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Planning for Disabled Beneficiaries Post SECURE: Minimize Income Tax with Qualified Disability Trusts

The SECURE Act ("SECURE") ended beneficial treatment to those who inherit IRAs; however, a Qualified Disability Trust ("QDisT") still offers substantial tax benefits to special needs children.

A QDisT is a non-grantor trust for a beneficiary with a disability. It may be a testamentary trust or an inter-vivos trust. Properly drafted, it not only shelters assets for government entitlement purposes but also provides major income tax benefits to the beneficiary. A QDisT is authorized under I.R.C. § 642(b)(2)(C)(ii), which states:

> [T]he term 'qualified disability trust' means any trust if:
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> (I) such trust is a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. 1396p), and
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> (II) all beneficiaries of the trust as of the close of the taxable year are determined by the Commissioner of Social Security to have been disabled (within the meaning of *Id.* § 1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c(a)(3)) for some part of such year.
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> A trust shall not fail to meet the requirements of subclause (II) merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is so disabled.

A QDisT is purely a tax concept. No election is necessary if the trust beneficiary meets the statutory requirements cited above. That the trust may also be or need not be a Special Needs Trust does not affect the status of the trust as a QDisT. The law's primary purpose is to reduce the income taxes of the special needs community. The SECURE Act defined "disabled" for use in determining an eligible designated beneficiary by cross-referencing sections of the Internal Revenue Code and the Social Security Act. However, these definitions are inconsistent. In February 2022, the IRS released proposed regulations. The regulations addressed many of the comments submitted by NAELA's Tax Steering Committee. The IRS, following NAELA's comments, adopted the Social Security Act definition of disability and accepted Special Needs Trusts as beneficiaries of an IRA without affecting the status of the trust beneficiary.[1]

Tax Benefits of a QDisT

Increased Trust Income Tax Exemptions

The Tax Cuts and Jobs Act of 2017 (the "Act") eliminated the personal exemption for individuals. However, it retained the $100 income tax exemption for a complex trust (a trust that accumulates income), the $300 tax exemption for a simple trust (a trust required to distribute all income every year), and the $600 income tax exemption for an estate. The Act instituted a $4,150 income tax exemption for a QDisT (indexed for inflation). In 2022, the income tax exemption is $4,400. The QDisT can thus retain an amount equal to the annual QDisT exemption tax-free each year. In 2023, the income tax exemption amount is estimated to increase to $4,750.

In 2022, the beneficiary will have only taxable income if the trust's income exceeds $17,500, the total of the $4,400 QDisT income tax exemption, and the $17,500 standard deduction.

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1 2022 IRB LEXIS 260 (2022).

Assume the income tax exemption is kept in the trust and invested with a 6% return. Any income is still not subject to the "Kiddie Tax." When the beneficiary is no longer subject to the Kiddie Tax, a pool of over $109,000 will be available for the beneficiary's needs going forward.

Increased Standard Deduction for Trust Beneficiary

Instead of the personal income tax exemption, the Act increased the individual standard deduction, indexed for inflation. For 2022, the standard deduction is $12,950 for a single filer and $25,900 for a married couple filing jointly. In 2023, the standard deduction increases to $13,850 for a single filer and $27,700 for a married couple.

However, the standard deduction for an individual with unearned income claimed as a dependent remains the same. The standard deduction for a person claimed as a dependent on someone else's tax return in 2022 cannot exceed the greater of $1,150 or $400 plus the individual's earned income up to the standard deduction for unmarried taxpayers. However, the reduced standard deduction for a dependent does not apply to the beneficiary of a QDisT.

Income Distributed from QDisT Is Exempt from the "Kiddie Tax"

Usually, distributing income from a trust to a child is subject to the so-called "Kiddie Tax" under I.R.C. § 1(g). The Kiddie Tax was created by the Tax Reform Act of 1986. The law taxed unearned income of a child who is claimed as a dependent at the parents' marginal rate.

In 2006 Congress enacted a law that attracted little notice, I.R.C. § 1(g)(4)(C),[2] which exempted income from a QDisT from the Kiddie Tax. This section states:

For a beneficiary with special needs — especially minor children — the QDisT is an ideal vehicle as the beneficiary of the IRA. The initial minimum distributions are so low they would have little or no effect on the benefits received by the beneficiary.

> 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.

The definition of unearned income is simple. All income not received as compensation by the individual is unearned income.[3] Unearned income includes (i) interest, dividends, rents, royalties, and gains from the sale of investment property and (ii) social security and pension benefits paid to the child to the extent they constitute gross income to the child. Earned income is essentially wages, salaries, and other amounts received as compensation for personal services.

There is a three-prong test used to determine if the Kiddie Tax is applicable:

1. The child does not turn 18 years before the close of the taxable year;[4] or the child is a student and has not turned 24 years before the close of the taxable year.[5]
2. The child must have at least one parent alive as of the close of the taxable year.[6]
3. The child must not file a joint return for the taxable year.[7] If a child meets these tests, any unearned income of more than $2,300 in 2022 ($2,500 [est.] in 2023) is subject to the Kiddie Tax.

If the income is subject to the Kiddie Tax, the income tax is calculated at the parents' rate, but the child's standard deduction for trust income in 2022 is limited to $1,150 ($1,250 in 2023) if the child is a dependent on another's income tax return.

QDisTs and IRA Accounts

For a beneficiary with special needs — especially minor children — the QDisT is an ideal vehicle as the beneficiary of the IRA. The initial minimum distributions are so low they would have little or no effect on the 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.

> **Example:** A grandparent names a trust for a grandchild with special needs as the beneficiary of his $750,000 IRA. Upon the grandparent's death, the grandchild is 10 years old when RMDs

2 Tax Increase Prevention and Reconciliation Act of 2005 I.R.C. § 510.

3 I.R.C. § 1(g)(4)(A).

4 I.R.C. § 1(g)(2)(A)(i).

5 I.R.C. § 1(g)(2)(A)(ii)(i).

6 I.R.C. § 1(g)(2)(B).

7 I.R.C. § 1(g)(2)(C).

commence. Since the trust is a non-grantor trust, it qualifies as a QDiST. Since the grandchild qualifies as an Eligible Designated Beneficiary, the beneficiary can stretch the payments over the beneficiary's life expectancy. The beneficiary is a student until she is 24 years old. The annual rate of return of the IRA is 7%.

Assume the trustee only withdraws the RMDs, retains the annual trust income tax exemption, and uses the balance of the withdrawn funds to or for the beneficiary's benefit. Assuming the child attends college during the first 14 years she receives required minimum distributions, the total distributions exceed $235,000 but the beneficiary will pay only $3,600 in income tax! And, at the end of the 14-year period, the balance remaining in the IRA will exceed $1.5 million. If the beneficiary were not disabled, she would receive almost $1 million in distributions and pay over $195,000 in income tax.

Drafting Tips

Although enacted almost 18 years ago, the IRS has issued no regulations or guidance on this statute. However, note:

1. If parents establish a trust for a child, they should name an independent trustee due to the complexity of the grantor trust rules. A trust protector can be named to allow a change in trustee if warranted.
2. The trust cannot have multiple beneficiaries. 42 U.S.C.S. § 1396p(c)(2)(B)(iv) (LexisNexis) refers to "…a trust described in subsection (d)(4) established solely for the benefit of an individual under 65 years of age who is disabled (as defined in *Id.* § 1382c(a)(3) of this title). Compare the language "**solely for the benefit of an individual**" with the language of I.R.C. § 642(b)(2)(C)(ii)(II), which begins with "**all of the beneficiaries of the trust.**" *I.R.C. § 1(g)(4)(C) (emphasis added).* The Internal Revenue Code Section appears to conflict with the cross-referenced section of the Social Security Act. The general opinion is that a QDisT can have only a single beneficiary; however, there is scant authority to support this position.
3. A self-settled SNT cannot be a QDisT. I.R.C. § 642(b)(2)(C)(ii) states that any trust referenced in 42 U.S.C. § 1396p(c)(2)(B)(iv) may be a QDisT and that statute references first-party SNTs, 42 U.S.C. § 1396p(d)(4)(A). However, since a self-settled trust is a grantor trust regarding the beneficiary, it cannot be a QDisT. A grantor trust is not a tax-paying entity.

   In a grantor trust, the grantor is the taxpayer for all trust income and reports the income on the grantor's tax return.[8] One must be careful as the code erroneously references all 42 U.S.C. § 1396p(c)(2)(B)(iv) trusts as possible QDisTs.
4. I.R.C. § 642(b)(2)(C)(ii)(II) provides that a beneficiary is disabled as "determined by the Commissioner of Social Security to have been disabled (within the meaning of *I.R.C. § 1614(a)(3)* of the Social Security Act, 42 U.S.C. § 1382c(a)(3)) for some portion of such year." For the most part, a child with no work record will not be eligible for SSDI. In addition, a child with no work record will not be eligible for SSI if his/her parents have income and assets above the poverty level. 42 U.S.C. § 1381 et seq. The QDisT statute cross-references 42 U.S.C. § 1382c(a)(3)(A) subparagraph (C), *Id.* § 1382c(a)(3)(C) of the section which states:

   > (i) An individual under the age of 18 shall be considered disabled for the purposes of this subchapter if that individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.
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   > (ii) Notwithstanding clause (i), no individual under the age of 18 who engages in substantial gainful activity (determined in accordance with regulations prescribed pursuant to subparagraph (E) may be considered disabled.

   What proof, if any, of disability is required when a parent wants to establish a QDisT for a child who will not be eligible for SSI due to the parent's assets and income and who has not worked sufficiently to have an application filed for SSDI? Will the IRS inquire as to the disability or re-

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8 I.R.C. §671.

quire physician affidavits, or may the parent simply presume the disability when establishing the trust? Again, without regulations for guidance, it is an open question. However, it appears a *prima facie* showing of a disability should suffice.

Conclusion

As a result of eliminating many deductions and exemptions, the SECURE Act increases the importance of the QDisT as a planning tool. Most third-party special needs are grantor trusts — the grantor, usually a parent or other relative, is taxed on income generated by the trust. In light of the SECURE Act, any new third-party trust should probably not be a grantor trust so it can qualify as a QDisT. Elder law and special needs planning practitioners must re-examine all existing third-party grantor trusts and determine the benefit of terminating the grantor trust status to take advantage of the substantial income tax savings under SECURE. ■