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FINANCIAL ADVISORY SUPPORT

RRSP/RRIF Meltdown Strategy

Always use caution when deregistering assets

This article describes how the RRSP/RRIF meltdown strategy works and highlights some potential risks to consider if you're thinking about implementing this type of tax-saving strategy.

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.

While this strategy often results in no tax on the withdrawal, there are some risks you should know about before implementing it. Since this strategy relies on the interest deductibility rules, which are currently under review by the Department of Finance, it is most appropriate for those with a high risk tolerance and the ability and desire to implement a loan for investment purposes.

What is an RRSP/RRIF meltdown?

Some people promote the use of a tax-saving strategy called "the RRSP/RRIF meltdown." The strategy is to replace registered assets with non-registered assets using an investment loan, then pay the interest on the loan with the deregistered assets from the RRSP/RRIF. The goal is to offset the income tax liability of your RRSP/RRIF withdrawals with a tax deduction from the interest portion of your investment loan.

Additionally, you may be able to benefit from the $2,000 pension tax credit if you are 65 or over and the funds are withdrawn periodically from a RRIF. You can also use the meltdown strategy with an RRSP, but with an added level of complexity because of withholding tax (discussed later in this article).

The minimum payment RRIF-based strategy, which does not have withholding tax issues, will be the main emphasis in this article.

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 $3,000 per year is then withdrawn from a RRIF to pay for the interest cost.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.

There is controversy over the fact that a capital-growth asset can currently be purchased with borrowed funds and the interest can be deducted from other income as long as there is a reasonable expectation that income will be produced at some time in the future. The federal government is currently reviewing these interest-deductibility rules. One proposal being examined recommends that there must be a reasonable expectation of profit over the projected investment time horizon in order to deduct the interest cost of an investment loan. The term "profit" would not, in this case, include capital gains. Another possibility being examined is that the interest cost may be deductible only up to the income level generated by the leveraged investments.

These possible changes to the interest-deductibility rules could increase your risk and influence the asset allocation of an investment-loan portfolio. If using this strategy, you may have to put a greater emphasis on income-bearing investments rather than deferred-gain or equity-based investments, which could have repercussions in two important ways:

- With these changes, income-bearing and fixed-income investments, such as those that have the potential to generate dividends and interest, would be emphasized. These investments create an annual tax liability; whereas deferred-gain and equity-based investments do not. This would result in greater annual tax liability and a reduced compounding effect.

- Traditionally equity-based investments in general have higher long-term rates of return than fixed-income investments; therefore, the portfolio may have an overall lower rate of return.

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.

RRIF versus non-registered portfolio

Another benefit of the RRIF meltdown is that it results in a large non-registered account where Canadian dividends and capital gains can receive favourable tax treatment in contrast to the fully taxable RRIF withdrawal. Although the income in the non-registered account earns tax-preferred investment income, you don’t have the tax-deferral opportunity of the investment income that you get within a RRIF.

Both registered and non-registered portfolios have their advantages and disadvantages depending on your situation. All factors and assumptions, such as interest rates, tax rates and time frame (to name a few) have to be considered.

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.

The rates are outlined in Table 1 below. The amount that is withdrawn needs to be greater than the funds needed to pay the interest cost. This additional taxable amount creates a tax liability that the interest cost will not be able to offset. This means that taxable funds will be withdrawn, and they will not have an offsetting tax deduction.

Table 1 — Withholding tax rates applied to withdrawals from an RRSP or RRIF withdrawals in excess of the minimum

Amount withdrawn	All provinces except Quebec	Province of Quebec
$5,000 or less	10%	21%
$5,001 – $15,000	20%	26%
Over $15,000	30%	31%

Example of the withholding tax issue

Using the information from the earlier example of the $50,000 investment loan with an interest cost of $3,000 per year and taking into consideration RRSP withholding tax, this example illustrates another reason why the RRSP/RRIF meltdown strategy may not be suitable.

For withdrawals from an RRSP, there is generally a 10% withholding tax for amounts less than $5,000. Therefore in order to withdraw the required $3,000 per year, $3,333.33 gross needs to be withdrawn from an RRSP as illustrated below. The additional $333.33 withdrawn from the RRSP will be fully taxable and will not have an accompanying interest-cost deduction.

Alternatively, if only $3,000 is withdrawn from the RRSP, $2,700 net will be received in hand and an additional $300 will have to come out of current cash flow. The $300 from current cash flow, to make up the difference, will increase the cost of this strategy since the additional $300 is after tax.

Gross withdrawal from RRSP	Withholding tax (10%)	Net withdrawal from RRSP
$3,000	$300	$2,700
$3,333.33	$333.33	$3,000

If additional funds do not come from the RRSP/RRIF, you will need to reduce your current cash flow to pay for the interest cost. Promoters of this strategy typically do not mention withholding taxes and the ensuing consequences to either current cash flow or increased tax liability.

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. A closer look at the RRIF meltdown strategy reveals that the prudent investor should first consider whether an investment loan is suitable, independent of the taxability of the RRSP/RRIF withdrawal, before embarking on this strategy.

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.).

As well, this leverage strategy is usually implemented once a sizeable amount of funds has accumulated in a RRIF, which is usually close to or at retirement, when you will need the income. The timing of the strategy is a reason why you really need to be cautious. The common, conservative time horizon for a leverage strategy is at least a 10-year period. If you are close to retirement or have already retired, you may not have the time frame you need to commit to this strategy.

The key factors that you should consider when determining if borrowing for investment purposes is for you are:

- Risk tolerance
- Time horizon
- Surplus cash flow
- Deductibility of interest

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.

Having said this, you may find a leverage strategy appealing if you have considered and are willing and able to accept the associated risks. Furthermore, if the original assumptions come to fruition, you could end up with a higher net worth than you would have had, had you not used leveraging.

Conclusion

Because of the issues associated with borrowing to invest, the RRSP/RRIF meltdown strategy is not necessarily well suited to everyone that may hear about it. The risk factor and time frame needed may disqualify many people that have enough funds within their RRIF in order to make this strategy beneficial. It is necessary for you to thoroughly weigh both the advantages and disadvantages of any investment-loan strategy and to discuss the strategy with your qualified tax advisor before proceeding.