

Planning For Families with Disabled Dependants (Part 2): Henson Trusts.

The last article in this series told the story of Leonard Henson, and introduced Henson trusts as one of the mainstays of estate planning for the disabled.

Do Henson trusts work in Manitoba? Yes. The viability of Henson trusts was tested and proven in the by our Court of Queen's Bench in the case *Quinn vs. Director of Income Security*. Regulation changes in the April of 2003 did not do away with the availability of Henson trusts, but may herald more restrictive government treatment than that enjoyed in past (more on that in another article in this series).

How does a Henson trust work? If a disabled beneficiary is in receipt of provincial government support then they can have a trust established by a third party, such as a father or an uncle, and the beneficiary will retain their eligibility for government support. To be effective the trust has to be fully discretionary. The trustees must have the discretion to distribute income and capital from the trust as they see fit. It is the converse side to this discretion that is key: they must have the power to withhold the income and capital. It is that power to withhold benefits which is the core of the Henson trust. The beneficiary gains no vested right to income or capital under the trust. They cannot claim payments from the trust, they cannot demand them, and they do not, as a result, own the contents of the trust.

This generally dovetails with the regulations that establish a disabled person's eligibility for government support. Those regulations provide that a person will qualify if they do not own significant assets or have significant income. The regulations do allow for some money in hand, and do not hold it against a disabled person when a third party provides a discretionary benefit. Money from a discretionary trust can be used to pay for expenses on their behalf, such as trips, clothes, homecare attendants and the like. Their quality of life can be improved enormously and at the same time their government support and access to government programming continues.

This is a matter of provincial law and is not uniformly true across Canada (a topic dealt with at greater length in a later article in this series).

What income tax treatment does a Henson trust receive? The tax treatment of a trust for the disabled is generally the same as the tax treatment of any other trust, whether testamentary or *inter vivos*.

Here is a summary of the general tax rules that apply to trusts:

- A trust is a separate taxpayer and files its own tax return each year.
- Trusts of the kind discussed in this article are divided into two kinds for tax purposes, *inter vivos* trusts and testamentary trusts.
 - A testamentary trust is one that is established by a person at the moment they die, and is generally (although not exclusively) created under the terms of their will.
 - An *inter vivos* trust is defined for tax purposes as any personal trust that does not qualify as a testamentary trust but most *inter vivos* trusts are established by a people while they still are alive.
- Income earned by assets in a trust can be kept in the trust or paid out to a beneficiary.
- If income is retained in the trust will generally be taxed in the hands of the trust on the trust's tax return.
- The tax rate depends on the type of trust:
 - If the trust is *inter vivos*, every dollar of retained income is taxed at the highest tax rate. That is a disadvantage. Generally, *inter vivos* trusts are considered tax inefficient.
 - If the trust is testamentary, then the income is taxed at graduated rates, like your taxes and mine, such that the first \$32, 500.00 of income is taxed at the lowest rates in the bottom tax bracket, with any additional income being taxed in the next bracket and so on with higher and higher

rates being charged up the tax brackets. Access to lower rates is an advantage available to testamentary trusts.

- Income paid out of a trust to a beneficiary is generally taxed in the hands of the beneficiary.

Do Henson trusts get special treatment? Yes. One of the general rules, stated above, is that income retained in a trust will be taxed in the trust. When dealing with a trust for the disabled, that general rule is subject to one major exception: the preferred beneficiary election.

The preferred beneficiary election is available when the beneficiary of a trust is suffering from a mental or physical impairment within the meaning of the *Income Tax Act* (Canada). The impairment has to be severe and prolonged. Further, the beneficiary has to be related to the person establishing the trust (referred to as the “settlor” in trust law). The beneficiary can be a spouse or common-law partner of the settlor (a former spouse or common-law partner qualifies as well), or can be a child, stepchild, grandchild, step grandchild, great grandchild or step great grandchild of the settlor.

Where a person qualifies as a preferred beneficiary, a joint election can be filed by the trust and the preferred beneficiary, or their legal decision maker. That election has the effect of taxing income amounts on the tax return of the beneficiary even though those amounts were retained in the trust, and were re-capitalized rather than being paid out to the beneficiary for their benefit. In short, the income stays in the trust but is taxed as if it had been paid out to the beneficiary.

The availability of the preferred beneficiary election will remove the tax inefficiency described earlier as a common impediment identified by planners when considering an *inter vivos* trust. Generally, an *inter vivos* trust is taxed on each dollar of income at the highest federal provincial rate of tax. If the beneficiary of such a trust qualifies for the preferred beneficiary election then the income of the trust can be retained by the trust but be taxed at the graduated rates that might be available to the beneficiary as a flesh and blood person. Because the income is only taxed in the hands of the beneficiary, and not

received, that tax positioning should not interfere with social assistance entitlement.

In a testamentary trust, income can be split between the trust and the disabled beneficiary in such a way as to double access to the bottom tax bracket, even in circumstances where the individual receives provincial support and the income is actually retained within the trust rather than being given to the beneficiary. That, again, is the result of exercising the preferred beneficiary election in appropriate circumstances.

There are several planning opportunities available here. If a client has a modest amount and wants to settle it into a trust for a disabled beneficiary, then they can place a relatively modest amount in a trust, whether *inter vivos* or testamentary, and improve the lifestyle of that beneficiary while sustaining their provincial entitlement for government support. If regulations change, the individual might be cut off support until they drain the trust, but if regulations remain the same they can see a significant improvement in their style of living. The preferred beneficiary election, where available, will ensure that the income is always taxed under the graduated tax system, notwithstanding the fact that the trust might be set up *inter vivos*.

A client might settle a larger amount into a Henson trust and intend that it be used over the short term to pay for extras and improve the standard of life for the disabled person. The long-term goal, however, might be to ultimately have that individual freed from government support and provided for at a higher level. A sum of money placed in a Henson trust and left to grow for a decade or two can become substantial. This is particularly the case if the preferred beneficiary election is available to double the income in each year enjoyed at the lowest tax brackets, splitting income between the trust return and the return of the disabled beneficiary. At such time as the trustees conclude that the standard of living of the beneficiary can be significantly improved by sole reliance on funds within the trust, the trustees simply begin to payout the income at a level that will disqualify ongoing social assistance. The idea here is to subsidize the growth of the fortune with government support until the government can be relieved of its role in that regard entirely. This is an area where families are obliged to tread cautiously. There are

some government programs that are available to individuals who qualify for government support that are not available otherwise. These programs cannot be replaced. They cannot be purchased. Some families have significant wealth, and at the same time make carefully sure that a Henson trust is put in place for their disabled beneficiary. They do not want to lose access to programs that cannot be replaced.

This is the second of a four part series on planning for the disabled. It is an introduction to the topic, is general in nature, and is not a substitute for legal advice. Individuals planning to structure or restructure their affairs should consult a lawyer for assistance specific to their needs and circumstances.

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Province	Status of Henson trust	Title of personal decision maker/statute	Title of financial decision maker/statute	Source (lawyer and firm name)
Alberta	Defunct October 1, 1999 changes to Assured Income for the Severely Handicapped Act -- Some planning opportunities may still exist	Guardian The Dependent Adults Act	Trustee The Dependent Adults Act	Douglas G. Gorman Davis & Company, (780) 426-5330
British Columbia	Alive and well	Committee of the Person The Patients Property Act or Representative for Health Care The Representation Agreement Act	Committee of Finances The Patients Property Act or Representative for Finances The Representation Agreement Act	Lauren Blake-Borrell Davis & Company (604) 643-2957
Manitoba	Alive and well April 2003 regulation change expands availability	Substitute Decision Maker For The Person The Vulnerable Persons Living With a Mental Disability Act	Substitute Decision Maker For Property The Vulnerable Persons Living With a Mental Disability Act	John E.S. Poyser Inkster Christie Hughes, (204) 947-6801
New Brunswick	Alive and well	Attorney for Personal Care The Infirm Persons Act	Attorney The Property Act	Gerald S. McMackin Stewart McKelvey Stirling Scales (506) 632-2768
Newfoundland and Labrador	Challenged Any trust settled	Substitute Decision Maker	Guardian	Meg Gillies Stewart

	with more than \$100,000 makes beneficiary ineligible for government support	The Advance Health Care Directives Act	The Mentally Disabled Persons' Estates Act	McKelvey Stirling Scales (709) 570-8840
Northwest Territories and Nunavut	Challenged Current laws may not permit Henson Trusts, and no test case as of yet	Guardian The Guardianship and Trustee Act	Trustee The Guardianship and Trustee Act	Cynthia Levy Davis & Company, (867) 669-8402
Nova Scotia	Alive and well	Guardian of the Person The Incompetent Persons Act	Guardian of the Estate The Incompetent Persons Act	Timothy C. Matthews Stewart McKelvey Stirling Scales (902) 420-3325
Ontario	Alive and well	Attorney For Personal Care The Substitute Decisions Act	Attorney for Property The Substitute Decisions Act	Patricia Robinson Goodmans LLP (416) 324-9412
Prince Edward Island	Alive and well	Guardian of the Person The Adult Protection Act	Guardian of the Estate The Adult Protection Act	Thomas A. Matheson Cox Hanson O'Reilly Matheson (902) 894-7051
Saskatchewan	Alive and well Attack by government may be possible in some cases using dependents relief legislation, but untested in courts	Personal Decision Maker The Adult Guardianship and Co-decision-making Act	Property Decision-Maker The Adult Guardianship and Co-decision-making Act	George Nystrom Balfour Moss (306) 347-8392