

How to draft and use DRA compliant promissory notes

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As we all know, on Feb. 8, 2006, President George W. Bush signed the Deficit Reduction Act of 2005² (the DRA) into law. Portions of the DRA constitute the first monumental changes to the Medicaid eligibility rules since OBRA 1993. By now, most states have adopted enabling legislation and/or rulemaking implementing the DRA, with only a handful of states yet to do so. To assist the states with interpreting the DRA, the Center for Medicare & Medicaid Services issued a transmittal on July 27, 2006 (Transmittal SMDL # 06-018), arguably to clarify the federal government's position on the DRA transfer of assets provisions.³

We in Florida approached the new DRA provisions with trepidation, not knowing how or when the DRA would be implemented. Yet, one area where the elder law bar considered there to be an expanded planning opportunity was in promissory note planning. Since December 2004 (later extended to March 2005), the Florida Department of Children and Families effectively eliminated the use of all promissory notes as a planning tool via the issuance of the now infamous promissory note transmittal. Then along came the DRA, with provisions that seemed to revive the use of notes in the planning process by setting clear guidelines, which, if followed, deemed the use of a note *not* to be a transfer of assets subject to a penalty period. Given these changes, an opportunity existed for Florida elder law attorneys well versed in these sophisticated Medicaid eligibility rules to provide clients with an additional asset preservation solution. This article will provide an overview

of the rules, drafting suggestions and tax considerations involving the DRA compliant promissory note in “Non-Partial Return of Funds States” and in “Partial Return of Funds States” (Florida being a Partial Return Funds State).

The promissory note strategy in ‘Non-Partial Return of Funds States’ versus ‘Partial Return of Funds States’

In some states (Florida is not one of them), the post-DRA world resulted in a situation where asset preservation in the crisis planning scenario hinged upon dividing the client's estate into two shares; namely, the “gifted share” and the “DRA compliant share,” and then transferring both of these shares out of the client's estate. The need to create these two shares emanated from the state's position that if any assets were returned to the applicant subsequent to the initial transfer of funds (bringing the applicant below the applicable resource allowance), this return of funds rendered the individual otherwise *ineligible* for Medicaid and precluded the triggering of a penalty period under the new DRA transfer of asset rules (let's call these states “Non-Partial Return of Funds States”). Thus, promissory note planning in Non-Partial Return of Funds States had as its primary objective the preservation of the gifted share while utilizing the DRA compliant share (or the share transferred pursuant to the terms of the promissory note) as an income stream to contribute toward the cost of care during the Medicaid penalty period caused by transferring the gifted share. All other factors of eligibility must be satisfied to use the DRA compliant note in crisis planning. Thus, this strategy is only appropriate in Non-

Partial Return of Funds States in the situation where the client is in need of long-term care services (defined in some states to mean nursing home level of care, whereas other states follow the federal definition of long-term care as being the type of care provided in a nursing home setting, but which can also be provided in any other type of setting or through a home and community based waiver program). And as we know, the DRA mandates that the Medicaid penalty period on the transfer of the gifted share does not start until the applicant *files* an application for 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 long-term care services,⁴ and penalty period aside, the applicant is otherwise financially eligible for institutional Medicaid (i.e., non-exempt assets are less than the state's resource allowance and available monthly income is less than monthly medical expenses).⁵ 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” for Medicaid, 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 ensure 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 and other income) that is slightly less than the private pay rate for the cost of care

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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 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 promissory note to obtain "otherwise eligible" status, trigger the penalty on the previously made gift and ensure a payment stream during the penalty period.

Since Florida is a Partial Return of Funds State, meaning that a simple return of funds will not affect the "otherwise eligible" status of the individual, the need to use promissory note planning in a crisis situation did not (and still does not) exist. Nevertheless, it seemed rather odd, and a bit incongruous, that the DRA should specify parameters for the use of promissory notes, outlining the circumstances where such notes would not result in a transfer of assets/penalty period, and yet the Florida Med-

icaid agency refused to allow the use of such notes, declaring informally in discussions with the Joint Public Policy Task Force that notes would nevertheless be treated as an *available resource* (note the distinction between imposing a penalty period and treating the note as an available resource). The story of how Florida Medicaid came to reverse its position on the so-called secondary market issue, thereby allowing Medicaid to take the position that a DRA compliant promissory note could be treated as an available resource, is detailed in a prior article on the subject which appeared in the Spring 2010 issue of *The Advocate*. Once Florida began to allow the use of promissory notes (as per the January 2010 change in the ESS Manual), meaning that a DRA compliant note was neither a transfer of assets for penalty period purposes nor an available resource due to the secondary market issue, the use of notes could be pursued.

So where would we use a promissory note in the planning process? One circumstance that comes to mind is that of a community spouse who could use a promissory note to reduce countable assets to below the CSRA of \$109,560, thereby eliminating the need to execute a spousal refusal. For many elderly spouses, the execution of a spousal refusal weighs heavily on their minds, and they would prefer not to proceed in this fashion if we, the elder law bar, could present a vi-

able alternative. The promissory note is such an alternative. By making a loan to a family member in exchange for a promissory note, the community spouse's resources are brought below the CSRA at the point of application for Medicaid benefits for the ill spouse. This unmarketable income stream would constitute income to the community spouse, but not a resource, thereby avoiding the need to file a spousal refusal. Further, once the note is paid in full, because a spousal refusal was *not* filed, the community spouse could then request diversion of the ill spouse's income if necessary to bring the CS up to the maximum MMMNA level.

Another use of the promissory note in a Partial Return of Funds State is where the elder law attorney has concerns about the person designated by the client to receive the "loaned" funds that are intended to be returned. In a Partial Return State, such as Florida, a typical planning example would require that all but just under \$2,000 of an individual's funds be transferred to a son or daughter, with the intent that approximately one-half of the funds constitute a gift and the other one-half constitute a pool of funds that are intended to be returned to assist the individual with the payment of long-term care costs while the penalty period is running. What would happen if the son or daughter was involved in a lawsuit and a judgment was entered against him or her? Suppose the applicant's son or daughter needed the funds to cover college expenses for a grandchild. Any one of a number of life events could cause the unavailability of funds that were designated to be returned, and this would cause problems for the elder law plan after the train has already left the station. One way to protect against this result is by entering into a promissory note with the son or daughter, thereby creating a legal obligation to pay back the "loaned" funds, and if no payment is forthcoming, it puts the applicant in a better position vis-à-vis Medicaid because a legal note was entered into and an action to seek the return of the funds

can be brought. It justifies the loan as a legitimate legal transaction that, if it falls apart, gives rise to a possible undue hardship claim should the funds not be paid back as required under the note.

The DRA compliant promissory note

A promissory note is a transaction where one party purchases (the payee) from another party (the 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

1. 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;
2. provides for payments to be made in equal amounts during the term of the loan;
3. does not permit deferral or balloon payments; and
4. prohibits the cancellation of the balance upon the death of the lender.⁶

Any note that does not comply with *all* of these requirements shall be deemed an “asset” for purposes of the transfer of asset provisions of the DRA, and the value of the transferred asset will be the outstanding balance of the note on the date of application.⁷

Drafting tip - Be certain that the face of the note addresses each of the foregoing DRA requirements. The DRA graciously informs us how a note can avoid transfer of asset treatment, and these guidelines should be strictly 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 transfer of asset provisions (meaning that no transfer penalty will apply) still may be deemed an

available resource for determining Medicaid eligibility.

To avoid treatment as an available resource, the elder law attorney should ensure that the promissory note is not categorized as a negotiable instrument. Proper drafting would suggest that the elder law attorney should 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 by Florida’s Medicaid agency, particularly after the January 2010 alteration to the language in the ESS Manual at Section 1640.0561.03.

Drafting tip - For an added level of 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 attorney’s 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.

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 use. 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 amortization schedule based upon a reasonable rate of interest until the desired time to zero out the note is reached. (In Non-Partial Return of Funds States, this would be at the

expiration of the penalty period. In Partial Return of Funds States, this could be any amount of time desired as long as it was actuarially sound.) It is important to remember, however, that the final payment of the note must be scheduled to occur within the life expectancy tables required by the DRA. Further, the state need not be named as a remainder beneficiary with the use of notes as is the case with annuity transactions.

There are, however, tax considerations that must be discussed with the client and his or her income tax advisor. First, the interest received by the payee (our client) will be considered taxable income. In Non-Partial Return of Funds States, during the time the note is repaid, the client will be entitled to take the medical expense deduction, assuming that the long-term care costs exceed 7.5 percent 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 his or her accountant to ascertain whether the investment income expenses deduction is available to the maker.⁸

Putting the promissory note into practice

Non-Partial Return of Funds State

First, let’s see how a promissory note would operate in a state such as New York, which is a Non-Partial Return of Funds State. Assume the following facts: Client is an 83-year-old woman in a Westchester, New York, nursing home and has \$215,000 in cash. The private pay rate is \$400 per day. The client’s income is limited to Social Security and a VA benefit totaling \$1,473 per month. The Westchester regional rate is \$10,163 (the applicable divisor, as we call it in Florida), and the Medicaid individual resource amount is \$13,800 (the applicable

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DRA compliant
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resource allowance in New York).

How will a post DRA promissory note strategy assist this client? How does the attorney implement this strategy?

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:

suggested above, the strategy could be used in a spousal planning scenario, whereby assets of the community spouse are made the subject of a note to the extent such assets exceed the CSRA. This allows the CS to avoid executing a spousal refusal and the concomitant emotional distress that goes along with that planning strategy, while achieving the same if not better results from an income diversion standpoint.

Let's assume the same facts as set forth above in our crisis planning

resource allowance. The calculation would look like Table 1, below.

In this case, if the Medicaid eligibility date is May 2010, then the note would be entered into as of that date so as to remove the funds from the name of the CS. Thus, as of the snapshot date, the CS has an amount equal to or less than \$109,560 and need not execute a spousal refusal. Then, as long as the repayment terms are such that level payments are required to be made and the note is actuarially sound based on the life expectancy of the CS, the note will be a DRA compliant promissory note and will not result in a penalty period for purposes of establishing the institutionalized spouse's Medicaid eligibility. In fact, the note could be structured to pay back using a shorter term than might be advisable in a Non-Partial Return of Funds State because we don't need to concern ourselves with scheduling the note payments for any specific length of time (in a Non-Partial Return of Funds State for the length of the resulting penalty period). Thus, a repayment term of two months is conceivable, thereby giving the CS her excess funds back in a relatively short period of time while still avoiding the filing of a spousal refusal.

In addition, the CS could then seek diversion of the institutionalized spouse's income since a spousal refusal was not filed (in Florida, a spousal refusal eliminates the possibility of seeking an increased MMMNA). The diversion could not be sought at the time of the filing of the Medicaid application because while the note payments are being made, the note payments constitute income to the CS, and this additional income would clearly eliminate the ability to seek diversion.

- **Gift \$103,251.76 in April 2010**
 - Causes a 10.16 month penalty period (May 2010 – June 2011)

- **Transfer \$101,748 in exchange for a DRA compliant promissory note**
 - Term – 10 Months
 - Interest Rate: 3.25% (April 2010, IRC Section 7520 Rate)

- **Keep \$10,000 in client's name since she can have up to the Medicaid resource amount (\$13,800 for New York in 2010)**

- **The Promissory Note will “zero-out” in 10 months by paying \$10,327 month (principal and interest)**
 - 2010 Private Pay Rate = \$12,000 (30-day month)
 - Total income = \$11,800 (\$1,473 + \$10,327 Promissory Note Payment)
 - Medical expenses exceed income by \$200 = OTHERWISE ELIGIBLE

- **What is preserved?**
 - \$103,251.76 = 51% – of net assets
 - Medical expenses exceed income by \$200 = OTHERWISE ELIGIBLE

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 ensuring that her 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.

scenario in a Non-Partial Return of Funds State such as New York. However, instead of the A/R making the loan, the community spouse makes a loan equal to available assets, less the institutionalized spouse resource allowance, less the community spouse

Table 1

\$215,000	Available Cash
(\$2,000)	Less Institutionalized Spouse Resource Allowance
(\$109,560)	Less Community Spouse Resource Allowance
\$103,440	Equals Amount of Promissory Note/Loan

Partial Return of Funds State

In a state such Florida, which permits a partial return of funds, the promissory note is not essential to achieve a so-called reverse rule of halves planning result. Instead, as I

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Endnotes:

1 This article is based upon an article written by Michael J. Amoruso, Esq., which appeared in the *Elder Law Attorney*, a publication of the New York State Bar Association. The article was rewritten to address the use of promissory note planning in the state of Florida.

2 Public Law 109-171 (2006).

3 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).

4 42 U.S.C.A. § 1396p(c)(1)(C)(i).

5 42 U.S.C.A. § 1396p(c)(1)(C).

6 42 U.S.C. § 1396p(c)(1)(I).

7 *Id.*

8 Consult IRS Form 4952 to determine whether or not applicable.

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