THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Contribute to your RRSP even if you don’t have the cash

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I recall the story of Simon Chaplin from Wales who, about half a dozen years ago, hooked up a device to emit smoke from the back of his car. The idea was that, if the police ever tried to stop him for speeding, he’d create a smokescreen and make a speedy escape. As it turns out, Mr. Chaplin thought he was cleverly evading police one day using his James Bond-style invention, but when the smoke cloud lifted, the police simply followed the remaining smoke trail ahead and caught him.

A lot of Canadians are like Mr. Chaplin when it comes to their retirement planning. They make plans to save for retirement but find out when they do retire that their plans didn’t work out the way they expected. The reason usually is that they haven’t set aside enough money on a consistent basis. Today, I want to talk about three ideas to contribute to your RRSP if you don’t have the cash.

Top-up loan

If you’ve been contributing to your RRSP but still have unused contribution room, consider a top-up loan that can allow you to contribute more this year than you might otherwise. Now, when it comes to borrowing to contribute to your RRSP, you can’t deduct the interest cost, so you’ll want to pay off that loan quickly. Let me show you some math here.

Suppose that you have $5,000 of your own money to contribute to your RRSP. If you visit your bank and borrow another $3,333 this month and contribute this to your RRSP, you’ll have total RRSP contributions of $8,333. Let’s assume that your marginal tax rate is 40 per cent. In this case, you can expect tax savings from your RRSP deduction – likely coming back to you as a refund – of $3,333 (40 per cent of $8,333). That’s right, your refund will equal the amount that you borrowed. You can then use the refund to pay off your loan in full right away.

How do you figure out the amount to borrow to enable a full loan repayment using your refund? Easy. The amount to borrow should equal the amount of your own money contributed, divided by the following formula: 1/MTR – 1 (where MTR is your marginal tax rate). If your MTR is 40 per cent, the math looks like this: 1 divided by 0.40 is 2.5, subtract 1 equals 1.5. If your own contribution is $5,000, divide it by 1.5, and your answer is $3,333 – the amount to borrow.

Catch-up loan

Okay, suppose you have more than just a little RRSP contribution room available. It's not likely that you'll be able to pay off an RRSP loan all at once, or over a short period. But a catch-up loan can still work well. This is where you borrow a larger amount to give your RRSP a big shot in the arm today. Aiming to pay off a catch-up loan over five years can still make good sense.

Suppose you can afford a $300 loan payment each month on an RRSP loan. If you make repayment over five years, you could borrow $17,000 today to contribute (assuming today's prime rate of 2.45 per cent). Over that five years, you'd pay about $1,080 in interest to the bank, but you would have deferred taxes of $6,800 by claiming an RRSP deduction of $17,000, assuming an MTR of 40 per cent. The value of the tax deferral will outweigh your interest cost over several years. In this example, you'd end up with 30 per cent more in your RRSP over 20 years compared to just contributing the $300 to your RRSP each month over that time (assuming a 6-per-cent annual return in your plan).

Contribute in-kind

Finally, consider contributing in-kind to your RRSP if you have other investments outside of your plan. Do this by transferring some of your investments held outside of your RRSP into your plan. You'll be entitled to a deduction for the amount transferred to your RRSP. Just make sure you have sufficient RRSP contribution room before you do this.

Now, keep in mind that transferring investments to your RRSP will be treated as a disposition for tax purposes. So, if those investments have grown in value, you could trigger capital gains. But the deduction from the RRSP contribution will more than offset the tax owing on this transfer.

On the flip side, if your investments have dropped in value, transferring them to your RRSP will create a capital loss, but you won't be able to claim that loss. In this case, you'd be better off selling the investments first, then contributing the cash to your RRSP. This will allow you to claim the capital loss.

Finally, you could borrow to replace those investments outside your RRSP if you want, and you'd be allowed to claim a deduction for the interest on the loan.

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