Why withdrawing early from RRSPs to pay down debt can lead to ‘regret’

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By Deanne Gage
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Clients need to think about other ways of putting money aside when they run into financial difficulties, an expert says.

When clients face a financial crunch, some hastily tap into their registered retirement savings plans (RRSPs) to get by without considering the consequences.

Withdrawing from an RRSP before retirement means paying more taxes. Specifically, it means they pay a 10 per cent withholding tax if they withdraw up to $5,000, 20 per cent for withdrawing $5,001 to $15,000, and all the way to 30 per cent for withdrawals of more than $15,000.

Plus, any withdrawal is tacked onto their annual income, potentially pushing the client into a higher tax bracket come tax time, says Lana Gilbertson, senior vice president and licensed insolvency trustee at MNP Ltd. in Vancouver.

"They also permanently lose their contribution room as what they take out of an RRSP can't be put back," she explains. "And, of course, there's the loss of all the [investment] growth they may see over time."

Clients need to think about other ways of putting money aside when they run into financial difficulties, she adds.

Steve Bridge, an advice-only certified financial planner (CFP) at Money Coaches Canada in Vancouver, says some prospects have come to him for a consult after they've already made the RRSP withdrawal.

"It's a bit like closing the gate after the horse has bolted," he says of dealing with these client cases. "You do your best with what's left [of their assets]. The obvious advice is for them to stop taking money from their RRSP and do some cash flow planning."

He says investors need to understand the purpose of RRSPs better. The account is for their future long-term plans, not short-term emergency expenses. The tax-free savings account, for example, is better suited for short-term withdrawals as there are no withdrawal taxes or penalties, save for waiting until the following year to recontribute the withdrawn amount, he says.

Another option for parents may be looking at the contributions to their kids' registered education savings plan (RESP). While not ideal, a parent could withdraw from their principal contributions without penalty assuming their child is enrolled in a post-secondary institution for at least 13 weeks if full-time and five weeks if part-time, Mr. Bridge says.

"The Canada education savings grant is taxed in the child's hands and the parent contributions are not taxed at all, so it might be a decent option, depending on the situation," he adds.

'RRSP contributions at all costs?'

But Cindy Marques, chief executive officer and CFP at Money MakeCents Inc. in Toronto, notes that it's extremely rare for a parent to even consider going that route.

"I have found they would rather get into their retirement money before getting into the children's education money even though there's no penalty for doing so," she says. "I think it's a good thing. It's the mindset of it being the kid's money and being a provider for your child."

As Ms. Marques investigates solutions for clients, she says their lack of financial literacy on the subject is partially the fault of some overzealous advisors who emphasize RRSP contributions at all costs for every client.

She has had new clients come to her with significant RRSP assets, but also possess "endless monthly cash flow deficits" because they feel embarrassed about asking their previous advisor, more often than not a product salesperson, to lower their contributions or stop them altogether.

"Some advisors won't take the time to complete comprehensive budgets or cash flow reports to assess the situation – essentially blaming the client for spending too much," she says.

"But in reality, the recommendations provided by their previous advisor are not based on feasibility within their budget. RRSPs are great and saving is important, but there are other avenues to invest that can provide greater flexibility and liquidity."

Other clients have used RRSP savings for making lump sum repayments on large, out-of-control credit card debts, Ms. Marques adds.

"In those situations, there's a history of perpetual indebtedness to the point that credit card balances are in the five-digit range and regular monthly payments just barely scratch the surface after interest charges," she says.

But Ms. Gilbertson of MNP says using registered assets to pay off creditors is a mistake as the plans are creditor proof, so off limits. While clients want to do the right thing and pay down debt by any means they can, "there is often a fair amount of regret" when they don't know the options before making the best decision.

Instead, Ms. Gilbertson says if a client cannot meet creditor obligations, they should consult a licensed insolvency expert for further insight about how to proceed.