Zlotnik, Lamb & Company

federal budget bulletin

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ZLOTNIK LAMB & COMPANY

Budget 2005: what you need to know

Important changes for retirees and investors

Budget time is always a busy time of the year for financial professionals. This year was no exception. While some analysts were disappointed the federal budget tabled on February 23rd did not contain significant tax cuts, it did include a number of interesting developments for investors.

Here is a brief overview of some of the most important changes in this year's budget, along with some notes on what the changes might mean for you.

Basic personal credit increased

The 2005 budget establishes a fairly substantial increase in the amount of tax-free income available to all taxpayers. In 2005, the basic personal income exemption is $8,148. By the year 2009, the exemption will be increased to at least $10,000. Personal credits allowed for spouses, common-law partners, or wholly dependent relatives have also been increased; by 2009 the credit will be based on at least $8,500 of personal income, with a corresponding increase to the "threshold amount" – the amount of income the spouse, partner, or dependent is allowed to earn before credits begin to be clawed back. Note that these increases are *in addition* to any increases due to inflation due to the indexation of the tax system (indexation was restored in 2000).

New contribution limits for RRSPs, RPPs, and DPSPs

In response to lobbying from members of the financial industry, the government has increased annual contribution limits for RRSPs, IPPs, and other retirement savings programs. This decision continues the series of increases announced in the 2003 budget. By 2010, the annual RRSP contribution limit will be raised to $22,000, or 18% of earned income, whichever is less. This is an increase from $16,500, the limit today. The chart below provides a detailed breakdown of the proposed changes.

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2005 Budget changes to retirement savings limits

Year	DC/MP	RRSP
2005	$18,000	$16,500
2006	$19,000	$18,000
2007	$20,000	$19,000
2008	$21,000	$20,000
2009	$22,000	$21,000
2010	Indexed	$22,000
2011	Indexed	Indexed

DC/MP: *Defined Contribution or Money Purchase Pension Plan*

RRSP: *Registered Retirement Savings Plan*

Individual Pension Plan Current Service Contribution Limits

Age	Post-budget Contribution
50	$22,425
55	$24,631
60	$27,057
65	$30,122

Assuming individual attains exact age on Jan. 1, 2005, and employment earnings exceed $100,000.

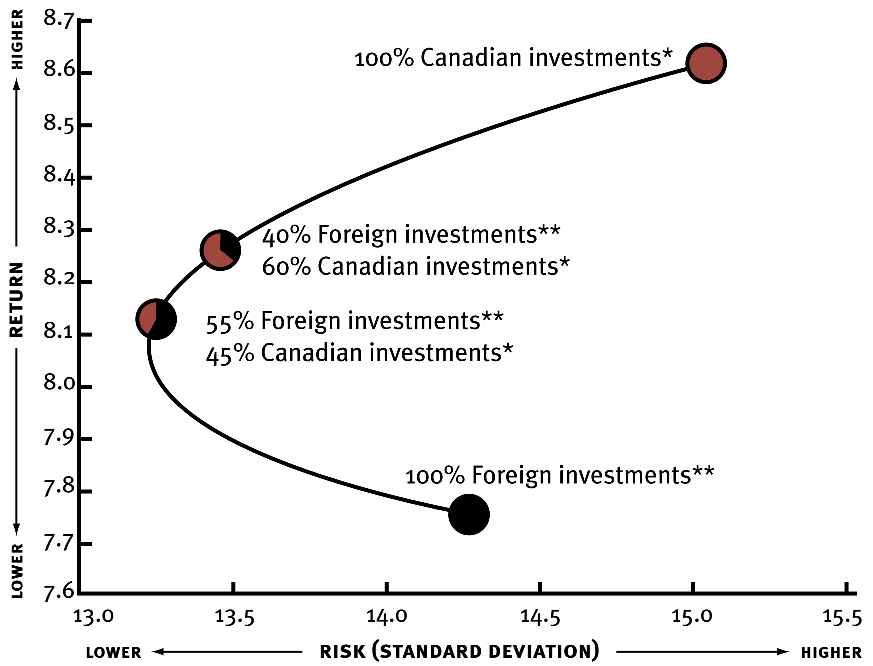
Foreign content restrictions eliminated

The budget has eliminated the 30% restriction on foreign content held within an RRSP, IPP, or RRIF. This is a significant development, and somewhat of a surprise. Now Canadian investors will be able to build an optimal asset allocation mix into their portfolios without the help of derivatives or other sophisticated investment products.

Does this mean you should sell your existing Canadian holdings in your RRSP? Our approach is to focus on our clients' individual circumstances and risk tolerance when developing a portfolio. A custom mix of fixed income, Canadian and foreign equities will ensure a balanced portfolio specific to our clients' needs. Recent studies by Connor, Clark, & Lunn show that a portfolio with 55% foreign content and 45% domestic content offers optimal geographic diversity to maximize equity returns and minimize risk for Canadian investors (see graph at right).

Geographic diversification can maximize returns and minimize risk

Risk vs. return for 15 years ending Dec. 31, 2003



** S&P/TSX Composite ** MSCI World (ex Canada)*

Clone funds made redundant

One of the implications of the foreign content elimination is the redundancy of so-called "clone" funds.

These 100% RRSP-eligible funds use sophisticated derivative products to mirror the performance of an underlying international equity fund while retaining their eligibility as "domestic" content. While this was an effective way of boosting foreign content in the portfolio, the higher fees associated with clone funds were a drag on investment performance.

With the elimination of the foreign content rules, we expect most mutual fund companies to phase out their clone funds over the next several months.

Deposit insurance coverage increased

Under federal legislation, all deposits in qualifying Canadian financial institutions are provided with deposit insurance guaranteed by the Government of Canada. The 2005 budget increased the maximum insured amount from $60,000 per account to $100,000 per account, effective immediately. This is the first time the coverage has been increased since 1983.

Annuity requirement for Life Income Funds eliminated

Employees who are members of a federally-regulated pension plan may choose to transfer the commuted value of that pension into a locked-in RRSP if they terminate their employment. By age 69, that locked-in RRSP can then be used to acquire a life annuity or converted into a Life Income Fund (LIF).

Under previous legislation, LIF holders were required to use any LIF assets that remained in the account when the annuitant reached the age of 80 to purchase a life annuity. This eliminated a retiree's ability to continue to control their investment and payment options, and leave a potential estate for their heirs.

Under the new legislation, this requirement has been removed. Retirees can now continue to withdraw funds from their LIF after age 80. In this, the federal government is following the changes instituted by several provinces including the BC Pension Commission, which eliminated the life annuity requirement for LIFs in April of 2004.

Interest deductibility

Under current legislation, interest and other expenses incurred for the purposes of earning income are generally deductible. However, in 2003, the government released draft legislation that would have limited the ability of taxpayers to deduct interest on money borrowed to purchase common shares or mutual funds.

Needless to say, tax professionals and other financial experts were alarmed at the move. In response to their opposition, the government has reconsidered this legislation.

The 2005 budget makes mention of a "more modest legislative initiative" that would achieve the government's objectives while balancing them with some of the industry's concerns. The timeline for such legislation remains vague – the Department of Finance said it would table legislation "shortly," but did not mention a deadline.

At this point, it's difficult to say what the impact of such legislation will be – or when (if ever) it will be introduced. However, the Department of Finance has made it clear that they intend to continue to allow interest deductibility for equity investments.

If you have any questions about what the 2005 budget means for you, we encourage you to call your ZLC Financial Advisor. What you learn today could have a big impact on your financial future!