



Henson and Other Discretionary Trusts

CBA NS

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"Mr. Frosty, it's March.
Time to talk estate planning."

What is Estate Planning?

- Planning directed at:
 - Accumulating wealth
 - Transferring wealth to succeeding generations
 - Protecting wealth from unnecessary income and probate taxes and from creditors and others challenging the estate plan

Agenda

- What is a Trust?
- Taxation of Trusts
- Henson Trusts
- Other Discretionary Trusts
- Conclusion

What is a Trust?

- A legal relationship whereby one person (the settlor) transfers property to another person (the trustee) to hold for the benefit of others (the beneficiaries)
- The settlor, trustee and beneficiary can all be the same person, but usually two or more persons fill those roles
- A formal trust agreement or trust deed is typically required
- Testamentary trusts are typically established in a will

What is a Trust? (Cont'd)

- Not a separate legal person (but often called “the trust” colloquially)
- Deemed a person for income tax purposes (s. 104(2))
- Trustee is a fiduciary and must always act impartially and in the best interests of the beneficiaries
- Trusts can be revocable or irrevocable, fixed interest or discretionary

What is a Trust? (Cont'd)

- Personal family trusts are often discretionary – the trustee decides who among the beneficiaries receives income and/or capital, how much each person receives and when
- Investments by the trustees can be limited or expanded in the trust agreement or left to the “prudent investor” standard in the Trustee Act
- Trusts are private (unlike a probated will) and so preserve confidentiality

What is a Trust? (Cont'd)

- Trust assets are generally free from claims by creditors, including those challenging an estate plan
- A very flexible tool for estate planning
- The main drawback is the settlor's loss of control over the assets transferred to the trust

Taxation of Trusts

- Detailed and specific rules in the Income Tax Act
- Exceptions to almost every rule
- The settlor generally pays tax on accrued capital gains on assets settled to the trust – a disposition for tax purposes
- Income retained in a trust is taxed at the top marginal rate for individuals (54% in NS) – now the same for both for inter vivos and testamentary trusts (except GRE's and QDT's – more later)

Taxation of Trusts (Cont'd)

- Income paid or payable to beneficiaries is taxed in the hands of those beneficiaries
- The trust receives a deduction for all amounts paid or made payable to the beneficiaries (s. 104(6))
- If the trust is revocable, or if the settlor retains significant control over the trust assets, all income (including capital gains) is taxed in the hands of the settlor (s. 75(2))

Taxation of Trusts (Cont'd)

- If the trust is irrevocable and the beneficiaries are under 18 years of age, income (interest and dividends) is taxed in the hands of the settlor, but capital gains can be taxed in the hands of the minor beneficiaries
- Detailed rules apply to the “attribution” of income to the settlor, spouses and minors (see s. 74.3, 74.4, 75.2, etc.)

Taxation of Trusts (Cont'd)

- All property held by a trust is deemed to be disposed of every 21 years after the year the trust was created and any resulting capital gain (or loss) calculated and taxed (s. 104(4)), unless the trust property becomes vested indefeasibly in one or more capital beneficiaries
- Can be rolled out to capital beneficiaries at cost under s. 107(2) prior to anniversary (unless s. 75(2) has ever applied to the trust)

Qualified Disability Trusts

- If beneficiary qualifies for the Federal disability tax credit, may be taxed as a QDT (s. 122(3) of ITA)
- Preserves graduated rates for the trust's income
- Must be a resident Canadian testamentary trust and make a joint election with a “qualifying beneficiary” who is then an “electing beneficiary”
- Only one QDT election per each electing beneficiary
- Beneficiary must be “named” in the trust (i.e. by proper name, not by relationship to testator)

QDT's (con't)

- QDT pays recovery tax equal to the amount of tax saved each year (compared with the high marginal tax rate) when capital in the trust is distributed to a non-electing beneficiary (i.e. the remainder beneficiary)
- Effectively a deferral only
- Henson trusts would normally qualify if the beneficiary qualifies



"Well, we've licked taxes—that just leaves death."

Henson Trusts

- A form of inter vivos or testamentary trust for disabled beneficiaries
- Testamentary Henson trust is more common
- A purely discretionary trust which does not vest any of the trust assets in the hands of the beneficiary
- Preserves the value of any social benefits being received by that beneficiary
- Taxation of a Henson trust is generally the same as a regular inter vivos or testamentary trust as described earlier (unless is a QDT)

Henson Trusts (con't)

- Key to a Henson trust is language ensuring that the assets do not vest in the beneficiary (neither income nor capital) – the trustees have absolute discretion to distribute income and capital
- Trust may include other discretionary beneficiaries for greater protection, although traditional Henson trust language does not do this
- Beneficiary cannot claim or demand payments from the trust

Henson Trusts (con't)

- Trustees can use assets of the trust to improve the quality of life of the beneficiary by paying for expenses (trips, clothes, etc.) while government support and access to government programming continues
- Consideration of the identity of the trustees is fundamental – choosing correctly is critical
- Consider judgment of the trustee, care and skill in investment and other decisions and potential conflicts of interest (i.e. siblings who might be residual beneficiaries after the disabled beneficiary's death)

Henson Trusts (con't)

- Do Henson trusts work in Nova Scotia?
- Key wording in the Nova Scotia Income Support Regulations is that “assistance shall not be granted where it is feasible for the applicant or recipient to obtain support” from a trust
- The Department of Community Services Policy Manual refers to having “access” to funds in trust
- Provided trust is drafted properly, it will **not** be “feasible” for the beneficiary to obtain support from the trust and therefore it will not reduce or affect access to financial support or related programs

Trust for [●]. Hold [\$ ● OR ●'s share of the rest of my estate] in trust for ● during ● lifetime. Keep it invested. Pay to or for the benefit of the beneficiary as much of the income or capital or both as my trustees in their absolute and unfettered discretion consider advisable for the beneficiary's benefit. Neither the income nor the capital of the trust property will vest in the beneficiary. The beneficiary's only interest will be in payments actually made to the beneficiary or for the beneficiary's benefit. Without in any way binding my trustees' discretion, it is my wish that in exercising their discretion they take account of, and insofar as they consider it advisable take such steps as will maximize, the benefits which the beneficiary would receive from other sources if payments from the income or capital were not paid to the beneficiary or for the beneficiary's benefit, or such payments were limited to an amount or time. In order to maximize these benefits, my trustees may make payments varying in amount and at such times as they in their discretion consider advisable. If they cannot make payments without causing a corresponding reduction in payments to the beneficiary from other sources, then they are not to make those payments to the beneficiary. I expressly relieve them of their duty to maintain an even hand between the beneficiary and those who will receive what remains of the trust property at the beneficiary's death. At their discretion, if there is surplus income at the end of any year, they may add the surplus income to the rest of my estate, or they may add it to the capital of this trust, or they may pay it to ●.At ●'s death, pay or transfer the residue of the trust property [add gift over]

Discretionary Trusts

- Generally refers to an inter vivos or testamentary trust which either:
 - is discretionary as to capital or income for one beneficiary or
 - has beneficiaries who are discretionary members of a class (each beneficiary can be either an income beneficiary a capital beneficiary or both)

Discretionary Trusts (Cont'd)

- Can be used in estate freezes when operating or holding corporations are involved (“family” trust) or in a will
- If in an estate freeze context, trust purchases shares at fair market value so there is no negative tax implication to using the trust at that time (need an independent settlor to avoid s. 75(2) and be careful around the s. 74 attribution rules re spouses and minors for investment holding companies)
- Used to ensure flexibility by allowing for dividends to be taxed in the hands of income beneficiaries (but see 2017 tax changes re TOSI rules!)
- Still allows for the distribution of shares on a tax-deferred basis to capital beneficiaries before 21 year mark

Discretionary Trusts (Cont'd)

- Still allows for multiplication of access to the enhanced capital gains exemption for sale of shares of a qualified small business corporation (s.110.6(2.1) - \$800,000 indexed after 2014) – confirmed no changes to this in October, 2017
- Trustees maintain control of the assets
- Terms of the trust usually provide wide discretion to the trustees to allocate income and capital among the family members

Testamentary Trusts

- If testamentary, established in the testator's will and funded at the time of her death
- Assets pass through the estate, but are then transferred to or held by the trustee of the testamentary trust
- Probate tax (1.695% in Nova Scotia) is usually payable on those assets (unless probate planning has been done – beyond scope of this presentation)

Testamentary Trusts (Cont'd)

- Income tax savings far outweighed the probate tax over time
- Testamentary trust could take advantage of the graduated tax rates in the Income Tax Act until December 31, 2015
- Different than an inter vivos trust which pays tax at the highest marginal rate

Testamentary Trusts (Cont'd)

- Depending on type of income earned in the trust and province of residence of the trust for tax purposes, tax savings could have been about \$15,000 per year per trust (subject to s. 104(2))

Testamentary Trusts (Cont'd)

- Was useful for adult children who would have significant income of their own (separate trusts for each child were best)
- Access to capital could be as tight or as loose as required
- Income splitting between the trust and the beneficiary was also a real benefit (before Jan 1, 2016)

Testamentary Trusts (Cont'd)

They continue to be useful in many situations:

- To protect assets from marriage breakdown
- To preserve continuity of ownership (i.e. cottage property, family business)
- To benefit charity after assets are no longer needed to support family (charitable remainder trust)
- Many other non-tax reasons for them - spendthrift beneficiaries, blended families, incapacitated or vulnerable beneficiaries, U.S. estate tax by-pass, avoidance of double probate, creditor proofing for beneficiaries, etc.

Testamentary Trusts (Cont'd)

- Effective January 1, 2016, several changes applied to testamentary trusts:
 1. Graduated rates for testamentary trusts gone – top marginal rate now applies to testamentary trusts and grandfathered *inter vivos* trusts (pre-June 18, 1971)
 2. Estates which are “graduated rate estates” or “GREs” still obtain graduated rates for 36 months – note: this is the estate itself, not the trust, though can designate a particular testamentary trust as the GRE (only one GRE per taxpayer) – can get four tax years within that 36 months (but two are short years)

Testamentary Trusts (Cont'd)

3. Limited exception for qualified disability trusts (discussed earlier)
4. Testamentary trusts must have a calendar year end starting January 1, 2016
 - Existing trusts with non-calendar year ends had a deemed year end on December 31, 2015, as did existing estates that were not GREs (i.e. estates older than 36 months)
 - GREs can still choose an off-calendar year end but they lose the status 36 months post date of death

Testamentary Trusts (Cont'd)

5. Testamentary trusts must remit quarterly installments – exception for GREs
6. Testamentary trusts will be subject to alternative minimum tax, will have liability for Part XII.2 tax, and will no longer be able to make investment tax credits available to beneficiaries

Testamentary Trust Tax Benefits

1. “Estate fund” type trusts for income splitting/sprinkling among class of beneficiaries – draft with discretion among a class
2. “Top up” trusts to maximize use of beneficiary’s graduated rates
3. Income “paid or payable” to a minor
4. Qualified trust for a disabled beneficiary

Trust for ●. Hold my ●, ●'s, share of the rest of my estate in trust for ● during ● lifetime. Keep it invested. Pay to my child, or apply for my child's benefit, the net income from the trust property, or such lesser portion as my child may direct from time to time. Pay to my child, or apply for my child's benefit, as much of the capital of the trust property as my trustees in their discretion consider advisable. In exercising their discretion, my trustees should consider my child's care and comfort as their primary concern, and not the preservation of the capital. My trustees have no duty to maintain an even hand for the benefit of subsequent beneficiaries and may fully exhaust the capital if they consider that advisable. [add gift over]

My Children. After my ● dies (or at my death if ● does not survive me), divide the rest of my estate into ● equal shares. Hold one such share of the rest of my estate in respective separate trusts known as “Estate Funds” in trust for each of my children and that child’s children on terms set out below.

While each child is alive, my trustees shall pay the income or capital or as much of either or both as they think best of each Estate Fund to or for the benefit of that child and that child’s children. When exercising their discretion, my trustees shall consider the care and comfort of my child and that child’s children as their primary concern, and not the preservation of the capital. My trustees have no duty to maintain an even hand for the benefit of subsequent beneficiaries and may fully exhaust the capital if they consider that advisable.

I expressly give the trustees of these trusts full discretion with respect to the allocation of payments as among the beneficiaries of these trusts, and with respect to the exclusion of any one or more of the beneficiaries, notwithstanding any rule of law or equity (including the rule sometimes referred to as the “even handed rule”) which may otherwise restrict the trustees’ discretion.

After each child dies (or at my death if that child is not alive at the time the Estate Funds are created), my trustees shall divide the residue of that child’s Estate Fund equally among those of that child’s children then alive or, if there are none, then add the residue of that Estate Fund to the other Estate Fund, to be administered and distributed as if it had been an original part of that Estate Fund.



Conclusion

- Estate planning is a customized processes – each plan is unique
- Various tools are available to maximize the benefits and minimize the risks
- The goal is to create a customized plan that is best for each client’s personal circumstances

Questions

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