Canada Pension Plan Enhancement: 50% Raise or Hidden Tax?

Description

Did you know that the Canada Pension Plan is being enhanced? From 2019 to 2023, CPP premiums are gradually increasing, to pay for bigger benefits later on. The promised benefit increase is substantial. Aiming to boost payouts by 50%, it sounds a lot better than what CPP pensioners get now.

But there's the flip side, which is having to pay steeper taxes today. CPP premiums come out of your paycheque and are part of your tax bill. Some say that they're not exactly "taxes," but they function much the same way while you're still working. It's not until much later in your life that they begin to pay you back.

Which brings us to an important question:

Is Canada Pension Plan Enhancement more like a pension pay raise, or more like a tax increase?

The answer actually depends on how long you'll be paying enhanced CPP premiums. I'll explain that in just a minute. First, let's explore whether CPP premiums are really a tax at all.

Are CPP premiums a tax?

There's significant debate over whether CPP premiums are a tax. The *Fraser Institute* argues that they are, mainly because they're mandatory and you can't pull your money out of the CPP pool at will. Others say they aren't because the money you pay into the program will come back to you later. Ultimately, the jury is out. What's clear, though, is that CPP premiums are a big part of your tax *bill.*

The increased cost

Canada Pension Plan enhancement will increase your CPP taxes over the next several years. From 2018 to 2023, the increase will amount to about 20%. That sounds like a lot, but do keep in mind that CPP taxes are offset by a credit. If you're self employed, you also get a deduction on the employer portion of your CPP.

The future raise

The stated goal of CPP enhancement is to boost the payout from 1/4 to 1/3 of lifetime insurable earnings. According to the Canada Revenue Agency, the maximum payout will be 50% higher than it would otherwise be. The only problem is that to get that 50% higher payout, you'll need to contribute for 40 years. So, if you're already nearing retirement age, you won't see much of an improvement.

Bottom line: you need to build your own pension

Ultimately, Canada Pension Plan enhancement is going to take a long time to pay off. If you're already nearing retirement age, it will not benefit you much. The annual increases are modest and take 40 years to reach their ultimate 50% goal.

Which is one reason why you need to take the time to save and invest. If you hold stocks like **Royal Bank of Canada** (TSX:RY)(NYSE:RY) in an RRSP, you realize enormous tax benefits that can offset increased CPP premiums. First, you get a big tax break for contributing. Second, you get to grow your assets tax-free for a long time–potentially until mandatory withdrawals at age 71.

Why mention Royal Bank specifically? Truthfully, you should aim for a highly diversified portfolio that minimizes your risk. But Royal Bank stock would be a worthy addition to it. As Canada's biggest and oldest bank, it has stood the test of time. It has a 4% dividend yield–which is perfect for retirees.

Finally, it stands to benefit from the arrival of the COVID-19 vaccine, which will reduce its risk factors significantly. All-in-all, a worthy addition to any retiree's portfolio. And if you hold it in an RRSP, you can even offset those pesky CPP taxes.

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