Client Connect

RRSP Season

The Ins and Outs of Borrowing to Invest

Let's take a look at some retirement savings options today – there are a few to choose from.

Take a situation where you have $5,000 after taxes available to invest each year. Let's compare four options:

RRSP option - Suppose you contribute $5,000 to your RRSP each year for 20 years and reinvest your tax savings from the RRSP deduction annually. In this case, you'll end up with $204,977 in your pocket after taxes at the end of 20 years. How so? You'd have $204,977 sitting in your RRSP after 20 years, at 7 per cent annually. Add to that $94,290 from reinvesting the tax savings each year, earning 7 per cent annually (I've assumed a 46 per cent marginal tax rate). I've assumed these tax savings will be reinvested in a tax-free savings account (TFSA) to avoid tax on the growth. Finally, subtract taxes owing of $94,290 on the RRSP at the end of 20 years assuming a complete liquidation and withdrawal at that time, and assuming the same 46-per-cent marginal tax rate at that time.

TFSA option - Now assume you contribute the $5,000 annually to your TFSA each year for 20 years. Assuming the same 7-per-cent return annually, you'd end up with $204,977 in your TFSA at the end of 20 years. There would be no tax on the withdrawal, so you'd end up with $204,977 in your pocket – same as the RRSP option above.

Open account option - Next, let's assume you invest $5,000 each year for 20 years in a non-registered investment account rather than an RRSP or TFSA. In this case you'd end up with $180,832 in your pocket after taxes at the end of 20 years. I've assumed the same 7-per-cent return and that you earn capital gains only, and those gains are not taxed until the 20th year (assume the same 46-per-cent marginal tax rate). If you were to earn interest income instead, taxed annually, you'd end up with just $145,537 after taxes at the end of 20 years (with the same assumptions otherwise).

Loan option - Finally, consider the scenario where you use the $5,000 annually to pay the interest on an interest-only loan at, say, 7 per cent. In this case, you could borrow $71,400 to invest. You'd end up with $252,059 after taxes at the end of 20 years. As for the math: Assume you invest the $71,400 plus the tax savings from the interest deduction annually (at the same 7-per-cent return and 46-per-cent marginal tax rate). The $71,400 would grow to be worth $276,295 after 20 years. Add $94,290 from the reinvestment of the tax savings from the interest deduction (assume this reinvestment takes place inside your TFSA to shelter the growth from tax). Subtract taxes of $47,126 and the loan repayment of $71,400 at the end of 20 years upon liquidating the investments.

If you were to borrow instead to contribute to your RRSP or TFSA rather than an open account you'd give up the interest deduction and the tax savings that come from that deduction. In the end, you would not be as well off as the open account loan option using the assumptions above.

Bottom line

Using the $5,000 to pay the interest on an interest-only loan will leave you better off than contributing the same amount to an RRSP or TFSA each year, for a few reasons: You have more money at work earlier in the case of the loan, there are tax savings from the loan interest that can be reinvested, and the liquidation of the account is more tax-efficient than withdrawals from the RRSP. You do, however, have to consider the appropriateness of, and whether you're comfortable, taking on debt.

There are, of course, other options. If you've been neglecting contributions to your RRSP and TFSA, you might consider borrowing to make a larger catch-up contribution to your RRSP and then taking your savings from the RRSP deduction and reinvesting those dollars in a TFSA. The results may not match the loan option described above, and your interest costs won't be deductible, but you could still do better than without borrowing money at all, particularly if your interest costs are less than what I've assumed above.

Courtesy of Tim Cestnick – The Globe and Mail

If you have any questions, please contact us.

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