

THE USE OF ANNUITIES IN MEDI-CAL PLANNING: A LIKELY POST DRA APPROACH

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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 California NAELA Chapter on the topic of The Use of Annuities in Medi-Cal Planning: A Likely Post DRA Approach, and with time being limited, the general aspects of California's Medi-Cal 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, of which California is included. 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 Mexico, West Virginia, 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 Medi-Cal 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 Medi-Cal purposes. However, as each payment is received by the owner, Medi-Cal 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: Medi-Cal 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.”

⁵ The OBRA legislation was passed in August of 2003.

However, the Secretary chose not to treat annuities as trusts, and continued to 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.

CALIFORNIA HISTORY OF ANNUITIES – PRE DRA

The California Department of Health Services (“DHS”) stated that for annuities purchased prior to August 11, 1993, the cash surrender value or balance of the annuity is considered unavailable if the applicant/beneficiary is receiving unconditional periodic payments of interest and principal. DHS further stated that the payments may be made monthly, quarterly, or annually. The aforementioned requirements became known as the “new regulations.”

Practical Point: California law allows immediate annuities to be used as a spend-down strategy in Medi-Cal planning. With no limit on the term of the immediate annuity, an individual could purchase a 30 year term, which provided the same economic results as a balloon style annuity.

Since the new regulations, DHS addressed annuities on three additional occasions. For annuities purchased between August 11, 1993 and March 1, 1996, DHS stated that in addition to meeting the new regulations, the annuity must be actuarially sound. DHS further stated that in those cases where an

⁶ See §3258.9(B) of Transmittal 64.

annuity could not meet the new measures, the annuity requirements could be waived by way of a hardship request.

Practical Point: With California law now restricting the term of the immediate annuity, in order to provide the best economic result, balloon style annuities appeared on the scene.

Next, for annuities purchased after March 1, 1996, DHS eliminated the opportunity for a non-compliant annuity to be approved by way of a hardship request.

Finally, for annuities purchased on or after September 1, 2004, DHS stated that in addition to meeting the requirements for annuities purchased after March 1, 1996, annuities would now be subject to estate recovery.

Practical Point: According to an insurance company, which sells Medi-Cal Compliant Annuities, even though there is potential estate recovery, some planners are still utilizing balloon style immediate annuities.

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.

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 payments⁷.

⁷ See DRA §6012 (c); 42 U.S.C. §1369p(c)(1)(G)

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.

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...⁸. 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.

MEDI-CAL ANNUITIES – SENATE BILL 483

On September 27, 2008, Governor Schwarzenegger approved Senate Bill 483, which essentially mirrored the annuity provisions of DRA. Senate Bill 483 also stated that if a community spouse used his or her community spouse resource allowance to purchase an annuity, the Medi-Cal program would not require that the State be named as the remainder beneficiary. Finally, Senate Bill 483 also contained language stating that it would be applied prospectively, thus protecting those Medi-Cal recipients⁹ and beneficiaries who relied on past legislation for Medi-Cal eligibility.

Practical Point: In order to meet the regulations outlined in Senate Bill 483, a Medi-Cal Compliant Annuity must be structured with equal payments, that

⁸ See DRA §6012(b); 42 U.S.C. §1396p(c)(1)(F)

⁹ The term “recipient,” as used in this sentence, is defined to mean; “those individuals who applied and were approved for Medi-Cal benefits.

are actuarially sound, and the Medi-Cal Compliant Annuity contract must contain language which makes it irrevocable, non-assignable, and names the Medi-Cal program as the primary beneficiary to the extent that medical assistance benefits are provided to the institutionalized individual.

MEDI-CAL ANNUITY PLANNING FOR A MARRIED COUPLE – POST DRA

For purposes of an example, assume that California has implemented DRA. To illustrate the use of a Medi-Cal Compliant Annuity in a community spouse case, assume the following:

Case Facts: After a long struggle with Parkinson's disease, George entered a California nursing home on February 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 Medi-Cal benefits.

Medi-Cal Annuity Plan: Of the countable resources, Betty and George are allowed to keep a total of \$111,560.00, leaving a spend-down amount of \$88,440.00. With Betty being 85 years of age, she is able to purchase a Medi-Cal Compliant Annuity with a period certain of 79¹⁰ months. With an investment amount of \$88,440.00, the Medi-Cal Compliant Annuity will pay Betty \$1,244.35 per month, with the first payment scheduled in March of 2009. If Betty purchases the Medi-Cal Compliant Annuity in February of 2009, the spend-down amount is immediately eliminated, and George is eligible for Medi-Cal benefits. As a result, in February of 2009, George's

¹⁰ 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.

Medi-Cal co-pay is \$0.00¹¹. Additionally, in March of 2009, and each month thereafter, George's Medi-Cal co-pay will be \$170.35¹².

Economic Results: With George and Betty expecting to pay \$6,000.00 per month for George's nursing home care, by immediately qualifying for Medi-Cal benefits, George and Betty will save \$6,000.00 in February of 2009, and \$5,829.65 in March of 2009 and each month thereafter.

Advantage of Medi-Cal Compliant Annuity Plan: George obtains immediate Medi-Cal eligibility.

Disadvantage of Medi-Cal Compliant Annuity Plan: If Betty pre-deceases the 79 month period certain term of her Medi-Cal Compliant Annuity, the Medi-Cal program will be entitled to be reimbursed for the Medi-Cal expenses paid on behalf of George¹³. In such an event, Betty's Medi-Cal 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 Medi-Cal benefits, does the primary beneficiary claim amount end at Betty's death, or does it continue until George's death?

Alternate Medi-Cal Compliant Annuity Plan: Assuming that the Medi-Cal program does not have a restrictive definition¹⁴ of "actuarially sound," Betty may want to reduce the period certain of her Medi-Cal Compliant Annuity to something less than 79 months.

¹¹ This amount was determined by reducing Betty's MMNA amount of \$2,739.00 by her monthly income of \$500.00 and George's monthly income of \$1,200.00.

¹² This amount we determined by reducing Betty's MMNA amount of \$2,739.00 by her monthly income of \$1,744.35, leaving a shortfall of \$994.65. With George's monthly income of \$1,200.00 being reduced by the \$994.65 income shortfall, less his \$35.00 monthly personal needs allowance, the net co-pay to the nursing home equals \$170.35.

¹³ On the assumption that George is still in the nursing home at the time of Betty's death.

¹⁴ To date, three states have re-defined the term "actuarially sound." In North Dakota, the term means "no shorter than 85% of the individual's Medicaid life expectancy." 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 term."

MEDI-CAL ANNUITY PLANNING FOR AN INDIVIDUAL – POST DRA

For purposes of an example, assume that California has implemented DRA. To illustrate the use of a Medi-Cal Compliant Annuity in an individual case, assume the following:

SHORT LIFE EXPECTANCY CASE: If the individual has a very short life expectancy, in light of his or her Medi-Cal life expectancy, a Medi-Cal 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 \$1,050.00. The Medi-Cal 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.

Medi-Cal Compliant Annuity Plan: In order to gain immediate Medi-Cal eligibility, Carol purchases a Medi-Cal Compliant Annuity with the \$134,900.00. The Medi-Cal Compliant Annuity is structured with 79 monthly payments of \$1,898.04. As a result of the Medi-Cal Compliant Annuity purchase, Carol becomes immediately eligible for Medi-Cal benefits, and her monthly Medi-Cal co-pay to the nursing home is \$2,913.04¹⁵. This amount was determined by totaling her monthly income from social security and her Medi-Cal Compliant Annuity, and reducing it by her \$35.00 monthly personal needs benefit.

Economic Results: If Carol dies in month 12, with the Medi-Cal program named as the primary beneficiary of her Medi-Cal Compliant Annuity, Medi-

¹⁵ (SS/\$1,050.00 + Medi-Cal Compliant Annuity/\$1,898.04) – Personal Needs Allowance/\$35.00 = \$2,913.04.

Cal will be looking to collect \$15,443.52¹⁶ for Carol's Medi-Cal room and board costs. With Carol's Medi-Cal Compliant Annuity having 67 monthly payments remaining - \$127,168.68, less the \$15,443.52 owed to Medi-Cal, Carol's children, as the secondary beneficiaries of her Medi-Cal Compliant Annuity, will receive \$111,725.16 in residual monthly payments. As a result, the Stand-Alone Medi-Cal Compliant Annuity Plan provided an excellent opportunity for Carol, in that she immediately qualified for Medi-Cal benefits, and she was able to provide a wealth transfer to her children.

LONG LIFE EXPECTANCY CASE: If the individual has a long life expectancy, in light of his or her Medi-Cal life expectancy, a Gifting/Short-Term Medi-Cal 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 February of 2009. Mary has limited furniture and personal property, a pre-paid funeral plan, and \$136,500.00 in savings accounts. Mary receives monthly social security income of \$1,100.00. Her nursing home bill is expected to average \$6,000.00 per month. Mary would like to qualify for Medi-Cal benefits as soon as possible, and provide a wealth transfer to her children.

Medi-Cal Compliant Annuity Plan: With the Gifting/Short-Term Medi-Cal Compliant Annuity Plan, Mary would immediately gift away \$71,105.42 of the \$134,500.00 spend-down amount. The immediate gift amount would create a 12.93 divestment penalty period¹⁷. As for the remaining spend-down amount of \$63,394.58, it would be immediately invested in a 13 Month Medi-Cal

¹⁶ This amount was determined by reducing the monthly Medi-Cal reimbursement rate by Carol's monthly Medi-Cal co-pay, and multiplying the result by 12 months. In addition to the Medi-Cal room and board costs, Medi-Cal will also be looking to collect for Carol's Medi-Cal prescription drug costs.

¹⁷ When the \$71,105.42 gift amount is divided by California's Monthly Divestment Penalty Divisor of \$5,496.00, the result equals a 12.93 month divestment penalty period.

Compliant Annuity¹⁸, which would pay Mary \$4,894.06 per month. Following the gift, and the purchase of the Medi-Cal Compliant Annuity, Mary would immediately apply for Medi-Cal benefits. With Mary being “otherwise eligible”, except for the divestment penalty period, she would be entitled to go on LTC Medi-Cal benefits following the 12.93 month divestment penalty period.

Economic Results: With the Gifting/Short-Term Medi-Cal Compliant Annuity Plan, Mary’s children will retain the gift amount of \$71,105.42. This is an excellent result when you consider that had Mary not done any Medi-Cal planning she would have exhausted her \$134,500.00 spend-down amount in approximately 27 months¹⁹.

Disadvantage: In order for Mary to receive an economic advantage, she has to live longer than the 12.93 month divestment penalty period.

CONVERTING AN IRA ACCOUNT INTO A MEDI-CAL COMPLIANT ANNUITY

Currently, California law treats a community spouse’s IRA account as a non-countable resource. In the case of the institutionalized person, if they are receiving periodic payments of interest and principal from their IRA account, the value of their IRA account is considered unavailable. Thus, in the case where an institutionalized person has an existing IRA account, such as a certificate of deposit, mutual fund, or money market account, and they want to transfer the account balance into an IRA Medi-Cal Compliant Annuity, they can do so by way of a “plan administrator to plan administrator 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

¹⁸ With Medi-Cal Compliant Annuities being issued in whole months, it is not possible to issue a Medi-Cal Compliant Annuity with a period certain of 12.93 months. Instead, a 13 month Medi-Cal Compliant Annuity will be issued.

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 \$134,900.00.

spouse's CSRA amount, the IRA account will need to be spent down. In community spouse cases, the Michigan Department of Human Services has ruled that the Medicaid Compliant Annuity that contains IRA funds is required to name the State Medicaid Program as the primary beneficiary to the extent that medical assistance benefits were provided to the institutionalized individual. In other states, such as Florida, if the community spouse utilizes a Medicaid Compliant Annuity with IRA funds, the State Medicaid Program is not required to be the primary beneficiary.

CONCLUSION

Even though DRA refined the rules related to annuities, if properly used, a Medicaid Compliant Annuity can provide excellent results.