THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Income splitting comes to the fore during COVID-19 era

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What a strange year it is – particularly for those who are, or were, getting married. We were supposed to attend two weddings this month, but because of COVID-19 one has become a Zoom wedding and the other, well, it's been postponed. Still, I've taken it upon myself to provide some words of advice to the engaged couples based on my years of experience. For example, I suggest that the husband always insist on having the last word in any argument – even if he has to go into another room and mumble it to himself. Every husband should learn that one.

The other thing worth learning is that tax planning can be done as a couple. I'm talking about income splitting, which is the idea of moving taxable income from the hands of one spouse to the other who will pay tax at a lower rate.

During this pandemic, I've met a number of couples where one is now earning significantly less than before COVID-19, with the result that he or she is going to be in a lower tax bracket this year. It could make sense to shift income to a lower-income spouse. There's still time to do this for 2020, so here are some ideas to consider.

Lend money and charge interest. You can lend money to your lower-income spouse and have him or her pay the tax on any investment income earned on those funds. You'll need to charge the prescribed rate of interest on that loan (which will drop to just 1 per cent on July 1, so wait until then to set up a loan), and can lock in that rate indefinitely. The borrower will have to pay the interest each year, by Jan. 30 after each year-end, and the lender will have to pay tax on that interest.

Transfer money for business purposes. If your lower-income spouse is looking to make up for lost income by starting a home-based business of any kind, you can give or lend money to your spouse to help in that business. You'll avoid the attribution rules, which normally apply to cause income earned on gifts and loans to your spouse to be taxed in your hands, not your spouse's. Since you're making the gift or loan for business purposes, there's no need to charge interest as is the case when transferring funds for passive investments.

Have the higher-income spouse pay the bills. By having the higher-income earner pay the household bills, you could free-up any earnings of the lower-income spouse to invest. This will allow the lower-income spouse to report more investment income, which will save the family taxes.

Only withdraw from an RRSP if you must. I've met a few folks who are making withdrawals from their registered retirement savings plans to help meet the costs of living during the pandemic. It's never an ideal situation to spend retirements funds if you're not in retirement (withdrawals from a tax-free savings account would be better). Nevertheless, if this is your situation, consider having the lower income spouse make withdrawals from his or her RRSP in 2020. Next year, perhaps you'll be able to contribute to your RRSP (or your spouse can contribute to a spousal RRSP) to bolster your retirement savings again. Remember: You won't get back that RRSP contribution room when you make withdrawals, so you'll need to have earned income to create additional contribution room.

Report your spouse's dividends. The fact is, you can elect to report all of your spouse's Canadian dividends on your tax return. This could make sense if your spouse has a very low income in 2020. By reporting your spouse's dividends on your tax return, you'll reduce your spouse's income even further, which may increase the spousal tax credit you can claim (in fact, you'll only be able to make this election if it increases your spousal tax credit). Since you'll also be entitled to a dividend tax credit on the dividends, you could save taxes as a couple.

Transfer capital losses to your spouse. Although this idea doesn't shift income from one spouse to the other, it does allow one spouse to transfer unrealized capital losses to the other, which could be handy if one spouse has capital gains this year, or in the past three years, while the other has capital losses that he or she can't utilize. This is a common situation today given COVID-19 and the impact on investment portfolios. There are some simple steps required to make this transfer properly. See my article from last Nov. 21 (tgam.ca/cestnick-losses) for the details.

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