferral compared to a relatively low financing cost.

(D) Qualitative factors

In any investment decision, there is always a subjective element that must be considered before a final decision can be made.

If you have a difficult time saving to contribute to your RRSP, borrowing may be a solution for you to ensure you make your contributions. You may feel relieved that you did. However, this method of forced savings is costly due to the non-deductible nature of the financing charges.

Having a loan, even if it is for a short period, will affect your cash flow. You should ensure that you can pay off your loan without creating a situation where your cash flow is affected to the point of causing you other financial issues.

(E) Risk Factors

Note, using money borrowed to purchase investments involves greater risk than a purchase using your own money. You will have a continuing obligation to repay principal and interest even if the value of the investment goes down; and a leveraging strategy could result in far greater losses than an investment strategy that does not involve leverage.

Conclusion

The decision to take out an RRSP loan is definitely not simple. Your decision consists of numerous quantitative and qualitative factors. It appears that the strongest argument for taking out an RRSP loan is that it is a good saving mechanism, even though there's a cost involved. If you can manage to pay off your RRSP loan in a short period of time and you will not be retiring in the near future, the RRSP loan may be a good solution for you. Prior to borrowing to invest in an RRSP, we recommend that you consult your own professional tax and/or legal advisors to evaluate the appropriateness of this strategy.

Please contact us for more information about the topics discussed in this article.

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