

## TAX-DEFERRED CAPITAL GROWTH

# THE RRSP AND HOME OWNERSHIP

The home is the most significant asset for many Canadian households. It can bolster personal net worth, and when paid off, reduce costs of living in the future. The government has made it easier to get into the market to buy a new home by allowing you to make tax-free withdrawals from your Registered Retirement Savings Plan (RRSP) to finance home purchasing. This opportunity can also be used by older people who must move to accommodate age-related disabilities.

### What should you do first?

Should you pay down your mortgage or invest in an RRSP? This is probably the most frequently asked question by young homeowners and it is difficult to answer precisely because the investment in each of the two financial commitments is so unevenly distributed. In fact, often too much of the monthly budget is going towards home ownership in comparison to investing for the long term, particularly for those under 45. Yet, home ownership is a significant reason why net worth of Canadian families is growing over time.

### The case for home ownership

Close to 70% of Canadians own their principal residence and these represent a significant anchor in building household net worth. Almost 60% of homeowners have a mortgage and their shelter costs are three times higher than mortgage-free homeowners. But for the close to 40% of Canadians who are mortgage-free, there is a significant opportunity to accumulate, grow and preserve overall wealth.

One reason is that there are tremendous tax advantages to home ownership. Gains in value of one principal residence in the family are tax exempt. This can make the purchase of a family home very tax efficient over the long run, especially in an appreciating market. Unfortunately, a capital loss on your principal residence is not tax deductible, nor are the interest payments made, unless the home is partially used for business purposes.

What's important in wealth management is to diversify away financial risk, if possible. Is it a sound choice to let one asset consume all other savings room, at the expense of your future

financial security? Ownership of the wrong home, can be an inhibitor to wealth accumulation. And so choices about how big a home, and how much debt it brings, can either throw family wealth management plans into jeopardy, or help you leverage your asset soundly towards greater financial stability. Families with too much debt, will want to work with their financial advisor to mitigate their financial risks, especially when things change: rising interest rates, loss of a job or changes in health, for example.

### The case for the RRSP first

While it's important to increase net worth with tax efficient home ownership, it needs to be managed in balance with future retirement goals. The RRSP can help you do both, with tax efficiency.

When home ownership takes the largest piece of after-tax income, it's true that RRSP savings can be meagre. As a result, many Canadians have accumulated vast amounts of RRSP contribution room.

But when families can maximize RRSP contributions, they can create significant tax savings, which can supplement retirement income plans as well as reduce mortgage debt. Put another way, the tax refund created by an RRSP contribution can free up "new money" to be used to pay down mortgage debt. This quickly increases family net worth.

So, investing in the RRSP first, mortgage second, can be a good plan for many families.



### RRSPs can create both short-term and long-term benefits

The main purpose of the RRSP is to build tax sheltered capital that will generate retirement income so that you no longer need to work. That's really important because today many people are retiring sooner and living longer. The length of the average retirement today is well over 20 years, with many living well into their 90's.

This means younger people need to save more money earlier in life and shelter it from tax as long as possible. Here, the RRSP can shine. It will create tax savings immediately, as discussed above, and over the longer term, the RRSP can be ideal for producing tax sheltered, compounded growth.

### RRSPs Sound Choices checklist:

- **Make RRSP room.** Accumulate contribution room of up to 18% of 'earned income' annually. You'll have to file a tax return to do so.
- **Keep track of your RRSP contribution room.** You'll find that important figure on your Notice of Assessment or Reassessment.
- **Make the contribution – get a bigger tax refund.** Money deposited into an RRSP will result in a tax refund if the taxpayer has the required contribution room and is age-eligible.
- **Get more tax credits, too.** By making RRSP contributions, you can reduce family net income, which may in turn increase refundable tax credits or certain social benefits payable through the tax system.
- **Get faster, compounding growth.** RRSP Investment earnings are tax deferred over time, so you accumulate more capital with the reinvestment of the full earnings.
- **Save your RRSP room.** You may not need unused contribution room because of low income earned this year. Know that this room can be carried over to future years to offset higher income in the future.
- **Save lots at the right time.** As long as contribution room and age eligibility exists, lump sum contributions can be made at any time, without the need to take a deduction. You can choose when to take the deduction, while your money grows. Consider dropping a signing bonus, severance or inheritance into your RRSP.

### Planning withdrawals

Great tax efficiency requires a professional eye on RRSP withdrawals. Consider the following:

- **Withdraw with tax efficiency.** You can split the income from the RRSP/RRIF (subject to age rules) with your spouse in retirement. This helps to reduce the taxes you may owe on withdrawal, and can be an easy way to put capital into your spouse's hands. It is important to talk this over with your advisors first, because both principal and earnings withdrawn from the RRSP are added to income on your tax return upon withdrawal in retirement. While there are many ways to reduce these taxes, this is a consideration you need to manage against all the 'pros' the RRSP has to offer.

**Some excellent tax withdrawal exceptions apply.** A special feature of the RRSP helps homeowners find new capital for their home purchase, tax free. It's known as the RRSP Home Buyers' Plan.

### THE RRSP HOME BUYERS' PLAN

The Home Buyers' Plan allows first-time home buyers (or those who have not owned a home in the current year or preceding four years) to withdraw, on a tax-free basis, up to \$25,000 of funds saved within their RRSP for the purpose of buying or building a home. Provided certain conditions are met, no tax will be withheld on such withdrawals. The withdrawals may be a single amount or you may make a series of withdrawals throughout the year as long as the total does not exceed \$25,000. In order to qualify, you must intend to occupy the qualifying home as a principal residence.

You can also make tax-free withdrawals from an RRSP for the purpose of building or purchasing a compatible home to meet the needs of a disabled person. If the home is for the use of a disabled person, the requirement that you be a first-time buyer is not applicable. This may be important for baby boomers who need to move from a two-storey to a one-storey home, for example, because of a health vulnerability in the family.

## Repaying your RRSP

You must repay the funds back into the RRSP, over a period not exceeding 15 years, beginning in the second calendar year after the withdrawal. Amounts due and not repaid are included in your taxable income in the year they are due. It is important to refer to your most recent Notice of Assessment (NOA) to confirm the amount to be repaid each year.

You and your spouse or common-law partner may each participate in the plan and together withdraw up to \$25,000 from your respective RRSPs to a maximum of \$50,000.

A qualifying home is a housing unit located in Canada. This includes existing homes and those being constructed. Single-family homes, semi-detached homes, townhouses, mobile homes, condominium units, and apartments in duplexes, triplexes, fourplexes or apartment buildings all qualify. A share in a co-operative housing corporation that entitles you to possess, and gives you an equity interest in, a housing unit located in Canada also qualifies.

If you contribute funds to your RRSP in the 90-day period prior to making a withdrawal and any of the deposit amounts are withdrawn, you may not claim an RRSP deduction for the amount of the contribution that you withdrew.

With your advisor's help you should carefully consider whether other capital is available to contribute to your home down-payment, particularly if that capital is not benefitting from the tax-deferred environment that earnings enjoy within the RRSP. If that is the case, it may be best to leave the RRSP undisturbed, despite the advantages of the Home Buyers' Plan, to continue its pure growth.

## Sound Choices: RRSP or home ownership?

When you compare the pros and cons of ownership in a principal residence with the advantages of investing in an RRSP, several factors should be considered:

**1. Mortgage reduction, at expense of RRSP earnings:** Ask your tax and financial advisor to help you do the math in both the short-term and the longer-term. In general, giving up the RRSP opportunity in favour of mortgage reduction only limits your opportunity to leverage tax advantages.

**2. RRSP contribution first, mortgage reduction second:** The RRSP can provide tax reductions to fund mortgage payments and tax deferral benefits to save for your retirement. Together with the added opportunity to withdraw some RRSP capital tax free for home purchases under the Home Buyers' Plan, the RRSP provides an excellent investment strategy. The best use of money for most people is to make the RRSP contribution in the first place, and then use the refund wisely to pay down non-deductible debt.

**3. RRSP Pro:** The RRSP is an investment made in larger pre-tax contributions, because of the a tax deduction, whereas a home is purchased with after-tax money, you have to buy it with smaller tax-paid dollars, unless you take advantage of the RRSP Home Buyer's Plan.

- **Watch the costs:** The annual management fee of an RRSP account invested in mutual funds may average several percentage points, and can make up 20% to 50% of the annual rate of return. By comparison, the long-term 'gross rate of return' of residential real estate in Canada is approximately 4% to 5% per year.<sup>1</sup> However, when you take into account mortgage costs, insurance, utilities, taxes and maintenance, the net rate of return is closer to 1% per year.<sup>1</sup>

- **Home pro:** The growth in home equity will be tax free for principal residence; the growth in the RRSP will be subject to taxation, eventually, on withdrawal.

- **Home con:** If liquidity is important, home ownership can be an obstacle. Being forced to sell at a non-deductible loss can seriously erode net worth.

It would appear that the RRSP, in most cases, is at least as important an investment as home ownership.

## The Right Home, Plan The Right Retirement

By purchasing the right size of home over a shorter period of time, two outcomes occur:

**1.** Debt repayment and interest costs on the mortgage debt can be better managed to reduce costs. Be aware that the interest component of a large monthly mortgage payment, on a 25- to 30-year amortized loan, can make up 75% or more of the total payment in the early years. Unless the property is appreciating significantly, that's a big cost, with compounding time working in the favour of the lender. Using the RRSP Home Buyer's Plan to shrink the debt up front, can be extremely beneficial.

<sup>1</sup> Source: Royal LePage

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2. More money is available to maximize RRSP contributions, thereby reducing taxes now, deferring tax on income and securing retirement income. Together with the tax-exempt gain from the successful sale of an appreciated home, the two investments together can be negatively correlated: when one is typically rising in value, while the other may not be. Net family worth will increase over time, while risks are managed.

The RRSP, in most cases, is at least as important an investment as home ownership. Rely on your financial advisor to help you make Sound Choices.

### ACTION PLAN: RRSP and home ownership working in tandem

The benefits of contributing to an RRSP are not just for the tax savvy and retirement saver. The RRSP is a valuable investment for home buyers, too. To maximize the growth of equity in home ownership and growth from RRSP investments consider the following action plan:

**1. Before buying a home, set some limits:** Understand the impact of home ownership on your non-discretionary spending and plan to pay down your mortgage quickly by structuring some options. For example, you may wish to reduce your interest costs by choosing a shorter amortization period. You may also wish to shop around to find a more advantageous interest rate and lock it in for as long as possible, or pay your mortgage twice a month instead of just once a month to pay down mortgage principal faster and save interest costs. These approaches will help to protect you against rising interest rates. You may also find new money for discretionary spending; like making RRSP contributions.

**2. Consider the benefits of the Home Buyer's Plan.** Your tax free withdrawal from your RRSP can help you make your new mortgage more manageable (or qualify for one in the first place, given requirements to have a larger down payment).

**3. Use your tax refund to pay down the mortgage:** This will give you some breathing room in the event that interest rates rise.

**4. Strengthen your balance sheet.** This 'combo' approach will give you some flexibility in restructuring your debt. Your lender will look more favourably to your request for more money when you can show the RRSP asset as part of your net worth, particularly if your home value has dropped or stagnated while your RRSP value has increased over time.

### Summary

Build more wealth exponentially with your RRSP and home ownership investments. When the two are structured to complement each other, you can enjoy more peace of mind.



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