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What to do with the tax refund?

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All that tax-planning work is now paying off and your client's rebate cheque is likely in the mail. The issue now is what to do with it. A popular answer is to pay off the mortgage.

BMO Financial has released some statistics that make a strong case for paying down the mortgage before doing anything else with the tax refund. According to John Turner, director of mortgage sales for BMO, a \$1,400 investment now at the beginning of a 25-year mortgage could save a client as much as \$38,000 in future interest payments.

"Typically with a mortgage amortized over 25 years, if we use the simple example of \$200,000 at a 6% fixed rate, the interest accumulated over that amortization period would be \$184,000," Turner says. "According to Revenue Canada, the average income tax refund this year is \$1,400. If that's applied to the mortgage, it will save about \$38,000 in interest costs over the life of the mortgage, and at the same time reduce amortization."

Debt reduction is obviously not an investment return; still, there are few investments that guarantee to put that type of money in a client's pocket. A refund could also be deployed to pay down higher interest debts on loans or credit cards, but Turner notes the amortization period of the mortgage makes it highly compelling to pay off as early as possible — even if it means carrying higher-interest debt on other things.

"Loans and credit cards tend to have the highest interest rates, but those amortizations are shorter," he says. "Depending on how the payment situation is, it may make more sense to put it towards the mortgage because of the amortization. In terms of total interest costs, right at the beginning of the mortgage is the best time to pay it down, because the sooner you can pay down the mortgage or increase your payment, clearly the more interest you'll save over the life of the mortgage."

David Phipps, a CFP and senior financial advisor with Assante in Ottawa, says debt-repayment should factor high on deployment of the refund, but he generally believes higher-interest debt should be tackled first.

"Sometimes these things are so obvious you kind of feel like an idiot even mentioning them, but I would say an excellent use of tax refund is to reduce debt. You should start with the debt that has the highest interest rate," he says. "It doesn't make sense to put the money against the mortgage if you have \$1,000 debt on your credit card that never gets paid off."

Phipps stresses it's important to consider the specific circumstances of the client before definitively deciding to pay off the debt first.

"Assuming they have RRSP contribution room and assuming a reasonable rate of return in the RRSP, they are probably better to take that money and put it in their RRSP because so many Canadians have not fully used their contribution room," he says. "If you've got somebody who has fully maxed out their RRSP room, the next best thing to do with it is to pay down some debt. If a person has significant RRSP contribution room and if the contributions are reducing tax at a high marginal tax rate it makes sense to put money in the RRSP rather than pay down debt."

Phipps determines which type of debt to pay off first by considering whether it's tax-deductible or not. A home equity line of credit being redeployed for investment purposes would not rank as high as a traditional mortgage where the interest is non-tax-deductible.

"You shrink your liabilities in the following order: non-tax-deductible debt at the highest interest rate, non-tax-deductible at the lowest interest rate and finally tax-deductible debt," he says. "Home equity line of credit they borrowed to purchase an investment so that the

interest is tax-deductible is not the first place you've got to pay it down, because having tax deductible debt alters the after-tax cost of the loan."

Fellow Ottawa-based CFP Diane Koven says there is no surefire answer as to whether it's better to invest the refund or pay down debt. She tends to favour the latter purely for the reason that it gives her clients peace of mind.

"There is no way to know what is better until you're looking back from years ahead, from when you did the calculations. You can't really know in advance what is going to be better in a dollars and cents way," she says. "Usually it turns out that there is not a tremendous difference or none at all. The main thing that tips the scale is the psychological aspect. Paying down the mortgage makes people feel more secure."

Koven attempts to bridge the two schools of thought by insisting her clients maximize their RRSP contributions and then use the income tax refund to pay down the mortgage.

"When you get the refund, you'll contribute to the mortgage. It feels good. You can sleep easier when you've done it. It no longer becomes an either/or situation. You've accomplished both, you're taking care of the future from both angles and you don't really feel like you're second-guessing yourself," she says.

Peter Ficek, a Calgary-based CFP, agrees that psychology factors heavily into the decision to use the refund against the mortgage.

"When it comes to paying down the mortgage versus RRSP decisions, most people reduce their planning to the flip of a coin," he says. "If the decision is to pay down the mortgage on a principal residence, people think the decision is a personal one and view it in a qualitative context, as in 'would they sleep better at night with a paid-down mortgage or with a retirement pension?'"

Ficek says because of the emotional nature of the decision, this is a classic situation where the objective advice of a financial planner is needed.

"Seek out a qualified planner and sit down and go over the quantitative and qualitative issues rather than just doing the flip of the coin," he says. "A mortgage broker is going to tell you to pay down the mortgage and an RRSP salesman is going to tell you to pay down the RRSP. A financial planner is going to make a decision by looking at the client's goals and objectives."

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