Things to Consider before Withdrawing Funds from Your RRSP

Money withdrawn from an RRSP not only reduces the number of dollars building your retirement fund, but also can create a substantial tax liability.

For most taxpayers RRSP savings will be needed to supplement income from the Canada Pension Plan and Old Age Security. Managing your RRSP to maximize the principal through capital gains and reinvested interest and dividends should be a number one priority for taxpayers. Naturally, life circumstances change and individuals may feel the need to “borrow” from their RRSP.
Although funds can be withdrawn from an RRSP at any time, a taxpayer weighing that option should consider the following:

Withdrawal of Funds Will Trigger a Tax Deduction

Withdrawal of funds will trigger a deduction for federal income tax:

- 10% (5% in Quebec) on any amount withdrawn up to and including $5,000;
- 20% (10% in Quebec) on amounts over $5,000 up to and including $15,000; and
- 30% (15% in Quebec) on amounts over $15,000.

In addition to the federal tax deducted at source Quebec withholds a provincial tax.

The gross amount withdrawn is added to income in the year of withdrawal and a credit is received for the tax deducted at source. If the withdrawal will move you into a higher tax bracket, you should consider whether the tax cost is worth it. A review of this year's taxable income plus a look forward to next year's potential taxable income may suggest that splitting the withdrawal between two years may be beneficial. Not only could the actual amount of tax withheld at the source be less, but, more importantly, the effect on your overall tax liability for the 2010 tax year may be less if you stay within the lower tax bracket. The lower tax bracket will mean you will have more useable cash.

Withdrawals Can Be Very Expensive

Withdrawal of RRSP funds will have a definite impact on your retirement nest egg. For example, if your goal at the age of 45 is to retire at 65 and your existing RRSP is $200,000 with a return on investment of 4%, a cash withdrawal of $20,000 on your 45th birthday will cost you $44,452 in lost interest over those 20 years. Extrapolate that amount until the age of 70 and the lost retirement income approximates $142,689. Sobering to say the least.

You should review your RRSP contribution room before withdrawing RRSP funds. If you contributed your maximum eligible amount, you will not be able to replace the $20,000 by simply writing a cheque to pay back the withdrawal. The only means you have of "putting the loan back" is by making up your undercontribution. Thus, if your contribution room is insignificant, the ability to earn tax-deferred RRSP investment income will be lost forever.

A Withdrawal Plus Unemployment Equals a Double Whammy

Future earned income should also be considered before withdrawing RRSP funds. Under current tax law if you earn no benefits under a Registered Pension Plan or a Deferred Profit Sharing Plan, your maximum deduction will be the unused RRSP deduction room carried forward from previous years plus the lesser of $21,000 or 18% of your previous year's earned income. If, however, you have no contribution room and were unemployed during 2009 but fully employed in 2010, you will not be able to make contributions in 2010 to offset taxable income as there was no income in 2009 when you were unemployed.

Thus, you would pay more income tax in 2010 than a taxpayer who was gainfully employed in 2009 and had carried forward RRSP contribution room. The result is that not only would you pay tax on the withdrawn funds at the time of withdrawal, but you would also pay more tax on the income earned in 2010 because you would have no eligible contribution amount from 2009 and no unused contribution room carried forward from previous years.

Just because you turn 71 in 2010 does not mean you cannot make RRSP contributions. You can still deduct the contributions made in 2010 against your earned income up to the RRSP deduction limit. And, although taxpayers turning 72 in 2010 can no longer contribute to their own plan, as long as they continue to have earned income, they can continue to make contributions to their spouse's plan provided the spouse has not attained the age of 72 in 2010.

Really Borrowing (Rather than Withdrawing) from Your RRSP

Your RRSP can lend you funds if it takes back a mortgage against real estate you hold, such as your residence. One of the catches, however, is that the RRSP must obtain mortgage insurance for such non-arm's length mortgages. If the mortgage is a second mortgage, both the first and second mortgages must be insured. Generally, the amount you borrow from the RRSP must be large enough to make this an economical proposition.

Take Care before Withdrawing from a Spousal RRSP

An interesting twist on RRSP contributions occurs when the contributor (the registrant) to an RRSP makes a contribution to a spouse's plan. Naturally, the contributor is entitled to deduct the amount contributed in computing income. But what happens if the spouse withdraws the contribution within days of the contributor's deposit to the spouse's plan? Normally, the owner of the plan is required to claim the income from any RRSP plan, but the Income Tax Act (ITA) 146(8.3) contains an income attribution provision of which both parties to this type of transaction should be aware.

If a withdrawal is made from a spousal RRSP and the registrant's spouse or common-law partner has made a contribution to the plan, either in the current year or in the two preceding calendar years, the withdrawal will be taxed to the contributing spouse or common-law partner, not the registrant of the plan.

Fortunately this ITA attribution rule applies to withdrawals only to the extent of the relevant contribution. Tax on any excess withdrawals is the burden of the individual withdrawing the funds. If the contributing spouse made the contribution but has not yet deducted the spousal contribution, the attribution rule applies. As well, even if the recipient spouse has not made any RRSP contributions to his/her plan, the ITA requires the original contribution to be taxed in the hands of the contributor.

The good news is that the ITA does not kick in if the contributing taxpayer and spouse or common-law partner are living apart due to a marital breakdown at the time of the withdrawal.

Take Care before Contributing to a Spousal RRSP

Given that the contributor cannot control what happens to RRSP contributions once they are in the recipient's RRSP, consideration should be given to the impact of contributing to an RRSP if there is any possibility of marital breakdown.

The Case of the RRIF

Any RRSP holder who will turn 71 in the year should generally acquire a Registered Retirement Income Fund (RRIF) unless, of course, they wish to withdraw some or all of their RRSP. In that case they would create a considerable tax liability since the withdrawal would be considered income. Although the rollover from an RRSP to a RRIF does provide deferred tax benefits, RRIF regulations require that a specified percentage of the fair market value of the RRIF assets must be withdrawn each year commencing with the year that the annuitant turns 72. At 71, this percentage is 7.38 and rises to 8.99 percent at age 81, and 14.73 percent at age 91. At age 94, the amount of withdrawal is 20 percent of the fair market value and remains at that level until the registrant dies.

If the holder of a RRIF is married or living common law, it is possible to irrevocably elect to use a spouse's age to calculate the minimum RRIF withdrawal. This could have significant tax advantages if the spouse is younger since the lower minimum amount provides the ability to defer the tax effect of the withdrawals.

Special Considerations for Withdrawals

There are special considerations for withdrawals for the Home Buyers' Plan (HBP) and Lifelong Learning Plan (LLP) that are not covered in this article. Taxpayers interested in the tax impact and conditions attached to these types of withdrawals from their RRSPs should contact their Chartered Accountant for guidance.

Think Twice before Deciding

Borrowing from your RRSP for personal needs, to purchase a home, or to further your education is certainly an individual choice. However, before making that choice review the long-term impact of such a decision and determine whether short-term personal or financial gains outweigh the long-term benefits of maintaining an asset that will provide tax deferred income growth and security for you and your spouse in your sunset years. ■