Business and Finance

Don't wait until house is paid off before starting RRSPs

Many of my clients face a dilemma during their peak earning years.

They know they should maximize their RRSP's, but they are also highly motivated to repay their mortgage.

I tell them not to wait until the house is totally paid off before starting their RRSPs.

You will lose so many years of potential savings, it will be virtually impossible to catch up.

Let me prove this with the following example.

*Bill Jones (not his real name) is 30 years old and is in the 40 per cent tax bracket.

He has a $150,000 mortgage, which he's repaying at $1,170 monthly, based on a 25-year amortization period and eight per cent interest. He is able to save $3,500 annually, and opts to put this entire sum into his mortgage. He plans to start contributing to his RRSP once his house is paid off.

*Mary Smith starts off in the exact same position. She too is 30, and her $150,000 mortgage has the same terms and repayment schedule as Bill's.

But she opts to put her annual savings of $3,500 into her RRSP instead of prepaying her mortgage.

In her 40 per cent tax bracket, this RRSP contribution entitles her to a $1,400 tax refund, which she does put against her mortgage. Over the years, her RRSP return averages 12 per cent annually.

Here's how their decisions play out over time.

Bill will pay down his mortgage in 16 years.

Because he didn't get a deduction for RRSP contributions over that 16-year period, he will have paid $22,400 in taxes that Mary voided. At age 46, he is finally ready to start his RRSP: he will replace his monthly $1,170 mortgage repayment with a monthly $1,170 RRSP contribution, which will maximize his annual contribution.

At this point in time, Mary is also 46. She owes almost $47,000 on her house and is four years away from discharging her mortgage. Her RRSP has grown to almost $170,000. She plans to continue her annual $3,500 RRSP contribution for the next four years, and continue applying her $1,400 tax refund against her mortgage. At that point, she too will replace her $1,170 monthly mortgage repayment with a monthly $1,170 RRSP contribution.

Now let's see where they're at when they turn 65. Both of them have paid-off homes of equivalent value.

But Bill's RRSP is worth about $765,000, while Mary has a plan worth almost $3.5 million.

Mary's 16-year jump-start has paid off with almost three million dollars more in her pocket.

For most people Mary's strategy is the ideal answer to the mortgage or RRSP question.

A well-diversified RRSP portfolio could provide earnings considerably higher than the advantage of pre-paying your mortgage.

However, there are shades of grey in any scenario. If you accelerate your mortgage repayment schedule and, housing prices really take off, for instance, you could enjoy a real financial windfall.

Consider this: those who opt to postpone their RRSP contributions assume that the government will stick to today's RRSP rules.

But what the tax man gives, the tax man can take away. A new government could choose to lower the RRSP limits, or repeal today's carry-forward provisions. If you've postponed RRSP contributions until your mortgage is completely paid off, you'll be out of luck, and further away from retirement security than ever.

This article was submitted by Richard Box, financial advisor with TD Evergreen Investment Services.