Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Holding your home mortgage in a registered retirement savings plan

Investing in a mortgage on your home within your registered retirement savings plan (RRSP) generally allows you to make interest payments to yourself, instead of to a financial institution. However, there are certain conditions, steps and costs associated with putting such an arrangement in place. This article provides an overview of how it works and shares some insights for your consideration.

What can be held in the RRSP

The Income Tax Act (the Act) contains rules that specify the kinds of property (qualified investments) that can be held in an RRSP or a registered retirement income fund (RRIF). Specifically, a debt obligation secured by a mortgage on real or immoveable property located in Canada is a qualified investment. Further, the Act requires that the mortgage be administered by an approved lender under the National Housing Act and be insured by the Canada Mortgage and Housing Corporation (CMHC) or by an approved private insurer of mortgages. The interest rate and other terms of the mortgage must reflect normal commercial practice and the mortgage must be administered in the same manner as a mortgage on property owned by an arm's length person. For example, this means that even though you're paying yourself (your RRSP), you can't pay less than the market interest rate and can't miss a payment. If you default on the mortgage, the RRSP trustee is obligated to collect and even foreclose on you. If the RRSP trustee does not take action that reflects normal commercial practice, adverse tax consequences may apply.

There's no income tax requirement that a mortgage in your RRSP be a first mortgage or a residential mortgage.

How the strategy works

When buying a fixed income investment in your RRSP, like a bond or a GIC, you are using the cash in the RRSP to buy the bond or GIC. Cash comes out of the RRSP and an investment replaces it.

Putting your mortgage in an RRSP is similar, except there are more fees and administration involved. The approved lender may take care of most of the administration. Your cash comes out of your RRSP and is replaced with the mortgage, making you the mortgage investor and the borrower. You now pay your normal principal and interest mortgage payments to your RRSP instead of to a financial institution so that you're benefiting from these payments.

RRSP contributions versus mortgage payments

Mortgage payments to your RRSP aren't a contribution to your RRSP. The payments are simply a repayment of the mortgage principal and the return on the RRSP's mortgage investment, much like any bond pays interest into your RRSP and a repayment of the principal amount.

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Does it make sense for you?

When you consider holding your mortgage in your RRSP, the question you should ask is: Is it better to hold my mortgage in my RRSP or to hold another type of investment? In answering this question, the best option should give you the largest after-tax pool of wealth at the end of the day, considering both your registered and non-registered assets.

The answer depends on which investment will give you the greatest returns. If the mortgage interest rate (less associated fees) is greater than the investment return you can attain in your RRSP using other investments with similar risk, then you should consider holding your mortgage in your RRSP. If the mortgage interest rate (less associated fees) is less than the investment return you can attain in your RRSP using other investments with similar risk, then you should consider holding your mortgage outside your RRSP. Also keep in mind that the analysis is more complicated and you need to consider the other factors discussed in the following sections.

Size matters

Even though the thought of paying yourself is appealing, it may not make sense for most people. In the beginning, your RRSP may not be large enough to hold your mortgage. By the time your RRSP is large enough to hold your mortgage, your outstanding mortgage may be too small to justify the fees to set it up in your RRSP. Although it is possible to set up a small mortgage in your RRSP and a larger conventional one outside your RRSP, you will be charged additional fees to set up two different mortgages, making this option likely too expensive.

Asset allocation

Holding a mortgage in an RRSP is meant to only replace the fixed income component of the RRSP, as both have similar characteristics and risks. Having an over-allocation in one type of investment is not usually a good thing. If your mortgage is a significant portion of your RRSP and you are not diversified, you may increase the risks you're exposed to.

Time horizon

You may be enticed to hold your mortgage in your RRSP because of the higher return versus conventional fixed income investments. Remember that the mortgage can have a 20- to 30-year investment horizon and interest rates will change in that time. Although it seems like a good idea to pay yourself more now, returns on other investments may be higher in say, five years' time. You can't simply sell your mortgage to invest in a better opportunity later on, like you would be able to with securities, as the unpaid balance would need to be repaid to the RRSP, along with additional fees to break a mortgage early and discharge it.

If you still have a mortgage inside your RRSP when you turn age 71, you can continue to hold the mortgage as an investment in your RRIF. You will need to ensure your RRIF has sufficient cash or assets to be able to make the required minimum payments each year.

Use of funds

If your home is already mortgage-free, you may want to set up a new mortgage and use the proceeds outside of your RRSP to invest. The mortgage proceeds may be used for any purpose approved by the lending financial institution. If you invest in a business or invest in non-registered investments, the interest portion of your mortgage payments may be deductible for tax purposes.

Although this may add to the potential benefit of this strategy, this is a leverage strategy, which also has a high degree of risk associated with it. Borrowing to finance a business or to purchase securities adds an additional level of risk compared to using cash resources only. If you borrow money to invest in a business or purchase securities, your responsibility to repay the loan and to pay interest as required by the loan terms remains the same even if the income from, or the value of, the business or securities declines.

Mortgage rates versus RRSP returns

It's important to remember that you are making mortgage payments with after-tax funds. As noted previously, you don't get an RRSP deduction for the mortgage payments made to your RRSP. Therefore, when you borrow from a financial institution, you'll want to pay the lowest interest rate and repay the mortgage in the shortest time possible to minimize the after-tax dollars you spend. But if you're holding your mortgage in your RRSP, you generally want to pay the highest interest rate possible for the longest term possible to maximize the RRSP's return. Although you may end up having more money in your RRSP by making higher mortgage payments for longer, remember that it's all taxable when it's withdrawn as RRIF payments later on. You may be better off having your mortgage outside of your RRSP, at lower interest rates and for a shorter period of time, and contributing the savings in a TFSA. The growth inside your TFSA is tax-free as are the withdrawals.

Financial institution may not offer this investment option

While a mortgage in an RRSP is possible under tax legislation, keep in mind that doesn't mean the financial institution where you hold your RRSP offers this as an investment choice. Generally, financial institutions only allow mortgages as permitted investments in a self-directed RRSP. That said, they have the right to limit what investments they will accept in RRSPs they administer. Therefore, you will need to check whether your financial institution offers a mortgage on your property as an investment choice.

A word about fees

As with a conventional mortgage, you will have to qualify for the mortgage following the approved lender's usual credit application process. This may include providing information to satisfy their income verification and cash flow requirements, credit bureau checks, conducting an appraisal on the property, and fulfilling requests for any other information they may require for mortgage approval

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purposes. Associated with this process, you may incur certain costs, such as:

- Appraisal fees
- Application/set-up fees
- Mortgage administrative charges
- Legal fees
- Mortgage loan insurance

The total cost of all fees may be much higher than fees charged on other types of investments, and should be considered when deciding whether holding your home mortgage in your RRSP is the best investment alternative for you.

Conclusion

It's recommended that you consider all of these factors and speak with your RBC advisor and a qualified tax advisor to determine whether there may be a benefit in holding your mortgage within your RRSP or if an alternative investment may be better.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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