Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Transferring a bonus to your RRSP without withholding tax

If you receive a bonus or other lump sum payment as part of your compensation, and you have RRSP contribution room, consider asking your employer to pay the amount directly into your RRSP without withholding income tax. This article explains how you can transfer your bonus or other lump sum payment to your RRSP and eliminate the requirement for withholding tax.

Any reference to a spouse in this article also includes a common-law partner.

The strategy

When your employer pays you a bonus or other lump sum payment (such as vacation pay or an ineligible retiring allowance), they are generally required to deduct withholding tax at source. Then, if you wish, you can contribute the net amount to your RRSP, provided you have sufficient contribution room. You can then deduct the amount of your RRSP contribution from your taxable income, which essentially lowers the taxes you pay in the year you claim the deduction. You then receive the benefit of your RRSP contribution when you file your income tax return the following year, either in the form of a refund, or as a reduction in the taxes you owe.

However, there is a way to maximize your RRSP contribution. You can request that your employer contribute all or a portion of your bonus or lump sum payment directly to your RRSP or your spouse's RRSP as a spousal contribution. If your employer makes this RRSP contribution directly, the requirement to withhold income tax on that amount is eliminated, if certain conditions (mentioned later) are met. The benefit of transferring the amount directly without withholding tax is that you can then invest the full amount, rather than the net after-tax amount, in your RRSP.

Let's look at an example. Say you receive a bonus this year of $20,000 and you have sufficient RRSP contribution room to make a $20,000 contribution. Let's also assume you have a marginal tax rate of 40%. If you contribute the funds to your RRSP yourself, you would only have the net amount of $12,000 to contribute because your employer is required to withhold tax of $8,000 ($20,000 x 40%). In this scenario your tax savings will only be $4,800 ($12,000 x 40%) and you will need to wait until you file your tax return the following year to get your refund and contribute those additional funds to your RRSP. If instead you asked your employer to contribute your bonus directly to your RRSP, your employer could contribute the full $20,000 to your RRSP saving you taxes of $8,000 ($20,000 x 40%) for the year. The $8,000 tax savings is already in your RRSP growing tax-deferred until you withdraw the funds.

Assuming your income level is relatively consistent year over year, this strategy may be even more beneficial when a bonus or lump sum payment is paid to you early in the year. This is because if your employer makes the direct contribution to your RRSP within the first 60 days of the year, you can claim a deduction in the prior year for the contribution, and you will not pay tax on the bonus or lump sum payment until the following year when you file your tax return.

Keep in mind that if the bonus or lump sum payment is paid to you early in the year, your employer will still be required to withhold Canada Pension Plan (CPP) and Employment Insurance (EI) from your compensation. If the bonus or lump sum payment is paid to you at the end of the year, you may have already reached the maximum annual amount for CPP and EI so the amount you will be able to put into your RRSP might be greater.

How it works

In order for your employer to directly transfer the gross amount of your bonus or other lump-sum payment to your RRSP without withholding tax, your employer needs to have reasonable grounds to believe that you can deduct the RRSP contribution for the year. Providing your employer with a copy of your most current Notice of Assessment, which indicates your RRSP deduction limit, might be sufficient for their records. Or, your employer may ask you to sign a confirmation that you can deduct the contribution for the year. There is no prescribed CRA form for this direct contribution.

If the bonus or lump sum payment is paid to you at the end of the year, you may have already reached the maximum annual amount for CPP and EI so the amount you will be able to put into your RRSP might be greater.

Please note that your employer is not obligated to provide this service to you and reduce withholding tax. Some employers will not transfer your bonus or lump sum payment directly to your RRSP and will instead pay you the amount less withholding tax.

An alternative to reduce withholding tax on compensation

An alternative option exists where you make RRSP contribution yourself during the year. You can request that your employer reduce withholding tax on your regular salary or on your bonus or other lump sum payment. In order for your employer to reduce withholding tax, they may require that you provide them with authorization from the CRA to reduce the withholding tax. To obtain approval from the CRA, you will need to send them a completed Form T1213, Request to Reduce Tax Deductions at Source. Quebec residents must also use Form TP-1016-V, Application for a Reduction in Source Deductions of Income Tax to request Revenue Quebec to authorize an employer to reduce the amount of income tax withheld at source. You should also include documents that support your request for the tax deduction. The CRA may not approve your request if you have not filed all your previous years' income tax returns and paid all your taxes owing.

Conclusion

Asking your employer to directly contribute your bonus or lump sum payment to your RRSP will provide you with immediate tax savings for the year that will enable you to put more into your RRSP. In addition, contributing directly allows your RRSP contribution to be made earlier, effectively boosting your RRSP's growth. This is because by contributing early, your RRSP assets will have more time to benefit from tax-deferred compound growth.

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