THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Give your RRSP a big boost every year without needing more cash

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED JANUARY 18, 2024

Last week I stopped to talk to my neighbour, Kevin, who told me that he's starting to feel old as he gets closer to retirement. "But Kevin, you're only 48 years old – you've got a lot of years ahead of you," I said. "Tim, when I go for a jog pretty much everyone zips past and leaves me in the dust," he complained.

"Well, at least you're keeping out in front with your retirement savings plan," I replied, recalling Kevin's annual exercise in RRSP-boosting. With a pretty straightforward approach, Kevin manages to give a big bump to his RRSP contribution without having to set aside the extra cash. Here's what he's been doing.

The idea

For several years, Kevin had been contributing about $8,000 per year to his RRSP. The problem? Kevin, like a lot of Canadians, was eager to contribute more, but didn't have the cash on hand to do so.

So, Kevin promised himself that he would take his tax refund, resulting from his RRSP deduction each year, and contribute that as well. Since his marginal tax rate is 40 per cent, an $8,000 RRSP deduction saves him $3,200 in taxes ($8,000 x 40 per cent is $3,200). Contributing his tax refund to his RRSP each year resulted in total RRSP contributions of $11,200 ($8,000 plus $3,200) each year.

While this improved Kevin's retirement savings significantly, he then learned how to contribute even more to his RRSP without having to sacrifice his current cash flow. He's been doing this for the last decade by using an idea known as the RRSP gross-up strategy.

This idea involves borrowing additional funds in the first 60 days of the calendar year – often through an RRSP loan, or on a line of credit – in order to make a larger RRSP contribution by the annual deadline (Feb. 29 this year). The borrowing will be very short-term (just a couple of months), and the loan will be paid off with the tax refund coming back when your tax return is filed.

Back to Kevin's example. This year, he'll contribute his usual $8,000 to his RRSP, but he's going to borrow another $5,333 before the RRSP deadline and will contribute this amount to his RRSP as well. So, his total contributions in the first 60 days of this year will be $13,333 ($8,000 plus $5,333). This total contribution is higher than the $11,200 we calculated above had he simply contributed his $8,000 plus the $3,200 tax refund. The $13,333 contribution is 19 per cent higher than the $11,200 "contribute-the-refund" strategy, and two-thirds more than merely contributing $8,000.

Kevin can expect a tax refund, coming back to him in March or April, of $5,333 ($13,333 x his 40 per cent marginal tax rate). He'll then use the refund to pay off the loan of that same amount. The only cost to Kevin will be the interest on the loan for approximately two months. Assuming loan interest at today's prime rate (currently 7.2 per cent), the cost to Kevin will be about $64 in (non-deductible) interest.

The nuances

Who should take advantage of the RRSP gross-up strategy? Anyone who wants to make an RRSP contribution for 2023 in the first 60 days of this year, has less cash on hand than they'd like to contribute, and has sufficient RRSP contribution room.

The first step is to calculate how much you should borrow to make a larger, grossed-up, contribution. The borrowed amount should equal the amount of your own money contributed, divided by the following formula: (1/MTR) – 1 (where MTR is your marginal tax rate). Using Kevin's numbers, his MTR is 40 per cent, so the math looks like this: 1 divided by 0.40 is 2.5, subtract 1 equals 1.5. Kevin's own contribution is $8,000, so let's divide it by 1.5, and the answer is $5,333 – the amount to borrow.

You can figure out your marginal tax rate by using different online resources. I like the calculator provided by accounting firm EY (www.ey.com/en_ca/tax/tax-calculators).

And, as for the loan, most financial institutions offer RRSP loans at prime rate, and some will defer payments long enough so that you have time to collect your refund before making your first loan payment. A secured line of credit can also be a good source of borrowing – but compare the interest rate to an RRSP loan. In either case, you should be able to pay off the loan in full without any penalties; confirm this is the case before borrowing.

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