

Two Cents Worth



In This Issue

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SPECIAL RRSP ISSUE

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Interview with Garth Turner

Garth Turner is Canada's best-selling personal finance author; a nationally syndicated newspaper columnist and broadcaster; and the country's most popular speaker. As Canada's Minister of National Revenue he ran the tax system

***Doug:** What challenges face Canadians as we head into the next RRSP season?*

Garth: The greatest challenge we face is breaking our rotten investment habits when it comes to retirement savings. Last year, for example, Canadians contributed just \$27 billion of the \$202 billion which we could have put in - a mere 13.5%. That means a huge amount of unused contribution room is

rolled over to a new year, where it probably will not be taken up. What a shame.

Too many people are unfamiliar with RRSP strategies that will allow them to make a contribution, even when they don't have the extra cash at the end of the year. Today with interest rates low (and about to go lower), it makes sense to borrow to contribute, for example, using the tax refund cheque you'll get to pay down the loan.

Then there are contributions in kind. The rules let you take assets you already own outside an RRSP (be they savings bonds, GICs, funds etc.) and put them inside your plan. So, for selling yourself assets you already own, the government will send you a

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tax refund cheque. With this kind of flexibility, there is just no excuse for millions more of us not doing the right thing, and maxing out on RRSPs in '99.

Doug: *What are the biggest risks facing Canadians heading into retirement?*

Garth: That too many of us are going to run out of money before we run out of life - either because we do not make those RRSP contributions, or because we put too much money into the wrong kinds of investments. Fixed-income instruments, for example, today pay basically nothing after inflation and taxes, if held outside an RRSP, and even inside a plan are dismal performers.

Let's face it - Canada has a huge problem with demographics. There are now nine million Baby Boomers about 15 years from retirement, and they will swell the ranks of the seniors by 300%. Just consider what that is going to do to health care, the pension system and the economy itself. Wise investors will make the most of the next decade when markets will likely be robust performers, building as much wealth as possible to shield them from the withering retirement crisis that now seems inevitable.

Doug: *How do you address the problem of being house-rich and cash-poor?*

Garth: For too many people, the Eighties are not over. They are still wary of inflation and believe that sitting on paid-for houses will give them security in retirement. That is a dangerous myth.

Inflation has turned into deflation. Commodity prices are going down, not up. The value of residential real estate has been flat or



negative in most markets for several years, and the situation's about to get worse. Demographics are against real estate, and I fear there will be scores of homes for sale in ten or fifteen years and very few buyers. As a result, prices will plop and people who thought they'd retire on their equity will be shocked.

For some reason, these beliefs of mine have been greeted in the Canadian media with shock and disbelief, but time will tell if I am right in my current conviction that excessive real estate equity is dangerous. In the meantime, I continue to advocate selling real estate and investing the proceeds, downsizing now into the kind of real estate that does have a future (bungalows, condominiums, gated communities etc.) and also removing equity through home equity loans to invest in financial assets, like mutual funds. When done the right way, the interest on loans taken for that purpose can be tax-deductible, giving a major break to the borrowers.

But, of course, this is for long-term investors who will not panic when markets turn negative, as they now do on a regular basis. Don't borrow too much. Don't put it in the wrong place. Don't fall for the media scaremongering. They just don't get it.

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Doug: *What to expect in the next budget?*

Garth: Paul Martin does not exactly confide in me, but I do expect two things: Personal tax cuts, probably at the higher end of the income scale, and an increase in the foreign content limits for RRSPs.

I expect he will move the 20% bar up to 30%, although not all at once. That will be good, and I think every reasonable Canadian should have as much foreign content as possible - thanks to Emperor Bouchard's latest electoral victory. Of course with today's derivative-based funds, you can effectively have 100% foreign content in your plan, so Mr. Martin risks being irrelevant.

Garth Turner

Garth Turner's Website:
<http://www.garth.ca/>

RRSP Contribution Limits

Year	Upper Dollar Limit
1996	\$13,500
1997	\$13,500
1998	\$13,500
1999	\$13,500
2000	\$13,500
2001	\$13,500
2002	\$13,500
2003	\$13,500
2004	\$14,500
2005	\$15,500
2006	indexed

The above table shows the "upper limits". To know precisely what you can contribute, look at your Revenue Canada "Notice of Assessment".

Understanding the ABCs of RRSPs

Imagine, if you can, a scenario in which the Canadian government pays you almost half of the money you require to make the investment of your choice. A GIC or a hot stock -- it's your call. Then, when you've made money on that investment, be it through interest earned on the GIC, or the capital gain generated by the sale of your stock, the government tells you don't have to pay tax on it. Keep the profits they say. No hitch. No hassles.

Sound far-fetched? Not at all if you are among the one in three Canadians currently taking advantage of the federal government's most generous form of tax relief -- the Registered Retirement Savings Plan -- commonly known as the RRSP.

An RRSP is a government approved program that is designed to encourage Canadians to save for their retirement by providing powerful tax reduction options. The tax breaks come in two forms. The first is that once you set up an RRSP, the financial contributions you make are deductible from your taxable income.

Taking an example from Gordon Pape's 9 Low Risk Ways to Get (& Stay) Very Rich, this means that people in the middle tax bracket whose marginal combined federal/provincial tax rate is somewhere around 42%,(depending on which province you live in), would receive a tax refund of \$2,100 on a contribution of \$5,000. Therefore, the "real" cost of the investment is only \$2900 but the full \$5,000 is still working inside the plan.

The second tax advantage resides in the

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sheltering of the income and capital gains that are generated by the investments in your RRSP. Simply put, your money is allowed to grow tax free. Anyone who has ever invested in a GIC (outside of an RRSP) knows that the interest earned is heavily taxed. Likewise, a capital gains tax is levied on investments like stocks and mutual funds. But all investments within an RRSP are effectively "sheltered" from tax and allowed to compound.

Using the example once again of the RRSP holder in the 42% tax bracket, let's examine the effects of a five-year \$10,000 GIC paying 10% interest held both inside and outside an RRSP. In a sheltered plan where no tax is paid, the investment would grow in value to \$16,105 in five years. Outside of an RRSP, the investor would be required to pay \$2,357 in tax resulting in a cumulative value of only \$13, 257.

But why you ask, would the government in these desperate times of budget slashing and tax grabbing allow itself to miss out on such lucrative revenues? Aren't governments supposed to encourage consumer spending, not saving?

The answer may well be simpler than the question. Governments are broke. They quite simply do not have the resources to continue to support the growing number of retired Canadians who will be dependent on government-sponsored pension plans in the future.

RRSPs are one method by which the federal government can encourage people to take responsibility for their financial future.

At the risk of providing too much of a good

thing, however, the government has established limits as to how much an individual can contribute to an RRSP on an annual basis. The yearly maximum allowable contribution limit is currently 18% of the prior year's earned income up to a maximum of \$13,500.

Once you've determined the amount of money you can afford to put into your plan, the next decision must be where to invest. Fortunately, there is a plethora of options. Among them Canadian equities, international equities up to an allowable limit, mutual funds, Treasury Bills, bonds, stripped coupons, GICs and the list goes on. It is best to explore your options with a financial advisor -- one who can help you identify the options that are best for you. After all, it's your money and your future.

(courtesy of Fidelity Investments)

Does it Make Sense to Borrow?

Let us assume that you are in the approximate 50% marginal tax bracket .

If you borrow \$1,000 the government will give you back \$500. Your cost is likely to be prime or prime plus 1%. Let's assume that it is 7% for this example. Over a one year period your monthly payments would be \$86.52 The total cost to borrow is \$38.32 ($\$86.52 \times 12 - \$1,000 = \38.32).

If you are 30 years old and plan to retire at age 65 that \$1,000 will grow to \$28,102 at 10%. By age 70, when you have to start taking money out in a RRIF it will be \$45,230.

So let's add this up. You paid \$1,000 but the government gave you back \$500 so your net

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cost is \$500. Add to this \$38.32 for a total of \$538.32. At this is likely to get you \$45,230 at RRIF age. It seems to me that it makes sense to borrow.

Spousal RRSP's

Definition, Spousal RRSP : An RRSP that is owned by your spouse, to which you can contribute. However, spousal contributions reduce the amount you can contribute to your own RRSP. Provided no money is withdrawn within two years after the year of your last contribution, the money will be taxed in your spouse's hands upon withdrawal. Spousal RRSPs are used by many couples to improve the tax effectiveness of their retirement planning.

In order to understand the reason for Spousal RRSP's, we must look at the concept of "income splitting".

Definition, Income splitting: The tax-planning strategy of arranging for income to be transferred to family members who are in lower tax brackets than the one earning the income, thus reducing taxes. Although attribution rules limit income splitting, there are still a number of legitimate ways to do so, such as through the use of spousal RRSPs.

Now let's examine what income splitting, via a spousal RRSP can do for you in practical terms.

Let's use an example. We will assume that we have a higher income spouse who we will call "HI" and a lower income spouse who we will call "LI".

Both spouses are 40 years old. HI has \$50,000 of taxable income each year and LI has a \$30,000 taxable income. They both plan to retire at age 60, 20 years from now.

HI also belongs to a pension plan at work where he will get 60% of his salary when he retires at age 60. LI doesn't belong to a pension plan and must rely on RRSP savings.

HI can contribute only \$3,000 per year to his

RRSP because of his pension adjustment. LI can contribute \$6,300.

If HI contributes to his own rrsp and earns 10% he will have \$211,208 in his RRSP. This will provide a minimum RRIF income of \$7,040 (see RRIF calculator at <http://www.retireweb.com>) and yes, I know that HI doesn't have to RRIF at age 60. Add to that \$40,000 of pension income and \$6,190 QPP (CPP similar, also note 1/2% reduction of full QPP/CPP per month prior to age 65). **Total income is \$53,230.**

At age 60 LI has \$443,537 built up (6,300, 20 years, 10%) and RRIF's it to get a minimum RRIF income of \$14,785. LI also has \$6,190 in QPP for a **total income of \$20,975.**

Now let's go to the Fidelity Tax estimator here: http://www.fidelity.ca/english/planning_tools/tax/tax97.html and see what this gives us (assume Ontario as there is no Quebec estimator at this site):

HI: tax = \$15,284 LI: tax = \$3,727 Total: **\$19,011.**

Now, what if HI had made spousal contributions instead of contributing to HI's own RRSP? LI would have \$654,745 in the RRIF and minimum RRIF income would be \$21,825.

HI's total income = 40,000 + 6,190 = \$46,190. LI's income = 21,825 + 6,190 = \$28,015.

HI: tax = \$12,445 LI: tax = \$5,534 Total: **\$17,979.**

The tax saved is \$1,214, or a vacation for two to Florida for a week!

(Note: QPP and CPP can be combined and split as well for further tax savings.)

Self-Directed RRSP's

There is not really a lot to say about self-directed RRSP's. There are some common mistakes that some people make and we'll talk about them here.

This is what you can hold in an RRSP:

- GIC's
- Mutual Funds
- Stocks - Self-Directed
- Bonds - Self-Directed
- Property - Self-Directed

Fees for self-directed plans can be anywhere from \$80 to \$300 per year and are not tax deductible. In other words, in order to have the \$300, in a 50% marginal tax bracket, you had to make \$600.

These plans are great if you have stocks, bonds and property in your RRSP. If you have GIC's and mutual funds, then it is very unlikely that you need a self-directed plan.

I have seen self-directed plans where the broker had four different mutual funds from four different mutual fund companies. The problem with this lies in the deferred sales charges should there be any switching between funds later down the road. There is normally no charge to switch between funds of the same family.

I have seen people with more than one self-directed RRSP. Why pay the self-directed RRSP fee to two or more institutions? It makes no sense.

Remember, up to 20% of the **book value** of your RRSP can be invested in foreign content. We'll talk about that next.



Foreign Content

Why do we want foreign content in our RRSP's?

Answer - to reduce risk and enhance the return of the portfolio.

Foreign Content Investing

If you are like many people, you are looking forward to doing some traveling once you have retired. Retirement will be your chance to see what you have only been able to read about or visit in your dreams. Given that so many Canadians hope to travel once they've retired, it is curious that so few have invested outside of the country when planning for their retirement.

Most people understand that as the value of the Canadian dollar falls, so too does the spending power of Canadians traveling abroad. The same principle applies to your retirement fund. If you invest in the United States, at least part of your portfolio will keep pace with the American dollar, making it easier to finance a trip to Florida or Arizona.

The desire to see the world isn't the only good reason to invest abroad. Every good investment strategy should include an element of international diversification. Portfolios may vary, depending upon the investor's age, risk tolerance, and retirement goals. However, the principle remains the same: every portfolio needs a mix of different types of investments.

Investments need to be diversified geographically, as well as by industry and security type. Canadian stock markets represent only 3% of the world's market capitalization, which means there are many more investment opportunities beyond our borders. Notably, American and Japanese markets have outperformed Canadian markets during the last decade.

The Canadian government currently allows RRSP investors to invest up to 20 percent of their portfolios abroad. While the percentage has changed over the years, the foreign content allowance has remained a long-standing feature of the RRSP program. Yet fewer than 30 percent of Canadians who have RRSPs hold any foreign content in their plans.

The foreign property limit is measured by the cost amount or book value of your foreign investments and not their current market value. Therefore, if your foreign investments outperform your Canadian investments, causing your foreign content to rise above 20 percent, you will not be penalized. Should you exceed your foreign property limit, however, your financial advisor can notify you and arrange to have any excess sold, and the cash transferred to the Canadian side of your RRSP.

A sound diversification strategy involves investing in markets around the globe. To do this properly, use the assistance of a financial advisor who can help you identify opportunities by region, industry, and investment vehicle. A good financial advisor is knowledgeable about world economies.

For most investors, mutual funds represent the easiest and most effective means of di-

versifying internationally. Mutual funds are a highly liquid form of investment that reports unit prices daily, unlike most foreign bonds and equities. Mutual funds also allow you the opportunity to increase your purchasing power, decrease your costs, and hire a professional portfolio manager to oversee the management of your Fund. Mutual fund companies that support a global network of researchers, analysts, and managers have a significant competitive advantage. These companies maintain offices in the regions where they invest, so they have an excellent understanding of their companies, industries and regional economies.

A wide variety of Mutual funds are available to Canadian investors: equity funds, fixed-income funds, balanced funds, and money market funds, to name just a few. Many Canadian funds are structured to make them suitable for RRSP investments: foreign content is kept within the defined limits. An experienced financial advisor can assist you in developing an RRSP program that is tailored to your particular financial profile. Proper planning, good management, and ongoing assessment of your RRSP will ensure that you and your RRSP portfolio are well positioned for a satisfying retirement.

courtesy Fidelity Investments

For a discussion on how to get more than 20% foreign content in your RRSP legally - go here: <http://www.rrsp.org/foreign.htm#How to get more than 20% foreign>

Glorianne Stromberg's 1998 Industry Canada Report

Glorianne Stromberg is both loved and hated in the mutual fund industry. Let's not mince words - there are those who prefer the status quo. Publicly they will pretend to support the report, but privately do all that they can to resist it's direction.

Glorianne is on the side of the investor. She is pro-investor education, pro-disclosure, pro-change. Before you lend much credibility to her more serious critics, determine how they are paid.

Her report calls for some radical changes in the way that the industry is regulated. Some of the humongous banks have already slammed the report.

Large mutual fund companies with their own sales force and products were targeted in the report and are likely to remain silent about the report. Representatives from these firms involved with the Mutual Fund Dealer's Association Self-Regulatory Organization cannot expect us to believe that they are there to protect the consumer investor and not their firm.

We are slowly but surely headed in the same direction as our cousins to the south with regards to education, disclosure and regulation.

My two cents? We should be going through a bench-marking of "best practices" in each of these areas and cloning them in Canada.

For info on how to obtain the report go here: <http://strategis.ic.gc.ca/SSG/ca01120e.html> or examine it directly in acrobat format here : <http://strategis.ic.gc.ca/pics/ca/mainbody.pdf> (570 KB) so go get a coffee.

Question from one of the visitors to my website (<http://www.rrsp.org>):

Hi Doug, First let me say that I really enjoyed your web page.

I had a question about borrowing from your RRSP to finance your education. I realize that you don't recommend it.

But can borrow from your own RRSP to finance another's education such as your spouses or children's?

Thanks, Edwin

Response:

You're right, I don't recommend it, but Gordon Pape does:

<http://www.pei.sympatico.ca/Contents/Business/pape93098-4.html>

So at least I give you an opposing view. I think that a person is better off simply withdrawing the funds and taking the tax hit. If you crunch the numbers, I think you'll agree.

To answer your question - you or your spouse are eligible, not your children. I am attaching the Revenue Canada pamphlet and form.

Yours Truly - Doug Hudson

Humor

The following is from a recent post in the Fundlibrary Discussion Group:

Date: 05-Jan-99 - 9:56 AM

Subject: SCAM ALERT! WARNING - READ IMMEDIATELY

From: Donut

If you get an envelope from a company called "Revenue Canada" DO NOT OPEN IT! This group operates a scam around this time every year. Their letter claims that you owe them money, which they will take and use to pay for the operation of essential functions of the Canadian government. This is untrue! The money Revenue Canada collects is used to fund various inefficient and pointless social engineering projects.

This outfit has connections to another shady outfit called "The Canada Pension Plan" who claim to take money from your paycheck and save it for your retirement. In truth the CPP uses the money to pay for the same misguided make-work projects that Revenue Canada helps to mastermind.

These scam artists have bilked hard working Canadians out of billions of dollars. Don't be among them!

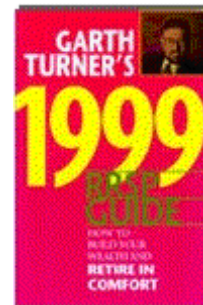
So, if you get a letter from Revenue Canada - DON'T OPEN IT!

Test Your RRSP Knowledge

I have placed a 5 question RRSP quiz at: <http://www.rrsp.org/mctest.htm>

Be careful, some of the questions are tricky!

BOOK REVIEW



This is a comprehensive guide for the average Canadian seeking answers to today's RRSP questions.

What do I mean by that? Simply put, other RRSP guides will address such topics as RRSP rules, tax savings, recent budgets etc. Pretty dry stuff.

You will get the facts in this book, but you will also get answers regarding questions that you may have after the recent market mini-crash. You will get the telephone numbers of mutual fund companies (I personally have found this to be very handy) and where to find them on the web. You will information on financial planning newsletters and other resources on the web.

How to put your mortgage into your RRSP is another jewel. There is an RRSP contribution calculator, statistics, comics, reviews and strategies by age group.

It's very readable.

To order this book on-line directly from Garth Turner go here: <https://www.turnerbooks.com/garth/orderform.htm>

By the way, Garth doesn't pay me to say nice things about his book. **My two cents worth** - go to your bookstore and check it out for yourself, you won't be disappointed.

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dian literature and 2) The Romance Depart-
ment prize for studies in linguistics. The
third year of this program was transferred
from l'Université Laval.

BACKGROUND AND EXPERIENCE

Doug has spent the last five years in the fi-
nancial services sector. Prior to that Doug
worked for the federal government as a bud-
get administrator and internal auditor. This
followed several years as a comptroller for a
medium-sized firm and several years with
KPMG as an Accountant.

Useful Links

Fund Performance:

<http://www.globefund.com>

<http://www.fundlibrary.com/home.cfm>

Financial Advisor Pages

<http://www.fapages.com/links.cfm>

Garth Turner's Website

<http://www.garth.ca/Default.html>

DISCLAIMER

**Don't buy anything based upon what you
read here!** That's not how you buy mutual
funds, invest or conduct your financial plan-
ning. You buy investment funds after hav-
ing sat down with a qualified, licensed pro-
fessional and after having determined that
the fund in question meets your require-
ments and that it fits into your overall plan.
Always take the time to read the fund's
prospectus. Fund companies spend a lot of
time and money paying accountants and
lawyers to prepare these things - read them.
Ask your financial advisor about what you
read in the prospectus. Go over the finan-
cial statements, and the comparative perfor-
mance figures found therein.

