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CERTIFIED PUBLIC ACCOUNTANTS | TAX & ADVISORY SERVICES

SUPPLEMENTAL NEEDS TRUSTS UNDER THE TAX CUTS AND JOBS ACT OF 2017

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I. THE KIDDIE TAX

INTRODUCTION:

Distributions to a beneficiary of a Supplemental Needs Trust ("SNT") are generally "unearned" income and may be subject to the Kiddie Tax (IRC §1(g)), unless the SNT is a Qualified Disability Trust where the distributions are treated as "earned income" (IRC §1(g)(4)(C)). Under the Tax Cuts and Jobs Act of 2017 (the "Act"), income subject to the Kiddie Tax is taxed using the compressed tax tables for Estates and Trusts, rather than, as under previous tax law, the potentially lower marginal tax rates of the child's parents.

WHEN IS INCOME SUBJECT TO THE KIDDIE TAX?

Unearned income of a child greater than $2,100 is subject to the Kiddie Tax if such child:

- Is under age 18, or under age 24 if the child is a full-time student and his or her earned income is less than one-half of his or her support;
- At least one of the child's parents is alive at the close of the tax year; and
- The child does not file a joint return for the tax year.

HOW IS THE KIDDIE TAX CALCULATED?

- If such a child can be claimed as a dependent, he or she is entitled to a standard deduction of only $1,050 (assuming that he or she has no "earned income".)
- If the child's taxable income is above the $1,050 standard deduction, the next $1,050 is taxed at the child's tax rate of 10% and the balance of the taxable income is taxed using the tax tables for Estates and Trusts, which reaches the highest tax bracket of 37% at taxable income above $12,500.

PLANNING IDEAS:

- QUALIFIED DISABILITY TRUSTS:
  - If a Supplemental Needs Trust qualifies as a Qualified Disability Trust (QDisT), the income from the Trust is not subject to the Kiddie Tax (see complete explanation under Section II, below). A QDisT, among other requirements, cannot be a grantor trust. Therefore, if possible, turn off the grantor trust status of Third Party Supplemental Needs Trusts so the trust can qualify as a QDisT. (As an alternative, the Trust possibly could be decanted.)

  - Draft new Third Party Supplemental Needs Trusts to include flexibility to turn grantor trust status on and off to take advantage of the trust qualifying as a QDisT.

- PARENT'S ELECTION TO INCLUDE CHILD'S INCOME ON PARENT'S RETURN (IRC §1(g)(7)):
  - Determine if it is beneficial for the child's parent(s) to make this election to include certain unearned income of the child on the parent's income tax return. Generally, to be able to make this election the following conditions must be met:
    - The child is under age 18 or under age 24 and a full-time student;
    - The child's income is only from interest, dividends, and capital gains;
    - The child's gross income is greater than $1,050 and less than $10,500;
    - No estimated tax payments were made, and no overpayments were applied from the previous year;
    - No federal income tax was withheld under backup withholding;
    - The child is required to file a return unless the parent makes the election; and
    - The child does not file a joint return.

II. QUALIFIED DISABILITY TRUSTS

INTRODUCTION:

A Qualified Disability Trust ("QDisT") under IRC § 642(b)(2)(C)(ii) is any trust as described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act, including Third Party Supplemental Needs Trusts and possibly Medicaid Payback Trusts, that are not grantor trusts (since IRC §1(g)(4)(C) refers only to distributions from non-grantor trusts (see IRC §§652 & 662)). Under the Tax Cuts and Jobs Act of 2017 (the "Act"), a QDisT and the Trust's beneficiary receive enhanced income tax benefits.

ENHANCED INCOME TAX BENEFITS UNDER THE ACT THROUGH TAX YEAR 2025:

- The QDisT receives an increased exemption of $4,150 (adjusted for inflation) (IRC § 642(b)(2)(C)(iii)) as compared to the $100 exemption for a complex trust or $300 exemption for a simple trust.
- QDisT income distributed to a beneficiary is treated as earned income (IRC §1(g)(4)(C)), and therefore, not subject to the Kiddie Tax. Under the Act, income subject to the Kiddie Tax is taxed using the compressed tax tables for Estates and Trusts (IRC §1(j)(4)(B)). However, income distributed to or for the benefit of a beneficiary of a QDisT is taxed using the tax tables for individuals.
- Since income distributed by the QDisT is treated as earned income, the beneficiary of a QDisT is entitled to a deduction up to the standard deduction amount for a single taxpayer ($12,000), even if he or she is claimed as a dependent (IRC §63(c)(5)&(7)).

QDisT REQUIREMENTS:

A QDisT is a tax concept and there is no special election necessary for a trust to be a QDisT as long as the following requirements are met:

- The Trust has one beneficiary;
- under age 65;
- who is disabled (as defined in section 1614(a)(3) of the Social Security Act);
- and the Trust is not a grantor trust for income tax purposes.

PLANNING IDEAS TO TAKE ADVANTAGE OF THE ENHANCED INCOME TAX BENEFITS FOR QDisTs UNDER THE ACT:

- Review existing Third Party Supplemental Needs Trust agreements. Often, these Trusts are established as grantor trusts for income tax purposes, but the agreements may have provisions to turn off the grantor trust status, thus qualifying as a QDisT. (As an alternative, the Trust possibly could be decanted.)
- New Third Party Supplemental Needs Trusts should be drafted to include flexibility to turn grantor trust status on and off to obtain the benefit of qualifying as a QDisT.
- Reminder, distributions to or for the benefit of the beneficiary must be made within sixty-five (65) days of the close of the tax year to take advantage of the lower individual tax brackets.

III. CONCLUSIONS:

THIRD PARTY TRUSTS

(A) QUALIFYING AS A QDisT:

In most cases it will be advantageous for the trust to be a QDisT (which must be a non-grantor trust) since the income will be treated as ordinary income and taxed at the tax rates for Individuals after an exemption of $4,150 (at the trust level) and will qualify for the standard deduction of up to $12,000 (for the child).

(B) GRANTOR TRUST STATUS:

In certain circumstances where there would be some tax under the QDisT regime, it could be advantageous to retain or obtain grantor trust status and have the income taxed to the grantor. (Tax projections should be made comparing the results as a grantor trust with the results under the QDisT regime.)

FIRST PARTY TRUSTS (WHICH ARE TREATED AS GRANTOR TRUSTS UNDER IRC §677)

(A) GROSS INCOME ABOVE $10,500 AND SUBJECT TO THE KIDDIE TAX:

If a child's gross income (from the trust or otherwise) is above $10,500 and is subject to the Kidde Tax rules, the income will be taxed at the rates for Estates and Trusts (which reach 37% on taxable income over $12,500).

(B) GROSS INCOME BELOW $10,500 AND SUBJECT TO THE KIDDIE TAX:

If the child's gross income is below $10,500 and is subject to the Kidde Tax rules, consideration should be given to the parent(s) making an election under IRC §1(g)(7) to include the income on the parent's return. (This would require a comparison of the income being taxed at Estates and Trusts rates versus being taxed at the parent's incremental tax rates.)

(C) GROSS INCOME AT ANY LEVEL BUT NOT SUBJECT TO KIDDIE TAX:

For gross income at any level which is not subject to the Kiddie Tax rules (e.g. 18 years of age or older and not a full-time student), the taxable income will be taxed to the child at the rates for Individuals (and not at the rates for Estates and Trusts.)

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