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Smart use of RRSP loans

The payback sets you up for the payoff

Saving for retirement is an important habit to cultivate. We hear about this a lot in January and February each year, as deposits to a registered retirement savings plan (RRSP) in the first 60 days of the year can be claimed as a deduction from the preceding year's income.

But what if you don't have the cash readily available to sock into your RRSP? One option is to borrow money for the purpose, using what is known as an RRSP loan. In doing so, keep in mind that this is not intended to be a permanent arrangement, but rather a temporary time-shifting tool. As with any loan, it is important to plan for how and when that loan will be repaid.

To appreciate why early repayment of the loan is so critical, the starting point is to understand how interest on an RRSP loan is treated.

Implications of non-deductible interest

If you borrow money to invest to produce taxable income, your interest cost is generally tax-deductible. However, when a loan is used to make an RRSP contribution, interest is not deductible. While at first this may seem unfair, remember that income and growth within an RRSP are not subject to tax. Thus there is an element of symmetry in this comparison:

- Deductibility with taxable income
- Non-deductibility with tax-exempt income

That's not the end of the story though, as RRSP money will eventually be taxed when it is drawn out of the plan. The combination of non-deductible interest with eventual taxable income should serve as reinforcement to repay an RRSP loan in a timely manner.

How timely? Let's look at some numbers to help show the cost of that non-deductible interest.

The cost of RRSP loan retirement

For RRSP loan interest, you must first earn income and pay tax on it, and then use what's left over to pay the interest. To illustrate, we'll assume a $60,000 income where the marginal tax rate is about 33% (allowing that some provinces are a little higher and others a bit lower). That means $1.50 in pre-tax income would be needed to pay 50 cents of tax, and end up with $1 to make that interest payment.

As a counterpoint, RRSP loans can usually be arranged on more favourable terms than other loans. While it is illegal for a financial insitution to compel you as a borrower to use the loan proceeds to invest with it, the lender is allowed to offer a better rate on the loan if you decide to do so.

But even with favourable rates, don't forget that the principal will eventually need to be returned to the lender, in addition to interest payments in the meantime. Just as the interest is not tax-deductible, neither is the principal repayment. As well, keep in mind that the tax issues have no effect on your legal obligation to repay the loan, even if the investment decreases in value.

When taking out the loan then, you should already be thinking about how and when you are able to pay it back.

Repayment timeline

Continuing our 33% tax rate example, if the loan is used to make a $6,000 RRSP contribution, it would generate a $2,000 refund. Unless a real emergency occurs between the contribution date and receivng the refund, an immediate paydown of the loan should be the first and only priority for that refund, leaving a $4,000 balance.

According to the Canada Revenue Agency (CRA), you can expect that refund within two weeks if you file online, or up to eight weeks for paper returns. So this year if you file by the Monday, May 2, 2022 deadline (with April 30 falling on a Saturday), you can have your refund by mid-May. That gives you almost eight months to pay off the remaining $4000 loan (or a little over $500 per month including interest) before the end of the year.

But of course an earlier filing means an earlier refund and an earlier start on those repayments, so if you're really keen, CRA will accept returns as early as Monday, February 21, 2022. The reason it is so important to retire the loan by the end of the year is that if payments continue into the following year, there will be less cash available to make the next round of RRSP contributions, whether or not loans are involved.

If that repayment schedule feels unmanageable, perhaps the amount of the RRSP loan should be reconsidered. One approach would be to begin by deciding how much of your monthly cash flow you can comfortably commit to repayments, and let that guide you on the size of loan you can handle.

Strategically getting ahead on your savings

If you are successful in retiring the loan before the end of the year, you can realllocate the monthly cash flow you used for repayment, directly into your RRSP. Whether that's a few weeks early or a few months, you are paying yourself back with three key benefits:

- First, the earlier the loan is retired, the lower the total interest you will pay.
- Second, those new RRSP contributions will be deductible, whereas the interest and principal repayments on your RRSP loan were not.
- Third, having already begun your RRSP contributions during the year, you won't need as large an RRSP loan when you come to next year's first 60 day period. By using this kind of strategic approach, you can progressively wean off of RRSP loans entirely in just a few years, putting your RRSP savings routine on a more stable and sustainable course.

Your financial advisor can help you determine where you are at with your savings presently, whether an RRSP loan fits your needs, and how to manage it so you get the optimal tax benefits from your RRSP savings.

For more information, please consult your financial advisor and tax professional.

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