Tax Planning 101: You Have Until March 1 to Reduce Your 2020 Tax Bill Using RRSP

Description

The year 2020 was different from other years for many Canadians even in terms of income. Many people lost their jobs, started home businesses, and got generous unemployment cash benefits. All these changes drastically impacted your income. Have you calculated your 2020 taxable income? Calculate it now, as you may have a higher tax bill waiting for you in April. You have time till March 1 to reduce your tax bill using the Registered Retirement Savings Plan (RRSP).

Tax planning using RRSP

Canada follows a progressive tax system where your tax rate can range from 15% to 33%, depending on your income. The RRSP deduction can help you lower your tax rate by reducing your taxable income. For the year 2020, the Canada Revenue Agency (CRA) allows you to contribute 18% of your earnings, or $27,230, whichever is lower, to RRSP. You can directly deduct this contribution from your 2020 taxable income.

Let’s understand this with an example. Rosy lives in Ontario. She earned $50,000 in taxable income in 2020. She can contribute up to $9,000 (18% of $50,000) in RRSP. If she maxes out on her contribution, she can reduce her taxable income to $41,000 and achieve tax savings of over $2,500.

If you haven’t yet contributed to RRSP, you have until March 1 to contribute. Don’t forget to collect receipts for all amounts you contributed from March 2, 2020, to March 1, 2021, from your RRSP provider.

RRSP tax savings come with a price

But before you rush into investing your money in RRSP, know that these lucrative tax savings come for a price. The CRA created the RRSP to encourage Canadians to save for their retirement. Hence, it offers such high tax savings. But the RRSP doesn't offer liquidity. If you withdraw your money fromyour RRSP before you turn 71, the CRA will charge a penalty ranging from 10% to 30%:

- 10% for the first $5,000
- 20% for amount between $5,000 and $15,000
- 30% for amount over $15,000

Moreover, your RRSP withdrawal will be added to your taxable income. However, there are exceptions if you are withdrawing to purchase a first home or continue your education. Even when you withdraw from your RRSP after 71, that amount will be taxable. But by 71, your income would be reduced, and you will have other tax benefits, such as the age amount credit. It is because of this liquidity drawback that fewer than 3% of Canadians max out their RRSP contribution.

How to save in RRSP

Now that you know the tax implications of an RRSP, plan out your investments and taxes wisely. As the RRSP is a long-term investment, look for a stable stock that is resilient to the economy. Some dividend stocks like energy, real estate, and infrastructure are good investments for an RRSP. One stock you can consider is **Enbridge** (TSX:ENB)(NYSE:ENB).

Enbridge has been in the pipeline business for more than 60 years and has been paying incremental dividends for over 25 years. This is because the pipeline infrastructure it has built over the years is paying off. It transmits about 25% of the crude oil produced in North America and nearly 20% of the natural gas consumed in the United States. It is gradually expanding its portfolio to include renewable energy and gas storage.

Enbridge will continue to increase its cash flow by adding new pipelines. It has three new pipeline projects coming online between 2021 and 2023. Even after the pandemic, it increased the 2021 dividend per share by 3%.

Investor corner

Enbridge can continue paying dividends for another 20 years. Such companies that existed for generations are a good investment for RRSP. If you invest $5,000 in Enbridge now, it will give you more than $6,700 in dividends in 10 years, considering it increases dividend per share at 8% CAGR.

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pujatayal