Money Matters

Seniors face important decisions on future income

IT'S YOUR MONEY

Paul J. Rockel

People who are turning 71 must make an important decision about how to convert their Registered Retirement Savings Plan (RRSP) into a source of income. The choice they make is crucial because the result will likely be their primary source of income during retirement.

Traditionally, investors have had two options: either withdraw all their money in cash, or convert their RRSP into a life or fixed term annuity. Withdrawing was less attractive because most people would be taxed heavily. So, the majority of people chose annuities, "life" plans that guaranteed them a regular income for the rest of their life. Some annuities also offered guarantees for a fixed period so that if the investor died, payments would continue to be made to his/her estate.

However, most annuities don't protect against inflation. The buying power of people who convert their RRSPs into annuities shrinks each year.

Since 1986, the situation regarding retirement income options has improved dramatically with Registered Retirement Income Funds (RRIFs) emerging as one of the best vehicles to handle investors' retirement income needs.

A RRIF is a contract that provides periodic payments to the investor from the starting date until the investor reaches age 90. For many years, RRIFs were unpopular because their rules were inflexible. Then, after the federal government loosened the rules, many people began converting their RRSPs into RRIFs instead of annuities.

Under the new rules, investors can own more than one RRIF. As well, there is no limit on the amount investors may receive from their RRIF each year. However, they must withdraw a minimum amount calculated by their current age subtracted from age 90 (see below). Another RRIF advantage is that investors can begin receiving payments from the RRIF immediately after purchasing it rather than being obliged to wait until the next calendar year. Also, a RRIF continues to allow investors to accumulate funds tax-free until they are withdrawn.

Here is how RRIF payments work. Each payment investors receive is a frction of the value of the investor's capital at the start of the year. This fraction is equal to one divided by the difference between your age and 90. So, if you have a plan valued at $300,000 and you are 70 years old, the payment you will receive is 1/20th of the fund or $15,000, this is the minimum annual payment in that year. It can be higher if you wish, but withdrawing too much money too soon can deplete your funds and the excess is subject to a withholding tax.

As you get older, the fractional amounts increase so that when you are 71, you will receive 1/19th; when you are 72, 1/18th, when you are 73, 1/17th and so on. When you become 89, you will receive 1/1, that is 100 per cent of the remainder.

While a disadvantage of a RRIF is that investors must exhaust all the funds' money by the time they turn 90, the advantages of a RRIF can make it far more attractive than an annuity.

Consider two of them. First, a RRIF offers a wide and varied range of investment choices. Unlike an annuity, which is based on fixed income returns, a RRIF can be invested in growth or balanced investments, such as mutual funds.

Second, a RRIF with growth producing investments will surpass annuities in generating income and compensating for inflation. Suppose at 60 you bought a $100,000 annuity invested at 12 per cent over 30 years. You would receive $12,414 each year until you reached 90 and your cumulative total would be $372,000.

On the other hand, if you had bought a RRIF with the same principal investment of $100,000, also invested at 12 per cent, you would receive $3,333 in the first year. Since less money is withdrawn in the early years of the RRIF, more money is left to compound and grow tax-free in the following years. By the 10th year, you would receive $9,610. By the 20th year, $32,057 and by the 30th year, over $135,000. Over 30 years, you would receive a total of $963,000, 2.6 times as much as the annuity.

Now, let's assume that inflation remains at five per cent during the next 30 years. That means the final $12,414 annual annuity payment would actually be worth only $2,870 in 1989 dollars. By comparison, the RRIFs final payment of approximately $135,000 would be worth $31,200 in constant dollars.

With this in mind, think what would have happened if you had invested your RRIF in a mutual fund that has the potential of yielding an average of 15 per cent a year. During 30 years, you would receive a return of $1.8 million.

For a FREE booklet on calculating retirement needs and a chart comparing the performance of an actual mutual fund RRIF with a 10 per cent RRIF investment over the last 12 years, contact Peter C. Masson M.B.A., Regal Capital Planners Ltd., 10 Fagan Drive, Georgetown, Ontario or phone 877-7216.

Paul J. Rockel is the author of the best seller "Why I Invest in Mutual Funds" and President of Regal Capital Planners Ltd.

Lucky draw winner

Presenting Janet Allison of Georgetown with the tickets she won for a trip to Atlantic City in a draw hosted by the Georgetown Kiwanis Club and Georgetown Travel, is John Schaljo, past president of the Kiwanis Club. Jane Panchyshyn from Georgetown Travel, who arranged the trip, holds up a pamphlet illustrating some of the delights Atlantic City has to offer. The draw was made at the annual Kiwanis Lobsterfest held on June 1, 1990. (Herald photo)