Income splitting can cut tax burden for your heirs
BY TIM CESTNICK
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Why testamentary trusts are a terrific tool.

If there are three things that are never convenient, they are death, taxes -- and childbirth.

And while I do like children -- in fact, I inherited eight nieces and nephews when I tied the proverbial marriage knot last month -- I don't purport to be an expert on childbirth.

Not to worry -- Dear Abby can more than handle your questions on the subject. Abby, however, doesn't know much about death and taxes, or income splitting -- I quizzed her once.

The good news? The idea I'm going to share today, while it won't make you immortal, will reduce the tax burden to your heirs after your death. Let's talk about income splitting with testamentary trusts.

Income splitting

Before turning to testamentary trusts, let's talk for a minute about what it means to split income, and the benefits of this pillar of tax planning. Consider the story of Ric and Shirley. Shirley earns $60,000 a year, and Ric -- being rather unemployable, doesn't have an income.

In 1996 Shirley paid total taxes of $19,131, at Ontario tax rates. If the couple had been able to split the $60,000 last year so that they each had earned $30,000 -- what do you suppose their combined tax bill would have been? Just $12,844. That's right -- they would have saved $6,287 in taxes.

How can this be? Simple. Any income under $29,590 will be taxed at just 25 per cent (a figure that varies slightly by province). Over $29,590, and the taxes quickly add up to between 42 and 54 cents on each dollar of income.

By splitting income, Ric and Shirley would have maximized the number of dollars taxed at the lowest marginal tax rate. The result? Significant tax savings.

Testamentary trusts

A testamentary trust is a terrific tool for splitting income. It works this way: A trust would be created on your death through instructions in your will. All or a portion of your assets would be transferred to the trust on your demise, and your intended heirs would be the beneficiaries of the trust.

Any investment income earned on the inheritance may now be taxed in the trust, rather than in the hands of your beneficiaries.
You see, the trust is considered to be a separate person for tax purposes, and will be taxed at the same graduated tax rates as any individual.

Rather than adding any investment income directly to the beneficiary's income where it will be taxed at his or her marginal tax rate -- very likely between 42 and 54 per cent, simply split income with the trust by having the trust pay tax on the income instead, at graduated rates.

Back to Ric and Shirley for a minute. Suppose Ric were to die this year. On his death, his assets would generate in the neighbourhood of $60,000 annually in investment income for Shirley.

Scenario A in the table, shows the tax bill Shirley would face if the $60,000 earned on the inheritance was added to her $60,000 of employment income. The tax bill would total $50,722.

If Ric were to set up a testamentary trust through his will on his death, Shirley would enjoy the benefits of income splitting with the trust.

Scenario B in the table says it all: The trust would pay $21,022 of tax on the investment income earned on the inheritance. Add this to the $19,131 Shirley will owe on her employment income, and the total tax bill comes to $40,153 -- a full $10,569 less than without the trust!

By the way, that's $10,569 of tax savings each year. Now that's something worth writing home about.

Here are some last thoughts: You may want to set up a separate trust for each beneficiary, to maximize the number of dollars that can be taxed in the lowest bracket. The trusts would provide that income may accumulate in the trusts, and that tax-free capital distributions could be made to beneficiaries.

The option would also exist to have the income in the trust taxed in the hands of the beneficiary in any given year, simply by paying the income to the beneficiary, or by making it payable to the beneficiary -- which may be a good idea if, for example, the beneficiaries are children with no other income and who will enjoy their first $6,456 of income tax-free because of the basic personal credit.

Tim Cestnick is a chartered accountant, author, and president of The WaterStreet Group Inc., a tax education and consulting firm based in Toronto.

Income splitting for heirs

Scenario A - No trust

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Scenario B - Trust set up

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<td>Taxes saved by splitting income with trust (A-B)</td>
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Source: The WaterStreet Group Inc.