Why Canadians should avoid tapping into their RRSPs when they're in a financial crunch

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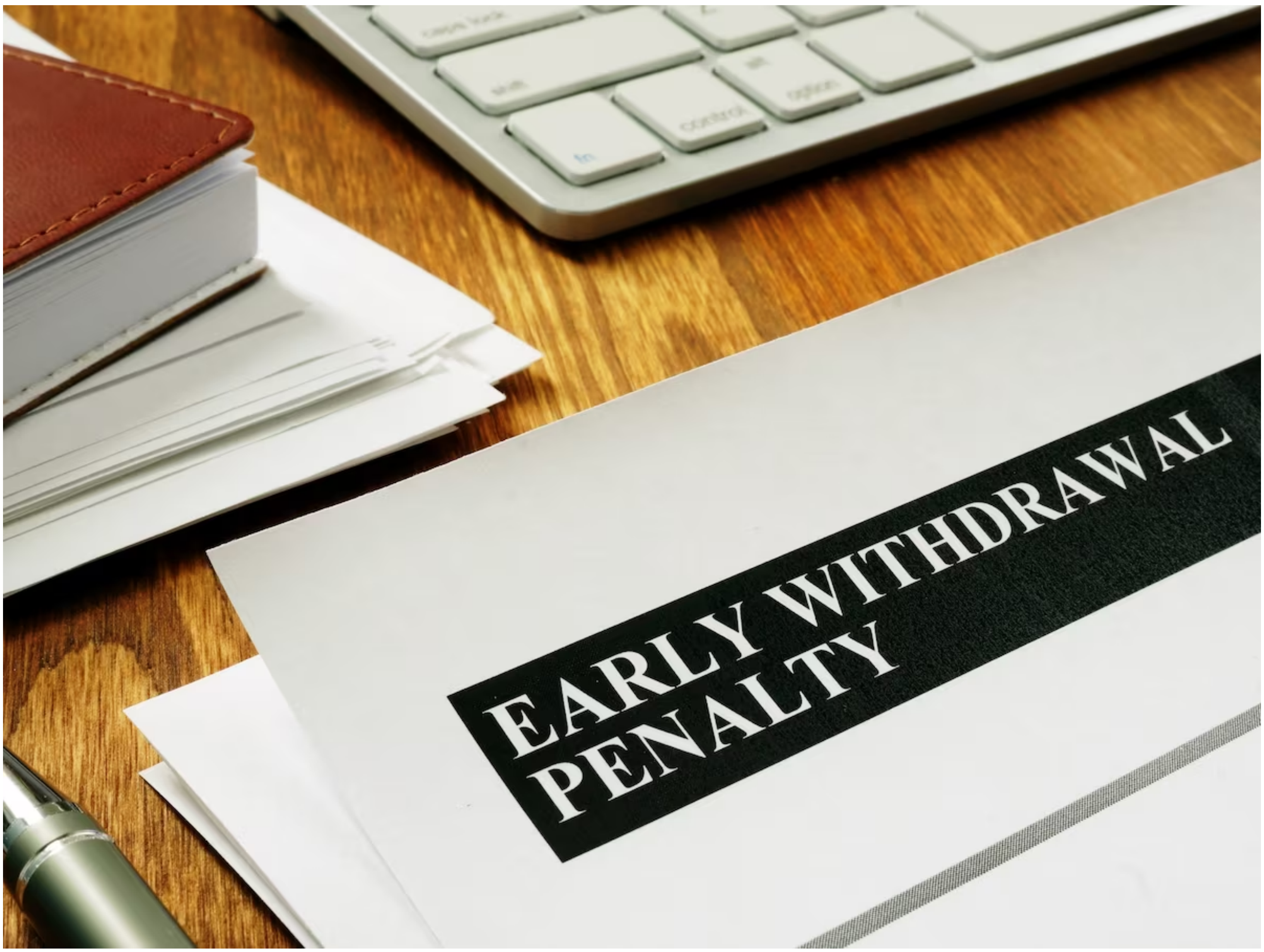

Some Canadians choose to tap into their RRSPs in the case of a financial emergency.

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With the rising cost of living, some Canadians may be eyeing their retirement savings as a way to help ease the financial pressure in the short term. In turn, financial advisors with clients looking to make an early withdrawal from their registered retirement savings plans (RRSPs) need to ensure they understand the implications.

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Matt Morrish, certified financial planner (CFP) at BlueShore Financial in Vancouver, began to see inquiries from clients last year about withdrawing their savings intended for another purpose, including those in their RRSPs. He says the questions are coming primarily from younger families concerned about larger mortgages and higher expenses who have exhausted other resources.

"People sort of managed through the higher rate environment," he says. "Now that [the environment has] lingered, their flexibility has really started to diminish."

According to Fidelity Investment Canada's 2023 Retirement Report, 11 per cent of survey participants who have advisors reduced their retirement savings to meet other expenses. For individuals without advisors, the percentage of affected people more than triples to 34 per cent.

Early withdrawal implications

A big risk of using an RRSP as an emergency fund is individuals are taking an asset away from their retirement savings. Taxation is another major concern. To start, RRSP withdrawals are subject to a withholding tax of 5 to 30 per cent, depending on the amount withdrawn and in which province the client resides.

As Hannah McVean, CFP at Objective Financial Partners Inc. in Squamish, B.C. explains, RRSP withdrawals are also considered taxable income, taxed at the individual's marginal rate in the year they're withdrawn. For clients who are employed, this likely increases their marginal tax rate – the opposite of how RRSPs are intended to work.

"You get a lot less in hand. That's a surprise to a lot of people," says Ms. McVean, who meets with clients virtually across Canada, and has also noticed a rising trend of inquiries about early RRSP withdrawals to pay off debt or cover expenses.

Individuals making early withdrawals also lose the RRSP contribution room permanently of the amount they're taking out of the plan – and forego the opportunity for compounding growth.

Ultimately, she says, if an RRSP withdrawal increases annual income, it could also affect eligibility for certain income-tested benefits.

Getting in front of the decision

For Kristen Pedersen, CFP and money coach at Money Coaches Canada Inc. in Vancouver, talking through the decision with clients is key, as is helping them examine their purpose for wanting to tap into their retirement funds.

"People don't think about the tax implications and they just want to have that security," she says. "That's why I like getting in front of the clients and we look at things from a goals perspective."

For some clients, Ms. Pedersen notes an early investment withdrawal may make sense as a short-term solution in a year during which there has been a dramatic drop in income because of a job loss, for example.

At the same time, these individuals also need to consider their longer-term plans before making an early RRSP withdrawal, including examining other areas in which they may be able to cut expenses.

"[We] look at those items first before we start tapping into an RRSP," Ms. Pedersen says.

Rebuilding an RRSP after withdrawal

While many clients who have made an early RRSP withdrawal are keen to start recontributing once they're able to do so, Ms. McVean says other actions need to happen first or they're at risk of repeating the situation. For example, clients should put cash savings into an emergency account. If a similar situation presents itself again, they can withdraw the money from that emergency account instead.

Besides an emergency fund, ensuring clients have adequate insurance will safeguard retirement savings in the case of future income disruptions due to death or disability, Mr. Morrish adds.

"Creating that safety net is an important way of protecting your assets that are set up for another goal," he says.

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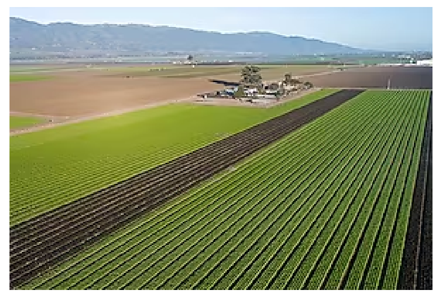

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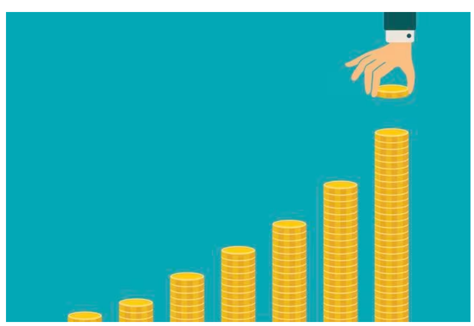

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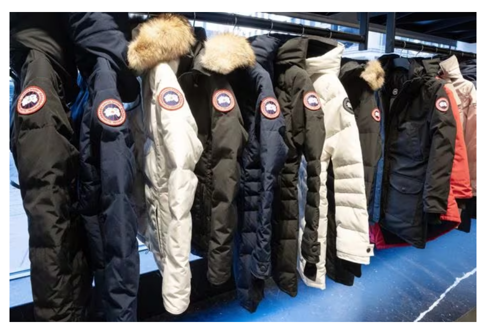

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