

RRSPs – A Big Bang for Your Buck

By Gail Vaz-Oxlade

The barrage of information on RRSPs has started streaming through the mailbox, over the radio and television, and through the newspapers. With legislative changes and all that has been written about RRSPs, it seems to get harder to figure out where we should be focusing our attention each year — even though RRSPs offer us the biggest bang for our investment dollars.

Are you planning to contribute?

It's amazing how many people don't take advantage of this easy way to defer taxes while saving for the future. Approximately four million people made RRSP contributions in 1990 which represents about 22% of Canadians who filed a tax return in 1990. That means that 14,000,000 didn't contribute. The numbers seesawed up and down over the next decade. Astounding when you think of all the material published emphasizing the benefits of an RRSP. There are lots of reasons people don't contribute. Some people don't see the benefits, so here they are.

Whatever amount you contribute to an RRSP is deducted from your taxable income. That means you'll pay less tax. At a marginal tax rate of 48%, a \$5,000 contribution will mean a reduction of taxes, or a refund, of approximately \$2,400. Where else can you make an investment of \$5,000 and get an immediate return of \$2,400?

Whatever money you have in an RRSP grows on a tax deferred basis. You pay no tax on the interest (dividends or capital gains) earned inside an RRSP. That translates into lots of extra bucks when you retire. A single RRSP contribution of \$8,000 compounding at 9% will be worth almost \$600,000 in 50 years. This leads to another point...

The earlier you start, the longer your RRSP has to compound on a tax-free basis. If you start at 22 and contribute \$2,000 a year for 8 years you'll have contributed \$16,000. At 9%, that will grow to over \$700,000 by the time you're 65. If you wait until 30 to make your first contribution, and you contribute \$2,000 a year until you're 65, you'll have contributed \$72,000, but your RRSP will only be worth \$600,000. Now, would you rather contribute \$16,000 and have \$700,000 at retirement, or contribute \$72,000 to have \$600,000? The point... start early!

Of course, it's never too late to start. Starting later just means you'll have to put away more each year to have enough to maintain your standard of living during retirement. It has been estimated that if you start in your 20's you'll need to put away approximately 6% of your gross income. If you start in your 30's, you'll need to put away between 8 and 10%; in your 40's you'll need to put away between 14% and 20%.

Do you know how much you're entitled to contribute?

If you don't, go back and have a look at the Notice of Assessment sent by Revenue Canada after you filed your last tax return. If you can't find your Notice of Assessment, Revenue Canada has a service that will be in place by late December which will let you call and find out what your limit is.

For 2000, your maximum deduction limit is 18% of your earned income for 1999 or \$13,500, whichever is less, minus your pension adjustment (and/or past service pension adjustment) if you belong to a company pension plan or deferred profit sharing plan.

Remember, if you didn't make your maximum contribution last year, you can top up your plan

this year with the difference. Or, you can continue to carry that contribution room forward (although the sooner you put it in, the soon it can start working to earn a return for you).

Do you have the money to make a contribution?

If you have the money, great. If you don't have the money put aside to make your maximum contribution, you're not alone. With the economy in a shambles, many people haven't been able to save as much as they may have wished.

You can contribute investments you already have to a Self-Directed RRSP and claim a tax deduction. If you have Canada Savings Bonds, term deposits or GICs, qualifying mutual funds or stocks or bonds, open up a Self-Directed plan and contribute your existing investment(s). It's best to put the ones earning interest in your RRSP so they can compound on a tax-deferred basis. Other types of income (i.e., dividend and capital gains) already benefit from preferential tax treatment.

If you don't have investment you can (or want to) contribute to an RRSP, consider borrowing. As long as you are prepared to pay it back within one year, its a good deal. If you choose not to borrow, and you don't have qualifying investments, don't lose heart. You can carry forward your deduction room and catch up your contributions in future years. However, you can't catch up on the compounding of your interest. That's gone for good.

Have you decided what to invest in?

If you haven't decided what to invest in, don't let anyone rush you into a decision. You'll be better off putting your money into a savings account RRSP, and then moving it later when the RRSP crush has abated.

Many people choose to hold interest-bearing investments in their RRSPs. If you're one of those people, you may be looking at the current rates with a sad face. Smile. The fact is, the real return being generated is pretty good. You see, if you take out a GIC at 18% and inflation is running at 16%, your real return is only 2% (18-16). With rates at about 6% and inflation running at under 2%, your real return is about 4%.

If you're trying to decide how long to lock your money up, you'll need a crystal ball to make an accurate prediction. Your best bet is to stagger your maturity dates. If you're contributing \$12,000 to your RRSP this year, you might put \$4,000 in for 1 year, \$4,000 in for 2 years, and \$4,000 in for three years. You'll have some money coming due each year so you can take advantage of increases in rates. If rates don't go up, you'll only have \$4,000 (and your next year's contribution) to worry about next year.

Some people choose to invest in a variety of other alternatives ranging from mutual funds to stocks, bonds, or even their own homes (using a Self-Directed Mortgage). Make sure you know what you're doing. Get plenty of advice. Weigh the cost of those investments in terms of the commissions charged or fees against the expected returns. And keep a keen eye on the economy. While some in the know are predicting great things for the stock market, the uncertainty of the day seems to be making most people pretty cautious.

Are you making a contribution to a spousal RRSP?

If your spouse is not eligible to contribute to an RRSP, consider making a spousal contribution for him or her. Your objective should be for each of you to have a similar amount saved for retirement. If either of you has considerably more, you may not be able to income-split as effectively.

If you're planning to make a spousal contribution, the timing of the contribution is important particularly if you're approaching retirement and plan to take more than the minimum payout from a RRIF. If you make a spousal contribution for 1999 in December 1999 and then no further contributions, withdrawn funds would qualify for taxation in your spouse's hands as early as January 2002 — since no contribution had been made in the year of withdrawal (2002) or the two preceding calendar years (2001, 2000). If you make the contribution for 1999 in February 2000, the earliest your spouse can withdraw funds without them being considered (all or a part of) your income, assuming no other contribution was made, would be January 2003 — since no contribution had been made in the year of withdrawal (2003) or the two preceding calendar years (2002 and 2001). It's better to make contributions to a spousal RRSP during the applicable tax year, rather than in the 60-day grace period that follows.

Do you have children 19 or older for whom you could make an over-contribution?

If your 19+ children don't have earned income, they don't qualify to make a deductible contribution to an RRSP. But they do still have an \$2,000 over-contribution limit. If you contribute that \$2,000, while you won't get a deduction, it'd be a great head-start since the money will grow on a tax deferred basis.

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About Gail Vaz-Oxlade

Gail Vaz-Oxlade has written ten books on personal finance, written hundreds of articles for the financial media, published a financial magazine for women (FinancialXPress), hosted and co-produced a prime-time personal financial television show (Your Money on TVO), and worked with Canada's leading financial services companies to help educate employees and clients.