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How to integrate RDSPs, Henson trusts and annuities

From the Investment Advisor
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The Inheritance Trust
In a few provinces, including Ontario, people receiving provincial disability support are allowed to receive an inheritance (and other types of settlements), without losing benefits, as long as the lump sum does not exceed $100,000.

While there are stipulations associated with these types of trusts (they cannot grow above $100,000 and income up to $5,000 must be paid out during the year), they do give the beneficiary control because they are inter vivos trusts created by the beneficiary and not testamentary trusts set up in the will. However, clients need to know that any amount over the yearly $5,000 will be deducted dollar for dollar from benefit cheques.

Henson Trusts
The Henson Trust is an Absolute Discretionary Trust, which sprinkles income to a beneficiary with a disability. Such a trust is of value only to beneficiaries who receive ODSP (or another provincial benefit program for people with disabilities), because it allows receipt of occasional benefits, but not an income stream.

As there's no right to income or capital in the trust document, and the trustees can withhold income and assets from the beneficiary, it's not considered an asset or income under provincial benefits definitions.

A Henson Trust may be testamentary or inter vivos. However, not all provinces recognize Henson Trusts and their status is fragile—regulations can change and Henson Trusts are continually being challenged. The following provinces allow Henson Trusts: Ontario, British Columbia, Manitoba, New Brunswick, Nova Scotia, and Saskatchewan. The provinces that have challenged the Henson Trust include: Newfoundland & Labrador, Nunavut, and Northwest Territories. The status of Henson Trusts in Alberta is defunct.

There are pros and cons depending on the individual situation:
• As long as the beneficiary is under age 65, he or she can continue receiving provincial benefits with the occasional payment of monies from the trust. At age 65, provincial payments stop and payments begin under the federal system and include CPP, OAS and GIS. While GIS (Guaranteed Income Supplement) is income tested, it isn't asset tested, and the reduction is not dollar for dollar.
• A trust, Henson or otherwise, could use the preferred beneficiary election to enable the tax to be paid in the trust and not affect GIS.
• A major benefit with Henson Trusts is the person with the disability is not required to be eligible for the Disability Tax Credit.
• The cost of setting up a Henson Trust is an issue for amounts of $100,000 or less. In these cases, an inheritance trust may make more sense.
• Trustees are entitled to an annual fee, which is a percentage of assets. This is typically 2% to 2.5%. A T-3 trust return must be filed by the trustee.
• All trusts are required to maintain records and to abide by any terms in the trust documents (typically spelled out in the will). These may include instructions on how to invest and acceptable investment vehicles.
• Trustees who are family members may have a conflict of interest when they or their immediate family are residual beneficiaries of a Henson Trust. Decisions to invest more for long-term growth and less for current income, and to withhold payments of income and capital, may not be in the interest of the beneficiary but rather in the interest of the trustee-beneficiary or other family members.

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• A Henson Trust beneficiary capable of handling his or her own affairs may resent the structure, as it creates or increases dependency on others.
• The Income Tax Act has a provision that allows an RRSP or RRIF to roll over on death to a disabled child or grandchild financially dependent on the deceased. If that person is a minor, the funds are used to purchase an annuity which pays out by age 18. But in the case of an older dependant with a disability, the RRSP or RRIF can roll over tax-free into a beneficiary's own RRSP. The person, however, must be financially dependent on the parent or grandparent, and eligible for the Disability Tax Credit. Financially dependent is usually defined as the deceased being able to claim the beneficiary as a dependant, and the beneficiary's income being below the sum of the basic personal tax credit and the disability tax credit. This amount was $16,490 in 2007.
• RRSPs and RRIFs can also be rolled over to Henson Trusts—the advantage is that none of the money will be lost to tax. If there's no surviving spouse or the spouse will not need the money, putting it directly into a Henson Trust may make sense.
• Some public service pension plans pay survivor benefits, first to a spouse and then to a dependant survivor. The dependant survivor would be an adult child who receives provincial benefits. It will likely have negative consequences for the dependant's provincial benefits, although if the end result is a significantly higher income, it's more beneficial.

Annuities
Parents wishing to provide a stable income stream for a disabled but employed adult child, who is not eligible for provincial benefits because his or her income (earned income, maximum CPP disability benefit, worker's compensation, minimal company or private disability payments) exceeds a set threshold, may want to consider an annuity. They can be structured in a variety of ways:
• Used in conjunction with the RDSP, a term certain annuity can be used to top up or replace other income for a period of 10 to 30 years, providing a regular and secure level of income. Once that fixed term is over, the annuity stops and the RDSP starts generating income, replacing the original annuity. Since the RDSP is a new program, it will likely take at least 20 to 30 years before an income stream can be regularly generated this way.
• An annuity could be purchased by the parents for themselves, paying the income to the beneficiary child. Rather than a term certain annuity, a prescribed life annuity with a guarantee period of 20 years could be chosen (with the child as beneficiary in case the parent dies before the guarantee period). The annuity would continue to pay the beneficiary until the guarantee period is up. The advantage is that if the parent lives longer than the 20-year guarantee period, the annuity carries on for as long as the parent lives.
• The annuity payments are made up of a return of capital and an income (interest) payment. On a term certain annuity providing $24,000 per year in income for a 30-year-old male, the taxable portion would be about $6,400.
• Advisors need to ensure income from an annuity in the beneficiary's name will not affect income from another source such as a disability pension or worker's compensation.
• Indexing is technically feasible for annuities. However, it comes at a price and most companies are averse to even issuing indexed annuities. A way around this is to keep the initial payments at a level that is reasonable and add a second annuity 10 years later. Staggering will achieve a similar result and the beneficiary will be older, so payments will be higher per dollar invested (on a life annuity).

Each new government program adds both opportunities and complexities for advisors and their clients. In such a climate, looking at all the options and advising clients appropriately becomes ever more critical.