

THE USE OF ANNUITIES IN MICHIGAN MEDICAID PLANNING

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Presented By:

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BIOGRAPHY
DALE M KRAUSE, J.D., LL.M.

For more than 20 years, Dale M. Krause, J.D., LL.M., and Krause Financial Services, LLC, has provided Medicaid Compliant Annuities to elder law attorneys, and their clients. As a result of his long standing national practice, Mr. Krause has been labeled "The Pioneer of Medicaid Compliant Annuities."

Krause Financial Services, LLC, is a Wisconsin based business that designs, develops, markets, and distributes Medicaid compliant products. Mr. Krause earned his B.S. degree from the University of Wisconsin-Stevens Point, in 1981, his J.D. degree from Thomas Cooley Law School, of Lansing, Michigan, in 1985, and his LL.M. in Taxation from DePaul College of Law, of Chicago, Illinois, in 1990. He is a licensed attorney in the states of Wisconsin and Michigan, and is an out-of-state member of the New York Bar Association. He is a licensed insurance agent, and is registered to sell stocks, bonds, and mutual funds.

Mr. Krause is a regular speaker at continuing legal education forums throughout the United States. In addition to his notable affiliations, including: National Academy of Elder Law Attorneys, Inc., Academy of Special Needs Planners, ElderLawAnswers, Florida Legal Education Association, MPS, American Association of Attorney-Certified Public Accountants, WealthCounsel Advisors Forum, and ElderCounsel, Mr. Krause's work and experience has also been recognized in major publications, including: Senior Market Advisor, NAELA News, The Wall Street Journal, and Lawyers Weekly USA. In Adriane G. Berg's recent book entitled "How Not to go Broke at 102", Mr. Krause was interviewed on the topic of Medicaid planning and the use of Medicaid Compliant Annuities. In Attorney K. Gabriel Heiser's book entitled "How to Protect Your Family's Assets From Devastating Nursing Home Costs - 2nd Edition", Mr. Krause provided state specific Medicaid references.

As a result of his national sales, Mr. Krause continues to achieve some of the top honors in the insurance industry, including the "Top of the Table" (highest distinction) with the Million Dollar Round Table - The Premier Association of Financial Professionals, for 2007, 2008 and 2009. Additionally, Mr. Krause has been recognized by Lincoln Financial Group, as a 2008 Premier Partner. Furthermore, Mr. Krause has consistently achieved President's Club status (highest ranking) for the past 10 years with Employees Life Company (Mutual), an Illinois based insurance company which offers Medicaid Compliant Annuities.

Finally, in that long-term care insurance is now highly recommended to protect against future long-term care costs, in May of 2008, Mr. Krause obtained the designation of Long-Term Care Professional (LTCP) from the Center for Insurance Education and Professional Development, and is licensed to sell Partnership and Non-Partnership long term care insurance throughout the U.S.

PREFACE

The presentation and this outline are being given to the Michigan Forum of Estate Planning Attorneys on the topic of The Use of Annuities in Michigan Medicaid Planning, and with time being limited, the general aspects of Michigan's Medicaid Program will not be covered.

DISCLAIMER

Krause Financial Services is a Wisconsin limited liability company. Dale M. Krause, J.D., LL.M., and Krause Financial Services, LLC, by means of the presentation and this outline are not offering legal advice. The presentation and this outline may be affected by current and future changes in the law, and for those reasons, the accuracy and completeness of the materials, and the opinions of Mr. Krause are not guaranteed. In addition, because of the complexity and interrelationship of various areas of law, from which there may be certain exceptions or limitations, the strategies, plans, and products presented in the presentation and this outline may not be suitable for every individual, or available in every state. Mr. Krause highly recommends that before utilizing any strategy, its current use and applicability needs to be reconfirmed with the proper authorities.

INTRODUCTION

More than three years ago, President Bush signed the Deficit Reduction Act of 2005 (“DRA”) into law¹. The legislation, which is supposed to curb federal spending, has been implemented in all states, with the exception of six². The DRA legislation modified Medicaid rules and statutes, including those related to annuities. As a result, elder law attorneys have had to change the way that they utilize Medicaid Compliant Annuities in their practices.

HISTORY OF ANNUITIES

Life insurance companies first developed annuities to provide for retirement income. Even though annuities were developed for that purpose, there is no requirement that an annuity be used only for retirement planning. In fact today annuities are used for many financial goals, including paying for college educations and funding business ventures. With more than 1,400³ insurance companies offering them, annuities come in many different variations, with some offering long-term care coverage.

Practical Point: One of the first annuities was traced back to the 18th century, when a company first offered an annuity to a minister and his family.

BASIC TYPES OF ANNUITIES

Annuities come in two basic types: tax-deferred and immediate. A tax-deferred annuity is an investment with an insurance company, which remains an investment until the owner makes a complete withdrawal, or annuitizes the account. On the other hand, an immediate annuity is not an investment with an insurance company, but an account that has been structured into a fixed schedule of payments.

¹ DRA was enacted into law on February 8, 2006.

² The 6 states include: California, Hawaii, Illinois, New Jersey, New Mexico, and Wyoming.

³ According to AM Best, there are 1,464 rated and non-rated life insurance companies in the U.S.

Practical Point: A tax-deferred annuity can be converted into an immediate annuity, but an immediate annuity can never be converted into a tax-deferred annuity.

TAXATION OF ANNUITIES

The advantage of a tax-deferred annuity is that the annual growth is not taxed each year. Without annual income taxation, unlike like other investments such as a CD, the tax deferred annuity's value will increase at a faster rate – assuming the same rate of return. Additionally, if the owner liquidates the tax-deferred annuity, they will only be required to pay income taxes on the appreciated value. As for the taxation of an immediate annuity, each payment is comprised of two parts: a non-taxable portion, and a taxable portion. Each non-taxable portion is comprised of an equal portion of the original investment, while the taxable portion is comprised of an equal portion of the appreciated value. The relationship between the two portions is commonly referred to as the “exclusion ratio.”

Practical Point: If an individual has a tax-deferred annuity with significant appreciation and wants to transfer the investment to another annuity company without recognizing income tax consequences, the transfer can be accomplished by way of a 1035 tax-free exchange.

ANNUITIES AS A COUNTABLE RESOURCE

With the investment value of a tax-deferred annuity being available to the owner, less any applicable surrender charge⁴, it is deemed a countable resource for Medicaid purposes. As for an immediate annuity, in that it only provides future payments according to a fixed schedule, it is not deemed a countable resource for Medicaid purposes. However, as each payment is received by the owner, Medicaid will treat the payment as income in the month of receipt.

⁴ A surrender charge is a penalty for prematurely liquidating a tax-deferred annuity.

PARTIES TO AN ANNUITY

An annuity has five parties, including:

Issuer/Obligor

The issuer is an insurance company, and is obligated to fulfill the terms of the annuity contract.

Owner

The owner is the investor, and makes any decisions related to the annuity contract.

Annuitant

The annuitant is only a necessary party when the annuity contract calls for a lifetime of payments.

Payee

The payee receives the annuity payments.

Beneficiary

In the case of a tax-deferred annuity, following the death of the owner, the beneficiary receives the investment value of the annuity. As for an immediate annuity, following the death of the owner, the beneficiary receives the remaining fixed scheduled payments. Annuities typically have a primary beneficiary, and a secondary beneficiary. If the primary beneficiary survives the owner, they will receive the aforementioned benefits. If the primary beneficiary does not survive the owner, then the secondary beneficiary will receive the aforementioned benefits.

Practical Point: Medicaid Compliant Annuities are generally structured with the same person being the owner, annuitant, and payee.

FEDERAL HISTORY OF ANNUITIES – PRE DRA

Annuities were first addressed by the Omnibus Budget Reconciliation Act of 1993 (“OBRA”)⁵. OBRA provided that “annuities may be treated as trusts to the extent and manner specified by the Secretary of Health and Human Services.” However, the Secretary chose not to treat annuities as trusts, and continued to

⁵ The OBRA legislation was passed in August of 2003.

allow annuities to be used in Medicaid planning. Furthermore, in order to clarify the annuity rules of OBRA, the Healthcare Financing Administration (HCFA), which is now the Centers for Medicare and Medicaid Services (“CMS”), issued HCFA Transmittal 64 in November of 1994. Within Transmittal 64, which included gender based life expectancy tables⁶, an immediate annuity was defined as an unavailable resource when the owner could show that the entire investment amount would be returned to them within their Medicaid life expectancy. The test became commonly known as the “actuarially sound test”. Since the implementation of OBRA and Transmittal 64, many states, including California, have supplemented the federal rules with their own regulations.

MICHIGAN HISTORY OF ANNUITIES – PRE DRA

For annuities purchased, or amended, on, or after September 1, 2005, the Michigan Department of Human Services (“DHS”) considers it a transfer for less than fair market value **unless** it⁷:

- Is commercially issued by a company licensed in the United States and issued by a licensed producer; and
- Is irrevocable; and
- Is purchased by an applicant or recipient for Medicaid or their spouse and solely for the benefit of the applicant or recipient or their spouse; and
- Is actuarially sound and returns the principal and interest within the annuitant’s life expectancy⁸; and
- Its payments are in substantially equal monthly amounts and continue for the term of the payout (no balloon).

⁶ See §3258.9(B) of Transmittal 64.

⁷ See PEM 401, Page 4 of 14, “Transfers to an Annuity Effective 9/1/05.”

⁸ See PEM 405, Page 3 of 16, “Annuity Not Actuarially Sound.”

FEDERAL HISTORY OF ANNUITIES – POST DRA

DRA brought three major changes to annuities. The changes impacted the annuity's classification, disclosure, and remainder beneficiary designation.

Classification. DRA classified an annuity as an asset “of an annuitant who has applied for medical assistance” for long-term care **unless** (a) it is an individual retirement annuity or purchased with the proceeds from certain retirement assets, **or** (b) the annuity is irrevocable and nonassignable, is actuarially sound, and provides for equal payments with no deferral or balloon payments⁹.

Disclosure. DRA stated that at the time of a Medicaid application, or Medicaid recertification, the Medicaid applicant, and his or her spouse, must disclose any interest in an annuity. Additionally, DRA further stated that the state Medicaid program may notify the insurance company of its position as a preferred beneficiary and may require the insurance company to notify it when there is a change in amounts being withdrawn from the annuity.

Remainder Beneficiary. When DRA was implemented, it stated that the purchase of an annuity will be treated as a divestment unless 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** is named as second beneficiary after the community spouse or minor or disabled child...¹⁰.

Practical Point: On December 20, 2006, the DRA beneficiary language was modified by the “Tax Relief and Health Care Act of 2006” (“TRHC”). Within the annuity provisions of TRHC, the word “annuitant” was replaced with the words “institutionalized individual,” and the change was made retroactive to February 8, 2006.

MICHIGAN HISTORY OF ANNUITIES – POST DRA

For annuities purchased on, or after, February 8, 2006, in addition to the criteria for annuities purchased on, or after, September 1, 2005, DHS stated that an annuity would be considered a transfer for less than fair market value, unless it

⁹ See DRA §6012 (c); 42 U.S.C. §1369p(c)(1)(G).

¹⁰ See DRA §6012(b); 42 U.S.C. §1396p(c)(1)(F).

names the State of Michigan as the remainder beneficiary, or as the second remainder beneficiary after the community spouse or minor or disabled child, for an amount at least equal to the amount of the Medicaid benefits provided.

Practical Point: Contrary to the federal DRA legislation, as of the date of this outline, DHS has required that annuities containing qualified funds must meet all of the aforementioned criteria, including the beneficiary designation in favor of the State.

MEDICAID COMPLIANT ANNUITY PLANNING FOR A MARRIED COUPLE

To illustrate the use of a Medicaid Compliant Annuity in a community spouse case, assume the following:

Case Facts: After a long struggle with Parkinson's disease, George entered a Michigan nursing home on April 1, 2009. He is receiving custodial care. Together, he and his wife, Betty, have a home, standard furniture and personal property, one car, pre-paid funeral plans, and \$200,000.00 in non-IRA bank accounts. George has monthly income from social security and pension of \$1,200.00, while Betty has monthly social security income of \$500.00. The nursing home bill is expected to be \$6,000.00 per month. Betty would like to immediately qualify George for Medicaid benefits.

Medicaid Annuity Plan: Of the countable resources, Betty is allowed to keep one-half, but no more than \$109,560.00. In this case, Betty is allowed to keep \$100,000.00 as her community spouse resources allowance. George is allowed to keep \$2,00.00, which leaves a spend-down amount of \$98,00.00. With Betty being 85 years of age, she is allowed to purchase a Medicaid Compliant Annuity with a period certain of 79¹¹ months. With an investment amount of \$98,000.00, the Medicaid Compliant Annuity will pay Betty \$1,282.11 per month, with the first payment scheduled in May of 2009. If Betty purchases the Medicaid Compliant Annuity in April of 2009, the spend-down amount is immediately eliminated, and George is eligible for

¹¹ According to Transmittal 64, a female, age 85, has a Medicaid life expectancy of 6.63 years/79.56 months. Utilizing the most recent Social Security Administration Life Expectancy Table, identified as "Period Life Table, 2004", last modified on March 27, 2008, a female, age 85 has a Medicaid life expectancy of 6.62 years/79.44 months.

Medicaid benefits. As a result, in April of 2009, George's Medicaid co-pay is \$0.00¹². Additionally, in May of 2009, and each month thereafter, George's Medicaid co-pay will be \$1,140.00¹³.

Economic Results: With George and Betty expecting to pay \$6,000.00 per month for George's nursing home care, by immediately qualifying for Medicaid benefits, George and Betty will save \$6,000.00 in April of 2009, and \$4,860.00 in May of 2009 and each month thereafter.

Advantage of Medicaid Compliant Annuity Plan: George obtains immediate Medicaid eligibility.

Disadvantage of Medicaid Compliant Annuity Plan: If Betty pre-deceases the 79 month period certain term of her Medicaid Compliant Annuity, the Medicaid program will be entitled to be reimbursed for the Medicaid expenses paid on behalf of George¹⁴. In such an event, Betty's Medicaid Compliant Annuity may leave little, or no, residual benefits to their children.

Potential Question: If Betty pre-deceases George, and George is still in the nursing home receiving Medicaid benefits, does the primary beneficiary claim amount end at Betty's death, or does it continue until George's death?

Alternate Medicaid Compliant Annuity Plan: Assuming that the Medicaid program does not have a restrictive definition¹⁵ of "actuarially sound," which Michigan does not have at this time, Betty may want to reduce the period certain of her Medicaid Compliant Annuity to something less than 79 months. Presently, Krause Financial Services offers a Medicaid Compliant Annuity as short as 2 months; however, it is highly recommended that the Medicaid Compliant Annuity should not be so short as to create an unreasonable amount of monthly income. In short, the monthly income created by Betty's

¹² This amount was determined by reducing Betty's MMNA amount of \$1,750.00 by her monthly income of \$500.00 and George's monthly income of \$1,200.00.

¹³ This amount we determined by reducing George's monthly income of \$1,200.00 by his \$60.00 monthly personal needs allowance, the net co-pay to the nursing home equals \$1,140.00.

¹⁴ This is true whether, or not, George is still in the nursing home at the time of Betty's death.

¹⁵ To date, two states have re-defined the term "actuarially sound." In Oregon, the term means "within three months of the individual's Medicaid life expectancy." In Washington, the term means "if the individual's Medicaid life expectancy is more than five years – no less than five years, and if the individual's Medicaid life expectancy is less than five years – the actual life expectancy."

Medicaid Compliant Annuity, when added to her other monthly income from social security and pension, should be in an amount that is reasonable to meet her current and future monthly needs – assisted living, etc.

Practical Point: The other disadvantage in utilizing a very short Medicaid Compliant Annuity is that the community spouse will not receive a shifting of monthly income from the institutionalized spouse, in that his or her total monthly income is likely to exceed his or her monthly maintenance needs allowance (“MMNA”).¹⁶

Potential Question: If Betty’s Medicaid Compliant Annuity offers a cash commutation feature to the primary beneficiary, does it not make sense to name George as the primary beneficiary? In such a case, George would elect to cash out the remaining monthly payments, by receiving a cash settlement check. Upon receipt of the check, in order for George to regain Medicaid eligibility as soon as possible, he would need to implement a Gifting/Short-Term Medicaid Compliant Annuity Plan – see below.

MEDICAID ANNUITY PLANNING FOR AN INDIVIDUAL

To illustrate the use of a Medicaid Compliant Annuity in an individual case, assume the following:

LONG LIFE EXPECTANCY CASE: If the individual has a long life expectancy, in light of his or her Medicaid life expectancy, a Gifting/Short-Term Medicaid Compliant Annuity Plan will provide the best economic result. For purposes of example, assume the following facts:

Case Facts: Mary Morgan, a widow, is 85 years of age. After a long struggle with Alzheimer’s disease, Mary entered a nursing home in April of 2009. Mary has limited furniture and personal property, a pre-paid funeral plan, and \$135,500.00 in savings accounts. Mary receives monthly social security income of \$1,100.00. Her nursing home bill is expected to average \$6,000.00

¹⁶ In Michigan, for 2009, the minimum MMNA is \$1,750.00, and the maximum MMNA is \$2,739.00.

per month. Mary would like to qualify for Medicaid benefits as soon as possible, and provide a wealth transfer to her children.

Medicaid Compliant Annuity Plan: With the Gifting/Short-Term Medicaid Compliant Annuity Plan, Mary would immediately gift away \$75,389.70 of the \$133,500.00 spend-down amount. The immediate gift amount would create a 11.85 divestment penalty period¹⁷. As for the remaining spend-down amount of \$58,110.30, it would be immediately invested in a 12 Month Medicaid Compliant Annuity¹⁸, which would pay Mary \$4,868.68 per month. Following the gift, and the purchase of the Medicaid Compliant Annuity, Mary would immediately apply for Medicaid benefits. With Mary being “otherwise eligible”, except for the divestment penalty period, she would be entitled to go on LTC Medicaid benefits following the 11.85 month divestment penalty period.

Economic Results: With the Gifting/Short-Term Medicaid Compliant Annuity Plan, Mary’s children will retain the gift amount of \$75,389.70. This is an excellent result when you consider that had Mary not done any Medicaid planning she would have exhausted her \$133,500.00 spend-down amount in approximately 27 months¹⁹.

Disadvantage: In order for Mary to receive an economic advantage, she has to live longer than the 11.85 month divestment penalty period.

SHORT LIFE EXPECTANCY CASE: If the individual has a very short life expectancy, in light of his or her Medicaid life expectancy, a Medicaid Compliant Annuity, by itself, will provide the best economic result. For purposes of an example, assume the following facts:

Case Facts: Carol Nelson, a widow, is age 85, and has been given 12 months to live. Presently, she is in a nursing home receiving custodial care at a monthly cost of \$6,000.00. Carol receives monthly social security income of

¹⁷ When the \$75,389.70 gift amount is divided by Michigan’s Monthly Divestment Penalty Divisor of \$6,362.00, the result equals an 11.85 month divestment penalty period.

¹⁸ With Medicaid Compliant Annuities being issued in whole months, it is not possible to issue a Medicaid Compliant Annuity with a period certain of 11.85 months. Instead, a 12 month Medicaid Compliant Annuity is required.

¹⁹ This amount was determined by reducing the \$6,000.00 monthly nursing home cost by Mary’s monthly social security income of \$1,100.00 and dividing the net result into the spend-down amount of \$133,500.00.

\$1,050.00. The Medicaid rate for the nursing home is \$4,200.00. After purchasing a pre-paid funeral plan, some personal property, and setting aside \$2,000.00 in her checking account, Carol has a spend-down amount of \$134,900.00.

Medicaid Compliant Annuity Plan: In order to gain immediate Medicaid eligibility, Carol purchases a Medicaid Compliant Annuity with the \$134,900.00. The Medicaid Compliant Annuity is structured with 79 monthly payments of \$1,898.04. As a result of the Medicaid Compliant Annuity purchase, Carol becomes immediately eligible for Medicaid benefits, and her monthly Medicaid co-pay to the nursing home is \$2,888.04²⁰. This amount was determined by totaling her monthly income from social security and her Medicaid Compliant Annuity, and reducing it by her \$60.00 monthly personal needs benefit.

Economic Results: If Carol dies in month 12, with the Medicaid program named as the primary beneficiary of her Medicaid Compliant Annuity, Medicaid will be looking to collect \$15,743.52²¹ for Carol's Medicaid room and board costs. With Carol's Medicaid Compliant Annuity having 67 monthly payments remaining - \$127,168.68, less the \$15,743.52 owed to Medicaid, Carol's children, as the secondary beneficiaries of her Medicaid Compliant Annuity, will receive \$111,425.16 in residual monthly payments. As a result, the Stand-Alone Medicaid Compliant Annuity Plan provided an excellent opportunity for Carol, in that she immediately qualified for Medicaid benefits, and she was able to provide a wealth transfer to her children.

CONVERTING AN IRA ACCOUNT INTO A MEDICAID COMPLIANT ANNUITY

Currently, Michigan law treats a community spouse's IRA account as a countable resource. Thus, in the case where there is an existing IRA account, such as a certificate of deposit, mutual fund, or money market account, and the individual

²⁰ $(SS/\$1,050.00 + \text{Medicaid Compliant Annuity}/\$1,898.04) - \text{Personal Needs Allowance}/\$60.00 = \$2,888.04.$

²¹ This amount was determined by reducing the monthly Medicaid reimbursement rate by Carol's monthly Medicaid co-pay, and multiplying the result by 12 months. In addition to the Medicaid room and board costs, Medicaid will also be looking to collect for Carol's Medicaid prescription drug costs.

wants to transfer the account balance into an IRA Medicaid Compliant Annuity, they can do so by way of a “trustee to trustee transfer” or “60 day rollover.”

Practical Point: In the majority of states, such as Michigan, where an IRA account is a countable resource to a community spouse, as well as an institutionalized person, unless the IRA account is part of the community spouse’s CSRA amount, the IRA account will need to be spent down.

CONCLUSION

Even though DRA refined the rules related to annuities, it is my opinion that if a plan involving an annuity that is Medicaid compliant is properly structured, a family faced with having a loved one in a nursing home can experience significant economic benefits.