Your Money, Your Future

Taking Charge Of Your Money In Tough Economic Times

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Topic 1 CASE STUDY – FULL VERSION

Waiting at a coffee shop for a meeting, Jeffery, a 33-year-old primary school teacher remembered his thoughts six months ago when he left his father's funeral. Dad was eighty-three (83) years old when he passed. A generous man – dad spent money as easily as he received it – leaving behind a legacy of debts and outstanding rent payments. Jeffrey made a promise to himself that unlike his father, he would leave an inheritance for his children's children, instead of a string of bad debts. Jeffrey also wants to acquire his own home and build a solid retirement plan, so that he would **not** be dependent on his children.

Jeffrey's financial freedom goals hinges on this meeting with Winston – a successful insurance agent – who, is recommending swapping out Jeffrey's existing registered annuity from another company and transferring the $55,350 cash value into Winston's new plan then increasing the monthly investment from $300 to $2,500 until age 60. At that time he should have a future value of $1.5 million, which may generate a monthly taxable pension of $7,500.

Jeffrey likes the idea that this pension income is close to his present salary of $8,000 but the monthly payments leave very little room for a mortgage payment, but Winston assures him that the tax break will reduce his payments by 25%.

Nick's Advice

So how does Jeffrey choose between the seemingly, mutually exclusive, financial security at retirement and the acquisition of his own home?

The Retirement Problem

[Registered Annuity: Is defined as a series of fixed regular payments into or from an investment, which also offers a deferral of income taxes]

Whilst Jeffrey's likes the projected monthly pension figure, he has not factored the effects of inflation. By the time he turns 60 (27 years from now) the purchasing value of his $7,500 projected pension would be significantly less than what it is today.

Let us use some everyday numbers to get an idea of the future value of Jeffrey's pension: Ten (10) years ago a loaf of bread cost approximately $6.00, today it is more than $12.00, that is over 100% increase in price or a 50% fall in the value of money. So if you gave your baker $6.00 today, he would give you half of a loaf. Therefore as prices double, the value of money is halved.

After almost three decades $7,500 would be worth $937 (*$7,500 x 50% = $3,750 x 50% = $1,875 x 50% = $937)* and by age 83 it would be worth about $234 *($937.50 x 50% = $468 x 50% = $234).* This is probably why Winston cautioned Jeffrey about investing less than $2,500 per month. From another perspective: if Jeffery were already sixty (60), he would need to collect $60,000 per month in his first year of retirement to be able to afford the same basket of goods with $7,500 today (First Decade: $7,500 x 2 = $15,000, Second Decade: $15,000 x 2 =

$30,000, Roughly Third Decade $30,000 x 2 = $60,000). Now this sounds a bit far fetched, but ask anyone who is eighty (80) years old or older, what was the average salary when they were thirty-three or rather what was the cost of bread, automobiles or houses back then.

Annuity Swapping & Taxes

Winston's advice to surrender one plan, and rollover the funds into the new plan has two (2) major drawbacks.

1. Jeffrey would have already paid expenses such as agent commissions, administration fees and other charges and now he has to pay a fresh set of charges with the new plan.

2. Surrendering a registered annuity (Approved by Inland Revenue), will incur an immediate tax penalty of 25% of the fund value – after the company's charges. Although investing in the new plan will give him a tax break, he may not completely recover the tax charge from surrendering the first plan.

Here are the numbers from an annual standpoint: Firstly he would have to pay a tax penalty of $13,838 ($55,350 x 25%) which leaves him with $41,512 ($55,350 minus $13,838) then invests in the new plan, which *may yield* a tax refund of $10,378 ($41,512 x 25%). We say, *"may yield"* because the current *"contribution limit"* to get tax relief from registered retirement plans inclusive of 70% of National Insurance (NIS) contributions is $50,000 annually.

By contributing a combined total of $76,552 (assuming his NIS contributions were: 7,200 x 70% = $5,040 *plus* the initial lump sum of $41,512 plus $30,000: $2,500 x 12 months of contributions), he would have exceeded his allowable limit by $26,552 ($50,000 minus $76,552) and therefore not receive a tax break on this portion of the investment.

Now if for any reason Jeffrey were to surrender the new plan, he would have to pay tax on the entire sum withdrawn (of course after the company's surrender charges). So if the fund had $71,512 ($41,512 + $30,000 excluding the NIS figure) he would have to pay a tax penalty of $17,878 ($71,512 x 25%). Remember he did not get a tax break on the entire $71,512 invested because $26,552 exceeded the allowable limit. So his initial tax refund from investing in the new plan would only be $11,240 ($71,512 minus $26,552 = $44,960 x 25%) compared with the penalty of $17,512 resulting in a net loss of $6,272.

Retirement, Home Ownership & Mortgages

If there is some way that Jeffrey could fast-track his home ownership goal, then he could profit from inflation by the natural rise in property values and rental income, which is both an excellent store of wealth and a great source of retirement income.

Of course the obvious challenge is how does a 33-year-old teacher, earning $8,000 per month, close the gap of property ownership, at current prices?

The first truth is, no matter what era you are in, property prices will always be considered high – relative to people's incomes. Secondly, there are always deals! Deals come in all shapes and sizes – from an inheritance disposed of quickly by an owner living abroad, to someone looking for a quick sale to raise money to help a critically ill relative. You may be saying that this sounds more like luck than financial planning. Well guess what? *"Luck is when preparation meets opportunity*". The preparation is acquiring the ticket that prevents most people from getting into the real estate game – that is cash for the down payment and closing costs.

With a well-structured and systematic plan of saving and investing in the right instruments, Jeffrey could position himself for the right opportunity.

Now if Jeffrey already had a mortgage, he would be paying about $3,200 per month ($8,000 x 40% maximum debt service ratio). So if he tried living without this money from today, combining it with the $41,512 from the existing annuity, investing in say a credit union share account (with no charges) that earns a dividend of 2% per annum, he would accumulate approximately $336,000 by age 40.

If at that point he were to get a mortgage for twenty years at say 4.5% per annum, he may be able to borrow roughly $500,000, which puts him in the $700,000 - $800,000 property price range. Though this figure seems modest, it could be higher if he were to have a longer-term mortgage, a lower interest rate, a higher salary and the benefit of combining incomes with a spouse.

Now depending on the configuration of the property he purchased, if he could squeeze even a tiny studio apartment out of the house's footprint to earn a monthly rent of say $1,500 (in today's dollars), he would have a potential rental income in his first year of retirement of **$12,000** as rent often doubles every ten (10) years ($1,500 x 2 = $3,000 x 2 = $6,000 x 2 = $12,000).

The sooner that he can materialize this plan, faster that potential rent can be used to subsidize his mortgage payments, allowing him to build even more wealth for the future.

Other Sources of Retirement Income

Lets touch briefly on pensions from National Insurance and the Government. Once Jeffery makes a minimum of 750 weekly contributions to NIS he would be eligible for a monthly pension $3,000 (currently) at age 60, which is enhanced where contributions exceed 750.

Now if Jeffrey remains in the teaching service until retirement he would also be entitled to a gratuity and monthly taxable pension. If we assume that his projected government pension was half of his final salary and that his present salary was to increase by 1% per annum for the next twenty-seven (27) years then he could receive about **$5,240** (Projected Final salary of $10,479 x 50%)

Conclusion

Regardless of where you are in life, there is always a financial plan that can be crafted to achieve your goals. It is essential to establish one, as this process greatly improves your chances of success. By making adjustments to any of the key variables over time, your goals could be accomplished sooner than expected.