-->

thestar.com

Bob Aaron *bob@aaron.ca*

February 11, 2006

Use RRSP funds to pay down mortgage now

Usually good advice for young homeowners

Get advice from someone not promoting funds

As RRSP season runs into high gear, it's time for a reminder that the federal government's Home Buyer's Plan, or HBP, is not the only way to use RRSP money to pay down a home or condominium mortgage.

Under the HBP, taxpayers are allowed to withdraw up to $20,000 from their Registered Retirement Savings Plan without paying tax on the money, if they buy or build a qualifying home with the money.

The main requirement is that the money has to be repaid to the plan within no more than 15 years.

Payments have to be made to the RRSP each year until the HBP balance is zero. If a taxpayer does not repay the amount due for any year, it will be treated as a taxable withdrawal in that year, and will have to be included in income for that year.

These were the rules Stephanie and I were discussing when she recently visited my office to review the builder's purchase agreement for a new downtown Toronto condominium.

After we went over the offer in some detail, she told me that she had to get high-ratio financing for the purchase because she had only a 20 per cent down payment after taking full advantage of the $20,000 HBP contribution.

With a purchase price of about $253,000, and a healthy down payment of $51,000, she was going to be about $12,000 short in order to get a 75 per cent mortgage without paying CMHC insurance fees. In other words, if Stephanie had an extra $12,000, she would avoid paying the CMHC high ratio premium of 1 per cent (plus 8 per cent provincial sales tax on the 1 per cent) on her $202,000 mortgage.

For lack of an extra $12,000, Stephanie would have to borrow and repay about $2,350 in mortgage insurance charges a premium of almost 20 per cent on the $12,000.

It was then that I told Stephanie about a neat way of avoiding the CMHC fees and reducing her borrowing from 80 per cent to 75 per cent of the cost of the condominium.

First, I asked her the magic question: Do you have any money besides the first $20,000 in your RRSP?

Yes, she said, I have another $20,000 after I take out the initial $20,000.

Is it liquid? I asked.

Yes, she replied, but why?

Then I explained to her that although she had that extra $20,000 in her RRSP, about $8,000 of that money really belonged to Ottawa. It was the tax money she didn't have to pay when she put the money into the savings plan. Eventually, she would have to pay the taxes back to the government sometime before the year 2043 when she turns 69.

Or, I said, she could pay the tax now and collapse the plan. If you pull the second $20,000 out of the RRSP now, you'll have about $12,000 left after taxes depending on your tax bracket. You can add it to your down payment, and avoid paying any CMHC fees at all.

In addition, I pointed out that her mortgage would be $12,000 smaller, resulting in lower payments and an interest savings of $576 a year in after-tax dollars for the next 25 years. If she put that money into the mortgage along the way, and invested all her after-tax RRSP money into the mortgage instead of the plan for the next 15 or so years, the mortgage would be paid off much sooner than the original 25-year amortization.

Then Stephanie noted that aside from repaying the $20,000 to her RRSP for the Home Buyers Plan loan, she wouldn't have the additional $20,000 in her plan because she would spend it on the condo. This bothered her until I explained why I thought it was a good idea.

Over the years, I have usually advised young clients to forget the RRSPs and instead pay down the mortgage on their homes as fast as possible.

Most of the conventional advice to the contrary is given by financial institutions and advisers who are promoting investments in their own RRSPs.

Institutions typically advise RRSP clients to use excess cash to invest in an RRSP and then pay down the mortgage with the tax refund. The flaw in that argument is that if it makes sense to use just the tax refund to reduce the mortgage, why not take all the excess cash, pay tax on it, and use all of what's left over to pay down the mortgage.

This way, the mortgage will be paid down much faster.

There is no simple answer to the mortgage vs. RRSP debate. Among the factors to be taken into account are the homeowner's age, lifestyle, tax rate, mortgage interest rate, investment return inside the RRSP, general financial health, pension plan and the target age for paying off the mortgage.

I always tell clients to obtain independent financial advice from someone who is not selling RRSPs.

Surplus after-tax cash invested in a home mortgage rather than an RRSP could result in having a debt-free home five or 10 years earlier than the typical 25-year payout period.

See also Smart investors skip RRSPs to pay down mortgage now - *Title Page*, Feb. 1, 2003 .
