Canada Revenue Agency: 1 RRSP Mistake That Could Cost You Heavily in Taxes

Description

As an investor, your primary focus is usually the stocks. Which companies are growing faster, which ones are paying the best dividends, and how can you make a well-balanced portfolio? But with all this, it's important to know about your asset allocation as well. Whether you are using an RRSP or a TFSA to grow your wealth, you have to be sure that you are not making any mistakes that will cost you down the road.

In an RRSP, that one mistake is over-contribution.

Breaking the limits

It's good to try and push past your limits. But it's never a good idea to break the boundaries of the law, human decency, and financial institutions like the CRA. Specifically, the limit CRA places on your RRSP contributions.

The contribution limit is fairly simple to understand. It's either 18% of your earned income or the maximum contribution limit for that year ($27,230 for 2020), whichever is lesser.

Let's say you made $100,000 in a year. Your contribution limit based on your income would be $18,000. You can't contribute any more than that, or it will be considered over-contribution, which will incur a tax penalty. If someone made $200,000 a year, 18% for them comes down to $36,000. But they can only contribute $27,230 in 2020 since it's the lesser of two limits.

Cost of your mistake

The cost of your mistake is high, indeed. If someone over-contributed an amount of $20,000 for a year, the excess taxable amount will be $18,000 after a $2,000 reduction. That $2,000 is a once-in-a-lifetime cushion provided against CRA over-contribution. So the penalty will be assessed on $18,000.

The penalty is 1% every month of the exceeded amount. So that comes to $180 for the first month, about $178 for the second. If you take out the excess amount, the penalty stops. But if you don't, it can add up to about $2,045 for the year. If the excess amount is covered in the next year's contribution limit, you won't be penalized, but if it isn't, you will keep paying taxes until the excess amount is all used up.

Better alternative

Exceeding your RRSP might not be the right way to achieve your retirement nest egg goals. Instead, choose the stocks that are paying better than your current securities. A company like **SmartCentres REIT** (TSX:SRU.UN) might fit the bill.

The company is a trustworthy dividend payer, with a history of increasing dividends for seven consecutive years. The current yield is a tasty 5.7%. So even if you allocate $50,000 from your fully stocked RRSP into the company, you will be earning $2,850 a year through dividends.

Currently, the company is trading at $32.17 per share, which is a bit overvalued, considering its price-to-earnings ratio. It has a smart business model and dependable tenants. And since its primary focus is on retail real estate, the company is relatively sheltered against residential real estate head swings and even a recession.

Foolish takeaway

Think of your RRSP savings as a tree that you constantly have to water through contributions to make it grow. But you have to be careful. If it grows over the CRA limit, they won't hesitate to prune it for you. So rather than seeing your hard-earned money getting burned in penalty taxes, be mindful of your RRSP contributions.

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