RRSPs pave the road to retirement

By Jim Middlemiss • Bankrate.com

Twenty-nine per cent of Canadians say they will contribute more money to their Registered Retirement Savings Plan (RRSP) this year than they did last year, according to a survey by Winnipeg-based Investors Group. A further 44 per cent expect to contribute the same amount as they did in 2002, while only 17 per cent expect to invest less.

"The level of enthusiasm for RRSP investment has increased from last year" and those who are "pessimistic" are in retreat, says Debbie Ammeter, vice president of advanced financial planning at Investors Group.

The findings come after four years of a brutal market decline that saw millions of dollars in RRSP assets go up in smoke as mutual funds and stock valuations plummeted. They also come at a time when the federal government is raising the maximum contribution rate to $14,500, up from $13,500 last year.

When it comes to retirement assets, Statistics Canada reports that Canadians had about $1.51 trillion stashed away at the end of the 2001 tax year (the most current available statistics). About 69 per cent of that money was in employer-sponsored pension plans and eight per cent in government pension plans. A further 25 per cent, or $292.5 billion, was held in RRSPs. That's more than double in 1991, when Canadians had $131.8 billion tucked away.

So, what exactly is an RRSP?

An RRSP is simply a tax-deferred savings program established by the federal government, designed to encourage Canadians to save for retirement, explains Frank Zeppieri, a chartered accountant and certified financial planner at the Investment Planning Council of Canada in Thornhill, Ont.

"It's probably the most well-known and safest, simplest tax break, as opposed to complex tax shelter schemes, which tend to be more risky," he says.

Anyone who earns income can contribute to an RRSP. It's not a specific financial product; think of an RRSP as a basket to hold a variety of financial products. The amount you can contribute is based on how much you earn and whether or not you already contribute to an employer pension plan.

The maximum individuals can contribute is $14,500 or 18 per cent of their gross income from the previous year. So those earning more than $80,556 can contribute the maximum, provided they don't already pay into a private pension plan. The maximum contribution rate is scheduled to rise to $15,500 for 2004, $16,500 in 2005 and max out at $18,000 in 2006, Zeppieri explains. The deadline for 2003 contributions is March 1, 2004.

An RRSP has two major effects. First, the contributor gets a tax break and can claim the contribution against income. The amount of the break depends on a person's marginal tax rate.

Second, and more importantly, the money inside the RRSP is sheltered, and the investor doesn't have to pay tax on any of it until the money is withdrawn from the RRSP. "It's a tax deferral," explains Michel Mafitat, a chartered accountant who heads up the financial planning practice at KPMG in Vancouver. Matifat says the theory is that in retirement, investors' income will be lower than it is during their working lives, which puts them in a lower tax bracket so they effectively pay less tax on the money.

There are lots of options for RRSP investments

Matifat says money inside an RRSP can be invested in a wide range of products, including stocks, bonds, mutual funds and guaranteed investment certificates. The investment must be eligible under the Income Tax Act.

There are some restrictions. For example, there are foreign content limitations. Only 30 percent of the funds in an RRSP can be invested in foreign investments. Since Canada accounts for only two to three percent of the global capital markets, it means RRSP contributors must have their assets highly concentrated in Canadian investments.

However, Zeppieri adds there are ways to jack up exposure to foreign investments. A number of mutual fund companies sell clone funds, mutual funds that replicate U.S. or foreign funds using derivatives. This allows investors to skirt the 30-percent limit and garner more exposure to foreign investments. However, Zeppieri notes, the fees for clones funds are higher than traditional mutual funds.

Investors can also jack their foreign content to 51 percent. Take a $100,000 portfolio. First, $30,000 can be used to buy foreign investments. Then with the remaining $70,000 the investor purchases Canadian equity mutual funds that maximize their own 30 percent foreign content allotment. That means $21,000 (30 percent of $70,000) would be invested in foreign content. That plus the $30,000 brings it up to $51,000 or 51 percent.

As well, foreign currency bonds from Canadian issuers qualify as Canadian content even though they are in U.S. dollars or Euros. So theoretically, an investor could use such bonds or bond funds to crank the content up to 100 percent.

RRSPs are under-utilized

While RRSPs can be an appealing investment, they are still under-utilized, experts say. Statistics Canada reports that only about one-third of Canadians invest in an RRSP. As well, Canadians contribute far less than the permissible maximum. The median contribution is only around $2,600, whereas the median Canadian salary would suggest contribution room is closer to $7,000. Fortunately, investors can bank their contribution room if they don't use it. In fact, Canadians have more than $340 billion in unused contribution room and more than 80 percent of Canadians who file taxes have unused room.

Tapping the money in an RRSP

With interest rates at historical lows, Matifat says one way that investors can take advantage of that excess room is through RRSP loans, offered by most financial institutions and many investment firms.

He says it's particularly beneficial for those who are "in the top marginal tax rate or about $100,000 in income," especially if they're facing the deadline and don't have the maximum contribution. They can then use the tax refund to pay down part of the loan. The key to RRSP loans, he says, is to pay them off within a year.

Investors can dip into their RRSP at any time, however, the money they take out must be claimed as income for that tax year. First-time homebuyers may also tap into their RRSP for a down payment on a home, but the money must be repaid within 15 years and the maximum they can take is $20,000.

Ammeter notes that RRSPs can also be used as a form of income splitting among couples through the use of a spousal RRSP. The high-income earner can contribute to a spouse's RRSP and claim the deduction. The money then grows tax-free in the hands of the spouse who has lower income and should be taxed at a lower rate when it's withdrawn.

RRSPs don't last forever. Under the rules, investors can only contribute until the last day of the year in which they turn 69. At that point, they must collapse their RRSP. They may cash it out, which would trigger a huge tax bill, since the money would be included in their tax return as income. To limit that, Zeppieri says the proceeds can be used to purchase an annuity or they can be rolled over into a Registered Retirement Income Fund (RRIF).

Both products will pay investors an income stream in retirement and they will be taxed on the money as it's paid out. Zeppieri says "an annuity will probably pay you a higher monthly income, but once you pass away, you lose your capital. A lot of people don't like the notion of losing their capital," since they want to leave money to a beneficiary, he says.

With a RRIF, the money continues to grow tax-free, but the investor must withdraw a minimum amount each year under a formula based on age and the amount in the plan. Investors pay tax on the money withdrawn, based on their marginal rate. Like an RRSP, they can hold a wide range of investments.

While RRSPs provide investors with a lot of flexibility, they might not be for everyone, warns Zeppieri. "It depends on their income level. If they are in a lower tax bracket, it may not be the best use of their money." That's because the federal government has steadily reduced the capital gains tax, making it attractive to hold equities in an unregistered account. In an RRSP, a capital gain would not be subject to the capital gains tax; rather it's taxed later as income when withdrawn from the RRSP. The amount of tax paid would depend on the investor's marginal rate and that could be higher than the tax they would have paid on a capital gain held outside of an RRSP. "You need to take a good look at whether it's worthwhile."

Jim Middlemiss is a freelance writer based in Toronto. He's a frequent contributor to National Post, Investment Executive and Wall Street and Technology.

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