HOLDING A MORTGAGE IN YOUR SELF-DIRECTED RRSP

If an individual has a self-directed RRSP, he or she can choose to invest in their own mortgage through their RRSP. In essence the RRSP holds a mortgage investment (receivable).

Who is eligible?

The following criteria must be met, for the individual to hold his own mortgage in his self-directed RRSP:

1. The individual must have a **self-directed RRSP**
2. The self-directed RRSP must have **sufficient assets** to fund the mortgage
3. The mortgage must be used by the individual to purchase a **real-property located in Canada**

What is the theory behind this?

- From a big picture point of view, your RRSP has lent you money, you make interest payments to your RRSP at the normal market rates for mortgages
- If you are an investor who holds low risk fixed income securities like GIC's in your self-directed RRSP, in the long run you can generate more interest income in your RRSP by holding your mortgage in your RRSP. This is because mortgage interest rates are usually higher than investments like GIC's.

How it works?

1. Take out a mortgage loan from your self-directed RRSP
    - Note, there are no tax consequences of this because the mortgage is an investment in your self-directed RRSP
2. You make mortgage payments to your self-directed RRSP (this includes both principal and interest) instead of a bank
    - These are not considered RRSP contributions; therefore, you do not get a deduction for tax purposes, nor does it decrease your contribution room
3. The interest payments that you make to your self-directed RRSP can be re-invested in other investments to generate additional income

Numerical Example:

Suppose you have two people:

1. **John** has $500,000 invested in a 10 year GIC at 2% compounded per annum; John doesn't know about holding a mortgage in his RRSP. John buys a home and takes out a $500,000 mortgage, 20 years, interest payable 5% annually.

2. **Mike** on the other hand, had $500,000 of liquid assets in his self-directed RRSP, he then uses these funds to take out a mortgage from his self-directed RRSP to fund the purchase of a home. The mortgage terms are as follows: $500,000 principal, 20 years, interest payable 5% annually.

In 10 years who is better off?

John's payments and income:

Earnings from GIC in RRSP	$ 109, 500
Mortgage Interest Paid to the Bank	$ 211,000
Mortgage Principal Paid	$ 190,200

Mike's payments and income

Earnings from GIC	$ 109, 500
Mortgage Interest Paid to his own RRSP	$ 211,000
Mortgage Principal Paid	$ 190,200
Fees Paid to set up self-directed RRSP Mortgage	$ 25,000

Starting Point:

- Both Mike and John each had **$500,000** in their respective RRSP accounts
- Mike decided to hold his mortgage in his RRSP
- John decided to take a mortgage out with his bank, while his funds in the RRSP were invested in long-term GIC's

Cash outflows:

- Mike made a total of **$211,000** in interest payments and **190,200** in principal payments to his own RRSP
- John made a total of **$211,000** in interest payments and **190,200** in principal payments to his Bank
    - Therefore, both of them had the same cash outflows (before fees)

Interest Income:

- Mike has $211,000 in "interest income" in his self-directed RRSP;
- John has $109,500 in "interest income" in his RRSP (from low risk/ fxd. income investments)
    - There is a **net benefit for mike** = 211,000-109,500 = $101,500

Fees:

- Mike paid an additional $25,000 in fees to set up this financing structure
- John paid no fees

Conclusion:

- Mike earned $ 101,500 more in interest income and paid $25,000 in legal fees; he is better off than John by $ 101,500 – 25,000 = $76,500
- Furthermore, Mike's higher interest income can be re-invested in other assets to generate additional second generation income. All else equal, Mike may have more money when he retires.
    - Mike is paying off his mortgage and saving for the future at a better rate than John!

Is this ideal for every one?

Holding your own mortgage in your RRSP, is not for everyone. There are advantages of such structure; however, with these advantages also come many disadvantages. Some of these are highlighted below.

Advantages:

- **More income in RRSP:** As our numerical example shows because mortgages have higher interest than low-risk fixed income investments such as GIC's; in theory you will have more money in your RRSP for retirement
- **Second Generation Income:** You can re-invest these mortgage interest in your RRSP to generate additional income. This growth is tax sheltered, and moreover it does not eat up your contribution limit!

Disadvantages

- **Fees**: The fees are high for holding a mortgage in your self-directed RRSP
    - **Fees include**:
        - Application Fee
        - Appraisal Fee
        - Mortgage Insurance
        - Legal Fees
        - Mortgage Administration Fee

    - **All non-arm's length** mortgages made through your self-directed RRSP must be insured by CMHC or GE Capital Mortgage Insurance Canada
    - This insurance protects your self-directed RRSP in the event you default
    - Mortgage insurance makes up a significant amount of the fees

- **Need Liquid Assets in RRSP :** You need to have liquid assets in your self-directed RRSP; if not you would need to pay penalties and fees to liquidate your non-liquid assets.

- **Potential Lack of Diversification:** The bulk of your self-directed RRSP is tied up in the mortgage. Mortgage is a fixed income investment and it may not meet your investment goals if your aim is to hold more equity investments.