



## The New Crisis Planning Strategy: How to Draft and Use DRA Compliant Promissory Notes

By: Michael J. Amoruso, Esq., ElderCounsel Principal



On February 8, 2006, President George W. Bush signed the Deficit Reduction Act of 2005<sup>1</sup> (“DRA”) into law. Portions of the DRA provide for the first monumental changes to Medicaid eligibility rules since OBRA 1993. Numerous states already have adopted enabling legislation to make the DRA effective in their states. To assist the states with interpreting the DRA, the U.S. Department of Health & Human Services’ Centers for Medicare & Medicaid Services issued SMDL # 06-018 to clarify the Federal government’s position on the DRA transfer of assets provisions.<sup>2</sup>

Given these changes, opportunities exist for elder law attorneys schooled in the sophisticated Medicaid eligibility rules to provide clients with asset preservation solutions. This article will provide an overview of the rules, drafting suggestions and tax considerations involving a tool offered by the DRA namely, the DRA compliant promissory note. It is important to note, however, that this article will only address this tool in the context of short term planning strategies to contribute towards the cost of long term care services throughout the duration of a properly triggered DRA Medicaid eligibility penalty period. In the event the reader is interested in utilizing these tools to plan for an estate where a promissory note will be utilized for a long term strategy or where the estate may be subject to gift and estate tax, then the reader must fully consider the impact of the federal and state estate tax laws and regulations in such situations. Such an analysis is beyond the scope of this article.

### I. THE STRATEGY

In a DRA world, asset preservation in the crisis plan fact scenario hinges upon dividing the client’s estate into two shares, namely, the gifted share and the DRA compliant share, and then transferring these shares out of the client’s estate. The objective is to preserve the gifted share while

utilizing the DRA compliant share as an income stream to contribute towards the cost of care during the Medicaid penalty period caused by transferring the gifted share. It is important to note, however, that this strategy is only appropriate in the situation when the client is in need of immediate institutional level care. This is due to the fact that the DRA mandates that the Medicaid penalty period (“Penalty Period”) on the transfer of the gifted share does not start until the A/R files an application for institutional Medicaid and would be eligible for such coverage except for the resulting Penalty Period. This is the point in time that the individual is receiving nursing home services<sup>3</sup>, and, Penalty Period aside, the A/R is otherwise financially eligible for institutional Medicaid (i.e., non-exempt assets < \$13,050 and available monthly income < medical expenses)<sup>4</sup>. If the client meets the level of care requirement and has monthly income that is less than the monthly cost of care, the transfer of the gifted share and the DRA compliant share out of the client’s estate will render the client “otherwise eligible” thereby triggering the penalty period for the gifted share.

The computation of the gifted share and the DRA compliant share requires a careful balancing of the desire to preserve the client’s assets, the need to obtain otherwise eligible Medicaid status and the ability to insure payment for the client’s care during the resulting Penalty Period. The key is that the DRA compliant share will return an income stream coupled with the client’s income (i.e., Social Security, pension, other income) that is slightly less than the private pay rate for the cost of care and will continue paying until the Penalty Period expires. At that point, the gifted share is preserved and the client is eligible to receive Medicaid benefits.

It should be noted that the strategy may also be used to correct a post-DRA gift by the client made prior to meeting with the elder law attorney. In such a case, where a return of the previously gifted funds is not available, the elder

<sup>1</sup>Public Law 109-171 (2006).

<sup>2</sup>Dennis G. Smith, “New Medicaid Transfer of Asset Rules Under the Deficit Reduction Act of 2005”, Center for Medicare & Medicaid Management, SMDL #06-018 (July 27, 2006).

<sup>3</sup>42 U.S.C.A. § 1396p(c)(1)(C)(i).

<sup>4</sup>42 U.S.C.A. § 1396p(c)(1)(C).

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law attorney's focus will shift from determining the gift share (since the client already made the gift) to calculating the appropriate payback timeframe of the DRA compliant vehicle to obtain "otherwise eligible" status, trigger the penalty on the previously made gift and insure a payment stream during the Penalty Period.

## II. THE DRA COMPLIANT PROMISSORY NOTE

A promissory note is a transaction where one party purchases ("Payee") from another party ("Maker") the promise to receive a specified sum with interest over a period of time. The DRA explicitly excludes funds used to purchase a promissory note if the note (a) has a repayment term that is actuarially sound as determined in accordance with actuarial publications of the Office of the Chief Actuary of the Social Security Administration; (b) provides for payments to be made in equal amounts during the term of the loan; (c) does not permit deferral or balloon payments; (d) prohibits the cancellation of the balance upon the death of the lender.<sup>5</sup> Any note that does not comply with all of these requirements shall be deemed an "asset" for the transfer of assets provisions of the DRA and the value of the note will be the outstanding balance of the note on the date of application.<sup>6</sup>

**Drafting Tip:** As mentioned above, be certain that the face of the note addresses each of these DRA requirements. The DRA gratuitously informs us how a note can avoid transfer of asset treatment and such suggestions should be adhered to by the elder law attorney.

It is important, however, that the elder law attorney does not get lost in the trees when drafting a promissory note that complies with the DRA. Arguably, even a note that complies with the DRA still may be deemed an available resource for determining Medicaid eligibility. For example, in New York, the New York State Medicaid Reference Guide explains that,

A promissory note is a written, unconditional promise, signed by a person, to pay a specified sum of money at a specified time or on demand to the person named on the note. A promissory note, if negotiable, is considered

a resource in the amount of the outstanding principal balance.<sup>7</sup>

In order to avoid treatment as a resource, the elder law attorney should insure that the promissory note does not fall into the category of a negotiable instrument as defined by the Uniform Commercial Code § 3-104. Specifically, Uniform Commercial Code defines a negotiable instrument as any writing that (1) is signed by the maker; (2) contains an unconditional promise or order to pay a sum certain money; (3) is payable on demand or at a definite time; and (4) is payable to order or to bearer.<sup>8</sup>

Complete drafting would suggest that the elder law attorney will draft the note by explicitly stating on the face of the note that it is non-negotiable, non-assignable and otherwise not transferable by the Payee. These precautions should remove the availability of the note from treatment as an available resource.

**Drafting Tip:** For added comfort, make the note even less attractive to a potential third party buyer. For example, (1) do not provide for acceleration in the event of default, (2) do not provide for an incremental increase in interest rate due to a missed payment or default, (3) do not add a provision authorizing the collection of attorneys fees in the event of default, and (4) do not waive the requirements for presentment, notice of dishonor and protest – make it difficult for a potential third party to enforce the note. Obviously, the import of these suggestions must be thoroughly discussed with the client prior to including them in any document.

It is important to note that, practically, the promissory note is a document that may be easier for the client, the Medicaid caseworker and the elder law attorney to comprehend and utilize. Unlike a private annuity transaction, the promissory note is not subject to the Internal Revenue Code's annuity factors, linear interpolations, interest rate, and calculation of the return of ordinary income and capital gain with each monthly payment. Instead, the promissory note merely requires the calculation of a monthly loan amortiza-

<sup>5</sup>42 U.S.C. § 1396p(c)(1)(I).

<sup>6</sup>*Id.*

<sup>7</sup>New York State Medicaid Reference Guide at 269.

<sup>8</sup>UCC § 3-104(1) (McKinney's 2006).

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tion schedule based upon a reasonable rate of interest until the desired time to zero out the note is reached – typically, this should be at the expiration of the penalty period. It is important to remember, however, that the final payment of the note must be within the life expectancy tables required by the DRA.

There are, however, tax considerations that must be discussed with the client and their income tax advisor. First, the interest received by the Payee (our client) will be considered taxable income. Hopefully, during the time the note is repaid, the client will be entitled to take the medical expense deduction assuming that the cost paid to the nursing home exceeds 7.5% of the client's adjusted gross income. On the other side of the transaction, assuming that the Maker deposited the lump sum of principal into an investment account to generate the required interest payment, the interest generated would be subject to income tax for the Maker. However, it would be important for the Maker to consult their accountant to ascertain whether the investment income expenses deduction is available to the Maker.<sup>9</sup>

## 1. Fair Hearing Decisions.

Recently, the State of New York has approved the use of a DRA compliant promissory note to achieve the objective of this strategy. See Matter of Geraldine A, Matter of Anna M. and Mary K.

## III. PUTTING THE ANNUITY OR PROMISSORY NOTE INTO PRACTICE:

Case Study for Discussion: Assume the following facts: Client is 83 year old woman in a New York City nursing home and has \$246,875 in cash. The Private Pay rate is \$360 per day. The client's income is limited to Social Security and a VA benefit totaling of \$1,473 per month. The New York City regional rate is \$9,636 and the Medicaid individual resource amount is \$13,050.

How will a post DRA promissory note strategy assist this client? After crunching the numbers to determine the DRA compliant share, the gifted share and the amount to retain in the Client's name the following asset preservation can be achieved:

- Gift \$125,875

<sup>9</sup> Consult IRS Form 4952 to determine whether or not applicable.

- Causes a 13.06 month penalty period (4//2008-5/2009)
- Transfer \$118,000 in exchange for a DRA compliant promissory note
  - Term (Months): 13
  - Interest Rate: 3.45% (April 2008, 7520 Rate)
- Keep \$3,000 in Client's name as she can have up to the Medicaid resource amount (\$13,050 for New York).
- PN will "zero-out" in 13 months by paying \$9,260.64 month (principal and interest)
  - April 2008 Private Pay Rate = \$10,800
  - Total income = \$10,733.64 (\$1,473 + \$9,260.64 Promissory Note Payment)
  - Medical expenses exceed income by \$66.36 = OTHERWISE ELIGIBLE!!
- What is preserved?
  - \$125,875 = 51% !!!! -if interest generated
  - \$123,486.60 = 50% !!!! -if interest paid out of the gift

As the numbers reveal, with the proper guidance from an experienced elder law attorney schooled in the DRA compliant promissory note strategy, the client can properly preserve assets while insuring that their long term care expenses are paid with the returning income stream from the promissory note during the resulting period of Medicaid ineligibility caused by the gift.

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