



RRSP/RRIF Meltdown Strategy

Always use caution when deregistering assets

The RRSP/RRIF meltdown strategy involves paying the interest accrued on a non-registered investment loan with deregistered funds from a registered plan. There are many aggressive promoters in Canada touting this concept as a tax-free way to withdraw funds from an RRSP. In fact, all they are really accomplishing is offsetting the income inclusion of their RRSP/RRIF withdrawal with an interest expense deduction.

How the Minimum Payment RRIF-Based Strategy Works

This strategy can be broken down into three parts as illustrated by this example:

1. A \$50,000 investment loan is taken out at an interest rate of 6%, which means the borrower must make a payment of \$3,000 per year in order to pay the loan interest.
2. The proceeds from the loan are directly invested into a non-registered portfolio.
3. \$3,000 per year is then withdrawn from a RRIF to pay for the interest cost.

The main idea behind the RRIF-based strategy is to offset the \$3,000 RRIF income inclusion with a \$3,000 interest-cost tax deduction. In theory the registered funds are replaced with the non-registered funds tax-free, but it is not that simple. There are several complicated factors that you should weigh before you consider implementing this strategy.

Factors to Consider

Tax-Deductibility of Interest Cost

This strategy relies upon the tax-deductibility of the interest cost of an investment loan. The interest cost of an investment loan is currently tax-deductible if the proceeds are used directly to fund an investment that has a reasonable expectation of earning income. Current Canadian tax law includes interest, dividends and rental income, but not capital gains, as "income" for interest-deductibility purposes. The federal government is currently reviewing these interest-deductibility rules.

Principal Repayments

Most investment loans require a monthly repayment that is a combination of interest and principal. Keep in mind that the principal repayments on the loan need to be funded from your resources as well. If you do not already have non-registered funds that can be drawn on to make the principal repayments, the funds will have to come from your registered assets. The registered assets will be withdrawn and taxed as income without any offsetting tax deduction.

Keep in mind, if you get an interest-only loan, you will simply pay your borrowing costs with registered assets. If the payments go on long enough, you may exhaust your registered assets and still have an investment loan outstanding.

RRSP/RRIF Withholding Tax Issue

RRIF withdrawals that do not exceed the minimum payment for the year can be withdrawn from your RRIF without any withholding tax applied. The meltdown strategy does not take into consideration the withholding tax on RRSP withdrawals or the tax on RRIF withdrawals in excess of the minimum limit. If any funds from an RRSP or funds from a RRIF over the minimum withdrawal are needed to pay the investment-loan cost, withholding tax will apply.

Investment Loan First, Withdrawal Strategy Second

There is also the inherent risk of borrowing to invest that you must consider. Using assets for this strategy that were intended to create a retirement income for yourself may imperil your ability to meet your expenses during retirement.

With any investment-loan strategy, you must be cautious and aware of the possible risk if the assumptions originally used change (e.g. the borrowing rate fluctuates, investment values decline, etc.).

Generally, if you are either approaching retirement age or are already in retirement, you will tend to have a lower risk tolerance, shorter investment time horizon and possibly less potential surplus cash flow. You may not necessarily be a good candidate for a regular investment-loan strategy, and therefore, will definitely not be a good candidate for withdrawing funds from a RRIF to offset the interest cost of an investment loan.

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