Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Borrowing to contribute to your RRSP

Does it make sense for you?

Determining whether or not you should borrow to contribute to your Registered Retirement Savings Plan (RRSP) depends on a few key variables. You may have to look beyond the interest costs and the potential rate of return on the investments you choose. Let's take a look at some of the key variables you should consider when deciding if an RRSP loan is beneficial for you.

Why consider an RRSP loan?

Although borrowing to contribute to your RRSP may be effective in very limited circumstances, it's not for everyone. The reasons will be discussed in the later section on key variables to consider.

Some people consider borrowing to make an RRSP contribution by the deadline because they're in a high tax bracket and can benefit from the tax deduction in the previous year. But, they didn't make any or enough RRSP contributions and don't have the funds to make the contribution at that time. Some may want to make a large RRSP contribution to maximize their tax deduction for a year in which they're in a higher than usual tax bracket and they have unused RRSP contribution room carried over from previous years.

An RRSP loan can increase the growth potential of your retirement savings through the power of tax-deferred compounding. The larger your initial investment and the longer the funds remain invested, the more income you can earn on a tax-deferred basis and the larger your investments can grow. However, since there are additional risks associated with borrowing, and the interest cost of borrowing to contribute to your RRSP is not tax deductible, it is better to repay the loan as soon as possible.

How it works

Here's how an RRSP loan works:

You borrow money to make an RRSP contribution. You'll have principal and interest payments to make regularly over the period of the RRSP loan. You can claim a deduction on your tax return for the amount of your RRSP contribution. This deduction may result in a tax refund when you file your tax return or may otherwise reduce the taxes you owe.

If you receive a tax refund, you can use the refund to pay off your loan faster while your RRSP investments continue to grow. In the case where your RRSP deduction reduces your other taxes payable, this can free up some cash that would have otherwise

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been paid to the government, which can instead be used to pay down your loan. In either case, using your tax refund or excess cash to immediately repay your loan balance will reduce the amount of non-tax deductible interest you'll have to pay over the course of the loan repayment period.

Key variables to consider

Since RRSP contribution room can be carried forward indefinitely, does it make 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 to make the RRSP contribution? In other words, is it beneficial to incur some financing costs in order to get the benefit of the tax deduction this year versus next year or the year after? Here are some of the key variables to consider in determining whether borrowing to contribute to your RRSP makes sense for you.

Income tax rates

Simply from a tax perspective, it generally makes sense to contribute to an RRSP if you'll likely be in a lower marginal tax bracket in retirement than in your working years. This is a key benefit of an RRSP, since you may get a larger tax deduction up front, and pay tax at a lower marginal tax rate when you withdraw from the RRSP in retirement. From this standpoint, the higher your current marginal tax rate and the lower your expected marginal tax rate in retirement, the more sense it may make to invest in an RRSP. That said, you will be repaying an RRSP loan with after-tax funds, so if you're in a high marginal tax bracket now, consider that you have to earn more before-tax income to be able to repay the loan.

If you're currently in a low marginal tax bracket, or you expect to be in a higher marginal tax bracket when you withdraw the RRSP funds in retirement, an RRSP loan may not make sense for you.

The bottom line is that the tax benefit from the RRSP contribution should be greater than the tax you're going to pay when you withdraw the funds in retirement.

Cost-benefit analysis

It's important to compare the cost of financing an RRSP loan with your potential after-tax rate of return on your RRSP investments. And, keep in mind that you'll be paying the interest with after-tax dollars because the interest is not deductible. So essentially, from a numerical perspective, if the non-deductible interest expense on your RRSP loan is equal to your after-tax return on your RRSP investments, then in theory, you should be indifferent to borrowing to contribute to your RRSP. On the other hand, if your after-tax return on your RRSP investments is greater than the interest rate on your loan, you may want to consider borrowing to contribute to an RRSP, after considering all of the other risk factors. You will have to make some assumptions in completing this analysis (e.g. the after-tax return on your RRSP investments), which means there is an element of risk involved.

Repayment timeline and interest rate risk

An RRSP loan is meant to be a short-term borrowing strategy. Ideally, you'd want to pay off the RRSP loan within a relatively short time frame (within one year or less) since this minimizes the interest you have to pay over the course of the loan repayment period. This is especially important since the interest payments on an RRSP loan are not deductible on your tax return.

There is also additional interest rate risk the longer the loan is outstanding. Many RRSP loans are variable rate loans, so be aware of future rate forecasts when deciding whether an RRSP loan is worthwhile. If rates are expected to rise, so will the interest cost of your RRSP loan.

RRSP loans work best when you can repay your principal quickly. The longer your loan balance is outstanding, the less likely the RRSP loan strategy will be advantageous.

Some financial institutions will set up the RRSP loan with a deferred payment period—for example, you can defer the start of your loan repayment by up to 90 days. Deferring your payments gives you time to get your tax refund and use it to repay all or some of your loan, before you have to begin making any loan repayments. Note that although the initial payment is deferred, interest continues to accrue on the entire balance of the outstanding loan from the time the funds are borrowed.

Years before retirement

The longer time horizon before retirement, the more time you have for your investments to grow on a tax-deferred basis, potentially increasing the value of your retirement savings.

Increased investment risk

Most investments have some degree of risk associated with them, but 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. For example, if you borrow $50,000 to invest but the value of your investments decreases to $40,000, the loan that has to be repaid is still $50,000.

Also, if you don't achieve your assumed after-tax rate of return on your investments, this makes the loan less beneficial.

Cash flow

Loans, in general, affect your cash flow. This is because you'll have a continuing obligation to repay principal and interest. You should ensure you have adequate surplus cash flow (i.e. after-tax income less expenses) to repay your RRSP loan and the associated interest. You will want to avoid the cycle of borrowing one year and then being in a situation where you have to borrow again year over year to make the payments.

In addition to being able to make your interest payments, RRSP loans work best when you can repay your principal quickly as well. The longer your loan balance is outstanding, the less likely the RRSP loan strategy will be advantageous.

Another aspect to keep in mind is that the source of your cash flow should be sufficient to absorb the effects of a market downturn. A market downturn may 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. You should be able to easily afford the monthly payments without straining your budget and have enough flexibility in your budget in case of unforeseen circumstances.

Alternative method for contributing to your RRSP

An alternative to borrowing may be to set up automatic deposits to your RRSP. This will ensure that a portion of your pay is immediately and regularly contributed to your RRSP. Automatic deposits to your RRSP can help you gradually build up your RRSP without incurring additional debt or financing costs.

Illustrations

Illustration 1

Let's assume you exercised some employee stock options last year and you're going to be in a higher than usual marginal tax bracket due to the stock option benefit (your marginal tax rate is normally 40%). The March RRSP contribution deadline is approaching and you don't have enough funds to make an RRSP contribution that you

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can claim against last year's income. You decide to borrow $50,000 at a 4% interest rate to contribute to your RRSP and maximize your tax deduction for last year. You're in a 50% marginal tax bracket, so your expected tax refund on a $50,000 contribution to your RRSP will be $25,000.[1] You intend to repay the loan as quickly as possible over the next year and to apply the tax refund against your loan balance. You have 20 years until retirement, and want to understand the benefit of borrowing to make your RRSP contribution. You use the RBC RRSP Loan Calculator[2] to obtain your results.

Your monthly loan repayment amount will be approximately $4,257, which includes interest and principal. However, because your tax refund is used to reduce the loan principal as soon as you receive it, you will only have 6 payments instead of 12. Based on an estimated annual RRSP rate of return of 6%, the value of your RRSP at retirement in 20 years will be approximately $160,000. The total interest cost over the life of the loan will be approximately $627. In addition, because you only have to make 6 months of loan payments, you can invest the other 6 loan payments in a non-registered account. Assuming a 6% rate of return and a marginal tax rate of 40%, after 20 years, these savings would grow to $48,000. Assuming a 30% marginal tax bracket in retirement, the total after-tax amount in your hands at retirement is approximately $160,000.

To compare, let's say you didn't borrow $50,000 up front, so you missed the March RRSP contribution deadline. As a result, you were unable to deduct the RRSP contribution for the previous year when your marginal tax rate was 50%. Instead you start to contribute approximately $4,257 monthly for 11 months and $3,173 in the last month for a total contribution of $50,000 to your RRSP. Because your normal marginal tax rate is 40%, your RRSP refund will only be $20,000. You can invest the refund in your non-registered account. Provided you had 20 years until retirement and estimated an annual RRSP rate of return of 6%, the value of your RRSP at retirement will be approximately $156,000. The $20,000 refund and the interest that you did not have to pay ($627) that is invested in your non-registered account will be worth approximately $40,000 in 20 years. Assuming a 30% marginal tax bracket in retirement, the total after-tax amount in your hands at retirement is approximately $149,000.

In this scenario, there was an advantage to doing an RRSP loan to allow you to meet the RRSP deadline and use your 50% marginal tax bracket. Of course, you still need to weigh the other risks involved that were previously discussed, with borrowing to contribute to your RRSP.

Illustration 2

Let's look at a different illustration where you are always in a 50% tax bracket in your working years but a 40% tax bracket in retirement. This illustration will compare borrowing $25,000 at the beginning of the calendar year to make an RRSP contribution versus contributing monthly. You borrow $25,000 at a 4% interest rate and your expected tax refund will be $12,500.[3] You intend to repay the loan as quickly as possible over the next year and to apply the tax refund against your loan balance. You have 20 years until retirement, and want to understand the benefit of borrowing to make your RRSP contribution. You use

1) This assumes you claim the entire contribution as a deduction on your tax return and that the entire tax savings resulting from the RRSP contribution results in a tax refund payable to you.

2) https://www.rbcroyalbank.com/personalloans/rrsp/rrsp-loan-calculator.html

3) This assumes you claim the entire contribution as a deduction on your tax return and that the entire tax savings resulting from the RRSP contribution results in a tax refund payable to you.

An RRSP loan may allow you to stick to your retirement savings plan, not miss your RRSP contribution deadline and take advantage of a higher than normal tax benefit. This may result in immediate tax savings and may boost the long-term growth of your RRSP.

the RBC RRSP Loan Calculator[4] to obtain your results.

Your monthly loan repayment amount will be approximately $2,129, which includes interest and principal. However, because your tax refund is used to reduce the loan principal as soon as you receive it, you will only have 6 payments instead of 12. Based on an estimated annual RRSP rate of return of 6%, the value of your RRSP at retirement in 20 years will be approximately $80,000. The total interest cost over the life of the loan will be approximately $314. In addition, because you only have to make 6 months of loan payments, you can invest the other 6 loan payments in a non-registered account. Assuming a 6% rate of return and a marginal tax rate of 50%, after 20 years, this would grow to approximately $21,700. Assuming a 40% marginal tax bracket in retirement, the total after-tax amount in your hands at retirement is approximately $69,700.

To compare, let's say you didn't borrow $25,000 up front, but you instead start to contribute approximately $2,129 monthly for 11 months and $1,581 in the last month for a total contribution of $25,000 to your RRSP. Because your normal marginal tax rate is 50%, your RRSP refund will be $12,500 in the following year. You can invest the refund in your non-registered account. Provided you had 20 years until retirement and estimated an annual RRSP rate of return of 6%, the value of your RRSP at retirement will be approximately $78,000. The $12,500 refund and the interest you did not have to pay ($314) that is invested in your non-registered account will be worth approximately $22,300 in 20 years. Assuming a 40% marginal tax bracket in retirement, the total after-tax amount in your hands at retirement is approximately $69,100.

4) https://www.rbcroyalbank.com/personalloans/rrsp/rrsp-loan-calculator.html

In this scenario, there's a very small advantage (approximately $600 after 20 years) to doing an RRSP loan. It is likely that the risks of borrowing will outweigh such a small benefit.

Conclusion

An RRSP loan may allow you to stick to your retirement savings plan, not miss your RRSP contribution deadline and take advantage of a higher than normal tax benefit. This may result in immediate tax savings and may boost the long-term growth of your RRSP. If you can manage to repay your RRSP loan within a very short period of time, and you don't plan on retiring in the near future, an RRSP loan may help you achieve your tax planning and retirement goals. That being said, keep in mind that borrowing to contribute to your RRSP may be an aggressive strategy with associated costs and risks. An RBC advisor along with a qualified tax advisor can help you evaluate whether or not borrowing to make an RRSP contribution is appropriate for you.

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