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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Henson Trusts

Planning for persons with disabilities

The following article considers the use of a Henson Trust as an estate planning tool to provide for the ongoing care and financial support of a person with a disability.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a lawyer, notary or accountant, as applicable, before acting on any of the information in this article.

The Henson Trust

When planning to provide financially for a person with an ongoing physical or mental disability, whether during your lifetime or after your death, care must be taken to ensure that the person's entitlement to provincial and territorial disability related income support and other benefits are not inadvertently jeopardized. Generally, provincial or territorial disability related income support programs and benefits are income- or asset-tested, meaning that individuals cannot own certain assets or earn or receive income in excess of specified amounts. If these income and asset thresholds are exceeded, the person may be disqualified or ineligible to receive income support and other benefits until the excess assets are depleted.

One common tool that is often employed to preserve a beneficiary's entitlement to government income support and benefits is a Henson Trust. A Henson Trust is a trust that provides the trustees with the absolute discretion to distribute income and capital from the trust to the beneficiary as they see fit. The trustees have full control as to when, if and how much income or capital is to be paid to the beneficiary. The beneficiary of a Henson Trust has no vested interest in the income or capital of the trust. This means that they cannot claim or demand payments from the trust and, consequently, they are not considered to own the trust assets.

Henson Trusts are subject to provincial and territorial regulations and may not be available as an

effective strategy in every province or territory. It is imperative that you consult with a qualified legal advisor to determine whether a Henson Trust is recognized in the beneficiary's province of residence before utilizing this tool.

History of Henson Trust

The concept of the Henson Trust arose out of the 1987 Ontario court case *Ontario (Ministry of Community and Social Services, Income Maintenance Branch) and Henson*[1]. Leonard Henson established a discretionary trust in his Will for his disabled daughter, Audrey. The Will provided that the trustees had an absolute and unfettered discretion to pay income or capital from the trust for Audrey's benefit. It also stated that Audrey did not have a vested interest in the trust assets except to the extent that payments were made to her or for her benefit. The objective was to allow Audrey to benefit from her father's estate while preserving her entitlement to government assistance.

After Leonard Henson died, Audrey's provincial government benefits were terminated as she was found to have inherited her father's estate and to be in excess of the allowable amount of assets. This decision was challenged in the courts. The courts determined that such a trust did not disentitle Audrey from receiving government benefits. Since the trustees had an absolute discretion over the trust property, Audrey was found not to have a beneficial interest in the trust assets. As such, her interest in the trust would not be considered to be a liquid asset which would otherwise reduce or eliminate her entitlement to government benefits.

Establishing a Henson Trust

A Henson Trust can be set up as an inter vivos trust (established during your lifetime) or as a testamentary trust (established on death under the terms of your Will). A Henson Trust must be planned in advance as it cannot be settled by the beneficiary.

There is no limit on the amount of assets that can be settled into or contributed to a Henson Trust. There may, however, be limits with regards to the distributions that can be made from a Henson Trust to the disabled beneficiary without affecting the beneficiary's eligibility for income support and benefits. The usefulness of a Henson Trust may therefore be limited by provincial and territorial regulations which restrict the distributions that a beneficiary can receive from a Henson Trust without impacting the beneficiary's income support. This is something that should be considered when contemplating this estate planning tool.

1) [1989] O.J. No. 2093 (Ont. C.A.) (1987), 28 ETR 121 (Ont Div Ct), affirmed 36 ETR 192 (Ont CA).

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Tax treatment of a Henson Trust

As with any other trust, a Henson Trust is a separate taxpayer that must file its own income tax returns. Income earned in a Henson Trust can either be retained in the trust or paid out to the beneficiary. In general, income that is earned and retained in either an inter vivos Henson Trust or a testamentary Henson Trust will be taxed in the hands of the trust at the highest combined federal and provincial marginal tax rate in the trust's province or territory of residence. Income that is earned in a trust and paid or made payable to a beneficiary will generally be taxed in the beneficiary's hands.

There are two exceptions to the tax treatment mentioned above.

Qualified Disability Trust (QDT)

If a Henson Trust qualifies as a QDT, the income earned and retained in the trust may be taxed at graduated tax rates. A QDT is a testamentary trust that jointly elects, together with one or more beneficiaries under the trust, in its tax return for the year to be a QDT. To be a QDT for the year, the following conditions must be met:

1. The electing beneficiary must be eligible for the Disability Tax Credit (DTC);
2. The electing beneficiary must be an individual named as a beneficiary (e.g. John Doe) in the instrument that created the trust. For example, if the deceased set up the trust for "my issue", then the beneficiary cannot elect to have the trust treated as a QDT;
3. The election must include the electing beneficiary's Social Insurance Number;
4. The electing beneficiary must not make an a QDT election in respect of any other trust;
5. The trust must be factually resident in Canada (i.e. not a non-resident trust that is deemed to be resident in Canada)
6. The trust must be resident in Canada throughout the year (and not just the end of the year); and
7. The requirement to pay a recovery tax cannot apply to the trust for the year (a detailed discussion on the recovery tax is beyond the scope of this article but is briefly mentioned later).

An electing beneficiary is an individual beneficiary under the trust who qualifies for the federal DTC and who has jointly elected with the trust for the trust to be a QDT for the year. This means that a testamentary trust can be a QDT in one year but not in another year. It is an annual election that gives the testamentary trust its status as a QDT.

Recovery tax, that was mentioned previously, is generally a claw back of tax savings enjoyed by a QDT for income taxed at graduated rates in a previous year. Income that was subject to taxes retained in the trust becomes capital of the trust. However, where that capital was or will be subsequently distributed to a non-electing beneficiary, recovery tax may need to be paid.

A QDT will have to pay a recovery of tax if:

1. None of the beneficiaries at the end of the year are an electing beneficiary for a preceding year;
2. The trust ceased to be resident in Canada; or
3. A capital distribution is made to a non-electing beneficiary.

Essentially, a QDT will be required to pay a "recovery tax" when it distributes income that has been taxed at graduated rates to any beneficiary other than the eligible beneficiary. A QDT will therefore only defer tax at the top rate for all income which has not been paid to or used for the benefit of the eligible beneficiary.

Note that in order to qualify as a QDT, the beneficiary must qualify for the DTC. Not every person who receives provincial or territorial disability related income support may be eligible for the DTC. If a Henson Trust is set up in a Will for a disabled beneficiary who is not eligible for the DTC, an election cannot be made to treat the trust as a QDT and income earned and retained in the trust would be taxed at the top marginal tax rate.

Also, there can only be one QDT per beneficiary. This may be issue where there are multiple persons who have chosen to create a testamentary trust in their Will for the benefit of the same disabled beneficiary. In such a case, you may need to consider as part of your estate planning process which trust will be designated as a QDT.

Preferred beneficiary election

The second exception to flat top-rate taxation of income earned and retained in an inter vivos or testamentary Henson Trust is where the preferred beneficiary election is available and utilized. Under the Income Tax Act, a trust and a “preferred beneficiary” (or the individual or organization legally authorized to make decisions on the preferred beneficiary’s behalf) can file a joint election to

> The second exception to flat top-rate taxation of income earned and retained in an inter vivos or testamentary Henson Trust is where the preferred beneficiary election is available and utilized.

have some or all income earned and retained in the trust taxed in the beneficiary’s tax return at the beneficiary’s marginal tax rate. In such a case, the income continues to accumulate in the trust but is taxed as if it has been distributed to the beneficiary.

To qualify as a preferred beneficiary, certain conditions must be met. They include:

1. The beneficiary must be a resident of Canada;
2. The beneficiary must be entitled to claim the DTC by reason of a mental or physical impairment, or must be an adult who was dependent on another individual because of mental or physical infirmity and whose income does not exceed the basic personal exemption for that year (determined before allocations under the preferred beneficiary election);
3. The beneficiary must be the person who established the trust (the “settlor”) or must be the settlor’s current or former spouse or common law partner, child, stepchild, grandchild, step-grandchild, great grandchild or step-great grandchild. The relationship between the beneficiary and the settlor of the trust is critical to the preferred beneficiary election. Care must be taken to ensure that the settlor’s status remains intact after the creation of the trust. An issue may arise if someone other than the settlor contributes additional property to the trust. This may cause the settlor to lose their status, with the result that the beneficiary could cease to be considered a preferred beneficiary of the trust.

As mentioned before, income earned and retained in an inter vivos or testamentary trust is generally taxed at the highest federal and provincial tax rate. With the preferred beneficiary election, the income can be retained in the trust but taxed on the beneficiary’s return, taking advantage of their potentially lower tax rates. The beneficiary’s eligibility for income support programs may be preserved at a lower tax cost. The preferred beneficiary election may also be useful where a testamentary Henson Trust qualifies as a QDT. In such a case, the income can be split between the QDT and the disabled beneficiary in such a way as to double the amount of income that can be taxed at a low federal and provincial tax rate.

It is important to consider how the preferred beneficiary election may impact the beneficiary's eligibility for income support and benefits. For example, the beneficiary will be required to pay tax on the income that is allocated to them and may need additional funds from the trust to pay these taxes. This may result in the beneficiary's disentitlement to provincial and territorial benefits. The trustee of the Henson Trust should exercise caution when implementing this tax planning strategy.

Can a Henson Trust also qualify as a Lifetime Benefit Trust (LBT)?

An LBT is a personal trust under which a mentally infirm spouse of the deceased or a child or grandchild of the deceased who was financially dependent on the deceased because of mental impairment is the only person entitled to receive or use any of the income or capital of the trust during their lifetime. The trustees of an LBT must have the discretion to distribute amounts to the beneficiary and are required to consider the needs of the beneficiary in determining whether to pay amounts to the beneficiary.

If your Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF) proceeds are paid to an LBT set up under your Will on death, it may be possible to defer the tax on the RRSP or RRIF proceeds. The default tax treatment with respect to your RRSP or RRIF on death is that the fair market value of the RRSP or RRIF on the date of death must be included as income on your final tax return and taxed at your marginal tax rate. To defer the tax on the RRSP or RRIF proceeds, the proceeds must pass to a properly structured LBT and used to purchase a "qualifying trust annuity" (QTA). The LBT must be named as the annuitant of the QTA. The QTA must be for the life of the beneficiary or for a fixed term equal to 90 years minus the age of the beneficiary. Any amounts paid out of the LBT to the beneficiary will be taxable to the beneficiary. The fair market value of the annuity at the time of the beneficiary's death will be taxable to the beneficiary upon their death. Any income remaining in the LBT after the beneficiary's death may be made available to other beneficiaries named in the LBT.

You may wish to discuss whether a standard Henson Trust would qualify as an LBT with your qualified tax and legal advisor. In some jurisdictions, such as Ontario, there may be a problem with structuring a Henson Trust as an LBT, because the accumulation of income inside a trust is limited to a certain period of time defined under statute (i.e. 21 years). After the accumulation period has expired, all of the trust's annual net income must be paid out to the beneficiary and cannot be added to the capital of the trust. If the beneficiary is receiving disability related income support, there is generally a limit on how much income they can receive from a trust and other voluntary payments in a 12 month period without affecting their eligibility for provincial assistance. If the trust's income for the year exceeds this threshold and the disabled person is the only beneficiary of the trust, their disability related benefits may be impacted. Because of this, a Henson Trust is usually structured to include additional income beneficiaries who will receive the income after the expiration of the accumulations period. This is not allowed in the case of an LBT, as only the disabled person can be the beneficiary of an LBT.

> The assets used to fund a Henson Trust may afford a higher standard of living than that provided by government benefits.

Is a Henson Trust appropriate?

A Henson Trust may be a useful option for providing financial security for a disabled person, but it is only appropriate in limited circumstances. For instance, if the disabled person has significant assets and does not qualify for provincial or territorial income support programs or benefits, then establishing a Henson Trust may not be necessary. (If, however, these assets may eventually be depleted by the costs of living and the disabled person will be reliant on government assistance in the future, it may be appropriate to provide financial assistance to that person through a Henson Trust.)

A Henson Trust may also be inappropriate where the actual value of the inheritance far exceeds the amount that the beneficiary would receive in government benefits over a lifetime. The assets used to fund a Henson Trust may afford a higher standard of living than that provided by government benefits. If this is the case, you may want to consider an alternative arrangement. You should, however, be aware that some government benefits, aside from income assistance, are only available to individuals who qualify for government support. For example, in Ontario, individuals who are eligible for the Ontario Disability Support Program (ODSP) may be eligible for a range of other benefits and supports aside from income support. These include health benefits covering prescription drugs and dental care and assistance with expenses relating to the individual's disability, for example, hearing aids and guide dogs. Assistance is also available for a range of other costs including expenses tohelp an ODSP recipient remain in his or her home, repair the home or move to a new home. The benefits of some of these services can be significant and the impact of potentially losing entitlement to such assistance should be taken into consideration when evaluating the merits of setting up a Henson Trust.

As well, if the beneficiary desires or is capable of exercising more control of the assets held in trust, a Henson Trust may not be a good option, as the beneficiary will not have control of the trust assets.

In addition to the considerations discussed above, the following are some of the advantages and disadvantages of a Henson Trust you should consider when determining whether setting up such a trust is appropriate.

Advantages of a Henson Trust

A Henson Trust may provide potential advantages:

- Funds from a discretionary trust can often be used to improve the quality of life for a person with a disability. For example, funds can be used to pay for expenses, such as homecare attendants, while safeguarding ongoing eligibility for government support and access to government programming.
- A Henson Trust can help provide financial security for a person with a disability, even if the settlor who established the trust subsequently loses mental capacity. The trust will continue to exist and operate, subject to its terms, even on the death or incapacity of the settlor.
- By placing assets into a discretionary trust during the settlor's lifetime, the assets will not be included in the settlor's estate on death and therefore, not be subject to probate taxes.
- A Henson Trust can result in an overall tax savings. It may be possible to have income earned in the trust taxed at the marginal tax rate of the disabled beneficiary rather than at the highest marginal tax rate as would be the case if the trust was set up as a regular inter vivos trust.

Disadvantages of a Henson Trust

A Henson Trust may present some potential challenges:

- It can be difficult to find a trustee who is willing to manage the trust property for the benefit of the person with a disability throughout their life. It is important to choose the right trustee(s) as they will have complete control and absolute discretion over the trust's assets. Siblings are often a logical choice but they frequently have a potential conflict of interest due to the likelihood that they may also be beneficiaries of the trust, either during the lifetime or on the death of their disabled brother or sister. It may make sense to appoint a corporate trustee, such as a trust company, particularly in cases where there are no close relatives able or willing to act, where the trust is likely to be administered over a long period of time or where conflict is anticipated. However, there are significant costs associated with appointing a third party as trustee.

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- The disabled beneficiary has no guarantee of or control over the funds in the Henson Trust.
- Provincial and territorial governments can legislate to disallow the use of Henson Trusts in their jurisdiction and apply those changes to existing and future trusts.
- An improperly drafted trust may disqualify a disabled beneficiary from entitlement to government disability benefits. Careful drafting of the trust deed or Will is important. The language in the trust deed or Will must specifically provide that the trustee has no obligation to make payments from the trust to the beneficiary and the beneficiary has no vested interest in the income or capital of the trust other than the actual payments made to him or her. Be sure to choose a lawyer familiar with Henson Trusts.
- There are costs involved in administering a Henson Trust, including fees for preparing annual tax returns, accounts or records and trustee compensation.
- In order to prevent the indefinite deferral of capital gains accumulated in a trust, the tax laws require that unrealized gains on the trust's assets be declared every 21 years. This means that the trust must report all accumulated gains on its tax return as if it actually sold the assets for fair market value. If the trust holds real estate or business assets, you may need to engage valuators to establish a proper value. Any gains realized as a result of this deemed disposition are taxed in the trust at the highest marginal tax rate in the trust's province of residence. These gains cannot be allocated to the beneficiary to be taxed in their hands. For more information on the 21-year deemed disposition rule that applies to trusts and any strategies that may be utilized to deal with this deemed disposition, speak to your qualified tax advisor.

Conclusion

A Henson Trust can be effective estate planning tool when planning for a beneficiary with a disability who benefits from provincial and territorial income support

and benefits. It is imperative that you consult with a qualified legal advisor who is familiar with estate planning strategies for persons with disabilities to determine whether a Henson Trust is recognized in the proposed beneficiary's province of residence and whether it is appropriate to set up a Henson Trust or use other estate planning tools.

Wealth Management

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