Planning for Disabled Beneficiaries Using Life Insurance Trusts

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Introduction

A life insurance trust can be a useful tool when planning to provide support to a family member living with a disability.[1] The life insurance trust may have certain advantages if it is structured as a "Henson trust"[2] designed to preserve entitlements to government income-tested benefits and/or a "qualified disability trust" ("QDT").[3] In addition, the preferred beneficiary election[4] can provide significant tax advantages in certain situations. A review of various situations in which a life insurance trust can be of value, and some applicable tax elections and implications, will be provided.

The use of Trusts in General

Trusts are frequently used for gifts or bequests (both of life insurance proceeds and other assets) to minor beneficiaries, who have not yet reached the age of majority.[5] Since the beneficiary cannot legally manage the funds, someone must be appointed to do this on behalf of the child until the child reaches the age of majority. Trusts can also provide control over the timing and amount of distributions to beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves. A trust can provide flexibility in structuring payments to beneficiaries to allow for changes in the amount and timing of distributions, or perhaps even for changes in the choice of beneficiaries, based on future circumstances. Even if there are no concerns about the ability of a beneficiary to be financially responsible, leaving assets in a trust may help protect inheritances from third-party claims (for example, creditor or family law claims against the beneficiary). A trust can also be used to preserve income and/or asset-tested government benefits when properly structured as a "Henson trust."

The use of a Life Insurance Trust

Although trusts should generally be considered when providing for beneficiaries with a disability, this becomes particularly important in the context of a life insurance policy, because often a large, lump sum amount is paid out on death.

For example, the trustee could be given discretion to pay for expenses related to the beneficiary's support and education. The trust terms could also specify an age at which the trustee could transfer outright any remaining funds to the beneficiary, such as when they reach a particular age. This would delay final distribution of the funds until a time when a beneficiary might be in a better position to make responsible financial decisions. If the goal is for the trust to qualify as a Henson trust (discussed below), this must be considered. If a beneficiary will have a vested right to receive income and capital from the trust, the interest in the trust will not be treated as an interest in a Henson trust. An example of a vested right would be that the beneficiary can get half of the capital at age 25 and the rest at age 30, with no provision as to what would happen if they did not reach one (or both) of those ages.

A life insurance trust is created on and in consequence of an individual's death[6] by way of an insurance declaration[7] in favour of a beneficiary for whom a trustee is appointed.[8] An insurance declaration may be made in a will or any other written instrument (including the insurer's beneficiary designation form). Where an insurance declaration is made, the proceeds of the life insurance policy paid on death pass outside of and do not form part of the estate. Such a declaration creates a separate insurance trust notwithstanding that the trustee of this trust may be the same person as the estate trustee and the declaration may be made in a will.

On the other hand, when the estate is designated as the beneficiary of a life insurance policy, and the terms of the will specify that funds are to be transferred to a trust for the benefit of a beneficiary with a disability, the insurance proceeds form part of the estate. As such, the life insurance proceeds will be included in the estate for purposes of calculating applicable provincial probate fees or estate administration tax.[9] Depending on the province or territory in which the deceased is resident, and the amount of the proceeds, this amount may not be insignificant. Passing through the estate would also make the life insurance proceeds available to creditors of the estate.

The "Henson Trust"

A Henson trust is often used to receive assets, including an inheritance or life insurance proceeds, on behalf of a beneficiary with a disability to preserve the beneficiary's rights to collect asset- or income-tested government benefits and entitlements. The trust must be fully discretionary, where the trustee has full discretion as to whether the beneficiary receives any distributions; consequently, there is no direct entitlement of the beneficiary to the trust's assets or income. The general rule in most provinces is that these trusts can be established for a beneficiary without affecting the beneficiary's entitlement to provincial government benefits. They are often set up by a parent or other relative during their lifetime or upon their death. An insurance trust with Henson trust terms could be created upon death.

The Henson trust got its name from an Ontario court decision[10] involving a father who established a fully discretionary trust for his daughter. The Ontario government tried to look through the trust such that the daughter would be disqualified from certain asset-tested government benefits. The court ruled in her favour, finding that the assets did not belong to her.

A 2019 Supreme Court of Canada decision[11] opined for the first time on the validity of the Henson trust finding that an interest in a fully discretionary trust set up for a B.C. woman with a disability is not considered an asset that may be taken into consideration when determining her eligibility for public housing assistance.

The case involved a woman with disabilities ("S.A.") who resided in a Metro Vancouver Housing Corporation (MVHC) subsidized housing complex since 1992. She had been receiving rental assistance from MVHC every year until 2015. Tenants who wish to receive rent subsidies from MVHC must demonstrate, on an annual basis, that they meet the eligibility criteria by completing and submitting an assistance application. MVHC limits eligibility for rental assistance to tenants who have less than $25,000 in total assets.

S.A.'s father passed away and a third of her father's estate was placed into a Henson-type discretionary trust in 2012 "for her care and maintenance." In 2015, MVHC requested that S.A. disclose the balance of the trust. She refused, arguing that her interest in the trust was not an "asset" that could affect her eligibility for rental assistance. MVHC advised her that it was unable to approve her application, as in its view, her trust was an asset and its value was required for it to determine her eligibility for rental assistance. As a result, on June 1, 2015, S.A. stopped receiving rental assistance and since then she paid her full rent "under protest."

The lower courts held that the meaning of the word "assets" as used in the tenancy agreement was broad enough to encompass S.A.'s interest in the trust, and therefore that MVHC was entitled to require that she disclose the value of the trust before it would consider her application for rental assistance.

The Supreme Court disagreed and ruled that since S.A. "has no actual entitlement to the trust property under the terms of the Trust, … her interest in the Trust is not an asset that could disqualify her from being considered by MVHC for a rent subsidy".[12] Accordingly, S.A. was eligible to be considered by MVHC for rental assistance in 2015.

A word of caution, however, is warranted in that the SCC indicated it is possible for the criteria for social assistance to be structured to consider an interest in a trust as an "asset." As the SCC wrote, "I would add that these reasons should not be taken to suggest that the interest of a person with disabilities in a properly constituted Henson trust can never be treated as an "asset" for any purpose whatsoever. As the Court of Appeal observed, "[w]hether benefits from a discretionary trust must be taken into account will vary from program to program and depend upon the rules and regulations that govern eligibility for any particular program" (para. 47). The eligibility criteria associated with any social assistance program must be analyzed on their own terms to determine whether and, if so, how an interest in a Henson trust factors into any applicable means test."[13]

Taxation of a Life Insurance Trust

An insurance trust is taxed like any other personal trust for tax purposes. Any income paid or payable to a trust beneficiary in a year is taxed in the hands of the beneficiary, assuming the trust claims the deduction. An amount is considered payable if "the beneficiary was entitled in the year to enforce payment of it."[14] Most amounts flowed out from the trust retain their character for tax purposes. For instance, where Canadian dividends are allocated to a beneficiary from a trust, the beneficiary may claim the dividend tax credit.[15] Capital gains received by a beneficiary continue to be included in income at a 50% rate.[16] Income or gains that are not paid or payable to a beneficiary are taxable in the trust at the highest personal marginal tax rate. One exception to this rule is a QDT (discussed below). Income taxed in a QDT is taxed at graduated tax rates.

When capital property is transferred to a trust, generally it is deemed to be disposed of by the transferor, and a capital gain or loss is recognized at that time.[17] Life insurance is not capital property under the *Act* and life insurance policy proceeds that settle a life insurance trust would not bring about any capital gain or loss. Life insurance proceeds are received by the trustee tax-free.[18]

What is a QDT?

In order to qualify as a QDT, at least one of the beneficiaries of the trust must be eligible for the disability tax credit (the "DTC"), and the trustee must make a joint election with one of those beneficiaries for the trust to be a QDT for the year.[19] A beneficiary can only elect for one trust to be a QDT. It is not required for all of the trust beneficiaries to be eligible for the DTC.

In addition, the trust must be a testamentary trust, that is one that "arose on and as a consequence of" the death of an individual. In order to qualify as a testamentary trust, no property may have been contributed to the trust "otherwise than by an individual on or after the individual's death and as a consequence thereof."[20] The Canada Revenue Agency (CRA) has commented on when this condition will be considered to be satisfied with respect to life insurance trusts. Where a trust is established by the will of an individual, it may qualify as a testamentary trust where it receives the proceeds of a life insurance policy on the death of that individual.[21] Further, the CRA has taken the position that a trust may also qualify as a testamentary trust where the terms of a trust have been set during the lifetime of an individual, as opposed to under a will, the trust is designated as a beneficiary of an insurance policy, and the trust is only funded with the insurance proceeds on the death of that individual. The CRA does not consider the trust as having been created until the insurance proceeds are paid to the trust.[22] This continues to be the CRA's view when a joint last-to-die policy is used;[23] however, if a trust is settled during a person's lifetime, even if it receives "the bulk of its capital as a beneficiary under an insurance policy," it will remain an inter vivos trust and not qualify as a testamentary trust.[24]

A QDT is subject to tax at graduated personal tax rates.[25] Using a life insurance trust that qualifies as a QDT in an estate plan could result in tax savings. Any income retained in a trust that qualifies as a QDT will be taxed at graduated tax rates, whereas a trust that does not qualify will be taxed at the highest marginal tax rate.

If a beneficiary who is eligible for the DTC is designated as the beneficiary of a life insurance policy, when the beneficiary invests the insurance proceeds they will be taxable at their personal marginal tax rate on the investment income and gains generated. If the beneficiary has other income, then this additional investment income or gains could be taxable at a high, if not the highest, marginal tax rate. If instead the trustee of a QDT was the beneficiary of the life insurance proceeds or if an insurance trust is created that qualifies as a QDT, it might be taxable at a lower tax rate on the same investment income.

Preferred Beneficiary Election (PBE)

For trusts, including life insurance trusts, with a beneficiary who is living with a disability but where the trust does not qualify as a QDT, it may be possible to achieve graduated rate taxation by the trustee and beneficiary making the "preferred beneficiary election".[26] For instance, a trust may not qualify as a QDT even though a beneficiary is living with a disability, if they are not eligible to claim the DTC. Where a preferred beneficiary election is made, income or capital gains of the trust is taxed in the hands of the beneficiary, even though it is not paid or payable to the beneficiary.[27]

In order to make the PBE, the beneficiary must be either eligible to claim the DTC, or the beneficiary must be over the age of 18, have a low level of income, and be dependent on another for support because of the disability.[28]

If the trust qualifies as a Henson trust as discussed above, care should be taken before making such an election. Consideration should be given to whether a preferred beneficiary election could impact the beneficiary's eligibility to provincial disability benefits.

Age 40 Trusts

A final option for graduated rate taxation, while retaining income in a trust, may be available even where a trust (including an insurance trust) does not qualify as a QDT and a beneficiary does not qualify as a preferred beneficiary. Where a trust is non-discretionary in nature, a beneficiary is under age 21 throughout the year and has a vested right to income or capital gains of the trust, so long as the only condition before the income or gains is distributed is that they attain an age of 40 or less, then the income and gains of the trust is deemed to be payable to the beneficiary for the year.[29] What is key for this deeming rule to apply is that the right to the income must have vested, other than the condition of attaining the particular age.

Note that as the trust must be non-discretionary in order for this provision to apply, the trust will not qualify as a Henson trust.

Conclusion

There are numerous non-tax reasons for designating a trust as the beneficiary of a life insurance policy. For instance, trusts which qualify as a Henson trust can help to preserve disability support benefits. In addition, certain trusts may result in a lower overall tax rate on income generated from life insurance proceeds.

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[1] This article does not take into account the particular *Civil Code* or legal requirements for residents of Quebec.
[2] *Ontario (Director of Income Maintenance, Ministry of Community & Social Services) v. Henson*, 1989 CarswellOnt 542, [1989] O.J. No. 2093 (Ont. C.A.), affirming (1987), 28 E.T.R. 121 (Ont. Div. Ct.).
[3] Subsection 122(3) of the *Income Tax Act*, R.S.C. 1985, c. 1, 5th supplement, as amended (the "*Act*"). Unless otherwise stated, all statutory references are to the *Act*.
[4] *Ibid*., subsection 104(14).
[5] Age 18 or 19 depending upon the province or territory of residence.
[6] And thereby may qualify as a "testamentary trust" pursuant to subsection 108(1) of the *Act*. For a prior article that goes into more depth regarding the manner in which insurance trusts are created and the impact of the 2016 testamentary trust tax changes to them see: Glenn R. Stephens "Life Insurance Testamentary Trusts: Impact of Recent Tax Changes" *Insurance Planning*, Vol. XXI No. 1 at pg. 12.
[7] See *Insurance Act* (Ontario), R.S.O. 1990, c.I.8, section 171.
[8] *Ibid*., subsection 193(1).
[9] See for example the Ontario Estate Information Return Guide which can be found at http://www.forms.ssb.gov.on.ca/mbs/ssb/forms/ssbforms.nsf/FormDetail?OpenForm&ACT=RDR&TAB=PROFILE&SRCH=&ENV=WWE&TIT=9955&NO=9955E which includes as part of estate assets "Insurance, if proceeds pass through the estate, e.g., no named beneficiary other than "Estate."
[10] *Supra* note 2.
[11] *S.A. v. Metro Vancouver Housing Corp.*, 2019 SCC 4 (S.C.C.).
[12] *Ibid*., paragraph 4.
[13] *Ibid*., paragraph 55.
[14] Subsection 104(24) of the *Act*.
[15] See subsection 104(19) of the *Act*.
[16] See subsection 104(21) of the *Act.*
[17] There are exceptions for certain life interest trusts for the benefit of a spouse or common-law partner.
[18] Subsection 148(9) definition of "disposition" excludes a payment under the policy in consequence of the death of any person whose life was insured under the policy.
[19] *Supra* note 3.
[20] *Supra* note 6 definition of testamentary trust in subsection 108(1) of the *Act* and definitions related to "as a consequence of death" in subsection 248(8) and (23) and "by will" in subsection 248(9.1).
[21] See CRA Technical Interpretation 9605575 dated December 17, 1996.
[22] *Ibid.* and CRA Technical Interpretations 9625975 dated October 7, 1996, 2000-0059755 dated March 23, 2001 and 2009-0350811E5 dated April 1, 2011.
[23] See Question 2 from the CRA Roundtable at the 2008 STEP National Conference. This does not take into account any issues that may arise if a beneficiary designation is changed after the first death of one of the life insurance policy owners.
[24] *Supra* note 22.
[25] If a beneficiary who is not eligible for the DTC, or is eligible but has not elected for the particular trust to be a QDT, receives any trust capital during a year, then the trust will not qualify as a QDT that year and will be required to pay a "recovery tax."
[26] *Supra* note 4.
[27] *Ibid.* and subsection 104(15) of the *Act*.
[28] Definition of "preferred beneficiary" in subsection 108(1) of the *Act*. The beneficiary must also either be the settlor, or have a specific relationship with the settlor such as a spouse or common-law partner, or child or grandchild.
[29] Subsection 104(18) of the *Act*.