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MEDICAID ANNUITY WHITE PAPER

Safe Harbor for Short-Term Medicaid Compliant Annuities

Michael Anthony, JD, CMP™

The Zahner Opinion

Safe Harbor for Short-Term Medicaid Compliant Annuities

The U.S. Court of Appeals for the Third Circuit handed down one of the best written opinions on the topic Medicaid compliant annuities since Transmittal 64 was authored in 1994. The court in *Anabel Zahner v. Secretary of Pennsylvania Department of Human Services* overrules a Pennsylvania district court opinion[1] that had left many scratching their heads about the use of short-term annuities.

Background

To achieve the opinion in *Zahner*, the appeals court consolidated two cases where Medicaid annuities played a significant role in determining the eligibility of an applicant for long-term care Medicaid.[2] In both cases, there was a certain amount of gifting that transpired which created a period of ineligibility based upon the transfer of asset restrictions in place. Additionally, there were also the purchase of short -term annuities that dovetailed into the overall planning objectives of the applicants.

The first family was the Claypoole family. They had gifted hundred thousand dollars in cash. The gift created a penalty period for Medicaid eligibility and they purchased an annuity with a premium of $84,8784.08 that paid out $6,100.22 for a term of 14 months.

The second family was the Sanner family, they also purchased a short term annuity lasting 12 months. The premium amount was $53,700.00, which created a monthly payout of $4,499.17.

In both circumstances, the purchase of the short term annuity was for the purpose of paying for the nursing home during the period of ineligibility created from large gifts. Under federal rules governing Medicaid compliant annuities, the annuity is not supposed to be considered an asset or resource and the purchase of the annuity is also considered to be a proper transfer (i.e., one that does not create a penalty period).

Both families did their own version of the "Modern Half-a-Loaf."

Modern half-a-loaf planning

Before the Deficit Reduction Act of 2005 (DRA), a common planning technique was to give away half of the assets and use the other half to pay through the penalty period created by the gift. Since this protected approximately one-half of the total value of the available resources, it was known as the "half -a-loaf" plan. When dealing with pre-DRA gifting rules, the half-a-loaf was simple to understand and easy to do. So easy, that when Congress passed the DRA it made proactive steps to curtail the activity. The principal way of doing so, was to change the penalty start date from the date that the gift was given until the person who applies for Medicaid is "otherwise eligible."

The change in the penalty start date was significant. Under the half-a-loaf plan, half of the assets were given away but you still had the other half intact and therefore the person was not otherwise eligible, nor did the person have to apply for Medicaid in order for the penalty start date to begin. This basically put people in the position of having to spend down the entire loaf.

If it took becoming otherwise eligible for Medicaid and applying in order to start the penalty period, then it became obvious that a strategy under the DRA would be to give away approximately half of the assets and take the remaining half and purchase a Medicaid compliant annuity. This process is known as the "modern half-a-loaf."

The gift creates a penalty that does not start until the person is below the individual countable asset limit. By purchasing a Medicaid compliant annuity with the remaining assets, the applicant successfully spends down assets to become Medicaid eligible. The annuity, if done properly, produces enough income to help pay for the nursing home costs during the penalty period. Under this formula, the length of the penalty. And the length of the annuity is primarily based upon the size of the assets that are used to fund the gift and the annuity purchase.

For someone with substantial assets, the penalty period and the term of the annuity would be rather long; however, for someone with a smaller nest egg, the penalty period and the term of the annuity are relatively short. Such is the case with the families discussed in the *Zahner* case.

Prior to the circuit court ruling in this matter, the District Court opinion that preceded it had invalidated the use of substantially short annuities in Pennsylvania as being "sham" transactions and not passing the "sniff test" because the terms of the annuities were so short that they offended the sensibilities of the District Court judge.

States are relatively divided about how to treat short-term annuities. This issue has been litigated in in New Jersey which has reaffirmed the use of short-term annuities.[3] However, in the state of Washington, they put a minimum five-year term as a floor on annuities when the person's actuarial life expectancy is longer than five years,[4] making half-a-loaf planning virtually impossible.

Safe harbor

The opinion starts with a very concise understanding of how annuities work in conjunction with Medicaid eligibility. The court clearly sees that Medicaid rules have created a safe harbor for resources placed within certain types of annuities.

"Congress created a 'safe harbor' pursuant to which, certain annuities are not considered resources for purposes of Medicaid eligibility."

The concept of the safe harbor is something that even a layperson can easily understand. This is a carved out exception to the rules on what is a countable asset when determining Medicaid eligibility. Congress created the safe harbor because Congress has also implemented rules to encourage people to save for their retirements. By exposing those assets to the threat of a long-term care spend down, Congress has been keenly aware of the moral hazard inherent in such a problem and has also chosen specifically to not provide universal health care coverage for long-term care. So a delicate balance is struck.

Assets can be preserved in the form of an income stream, but that income stream has to be set up with strict, rigid requirements. Such requirements form the predicate for what we now commonly referred to as the Medicaid compliant annuity.

"Congress created a 'safe harbor' pursuant to which, certain annuities are not considered resources for purposes of Medicaid eligibility."

Not a 'sham'

The District Court opinion that was overruled, specifically found that short-term annuities issued by ELCO Mutual were considered to be "sham" transactions. This was principally found upon the concept that the annuity term was so short that it was not a real investment, but merely a work around the Medicaid eligibility rules. This so offended the District Court judge, that the short-term annuities were invalidated.

The Circuit Court took a different approach. They evaluated the nature of the investment. They found that it was a proper investment because it met the general understanding of the term. Additionally, they point out that all insurance products are licensed by a state insurance Commissioner. These short-term annuities are licensed insurance products and are approved for sale in Pennsylvania by the Insurance Department. Insurance commissioners do not inherently approve sham investments for sale to the public.

Additionally, one of the reasons the lower court found the product to be a sham investment was because the fee associated with setting up the annuity actually caused a loss in value. The Circuit Court differentiated between the investment itself, which paid a limited interest rate and the fee to set it up as being more akin to paying a Medicaid planner a fee for advice. The fee itself is separate from the investment. Plus, if an investment had to make money to not be a sham, investments that lost money from market fluctuation would certainly not withstand the District Court's analysis, with or without a fee.

'Years' is a term of art

Transmittal 64 is still the basis of most instruction from the Centers for Medicare and Medicaid Services (CMS) on the treatment of annuities. In Transmittal 64, the term annuity was defined as "a right to receive fixed, periodic payments, either for life or a term of years." The state sought to read into Transmittal 64 a requirement that the term of the annuity must be for at least two years or longer because the plural term "years" was utilized.

While the term "years" is less than instructive when used in the context of Transmittal 64, the Court of Appeals goes through a lengthy analysis of how the term "years" is actually a term of art that is used to describe timeframes that could be less than multiple years. The term is actually akin to "estate of years" which could be terminated by someone's death in less than multiple years, and so must include timeframes of less than a year. The use of the plural term, therefore, does not give rise to an actual requirement that an annuity exceed two years.

'Actuarially Sound' is less-than

There has been a lack of explicit definition to the term "actuarially sound." Clearly, actuarial soundness as to the length of the annuity is capped at the Social Security Administration (SSA) life expectancy table. Beyond knowing what the ceiling is, there is a dearth of direction about whether there is a floor. In absence of an explicit floor, the annuity companies have issued annuities that are fully Medicaid compliant and can go down to only a few months in length.

Some, including the State of Pennsylvania, have asserted that an annuity is only actuarially sound if it is for the full length of life expectancy under the SSA chart and that anything more than a minor downward departure from that is no longer actuarially sound. In Transmittal 64, there is nothing that explicitly that says that any term less than the SSA life expectancy is considered actuarially sound, but it uses the terms "commensurate with" and "coincide with" to connect life expectancy and the term on the annuity.

There is, however, in an example in Transmittal 64 an example that is illustrative of the principal that the actuarially-sound can be met if the term is shorter than life expectancy. In a simple example, Transmittal 64 provides that if an annuity is for a term of 10 years, it is not actuarially sound if the beneficiary's reasonable life expectancy is 6.98 years, but it is actuarially sound if the beneficiary's reasonable life expectancy is 14.96 years.

The Circuit Court found that since no minimum term was explicitly set by law, it was reasonable to conclude that any annuity term less than full life expectancy would still be considered actuarially sound.[5]

> "Congress did not require any minimum term for an annuity to qualify under the safe harbor."

No 'floating floor'

Pennsylvania posited the concept of a "floating floor" when dealing with Medicaid compliant annuities, but the Circuit Court found that neither the DRA nor Transmittal 64 impose one.

The concept of a floating floor can be seen in the explicit language of the Washington State Medicaid Manual. Washington State considers the purchase of an annuity to be an available resource unless it is:

i. Over a term equal to the actuarial life expectancy of the annuitant;

Ii. Over a term that is not less than five years if the actuarial life expectancy of the annuitant is at least five years; or

Iii. Over a term not less than the actuarial life expectancy of the annuitant, if the actuarial life expectancy of the annuitant is less than five years.

Notice under the Washington scheme that if life expectancy is 100 months, the shortest annuity you could write is 60 months and any annuity between 60 months and 100 months would be considered actuarially sound. However, if life expectancy is 45 months, the shortest Medicaid compliant annuity you could write is 45 months. This is what is referred to as a floating floor.

There is absolutely no justification for a floating floor in the Medicaid statute concerning annuities or in Transmittal 64 and Circuit Court could not find any justification for it in the law, nor did it feel compelled to extra-judicially impose one that was not created by law.

No 'sniff test'

In what was seen as a blatant act of judicial activism, the District Court invalidated short-term annuities based on what it called a "sniff test." To the District Court, the short-term annuity transaction did not smell right and therefore should not be allowed.

The Circuit Court held that a judge's pseudo-olfactory senses are not an appropriate measure of the validity of a financial transaction when determining Medicaid eligibility. The District Court basically considered the purchase of a short-term annuity to be clever financial trickery that subverted the overall intent of the Medicaid eligibility laws by allowing someone to gift assets and still get Medicaid and this impure motive was sufficient to invalidate the transaction's effect.

However, the Circuit Court indicated that the applicant's motives were completely irrelevant as long as they followed the Medicaid rules. In doing so, they authored one of the best lines in any opinion concerning the concept of Medicaid planning: "Financial planning is inherent in the Medicaid scheme: annuities are not barred from the safe harbor, and the lookback period that considers gifts as resources for purposes of Medicaid assistance is of limited duration."

This case recognizes something inherent in the Medicaid system. There are a set of rules concerning an applicant's finances set out to encourage or discourage certain activities. Certain protections are allowed for purchasing funeral contracts and burial spaces. Transfers of assets outside of the 60-month lookback are not factored in. And immediate income annuities purchased in compliance with the Medicaid rules are allowable. The rules both allow and encourage such financial planning to take place, similar to how the tax rules allow for and encourage financial planning to reduce or defer tax liability.

Annuities are not 'trusts'

Several states attempt to lump annuities and trusts together. A good example of this is in Michigan, where the annuity transfer rules are contained in the Medicaid Eligibility Manual under BEM 401, entitled "TRUSTS-MA." Under the sub-section entitled "Medicaid Trust Definitions" is contained the definition of an "Annuity."

States attempt to lump these together because the concept of a trust is similar to the concept of an annuity in that an asset is given to a third party. But beyond that, the two things are vastly different in concept, scope and function. In most cases, where a person has access to assets in a trust, the full amount of the money that could be paid out to them is a countable assets; whereas, in an annuity that is irrevocable and non-assignable, the annuitant is entitled to nothing more than an income stream for a set term of months. Attempting to view them as one in the same is usually meant for the purpose of treating the annuity as an available resource when it should not be.

The Circuit Court set the record straight concerning this attempt to view annuities and trusts as one in the same. The two are treated completely different under the Medicaid rules and, as such, annuities are not to be considered under as trusts or under rules governing trusts. "Transmittal 64 does not present any support for treating these annuities as trust-like devices."

Federal Medicaid law pre-empts state insurance law

Pennsylvania has an interesting state law that requires all immediate annuities to be assignable. Relying on this rule, the state asserted that any annuity sold that was non-assignable was contrary to state law and when viewed in light of the requirement for assignability, would not be Medicaid compliant. It would follow that if it wasn't Medicaid compliant, the purchase of the annuity would create a transfer penalty and the annuity itself could not be viewed as a non-countable resource for eligibility purposes.

In what was likely the boldest move in the Circuit Court opinion, the non-assignability rule was considered trumped by the federal Medicaid law. Because Pennsylvania chose to participate in the Medicaid program, that program had to recognize annuities that complied with federal Medicaid law as being compliant. The court relied upon the Supremacy Clause of the US Constitution to basically say that if you want to run a Medicaid program, you have to allow people to use Medicaid compliant annuities.

Additionally, there is a federal rule that many states attempt to thwart on a regular basis. In short, it requires states to not have stricter asset standards for Medicaid eligibility than the national federal rules require.[6] States can be more liberal in allowing eligibility, but not more restrictive. According to the Circuit Court, if a state attempts to invalidate Medicaid compliant annuities (directly or through a rule that does not allow non-assignability) then the state has made getting Medicaid harder than the federal rules require and anything adding restrictions on the treatment of assets would be considered overruled by the federal Medicaid statues.

Beware the Ohio problem

It's refreshing to see the Circuit Court issue a strong, clear and unambiguous opinion concerning long-term care Medicaid compliant annuities. But those of us who read the well-drafted *Hughes* opinion issued by the Sixth Circuit in 2013, would have clearly expected the state of Ohio to immediate correct its errant ways.[7] But that hasn't been the case.

To this day, Ohio is refusing to allow families to transfer more resources than the CSRA into an annuity before a Medicaid application is filed despite the *Hughes* court telling them they were flat wrong. In the US District Court there currently sits a petition to certify a class action against Ohio for failing to abide by the Hughes ruling. Families negatively affected by the failure of Ohio to follow Hughes are required to file seek an injunction against the state in federal court as their only possible remedy.

If the same thing happens in states covered by the Third Circuit,[8] practitioners will have no choice but to hold a state's feet to the fire through advanced judicial advocacy in the federal courts.

Impact

This opinion is only binding in the limited number of states covered by the Third Circuit. That said, the concise nature of this opinion is likely to have far-reaching effects on the use of short-term Medicaid complaint annuities nationally.

Ideally, Pennsylvania's Department of Human Services should take heed and no longer challenge the use of short-term Medicaid compliant annuities at the caseworker level. If the state properly applies the *Zahner* opinion, Medicaid planners should have no problem doing effective modern half-a-loaf strategies with their clients as those situations warrant it.

In other states where there is pushback – either overtly through state rules that limit the use of short-term Medicaid complaint annuities or where states informally deny these annuities at the caseworker level – *Zahner* provides fresh and compelling ammunition to launch a challenge at the federal level against a state's negative case action. This could have the impact of greatly expanding the use of short-term annuities in states where such a practice is verboten and also keep other states that may have attempted to curb their use from doing so in the future.

> "Financial planning is inherent in the Medicaid scheme: annuities are not barred from the safe harbor, and the lookback period that considers gifts as resources for purposes of Medicaid assistance is of limited duration."

End Notes

[1] *Anabel L. Zahner, et al. v. Beverly Mackerth*, No. 11-306 (W.D. Pa. 1/16/2014).

[2] Note: The case's namesake, Anabel Zahner, had died before the case reached the Court of Appeals. She had utilized a short-term promissory note.

[3] *M.W. v. Division of Medical Assistance and Health Services*, OAL Dkt. No. HMA 2998-13.

[4] WAC 388-561-0201 Sec. (4)(b).

[5] *Zahner*, supra, at page 1.

[6] 42 U.S.C § 1396a(a)(10)(C)(i)(III); 42 U.S.C. § 1396a(r)(2)(A), (B) 4.

[7] *Hughes v. McCarthy*, 734 F.3d 473 (6th Cir. 2013).

[8] Delaware, New Jersey, Pennsylvania and the US Virgin Islands.

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