Laid off Due to COVID-19? That $2,000 CERB Check Won't Get You Far

Description

If you've been laid off due to COVID-19, there's a good chance you're already getting CERB payments. The CRA rolled out the program to help Canadians who desperately needed cash, so applications were moved along swiftly. If you haven't applied for the CERB yet, you'll probably be approved quickly.

As an out of work Canadian, you may be excited about your new $2,000 a month payment. Depending on how much you made before getting laid off, the CERB could pay you more than EI. The pre-tax amount is enough to cover rent in most Canadian cities, making it a pretty helpful cash transfer.

But note the key phrase: *"PRE-tax amount."* The CERB is taxable, and you're responsible for paying the taxes manually to the CRA. So when CERB money hits your bank account, you have to figure out your tax rate and pay the appropriate amount.

If you're a high earner and you go back to work fairly quickly, the amount of taxes you owe could be substantial. Here's why.

The CERB is considered ordinary income

Under CRA guidelines, the CERB is taxed as ordinary income, which means it doesn't get any special tax treatment: it's just taxed like employment income. The taxes payable on it will therefore depend on how much money you earn this year.

To illustrate this, let's consider a worker who earned $20,000 a month, got laid off because of COVID-19 in April, and was re-hired in May. That person's income would be $222,000 ($240,000 minus the $20,000 they lost in April, plus $2,000 from CERB).

If this person lived in Ontario, they'd have a marginal tax rate of 52%. So he or she would have to pay $1,040 on their lone CERB payment, leaving a paltry $960!

Of course, we're considering an example of a high earner here. For someone with a marginal tax rate of 30%, the taxes would only add up to $600. However, this extreme example goes to show how little the CERB could end up paying you in after-tax terms.

What to do

If you're concerned about taxes eating up your CERB money, the first thing you can do is to lower your taxable income. As far as employment income goes, that all depends on when you go back to work. Basically, it's outside of your control. But minimizing investment income is very much within your power.

One way to do it is to hold your investments in a Tax-Free Savings Account (TFSA). Any returns from investments you hold in a TFSA don't count toward taxable income, which includes dividends, interest and capital gains. Held outside a TFSA, they'd increase your taxable income and, potentially, your marginal tax rate. Inside a TFSA, they would not.

Let's imagine you were holding $60,000 worth of the **iShares S&P/TSX 60 Index fund** (TSX:XIU) in a TFSA. With a 3% dividend yield, that position would pay out $1,800 a year. That's easily enough money to bump you into a higher tax bracket.

But by holding the XIU units in a TFSA, you avoid that negative tax implication–not to mention the dividend taxes themselves.

Of course, if you have a large portfolio, you may not be able to hold *all* of your investments in a TFSA. The absolute maximum contribution room is $69,500, and that assumes you were over 18 in 2009 and haven't contributed yet. If you have, say, a $500,000 portfolio, you'll inevitably pay taxes on most of it.

But by holding a good sized portion in a TFSA, you minimize your overall taxes. That's particularly true for dividend-paying investments like XIU, whose taxes can't be avoided by simply not selling.

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