RRSP's 101 - the Basics for 2009

1. What exactly is an RRSP?

An RRSP (Registered Retirement Savings Plan) is a tax shelter and *not* an investment in and of itself. Think of it as a garage. You must still put vehicles into your garage. It's simply a house for your investments. Investments (such as stocks, bonds, mutual funds, GICs and more) in this garage receive special tax treatment (see my visual explanation).

If your investments were held in a non-registered garage - a garage that does not provide a tax shelter, they're simply purchased on their own in a regular account (also called non-registered or non-RRSP assets), then, what they earn each year is taxable and you do not receive a tax deduction.

When you contribute to your RRSP, the amount you invest qualifies for a tax deduction, the entire portfolio grows tax deferred (will explain this shortly), and the government has many rules governing the mechanics.

To recap, you could invest in a stock, bond, GIC at your bank, a mutual fund or any combination of investments. If you simply do so, what they earn is taxable each year. If these same investments were held within an RRSP tax shelter, your investment would not be taxable each year. Instead, you would pay tax on the funds withdrawn, usually at retirement. Also, you receive a tax deduction when contributing to an RRSP.

2. What are the benefits of an RRSP?

- anything you deposit grows tax deferred until retirement or you need to take the money out for some other reason. Since you're not paying tax on the interest or gains within your RRSP, more money goes to work for you each year and therefore the compounding effect has a preferred benefit to investing outside an RRSP.
- you received a tax deduction for your contribution.
- you can name a beneficiary on your account which you can not do with a regular non-registered account (a beneficiary is someone you designate to receive your investment at death - however, it would be taxable at that point).

3. So how does the Tax Free Account vs. an RRSP work?

The tax free account is totally separate. You can contribute $5,000 a year where the proceeds grow tax free and you can take it out anytime without penalty or tax consequences. This is a new option introduced by the government in January, 2009. With the Tax Free Savings account, you do **not** receive a tax deduction where you do with an RRSP and you are **not** taxed if you take the money out where again, you are with an RRSP. The only similarity is that they are both tax shelters (don't pay tax each year on the growth of the investments).

4. How do I calculate what I can contribute and what if I don't fully contribute?

The government allows you to put away a maximum of 18 percent of last year's earned income or up to $20,000 for 2008 -- for 2009 it's $21,000. With so few people ever contributing the maximum allowable to them, consider starting somewhere, even if it's only putting aside $100 a month.

If you have a pension at work, this is known as a PA or Pension Adjustment with regards to your RRSP and will reduce the amount you can contribute.

See your "blue tax pages" for a detailed account of your personal contribution room.

If you don't use your entire contribution room, you can carry it forward indefinitely. For example, if your "room" was $10,000 for the past 4 years and you only contributed $5,000 per year, you would be left with $20,000 of "room" that you could later use to your advantage. You may wish to do this in a year where you're in a high marginal tax bracket (earning a high level of income). Why? Because your tax deduction is directly based on your marginal tax bracket. Therefore, the more you earn, the greater your potential tax deduction (please note that not all income is considered "earned" income for RRPS contribution purposes).

5. What happens if I need my money?

You will be taxed at your marginal tax rate in the year you withdrawal it.

6. Should I pay down the mortgage or contribute to an RRSP?

It all depends on your personal situation. With mortgage rates staying very low (and most current mortgages also have fairly low rates), it generally makes more sense to save for one's retirement as many Canadians are notoriously house poor at retirement (meaning that they have their home paid off at retirement but no savings to live on.)

A popular strategy is to invest in an RRSP each year and use the tax refund that it generates to then pay that down on the mortgage - a win/win if you don't then blow the tax refund.

7. What else do we need to know?

- The deadline is March 2nd.
- You can go to any bank, brokerage, financial planner, etc. but do it earlier than later.
- Get on a monthly system so you're chunking it down each month to invest and don't have to wait to the last minute or come up with a large sum to contribute.
- There are some fees with setting up an RRSP portfolio, so be sure to ask your financial institution.
- Consider an RRSP loan if it makes sense for your personal situation.
- What should you invest in? If your financial person is rushed due to the "season", invest in something safe like a money market or T-bill mutual fund which won't put your principal at risk. Just don't leave it there - book a follow-up appointment *then and there* with your professional and come back in a month to allocate those dollars so they go to work for you.