Qualified Disability Trusts

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Since the tax year 2002, trustees of certain trusts for disabled individuals (Qualified Disability Trusts) have been able to claim on the trust's income tax return the same personal exemption that an individual may claim on his/her individual tax return.[1] For tax year 2007 that exemption is $3,400. If a trust does not qualify for this exemption the trust is limited to a $100 or $300 exemption. This Qualified Disability Trust exemption was enacted as part of the Victims of Terrorism Tax Relief Act of 2001[2].

QUALIFIED DISABILITY TRUST: THE REQUIREMENTS

In order to be a "qualified disability trust" for this special exemption, the trust must meet the two criteria set forth in the statute:

1. The trust must be a disability trust is described in 42 U.S.C. §1396p(c)(2)(B)(iv); and.

2. All of the beneficiaries of the trust, as of the end of the taxable year, are determined by the Commissioner of Social Security to have been disabled (as defined by the Social Security Act) for some portion of the tax year.[3]

To be a "qualified disability trust" a trust must be:

1. Irrevocable;

2. Established for the sole benefit of the disabled beneficiary;

3. Who is under the age of 65; and

4. Who is disabled in accordance with the terms of the Social Security Act.

In order to meet the "for the sole benefit of" requirement no person or entity can benefit from the trust during the lifetime of the disabled beneficiary other than that beneficiary.

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[1] IRC 242(b)(2)(C) or 26 U.S.C. § 642(b)(2)(C)

[2] Public Law 107-134, enacted January 23, 2002

[3] The fact that the trust may revert to a nondisabled person when the trust ceases to have a disabled beneficiary does not cause it to fail this criterion.

In order for a beneficiary of the trust to considered "disabled", the beneficiary must have been determined to be so by the Commissioner of Social Security Administration. Unless the beneficiary is actually receiving SSI, SSDI, or in some cases Medicare, it may be impossible for the trust to meet the statutory requirements.

If a trust is taxed as a grantor trust, it cannot take advantage of this exemption. [4] Self-settled Special Needs Trusts are generally, but not always, taxed as grantor trusts.[5] Thus, a Qualified Disability Trust is most often a third party trust.[6]

QUALIFIED DISABILITY TRUST: THE BENEFIT

Unless a trust qualifies as a Grantor Trust[7], it must file an income tax return when it has:

- gross income of $600 or more;
- any taxable income; or
- has a beneficiary who is a non-resident alien.[8]

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[4]Income earned by a Grantor Trust is taxed to the Grantor. The Grantor him/herself may take whatever personal exemptions are available to the Grantor.

[5]See http://www.canhr.org/publications/newsletters/NetNews/Feature%20Article/NN_wilcox_200303.htm for a discussion of the tax status of trusts created under 42 U.S.C. §1396p(c)(2)(B)(iv).

[6]The drafters of the Victims of Terrorism Relief Act of 2001 may have unwittingly limited the use of the Qualified Disability Trust exemption by adopting the definition of a disability trust found in 42 U.S.C. 1396p(d)(2)(B)(iv). That statute refers to trusts created *by disabled persons themselves* and describes the situations under which transfers of assets to that type of trust will not lead to a disqualifying transfer for Medicaid purposes. If read strictly, therefore, a QDT exemption is only available to self settled and not third party trusts.

[7] See IRC §§671-678.

[8] See Instructions for Form 1041 and Schedules A, B, D, G, I, J, and K (2007), pg 4.

Unless a trust qualifies for the special Qualified Disability Trust exemption, the largest personal exemption for which it can qualify is a $300 personal exemption. This exemption is available if the trust is a simple trust (one that is required to or actually distributes out all of its income). A trust is otherwise taxed as a complex trust and allowed a personal exemption of only $100.

If a trust qualifies as a Qualified Disability Trust it is allowed to claim a personal exemption and, thus, the net income retained by the trust up to the amount of the personal exemption is not taxed. A trust may have other deductions as well, such as for trustee fees. The trust pays tax on any retained income in excess of the personal exemption amount and deductions. However, as the beneficiary also has the right to claim a personal exemption on his or her individual income tax return, the trustee can distribute to the beneficiary an amount of income equal to the personal exemption and that distribution will be free of tax as well.

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