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A Clear Winner in the Tax Cuts and Jobs Act of 2017: Qualified Disability Trusts

The Tax Cuts and Jobs Act of 2017 greatly enhances the income tax benefits of a Qualified Disability Trust.

Tax professionals have been losing sleep over The Tax Cuts and Jobs Act of 2017 (the Act). Congress pushed the Act through in three weeks and many deductions and exemptions that had been in place for years are gone.

While the effect of many changes under the Act is still unknown, one thing is clear: The Act greatly enhances the income tax benefits of a Qualified Disability Trust (QDisT). Unless otherwise stated, the Internal Revenue Code (IRC) discussed below are effective January 1, 2018, and expire on December 31, 2025.

The 2001 Patriot Act created the QDisT.[1] A QDisT is a non-grantor trust and provides income tax benefits if the beneficiary is disabled. Before 2017, a QDisT received an income tax exemption equal to the personal exemption available in that year ($4,050 in 2017).[2]

1 Adding IRC §642(b)(2)(C).
2 IRC §151(c).

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Note that a QDisT is purely a tax concept, and there is no requirement that a QDisT is a special needs trust (SNT). A QDisT can only have one beneficiary, and if the beneficiary meets the disability requirement of IRC §642(b)(2)(C)(ii), then the trust is a QDisT. No election is necessary. However, a SNT can be a QDisT if it is a non-grantor trust.

What makes the QDisT attractive is:

1. The Act increases the personal exemption for a QDisT to $4,150;[3] and
2. Income from a QDisT is exempt from the Kiddie Tax.

A mostly unnoticed provision IRC §1(g)(4)(C), added in 2006[4] exempts the income from a QDisT from the Kiddie Tax The statute provides:

> For purposes of this subsection, in the case of any child who is a beneficiary of a qualified disability trust (as defined in section 642(b)(2)(C)(ii)), any amount included in the income of such child under sections 652 and 662 during a taxable year shall be considered earned income of such child for such taxable year.

Unless the practioner is familiar with the Kiddie Tax rules, the exemption is not obvious. One must use their knowledge to understand the result. Language to the effect QDisT's are exempt from the Kiddie Tax is much clearer.

3 IRC § 642(b)(2)(C)(iii)(I).
4 Tax Increase Prevention and Reconciliation Act of 2005 §510.

Personal Exemptions

The Act eliminated the personal exemption for individuals[5] and increased the standard deduction to $12,000 for individual taxpayers and $24,000 for married couples filing jointly.[6] However, the standard deduction for an individual claimed as a dependent remains the same. The standard deduction claimed by a dependent in 2018 cannot exceed the greater of $1,050 or $350 plus the individual's earned income up to the standard deduction for unmarried taxpayers.

The Act retains the tax exemption for trusts and estates. The tax exemption for an estate is $600.[7] The tax exemption is $300 for a simple trust (one that distributes all its income annually) $100 for a complex trust (one that does not distribute or accumulate such income) receives an income tax exemption of $100.[8]

The Act eliminates the personal exemption for individuals. However, the Act increases the tax exemption for a QDisT to $4,150[9] indexed for inflation.[10] The QDisT can retain $4,150 tax-free each year creating a fund that

5 IRC 151(d)(5)(A).
6 IRC 63(c)(7).
7 IRC §642(b)(1).
8 IRC §642(b)(2)(A) and (B).
9 IRC § 642(b)(2)(C)(iii)(I).
10 IRC § 642(b)(2)(C)(iii)(II).

provides for the beneficiary's future needs.

Kiddie Tax

Distributing income from a non-grantor trust to a child is subject to tax liability under IRC §1(g), which is commonly called the "Kiddie Tax." For tax years before January 1, 2018, under IRC §1(g) a child's net unearned income was taxed at the higher of the parent's marginal income tax rate or the child's marginal tax rate. The straightforward definition of "net unearned income" is all income not earned income.[11] Unearned income includes: 1) interest, dividends, rents, royalties, and gains from the sale of investment property;[12] and 2) social security and pension benefits paid to the child to the extent they constitute gross income to the child.[13] Earned income is essentially wages, salaries, and other amounts received as compensation for personal services.[14] These provisions, which remain intact under the Act, are crucial to the tax benefits of the QDisT.

The Act substitutes the parental tax rate used to determine the Kiddie Tax with the substantially higher tax rate for trusts and estates for tax years beginning January 1, 2018.[15] The income tax rate on income over $12,500 is 37% (see schedule A on page 5). By contrast, unmarried individuals and married individuals filing a joint income tax return and do not reach the 37% bracket until their taxable income exceeds $500,000 and $600,000 respectively. If the Kiddie Tax applies, a child's income tax liability can be more than their parents due to the increased Kiddie Tax rate, even though the child's total income is less.

The three-prong test used to determine if the Kiddie Tax applies remains unchanged by the Act. First, the child is not 18 years old before the close of the taxable year[16] unless he or she is a student, in which case the age limit is 24 years.[17] Second, the child must have at least one parent alive as of the close of the taxable year.[18] Finally, the child must not file a joint return for the taxable year.[19] If a child meets these tests, any unearned income more than $2,100 is subject to the Kiddie Tax.

If the income is subject to Kiddie Tax, besides the high tax rate, then the child can be claimed as a dependent, and the child's standard deduction for trust income is limited to $1,050.[20] If the child's trust income and other unearned income exceed the standard deduction of $1,050, the first $1,050 of any remaining income is taxed at the child's tax rate of 10%. Any remaining income is taxed at the tax rates for trusts and estates.

If a child is the beneficiary of a QDisT, his or her tax liability is substantially less. The IRS treats unearned income paid to or used to benefit the beneficiary of a QDisT as earned income for all income tax purposes. All income from a QDisT distributed to or used for the benefit the beneficiary is *exempt* from the Kiddie Tax.[21]

The child uses the tax table for single individuals for ordinary income and the corresponding capital gains tax table (see schedule B on page 5). Under that table, the child's income is not taxed at 37% until it exceeds $500,000. If a beneficiary of a QDisT receives a $37,000 capital gain distribution, there is no capital gains tax. The same distribution to a beneficiary of a conventional trust incurs a tax liability of $7,400.

Also, the QDisT beneficiary is eligible for a standard deduction equal to the greater of: 1) $1,050; or 2) the child's income plus $350 up to the individual standard deduction for a single person ($12,000), regardless if the beneficiary is a dependent.[22] Including the $4,150 trust income tax exemption, the first $16,150 of trust income is federal income tax free. If there is a concern over the income distributed to the beneficiary, a Medicaid payback trust ((d)(4)(A) trust) can receive the distributed income.

If the QDisT retains the $4,150 trust income tax exemption and earns a 7% annual return, at the end of the 14-year period, there will be a fund of more than $95,000 to be used for the beneficiary's future needs.

Examples

1. Jane is 14 years old and receives $1,800 from a non-grantor trust. Her taxable income is $750 ($1,800 less the standard deduction of $1,050). Her income tax due is $75 based on her tax rate of 10%.

2. Robert is 20 years old and is a student. A non-grantor trust established by his grandfather distributes $2,300 to him. His taxable income is $1,250 ($2,300 less the standard deduction of $1,050). The income tax on the first $1,050 uses Robert's tax rate of 10%, and the remaining $200 of income is

11 IRC §1(g)(4)(A)(i) .
12 Reg. §1.1(i)-1T, Q&A-6.
13 Reg. §1.1(i)-1T, Q&A-9.
14 IRC §911(d)(2).
15 IRC §1(j)(4)(B).
16 IRC §1(g)(2)(A)(i).
17 IRC §1(g)(2)(A)(ii)(I).
18 IRC §1(g)(2)(B).
19 IRC §1(g)(2)(C).
20 IRC §63(c)(5).
21 IRC § 1(g)(4)(C).
22 IRC §63(c)(7)(A)(ii).

taxed using the trust tax rate of 10%. His total income tax due is $125.

3. Same facts as #2 except Robert receives a distribution of $5,000. His taxable income is $3,950. The tax rate for the first $1,050 of income is 10%. The trust tax rate of 10% applies to the next $1,500 of income.

Since Robert's remaining income exceeds $2,550, the upper limit of the new Kiddie Tax 10% bracket, the income tax on the remaining $1,400 of income uses the 24% tax rate. Robert's total tax due is $591.

If the trust were a QDisT, Robert would pay no income tax even if the trust did not use its $4,150 income tax exemption since Robert's standard deduction is $5,000.

QDisT's and IRA Accounts

The QDisT is an attractive vehicle as the designated beneficiary of an IRA. Initially, the Required Minimum Distributions (RMD) are so low, they would have little or no effect on government benefits received by the beneficiary. Over the years, the tax-free accumulation of the IRA will yield a substantial amount for the beneficiary's future needs. If needed, the IRA can make excess distributions, and there is no income tax liability until the total distributions in a single year exceed $16,150.

For example, let's assume these facts: a grandparent passes away and names an IRA-qualified trust for a grandchild with special needs as the designated beneficiary of $750,000 of his IRA. The grandchild is 10 years old when commence. The trust beneficiary is a student until she is 24 years old. The annual rate of return of the IRA is 7 %. What follows are three scenarios:

1. RMD's commenced in 2017, and the trust qualified as a QDisT, and the prior law is unchanged;
2. RMD's commence in 2018, and the trust qualifies as a QDisT under current law; and
3. RMD's commence in 2018, and the trust is a not a QDisT and subject to Kiddie Tax. The trust is a conventional IRA conduit trust (the results are the same if the trust is an accumulation trust since the Kiddie Tax rates equal to the trust and estate tax rate.

1. Qualified Disability Trust — 2017

Age	RMD	Trust Exemption	Beneficiary's Gross Income	Beneficiary's Standard Deduction	Beneficiary's Net Income	Income Tax
10	$10,302.20	$4,050.00	$6,252.20	$1,050.00	$5,202.20	$520.22
11	$11,023.35	$4,050.00	$6,973.35	$1,050.00	$5,923.35	$592.34
12	$11,794.99	$4,050.00	$7,744.99	$1,050.00	$6,694.99	$669.50
13	$12,620.64	$4,050.00	$8,570.64	$1,050.00	$7,520.64	$752.06
14	$13,504.08	$4,050.00	$9,454.08	$1,050.00	$8,404.08	$840.41
15	$14,449.37	$4,050.00	$10,399.37	$1,050.00	$9,349.37	$936.15
16	$15,460.82	$4,050.00	$11,410.82	$1,050.00	$10,360.82	$1,087.87
17	$16,543.08	$4,050.00	$12,493.08	$1,050.00	$11,443.08	$1,250.21
18	$17,701.09	$4,050.00	$13,651.09	$1,050.00	$12,601.09	$1,423.91
19	$18,940.17	$4,050.00	$14,890.17	$1,050.00	$13,840.17	$1,609.78
20	$20,265.98	$4,050.00	$16,215.98	$1,050.00	$15,165.98	$1,808.65
21	$21,684.60	$4,050.00	$17,634.60	$1,050.00	$16,584.60	$2,021.44
22	$23,202.52	$4,050.00	$19,152.52	$1,050.00	$18,102.52	$2,249.13
23	$24,826.70	$4,050.00	$20,776.70	$1,050.00	$19,726.70	$2,492.75
24	$26,564.57	$4,050.00	$22,514.57	$1,050.00	$21,464.57	$2,753.44
Totals	$258,884.16	$60,750.00	$319,634.16		$182,384.16	$21,007.86

Under the QDisT rules in effect in 2017, the trust beneficiary will have an income tax liability of $21,007.86 or 8.11% of the total of all RMD's The cost is offset since the QDisT can accumulate $4,050 each year tax-free creating a fund of $60,750. If the exemption amount is invested and appreciates 7% per annum, the fund will be worth more than $90,000. Finally, the parents have a $4,050 personal exemption for the trust beneficiary, which reduces the tax liability caused by the Kiddie Tax.

For 2018, the personal exemption of the trust increases to $4,150 (indexed for inflation). Eliminating the trust beneficiary's tax exemption is made up by the increase of the standard deduction to $12,000. Under the Act, the tax liability of the trust beneficiary over the same 14-year period is $4,053.70, only 1.57% of the of the total RMD's paid, and almost 80% less income tax than under the prior QDisT tax regime. If the $4,150 trust exemption amount remains in the QDisT and grows at 7% annually, it creates a $95,000 fund to use for future benefits.

Contrast the QDisT results to a standard IRA accumulation trust (see Chart 3. Traditional IRA Conduit Trust — 2018).

With only a $1,050 standard deduction and a $300 trust tax exemption, the federal income tax liability is $68,780.96 or 26.57% of the RMD's paid.

Conclusion

As the result of eliminating many deductions and exemptions, the Act increases the importance of the QDisT as a planning tool. Most third-party SNTs are grantor trusts in which the grantor, usually a parent or other relative, is taxed on income generated by the trust wasting the trust exemption and child's standard deduction. The grantor will pay income tax on the $16,150 that would have been tax-free in a QDisT

Due to the changes in the Act, the elder law and special needs planning attorney must discuss with clients the benefits of a QDisT, to preserve the tax benefits explained above. Additionally, elder law and special needs planning attorneys have to re-examine all existing third-party grantor trusts and consider the benefit of terminating the grantor trust status or decanting the trust to take advantage of the substantial income tax saving under the Act (see Schedule A: Kiddie Tax Rates; Schedule B: QDist Beneficiary Individual Tax rates; and 2018 Capital Gains Tax Rate: Kiddie Tax Rates and QDisT Beneficiary Tax Rates). ■

2. Qualified Disability Trust — 2018

Age	RMD	Trust Personal Exemption	Gross Income	Standard Deduction	Taxable Income	Income Tax
10	$10,302.20	$4,150.00	$6,152.20	$6,152.20	$0.00	$0.00
11	$11,023.35	$4,150.00	$6,873.35	$6,873.35	$0.00	$0.00
12	$11,794.99	$4,150.00	$7,644.99	$7,644.99	$0.00	$0.00
13	$12,620.64	$4,150.00	$8,470.64	$8,470.64	$0.00	$0.00
14	$13,504.08	$4,150.00	$9,354.08	$9,354.08	$0.00	$0.00
15	$14,449.37	$4,150.00	$10,299.37	$10,299.37	$0.00	$0.00
16	$15,460.82	$4,150.00	$11,310.82	$11,310.82	$0.00	$0.00
17	$16,543.08	$4,150.00	$12,393.08	$12,000.00	$393.08	$39.31
18	$17,701.09	$4,150.00	$13,551.09	$12,000.00	$1,551.09	$155.11
19	$18,940.17	$4,150.00	$14,790.17	$12,000.00	$2,790.17	$279.02
20	$20,265.98	$4,150.00	$16,115.98	$12,000.00	$4,115.98	$411.60
21	$21,684.60	$4,150.00	$17,534.60	$12,000.00	$5,534.60	$553.46
22	$23,202.52	$4,150.00	$19,052.52	$12,000.00	$7,052.52	$705.25
23	$24,826.70	$4,150.00	$20,676.70	$12,000.00	$8,676.70	$850.70
24	$26,564.57	$4,150.00	$22,414.57	$12,000.00	$10,414.57	$1,059.25
Totals	$258,884.16	$62,250.00			$40,528.72	$4,053.70

3. Traditional IRA Conduit Trust — 2018

Age	RMD	Trust Exemption	Gross Income	Standard Deduction	Taxable Income	Income Tax at Beneficiary Rate	Taxable Income Subject to Kiddie Tax	Kiddie Tax	Total Income Tax
10	$10,302.20	$300.00	$10,002.20	$1,050.00	$8,952.20	$105.00	$7,902.20	$1,611.53	$1,716.53
11	$11,023.35	$300.00	$10,723.35	$1,050.00	$9,673.35	$105.00	$8,623.35	$1,784.60	$1,889.60
12	$11,794.99	$300.00	$11,494.99	$1,050.00	$10,444.99	$105.00	$9,394.99	$1,924.75	$2,029.75
13	$12,620.64	$300.00	$12,320.64	$1,050.00	$11,270.64	$105.00	$10,220.64	$2,213.72	$2,318.72
14	$13,504.08	$300.00	$13,204.08	$1,050.00	$12,154.08	$105.00	$11,104.08	$2,522.93	$2,627.93
15	$14,449.37	$300.00	$14,149.37	$1,050.00	$13,099.37	$105.00	$12,049.37	$2,853.78	$2,958.78
16	$15,460.82	$300.00	$15,160.82	$1,050.00	$14,110.82	$105.00	$13,060.82	$3,219.00	$3,324.00
17	$16,543.08	$300.00	$16,243.08	$1,050.00	$15,193.08	$105.00	$14,143.08	$4,655.44	$4,760.44
18	$17,701.09	$300.00	$17,401.09	$1,050.00	$16,351.09	$105.00	$15,301.09	$5,083.90	$5,188.90
19	$18,940.17	$300.00	$18,640.17	$1,050.00	$17,590.17	$105.00	$16,540.17	$5,542.36	$5,647.36
20	$20,265.98	$300.00	$19,965.98	$1,050.00	$18,915.98	$105.00	$17,865.98	$6,032.91	$6,137.91
21	$21,684.60	$300.00	$21,384.60	$1,050.00	$20,334.60	$105.00	$19,284.60	$6,557.80	$6,662.80
22	$23,202.52	$300.00	$22,902.52	$1,050.00	$21,852.52	$105.00	$20,802.52	$7,119.43	$7,224.43
23	$24,826.70	$300.00	$24,526.70	$1,050.00	$23,476.70	$105.00	$22,426.70	$7,720.38	$7,825.38
24	$26,564.57	$300.00	$26,264.57	$1,050.00	$25,214.57	$105.00	$24,164.57	$8,363.39	$8,468.39
Totals	$258,884.16	$4,500.00		$238,634.16	$1,575.00			$67,205.93	$68,780.93

Schedule A: Kiddie Tax Rates

If taxable income is:	The income tax is:
Up to $2,550	10% of taxable income
Over $2,550 but not over $9,150	$255, plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839, plus 35% of the excess over $9,150
Over $12,500	$3,011.50, plus 37% of the excess over $12,500

Schedule B: QDisT Beneficiary Individual Tax Rates

If taxable income is:	The tax is:
Up to $9,525	10% of taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

2018 Capital Gains Tax Rates

Kiddie Tax Rates

If Income is:	Capital Gain Tax Rate
Up to $2,600	0%
$2,601 to $12,700	15%
Over $12,700	20%

DDisT Beneficiary Tax Rates

If Income is:	Capital Gain Tax Rate
Up to $38,600	0%
$38,601 to $425,800	15%
Over $425,800	20%