Making the most of the RRSP

An RRSP is a wonderful opportunity to save for your future, allowing your money to grow on a tax-deferred basis. Plus you get to take an immediate tax reduction at the same time. However, there are a few things you need to know if you want to take full advantage.
To learn more about RRSPs, please click on one of the following topics:

-Why RRSP's are essential to retirement
-Investments you should hold in your RRSP
-Getting more out of your RRSP
-Contribute to an RRSP or pay down the mortgage
-Borrowing to make a contribution
-Turning 69, some things to know
-Retirees can save on taxes

Why RRSPs are essential to retirement

An RRSP is a generous gift for you from the government. In exchange for your willingness to save for your retirement in a registered plan, the government is willing to . . .

Let you deduct your contribution from your taxable income, letting you reduce the taxes you pay each year by as much as $8,000

Let you grow your money in the plan tax-deferred

For these two reasons, an RRSP is one of the most powerful and beneficial financial tools you'll find anywhere. Which is why they are used by just about everyone and for many are the foundation of their retirement income.

Here's how an RRSP works.
The first thing you do is establish your RRSP account at a financial institution or brokerage house. You can then contribute money to your RRSP up to an annual limit. You're then entitled to deduct the amount of your contribution from your gross income. That reduces the tax you have to pay.

For example, if you contribute $5,000 to your RRSP and your tax rate is 40%, you'll save $2,000 in taxes. Or looking at in another way, the $5,000 that you added to your savings only costs you $3,000. However you look at it, it's a great opportunity that you should take advantage of every year.

And here's the second gift the government gives you. All the investments in your RRSP plus all the earnings they generate are allowed to grow tax-deferred. Your investments enjoy compound growth in a tax shelter and that's hard to beat.

Of course, you do have to pay tax on this money eventually, but when you do pay tax, it will likely be at a much lower rate than when you made your contributions. The theory is that you'll be retired, your income will be much lower and you'll pay tax at a lower rate.

If you'd like to know more about setting up an RRSP, click here to find the CPA financial planning professional closest to you.

Investments you should hold in your RRSP

RRSPs fall into 3 general categories when it comes to investments and each has its advantages and disadvantages.
Guaranteed RRSPs – With guaranteed plans such as GICs, the advantage is you know exactly what you're going to get. The disadvantage is it won't be very high. If all of your RRSP savings are in GICs, you run the risk of losing to inflation.

Mutual Fund RRSPs – The second category is mutual funds. Mutual funds come in all types and offer a wide variety of risk and reward combinations, from ultra-conservative to risky, high growth.

By investing in stocks and bonds, mutual funds offer far better returns over the long-run than guaranteed investments. However, they can be volatile and unpredictable and their values are not guaranteed.

Self-directed and broker-directed RRSPs – These are plans you can manage yourself though financial institutions and brokerage firms or that you can have managed for you by the broker.

Their advantage is that they can contain a diversified portfolio of investments designed for minimum risk and maximum returns based on your investment objectives and risk tolerance. It's self-directed so you can be as conservative or aggressive as you like.

Now what. These are 3 different approaches to RRSPs. But you haven't really dealt with the question of what should be in your RRSP. That's because the answer lies in another area of financial planning. We have to look to investment planning to find the answer.

If you'd like to tackle that question yourself, click here and you'll be taken to the section on Investment Planning. If you'd like to get expert help, click here to find the CPA financial planning professional closest to you.

Getting more out of your RRSP

How to get 4% to 8% more from your RRSP
It's simple. Instead of waiting until the end of the year to make your contribution, make it at the beginning of the year.

Here's the result of an annual contribution of $5,000 made in 3 different ways. In each case it's assumed that the annual growth rate is 8%.
$5,000 at end of year for 30 years is worth $566,000
$5,000 in 12 equal installments for 30 years is worth $587,000
$5,000 at beginning of year for 30 years is worth $611,000

Investing monthly gives an extra $21,000. The lump sum at the beginning of the year gives an extra $45,000. So why wait? Get the biggest bang for your dollar by either investing throughout the year or even better, with a lump sum at the beginning.

Contribute to an RRSP or pay down the mortgage?

It's a tough question. One expert says paying down debt is the most important thing. Another says building an RRSP is first priority. Who's right?

The right answer depends on interest rates, mortgage rates, investment returns and your own situation. But putting all that aside, here's a strategy that allows you to satisfy both objectives.

Just make your RRSP contribution and use your tax refund to reduce your mortgage. Let's look at the following example:

Assume you have a $100,000 mortgage, a mortgage interest rate at 8 per cent per annum, and make monthly mortgage payments of $836. You have 20 years until retirement and have $5,000 in savings to invest.
You invest your savings in an RRSP, receive a $2,000 tax refund assuming you are in a 40 per cent tax bracket, and use your tax refund to pay down your mortgage.

Over a twenty-year period, if your $5,000 investment in an RRSP earns an 8 per cent annual rate of return, the investment would be worth $23,305.

With the lump sum payment of $2,000 on the principal amount of your mortgage you have reduced the principal from $100,000 to $98,000, reduced your amortization period by one year, and saved approximately $9,900 in interest. Your combined savings of $23,305 in your RRSP and interest savings of $9,900 total approximately $33,205.

This is based on a one-time contribution. Do this every year and you'll build an RRSP and at the same time, reduce the principal, the amortization and the interest on your mortgage.

Is this strategy right for you? You can find out by clicking here to find the CPA financial planning professional closest to you.

Borrowing to make a contribution

What do you do when the deadline for contributing is near and you don't have the money? Usually it does make sense to borrow.

As a rule, if you can repay your RRSP loan within one year, borrowing is a wise strategy. Your cost will be the interest you paid for one year. Your gain will be one year of tax-deferred growth, which should far outweigh the cost of borrowing.

And if you know you're getting a tax refund, you can fully leverage the benefit of this strategy and reduce the cost of borrowing by applying your tax refund directly to your outstanding loan principal.

If you'd like to find out how you can make or maximize your RRSP contribution by using a loan or a Line-of-Credit, click here to find the CPA financial planning professional closest to you.

Or if you'd like to read more on borrowing to invest in general, click here to go to How to leverage your money to invest more profitably.

Keep in mind that if you don't contribute in one year, you can carry forward your unused contribution to a future year when cash may be more easily available.

Also, an alternative to borrowing is making a contribution "in kind" to your RRSP using GICs, mutual funds, bonds or equities, mortgages or other eligible assets.

You should also know that when you borrow to invest in a non-registered investment, the interest costs are potentially a tax-deductible expense. However, borrowing to make an RRSP contribution is not.

Turning 69, some things to know

When you turn 69, the government has decided that your financial life should switch from the wealth accumulation stage to the wealth distribution stage.

So, by December 31st of the year you turn 69, the rules say you have to terminate your RRSPs. And you have three options as to what you can do with your savings:

1. You can just take the money you've accumulated in one lump sum. Of course, you'll have to pay tax on that lump sum income, which rather defeats the purpose of having the RRSP in the first place. Unless your RRSP is extremely small, this is generally not a good option.
2. Your second option is to convert your RRSP into a RIF, a Registered Retirement Income Fund. And that's easy to do. It's simply a transfer of the assets you had in your RRSP to your RIF, where they will continue to grow tax-deferred.

In a sense, your new RIF is an extension of your old RRSP. You'll have the same flexibility in managing your assets – you can have a self-directed RIF – and as with the RRSP, when you take money or assets out, you'll be taxed at your current rate. You can also have more than one RIF.

The difference is that the RRSP was designed for saving while the RIF is for providing an income. In fact, you are required to take out a certain minimum amount from your RIF each year.

The rules that apply to self-directed RRIFs are generally the same as those for RRSPs with one major exception:

In general, a RIF can only hold assets that are transferred from existing registered savings or pension plans. As stated above, a RIF is simply a transfer of assets. Although it would be nice to take advantage of the tax-deferred growth in the RIF, you can't simply buy investments and register them in your RIF.

3. Your third option is to use the funds in your RRSP to purchase an annuity. This strategy is discussed in the section, One form of income you can count on.

Special tips for your 69th year
-Be sure to top up your RRSP. Make your final year's RRSP contribution as large as the rules will allow. And remember, you don't have until March. You have to make your contribution by December 31st.
-If you have earned income in the year you turn 69, you may want to overcontribute to your plan in December before you wind it down. The amount would be whatever you're entitled to contribute based on your earned income in that year. You would have to pay a 1% penalty for the month of December on the overcontribution but the tax savings would far exceed that.
-Remember that this is your last chance to make up any unused contributions from previous years.
-If your spouse is not yet 69, you can keep on contributing to your spouse's RRSPs until they turn 69 if they have RRSP contribution room.
-If you like, you can delay withdrawing from your RIF until the end of the calendar year after it was set up. Which means all the more time for you to benefit from tax-deferred growth.

Important Note: The world of RRSPs and RIFs and all the other government-sanctioned tax shelters can offer significant financial advantages and benefits. But to take full advantage and receive what you are entitled to requires knowledge of the rules and regulations and how they apply to your own individual situation. In short, this is an area in which it is generally wise to seek professional help.

Please note: Because the rules on RRSPs and other registered investments are complex and subject to change, you should always seek professional advice so you can be sure you are taking maximum advantage for your situation.

Retirees can save on taxes

There are many tax benefits available to you. And there are many strategies you can use to reduce your taxes. These are just a few of the things you can do.

-If you're over 65, depending on your income, you may be eligible for the federal age tax credit on your income tax return. Be sure to take advantage if you can.

-Remember that your first $1,000 of pension income is eligible for a provincial credit as well as a federal tax credit. Again, be sure to take advantage.

-Although you may not have qualified for the GST credit when you were working, now that your income is lower, you might qualify. Look into it.

-Remember that when it comes to taxes, all income is not equal. Income earned through dividends or capital gains receives favourable tax treatment, so you should ensure your non-registered investment portfolio includes equities.

-Use income splitting wherever you can. Perhaps you can avoid or at least reduce OAS clawbacks by shifting a portion of your investments to the lower income spouse. But be careful how you do it for attribution rules will apply.

-Another form of income splitting: Whenever you can, consider maximizing spousal RRSP contributions. And contribute each year as long as one of you is still under 69.

-Whenever you're considering withdrawing additional income from a RRIF or other plan, keep this in mind. That extra income could impact your eligibility for various government programs such as age credits, GST credits, OAS and more. Always check first.

-Maximize your deduction for any charitable donations you and your spouse made by combining them on one tax return.