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.**

THE HENSON TRUST
THE MYSTERIES EXPLORED AND EXPLAINED

Social assistance for individuals with disabilities in Ontario is reduced and sometimes eliminated entirely if they have a certain level of assets or monthly income. If their assets (other than exempt assets) exceed $5,000, social assistance will be denied. If gifts and other voluntary payments by family are over $6,000 for any continuous twelve month period, that excess amount is counted as income and will reduce social assistance dollar-for-dollar.

Financial support by family members is often the only help available to improve the quality of life of an individual with disabilities beyond social assistance. Under the Ontario Disability Support Program (ODSP) rules, voluntary payments mentioned above include money from trusts, honorariums and windfalls but do not include casual gifts of insignificant value such as basic clothing, meals and basic food purchases.

The Henson Trust is Born

Some years ago, Leonard Henson, wanted to provide a fund to assist his daughter, Audrey, so he set up a trust for her in his will. The terms of the trust gave the trustees complete discretion on the amount and timing of any payments to Audrey. Audrey could not demand payments from the trust because she was a discretionary beneficiary. That seemed to assure Leonard that his daughter would not be disqualified from ODSP because trust assets would not belong to her and trustees could control the income flow to meet her needs.

Despite these restrictions, the Ontario government said that the assets of the trust were assets *available* to Audrey and disqualified her from ODSP. To make a long story short, Ontario lost its case and the Henson trust was born.

To help the readers understand the relevance of Henson trust provisions, the wording used by Leonard Henson in his will was as follows.

> *To pay so much of the income therefrom, or the whose of the income therefrom, together with so much of the capital thereof to or for the benefit of my daughter AUDREY JOAN HENSON as my Trustees shall in the exercise of their absolute and unfettered discretion consider advisable from time to time. Any income not so paid in any year shall be accumulated by my Trustees and added to the capital of the residue of my estate, provided, however, that if it becomes unlawful*

> *for my Trustees to continue such accumulation of income, then the income not so paid in any year to or for the benefit of my said daughter shall be paid to the Guelph and District Association for the Mentally Retarded Incorporated.*
>
> *The residue of my estate and the income therefrom shall not vest in my said daughter and the only interest she shall have therein shall be the payments actually made to her, or on her behalf, and received by her or for her benefit therefrom. Without in any way binding the discretion of my Trustees, it is my wish that in exercising the discretion in accordance with the provisions of this paragraph, my Trustees take account of and in so far as they may consider it advisable take such steps as will maximize the benefits which my said daughter would receive from other sources if payments from the income and capital of the residue of my estate were not paid to her for her own benefit, or if such payments were limited to an amount or time. In order to maximize such benefits, I specifically authorize my Trustees to make payments varying in amounts and at such time, or times, as my Trustees in the exercise of their absolute discretion may consider in the best interests of my said daughter.*

Currently, all provinces except Alberta allow Henson trusts.

It is clear from the words used in Leonard Henson's will that it accomplished the following:

- Restricted income payments to Audrey based entirely on the discretion of the trustee.
- Allowed the trustees to pay income to an alternate beneficiary – namely a charity.
- Assured that Audrey had no direct interest in trust assets and they were not *available* to her.
- Allowed the trustee to consider restrictions to Audrey's income to maximize social assistance benefits that she would not otherwise receive.
- Authorized the trustee to make payments to Audrey in amounts and at such time as the trustees considered to be in her best interest.

In legal parlance, Henson trusts are referred to as *absolute discretionary* trusts. In other words, the trustees have absolute discretion in regard to the management of trust funds and decisions to make payments to beneficiaries. On the death of the individual with disabilities, the assets remaining in the trust are usually disbursed to family members or sometimes to a charity.

Henson trusts are a common tool used in disability planning and should be prepared by lawyers who specialize in or experienced in the complexities of trust law and disability planning. The Henson trust also needs to fit into the total financial and tax planning picture of the individual with disabilities and his or her family.

Henson Trust Distributions

From time to time it has been suggested that payments made by a Henson trust to third parties on behalf of an individual with disabilities do not count as income that reduces ODSP support. That is clearly incorrect. Section 37(1) of the ODSP regulations indicates that income is calculated by adding the total amount of all payments of any nature paid to or on behalf of or for the benefit of the special needs individual. However, trust payments made for (ODSP approved) disability related items or services are specifically exempt as income that would otherwise reduce ODSP support.

ODSP reporting requirements for Henson trusts are found in their Policy Directive 4.7. Essentially a trustee has a duty to report trust finances to the beneficiary who in turn must report to ODSP. The

Policy Directive points out that the government's demand for such information is based on Section 5 of the ODSP Act which states that a person is not eligible for ODSP unless they *provide information and the verification of information required to determine eligibility*. Amen!

Trusts and Taxation

Family members may wish to establish a Henson trust during their lifetimes as well as in their will. This is known as an inter vivos trust as distinguished from the testamentary trust that was contained in Leonard Henson's will. The purpose of the inter vivos trust is essentially the same as the testamentary trust which is to supplement the income of a person with disabilities and stay on side of the asset and income tests.

The inter vivos trust has a tax disadvantage since trust income is taxed at the top personal rate (currently 46% in Ontario) whereas testamentary trust income is taxed at graduated rates. Additional contributions should not be made to testamentary trusts after they are established or they will then be taxed at the top personal rate that applies to inter vivos trusts. Trust income distributions are helpful since they reduce trust income and are added to the taxable income of the recipient – most likely at lower tax rates.

Income taxes on the trust can also be reduced by what is known as the preferred beneficiary election which allows trust income to be taxed in the hands of a beneficiary with disabilities. Since the beneficiary will most certainly be in a lower tax bracket than the trust, this is clearly a tax advantage. Bear in mind that the beneficiary must pay the tax on this income which may in turn result in increased funding needs and ODSP benefit constraints.

Investment of trust assets in blue chip stocks would probably be advantageous because no tax would likely be payable by the trust due to the lower tax rate on dividends and capital gains (significant dividends a year can be received without income tax and capital gains are only half taxable). Creating a trust creates a new taxpayer and therefore spreads income around which should in itself help lower taxes.

Finally, trusts have some other unique characteristics that are important to understand. Without dealing extensively with the rules and depending on the particular circumstances 1) trust assets may be deemed to be sold by the trust every 21 years (possibly producing capital gains) and 2) trust assets can usually be transferred to final beneficiaries tax free when the trust is wound up. The rollover, as it is called, on the winding up of a Henson trust or any other trust is a major tax advantage in trust tax planning.

The tax rules for trusts are complex and minor wording changes can produce amazing or tragic results. They must be reviewed by someone with legal and tax expertise.

CRA is raising the bar with respect to tax compliance for trusts. They expect that trustees comply with the terms of the trust and back up their actions with proper documentation. Amongst other things, they expect the following:

- Proper accounting records.
- Trustee minutes document the actions of trustees.
- The property used to settle the trust is available and can be examined by CRA.
- Payments to beneficiaries with promissory notes are enforceable.

- Verification shows that payments to beneficiaries match T3 information slips.

Most trustees are far too lax in documenting their actions to show they have complied with the terms of the trust and the tax rules governing their particular trust.

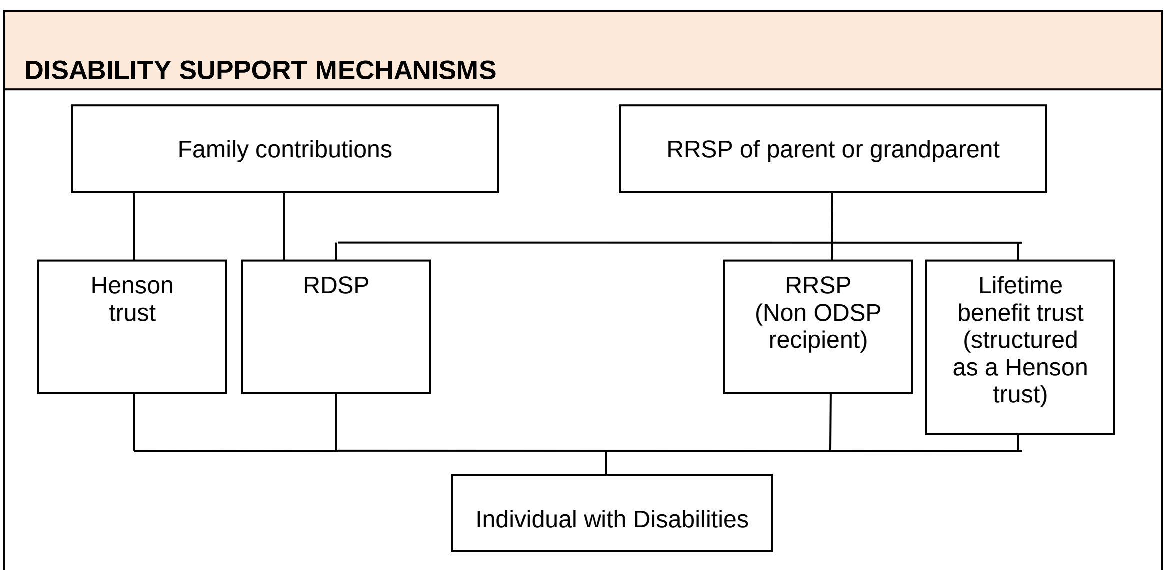
Trusts – Complying with Provincial Laws

The Accumulations Act in Ontario is another hurdle to overcome. This legislation dictates that after 21 years, income cannot be added to the capital of a trust and must be paid out. Normally this is not a problem because the trust will usually provide that annual income can be divided amongst all trust beneficiaries or distributed as the trustees determine. Since the ODSP benefit recipient cannot have any enforceable right to income or capital of the trust, the Henson trust must direct that part or all of the income after the accumulation deadline can be paid to another beneficiary or group of beneficiaries.

Investment powers of a trust are another important consideration. Legislation of most provinces mandates specific types of investments if none are specified by the trust. It is important, therefore, that the trust specify the types of assets allowed as investments. In Ontario, the only provision is that investments must be made prudently.

Other Support Mechanisms

Until fairly recently, the Henson trust stood almost alone as the major funding vehicle to supplement income of individuals with disabilities. However, support can now be provided by other tax effective funding vehicles as illustrated below:



Note: The lifetime benefit trust under the Income Tax Act is not yet law.

Space does not permit a discussion of these alternatives but they all can each apply separately or together depending upon the situation. That's where the family needs to put their heads together and do some serious financial planning for their loved one with disabilities.

Funding the Trust

Trusts can be settled with a variety of types of property including cash, investments, or real property of the person wishing to establish the trust. It is also possible to establish a trust using proceeds of a life insurance policy. If the trust is intended to be testamentary to obtain certain tax advantages, it is critical that the trust not be set up before death or own the insurance policy with the expectation that the proceeds will be paid into the trust. This would be an inter vivos trust and taxable at top personal rates. For the trust to be testamentary a beneficiary of the policy needs to be designated and a trustee appointed to receive the proceeds on behalf of the beneficiary when the person insured dies. The person insured must be the same person as the owner of the policy. Where the owner and life insured are different people, the trust will not be testamentary.

An insurance-funded testamentary Henson trust can be structured in a will or separate declaration. If it is included in a will, care needs to be taken to try to ensure that estate administration tax (probate fees) is not triggered. The payment of insurance proceeds to or on behalf of a designated beneficiary is generally considered not to trigger this tax.

Choosing a Trustee for the Henson Trust

The trustees of a Henson trust (or any trust for that matter) have heavy responsibilities to the individual with disabilities which should not be taken lightly. Some of the important ones are as follows:

- Involvement with the life of the individual with disabilities on an ongoing basis.
- A sensitivity to the financial requirements of the individual with disabilities.
- A good understanding of the terms of the trust and expectations of the settlor.
- A good understanding of provincial social assistance laws.
- Competent legal and financial advisors.

Sometimes the trustee of the Henson trust lives in a different province than the individual with disabilities. In that case, the trust return will be filed for the province where the trustee lives.

Finding someone in the family to take on the caregiver and financial aspects of the affairs of individuals with disabilities is probably the biggest concern of aging parents.

Talk to Uncle Bill

Henson trusts are designed to keep legal ownership of assets out of the hands of individuals with disabilities and restrict their income so they can get social assistance. But make sure you talk to Uncle Bill. You see Uncle Bill has let it be known that he is going to leave something in his will to his niece, Kimberly. Kimberly's mom and dad have set up a Henson trust to maximize ODSP but if Uncle Bill gives Kimberly a bequest, he will most surely undo everything. Ask Uncle Bill to make his bequest to a Henson trust established in his will rather than giving her a direct bequest.

Henson Trusts for High Wealth Families

Henson trusts fill a special niche with respect to maximizing ODSP benefits but trusts in general are excellent vehicles for those who cannot or should not own property or may not be able to have a will. The trust becomes a holding tank to distribute funds to individuals with disabilities – even if the individual with disabilities does not receive social assistance. For high wealth families, a Henson type trust most likely should be a part of disability planning, tax planning, asset management and an estate planning strategy. *This article was originally published in the Canadian MoneySaver magazine.*

Blair Botsford, partner at Miller Thomson LLP in Waterloo, Ontario added helpful comments on the legal aspects of trusts and assisted in the review of this article.

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