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THE NAVIGATOR

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 is 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. For example, Henson Trusts are not recognized in Alberta, Northwest Territories and Nunavut. 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.

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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. For example, under the Ontario Disability Support Program (ODSP), a recipient may generally only receive a maximum of $6,000 in any 12 month period for any purpose from gifts, inheritances, insurance proceeds, trusts and certain other voluntary payments. This rule is subject to certain exemptions. For instance, in addition to the $6,000, an ODSP recipient may receive an unlimited amount from these sources if the funds are used to purchase a pre-approved disability related item or service, such as assistive devices. 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.

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

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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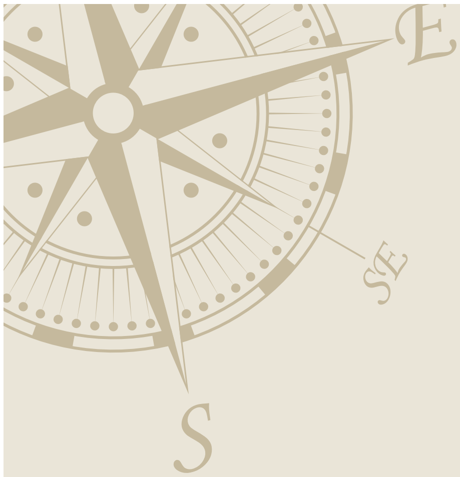
can either be retained in the trust or paid out to the beneficiary. In general, income that is earned and retained in a trust will be taxed in the hands of the trust. The tax rate will depend on whether the trust is an inter vivos trust or testamentary trust. Income retained in an inter vivos trust is taxed at the highest combined federal and provincial marginal tax rate. Inter vivos trusts are therefore generally considered to be tax inefficient. In contrast, income retained in a testamentary trust is taxed at graduated rates, like an individual. Please note that at the time of writing this article, the federal government has proposed to eliminate graduated tax rates for existing and new testamentary trusts beginning in 2016, subject to certain exceptions. Graduated tax rates will continue to apply to testamentary trusts, where the beneficiary of such trust is eligible for the Disability Tax Credit. There are no details at this time on how the rules related to this exception will work but more details are expected to be released in the coming months.

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 is an exception to the tax treatment mentioned above, 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 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 disability tax credit



It is important to consider how the preferred beneficiary election may impact the beneficiary's eligibility for income support and benefits.

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 his status, with the result that the beneficiary could cease to be considered a preferred beneficiary of the trust.

The preferred beneficiary election makes the idea of setting up an inter vivos Henson Trust more favourable. As mentioned before, income earned and retained in an inter vivos trust is 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 is also currently useful where a testamentary Henson Trust has been created. In such a case, the income can be split between the testamentary trust 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 him 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.

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

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appropriate to provide financial assistance to that person through a Henson Trust.)

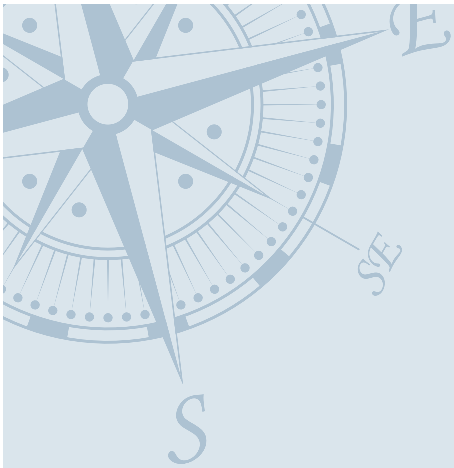
A Henson Trust may also be inappropriate where the actual value of the inheritance far exceeds the amount that the beneficiary would receive in government benefits over a lifetime. The assets used to fund a Henson Trust may afford a higher standard of living than that provided by government benefits. 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 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 to help 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.

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



An improperly drafted trust may disqualify a disabled beneficiary from entitlement to government disability benefits.

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 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.
- 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.

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

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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.

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