This One Debt Trick Can Help Lower Your Tax Bill and Increase Your Refund

Description

Every year, from January 1 to March 1, Canadians have one last chance to contribute the maximum to their RRSP and count it against last year's taxable income.

But for some Canadians, socking away a hefty sum in their RRSP just isn't possible, no matter how much it could save them on taxes.

Enter—the RRSP loan. To help you contribute the maximum to your RRSP, some banks will let you borrow money. The loan comes with an interest rate, but as counterintuitive as it sounds, the amount you save on taxes could save you more than the loan costs you.

Should you take on debt to fill your RRSP? Let's take a closer look.

When should you take out an RRSP loan?

An RRSP loan usually only makes sense for high-income earning Canadians. As such, you're in a high tax bracket, and the RRSP loan can help you lower your tax liability.

This is especially true when your income is tied to debt or other financial obligations, preventing you from making RRSP contributions throughout the year. In this way, borrowing money to contribute to your RRSP could result in a bigger tax refund, one that can help you pay down your RRSP loan.

For example, let's say you live in Ontario, and you make $120,000, putting you in a high tax bracket of 43.41%. The tax refund you get from RRSP contributions is calculated using your marginal tax rate. So, if you took out a $10,000 RRSP loan, you could get around $4,341 back, almost half the loan. Of course, this is only an estimate (everyone's tax situation is different), but it shows you just how useful this loan can be.

Another reason to take out an RRSP is to take advantage of low borrowing rates. Right now, loan rates are still fairly low. Though the rate you receive depends ultimately on your credit score and credit utilization, you could still snag a fairly low rate. If you then invested your loan into stocks or funds that yielded an annual average of 3% or more, you could end up earning more on investments than you pay in interest.

When doesn't it make sense?

Again, RRSP loans usually make sense for high-income Canadians. I wouldn't take out an RRSP loan if you're already in a low tax bracket, as doing so might not result in a higher tax refund.

For Canadians who are trying to increase their retirement savings, an RRSP loan might make sense, no matter your income bracket. But it could fail in one important way: investing a lump sum in your RRSP might not be the smartest idea, especially if you plan to invest it in stocks.

In general, lump-sum investing involves a high level of risk. True, you could choose your stocks wisely and dump that money in market-beating investments. At the same time, market volatility could tank your stock choices, resulting in a loss. If you're betting that your stock choices will outpace your loan's interest rate, watching your stock fall in value will be disheartening.

A better approach is dollar-cost averaging. Instead of investing all your money at once, you invest portions of it periodically. For instance, if you have $10,000, you could buy $10,000 of stocks today (lump-sum investing). Or, you could buy $1,000 of stocks every month for the next 10 months (dollar-cost averaging). In this way, you spread your money across time, which could help you buy stocks when prices are low as well as earn money when stock values are high.

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Date
2025/08/13
Date Created
2022/02/18

Author
sporrello