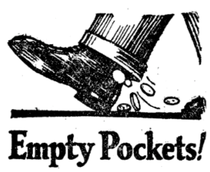
# Twins!

## *Managing God's Money Quarterly Letter*

### *February 2004 RRSP Edition*

**The Context**




**R**ecently the Bank of Canada responded to a sluggish Canadian economy by cutting interest rates from 2.75% to 2.5%. Rates are the lowest they have been for decades and are likely to remain low for at least a couple years. One major unknown, however, is the possible impact of Federal elections expected this spring.

Further, in the fourth quarter of 2003 the recovering US economy grew at 4%, which is lower than anticipated. US rates are also expected to remain at historic lows and the current differential between both countries' interest rates will probably remain and contribute to a strong Canadian dollar—around the present level of US$ 0.75.

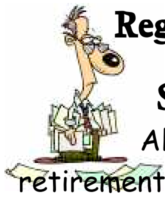
Meanwhile, Canadian and US stock markets continued their recovery during 2003 and the Dow Jones Industrial Index closed the year above 10,000, where it is today. Though the market outlook for 2004 is bullish, I have not seen a broad increase in earnings to support many high valuations. Certainly, euphoria is returning to financial markets!

High and increasing levels of consumer debt in Canadian and US households, and of course, the massive, growing US deficit will create quite a challenge for both economies to be robust in 2004.

According to a recent Ipsos-Reid survey for Bank of Nova Scotia, in 2003, Canadian household debt rose by 18 per cent from $56,700 in 1999 to $66,900. Fifty five percent of respondents expect to use the same amount of credit in the future although 50 percent said they'd be in trouble if someone in the household became unemployed. Sixty two percent said the idea of being in debt frightened them.

Watch out! Don't get carried away by greed as happened only recently when many chased high stock prices that inevitably collapsed and wiped out retirement savings.

Let's examine a significant vehicle that many Canadians use to save for retirement, Registered Retirement Savings Plans (RRSPs):



## Registered Retirement Savings Plans

Surely now is not the time to purchase RRSPs for 2003 tax deduction! Already you should have determined and have started implementing your retirement plans. However, for those who delayed and are tempted by aggressive and seductive advertising to buy RRSPs now, here are some ideas to ponder and to discuss with your financial adviser. As usual, before investing, which is what you do with your RRSP contribution, ensure you understand all your options.

Keep in mind the essence of an RRSP—merely a savings plan registered with Canada Customs and Revenue Agency to produce retirement income. Essentially, it's tax-deferred savings for retirement income—not savings for down payment on a home or for emergencies! More importantly, however, you should manage it as one segment of an overall retirement plan. You must close your RRSP in the year you turn 69 based on prescribed options.

The annual limit is fixed. For 2003 the *Notice of Assessment or Notice of Reassessment* you received after your 2002 tax return was processed shows this maximum value: 18% of earned income in 2002 to a maximum of $13,500, subject to various adjustments. This will increase to $14,500 in 2004 and $15,500 in 2005.

The deadline for contributing for 2003 tax deduction is midnight, March 1, 2004. Visit Canada Customs and Revenue Agency's web site at www.ccra.gc.ca, or call 1-800-959-2221 to get their publication *"RRSPs and Other Registered Plans for Retirement 2003"* for more information.

## The Benefits

Benefits are huge if you are patient and informed, and the RRSP is managed in the context of an overall strategy with which you are actively involved. Here are a few:

1. Allowable **contributions are deductible from earned income for tax** purposes at your option. You may contribute in one year but not claim the tax deduction until subsequently: maybe you have a low tax rate in year one and choose to take the deduction later at a higher tax rate!
2. If you contribute less than your maximum in one year, you may **carry the shortfall into subsequent years** without limitation.
3. **Investments grow tax free within the RRSP account** but are taxed when withdrawn, supposedly at a lower tax rate.
4. **Income earned in your RRSP account accumulates tax-free** on your gross deposit until withdrawn. Imagine your RRSP as containing two streams, both earning income: your net cost and *the re-invested tax refund!*

5. You may **contribute to a spousal RRSP** provided you have contribution room. The benefit here arises if your income is higher than the income of your spouse, and you expect it to remain higher. The RRSP becomes your spouse's. In theory, she or he will withdraw funds in the future at a lower tax rate than you. Get to know the rules.

I don't consider the Home Buyers' Plan and the Lifelong Learning Plan as benefits. Your RRSP is for retirement and you should develop alternatives, such as the Capital Fund[i], to save for education and for a down payment on a home. If you don't have the down payment or education funds, examine your total budget—spending and savings— then set goals and develop appropriate plans.

Here is an example to demonstrate some benefits, from page 167 *of Managing God's Money-The Basics*[ii]:

| | | |
|---|---|---|
| 1) Earned income | $50,000 | |
| 2) Contribution to company pension plan | $2,500 | |
| 3) Marginal (top) tax rate | 45% | |
| 4) Maximum RRSP contribution | $6,500 | 18% of $50,000 minus $2,500 |
| 5) Tax refund due | $2,925 | 45% of $6,500 |
| 6) Net cost to you | $3,575 | $6500-$2925 |

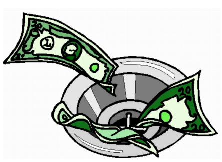
## Comments

- Although net cost in item six is $3,575, investment in the RRSP is $6,500.
- Earnings on $6,500 will not be taxed within this account, and will benefit from compounding.[iii]
- Taxes saved produce an instant return, which could be eliminated if your investments performed poorly. Some folks choose to invest RRSP funds in safe fixed income vehicles to protect the tax benefit.
- When withdrawn, funds from your RRSP will be taxed as ordinary income, even if investments produced capital gains, which presently are taxed at a lower rate.

## Possible Decision Path

Because of the benefits mentioned above, it would appear that everyone should maximize his or her contribution every year! However, as we saw earlier, an RRSP is merely one aspect of retirement planning which must fit your overall retirement goals and plans. Remember, the ultimate decision is yours. Pray and ask the Lord to guide you in this matter. Couples, ensure you get on the same page. Reflect on and discuss this process with your adviser before contributing to RRSPs:

1. **Goals and Plans:** Annually, review retirement **goals and plan,** specifically for proposed timing of retirement, estimated value of other pension plans, projected net worth[iv], **and size of retirement budget gap[v], if any.** Identifying this **gap** is essential because this is what you will be attempting to "fill" with your RRSP and other investments.
2. **Holistic Approach:** Despite pressure from media and sales people, don't consider your RRSP decision in isolation! Especially, don't decide based **solely on the tax benefit**. If you don't have a plan, start now to plan your retirement, including a plan to become debt free before starting RRSP contributions—you are never too young!
3. **Consumer and Mortgage Loans:**
   a. **Don't borrow to contribute:** if you need to borrow, you probably will not have funds to repay the loan amount in excess of your tax refund. In our example above, a deposit of $6,500 will produce a tax refund of only $ 2,925; **how will you repay the balance of $3575 not covered by the refund?**
   b. If you are in debt, you need to understand the **pre-tax cost of each debt** relative to potential income from investment[vi].
   c. **Eliminating debt produces a guaranteed saving** of interest that you pay, usually from after tax earnings: If you repaid a $10,000 debt with a pre tax interest cost of 30%, which is the after tax cost of a department store credit card, you would save $ 3,000 in **ONE YEAR—guaranteed!** Indeed, even at a lower interest cost, you should consider debt repayment because of the certain interest saving, compared with an RRSP investment. Remember also the emotional and family cost of carrying debt!



   d. Should you **repay your mortgage** before starting an RRSP? If you have a mortgage of $ 100,000 at 6% repayable over 25 years, you will pay around $500 per month in interest in the initial years. The table below shows the assured investment return by putting annual lump sums toward your mortgage:

| Mortgage $ 100,000 | No Prepayments | Prepay $1000 per year | Prepay $3000 per year |
|---|---|---|---|
| **Interest paid** | $92,000 | $69,600 | $48,000 |
| **Interest saved** | 0 | $22,400 | $44,000 |
| **Repayment period** | **25 years** | **19.7 years** | **14 years** |

Consider debt repayment as an investment with a guaranteed return! Don't forget that interest rates are at historic lows and will increase. Therefore, your debt repayment costs will rise! Further, your **age and timing of retirement** should influence how you invest retirement funds after repaying your loans; the closer to retirement, the more secure the investment vehicle.

I could demonstrate mathematically, that if all went well, you'd be "better off" borrowing to contribute to an RRSP! Equally, I could show the awful downside if investments didn't perform! However, I won't go there! I prefer the debt elimination route that produces a certain return!

If you decide to invest in an RRSP, you should consider several specific issues, including these:

1. **Retirement plan: Have you prepared one in writing?** Are you implementing it? If it includes RRSP contributions, start now but **stay invested!**
2. **Costs: Do you understand the charges** levied by Mutual Funds and others? Especially Management Expense Ratios (MER's) that presently are high and often not transparent.
3. **Interest** on an RRSP loan is not tax deductible.
4. **Investments: How much of your portfolio should be inside an RRSP versus outside? Get advice. C**apital gains included in an RRSP withdrawal are taxed as ordinary income.
5. **Self-directed: Are you comfortable with the investing process?** You need to be reasonably informed with investing to choose this option. You don't have to be an expert but you need to know a few questions to ask – see our **Spring 2003 quarterly letter** at www.managinggodsmoney.com
6. **Expectations: Are they realistic?** Your age, risk tolerance, personal and family values will determine where you invest, including taking advantage of the foreign content allowance of 30% of book value. Additionally, be assured that some investments rise and fall—others just keep falling!
7. **Timing of deduction:** You don't have to take the **tax deduction in the same tax year** as your contribution.
8. **Be patient!** *Trust in the Lord with all your heart and lean not on your own understanding in all your ways acknowledge Him and He will make your path straight* - Proverbs 3:5-6.

## Some 2002 RRSP Statistics

*The Daily* of 23 October 2003, issued by Statistics Canada, reported the following facts for 2002 tax year:

1. Both contributors and contributions to RRSPs dropped sharply for the second straight year.
   a. Almost six million taxfilers contributed just

under $27.1 billion to an RRSP in the 2002 tax year.

b. The number of contributors was down 4.0% from 2001, while the amount of contributions fell 4.8%. These declines occurred despite a 2% increase in the number of taxfilers with room, and despite stability in median employment income.

2. Eighty percent of those who filed taxes had contribution room. Of these, about 34% made contributions.
3. The contributions in 2002 represented only about 9% of the total room available to those who filed taxes in 2002, and less than half of the new room that was generated in 2002.
4. The median RRSP contribution in 2002 declined $100 from $2,600 in 2001 to $2,500.

**This letter is for informational purposes only**. Before making any financial decision, consult an independent (fee-only) professional financial adviser.

Managing God's Money Ministries teaches individuals, couples and groups to manage God's resources so they may use them for His Glory and to further His Kingdom. It is not a charity, does not solicit funds, and does not charge fees to present seminars and workshops. Visit www.managinggodsmoney.com for more details.

---

[i] *Michel A. Bell, Managing God's Money-The Basics* (Belleville, Ontario: Essence Publishing) p. 82

[ii] Ibid, p.167.

[iii] If you deposit $100 at 10 percent, at the end of one year it will grow to $ 110. At the end of the second year, both your original $100 and the $10 earned will attract interest: the value at the end of the second year will be $121, of which, $10 earned from your original deposit and $ 1 from income earned in year 1.

[iv] Total assets, which are things of value that you own, minus the total of all your loans.

[v] A retirement budget gap reflects the difference between our estimated retirement income and estimated retirement budget. One key aspect of retirement planning is to decide how to fill this gap! Additional RRSP contribution is only one way to fill the gap.

[vi] Refer our March 2002 Newsletter at www.managinggodsmoney.com.