

Things to think about during RRSP season and tax time

1. How RRSPs work and their benefits.
2. Are RRSPs a good way to invest? The answer may surprise you.
3. Tips for maximizing the benefit of RRSPs.
4. A strategy to increase your RRSP value using the government's money.

RRSPs - How they work and basic tips

Registered Retirement Savings Plans are a valuable investment tool for most working Canadians.

How RRSPs work:

1. When you put money into your RRSP, you reduce your taxable income by the same amount. So if your marginal tax rate is 43.7% you will reduce your tax owing by \$437 for every \$1,000 you contribute.
2. You pay no tax on the original money and you pay no tax on the growth of your money until you pull it out.
3. When you pull the money out, it is taxed as income.

Some investments that you can invest in an RRSP:

1. Mutual Funds
2. GICs
3. Stocks
4. Bonds
5. Mortgages

Some investments you cannot invest in an RRSP:

1. Gold
2. Shares in private corporations
3. Futures contracts
4. Art, antiques
5. Gems, precious stones
6. Real estate

Some things you may not know:

1. The Federal Government passed a bill making all RRSP contributions (with the exception of the most recent year's contributions) protected from creditors (it's about time).
2. If you are over age 65 and convert your RRSP to a RRIF, you can withdraw \$2,000 per year tax free.
3. If you are retired – and you have more money in your RRIF than your spouse, the government now allows you to split the pension income evenly to reduce your tax bill.

Contribution Limits for RRSPs:

Maximum Contribution room for 2008: \$20,000 or 18% of income (whichever is less)

Maximum Contribution room for 2009: \$21,000 or 18% of income

Maximum Contribution room for 2010: \$22,000 or 18% of income

Are RRSPs a good way to invest? The answer may surprise you.

Because we are financial planners by occupation we are sure that you are expecting a quick yes, however, if we were to look at the numbers this is not necessarily the case. There are situations where it is not smart to put money in an RRSP other than peace of mind.

The purpose of RRSPs is threefold:

1. Reduce tax payable now.
2. Defer paying the tax until later and
3. Reduce the amount of tax that is payable when you need the money.

It is possible that someone may actually increase their taxable income at retirement even though they defer tax now. If there were some non-registered investments that made it possible to defer a large amount of growth similar to an RRSP (but it maintains what I call its identity)

What do I mean by identity? When you pull money out of an RRSP your money always pays out (and is taxed) as income. So all your money, including the growth in an RRSP is taxed as if you earned it in a job. Alternatively, if it is earned outside of an RRSP we can reduce the tax by as much as 50% (capital gains is taxed at half of what income is taxed).

So if you can defer taxation like an RRSP and you will not reduce tax at the time of retirement, you have eliminated the benefit of the RRSP but gained a potential tax rate of 50% less.

Does this make sense for you? If the following situations sound familiar, we should talk.

1. If you are in the lowest tax bracket, RRSPs may not be the best option (less than \$35,000 in income) unless you like the tax money back now and it is the only way you are going to save.
2. If you are near retirement – it may not be wise to continue to do RRSPs. This will depend on the level of your income and how much you have already saved for retirement.
3. You may not be near retirement but have built substantial RRSPs, it may be wise to stop contributing to RRSPs and look for alternative investments that provide other ways of deferring taxes.

For the majority of you, RRSPs are still the best way to invest, but there are times where it may make sense to look at other options. So maybe the purpose of my writing this is to put a small dent into the mythical status RRSPs have been given as being the only way to save for retirement. If you are interested in discussing this further give us a call. 604-542-4298.

Tips to make your RRSP contributions work best for you

1. **Contribute regularly:** Although this may seem like an obvious thing, many people leave their RRSP contribution to the last minute. So all the investment dollars for a year are invested at the same time. This can be good or bad (depending on the market price when invested). Contributing on a regular basis

(bi-weekly or monthly, for example) and doing top-ups when possible smoothes out the effects of the market (especially in the early years).

2. **Maximize contributions to the higher income earner:** I often see couples that are both contributing to RRSPs even though one of the spouses is in a higher tax bracket. In this situation you should contribute to the RRSP of the higher earner and to a spousal plan for the lower income earner until the maximum RRSP room is used up for the higher income earner. This can put a lot more money in your pocket.
3. **Start Early:** The earlier you start, the more money you will have later all as the result of compounding. Below are examples of what it would look like if 4 people at different ages invested \$500/mo until they are 65 at 10% rate of return:
 - a. **Age 20:** \$5,241,250
 - b. **Age 25:** \$3,162,039
 - c. **Age 30:** \$1,898,319
 - d. **Age 40:** \$633,416Quite the difference isn't it.

4. **Understand the power of compounding:** Compounding is what makes your money grow at an accelerated rate. Let me give you an example where you invest \$10,000 (assuming a 10.5% rate of return for simplicity):

Year 1: \$10,000

Year 7: \$20,115

Year 14: \$40,464

Year 21: \$81,396

Year 28: \$163,735

So you put in \$10,000 and someone gives you over \$160,000. Not bad for a day's work. This also re-emphasizes point 3 – start early. The more years you have the more times your money can turn over.

5. **Keep on keeping on:** This was the best way I could put it. I find people get discouraged when the market is down. Keep investing, in the good times and the bad. I recently read an article where a recently retired Peter Lynch, one of the most successful fund managers, commented that although he averaged more than 29% over 13 years he found over ½ of the people in the fund LOST money. How does that happen? Investors left when the fund was low and bought high. Another quote in the article states that “it is during periods of market decline that stocks are returned to their rightful owners”.

Week 4 - Increasing your RRSP Value using the “Government’s” Money

This is it. Over the past three weeks we have taken a close look at using RRSPs as a tool to reach our desired financial freedom. We have looked at who should buy an RRSP, how they work and some useful tips to maximize their benefit. We have also discussed if they really are a good way to build wealth. In our final week, we thought you might like to see how you can squeeze even more benefit out of your RRSPs using the Government’s money (which is our money in the first place that they give back to us).

The basic concept is this. We take cash that we have available and add in a borrowed amount for the time it takes us to make our RRSP contribution and submit our tax return, and come away with more money in our RRSPs and it doesn’t cost us a penny.

Let’s use an example:

1. Joe has \$2,000 that he contributes to his RRSP using an automatic monthly withdrawal.
2. We will assume that he has a 37% marginal tax rate (i.e. he is earning between \$74,357 and \$78,984 per year).
3. If Joe does nothing else he will receive a refund of \$740.00 when he does his tax return.

Alternatively Joe could do this:

1. Joe has \$2,000 that he contributes to his RRSP using an automatic monthly withdrawal.
2. We will assume that he has a 37% marginal tax rate (i.e. he is earning between \$74,357 and \$78,984 per year).
3. Here is where it changes: Joe borrow’s \$1,000 from his line of credit (assume 6.5% interest rate) and puts that \$1,000 into his RRSP.
4. He pays interest for 1 month (\$65). The time it takes for him to get his tax return back
5. His Tax return is now \$1,110.
6. He pays off the line of credit and the interest cost and still has \$45 left over.

The end result:

1. The first instance Joe has \$2,740 in his RRSP
2. In the 2nd instance Joe has \$3,000.

In this example the difference is \$260 (9.5% more than not borrowing the funds). It doesn’t look like much when we are talking about 1 year, but if we continued to do this for 30 years that \$260 works out to more than \$29,453, just by playing with the timing of money.

If you would like to see if this could be an option for you, e-mail us and we can see if this is something that makes sense.

We hope you have found these four weeks helpful and look forward to working with you in 2008.