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RSP Express

RSP contribution ceiling climbs another $1,000

The RSP contribution ceiling continues to rise under a multi-year schedule set in 2003 and extended by the 2005 federal budget. The maximum contribution limit for 2006 is $18,000. That's $1,500 higher than the limit for 2005. The maximum for 2007 climbs by another $1,000, to $19,000.

The accompanying table shows the new contribution ceilings for 2006 through 2010 and the income required to qualify for these higher ceilings. Remember that RSP contribution room runs on a one-year lag. So, your earned income in 2006 determines how much you are allowed to contribute in 2007.

These changes only affect the RSP ceiling. Your personal RSP contribution room is still determined by computing 18% of your earned income for the prior year, and subtracting any "pension adjustment" reported by your employer on your T4 tax slip, should you belong to a pension plan or deferred profit-sharing plan.

As the table shows, those with at least $105,556 of earned income in 2006 may contribute as much as $19,000 to their RSPs for 2007. If you own an incorporated business, you might wish to have your accountant review how much compensation you take as salary and bonus, and how much as dividends. Salary and bonus create RSP room; dividends do not.

RSP contribution ceilings

Tax year	RSP contribution ceiling*	Earned income required in the previous year in order to contribute this amount *
2006	$18,000	$100,000
2007	$19,000	$105,000
2008	$20,000	$111,111
2009	$21,000	$116,667
2010	$22,000	$122,222
2011	Indexed to growth in average national wage	

** Assumes no membership in an employer-sponsored pension plan or DPSP*

Pension limits are also rising. The maximum contribution to a defined contribution pension plan was $19,000 for 2006. That goes to $20,000 for 2007 and will increase by $1,000 each year to $22,000 for 2009. After that it will rise in line with growth in the average national wage. RSP limits lag pension limits by one year to give employers time to calculate and report the pension adjustments that reduce RSP room for plan members.

Defined benefit pension limits are going up too, but are calculated differently. The maximum pension benefit you are allowed to accrue per year of service rises from $2,111 in 2006 to $2,444 in 2009, and will be thereafter indexed to the average industrial wage. A defined benefit pension plan will thus be allowed to pay a higher level of retirement income but, unless required by the plan's rules, that decision to increase your retirement benefit is up to the sponsoring employer. If you are a high-income member of a defined benefit plan whose coverage limit is not raised, you will end up getting more contribution room for your own RSP.

Pension splitting offer potential tax savings

Federal finance minister Jim Flaherty did a "trick AND treat" this past Halloween. The trick was the proposed distribution tax on income trusts that has attracted so much attention and controversy. The treat was less noticed, but government officials estimate it will save seniors nearly $4 billion in federal income tax over the next six years.

The biggest beneficiaries are retirees with defined benefit pensions and those who did not start doing spousal RSP contributions years ago.

Flaherty has decided to let couples split certain types of retirement income when calculating their income tax. The measure applies to both married and common-law couples and will take effect for 2007. It will be several months before we know if all the provinces offer the same break, although Quebec has already announced harmonization of its tax legislation to allow such pension income splitting.

Income splitting means that part of the income received by the better-off spouse will be taxed at his or her partner's lower rate. This could produce significant savings for couples in which one partner has a large pension and the other does not, or couples in which one has a large RSP and the other does not.

There are, however, several wrinkles.

First, this applies only to certain income that qualifies for the $2,000 pension tax credit, and that depends on the recipient's age.

A recipient of any age can split Income from an employer-sponsored registered pension plan (RPP). This includes a defined benefit pension as well as payments from an annuity bought with money from a defined contribution pension account.

People aged 65 or older can split those workplace pensions plus:

- RIF withdrawals. This provision also covers pension money moved to locked-in plans such as life income funds (LIF), locked-in retirement income funds (LRIF) and the prescribed retirement income funds (PRIF) available in certain provinces.
- Income from a life annuity purchased with RSP money. Note that lump sum RSP withdrawals do not qualify.
- Income from a life annuity purchased with money from an employer-sponsored deferred profit sharing plan (DPSP). Lump sum DPSP withdrawals do not qualify.

There is one case in which these three types of income would be eligible for splitting by someone younger than 65. That's if they're received as a result of the death of a spouse or common-law partner. For example, suppose Tom bought an RSP annuity with payments guaranteed for 10 years and died during that time. The remaining guaranteed payments received by his widow as beneficiary would be eligible for splitting either with Tom's final return or with her new spouse if she remarried.

The second wrinkle is that the split can cover only up to half the eligible income. So, someone with a lot of investment, business or employment income could not shift his or her entire pension to the lower-income partner. (Please see accompanying article on spousal RSPs)

The Finance Department said the higher income spouse will get a tax deduction for the portion of the retirement income shifted to his or her partner. This suggests that splitting can reduce exposure to the Old Age Security clawback, but that won't be known for sure until the tax forms are designed later this year.

Changes for federal locked-in plans

Are, or were, you in a federally regulated pension plan? If so, you should be aware of two big changes in the rules that apply if you leave the plan before reaching retirement age.

In addition to covering government and Crown corporation employees, the federal rules govern private sector pension plans at chartered banks, and railway, airline, shipping, broadcasting and telecommunications companies.

Most people who leave such plans before the early retirement age, move their vested money to a locked-in RSP (LI-RSP) or locked –in retirement account (LIRA) and later convert the LI-RSP or LIRA to a life income fund (LIF) when they wish to start taking income.

The first change made recently involves what happens to the LIF at age 80. Previously, all money in the account had to be used to buy a life annuity at that point. But this requirement has now been dropped, bringing Ottawa in line with the provinces. This means you can retain investment control for as long as you live.

The second change allows you to unlock the LI-RSP, LIRA or LIF if you leave Canada and qualify as a non-resident for tax purposes. Quebec, Alberta, New Brunswick and British Columbia also allow non-residents to unlock their money. The unlocked money can be taken as taxable cash. Or it can be transferred directly to a regular RSP or RIF. The direct transfer would keep the money sheltered from Canadian tax until it's withdrawn. Whether your new country of residence will tax the money depends on its laws and whether it has a tax treaty with Canada.

Also, Alberta has announced important changes to locked-in funds. Since November 1, 2006, a one-time withdrawal for a fixed amount corresponding to 50 % of the plan is permitted. Certain conditions regarding age of the owner and type of fund apply. Ask your Investment Advisor for further details.

Spousal RSPs are still worth considering

At first glance you might think the new pension splitting provision means there's no longer any point in making spousal RSP contributions. That's not so. A spousal RSP remains useful for several reasons.

The first reason is a disparity in when income qualifies for pension splitting. As discussed in the previous article, benefits from employer-sponsored registered pension plans qualify at any age. But the other income streams qualify only for those at least 65-years-old unless the income results from the death of a spouse or common-law partner. So, those without employer-sponsored pensions will need spousal RSPs to be able to split income before 65.

Here are three other reasons:

- The proposal allows retirees to shift only up to 50% of their eligible income. With long-term planning, a spousal RSP offers the flexibility to split more than 50%.
- A spousal RSP can double the amount of RSP money couples can access under the Home Buyers' Plan and Lifelong Learning Plan.
- Those over 69 who are still generating earned income can use spousal contributions to make tax-deductible contributions to their partner's RSP until the end of the year in which that person turns 69.

Ongoing spousal RSP contributions also create flexibility to deal with unexpected events. For example, a couple in their 40s might assume now that the lower-income spouse will retain that status in retirement. But, thanks to a career move, inheritance or other unanticipated windfall, today's lower-income spouse might wind up as the higher-income retiree and find it useful to split income from the spousal RSP built up over the years.

When small is beautiful

Here's a common occurrence in today's dynamic work environment. You spend a few years in a job and then move on. At the time of departure you might have only a few thousand dollars of pension money that can be transferred to a locked-in retirement account (LIRA) or a locked-in RSP

A low-value locked-in plan can be a nuisance because it is hard to invest small amounts on a cost-effective basis. It's also yet another account to keep track of – and you might even accumulate more than one if you work for several employers whose pension plans are governed by different jurisdictions.

Many people are not aware that provincial pension laws let you unlock a plan if its value falls below a certain level, either because it was low to begin with or because of investment losses. You must, however, meet age requirements in most cases. The unlocked money can be rolled tax-free to your regular National Bank Financial RSP or RIF.

The rule that applies to your account is the one for the province that governs the pension plan from which the money was originally transferred, not the province where you now live.

- **Alberta:** The 2007 limits are $8,740 for those under 65 and $17,480 for those who are older.
- **British Columbia:** Same as Alberta
- **Manitoba:** The 2007 limit is $17,480 for those aged 65 or older. Those younger face an age-based limit that represents the present value of $17,480 discounted by 6% a year for the years between now and age 65. For example, the limit for a 40-year-old is $4,072.
- **New Brunswick:** Same as Manitoba
- **Newfoundland & Labrador:** The 2007 limit is $4,370 for those under 55 and $17,480 for those over.
- **Nova Scotia:** The 2007 limit is $17,480 for those aged 65 or older.
- **Ontario:** The 2007 limit is $17,480 for those aged 55 or older.
- **Quebec:** Same as Nova Scotia
- **Saskatchewan:** The 2007 limit is $8,740. There is no age requirement.

There is no small plan rule for federally regulated locked-in plans.

Before you leave an employer, ask if your pension money can be unlocked under a small plan rule. Also note that two or more locked-in plans under the same jurisdiction can usually be combined. Consult the plan administrators and your NBF Investment Advisor.

Now that there's no more foreign content rule, you can invest as much of your RSP or RIF as you want anywhere in the world.

Adding foreign content adds currency risk

Canadian dollar appreciates

Canadian dollar gain 5%
Rate of return 10%

$$R = \frac{(1 + 0.10)}{(1 + 0.05)} - 1$$

$$R = 0.0476 = 4.76\ \%$$

Rate of return in Canadian dollar terms: 4.76%

Canadian dollar depreciates

Canadian dollar loss 5 %
Rate of return 10 %

$$R = \frac{(1 + 0,10)}{(1 - 0,05)} - 1$$

$$R = 0,1579 = 15,79\ \%$$

Rate of return in Canadian dollar terms: 15.79%

Foreign content is important for Canadians because our stock market is very small by world standards and heavily concentrated in just a few sectors: financial services, energy and resources. Also, Canada's high level of imports means that, to some extent, we're importing inflation from other countries. As well, Canada is a mature economy and there are several regions with much stronger current and potential growth.

Nevertheless, be careful about going overboard. If you retire in Canada, most of your expenses will be in Canadian dollars. To produce spending money, your foreign investments will have to be converted into those dollars at whatever the exchange rate is at the time. This could produce a windfall if our currency falls in value, but could also hurt if the loonie goes up.

That adds a layer of "currency risk" because investing outside Canada involves two simultaneous bets. One is on the underlying investment. The other is on the foreign exchange value of the Canadian dollar. Foreign investments did so well in the 1980s and '90s in part because they got an added boost from the prolonged slump of our dollar. More recently, though, the soaring loonie has offset or even wiped out the performance of foreign holdings when their value was converted to Canadian dollars. For example, when valued in its home currency – U.S. dollars – the S&P 500 index gained 12.1% for the first 10 months of 2006. But conversion into Canadian dollars reduced that to 7.9% for Canadian investors.

Here's how to adjust your foreign investment returns for the impact of both a rising and a falling Canadian dollar. Let's assume you hold a U.S. stock that has gained 10% when valued in its home currency, the greenback. If we express this as a decimal – 0.10 – and then add 1.00, we get a "performance factor" of 1.10.

Loonie goes up

Suppose the loonie has gained 5% in relation to the greenback.

- Express this gain as a decimal – 0.05 – and add 1.00 to get a "currency factor" of 1.05.
- Divide the 1.10 performance factor by the 1.05 currency factor. The result is 1.0476. Subtract 1 to get the final result: 0.0476 or 4.8% when stated as a percentage.

So your stock gained 10% on the New York Stock Exchange, but the rising loonie offset more than half of that, leaving you with a 4.76% gain in Canadian terms.

Loonie goes down

Suppose the loonie has lost 5% in relation to the greenback.

- Express this loss as a negative decimal and add 1.00 to get the currency factor: 0.95.
- Divide the 1.10 performance factor by the 0.95 currency factor. The result is 1.1579. Subtract 1 to get the final result: 0.1579 or 15.8%.

In this case the falling loonie boosted your return by more than half.

As you can see, currency impact can make foreign investing quite volatile. Because of this, and because their future benefit obligations are in Canadian dollars, defined benefit pension funds tend to target their foreign content at 30-50%.

What if you plan to spend a large part of your retirement outside of Canada, perhaps heading to the U.S. sunbelt for three months of winter each year? It's virtually impossible to predict with any certainty where the U.S. dollar will be in relation to our loonie years from now. Yet the movements of those currencies between now and then will make a huge difference in how much time you'll be able to spend down south and your level of comfort. Fortunately, you don't have to make a long-range currency call. Talk to your National Bank Financial Investment Advisor about a currency immunization strategy. In this case, you plan to spend one-fourth of each year in the U.S. If that will likely represent one-fourth of your annual spending, consider allocating one-fourth of your retirement money to U.S. dollar investments for this specific goal. You then no longer have to worry about whether the loonie will rise or fall over the years to come. You're essentially setting aside U.S. dollars now.

Whether optimizing your portfolio returns in general or pre-funding foreign expenses, your National Bank Financial Investment Advisor can help determine the appropriate level of foreign content for your needs.

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