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ACCOUNTING, TAXATION, BUSINESS VALUATIONS & GENERAL BUSINESS CONSULTING

Contribute to your RRSP or Pay Down Your Debt? The Age-Old Question Explored

Christopher J. Alexander
CA•CBV

Every January and February, its next to impossible to miss the ads from financial institutions telling you why you should contribute to your RRSP. Beware though– financial institutions probably don't have your best interests at heart and have an incentive to encourage you to contribute to your RRSP. Don't get me wrong- making annual contributions to your RRSP (and saving for retirement in general), is very important. In some situations, however, you may be better off paying down debt with surplus cash instead of making that RRSP contribution. Below I have outlined some examples to help clarify the issue and highlight situations when you may be better off paying down debt.

Example 1:

Lets start with an easy example. When an individual has 'Bad' debt, in almost all cases, the individual is better off paying down the debt. Accept it if you will, debt is a part of life. There are, however, 'Good' types of debt and 'Bad' types of debt. An example of a 'Good' type of debt would be a mortgage. I'm sure you can guess an example of a 'Bad' type of debt. I'll give you a couple hints. You carry it in your wallet and you paid for last year's vacation with it (as it turns out, you are still paying for last year's vacation). You guessed right, the credit card. That is an example of 'Bad' debt. If you carry a balance on your credit card, there is a good chance you are paying interest in excess of 15%. In this situation, you are almost always better off paying down your 'Bad' debt balances before contributing to an RRSP. Your interest costs on this debt will by far outweigh the potential tax savings and tax-free compounding of investment income you may achieve by contributing to your RRSP. As a general rule, any debt that you have where the interest rate is more than 10%, it should be considered 'Bad' debt and you should focus on paying it off before contributing to an RRSP.

Example 2:

In the next example, assume we have two individuals (Mr. A and Mrs. B), both with a $100,000 mortgage with an interest rate of 7.5% and a 30% marginal tax rate.

Mr. A is paying $1,187 per month to pay off his mortgage in 10 years, then will continue to pay $1,187 per month into his RRSP for the next 15 years after his mortgage is paid off, plus the tax savings from his RRSP contributions ($356 per month).

Mrs. B on the other hand is paying $739 per month to pay off her mortgage in 25 years. She is also contributing $448 per month into her RRSP for 25 years (her RRSP contribution is the difference between Mr. A's and Mrs. B's monthly mortgage payment so that they are each paying the exact same per month over the 25 years, albeit to different sources), plus the tax savings from her RRSP contributions ($134 per month).

Depending on the investment returns earned on their RRSPs, each individual's RRSPs would be worth the following after 25 years:

Individual	Return of 5%	Return of 7.5%	Return of 10%
Mr. A	**$ 400,000**	**$ 485,000**	$ 595,000
Mrs. B	$ 335,000	$ 480,000	**$ 695,000**

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CJA Professional Services Limited

1309 Woodgrove Place

Oakville ON L6M 1V5

905-334-6674

chris@cjaps.ca

www.cjaps.ca

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Its fairly clear from the table on page 1 that *it depends* on what an individual earns on their RRSP whether they should contribute to their RRSP or pay down debt. In the scenario with a 10% return on her RRSP, Mrs. B's strategy of contributing to her RRSP instead of paying off debt is the clear winner. The question is though, is a return of 10% a reasonable rate of return for her RRSP? If this was a real life scenario, chances are Mrs. B's portfolio would have taken a significant hit in 2008 which would impact the results noted above as it assumes a **consistent return of 10%**. On the other hand, paying down a mortgage with an interest rate of 7.5% is the same as earning a **guaranteed** pre-tax rate of return of about 11%. I don't know about you, but a **guaranteed** rate of return of 11% sounds pretty good to me!

Example 3:

In our final example, similar to Example 2, assume we have two individuals (Mrs. C and Mr. D), both with a $100,000 mortgage at 4.5% and both have a marginal tax rate of 45%.

Mrs. C is paying $1,036 per month to pay off her mortgage in 10 years, then will continue to pay $1,036 per month into her RRSP for the next 15 years after her mortgage is paid off, plus the tax savings from her RRSP contributions ($466 per month).

Mr. D on the other hand is paying $556 per month to pay off his mortgage in 25 years. He is also contributing $480 per month into his RRSP for 25 years (his RRSP contribution is the difference between Mrs. C's and Mr. D's monthly mortgage payment so that they are each paying the exact same per month over the 25 years, albeit to different sources), plus the tax savings from his RRSP contributions ($216 per month).

Depending on the investment returns earned on their RRSPs, each individual's RRSPs would be worth the following after 25 years:

Individual	Return of 5%	Return of 7.5%	Return of 10%
Mrs. C	$ 390,000	$ 475,000	$ 580,000
Mr. D	**$ 400,000**	**$ 570,000**	**$ 830,000**

In this example, with a low mortgage rate (typical for today's rates) and a high marginal tax rate (individuals with employment income in excess of $100,000), even a 5% return on an RRSP (which is a realistic, but conservative return), an individual would be better off contributing to their RRSP. As the rate of return for the RRSP increases, the benefits of contributing to an RRSP vs. paying off debt become even greater.

As mentioned at the start of this article, every person has a unique situation. There are numerous online calculators available that can calculate which option might suit your particular situation best. Additionally, your accountant or financial advisor should be able to assist you with the calculation.

While the numbers are rather telling, there are also qualitative factors to consider. Some individuals like the idea of being mortgage free sooner at the expense of saving for retirement. I typically advise my clients to consider both options by making regular contributions to your RRSP and then using the tax savings generated from those contributions to pay down mortgage principal. It really comes down to personal preference. Which ever option will allow you to sleep most comfortably at night is probably the best one for you.

If you would like to look at your particular situation and develop a plan, please contact Chris Alexander at chris@cjaps.ca or 905-334-6674.

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About the Author:

Recognized in 2009 as one of the "Top CA's Under 40" in Ontario, Chris is a Chartered Accountant and Chartered Business Valuator with more than nine years of finance and accounting experience working with organizations that have ranged from large publicly listed NYSE and TSX companies to small owner-managed businesses and individuals.

Chris earned his Chartered Accountant designation while working for Deloitte & Touche LLP in Toronto. In 2009, he was recognized by the Institute of Chartered Accountants of Ontario as being one of the "Top CA's Under 40" in Ontario, being a recipient of the ICAO's prestigious Award of Distinction.

Chris earned his Chartered Business Valuator designation while working for a boutique business valuation firm in Toronto. He is recognized by the Canadian Institute of Chartered Accountants as being a specialist in the field of business valuations.

Chris is involved in the training of new CA students as a seminar leader at the ICAO's School of Accountancy. Chris has previously marked the practice and end of school exams for the School of Accountancy.

Chris also teaches part-time at the School of Business and Economics at Wilfrid Laurier University.

Chris is a board member and the Assistant Treasurer of the Oakville Parent-Child Centre, a charitable organization in Oakville focused on supporting, nurturing and empowering families, children and their caregivers.