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TAX MATTERS

Skipping RRSP contributions can make sense in some years

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I was at the grocery store last week when a young guy approached me. He recognized me from an appearance I had made on BNN Bloomberg not long ago and wanted advice. He had set aside $25,000 of cash savings over the past year and wanted to contribute the amount to his RRSP before the deadline of March 1.

He then asked me: "Dude, what investments should I hold in my RRSP today?" At that moment, I thought about the comedian Demetri Martin, who once pondered "what is the most intelligent thing ever said that started with the word 'dude.' 'Dude, those are isotopes.' 'Dude, we removed your kidney – you're gonna be fine.' 'Dude, I am so stoked to win this Nobel Prize." But then I emerged from my brief mental musing, and we continued our conversation. As we talked, I suggested that he not contribute to his registered retirement savings plan this year.

Does it ever make sense to skip an RRSP contribution to use those funds for something else? The answer is yes. Now, don't get me wrong – I think RRSPs are important. But in a given year, there may be other priorities that can make sense instead. Let's talk about three of those priorities.

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Paying down debt. The young man told me that he had some debt. So I asked him, "What rate of interest are you paying on that debt?" "I have some credit-card debt, and then I have a line of credit where I'm paying 6.6 per cent," he said. The fact is, when you pay down debt, you're earning a return on that payment equal to the after-tax rate of interest on the debt.

For example, if you're paying 6.6-per-cent interest but it's deductible, and your marginal tax rate is 50 per cent, then your after-tax interest cost is 3.3 per cent. By paying down that debt, you'll

effectively be earning a guaranteed 3.3 per cent after taxes. As it turns out, this young man could not deduct any of his interest. So, paying down his line of credit was going to provide him with a guaranteed 6.6-per-cent after-tax return, and an even higher return on his credit-card debt. This is a very good return and is higher than what he'd be able to achieve on a guaranteed basis inside his RRSP. So, paying down debt, at least this year, makes more sense for him.

Making TFSA contributions. As a general rule, it makes sense to maximize contributions to both your RRSP and a tax-free savings account. But you may not have the dollars for both. In some cases, it may make sense to contribute to your TFSA first, notably where your marginal tax rate is expected to be higher in retirement. This can be the case where, for example, you're a younger person and expect to be in a higher tax bracket in the future, or you're on parental leave or a sabbatical and your income is lower today.

Perhaps you're a senior and can't contribute to an RRSP any longer since you were age 71 or older last year – but TFSAs are still an option for you. Or you're expecting above-normal rates of return (a TFSA will then allow you to realize those capital gains and withdraw them – all tax-free). Maybe you'll never need the assets (withdrawals from an RRSP or registered retirement income fund are mandatory, and are taxable to boot, but withdrawals from a TFSA are not mandatory). Finally, maybe you're saving for short-term consumption, or you want collateral for a loan (TFSA assets can be pledged as collateral but RRSP assets cannot).

Making RESP contributions. It might also make sense to contribute to a registered education savings plan rather than an RRSP. The reason? The Canada Education Savings Grant. CESGs are grants from the government generally equal to 20 per cent of RESP contributions, to a maximum of $7,200 in the lifetime of a beneficiary (your child).

In a perfect world, you should contribute $2,500 to an RESP each year for each beneficiary. This will give you the maximum $500 CESG for the year ($2,500 times 20 per cent is $500). If you don't contribute each year, you can catch up and collect CESGs, but only up to $1,000 in a year (representing 20 per cent on a $5,000 contribution for a beneficiary).

Suppose you have three young children, and you haven't made enough contributions to an RESP to maximize the CESGs available. If you were to contribute $15,000 to an RESP today, you'd be immediately entitled to collect CESGs of $3,000 (a $5,000 contribution for each child will yield a $1,000 CESG for each of them, and with three children that would be $3,000). So, the RESP can make more sense than an RRSP if you're behind in making RESP contributions and collecting CESGs.

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