

## Self-Directed Mortgages

Addison and Brook Jones have been pre-approved for a \$100,000 mortgage on an investment property, charging 5% interest for a 5-year term. They have heard that it is possible to hold their own mortgage within one of their self-directed Retirement Savings Plans (RSPs) and would like to explore the possibility.

### So, what exactly is a mortgage held within a self-directed RSP? How does it work, and what are the factors to be considered from a planning perspective?

An RSP or Retirement Income Fund (RIF) can be used to hold or refinance a mortgage on commercial or residential Canadian real estate.

With a self-directed mortgage, the RSP or RIF becomes the mortgage holder. Since cash is needed to arrange for a self-directed mortgage, there must be sufficient liquid assets in the RSP or RIF for the annuitant to cover the amount of the mortgage loan. The annuitant may need to sell securities to ensure they have sufficient cash on hand in the RSP or RIF.

The rate of return earned on the amount loaned will be equivalent to current mortgage rates.

Income Tax Act Regulations (ITAR) permit both “arm’s length” and “non-arm’s length” mortgages as qualified investments in an RSP or an RIF. However, the rules differ depending on whether the mortgage is “arm’s length” or “non-arm’s length”.

An **arm’s length mortgage** is a mortgage that allows RSP or RIF annuitants to use the money from their self-directed RSP/RIF to fund a mortgage to a third party not related to them by blood, marriage or adoption.

A **non-arm’s length mortgage** is a mortgage where the borrower is the annuitant themselves or is related to the annuitant. Persons related to the annuitant include the annuitant’s spouse or common-law partner, a blood relative or a relative through marriage or adoption.

The main difference between holding an arm’s length and a non-arm’s length mortgage is that, in the case of the arm’s length mortgage, there is no requirement to have the mortgage insured.

For a non-arm’s length mortgage to be accepted as a qualified investment in a self-directed RSP or RIF, the mortgage must

- be administered by an approved lender under the National Housing Act (which includes most financial institutions);
- reflect normal commercial practice regarding interest rates and other terms and conditions;
- be insured either by the Canada Mortgage and Housing Corporation or by a private insurer of mortgages. The mortgage insurance requirement ensures that retirement savings are protected in the event the annuitant defaults on the mortgage.\* The insurance fee can be paid as an upfront fee or added to the face value of the mortgage.

*\*If the annuitant is unable to make his or her monthly mortgage payment, the financial institution will place the mortgage in default. It will then attempt to collect the proceeds upon a power of sale of the property or, if insufficient, from the mortgage insurance.*

*Note: If the proceeds from the mortgage are being used to finance investment property, the cost to set up the mortgage as well as the mortgage interest may be considered tax deductible expenses. Canada Revenue Agency (CRA) requires a clear audit trail of the investment and the mortgage.*



### **Can you hold a mortgage within a locked-in plan?**

This depends on the governing jurisdiction of the plan. Ontario, for instance, permits locked-in accounts to hold an owner's personal mortgage provided that money in the locked-in accounts is held in self-directed LIRAs, LIFs or LRIFs.

In addition, effective October 2006, Alberta pension legislation allows the funds of a LIRA or LIF to be invested in the plan owner's personal mortgage or mortgage of a close relative.

BC pension legislation, on the other hand, provides that the funds of a LIRA or LIF cannot invest either directly or indirectly in a mortgage where the mortgagor is the plan owner, the parent, brother, sister or child of the plan owner or the pension partner of any such person.

Therefore, to determine whether a self-directed mortgage can be held within a locked-in plan, it is necessary to check the locked-in plan agreement.

### **Is a self-directed mortgage an appropriate investment for your RSP or RIF?**

An individual's investor profile and goals will determine if a self-directed mortgage is an appropriate investment from a planning perspective. The self-directed mortgage is considered a fixed income investment. Consequently, a mortgage which generally involves a substantial sum of money could outweigh the asset allocation of the RSP or RIF in fixed income and could potentially affect your retirement goals.

### **Example**

Jamie and Sidney Smith are both 46 years old and plan to retire in 16 years. Jamie's investor profile is Income and Moderate Growth (i.e. 55% fixed income, 45% equities) and she has accumulated an RSP worth \$185,000. Sidney's investor profile is Aggressive Growth (i.e. 20% fixed income, 80% equities), and has accumulated an RSP worth \$176,000. Sidney and Jamie are re-financing their \$100,000 mortgage at the going rate of 5% for 5 years through their local bank branch.

Working with their financial advisor, the Smiths consider a mortgage to be held through Jamie's RSP. This

investment would fit within the fixed income portion of her RSP asset allocation, since the mortgage would make up approximately 55% of her RSP; the remaining 45% could be invested in equity funds.

The financial institution will need to arrange for the release of funds from Jamie's RSP and prepare to administer the mortgage investment. Monthly mortgage payments will be paid into Jamie's RSP. This creates a regular source of funds for Jamie to re-invest.

Jamie's advisor should help her utilize this monthly injection of cash by setting up a pre-authorized purchase plan with investments that fit her investor profile.

### **Must the entire mortgage amount be provided by one plan?**

Mortgages can be funded wholly or in part from the annuitant's RSP or RIF. Thus, in the preceding example, if Jamie's RSP was not large enough to fund the entire mortgage, the mortgage could be split between her and Sidney's RSP. Note that if this is the case, an annual fee is usually charged to each RSP or RIF.

It is also possible to use a split mortgage, in which case funds are borrowed from both an RSP and a financial institution.

### **What factors should be considered in deciding whether to set up a mortgage within a self-directed RSP?**

Apart from the effect on asset allocation (previously described) another consideration is the cost of holding a mortgage within a self-directed RSP.

There are both upfront fees and ongoing fees for a mortgage held within a self-directed RSP (see table below). In general, becoming your own mortgagor is probably only worth considering if the mortgage principal is at least in the \$50,000 - \$100,000 range.

Fixed Fees	Ongoing Fees
<ul style="list-style-type: none"> <li>• one-time mortgage set-up fee</li> <li>• lawyer's and disbursement fees</li> <li>• home appraisal fees</li> <li>• mortgage insurance premium - based on a percentage of the principal value of the mortgage (for non-arm's length mortgages)</li> </ul>	<ul style="list-style-type: none"> <li>• annual self-directed RSP/RIF fee</li> <li>• annual mortgage administration fees</li> </ul>

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