

Think twice before dipping into RRSPs

By Gordon Powers

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Despite stiff tax penalties, many Canadians are dipping into their RRSPs early to invest in homes, pay down debt and cover living expenses, Bank of Nova Scotia data suggests. And most of those have no real plan to pay it back.

Among those who've made the plunge, the average amount withdrawn was \$18,000 -- a move, for some people at least, that's going to prove quite costly.

Had they left that \$18,000 invested at, say 5%, it would have grown and compounded on a tax-deferred basis to roughly \$61,000 over 25 years. That's a loss of \$43,000 in potential investment gain.

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There's no doubt that at certain times in your life you might find yourself strapped for cash. You might find yourself unemployed, on disability leave, or on a maternity or paternity break. Nonetheless, before jumping at the chance to pull money out of your RRSP for reasons other than retirement, take a deep breath. It's generally not a good idea since you'll leave so much future income on the table.

And, you won't even get to keep the full amount you take out anyway. The government levies a tax by taking a percentage of the amount withdrawn right off the top. Currently, the bite is:

- 10% on withdrawals of \$5,000 or less
- 20% on withdrawals between \$5,000 and \$15,000 inclusive
- 30% on withdrawals over \$15,000

Think of these tariffs as instalments on your taxes. In most cases they won't be enough to satisfy your full tax bill on the RRSP withdrawal, and you'll have to make up the difference when you file your tax return the following year.

The only exceptions are government programs like The Home Buyers' Plan (HBP) and the Lifelong Learning Plan (LLP). The HBP allows you to withdraw up to \$20,000 (\$40,000 per couple if you both have a plan), assuming you're a first-time homebuyer, from your RRSP to buy or build a home for yourself or for a related disabled person. The LLP lets you access up to \$20,000 (\$10,000 a year) from your RRSP to finance training or education for you or your partner.

There's a good argument that these types of withdrawal make some economic sense, as home ownership and higher education are both likely to improve your financial circumstances in the long run. However, you must also consider whether your home will appreciate in value and by how much. If its value increases substantially over time, you could be further ahead since there won't be any tax owing on the sale of your principal residence.

As well, if the money was used as a down payment and allowed you to qualify for a cheaper mortgage, you'd enjoy another savings. For example, if you have less than 20% to put down on a

home, then you're looking at a high-ratio mortgage, which will add thousands of dollars to your mortgage costs.

But, remember that these are temporary loans; you have to pay back the amount you borrow from your RRSP within a certain period (HBP: 15 years; LLP: 10 years) or it will be added to your taxable income. And, again, you're not making anything on that money when it's not RRSP-based.

There are a few other times when it may make sense to consider an early withdrawal. Take spousal RRSPs, for instance. Spousal plans are just like regular RRSPs, with the exception that contributions are made by the higher income spouse into the lower income spouse's plan.

Here's a typical scenario: A dual-income couple planning a family opens a spousal RRSP. The husband makes contributions to his wife's plan for several years and then, when the first child is on the way, she stops working, collapses the spousal RRSP and pays taxes on the money withdrawn -- ideally at a far lower rate than when she was working. There's a trade-off, of course, since you can't put the money back in later.

Be careful not to withdraw funds from this type of plan until at least three years after the last contribution was made, otherwise it'll be added to the income of the contributor. Remember, it's the timing of the contributions to a spousal RRSP that governs this recapture rule, not when or whether you claimed a deduction.

This rule is designed to prevent couples from bouncing back and forth where one spouse contributes to the other's plan, takes the deduction, and then the following year the other spouse withdraws the money at a lower rate.

If you have to get at some spousal money, consider taking out half of the early withdrawal amount in December of one year, and the other half in January of the next year. That way the income tax paid is split between two taxation years.

Older investors have some RRSP withdrawal options as well. According to the latest rules, you have to convert your RRSP to some sort of income-paying vehicle by December 31st of the year you turn 71. But, suppose you're over 65 and want to take advantage of the federal pension tax credit on the first \$2,000 of pension income but have no qualifying -- OAS and CPP benefits don't count -- pension income.

In this instance, by converting a portion of your RRSP to a RRIF and arranging to withdraw \$2,000 a year, you'd create the necessary income to qualify for this tax credit. For couples, both of you can match this switch.

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