January 28, 2010

FINANCIAL ADVISORY SUPPORT

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b) Your applicable tax rates (during the year of contribution and the year in which the funds are withdrawn)

c) Your repayment timeline and the tax-deferred growth

d) Qualitative 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 may not know with certainty 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.

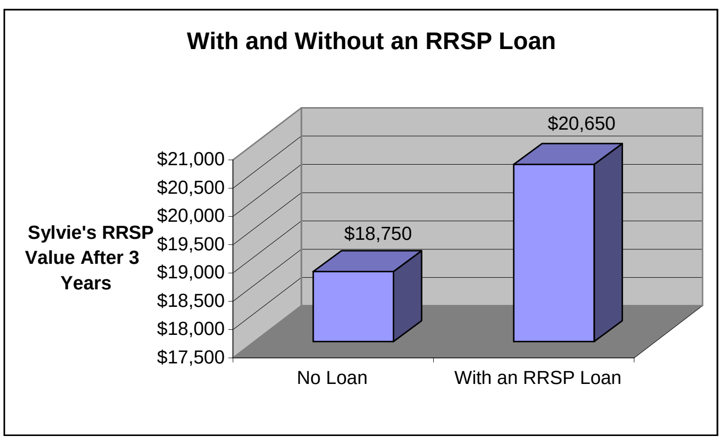
Example

Sylvie has $300 per month to dedicate to her RRSP. Based on her profile she estimates her ROR will be 8%. She can borrow funds at a 6% interest rate, and her marginal tax rate is 40%.

If Sylvie simply invests the $300 per month in her RRSP, at the end of three years, her RRSP will be approximately $18,750.

However, Sylvie's advisor shows her a better way of spending the same $300 a month. Based on her advisor's plan, Sylvie borrows $16,416 and makes an RRSP contribution, which provides her with a $6,566 tax refund, which she uses towards paying off her loan. She is left with a $9,850 loan*, which at $300 per month will be paid off in three years, and her RRSP will be worth $20,650.

For Sylvie, using an RRSP loan is a great idea. At the end of three years, her RRSP will be worth $1,900 more by using an RRSP loan than simply making the same monthly payments directly into her RRSP. And by the time she retires in another 20 years, this $1,900 difference will grow into an additional $8,850 in her RRSP — all this without changing her out-of-pocket cash outlay.



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

(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, 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, then should you simply save up the cash for your contribution, even if it means receiving the deduction for the next year and avoid the financing cost? 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 vs. 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 is 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 want to ensure you can pay off your loan without creating a situation where your cash flow is affected to the point that it is causing you other financial issues.

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.