

# The Navigator



Wealth  
Management

RBC Wealth Management Services

## The RRSP/RRIF meltdown strategy

Deregistering your RRSP or RRIF tax-efficiently

The RRSP/RRIF meltdown strategy may be a tax-efficient way to replace some of your excess registered assets with non-registered assets using an investment loan. This article describes the meltdown strategy and highlights some of the potential issues you should consider before incorporating this borrowing to invest strategy into your overall financial plan.

*It is important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines. The information in this article is not intended to provide legal or tax 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 advisor before acting on any of the information in this article.*

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

### The strategy

Every dollar that is withdrawn from your registered plan is fully taxable at your marginal rate in the year you make the withdrawal. In addition, upon your death, assuming you don't have a spouse or common-law partner, the full fair market value of the assets in your RRSP or RRIF must be included in your income and is commonly taxed at the highest marginal tax rate.

The meltdown strategy is based on the theory that it is more tax-efficient to make withdrawals from your RRSP or RRIF earlier in life, when your tax rate may be lower than the rate

you expect in the year of your death. The strategy involves obtaining an investment loan and paying the interest accrued on the loan with the deregistered funds from your registered plan. The withdrawals from your registered plan should equal the interest payment on your investment loan. What you are accomplishing is offsetting the income inclusion of your RRSP or RRIF withdrawal with an interest expense deduction resulting from your investment loan. You can then use the investment loan along with the deregistered funds to create a tax-efficient portfolio and benefit from the preferential tax rates of capital gains and dividends outside of your registered accounts.

With more assets outside your registered accounts, you may have a smaller tax liability over your lifetime.

### An example using a RRIF

The most tax-efficient way to implement the meltdown strategy is using a RRIF. This is because no tax is withheld when the minimum amount is withdrawn from a RRIF. It is only when withdrawals in excess of the minimum amount are made, that withholding tax applies. The best way to explain how the meltdown strategy works is with a simple illustration. Let's assume the minimum payment is withdrawn and no withholding tax applies.

Suppose you borrow \$50,000 at a 4% interest rate and directly invest the borrowed money in a non-registered portfolio of income-producing assets. This means that you would have to pay \$2,000 in interest per year. Since the borrowed money is used for the purposes of earning income, the interest on the investment loan should be deductible. In order to pay the \$2,000 of interest, you would withdraw \$2,000 from your RRIF. By borrowing to invest, you are able to offset the \$2,000 RRIF income inclusion with a \$2,000 interest deduction.

In theory, your \$2,000 of registered funds are replaced with the non-registered funds on a tax-free basis. The funds outside of your RRIF may be invested to generate capital gains and dividends which are generally more tax-efficient. With more assets outside your registered accounts, you may have a smaller tax liability over your lifetime. In addition, an added benefit of withdrawing funds from a RRIF is that you may be able to benefit from the \$2,000 pension tax credit if you are age 65 or over at any point during the year of withdrawal.

### Withholding tax

An added complexity to the meltdown strategy occurs when withholding tax is required. RRIF withdrawals in excess of the minimum or any RRSP withdrawals are subject to withholding taxes. The rate of withholding tax varies based on both the amount of your withdrawal and your province of residence. The following table shows the percentage of withholding tax that is currently required when you make a single lump sum withdrawal.

Amount Withdrawn	Withholding Tax (All provinces except Quebec)	Withholding Tax (Province of Quebec*)
\$5,000 or less	10%	21%
\$5,001 – \$15,000	20%	26%
Over \$15,000	30%	31%

\* For Quebec the withholding tax includes a provincial tax of 16% for all withdrawal amounts in addition to a federal tax that varies to equal the totals shown.



A major benefit of the meltdown strategy is that it allows you to create an overall tax-efficient portfolio and benefit from the preferential tax rates of certain investments outside of your registered accounts.

If you are withdrawing funds from your registered account where taxes are withheld, consider withdrawing an amount greater than the interest amount owing on your investment loan. Since the interest deduction will not be able to fully offset the additional amount you withdrew, you will owe tax on the difference. Let's look at an example of how to implement the meltdown strategy using funds from a RRSP.

#### An example using a RRSP

Using the information from our earlier example, let's again assume you borrowed \$50,000 at a 4% interest rate and directly invested the borrowed money in a non-registered portfolio of income-producing assets. The interest liability would be \$2,000 per year. This time, in order to pay the \$2,000 of interest, you want to withdraw from your RRSP. For withdrawals from an RRSP, there is generally a 10% withholding tax on amounts less than \$5,000. Therefore, to cover the required interest expense of \$2,000, you will need to withdraw a gross amount of \$2,222.22 from your RRSP. The additional amount of \$222.22 withdrawn will be fully taxable and will not have a corresponding interest deduction.

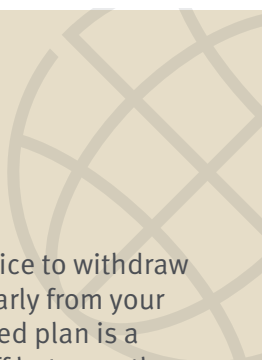
Alternatively, if you withdraw only \$2,000 from your RRSP, you will receive a net amount of \$1,800. You will need to come up with an additional \$200 in order to pay the \$2,000 interest liability. If the additional funds do not come from your RRSP or RRIF, you will need to reduce your current cash flow in

order to fund the difference. This will increase the tax cost of this meltdown strategy since you will be using after tax dollars.

Given the consequences of either an increased tax liability or reducing your current cash flow to fund the difference, the meltdown strategy may not be suitable for you if you are withdrawing from your RRSP or withdrawing more than the RRIF minimum amount due to the tax withheld.

#### Your investment mix

Both registered and non-registered accounts have their advantages and disadvantages, depending on your particular situation. However, a major benefit of the meltdown strategy is that it allows you to create an overall tax-efficient portfolio and benefit from the preferential tax rates of certain investments outside of your registered accounts. For example, capital gains and Canadian dividends are taxed at more favourable rates than interest and foreign income. As such, from a tax perspective, it might make sense to focus on holding equity investments outside your registered accounts to benefit from the preferred tax treatment of capital gains and dividends. On the other hand, since interest and foreign income (including dividends from foreign corporations) are fully taxable at your marginal tax rate, you may want to continue holding these types of fixed income investments inside your registered plan to defer tax on the interest income.



The choice to withdraw funds early from your registered plan is a trade-off between the benefit of lower tax rates when the funds are withdrawn and the benefit of the years of tax-free growth within the registered plan.

While evaluating investments based on after-tax return is important, you should also consider other factors such as the investment's risk, diversification, the opportunity for capital appreciation and liquidity.

### **Is this strategy right for you?**

#### **What is your trade-off?**

The choice to withdraw funds early from your registered plan is a trade-off between the benefit of lower tax rates when the funds are withdrawn and the benefit of the years of tax-free growth within the registered plan. If your marginal tax rate today is not significantly less than it will be at death, this strategy may not make sense for you.

#### **What is your time horizon?**

On one hand, this strategy requires a time commitment of approximately 10 years. A long investment time horizon increases the probability that your investments will appreciate in value such that your total investment assets will exceed your loan plus interest costs. It also creates a potential of lower volatility on investment returns.

On the other hand, this strategy becomes less efficient the longer you live after taking out the early withdrawals. This is because you are giving up the tax deferral that comes from leaving the assets in your registered plan. If you suspect you have a long-term deferral time horizon (of 20 years or more), it will generally be more advantageous for you to leave the funds in your registered plan.

### **Do you have surplus cash flow?**

Most investment loans require a monthly repayment that is a combination of interest and principal. The withdrawal from your registered accounts should cover the interest payment on the loan, but you should ensure you have adequate surplus cash flow to make the principal repayments on your debt as well. If you do not have sufficient non-registered funds that can be used to make the principal repayments, you might need to use more registered funds. These registered funds will be taxed as income when withdrawn without any offsetting tax deduction.

Your source of cash flow should also be sufficient to absorb the effects of a market downturn. A market downturn could result in a potential increase in your borrowing costs as well as a decrease in the value of your investments. If borrowing costs increase, you should have enough cash flow to cover any loan interest payment increases. If the value of the investments within your RRSP decreases, your yearly withdrawals will not last as long as you intended them to. In addition, the investments you purchased with borrowed money will also have decreased in value, resulting in significant unrealized losses. In this situation, it is prudent to have enough cash flow to cover any potential demands for repayment. Lastly, if you decide to sell your investments at a loss, you will need to come up with extra cash to pay off the difference between the outstanding loan balance and your investment proceeds.

If you want to deduct your interest expense, the borrowed money must be used for the purpose of earning income from a business or property.

### What is your investment risk tolerance?

Your investment risk tolerance is a measure of how comfortable you are with taking risk in the hopes of earning greater returns on your investments. Most investments have some degree of risk associated with them, and borrowing to invest adds an additional level of risk to your investing. Borrowing to invest will magnify your returns when your investments are appreciating in value. This is due to the larger pool of investment capital that can benefit from investment growth. However, the downside is that if your investments start to decrease in value, your losses will be magnified as well. Diversification of the assets you purchase with your investment loan can help reduce the volatility of the investments.

### How will your retirement be affected?

This strategy involves replacing registered assets that you had intended on using during retirement with non-registered assets. You will need to consider whether this strategy may jeopardize your ability to cover your expenses during retirement. Also, once you withdraw funds from your registered accounts, you are not able to recontribute the money back to your RRSP. That contribution room is lost forever.

Lastly, keep in mind that taking money out of your registered plan early can trigger the claw-back of Old Age Security benefits as your income rises.

### How can you keep your interest tax-deductible?

One major attraction of this borrowing to invest strategy is the ability to deduct your interest expense for tax purposes. This deductibility allows you to increase your after-tax rate of return on your investment. In order to keep your interest deductible, here are some important points you should bear in mind:

#### What can you invest in?

If you want to deduct your interest expense, the borrowed money must be used for the purpose of earning income from a business or property. Business income includes any activity you carry on for profit or with a reasonable expectation of profit. Property income includes interest income, dividends, rents, and royalties.

If you borrow money to purchase common shares, the interest expense will generally be deductible if there is a reasonable expectation, at the time the shares were acquired, that you will receive dividends. Recent court cases have proved the importance of being able to clearly demonstrate an income-earning purpose even on an ordinary acquisition of common shares.

The courts also seem to pay particular interest to the company's history of paying dividends. There have been cases in which, considering all the circumstances, interest deductibility was denied because there had been no history of paying dividends on the company's shares. All the more so, if a company expressly declares its intentions not to pay any dividends,



The amount of income earned does not affect the amount of interest you can deduct.

or the class of shares does not allow for dividends to be paid, then the interest incurred on borrowed money would not be deductible.

If your investment generates a return of capital (ROC), the ROC must be reinvested to ensure all of the interest continues to be tax-deductible. Otherwise, a pro-rated interest expense calculation is required to determine the amount that may be deductible.

#### **What if the interest expense exceeds the investment income earned?**

The amount of income earned (or expected to be earned) does not affect the amount of interest you can deduct. For example, if you borrowed money at 8% to invest in something that earns 5%, the Canada Revenue Agency will allow you to deduct the full 8%, unless the transaction is a sham.

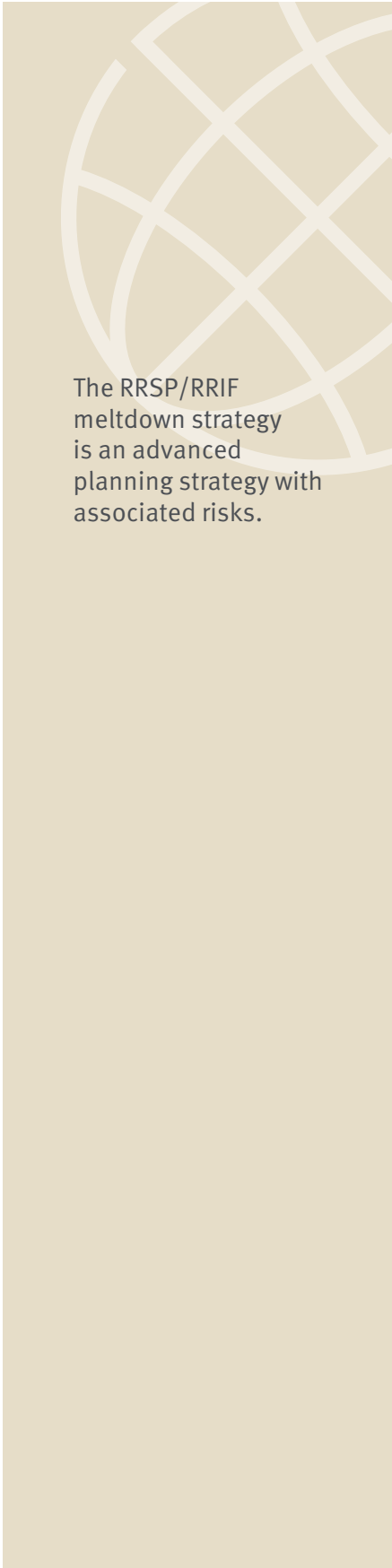
Please note that if you live in Quebec, the provincial tax laws limit the interest you deduct in any given year to the investment income you earn in that year. Unused interest expenses can be carried back three years and carried forward indefinitely to be deducted against investment income in other years.

#### **What if you dispose of your investments?**

When you dispose of all or a portion of your investments, you will need to identify the current use of borrowed money to determine the extent to which interest remains deductible.

For example, if you invest the proceeds from the sale into a new income source, the entire interest expense should continue to be deductible. If you sell your investments at a loss, it is likely that the proceeds will only cover a replacement investment of lesser value. As long as you can trace the cost of the replacement investment to the entire original borrowed amount, the full amount of the interest expense should be deductible.

If you dispose of a portion of your investments and decide to pay down your investment loan with the proceeds from the sale, then the interest expense on the remaining portion of the loan will generally continue to be deductible. In the case where you dispose of all of your investments at a loss, the proceeds from the sale may not be adequate to pay off the entire outstanding loan balance. In this case, the interest expense on the remaining portion of the loan will generally continue to be deductible as long as the original loan was used to purchase income producing assets.



The RRSP/RRIF meltdown strategy is an advanced planning strategy with associated risks.

If instead you decide to use the sale proceeds for personal purposes (such as travel, renovating your home, or paying down your mortgage), the interest on that portion of borrowed funds would cease to be deductible. Likewise, if you sell your investments at a loss, you will need to identify what portion of the originally purchased investments has been disposed of, and a pro-rated interest expense calculation will be required to determine the amount that remains deductible.

### **Conclusion**

The RRSP/RRIF meltdown strategy is a tax-efficient way to replace some of your excess registered assets with non-registered assets using an investment loan. However, it is an advanced planning strategy with associated risks.

This strategy is usually implemented once a sizeable amount of funds have accumulated in your registered

plan, which is usually close to or at retirement. If you are either approaching retirement age or are already in retirement, you will generally tend to have a lower risk tolerance, a shorter investment time horizon and possibly less potential surplus cash flow. Your RBC advisor along with your qualified tax advisor can help you evaluate whether or not this borrowing to invest strategy makes sense for you.

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