The Kiddie Tax and a Big Exception

By Bob Mason

Recently someone asked me how the Kiddie Tax applies to trust distributions. We were discussing third party special needs trusts that were being taxed as nongrantor trusts.

Of course, it depends.

Kiddie Tax Background

The so-called “Kiddie Tax” taxes the unearned income of a minor (and certain other dependents) at the parents’ highest marginal tax rate. As we’ll see, there is a huge exception in the context of most of our practices.

Under the Kiddie Tax, minors (and other young adult dependents - notably college students under 24 relying on Mommy and Daddy’s largesse) are taxed at the parents’ highest marginal tax rate on UNEARNED income over $2,100. IRC § 1(g)(1). If the child is over 19 and under 24 and is earning more than half of what his or her support needs are, the Kiddie Tax will not apply (alas, my college freshman son is not thus exempted).

The first $1,050 of the child’s unearned income is not taxed. The next $1,050 is taxed at the child’s tax rate. The parents’ highest marginal tax rate kicks in over $2,100.

Example: Don Draper set up an investment account for the benefit of his daughter Sally Draper at a Madison Avenue advisory firm (Jonathan Blattmachr’s firm Pioneer Wealth Partners . . . it IS on Madison Avenue . . . REALLY . . . not making that up). Dur-ing the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up). During the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up). During the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up). During the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up). During the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up). During the year the investment account pays Sally $5,000 in interest and dividends. She has earned income making that up).

The next $1,050 unearned income is taxed at Sally’s rate, as is her $2,900 excess unearned income is taxed to Sally at Don’s marginal rate of 39.6% (given his seven figure payout from Sterling/Cooper Advertising). Alternatively, Don could report Sally’s unearned in-come subject to the Kiddie Tax on his return.

Distributions of income from nongrantor trusts to a beneficiary generally retain their character in the hands of the beneficiary. Under the distributable net income (DNI) rules of IRC § 634, the beneficiary will report these distributions on her tax return. If the beneficiary is a minor (or other young person covered by the Kiddie Tax) distributions of unearned income that are carried out of the trust by DNI are subject to the Kiddie Tax rules.

Big Exception For Qualified Disability Trusts

Distributions from a “Qualified Disability Trust” (QDT) are not considered unearned income subject to the Kiddie Tax rules. IRC § 642(b)(2)(C).

A Qualified Disability 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(c)(2)(B)(iv)] . . . and all of the beneficiaries of the trust as of the close of the taxable year are determined by the Commissioner of Social Security to have been disabled . . . for some portion of the year.” IRC § 642(b)(2)(C)(ii).

A “(B)(iv)” trust refers to a trust “solely for the benefit of” a disabled individual under age 65. This raises a number of interesting issues:

My narrow reading of the statute is that 42 USC § 1396p(c)(2) (B)(iv) describes just two types of trusts: D4A Trusts and Sole Benefit Trusts. Such trusts have a number of requirements, chief among them being “solely for the benefit of” a single individual. Nevertheless, the tax statute refers to “all of the beneficiaries.” Strange, no?

A number of commentators (and, in practice, apparently the IRS) take a broader view that as long as “all” of the beneficiaries have been determined to be disabled, the exemption is available to any third party trust that benefits solely disabled beneficiaries during the applicable tax year.

The QDT may have non-disabled remainder beneficiaries. IRC § 642(b)(2)(C)(ii) last sentence).

A QDT may not be a grantor trust. Essentially a grantor trust is treated as the alter ego for income tax purposes of the grantor who funded the trust. Without getting too deep into technicalities, I take the position that a special needs trust under IRC § 1396p(d)(4)(A) (a “D4A Trust”) that has been funded by the beneficiary is always a grantor trust. If my narrow reading of IRC § 642 is correct, QDT treatment would be available to “sole benefit trusts” only, which gives credence to the more liberal interpretation of the statute because it seems improbable that Congress would wish to tailor such an incredibly narrow benefit for disabled individuals.

Incidentally, QDTs are entitled to the much larger personal exemption available to an individual ($4,050) as opposed to the $100 or $300 exemption usual available to trusts. IRC § 642(b)(2)(C). In fact, that seems to be the thrust of the QDT statute.

But the juiciest item for the special needs law attorney is that if a third party special needs trusts is, in fact, considered a QDT distributions to the beneficiary are not deemed unearned income. Accordingly, the distributions are taxed at the beneficiary’s rates and not subject to the Kiddie Tax.

Example: Back to Don Draper and Sally’s investment account. Because Sally has developed some sort of severe disability Don sets up the investment account under a third party special needs trust and names his partner Roger Sterling as trustee. ALL distributions subject to taxation will be taxed at Sally’s (no doubt) very low tax rate. That’s because the otherwise unearned income will be treated as “earned income” for purposes of the Kiddie Tax rules.

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