DISABILITY ALERT

***DISABILITY ALERT** is a commentary on topics of current interest – usually topics relating to planning for individuals with disabilities and changes to current tax and social assistance legislation. Professional advice should be obtained before acting on any of this information. www.thefamilyguide.ca*

DISABILITY - THE NEW TAX RULES FOR TRUSTS (UPDATED)

Many families should be using trusts in one way or another in their financial planning for a loved one with disabilities. When it comes this kind of planning, people automatically think of the Henson Trust to maximize social assistance. They believe it to be a unique arrangement that has legal characteristics different from all other trusts; but really that is not the case. There are many other uses for trusts in disability as well.

WHAT IS A HENSON TRUST

The Henson trust came into being when Leonard Henson set up a trust for his daughter Audrey so that she could receive small amounts of income from the trust that would not limit her ability to claim financial assistance under the Ontario Disability Support Program (ODSP). Since only the trustees had authority to provide Audrey with trust distributions, the assets and income of the trust were not part of Audrey's assets or income that would determine her entitlement to income assistance. The trust is a kind of holding tank to provide income to Audrey on a managed basis. A Henson trust is a discretionary trust just like any other discretionary trusts used for other reasons.

OTHER USES OF TRUSTS IN DISABILITY

Trusts can be utilized by families for reasons beyond the maximizing of social assistance. There are four main uses for trusts when it comes to disability and the related financial planning, tax planning and asset ownership. They are as follows:

- To maximize social assistance (Henson trust)
- To provide extra income to a person with disabilities
- To hold ownership of a property for a person with disabilities because they cannot or should not own property on their own. (A principal residence is one of these assets)

- To allow the ownership of assets which might otherwise fall under the control of the Office of the Official Guardian.

The third and fourth points shown above are important uses beyond the Henson trust. These trusts help families arrange their financial affairs over the long term despite the difficulties brought about by disability. The trust becomes the alter ego owner of property when personal ownership is not a good choice or even a possibility.

Trusts provide a proper legal place for property ownership for individuals who can't or shouldn't own property because of his or her lack of legal competence or the ability to make good judgments. Trusts work well at the time of death of a person with disabilities to transfer the remaining property of the trust to other family members on a tax-free basis. A trust allows a mechanism to be put in place far in advance of events so decisions can be carried out as the settlor would wish when the moment arrives.

Trusts can also serve important functions when it comes to managing the personal finances of vulnerable people who may not have significant disabilities but nevertheless cannot manage their personal finances.

It can be simply said that trusts have many special rules in law and under the Income Tax Act. In many cases, there is just no other way to property with the same satisfactory outcomes.

TAX RATES FOR TRUSTS

Overall, there have been significant changes to the tax rates for trusts as recently enacted into law. They will affect all trusts (starting in 2016) by taxing most of them at the highest tax rate on all income unless the trust fits under one of the few exceptions. One of these exceptions is the newly created QDT arising on death which will be subject to graduated tax rates and not the top rate. Existing testamentary trusts (such as testamentary Henson trusts) that have always paid tax based on the graduated rates may soon start calculating tax at the highest rate unless they can elect to be QDTs.

Generally speaking, under the new rules only the following trusts will qualify for graduated tax rates:

- QDTs
- Existing testamentary trusts until 2016 (no grandfathering)
- Estates (graduated rate estates) for three years after they come into existence on the death of an individual

Trusts not eligible for graduated rates and non-refundable tax credits will pay the top rate of tax on every dollar of income at the following approximate rates.

- Interest 46%
- Dividends 30%
- Capital Gains 23%

This seems punitive for legitimate trusts such as those established for people with disabilities.

2016 TAX RATE CHANGES FOR QDTs

The federal government believed that the graduated rates for testamentary trusts were being used unfairly to create uses for several taxpayers and reduce overall income tax. Accordingly, the government abolished the graduated rates for virtually all testamentary trusts starting in 2016. However, they have agreed to continue the graduated rates for testamentary trusts established for people with disabilities providing that the person qualifies for the disability tax credit. This new trust is called a qualified disability trust (QDT).

Here are the important qualifications for a QDT.

- At least one of the beneficiaries of the trust must qualify for the disability tax credit
- Only testamentary trusts will qualify as a QDT
- The trustee and the beneficiary with a disability (qualifying beneficiary) must jointly elect on an annual basis that the trust be a QDT
- There can only be one QDT for each person with a disability
- Existing testamentary trusts eligible for graduated tax rates will cease to be eligible for QDT status if they fail to qualify under the new rules outlined above
- The trust must pay back trust income taxed at the low rate if it was distributed to anyone but the qualified beneficiary

QUALIFIED DISABILITY TRUST DEFINED

The new QDT must meet several conditions to be allowed:

- It is a testamentary trust (arising on death).
- In its tax return each year, the trustee *and* electing beneficiary must elect the trust be a QDT.
- The electing beneficiary (EB) is a person who qualifies for the disability tax credit.
- There is no relief for a late election to be a QDT.
- The trust return must show the electing beneficiary's SIN.
- Only one QDT is allowed for each EB although there may be more than one EB in a QDT.

QDT PROBLEMS

There are some problems with the new QDT rules for people with disabilities. The restrictions will make the QDT difficult to use. Most certainly, people who are vulnerable but don't have a disability that is eligible for the disability tax credit is one of them.

Some restrictions on their use are as follows:

- The QDT rules are complex and will likely be beyond the understanding and affordability of many families. Tax filings and compliance will be complicated.
- Henson trusts that are in place now will not qualify as a QDT unless they are testamentary trusts and the elected beneficiary qualifies for the disability tax credit.
- Where the person with a disability has a intellectual challenge there will be a need for guardianship so the annual election for QDT status can be made.
- Different family members may wish to establish a QDT, but only one can do this because only one QDT is allowed for each person with a disability.
- The EB (person with disabilities) must be a signatory to the annual election to be a QDT. If the EB is not legally competent, then the election will have to be made by that person's attorney under a power of attorney or possibly by the person's legal guardian or a court appointed guardian. Since it is not at all common for people with mental disabilities to have either a POA or a guardian, in all likelihood the QDT will not be available. It certainly won't be available to the estimated 4 million vulnerable Canadians who do not qualify for the disability tax credit.
- Only one QDT is allowed for each EB even though each trust can have more than one EB. If different family members wish to participate in supporting a person with disabilities, they will all have to come under the umbrella of a single trust. That will often be practically impossible to structure.
- The QDT has complicated rules to recapture the low tax rate benefit from the use of graduated tax rates if someone other than the EB receives a distribution from the QDT. It is important to understand that only the EB should receive trust distributions to stay away from this problem. A possible solution is to establish two trusts on death – one for the disabled person and a family trust for other family members.

HOW TO REDUCE TAXES ON TRUSTS

The emphasis now will be to avoid this high rate of tax. It can be done in a few ways including the following:

- Distribute all trust income to beneficiaries

- ❖ Make the preferred beneficiary election (if possible) to have the beneficiary pay tax on trust income at his or her graduated rate even though the trust income is not distributed.
- ❖ Select investments that are taxed at the lowest tax rate.

For Henson trusts that have been set up in the past to maximize social assistance, the first option will not be possible where the person with disabilities lacks mental capacity. The second option may be possible if the beneficiary can legally file a tax return but again this is often not possible due to mental capacity. The third option may be available if special investments are utilized such as corporate class mutual funds which allow the taxpayer to choose the type of income they will be taxed on (interest, dividends, capital gains, return of capital). There is one mutual fund company that I am aware of that allows the income selection option even if the investments have actual income different than the selection.

Finally, no option will be available to vulnerable people who can't qualify for the disability tax credit. Income on trusts established for them will all be taxed at the top rate. What a shame! I can think it many instances where a trust is a legitimate and valuable vehicle for beneficiaries who do not have the ability to handle money or use it wisely.

GRANDFATHERING

No doubt there are many testamentary trusts in existence created for family members with mental disabilities. If the beneficiary does not qualify for the disability tax credit, the trust will cannot be a QDT and will not qualify for graduated tax rates. If no guardianship or POA exists for people with mental disabilities (allowing an election for individuals with disabilities) these trusts will also not qualify as QDTs and their tax rates will move to the top rate.

CONCLUSION

When you are drafting your will or reviewing the present one or setting up a trust for a disabled loved one, you need to understand the new trust rules. It's a new area and will take some figuring out.

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