NUMBER CRUNCHING BY TALBOT STEVENS

What to do with found money

Here are five RRSP strategies your clients should consider if they are receiving tax refunds

This is the first in a series of contributions from financial educator, speaker and author Talbot Stevens, who will investigate the mathematical consequences of financial planning strategies. E-mail him at talbot@-TalbotStevens.com with comments or suggestions for concepts you would like analysed.

As clients become more sophisticated, it becomes increasingly important for advisors to demonstrate the value of their advice. Helping your clients make the best use of found money is one way to do that. If your client's goal is retirement, for example, then it makes sense to use found money to produce retirement income.

By now, most clients acknowledge the benefits of an RRSP as a retirement planning vehicle. What clients often overlook, however, is the tax refunds their RRSP contributions generate. If they handle those refunds wisely, they can significantly boost their retirement income.

Let's look at five distinct RRSP refund strategies. To keep the math easy, we'll assume that Rob, our hypothetical client, has an after-tax cash flow of $1,000 a year available to invest, and is in a 50% tax bracket.

STRATEGY ONE: SPEND THE REFUND

My unofficial survey of advisors and investors at seminars indicates that 80% to 90% of people spend their RRSP refunds, with some people "mentally" spending the refund before they make the contribution.

If your client's primary financial goal is retirement, it is important to discuss with him or her what happens to any "new money" produced by an RRSP contribution, or any other tax strategy that produces a refund. If your clients are to achieve their goals, it is useful to point out that spending a refund does nothing to increase retirement income.

In a 50% tax bracket, Rob's $1,000 RRSP contribution produces a $500 refund. If Rob spends the $500 refund, his $1,000 of after-tax cash flow produces an annual RRSP contribution of only $1,000.

It's important to understand that in this case, even though Rob started with $1,000 after tax to invest, he has made an after-tax commitment of only $500 toward his retirement. (Assuming he is still in the 50% tax bracket when he cashes in, his RRSP contribution would be worth $500.)

The common approach, of spending the RRSP-generated refund, is obviously the least effective, yet it is the most widely used of all the refund strategies.

STRATEGY TWO: REINVEST THE FUND

If Rob is more disciplined and committed to his retirement goal, he could reinvest the refund into his RRSP until he has used all of his contribution room. By reinvesting the $500 refund, Rob raises his RRSP deposit to $1,500 — a 50% improvement.

Simply reinvesting the 25% to 50% refund generated by the RRSP increases a client's RRSP funds by 25% to 50%. Obviously, getting clients to direct their refunds toward their retirement goal also benefits the advisor by the same ratio, regardless of whether the refund is invested in or outside of RRSPs.

Few investors have the discipline to invest any of their RRSP refunds, so advising clients to reinvest their refunds is a simple way to add real value to your service.

You can remind clients that they don't have to reinvest the entire amount; any portion of the refund they invest is an improvement over spending it all.

STRATEGY THREE: "GROSS UP" THE REFUND

Rob can do even better by using a "gross-up" strategy. There are several ways to produce the gross-up result, and the easiest way to explain it is to use a temporary gross-up loan, in which the client borrows an amount equal to the refund that will be produced by the RRSP deposit.

Rob can borrow an additional $1,000, which, combined with his original $1,000, allows him to gross-up, or increase, his total contribution to $2,000. Rob's $2,000 contribution produces a refund of $1,000, which is exactly enough to repay the $1,000 loan almost immediately, ignoring a tiny amount of interest.

For clients in a 50% tax bracket, this approach grosses up $1,000 into a $2,000 RRSP contribution. The strategy effectively doubles the client's retirement fund relative to the common approach, in which the client spends the refund.

Rob could also gross up by increasing his monthly RRSP contribution by the appropriate gross-up amount and adjusting his withholding taxes so he doesn't get a refund. This would also eliminate the risk of spending the refund because he wouldn't receive one.

Gross-up amounts for different tax rates are shown in the table, per $1,000 available to invest. For example, a client in the 40% tax bracket would increase his or her $1,000 contribution to $1,667, or by 67%.

Unless the client's monthly contribution is grossed up by the correct amount as shown in the table, having the client's employer withhold less tax does not increase the RRSP funds. Reducing the withholding taxes simply gives the client a refund a little bit each pay period instead of all at once at the end of the

RRSP contributions from $1,000 after tax

Refund Strategy	25% tax	40% tax	50% tax
Spend refund	$1,000	$1,000	$1,000
Reinvest refund	$1,250	$1,400	$1,500
Gross-up refund	$1,333	$1,667	$2,000

INVESTMENT EXECUTIVE CHART

Math detail

You can calculate the gross-up amount by dividing the after-tax amount by one, minus the tax rate. For example, with a 40% tax rate, 1.0 minus 0.4 is 0.6. Divide $1,000 by 0.6 and you get 1,667, meaning that $1,000 after tax can be grossed up to a $1,667 RRSP contribution.

year.

Contributing to an RRSP to reduce the taxes owed is the third way of getting the gross-up result. Here again, no refund is generated that the client might spend.

The gross-up result occurs whenever the after-tax value of the RRSP contribution is the same as the after-tax amount the client started with. By grossing up, Rob's $1,000 after tax produces a $2,000 RRSP deposit, which is an after-tax commitment of $1,000. Again, when it is cashed in, if Rob remains in the 50% tax bracket, he would have $1,000 after taxes, which is the amount he started with.

STRATEGY FOUR: TOP-UP LOAN

The client can use a small, short-term loan to "top up" an annual RRSP contribution. If Rob's RRSP room was $4,000 and he had $1,000 available, he could borrow the extra $3,000. His $2,000 refund could pay off most, but not all, of the loan. Top-up loans are typically paid off in less than a year.

STRATEGY FIVE: CATCH-UP LOAN

The client can use a larger "catch-up" loan that could take five to 15 years to repay. Borrowing a larger amount may allow a client to catch up on unused RRSP contribution room — at least, temporarily. Since most clients don't maximize their RRSP every year, some have accumulated more than $30,000 of RRSP room that may never be used.

Each RRSP refund strategy produces different levels of retirement income, reflecting different levels of commitment to the client's retirement goal. Showing clients the benefits of reinvesting or grossing up their refunds is a simple way to increase their retirement funds — and your income from RRSP business — by 25% to 50% or more. **IE**

NEXT MONTH: When RRSP catch-up loans benefit investors, and when they don't.

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