Ron Graham and Associates
100, 10585 - 111 Street ,Edmonton, Alberta T5H 3E8
Telephone (780) 429-6775 Facsimile (780) 424-0004
rgraham@rgafinancial.com

What's Best...
Pay Off My Mortgage Or Contribute To An RRSP?

One of the more difficult financial decisions an individual must make is whether to contribute money to an RRSP or use that money to pay down their mortgage. Both have significant financial benefits. A payment against the mortgage will reduce the total amount of interest paid and pay the mortgage off sooner. On the other hand, the RRSP contribution will grow to create an income at retirement.

One way of determining which option is better is to calculate the interest savings on the mortgage and compare it to the tax savings and investment earnings of the RRSP.

Example #1: let's say you have a mortgage of $100,000 at 6% that will be paid for over the next 25 years. You can also contribute to an RRSP and invest in a term deposit paying 4%. You are in the third tax bracket so any tax deductions are worth 36% in tax savings.

If you pay an extra $1,000 against the mortgage, your interest savings would be ($1,000 X 6% X 25 years).	$1,500
If you contribute $1,000 to your RRSP, your tax savings would be ($1,000 X 36%)	$360
your interest earnings would be ($1,000 X 4% X 25 years)	$1,000
for a total of	$1,360

In this example, paying down the mortgage is the better option.

You may ask "What about the taxes on the RRSP?" Yes, there are taxes to be paid but the tax payment may be 30, 40 or 50 years from now. But the value of those future tax dollars is very small today.

"What about the size of the mortgage, does that matter?" Generally not. The size of the mortgage is only important if the lump sum payment is more than 10% of the mortgage. If it is more than 10% then the number of years of interest savings would be reduced.

Example #2: let's say you have a mortgage of $70,000 at 6% that will be paid off in 15 years. You are in the second tax bracket so any tax deductions are worth 32% in tax savings and can get a 4% return on you RRSP investment.

If you pay an extra $1,000 against the mortgage, your interest savings would be ($1,000 X 6% X 15 years).	$900
A $1,000 RRSP contribution is worth	$320
in tax savings and	$600
($1,000 X 4% X 15 years)	
for a total of	<u>$920</u>

In this example, making your RRSP contribution makes slightly more sense.

Example #3: let's assume you have a mortgage of $50,000 at 6% with 10 years to go. You can get a 4% return on your RRSP but you are in the lower tax bracket so that your RRSP contribution is worth 26% in tax savings.

An extra payment of $1,000 against the mortgage is worth ($1,000 X 8% X 10 years).	$600
The $1,000 RRSP contribution is worth a total of ($1,000 X 26% + $1,000 X 4% X 10 years).	$660

In this example, the RRSP contribution is slightly better.

Can we make any rules of thumb from these examples?

It would seem that:

* If you are in the second or higher tax bracket, RRSP contributions are better if you have 15 years or less to go on your mortgage.
* If you are in the lower tax bracket, mortgage payments are better unless you have less than 10 years to go on your mortgage.
* If you are receiving an equal or better return in your RRSP as what you are paying on your mortgage, then the RRSP contribution is best.

Apart from the above conclusions, the best scenario is to set up the mortgage repayment monthly or biweekly initially for 15 years, then make maximum RRSP contributions before making any extra payments against the mortgage. Once you are making your maximum RRSP contribution, then you can use the tax refund to pay down the mortgage.