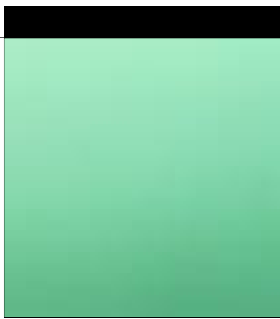

Medicaid Planning Is More Challenging After Recent Reforms

The Deficit Reduction Act of 2005 has tightened considerably the prerequisites for Medicaid eligibility. Nevertheless, some previous planning options are still available, and there are a number of new planning techniques that may be useful.

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On 2/8/06, President Bush signed the Deficit Reduction Act of 2005 ("DRA").[1] The effect of this legislation has made it more difficult for persons to become eligible for Medicaid. Unfortunately, the federal and state governments save money at the expense of health care for poor and middle-class seniors. Most of the major cutbacks in Medicaid were contained in sections 6011 through 6016 of the DRA. This article will examine each section and attempt to analyze which current Medicaid planning strategies are no longer viable and what other strategies may work.

Section 6011—Lengthening lookback period; change in beginning date for period of ineligibility; hardship waivers

Lookback. The lookback period is extended to five years.

Planning opportunities eliminated. It is no longer possible to transfer assets and wait three years for Medicaid eligibility.

New planning opportunities. Transfer funds. Set aside sufficient funds to pay for five years of care and transfer the balance to children. Include an inflation factor for care. A variation of this strategy is to transfer virtually all the assets to the children and let the children pay for the parent's care for five years or any portion remaining, and let a child claim the parent as a medical dependent on the child's income tax return.

Grantor trust. Use grantor trusts more frequently. The advantage is that risk factors associated with transferring assets to children are eliminated. In addition, the IRC Section 121 Exclusion of Gain for Sale of a Principal Residence can be retained, and a step-up in basis for appreciated assets is available. Income can also be taxed to the grantor.

In situations where the parent is receiving home care or assisted living, less money will need to be spent for care, but the tax deduction to the child will also be less.

Buy long-term care insurance for a five-year period. Healthy clients could buy long-term care insurance for a period of five years. If they need long-term care in the future, they could transfer their assets at that time and wait out the five-year lookback through the use of long-term care insurance.

Beginning date. The beginning date of the period of ineligibility has

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changed from the date the transfer was made to the later of the date the transfer was made or the date the individual: (1) would be eligible for medical assistance; (2) would otherwise be receiving institutional-level care based on an approved application for such care, but for the application of the penalty period, whichever is later; and (3) which does not occur during any other period of ineligibility.

Practice tip. Since the penalty period will not begin until the client is admitted to a nursing home and out of funds, it is likely many nursing home residents will be unable to pay for their care during the resulting period of ineligibility. The Congressional Budget Office estimates that this provision will delay Medicaid eligibility for about 120,000 people per year.[2] In these cases, the nursing home will likely sue the resident's children for payment of the cost of care based on "filial responsibility laws," "transfer in defraud of creditor laws," or guarantees of the facility admissions agreement.

Planning opportunities eliminated. Half-a-loaf transfers.

New planning opportunities. Reverse half-a-loaf. Under this strategy, the parent transfers assets, immediately applies for Medicaid, and is rejected. The child then retransfers roughly half the assets to the parent. The parent reapplies and is rejected because of the remaining outstanding transfer. The parent pays for that period of ineligibility from the retransferred funds.

Practice tip. This strategy will not work in states that do not permit a partial cure. HCFA Transmittal 64 permits partial cures.[3] It is likely that most states will prohibit partial cures once this strategy is discovered.

Hardship waivers. Each state must provide a hardship waiver process for situations when application of the transfer of assets penalty (1) would deprive the individual of medical care such that the individual's health or life would be endangered; or (2) would deprive the individual of necessities of life, such as food, clothing, and shelter.

The statute provides that notice must be given by the state that the hardship exception exists, a timely process for determining hardship must be developed, and an appeals process must be provided. All of this is similar to existing law. What is new is that either the individual *or the facility* may apply for a hardship waiver, and the state is authorized to pay for nursing facility services to hold a bed for a period not in excess of 30 days while an application for a hardship waiver is pending.

Planning opportunities eliminated. None.

New planning opportunities. It may be possible to get better results by having a nursing home file an appeal for hardship waiver.

Section 6012—Disclosure and treatment of annuities

Disclosure. At the time of a Medicaid application or re-certification of eligibility, the applicant must disclose a description of any interest the individual or the community spouse has in an annuity. The application or re-certification must include a statement that the state becomes a remainder beneficiary under such an annuity.

Notice. The state must notify the issuer of the annuity of the right of the state as preferred remainder beneficiary.

1 Pub. L. No. 109-171. A lawsuit has been filed alleging that the DRA is invalid as a result of the failure of both houses of Congress to pass identical bills. Zeigler v. Gonzales, 1:06-CV-00080-CG-M (S.D. Ala.).

2 www.cbo.gov/ftpdocs/68xx/doc6849/BartonLtr1.pdf.

3 HCFA Transmittal 64 § 3258.10 C 3.

Change in amount. The state may require the issuer to notify the state when there is a change in the amount of income or principal being withdrawn.

Guidance. The Secretary may provide guidance to states on categories of transactions that may be treated as a transfer of assets for less than fair market value.

Denial of eligibility. Nothing in the subsection pertaining to disclosures of income and resources derived from an annuity shall be construed as preventing a state from denying eligibility for Medicaid based on income or resources derived from the annuity.

State named as beneficiary. The purchase of an annuity will be treated as a transfer of assets for less than fair market value unless:

1. *Remainder beneficiary.* The state is named as remainder beneficiary in the first position for at least the total amount of medical assistance paid on behalf of the annuitant; or
2. *Second position.* The state is named as a remainder beneficiary in the second position after the community spouse or minor or disabled child and is named in first position if such spouse or a representative of such child disposes of any remainder for less than fair market value.

Design of annuity. An annuity is not subject to the transfer of assets provisions if:

- it is owned by an IRA or purchased with the proceeds from an IRA, a SEP, or a Roth IRA; or
- the annuity is irrevocable, non-assignable, and actuarially sound as determined in accordance with the actuarial publications of the Office of Chief Actuary of the Social Security Administration; *and*
- the annuity provides for payments in equal amounts during its term, with no deferral and no balloon payment.

Note: The tables published by the Office of the Chief Actuary must be used, rather than the tables in HCFA Transmittal 64.

Planning opportunities eliminated. This provision appears designed to eliminate balloon payments under annuities.

New planning opportunities. In states that had not previously permitted annuities, there may be an opportunity. Under the DRA, the purchase of an annuity is exempt from the transfer of asset penalties. In states that maintain that the annuity is a countable asset because there is a secondary market, the issue is not transfer of assets but availability. Buying an annuity would not be a viable strategy in those states. Does the statute require payback if the annuity is owned by the community spouse and the community spouse is the annuitant? Does actuarial life expectancy mean that the annuity cannot be longer *or shorter* than the actuarial life expectancy of the annuitant?

Practice tip. When an annuity is purchased, be sure that there is an irrevocable designation of payee and beneficiary to eliminate the value of the annuity in the secondary market.

Practice tip. Be sure the form of annuity contract has been approved by the State Department of Insurance. Otherwise, Medicaid can make the argument that the rights to assign the annuity, to change the payee, and to change the beneficiary are important consumer rights. Therefore, the annuity is void.

Section 6013—Income first rule

States must follow the "income first" rule when calculating an expansion of the Community Spouse Resource Allowance.

Planning opportunities eliminated. In states that followed the "resource first" rule, it was possible to protect significantly more assets to generate income to satisfy the community spouse's Minimum Monthly Maintenance Needs Allowance ("MMMNA"). This is no longer possible in those states.

New planning opportunities. Practitioners might take the position that the Social Security of the community spouse is not assignable in calculating the amount of resources needed to satisfy the MMMNA.[4]

Section 6014—Home equity

Limits. A person is ineligible for Medicaid if he has equity in his home in excess of $500,000, or at the state's option, $750,000. This number is indexed for inflation.

Exception. The maximum amount does not apply if the home is occupied by:

- spouse,
- child under age 21, or
- child who is blind or permanently and totally disabled.

Loan. The applicant is encouraged by the DRA to obtain a reverse mortgage or home equity loan to reduce the applicant's equity interest in the home.

Planning opportunities eliminated. The perceived abuse was that Medicaid applicants were using their assets to buy million dollar homes to become immediately eligible for Medicaid. In fact, this section will have very little effect on Medicaid planning, because in most states if the Medicaid applicant is single, the home either would have to be sold for the applicant to be granted Medicaid or the home

[4] See Robbins v. DeBuono, 218 F.3d 197 (CA-2, 2000).

would be subject to Medicaid estate recovery on the applicant's death.

New planning opportunities. The DRA does not affect a home occupied by the community spouse. The new planning opportunity is for practitioners to do exactly what this provision was intended to eliminate. Because easy Medicaid planning opportunities, such as transferring assets and waiting three years or half-a-loaf transfers, are no longer available, community spouses might want to consider buying more expensive homes as a means of sheltering assets.

Section 6015—CCRC contracts

Transfer provisions. Provisions in continuing care retirement community ("CCRC") contracts restricting transfers of assets are enforceable.

Practice tip. It is foreseeable that the nursing home industry will lobby for similar authorization to contractually restrict transfers of assets disclosed on admission agreements.

Entrance fees. Entrances fees are countable assets if:

- the contract provides that the entrance fee may be used to pay for care; or
- the individual is eligible for a refund; and
- the entrance fee does not confer an ownership interest in the CCRC.

Planning opportunities eliminated. Many practitioners ignored the restrictions in CCRC contracts prohibiting transfer of assets. This strategy is no longer viable.

New planning opportunities. None.

Section 6016—Additional reforms of Medicaid asset transfer rules

Partial month penalties. Partial month penalties are mandated.

Planning opportunities eliminated. It is no longer possible for Medicaid applicants to transfer small sums of money, lower than the state divisor, to escape the imposition of a penalty. Similarly, it is no longer possible to transfer assets and then make additional transfers within the lookback period structured in such a fashion that the penalty for those subsequent transfers did not extend beyond the original lookback period. This was a very useful strategy in dealing with retirement accounts.

New planning opportunities. None.

Accumulation of multiple transfers. Fractional transfers of assets in more than one month are accumulated. Moreover, transfers during all months are treated as one transfer.

Planning opportunities eliminated. The effect of this statute is to penalize all transfers made within the five-year lookback period. It is no longer possible to make a small transfer and wait until the penalty expires before applying for Medicaid.

New planning opportunities. None.

Notes and other loan assets. For transfer of assets purposes, promissory notes, loans and mortgages are included unless:

1. they include an actuarially-sound repayment term as calculated by the Office of the Chief Actuary of the Social Security Administration; and
2. payments are made in equal amounts during the term of the loan, with no deferral or balloon payment; and
3. the document prohibits the cancellation of the balance upon the death of the lender.

Planning opportunities eliminated. It is no longer possible to use a private annuity or a self-canceling installment note ("SCIN"). Most state courts took the position that transfers and exchanges for a private annuity and a SCIN constituted a transfer of assets in any event.

New planning opportunities. A transfer of assets from a Medicaid recipient or community spouse to children in exchange for a promissory note is clearly exempt from the Medicaid transfer of asset penalties. The note should be actuarially sound, use equal *monthly* installments to avoid violating the Pig Principle, bear a market rate of interest, and include a clause prohibiting cancellation of the indebtedness on the death of the lender.

Practice tip. The note should contain a provision that it is non-assignable, that the lender cannot demand prepayment, and that the borrower cannot make prepayment.

It may be that states will take the position that there is a secondary market for non-negotiable promissory notes and that such notes are, therefore, countable assets. This issue is likely to be litigated going forward.

Purchase of life estates. The purchase of a life estate in another individual's home is not considered to be a transfer of assets if the purchaser resides in the home for at least one year after the date of the purchase.

Planning opportunities eliminated. This provision was intended to stop abusive situations where a parent transfers money to a child with no intention of ever moving into the child's home; this is not a viable option. There is a now a bright-line test of one-year residency for the parent in the child's home in order for this strategy to be viable.

New planning opportunities. In many instances, a parent moves into the home of a child and lives

Practice Notes

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there for the rest of the parent's life. Typically, the institutionalized spouse goes to a facility, and the community spouse moves in with a child. As long as the community spouse lives there for one year, the community spouse could purchase the life estate from the child. The same strategy would apply to an individual who may live with a child for a period of time and then have to move to a nursing home. This strategy may be used for a single or a married client.

The capital gains tax consequences to the parent and the child must be considered. It would appear that the sale of the life estate would be subject to the child's IRC Section 121 Exclusion from Capital Gains Tax on the Sale of a Principal Residence. If the property is sold during the lifetime of the parent, the gain would be recognized and taxed to the parent and child in their individual capacities.[5] The parent should be able to use the Section 121 exclusion if the parent is occupying the residence as his home and satisfies the holding periods. It is uncertain if the child may also use the Section 121 exclusion on the sale of the remainder interest. Upon the death of the parent, the child will not receive a step-up in basis because the life estate was not a retained interest, but was purchased.

Practice tip. In most cases, the child will have a mortgage on the home. The mortgage will contain a "due on sale" clause. The Garn-St. Germain Act applies to transfers of "an interest" in real estate and makes an exception only for transfers to spouses and children, not to parents.[6]

Other planning opportunities that may become more widely used are divorce and care agreements.

Divorce.

Equitable distribution. It is likely that more couples will divorce so that the community spouse receives equitable distribution, which may exceed the Community Spouse Resource Allowance.

Alimony. It may be possible for the community spouse to obtain alimony that may exceed the Minimum Monthly Maintenance Needs Allowance.

Arm's length. The divorce must be arm's length, each party must be represented by separate counsel, and the agreement must be on the record and approved by a court after testimony.

QDRO. Consider a qualified domestic relations order ("QDRO") if retirement funds are being transferred from the institutionalized spouse to the community spouse.

Care Agreements. Children often provide significant care to parents. It is possible to compensate the children for such care. There must be a Care Agreement. The Care Agreement must be in writing, must be prospective in nature, and the compensation must be reasonable. This may arise in several different situations:

- *Parent's home.* Sometimes the child moves into the parent's home and provides the care there.
- *Child's home.* Sometimes the parent moves to the child's home and receives care there.
- *Separate residences.* In certain instances, the parent and child live separately, but the child provides certain services to the parent.
- *Direct care.* Child provides care.
- *Care coordination.* Child coordinates or manages the delivery of services to parent.
- *Single clients.* This arrangement may be used for single clients.
- *Taxable income.* Income is taxable to the child.
- *Social Security and Medicare tax withholding.* These taxes must be withheld if the child receives $1,500 + per year.
- *FUTA withholding.* This is required if the child receives $1,000 or more in any calendar quarter.
- *Federal income tax.* Withholding is not required absent agreement.
- *Value of services.* Document the value of the child's services.

Effective date. There is considerable confusion as to the effective date of the new rules. The effective date could be:

- the date of enactment of the Deficit Reduction Act of 2005,
- the date of the adoption by the state of implementing legislation,
- the date of adoption by the state of implementing regulations.

Practice tip. Any new state statute and/or regulations may be effective retroactive to the date of the federal legislation.

Small transfers until the date of the enactment of any new state statute or regulation may be a viable strategy, but only if the client's Medicaid application is approved before the state enacts new statutes and/or regulations. ■

[5] Rev. Rul. 71-122, 1971-1 CB 224, and FTC 1-2917.

[6] 12 U.S.C. § 1701j-3.