Big CPP Changes in 2021: Know How It Will Reduce Your Paycheck

Description

Service Canada is bringing changes to the Canada Pension Plan (CPP) in 2021. These changes could mean a higher payroll deduction. If you are a salaried employee, your employer deducts three things from your taxable salary and pays it to the Canada Revenue Agency (CRA). They are:

- Employee's contribution towards CPP
- Employment Insurance (EI) premiums
- Income tax

The CRA returns these deductions to employers and employees through tax credit and cash benefits. Today, I will talk about the first deduction.

2021 CPP changes

The CPP is a government pension plan that is funded by the contribution employers and employees make toward the program. Service Canada enrolls you in the CPP after you turn 18 and start earning more than $3,500 annually. You can elect to stop contributing to the CPP under special circumstances.

In 2019, Service Canada started a CPP enhancement plan, under which it will increase CPP contribution every year till 2025. For 2021, it has increased the CPP contribution rate to 5.45% from 5.25% in 2020. It has also increased the maximum pensionable earnings to $61,600 from $58,700. The CPP contribution is calculated on your income after deducting the $3.500 exemption amount.

What do 2021 CPP changes mean to your paycheck?

If your net income was $58,700 in 2020, your employer deducted up to $2,898 in CPP contribution. The CPP was calculated as 5.25% of $55,200 ($58,700-$3,500). Even if you earned more, your maximum CPP contribution 2020 cannot exceed $2,898.

By 2021, the CPP contribution rate increased to 5.45%. So if your income remains unchanged at $58,700 in 2021, your employer will deduct $3,008 (5.45% of $55,200) in CPP contribution from your 2021 paycheck. This means your CPP deduction for full-year 2021 will increase by $110, or $9.2 per month.

By 2021, Service Canada has also increased the maximum pensionable earnings to $61,600. For instance, Marcy earns $70,000 in 2020 and 2021, her employer will deduct up to $3,166 (5.45% of $58,100) in CPP contribution in 2021 from $2,898 in 2020. This means her CPP contribution will increase by $268.5 for full-year 2021, or $22.4 per month.

This modest increase in CPP contribution will go a long way. While it will reduce your current salary, it will give you a higher federal tax credit. Moreover, a higher contribution now will increase the CPP payout when you turn 65. After 65, Service Canada will pay you a monthly pension equivalent to a third of your average work earnings you received post 2019. I will leave the payout calculation for another time.

There is one income on which there are no deductions

The CPP enhancement will increase your contribution every year till 2025. This means you could see higher deductions from your paycheck every year. These deductions are on your working income. The higher your salary or business profit (for self-employed), the higher will be your deductions up to the maximum limit.

But there is one income where none of the deductions apply. That income is your investment income from your Tax-Free Savings Account (TFSA). You can contribute $6,000 annually in TFSA in 2020 and 2021. The CRA will not give you any tax benefit on the contribution. But whatever income you earn from TFSA investment will be exempt from income tax. As it is not taxable, there won't be any CPP or EI deduction on it.

Investors generally look for fixed income securities to earn passive income. But the pandemic crisis has pulled down interest rates to near zero, making fixed income securities unattractive. However, the pandemic has created some good dividend opportunities. **RioCan REIT** (TSX:REI-UN) is currently trading at a 36% discount that has inflated its dividend yield to 8.3%.

The REIT took a plunge from the pandemic-induced lockdown as many retailers shut down their stores. This impacted RioCan's rental income and occupancy rate. It will fill those empty stores as retail business recovers.

Foolish takeaway

A $6,000 investment in RioCan will give you $497 in annual dividend income. That will take care of the rising pension contributions. Moreover, when the economy recovers, RioCan stock will also recover, increasing your $6,000 to $9,300 in two years.

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