The trappings of tapping into your RRSP

Know the implications before you take from your retirement plan

I've had a lot of customers ask whether they should take money out of their RRSP (Registered Retirement Savings Plan) to pay down debt or other expenses.

And why not? Their retirement investments may be earning very little or even declining in value while the banks get rich on interest on loans and credit card debt.

If you're thinking about tapping into your RRSP while you're still working, remember why you put the money in there in the first place.

It's probably the best vehicle you have to reduce your tax obligation and maximize your long-term savings.

The amount you contribute can be deducted from your earned income, and any income from investments in your RRSP will compound tax-free.

By the time you retire, you'll probably be in a lower tax bracket than you are now, when you're working. Funds withdrawn at that time will be taxed at a lower rate.

Early withdrawals

If you take out funds from your RRSP for anything other than retirement, to pay post-secondary education expenses for you or your spouse, or to buy your first home, three things will happen:

1. You'll pay an immediate withholding tax of 10% on withdrawals up to $5,000; 20% on withdrawals of $5,001 to $15,000; and 30% when the amount exceeds $15,000 (in Quebec, the tax is 21%, 26%, and 31%, respectively).

2. The amount you take out will be added to your taxable income. So you'll not only pay more tax, the withdrawal amount may bump you into a higher income tax bracket.

3. The withdrawal amount is not added back to your unused contribution room.

Once you take money out of the RRSP, you can't put that sum back in.

However, there are a couple of special situations where the RRSP withdrawal rules differ.

Spousal RRSPs

One situation involves a spousal RRSP. This is an RRSP account that you have contributed to on behalf of your spouse or common-law partner.

Spousal RRSPs have a "three-year attribution" rule. This rule is designed to prevent a high-income spouse from contributing to a spousal plan and having the funds almost immediately withdrawn and taxed to the lower-income-earning spouse.

If you contribute to your spouse's RRSP, and he or she makes a withdrawal within three calendar years of your last contribution, the withdrawal is treated as income on your personal tax return.

If the withdrawal is made more than three years after the contribution, the withdrawal is treated as income on your spouse's tax return.

The important thing to note is that the three years are based on calendar years. If your last contribution was made in December 2011, any withdrawal is taxable as your income until January 2014.

Just because your spouse's name is on the account doesn't guarantee you will not be paying the tax.

Home-buyers plan

Of course, long-term planning does not always mean retirement. Under the Home Buyers Plan (HBP), you can take up to $25,000 out of an RRSP without having to pay taxes on the funds if you are buying your first home.

If you buy a home with your spouse or another person you can both withdraw up to $25,000.

The plan can also be used to buy a home for a relative who is disabled, although the conditions are slightly different.

Starting two years after your withdrawal, you get 15 years to repay the money to your RRSPs without incurring taxes.

If you don't pay back the required amount in any year, then it is considered taxable income for that year. You can pay back at a faster rate if you wish.

The repayments do not affect your RRSP contribution limit for a given year.

If you need to take money out of your RRSP before you retire, talk to an experienced accountant about whether it's the right move for you. (It may be).

Better still, that advisor can help you plan for times when cash is tight without having to deal with the consequences of tapping into your RRSP. □

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