Canada Revenue Agency: This 1 Mistake Could Get You Taxed in Your RRSP

Description

Did you know that you could end up getting taxed in your RRSP — before even cashing out?

It's not a well-known fact, but it's true.

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Last week, I wrote an article discussing how overcontributing to your RRSP could get you taxed at 1% a month. Normally, RRSPs aren't taxed until funds are withdrawn. However, if you overcontribute in excess of $2,000, you suddenly get hit with heavy bills.

Last week's article showed how overcontribution taxes can accumulate massively over 12 months. In this article, I'll be talking about an even bigger RRSP mistake that could hit you with a far larger bill.

Holding prohibited investments

Holding prohibited investments is, by far, the costliest RRSP mistake you can make. Taxed at 50%, prohibited investments held in an RRSP are so heavily penalized that it's nearly impossible to compensate for the loss with superior returns. Granted, there are certain situations where prohibited investment taxes can be refunded — namely, if you had no reasonable way of knowing that your holdings were prohibited. However, if the CRA determines that you are holding prohibited investments and either know or ought to know they were prohibited, prepare to pay up.

What are prohibited investments?

There are several categories of investments that aren't allowed in RRSPs.

Generally speaking, you aren't allowed to hold shares in companies where you own a large interest (10% or more), and you are not able to deal with the issuer at arm's length. The latter category is somewhat murky, but it basically boils down to having a significant influence over the running of the company.

You might think that avoiding a 10% interest in an RRSP is easy. After all, you're probably not rich enough to buy that much of a publicly traded company, and, at any rate, you'd trigger the overcontribution rule well before building up a 10% position. Remember, though, that not all corporations are publicly traded. There have been cases over the years of people trying to put shares in small private companies in their RRSPs, and getting taxed as a result.

What to hold in your RRSP instead

If you're worried about getting hit with prohibited investment taxes in your RRSP, the smartest thing you can do is stick to publicly traded companies. While a very rich investor could run afoul of RRSP rules by owning 10% of a TSX-listed stock in their RRSP, that's unlikely to happen, since most such people have teams of accountants looking after finances. So, if you're like 99.99% of people, you'll likely avoid the prohibited investment tax by sticking to publicly traded stocks.

Not sure which stocks to buy?

Then buy them all!

By investing in highly diversified index like **iShares S&P/TSX 60 Index ETF** (TSX:XIU), you get a basket of stocks that's basically guaranteed to deliver average performance.

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Studies show that the vast majority of money managers don't beat the market over the long term. By buying an ETF like XIU, you not only avoid the heavy fees such managers charge, but you also avoid the risk of losing it all on individual stocks you picked yourself.

XIU is my personal favourite Canadian ETF, because it enjoys a slight edge in both returns and income over the TSX. Its superior returns stem from the fact that it excludes many of the small-cap energy stocks that have been holding back the broader TSX recently. Its relatively high yield comes from the fact that it invests only in the 60 largest TSX stocks by market cap, and many of those stocks are high yielders. So, XIU has a higher yield than its sister fund, XIC, which holds the entire TSX index. This quality makes it an excellent RRSP pick for those trying to keep their holdings on the straight and narrow.

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