Twins!

Newsletter of Managing God's Money Ministries

RRSP Edition – February 2003

The Economy

The Canadian economy continued its strong performance in 2002: preliminary numbers show a 3.4% year-on-year increase in GDP, the best among the G-7 countries. Employment growth was the highest since 1987: the solid upward trend at the start of 2002 continued into December, with an increase of 58,000, mostly full-time jobs. For the year, employment rose 3.7%, representing 560,000 jobs[i].

In North America, stock markets fell for the third consecutive year! The market outlook for 2003 is for a bumpy ride. However, the Canadian economy should outpace the G-7 countries again!

Meanwhile, in Canada, household debt including mortgages, as a percent of disposable income continued to rise in 2001. The table below shows a snapshot at the end of 2001:

	Household Debt as % Disposable Income Including Mortgages	Household Debt as % Disposable Income Excluding Mortgages
Canada	113%	42%
British Columbia (highest)	165%	53%
Manitoba (lowest)	78%	35%

I think we should ask ourselves two questions:

- Have low interest rates induced us to buy homes we cannot afford?
- How will we cope when interest rates start to rise?

What does all this mean for Registered Retirement Savings Plans (RRSPs)? The potential to get deeper into debt because of attractive RRSP loans is real! According to Statistics Canada, following record RRSP contributions in tax year 2000, tax year 2001 saw a decline of 3% in contributions and 1% by the number of people contributing[ii]. Because of current stock market conditions and continuing uncertainty with Iraq, forecasters predict a further decline for tax year 2002. Thus, expect aggressive marketing by banks and financial institutions to entice you to buy RRSP products at low interest rates!

Before you buy an RRSP, ensure you understand all alternatives; try to understand how you will repay any loans offered to you! In this letter, I will suggest critical matters you may wish to consider as you decide. However, I encourage you to get independent advice from someone you can trust, before committing to a decision.

In this review I will cover the following areas:

- What is an RRSP
- What are the benefits
- Suggested approach to making the RRSP decision

What Is An RRSP?

It is a savings plan registered with Canada Customs and Revenue Agency to produce retirement income. It is essential that we not forget this purpose! You must close it in the year you turn 69; several closure choices are available.

You should know your maximum allowable deduction for 2002 from the *Notice of Assessment or Notice of Reassessment* the tax authorities sent you after they accepted your 2001 tax return. The general limit is 18% of earned income in 2001 to a maximum of $13,500, subject to various adjustments. The deadline for contributing is midnight, March 3, 2003. You may get more information from Canada Customs and Revenue Agency's web site at www.ccra.gc.ca, and their publication *"RRSPs and Other Registered Plans for Retirement 2002"*; call them at 1-800-959-2221.

What Are The Benefits?

- Your allowable deposits are deductible from your earned income for tax purposes.
- Income earned in your RRSP account increases tax-free on your gross deposit until withdrawn. Think of your RRSP as containing two streams, both earning income: your net cost and the tax refund!
- You may contribute into your RRSP until you turn 69.
- You may contribute to a spousal RRSP provided you have contribution room. The benefit arises if your income is higher than your spouse's, and you expect it to remain higher. The RRSP becomes your spouse's. She or he will withdraw funds in the future at a lower tax rate than you. If you choose to use this benefit, get to know the rules.
- If you contribute less than your maximum in one year, you may carry the shortfall into later years without limit.

I do not 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[iii], to save for education and for a down payment on a home.

Here is a brief example to show the benefits, from page 167 *of Managing God's Money-The Basics*[iv]:

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

Observations

- Although your net cost in item six is $3,575, investment in your RRSP remains at $6,500 and income accrues on this amount.
- You will not pay taxes on income earned within your RRSP account on the $6,500 deposit. Further, this income will compound.[v]
- Taxes saved produce an instant return! However, poor investment performance within the RRSP account would erode these savings.
- When you withdraw funds from your RRSP account, you will pay tax as if that income was "ordinary income", even if your RRSP investments produced "capital gains".
- If you deposited $6,500 outside the RRSP account, you would not receive the tax benefit and the earnings would be taxable.

Suggested Decision Procedure

Because of the major benefits, you might think everyone should maximize his or her contribution every year! However, as we saw earlier, an RRSP is merely one part of retirement planning. Your RRSP must fit your overall goals and plans for retirement. I suggest we adopt this procedure to decide if we will contribute to an RRSP:

- Review your retirement goals and plan, specifically for proposed timing of retirement, estimated value of other pension plans, projected net worth[vi], **and size of retirement budget gap[vii], if any.** Identifying this gap is essential because this is what you will try to "fill" with your RRSP.
- If you do not have goals and plans I suggest you set some now – you are never too young!
- Your age and timing of retirement will also affect where you invest these funds; the closer to retirement, the more secure the investment medium.
- Depending on your earlier answers, you will know the amount you ought to save now. However, this may not necessarily be in the form of an RRSP.
- If you are in debt, you need to understand the pretax cost of each debt compared to the potential income from investment a similar amount[viii].
- Removing debt is a "guaranteed" saving of interest. Repaying a $10,000 debt with a pretax cost of 30% would save $ 3,000 in one year. Note that interest cost after-tax, of your department store credit card is around 30%! Indeed, even at a lower interest cost, you should consider debt repayment over investing, because of the certain interest savings, compared to an RRSP investment. Remember also the emotional and family cost of carrying debt!
- **Do not borrow to contribute:** If you need to borrow, you probably will not have funds to repay the loan amount. Your tax refund will be less than your RRSP contribution. In our example, a deposit of $6,500 will cost you $3,575!
- Do not make your RRSP decision based solely on the tax benefit.

- Despite pressure from media and salespeople, do not look at your RRSP decision by itself! Start now to plan your retirement, including a plan to become debt free, before you start your RRSP contribution!
- You may ask: should I repay my mortgage before starting an RRSP? Yes, I suggest you should repay all interest bearing debt first. Repaying your loans will produce a definite saving of interest expenses!
- If you have a mortgage of $ 100,000 at 6% repayable over 25 years, you will pay around $500 monthly in interest in the early years. Of course, you would be better-off repaying this amount biweekly. However, for our example, let us assume monthly repayment. The table below shows the assured investment return by putting annual lump sums toward your mortgage:

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

Think of debt repayment as an investment with a guaranteed return! Do not forget that interest rates are at historic lows and will increase. Therefore, your debt repayment cost will rise!

I could prove mathematically, that if all went well, you would be "better-off" borrowing to contribute to an RRSP! Equally, I could show the losses if investments did not perform! However, I will not 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 issues, including these:

- **Cost:** Ensure you understand the charges levied, which are not always clear.
- **Self-directed:** You need to be reasonably comfortable with investing to select this alternative.
- **Get advice to understand how much of your portfolio should be inside an RRSP versus outside. Remember, Government taxes all withdrawals from RRSP's as ordinary income.**
- **Interest** on an RRSP loan is not tax deductible.
- **Start now** to contribute to your 2003 RRSP if you have the room and no debt!

Some RRSP Facts

The median[ix] contribution declined in 2000 from $ 2,700 to $2,600 in 2001. For tax year 2001, 83% of tax filers had unused RRSP contribution room. All tax filers used only 9% of available room!

Upcoming Events

- **Seminars**
  - **18 February: Improving Personal Effectiveness seminar** at Snowdon Baptist Church, 5275 avenue, Earnscliffe, Montréal, from 7:00 PM to 10:00 PM. To register call the church at 514-486-9860.
  - **22 February:** Focus on the Family sponsored, **Managing God's Money seminar** at the International Plaza Hotel, 655 Dixon Road, Toronto. To register, call 1-800-579-2059, or visit www.focusonthefamily.ca/mgm.
  - **15 March:** Focus on the Family sponsored, **Managing God's Money seminar, Winnipeg**. Details will be available shortly at www.focusonthefamily.ca/mgm and www.managinggodsmoney.com.

- **TV Appearances**
  - **20 February: Nite Lite Live** on CTS TV.
  - **27 February: 100 Huntley Street** on CTS TV.

For more information on Managing God's Money, visit www.managinggodsmoney.com.

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[i] Statistics Canada

[ii] 6.24 million tax filers contributed just over $ 28.4 billion in 2001 compared to 6.29 tax filers who contributed $ 29.3 billion in 2000.

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

[iv] Ibid, p.167.

[v] 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.

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

[vii] 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 one, but not the only way to fill the gap.

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

[ix] The middle amount if you ranked all contributions from the lowest dollar amount to the highest.