

Borrowing to Contribute to Your RRSP... Does it make sense?

If you have not yet made the maximum contribution to your RRSP for 2006, or have unused contribution room from previous years, now is the time to consider an RRSP loan.

Should you borrow to invest in your RRSP? There's no simple answer to this question as it really depends on your financial situation.

Short Term RRSP Loans

The general rule of thumb is that as long as you can pay back your RRSP loan within the year, you are better off than if you do not make the contribution at all. For example, if you borrow \$10,000 at 5%, your monthly payment would be \$856 and your total principal and interest payments for the year would be \$10,273. If your RRSP grew at 8%, the total value of the contribution after one year would be \$10,800. After one year, you are already ahead by \$527. This does not take into account that by making this contribution, you may be eligible for a tax refund. If you are in the highest marginal tax bracket (46.41% in Ontario), this \$10,000 RRSP contribution will result in a tax refund of up to \$4,600. If this refund is used to pay down your RRSP loan, this scenario gets even better as it will reduce your loan to approximately \$5,000.

Long Term RRSP Loans

What happens if you are unable to pay back your RRSP loan within the year? This may be the case if you have large amounts of unused RRSP room. For example, what if you had \$50,000 in unused room and were able to get a 5% loan for 5 years starting January 1, 2007, your monthly payments for the first six months would be roughly \$950. The tax refund generated from the contribution (\$23,000 assuming you are in the highest marginal tax bracket in Ontario) should be used to pay down your loan. Once you have reduced your outstanding loan by the tax refund you have two choices, you can either continue to pay \$950 a month, which would result in you paying off your loan by July 31, 2009. Or, you can keep your 5-year term and reduce your loan payment to \$470. Under the first option, your total payments are \$52,500 and under the second option, your total payments are \$54,000. Assuming an 8% rate of return in your RRSP, within 5 years the \$50,000 contribution will be worth \$73,466 and within 25 years it will be worth \$340,000!

As you can see from the above example, people that benefit the most from long term RRSP loans are those who are able to use up the majority of their unused RRSP room and have many years until retirement. The advantages of borrowing are most effective if the money can benefit from tax-free growth (in excess of the interest payable on the borrowed money) for many years.

Remember – RRSP Loans Are Not Tax Deductible

The interest on a loan for your RRSP is not tax deductible. However, money borrowed to earn non-registered investment income is deductible. This is why it may make sense to use extra cash to contribute to your RRSP and borrowed funds for non registered investments.





The Bottom Line

If the only way you are able to contribute to your RRSP this year is to take out a loan it may be a good idea. However, the longer the loan is outstanding the more non-deductible interest you will end up paying.

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