July 11, 2013

Protecting Those Who Need it Most: A Call for Change to the Tax Application of Qualified Domestic Relations Orders When Placed Into Special Needs Trusts

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ABSTRACT

This note calls for a change to the way the Internal Revenue Code is applied towards qualified domestic relations orders when used to fund or partially fund special needs trusts, specifically irrevocable (d)(4)(B) trusts created under § 1396p.

The current status of the law is that an individual can roll over a qualified domestic relations order into a new retirement account in a tax-free transfer. If an individual elects to not roll over into a new retirement fund, some additional exemptions to various early termination penalties and lump sum payments have already been carved out of the Code.

This note argues that a special needs trust is substantially similar to a retirement account due to the fact that an individual is able to draw income from each, be taxed on that income from each, and is not able to access the balance of either without paying substantial penalties.

In addition, the Internal Revenue Code has carved out various exemptions that allow individuals to make tax-free purchases of health care. Employer provided plans, flexible spending accounts and health savings accounts all allow individuals to transfer earnings tax-free into dedicated accounts that limit the funds to use on future health related costs.

This note also argues that special needs trusts are substantially similar to flexible spending accounts and health savings accounts in that both restrict the access of an individual to the balance, and both must be used to pay for healthcare costs.

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J.D. Candidate, December 2013 UMass School of Law. I would also like to thank my wife Tanya, her patience and understanding allows me to focus on school and also allows me the strength to succeed. I would also like to thank my son, Quinn, for giving me the reason to succeed.
I. INTRODUCTION

A client who is under fifty-nine and a half comes to see you, she has been diagnosed as bi-polar and schizophrenic and is facing a divorce from her husband of thirty years. Her husband has a large retirement account, and as part of the divorce decree she has obtained a qualified domestic relations order ("QDRO"), allowing her a percentage of the funds currently held in his retirement account.\(^1\) Is she able to transfer the money tax-free? She will probably be taxed on the amount she receives.\(^2\) That seems fair. Transferring the QDRO naked here should be treated no differently than if the individual who built the retirement fund through earned income decided to cash out the fund and move to Hawaii.\(^3\) However, certain exceptions have already been carved out in the Internal Revenue Code. The Code plainly states that those who receive QDROs will not be subject to the extra ten percent tax that is levied against those who cash in their

\(^{1}\) I.R.C. § 414(p) (2012).
retirement plans early. But what if she rolls the QRDO into another retirement fund? If our divorcee was not a disabled individual, the easiest avenue to avoid large taxes on the QDRO would be for her to transfer the QDRO into her own retirement account, or open a new account with these funds. Such a transfer would be exempt from various taxes or penalties.

But what if she wants to take the funds and place them into an irrevocable special needs trust? An individual with a disability can use special need trusts as mechanism to ensure that assets within the trust are not considered countable assets for purposes of qualifying for certain government benefits, such as Medicaid. The effect of these trusts is that individuals voluntarily impoverish themselves, but, because they opt to restrict their access to their own assets, they remain below the levels required by states to obtain Medicaid. Special needs trusts are specific trusts created under § 1396p of the United States Code for individuals with disabilities. These trusts have various rules about the assets placed in them, the administration of the trusts, the use of the trusts, and ultimately the settlement of the trusts. In that case, a transfer that does not first go into a retirement account, the QDRO would be treated as income, and subject to federal taxes. This would lead to a situation where an individual is subject to income taxes twice, first on the

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4 Subsection (t) is titled “10-percent additional tax on early distributions from qualified retirement plans” and goes on to limit the application of this additional tax to “[a]ny distribution to an alternate-payee pursuant to a qualified domestic relations order.” I.R.C. § 72(t)(2)(C).
7 See generally Miller, supra note 6.
9 Id.
10 Blaylock, supra note 2, at 9–12.
transfer of the QDRO into the trust, and then again when the individual draws income from that trust.11

This note argues that irrevocable special needs trusts are substantially similar to other spending elections that allow the transfer of a QDRO to be made tax-free. When receiving a QDRO in a divorce, a spouse—who then becomes the alternate-payee—who elects to place that amount into a special needs trust that is created for her own benefit, should be allowed to do so without incurring taxes that the Internal Revenue Service (“IRS”) can levy on such transfers. This note is a call to actively look at the policy behind the special needs trusts that are commonly referred to as (d)(4)(B) trusts,12 and argue that the trusts are substantially similar to retirement accounts that are defined under other sections of the U.S. Code (specifically “ERISA”),13 and are substantially similar to flexible spending accounts and Health Savings Accounts (“HSA”).14

Retirement funds under ELSIA and (d)(4)(B) trusts restrict an individual’s access to the balance (or “corpus”) of the fund, allow an individual to draw an income from that balance, and then tax an individual based on that income.15 Flexible spending accounts, HSAs, and (d)(4)(B) special needs trusts all require that the corpus of the fund be used to pay for healthcare.16

Because special needs trusts are substantially similar to these spending elections, the same tax benefits should be extended to an individual who elects to place earned

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11 See discussion infra Part IV.
14 I.R.C. § 125(a), (i) (2012) (defining flexible spending accounts); I.R.C. § 223(a) (2012) (defining health savings accounts (HSA)).
income into a special needs trust as are extended to individuals who elect to fund qualifying retirement or healthcare accounts. In doing so, the legislative intent behind the creation and use of these trusts can be fully realized.

First, this note will describe QDROs, what they are, how they work, and how they are taxed. From there, the note will discuss the various (d)(4) trusts, specifically focusing on the history and unique role of the (d)(4)(B) trusts. The note will also address the tax treatment of healthcare spending, specifically income-related issues, and finally the tax treatment of retirement plans in general.

In Part IV, this note argues that QDROs, when used to fund special needs trusts, should be viewed by the IRS in the same manner as individual retirement spending. When an alternate-payee elects to place a QDRO into a new or different retirement account, the transfer is done without being subject to various taxes. Because special needs trusts are substantially similar to retirement accounts, and a transfer of a QDRO into a retirement account can be made without a tax, special needs trusts should be afforded the same tax exemption upon the transfer as retirement accounts.

In Part V, this note argues that when placing a QDRO into a special needs trust, the transfer should be treated the same as other instances where an individual is allowed tax-free spending in respect to healthcare. When an individual elects to place their earned income from an employer into a flexible spending account or an HSA, they are allowed to do so without incurring income taxes, and the funds in those accounts must be used to pay for healthcare. An individual who utilizes a special needs trust must adhere to the statutory rules governing their construction which requires that when the trust ends

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17 SNYDER, supra note 5, § 5:13.
(through death or otherwise), the state gets “first crack” at the funds in the trust through the pay-back provision in order to pay for the care given to the individual through Medicaid.\textsuperscript{19} Because special needs trusts are substantially similar to Flexible Spending Plans and HSAs, the same tax-free spending rules should apply.

Doing so would simplify the treatment of these tools for attorneys, accountants, and taxpayers, while helping to preserve the intention behind Congress in creating these trusts. The \textit{Miller} case from Colorado in 1990\textsuperscript{20} helped usher in a new breed of trusts.\textsuperscript{21} These trusts have become common forms of Medicaid planning for individuals with disabilities when the trusts recognized in \textit{Miller} were codified in the 1993 Omnibus Reconciliation Act.\textsuperscript{22} The next step in applying this legislation to trusts is to insure that the legislative intent behind the trusts created in the 1993 statute is realized, and individuals are able to take full advantage of the care extended to them through Medicaid. At the very least, Congress should act to simplify the tax code in relation to the interaction between QDROs and special needs trusts.

\textbf{II. \textsc{What is a QDRO? Definition, Uses, and Taxing}}

This section will point to the specific statutes that control the inception and regulation of QDROs. The rules regarding the creation and treatment of QDROs have been somewhat relaxed. However, a discussion of the evolving nature of QDROs is

beyond the scope of this note. The final part of this section will deal with the tax implications of a properly drafted QDRO that fall upon the designated alternate-payee

A QDRO is a statutorily defined “judgment, decree, or order” that “assigns... an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan.” Simply put, if there is a divorce, a QDRO is a vehicle by which one spouse can obtain, at the very least, a percentage of a retirement plan held by the other spouse. In order for a QDRO to be valid, the order must meet additional requirements under § 1056(d)(3).

Retirement accounts, which are the source of the funds one is awarded through a QDRO, are made up of tax-free spending by an individual. The retirement accounts that an individual builds through ERISA are employer-sponsored programs that allow individuals to plan for their future, and build those accounts tax-free. Individuals can place the earned income into these accounts prior to taxes, and the retirement accounts themselves are not taxed until an individual begins to draw income from the account after the age of sixty-five. When an individual begins to draw an income from the retirement

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23 A brief discussion of QDROs is all that is within the scope of this note. For a more detailed and extensive look at the history, application, proper drafting, and how QDROs are a currently evolving tool for family law lawyers, see Terrence Cain, A Primer on the History and Proper Drafting of Qualified Domestic Relations Orders, 28 T.M. COOLEY L. REV. 417 (2011).
26 For a general understanding of other applications of QDROs, see Carla M. Oliveira, The Many Applications of Qualified Domestic Relations Orders, 32 FAM. L. Q. 641 (1998–1999).
27 A QDRO must contain the name and last mailing address of the “participant” and any “alternate payees”; amount or percentage of the fund being transferred, or the manner which that amount will be calculated; the number of “payments or period to which such order applies”; and must identify the plan affected. 29 U.S.C. § 1056(d)(3)(C) (2012). Additionally, the identified plan can only distribute property related to the plan; does not “provide increased benefits”; and does not release money previously earmarked “previously determined to be a qualified domestic relations order.” 29 U.S.C. § 1056(d)(3)(D) (2012).
28 SNYDER, supra note 5, § 6:5
29 Id.
account, the tax basis is not the entire account, but the actual amount an individual draws as income.\(^{32}\)

Because of the source of funds that make up a QDRO, the alternate-payee that receives a QDRO is subject to special tax considerations.\(^{33}\) Other than the specific statutes that exempt the recipient from the ten percent early distribution penalty,\(^{34}\) and the provision that allows tax-exempt roll overs of a QDRO into a new retirement account,\(^{35}\) a person receiving a QDRO is subject to taxes based on the status of the identified retirement account being attached.\(^{36}\) Annuity tax rates, lump sum penalties, and excess distribution taxes can all be waiting for the alternate-payee if he or she elects to simply cash-out the QDRO.\(^{37}\)

This note argues that a special needs trust itself is substantially similar to other retirement accounts because of the unique nature of the trust. Retirement accounts and special needs trusts both allow an individual to draw an income from a personally grown fund while restricting an individual’s access to the balance of the fund. An individual transferring the funds from a QDRO to a new retirement account would not be subject to taxes.\(^{38}\)

A special needs trust is also substantially similar to healthcare spending, and the type of income contained in a QDRO can be used by an individual to purchase various healthcare plans (specifically flexible spending accounts and HSAs) in a tax-free

\(^{32}\) Id.

\(^{33}\) SNYDER, supra note 5, § 2:13.

\(^{34}\) I.R.C. § 72(t)(2)(C) (2012).

\(^{35}\) Id. § 408(d)(6) (2012); SNYDER, supra note 5, § 5:13.


\(^{37}\) Blaylock, supra note 2, 9–12.

\(^{38}\) SNYDER, supra note 5, § 5:13.
spending election.\textsuperscript{39} This note argues that in addition to the similarities between special needs trusts and retirement accounts, the trusts are also similar to healthcare spending, that when an individual elects to “cash out” the QDRO, the resulting election to place the income into a special needs trusts should carry the same tax status as if an individual chose to place earned income into healthcare related spending accounts.\textsuperscript{40}

\textbf{III. What is a Special Needs Trust?}

A brief overview of the history, uses, and legislative intent behind the passage of § 1396p(d), which created special needs trusts, is necessary for the scope of this note. This section will address those issues, as well as define and share some guidelines of the Medicaid program that special needs trusts are geared towards.

\textbf{A. Definition, History and Uses}

Special needs trusts are defined under § 1396p of the United States Code. Section 1396p is a broad statute that defines the process by which states can place various liens on an individual’s assets in order to repay costs associated with Medicaid spending and how states can count the assets of an individual in determining eligibility.\textsuperscript{41} One of the methods to ensure that an individual’s assets are not fully counted against them when determining Medicaid eligibility is to place the assets into a special needs trust.\textsuperscript{42} In order to qualify as a special needs trust, an individual must be disabled, the trust must fit into a specific category, and may be either revocable or irrevocable.\textsuperscript{43}

\textsuperscript{39} I.R.C. § 125(a), (i) (2012) (flexible spending account); I.R.C. § 223(a) (2012) (HSA).
\textsuperscript{40} \textit{Id}.
\textsuperscript{41} \textit{See generally} 42 U.S.C. § 1396p (2012).
\textsuperscript{42} \textit{Id.} §1396p(d)(4).
\textsuperscript{43} \textit{Id.} § 1396p(d)(3)(A), (C).
In this note, the trust addressed is an irrevocable trust because of the different
ways states can assess the “corpus” of the trusts.\textsuperscript{44} The “corpus” of the trust is defined as
either “[t]he property for which a trustee is responsible”\textsuperscript{45} or the actual principal that
makes up a trust.\textsuperscript{46} In the case of a revocable trust, the “corpus” is considered to be an
available financial resource of the individual.\textsuperscript{47} However, in the case of an irrevocable
trust, the statute outlines that the individual’s counted assets are only the funds that are in
the trust and available to be drawn upon for income.\textsuperscript{48} Further, if the individual places the
funds in the trust, and is not able to derive income from that resource, the asset will not
be counted, as those assets are now “disposed by the individual.”\textsuperscript{49} The counting of these
assets is necessary to determine Medicaid eligibility.\textsuperscript{50} Because the tax calculations of an
irrevocable special needs trust do not occur until an individual draws income from the
trust,\textsuperscript{51} placing a QDRO into the trust and keeping the funds separate from other accounts
in the trust ensures that the funds are only used to pay for medical costs when the trust
ends through the “pay-back” provisions.

Since Medicaid eligibility is dependent on the need of an individual, placing the
money in an irrevocable trust shields much of the actual assets of an individual from
calculations necessary to determine the individual’s eligibility, and lowers the income
earned by an individual to levels consistent with Medicaid requirements.\textsuperscript{52}

\textsuperscript{44} \textit{Compare} 42 U.S.C. § 1396p(d)(3)(A) (requires revocable trusts count the corpus as “resources available
to the individual”) \textit{with} 42 U.S.C § 1396p(d)(3)(B) (requires that only the portion of the corpus from which payments “to or for the benefit of the individual” are made “shall be considered income”).

\textsuperscript{45} \textit{Id.}

\textsuperscript{46} \textit{Id.}


\textsuperscript{48} \textit{Id.} § 1396p(d)(3)(B)(i).

\textsuperscript{49} \textit{Id.} § 1396p(d)(3)(B)(ii).

\textsuperscript{50} \textit{Id.} § 1396p(d)(1).

\textsuperscript{51} \textit{Id.} § 1396p(d)(3)(B)(i).

\textsuperscript{52} \textit{Id.} § 1396p(d)(3)(B).
Three different types of irrevocable special needs trusts are allowed under § 1396p(d)(4). The trusts are very similar; the only difference between them is the way the trust itself is created. All three trusts require a “pay-back” provision, and the individual be defined as “disabled” under § 1382c(a)(3). Pay-back provisions require that “the State . . . receive all amounts remaining in the trust upon the death of [the] individual up to an amount equal to the total medical assistance paid on behalf of the individual.”

First, (d)(4)(a) requires that a trust that contain the assets of an individual who is under sixty-five; is created by a parent, grandparent, legal guardian or a court; and contains a pay-back provision. Second, (d)(4)(B) trusts can contain only the “pension, Social Security, and other income to the individual”; a payback provision; and “the State makes medical assistance available to individuals described in § 1396a(a)(10)(A)(ii)(V) of this title, but does not make such assistance available to individuals for nursing facility services under § 1396a(a)(10)(C) of this title.” The third type of trust deals with trusts maintained by non-profit organizations for people who qualify.

This note argues that because (d)(4)(B) trusts can be made up of an individual’s assets, and the QDRO is an asset of an individual, the election to place the QDRO into a special needs trust should be tax free. The construction of a special needs trust is similar to a retirement account, in that both allow an individual to draw an income while

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53 Id. § 1396p(d)(4).
54 See Id. § 1382c(a)(3)(A), (B), (D), (F), (G), (J) (2012) (various examples and definitions of disabilities for which special needs trusts can be created).
55 Id. § 1396p(d)(4) (2012).
56 Id. § 1396p(d)(4)(A).
57 Id. § 1396p(d)(4)(B)(i).
58 Id. § 1396p(d)(4)(B)(ii).
59 Id. § 1396p(d)(4)(B)(ii).
60 Id. § 1396p(d)(4)(C).
restricting the individual’s access to the balance of the account. Because the transfer of a QDRO into a new retirement account would be tax-free, the election to place the funds into a special needs trust should be offered the same exemption.

In addition, irrevocable special needs trusts greatly limit the access of an individual to the funds that are contained within the trust itself. Because individuals do not have direct access to these funds, and these funds are specifically earmarked for future healthcare spending, the tax applications of placing a QDRO into a special needs trust should be revisited because the special needs trust is substantially similar to flexible spending accounts and HSAs. The funds that make up a QDRO could be used by an individual as a tax-free election in order to establish or fund these accounts, and as such, the election to place the funds into a special needs trust should be allowed as a tax-free transfer.

B. Miller Trusts

The scope of this note will be to focus on the (d)(4)(B) trusts. The history behind this particular subsection is the Miller v. Ibarra case from Colorado in 1990. This case dealt with elderly individuals who clearly fell into the current statutory definition of disabled individuals who would be eligible for a special needs trust. However, the

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61 SNYDER, supra note 5, § 5:13.
62 Id. at § 6:5.
Medicaid Qualifying Trusts of the time did not allow individuals to protect income, and the individuals in the suit were denied Medicaid because of this income.

In *Miller*, the individuals wanted to continue to collect their Social Security payments, place that money into a trust, and remain eligible for Medicaid. The court addressed the treatment of income being added to trusts, holding that the determination of “annual income, for purposes of determining Medicaid eligibility in accordance with the SSI program, is the maximum amount the trustees of that plaintiff’s trust can distribute.” Prior to this decision, the Medicaid Qualifying Trusts were the method that individuals used in order to protect some assets from Medicaid computations dealing with an individual’s eligibility. With this court decision, and the ensuing legislation, non-discretionary trusts and trusts created by a court were recognized as an avenue for an individual to protect a variety of assets from Medicaid calculations. Before *Miller*, individuals could not protect income they were generating from counting against their Medicaid eligibility by placing those funds into a trust. In the case of our divorcee here, the QDRO she has obtained in the divorce decree is additional income that she can place into a special needs trust.

In order to determine how to treat transfers below fair market value, the court determined that “Congress’ concern in enacting the federal limitations on transfers of assets was to prevent the wealthy from disposing of assets in order to become eligible for

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65 Miller, 746 F. Supp. at 28.
67 See generally *Id.*
68 *Id.* at 27.
69 Wiesner *supra* note 63, at 702–703.
70 *Id.* at 703.
71 *Id.* at 723–724.
Medicaid benefits to which they would otherwise not be entitled”,72 and “Congress intended to forbid the creation of Medicaid qualifying trusts to meet income eligibility requirements.”73

The court based these findings on the recognition that the trusts were not created voluntarily.74 Specifically, the creation of the trust was “neither a voluntary transfer on the part of the plaintiff/beneficiary nor a transfer that can be imputed to that plaintiff.”75 Finally, the court decided that the transfers of the funds into a trust were not barred by § 1396p(c), that the corpus of the trusts should not be considered a resource, and only the income allowed by the trust document should enter into the Medicaid calculation.76 Here, the court recognized that an individual could continue to generate income, elect to place that income into a special needs trust, and that income would not enter into the calculations to determine need under Medicaid.77 These trusts have come to be known as “Miller Trusts”, and are expressly created under § 1396p(d)(4)(B).78

C. Medicaid

In this note, a short discussion of the Medicaid program is necessary to identify the various roles and players on the state and federal level. Medicaid is a broad program with players, rules, and regulations at both the federal and state level.79 Though the 1965 Social Security Amendments created Medicaid,80 the sections important to this note were

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72 Miller, 746 F. Supp. at 28.
73 Id. at 33.
74 Id. at 30.
75 Id. at 31.
76 Id. at 31–33.
77 Id.
78 See generally: Wiesner, supra note 63, at 721–734; and Miller, supra note 6, at 93–94.
79 For a comprehensive look at the last 40 years of Medicaid and the intent behind the program, see generally Sara Rosenbaum, Medicaid at Forty: Revisiting Structure and Meaning in a Post-Deficit Reduction Act Era, 9 J. HEALTHCARE L. & POL’Y 5 (2006).
80 Id at 8–9.
created under the Omnibus Reconciliation Act of 1993. Medicaid is a federally funded health plan that is administered by the states. States can opt-in to Medicaid, and the states must meet various federal guidelines in order to be fully compliant. Special needs trusts were created as a method to protect assets of individuals when facing end of life and disability related care, allow an individual to become eligible for Medicaid, and continue to earn income.

The 1993 act allowed states to bring claims against the estates of Medicaid participants who employ (d)(4)(B) trusts. This allows the state to ultimately recover costs associated with the care of those individuals. The statute created guidelines related to both income and resources of individuals, and outlined how the states could apply those funds towards the eligibility requirements.

Special needs trusts, specifically irrevocable (d)(4)(B) trusts, have very narrowly defined rules for their creation. An important step in their creation was the Miller case, which advanced many rules of public policy in granting benefits and a favorable decision towards disabled individuals who were initially ruled ineligible for Medicaid.

Imagine having to tell your client with this issue “sorry, but there is little we can do, a significant portion of that QDRO is going to have to go to taxes before we can place it into a special needs trust that will be used only to benefit and help your medical

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82 Rosenbaum, supra note 79, at 9–10.
84 See Wiesner, supra note 63, at 721–734.
87 Id. § 1396p(c).
treatment.” A tax-free transfer is allowed to the alternate-payee if they place the QDRO into a new or different retirement account.\textsuperscript{89} Is a special needs trust similar enough to a retirement account that the transfer should be made tax free? On the other hand, an individual is allowed to place earned income into a Flexible Spending Plan or HSA pre-tax.\textsuperscript{90} If a special needs trust is not substantially similar to a retirement account, should the spending of a QDRO in this instance be treated the same as pre-tax spending for other healthcare?

\textbf{IV. SPECIAL NEEDS TRUSTS SHOULD BE TREATED LIKE RETIREMENT SPENDING WHEN A QDRO IS USED AS A FUNDING SOURCE}

The Employee Retirement Income Security Act of 1974, commonly known as ERISA, was passed to ensure that private companies who offer retirement plans meet certain minimum requirements for their established plans.\textsuperscript{91} Though the act falls short of requiring private companies to establish these retirement plans, the intention behind ERISA is to protect the interests of the individuals who utilize these employer based retirement plans.\textsuperscript{92}

One section of ERISA has been codified as 29 U.S.C. § 1001. Under that section, a stated reason for protecting these funds is that the “security of millions of employees and their dependents are directly affected by these plans [these plans also] substantially

\textsuperscript{89} \textit{Id.} § 408(d)(6) (2012).

\textsuperscript{90} \textit{Id.} § 125(a), (i) (2012) (flexible spending account); \textit{Id.} § 223(a) (2012) (HSA).


\textsuperscript{92} Stacy Rogers Sharp, \textit{ERISA Preemption and MCO Liability: The Court's Search in AETNA Health Inc. v. Davila for Congress's Elusive Intent}, 84 \textit{TEX. L. REV.} 1347, 1348 (2006) (“ERISA was enacted to protect the employee”).
affect the revenues of the United States because they are afforded preferential Federal tax treatment.”

Section 408 of the IRC created Individual Retirement Accounts (“IRA”), while 408a created “Roth IRAs.” These plans are afforded specific tax protections, but are allowed to be included in the special needs trusts created under § 1396p(c)(1)(G). This section allows for transfers to the trust the assets of an individual who hold an annuity created under § 408, or one that is purchased with the proceeds from either § 408 or § 408a. These are the funds that an individual can access as an alternate-payee through a QDRO.

QDROs that are transferred into a new ERISA account are allowed a tax-free status. The alternate-payee who receives the funds in a QDRO and then places them into a different retirement account is not taxed until an individual decides to break the annuity. Additionally, the ten percent early cash-out provision is waived for those who are under fifty-nine and a half years old, and the lump sum tax does not apply.

A special needs trust created under § 1396p(d)(4)(B) is similar to an ERISA account. Neither allow the named beneficiary access to the funds without penalty. Additionally, both allow for a third party to control the corpus of the account.

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95 Id. § 408a.
97 Id.
98 SNYDER, supra note 5, § 6:5.
99 See discussion infra Part II.
100 Id.
101 Id.
102 An individual with a special needs trust can only obtain income from the trust as dispersed by the trustee. Hobbs ex rel. Hobbs v. Zenderman, 542 F.Supp.2d 1220, 1234 (D.N.M. 2008). Individuals who participate in ERISA plans are subject to various penalties for early withdrawal, such as the additional ten percent penalty. See I.R.C. § 72(t) (2012).
103 Id.
Section (d)(3)(B)(ii) states that any income or value of the annuity placed into the trust does not count as income against an individual until the annuity itself is drawn upon.\(^{104}\) This distinction seems arbitrary towards the treatment of the taxpayer. The individuals who qualify for special needs trusts are already disabled.\(^{105}\) Requiring them to take the extra step of finding a qualifying ERISA plan in which to place the QDRO seems like an arbitrary step when there are specific trusts that individuals can employ in order to help the disabled receive care, and make an effort to pay for that care. If an individual chooses to place the funds into a trust, which they have no access to the corpus of, apart from the stipulated income, the individual should not be taxed until the actual corpus of the QDRO is tapped as income.

The government is also afforded an additional protection in this instance. The money that makes up the trust must first go to pay for the medical care received under Medicaid before the funds can be transferred to a legal heir.\(^{106}\) This money will not enter into the spending or use decisions of the alternate-payee, at their own discretion, like regular income does, be it from an annuity or from their job.

Because of the unique circumstances that surround the creation of a special needs trust,\(^{107}\) especially one that is either funded, or partially funded, by a QDRO, the government should make a change to current tax policy to allow the individual full right to the funds, and not raise tax questions until the corpus of the QDRO is actually tapped as income through the trust.

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\(^{105}\) Id. § 1396p(d)(4)(B)(iii).
\(^{106}\) Id. § 1396p(d)(4)(B)(ii).
\(^{107}\) I.R.C. § 106(a) (2012); see also discussion supra, Part III.
V. SPECIAL NEEDS TRUSTS SHOULD BE TREATED LIKE HEALTHCARE SPENDING WHEN A QDRO IS USED AS A FUNDING SOURCE

Section 106(a) states the general rule that “gross income of an employee does not include employer-provided coverage under [a] . . . health plan.” Further, individuals are also offered tax credits if they chose to purchase their own plans under the HCTC program. The spending authorized under these rules is allowed broad discretion on the part of the taxpayer. Qualifying healthcare spending can come in the form of a plan that is subsidized or provided by the employer, in the form of a flexible spending accounts, or in the form of a HSA.

Additional rules apply to flexible spending accounts under § 125. Flexible spending accounts are a spending election available to taxpayers that allow an individual to place their income into an account tax-free, so long as the account is only used to pay for healthcare costs. There are no limits on the amount an individual can contribute to such an account, however, an individual forfeits the funds placed in the account at the end of a calendar year. When an individual places assets into a flexible spending account, the individual is allowed to take deductions on the income of the individual for healthcare costs not compensated by insurance. If an individual elects to place income

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109 33 AM. JUR. 2D Federal Taxation §1401 (WEST 2012), I.R.C. § 35(c) and (e)(1)(J) (2012).  
110 Id.  
112 Id. § 125(a), (i) (2012).  
113 Id. § 223(a) (2012).  
115 I.R.C. § 125(a), (i) (2012).  
116 Id. § 125(i).  
117 Id. § 213(a) (2012).
into Flexible Spending Plans, they are allowed preferential treatment on their taxes in the form of deductions against their income on their actual healthcare spending.

In addition to the flexible spending accounts that allow an employee to pull from a collected pool to deal with health costs,\(^{118}\) a similar preferential tax treatment is also extended to HSAs.\(^{119}\) The IRS Code treats the savings of individuals for future healthcare costs as tax deductible.\(^{120}\) The IRS Code further outlines the requirements of an HSA.\(^{121}\) An HSA is “a trust . . . created exclusively for the purpose of paying the qualified medical expenses of the account beneficiary”\(^{122}\) as long as it meets the following requirements: 1) the contribution be in cash, and it not exceed $2,250 for individual plans or $4,500 for family plans;\(^{123}\) a trustee agrees to administer the trust in a manner consistent with the requirements in § 223;\(^{124}\) the assets of the trust are not part of a life insurance contract;\(^{125}\) “the assets of the trust will not be commingled with other property except in a common trust fund or common investment fund”;\(^{126}\) and an individual cannot forfeit the balance of the account.\(^{127}\)

Money that is set aside for healthcare spending is exempt from income tax calculations if the money comes from an employer sponsored program, and if an individual decides to purchase their own plan, a tax credit is available.

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\(^{118}\) See Haggarty, supra note 114, at 380.

\(^{119}\) I.R.C. § 223(a) (2012).

\(^{120}\) Id.

\(^{121}\) Id. § 223(d).

\(^{122}\) Id. § 223(d)(1).  

\(^{123}\) Id. § 223(b)(2), (d)(1)(A).

\(^{124}\) Id. § 223(d)(1)(B).

\(^{125}\) Id. § 223(d)(1)(C).

\(^{126}\) Id. § 223(d)(1)(D).

\(^{127}\) Id. § 223(d)(1)(E).
Comparing the way healthcare spending is treated by the IRS Code when compared to income, the same exemptions should be allowed to those who use the QDROs to add to or fund their trusts. If a special needs trust is not seen as a retirement account, the spending election made by the individual should allow the transfer to be made tax-free because special needs trusts are substantially similar to other tax-free spending elections that an individual can make in regards to healthcare.

An irrevocable special needs trust that is created under § 1396p(d)(4)(B) should be treated as healthcare spending. A special needs trust has various requirements, including pay-back provisions, and the payments made from the trust to the benefit of the individual should not be considered income until the corpus of the QDRO is tapped as actual income related to the furtherance of the trust.

A (d)(4)(B) special needs trust is a limited trust created for the specific reason of providing income for the beneficiary of that trust, allowing the individual to remain eligible for Medicaid. Further, upon the death of the beneficiary, the first step of the trust is to pay-back the Medicaid costs associated with the expenditures related to the care of the beneficiary. Additionally, the trust itself acts in a manner similar to that of a flexible spending account. Flexible spending accounts allow an individual to place money into a general pool, then pull out what is needed for healthcare related costs, and do so without having to pay taxes on that money. In the case of an irrevocable (d)(4)(B) trust, and individual

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129 Id.
132 Id. § 1396p(d)(4)(B)(ii).
133 See I.R.C. § 125(a), (i) (2012).
is allowed to place earned income into a trust, remain eligible for Medicaid, and the pay-back provisions of the (d)(4)(B) trusts ensure the same result is achieved, the funds of the trust must be used to pay for medical care obtained by the beneficiary.\textsuperscript{134}

The HSAs also act much in the same way as the (d)(4)(B) trusts as well. HSAs allow an individual to save money in a qualifying plan, tax free, and then withdrawal that money as they need to pay for their costs.\textsuperscript{135} What is an irrevocable (d)(4)(B) trust other than an account that an individual can place their assets or earnings in order to save for healthcare costs? The individual does not have direct access to the funds in the special needs trusts.\textsuperscript{136} In an HSA, the individual likewise does not have access to the funds,\textsuperscript{137} and the IRS themselves has noted that an HSA is a “trust.”\textsuperscript{138} In both instances, the money is earmarked for future spending on the healthcare of the individual.\textsuperscript{139} In the case of a special needs trust, the money first goes to the state to repay Medicaid associated costs,\textsuperscript{140} and in the case of a HSA, the money can only be spend on future medical spending by the individual.\textsuperscript{141} The IRS classifies HSAs as simple trusts, with various requirements,\textsuperscript{142} and special needs trusts meet those requirements head on.

In \textit{Hobbs ex rel. Hobbs v. Zenderman}, the court outlined the benefits and drawbacks of a special needs trust,\textsuperscript{143} ultimately holding:

\begin{itemize}
\item \textsuperscript{134} 42 U.S.C. 1396p(d)(4)(B)(ii) (2012).
\item \textsuperscript{135} I.R.C. § 223(d)(2) (2012).
\item \textsuperscript{136} Lewis v. Alexander, 685 F.3d 325, 332 (3rd. Cir. 2012) (“the beneficiary does not actually own the assets of the trust, but instead has an equitable right to derive benefits from them.”).
\item \textsuperscript{137} I.R.C. § 223(d)(1) (2012) (“exclusively for the purpose of paying the qualified medical expenses of the account beneficiary”).
\item \textsuperscript{138} \textit{Id.} § 223(d)(1).
\item \textsuperscript{141} I.R.C. § 223(d)(2)(A) (2012).
\item \textsuperscript{142} \textit{Id.} § 223(d)(1).
\item \textsuperscript{143} See 542 F.Supp.2d 1220 (2008). Because special needs trusts can be easily used to defraud the state and hide assets in order to gain need-based benefits, states are afforded a greater ability to effectively monitor
\end{itemize}
“[t]he whole purpose of a special needs trust is to shelter resources so that the state, through Medicaid, pays for medical expenses rather than having the beneficiary's family pay for them. In exchange for the removal of that potentially ruinous responsibility, a family must choose to refrain from directly benefitting from the resources of a special needs trust.”

Hobbs makes it clear that a special needs trust must be first used to pay for the medical care of an individual. The main drawback of the employment of a special needs trust is that the individual places restrictions on their ability to use personal discretion over their own assets. HSAs work in much the same way, an individual elects to place money into an account, and they are not able to use the funds for anything other than healthcare related costs. The difference being that HSAs allow individuals to pay as they go, while special needs trusts simply allow an individual to save and grow the account before paying for the costs associated with their care at the termination of the trust.

The first requirement made by the IRS is a limit on the amount an individual can deposit in the account each month. A well drafted QDRO can ensure payments be spread out over a specified manner (time, number of payments) and in set amounts that and restrict the methods that payments from the trust are being used. Id. at 1230–1232. Special needs trust invest in the State a right to monitor the trusts to ensure that the trust is being used for the benefit of the disabled individual. Id. at 1233.

144 Id. at 1234.
148 29 U.S.C. § 1056(d)(3)(C) (2012) (requiring that a QDRO must contain the number of “payments or period to which such order applies”).
are below the threshold of deposits allowed into an HSA every year. Second, the requirement that the trustee act in accordance with the rules set forth in this section of the IRS code are either already similar to, or can be drafted into the trust document itself by the attorney creating the trust. Third, a special needs trust can only be made up of the “pension, Social Security, and other income to the individual” and HSAs require that “no part of the trust assets . . . be invested in life insurance contracts.” The fourth requirement requires that the HSA not commingle with other funds. Irrevocable trusts can allow accounts to remain apart from one another while under a single trust. The final requirement is that an individual not forfeit the balance of the trust, and in a special needs trust, the individual beneficiaries do not forfeit their right to the funds, rather they forfeit their remainder interest of the trust.

The Internal Revenue Code allows individuals to plan and save money earned from an employer in a variety of methods, and allows these transfers to be made tax-free. Individuals purchasing regular insurance plans, HSAs and Flexible Spending Accounts

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149 I.R.C. § 223(b)(2)(A) (2012) (requiring maximum of $2,250 for individual accounts); I.R.C. § 223(b)(2)(B) (requiring maximum of $4,500 for family accounts.). If the individual is already eligible for Medicaid, the limitation is zero. I.R.C. § 223(b)(7).
150 Id. § § 223(d)(1)(B).
151 Hobbs ex rel. Hobbs v. Zenderman, 542 F.Supp.2d 1220, 1234 (D.N.M. 2008) (holding that the trustee must make sure money is spent for the benefit of the disabled individual).
152 The role of the trustee beyond the requirement to provide income to the beneficiary is not outlined under the statute. See 42 U.S.C. § 1396p(d) (2012). The general rules of trust construction apply, and a trustee must act as a “reasonably prudent person” and “make payments and distribution to beneficiaries in accordance with the terms of the trust. 76 AM. JUR. 2d Trusts §402 (WEST 2012).
155 Id. § 223(d)(1)(D).
156 76 AM. JUR. 2d Trusts §278 (WEST 2012) (detailing the problems in co-mingling the various assets in a trust).
158 Lewis, 685 F.3d 325, 348 n.22 (3rd. Cir. 2012).
can do so for their own benefit, or for the benefit of their family members.\textsuperscript{159} A QDRO is made of pre-tax earned income as well.\textsuperscript{160}

Because the funds of the trust will first go to the healthcare costs of an individual through the pay-back provision, the money placed into the trust through a QDRO acts as a healthcare cost, and as such, should be exempt from taxes, much like the exempt status of income from employer contribution plans, and like the credits given to those who choose to purchase health insurance on the private market.\textsuperscript{161} Since the \textit{Miller} decision, individuals are allowed to place income into special needs trusts,\textsuperscript{162} and the election to place the income derived from a QDRO into a special needs trust should be treated like an individual placing income into a flexible spending account or an HSA.

\section*{VI. Conclusion}

The goals and intent behind Medicaid, the creation of special needs trusts and the use of QDROs would be better served if a tax exemption is allowed for people who place QDROs into a special needs trust.

Allowing an individual to place their QDRO into an irrevocable (d)(4)(B) trust in a tax-free transfer is a clear extension of the current rule that allows an individual to count their expenditures on health insurance as pre-tax income. The goal of the trust is to protect the assets of the individual while seeking medical care for specified illnesses. The trusts also contain “pay-back” provisions that require the corpus of the trust itself to first be used to pay for the associated healthcare costs. Because the trusts acts like a Flexible

\textsuperscript{159} See I.R.C. § 106(a) (2012); \textit{and} discussion supra Part V.
\textsuperscript{160} SNYDER, \textit{supra} note 5, § 6:5.
\textsuperscript{162} Wiesner, \textit{supra} note 63, at 721–734.
Spending Plan or an HSA, then the same rules should apply because though not strictly labeled a health spending account, the purpose and execution of the special needs trust is substantially similar.

The governance of trusts is simple enough that, in dealing with an irrevocable trust created under § 1396p(d)(4)(B), the amounts of the QDRO can be prevented from co-mingling with the general corpus of the trust. Proper reporting of the trust and the income derived from the trust can, and will, ensure that the beneficiary does not draw funds from the QDRO, and when the QDRO is finally tapped, the income can be properly reported as coming from the QDRO, which would result in the income falling under the rules pertaining to annuities. The idea that the only way to extend the tax advantages of the individual is to place the QDRO into a different ERISA plan is arbitrary, as a special needs trust acts like an ERISA plan in that it prevents the beneficiary access to the funds apart from an income derived from the base of the funds.

As the court outlined in *Hobbs*, special needs trusts are an avenue for individuals to qualify for state-funded care they may not otherwise be eligible for, but the cost of obtaining that care is to essentially allow the state to stand-in for the “legal and moral responsibilities”\(^\text{163}\) of a family member.\(^\text{164}\) This shows the great restrictions placed on an individual in their ability to make payments from the trust, or to simply access the funds within the trust at their own discretion.

The people who qualify for these trusts need, and deserve, to have the necessary breaks and advantages of allowing these judgments the ability to be transferred free of penalty. Congress should not wait for a judge to broadly define the meaning and

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\(^\text{164}\) *Id.*
application of the tax code like Judge Carrigan did in *Miller*,¹⁶⁵ and act directly to correct this shortfall in the current tax code.