

Tax, Retirement & Estate Planning Services

Tax Managed Strategy 24

The bigger bang RRSP strategy

For many Canadians, as the calendar year winds down, the time comes to think about making your annual contribution to your Registered Retirement Savings Plan (“RRSP”). Whether you contribute regularly to your RRSP throughout the year, or if you make a single lump-sum payment or additional “top-up” payment closer to the RRSP deadline,¹ there is a strategy you need to consider.

The typical scenario

A typical scenario may involve working with your advisor to determine the amount of the RRSP contribution you will need to make in order to help reach your retirement goals. However, it is not uncommon that you may have less cash on hand than the amount of the RRSP contribution you would like to make. So, you commit the amount of funds you can afford now with the promise to yourself that you will invest the tax refund when you receive it.

The numbers

Take for example an individual who has \$7,000 in cash with a marginal tax rate of 40 per cent. If they were to contribute this amount in the first 60 days of 2019 a deduction can be claimed on their 2018 tax return. This will result in a tax refund of \$2,800 ($\$7,000 \times 40\%$) which can be contributed to their RRSP when it is received and a corresponding deduction claimed on their 2019 tax return. Although the tax refund of \$2,800 cannot be claimed until filing their 2019 tax return they have increased their total RRSP contribution to \$9,800. While this is a better strategy than simply spending the refund, there is an alternative that can allow you to increase your RRSP contribution in the current year with very little cost.

¹The RRSP deadline is 60 days following the end of the year.



The bigger bang strategy²

The strategy works by acquiring an RRSP loan in the amount of your estimated tax refund in the first 60 days of the calendar year and then using the tax refund to pay off the loan when it is received. The bigger bang RRSP strategy results in a larger RRSP contribution while allowing you to claim a deduction in the current year. It also enables you to have more money working for you sooner in a tax sheltered investment.

The formula

Here's how to calculate the amount of the loan you can obtain so that when you receive your tax refund you can pay off the loan completely:

$$\frac{\text{Cash on hand} \times \text{marginal tax rate}}{(1 - \text{Marginal tax rate})}$$

Using our example of \$7,000 cash on hand with a 40 per cent marginal tax rate you can see that we can borrow up to \$4,667:

$$\frac{(\$7,000 \times 40\%)}{60\%} = \$4,667 \text{ loan}$$

For illustration purposes only.

The bigger bang

By borrowing an additional \$4,667 you have increased the overall contribution to your RRSP by \$1,867 (\$11,667 versus \$9,800 as seen below) and you are able to use the full amount as a deduction in 2018.

Let's look at how the two scenarios compare:

Total RRSP Contribution			
Reinvest Refund	(\$)	Borrow	(\$)
Cash (2018)	7,000	Cash (2018)	7,000
Refund (2019)	2,800	Loan (2018)	4,667
Total	9,800	Total	11,667

For illustration purposes only. Years in brackets represent year of the tax return.

The cost

In looking at what this strategy will cost you to implement, you will see it is minimal:

Implementation Cost	(\$)
Refund \$11,667 × 40%	4,667
Loan	(4,667)
Interest for 90 Days	(48)*
Not covered by refund	48

*An interest rate of 4.20% is used in this illustration for the purpose of an RRSP loan.
For illustration purposes only.

²The strategy assumes that there are no other factors that would impact the total tax refund.

Depending on when and how you file your tax return, your refund should take no longer than 8 to 10 weeks to be received. Tax returns that are filed early using electronic filing methods are often processed by the Canada Revenue Agency within 10 days. As the example shows, even if it is assumed that it took 90 days to receive your refund and you paid off the loan immediately, the costs not covered by the refund would only be \$48.

What to look for in an RRSP loan

Many institutions offer RRSP loans at very competitive interest rates and some will defer the payments long enough so that you have plenty of time to receive your refund before making the first installment. Interest accrues on the outstanding balance but the loan can be paid in full without penalty at any time.

Ideal candidates

- The bigger bang RRSP strategy is best suited for those:
- Looking to make an RRSP contribution in the first 60 days of the calendar year
- Who have less cash on hand than the amount of RRSP contribution they would like to make
- Who have sufficient RRSP contribution room

Take action

- To take advantage of the bigger bang RRSP strategy:
- Determine the RRSP loan amount that will equal your estimated tax refund for the year and then take out a loan in that amount (or less)
- Use the tax refund to pay off the RRSP loan

Borrowing to invest in an RRSP may not be appropriate for everyone. You will need the financial means to meet your loan obligations. Talk to your advisor to find out more about the advantages and obligations of borrowing to invest.

**For more information
contact your advisor or visit
manulife.ca/investments**

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