ADVANCED PLANNING

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See Circular 230 disclosure at the end of this article.

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New Law Complicates Medicaid Planning: Deficit Reduction Act of 2005, Public Law No. 109-171

Overview: President Bush signed the Deficit Reduction Act of 2005 (DRA 2005) into law on February 8, 2006. The Act includes some significant changes to Medicaid eligibility requirements that will be of interest to advisors who work with elderly clients. The most significant changes tighten the rules regarding eligibility for assistance if an applicant has given away assets and limit the viability of converting available assets (also known as "countable" assets) to an annuity where the goal is to qualify for assistance but still leave something to children. The rules are effective as of February 8, 2006 although the states are given a grace period for implementing these changes if new legislation is needed to bring the state Medicaid plan into compliance.

Eligibility for Medicaid: Medicaid is a combined federal and state assistance program designed to pay for the non-Medicare covered medical care of those with meager assets. Because Medicare only covers nursing home care for a limited period after a hospital stay, Medicaid is the primary source of funds for nursing home care for those with few assets. To qualify for assistance, in most states, an applicant cannot have more than $2,000 in countable assets. Exempt assets include a personal residence, automobile, prepaid funeral plans and an allowance for the applicant's spouse to have countable assets generally in the range of $100,000. Under prior law, there was no cap on the value of the home, but DRA 2005 places a $500,000 cap on the value of the residence with an option for states to increase the cap to $750,000. The cap does not apply to a Medicaid applicant who has a spouse or dependent children living in the home. While there is a limit on the amount of the spouse's countable assets, there is generally no limit on the amount of the spouse's income or a requirement that it be used to pay for the spouse's nursing home care. The eligibility requirements attempt to strike a balance between a valid need for assistance and the availability of financial resources for the spouse and dependent children.

Meeting the Asset Test: The theory behind the asset test is that an individual becomes eligible for Medicaid after spending all countable assets. Many elderly with modest means would rather leave a legacy to their children than spend their hard-earned assets on nursing home care. To achieve that goal, the logical course is to give assets to children in order to lower the countable assets below the eligibility limit. To prevent abuses of the Medicaid system, Congress previously enacted rules that imposed a look back period (three years for outright transfers and five years for transfers in trust). Any gifts during the look back period are used to calculate a penalty or waiting period before being eligible for Medicaid. The penalty or waiting period is calculated by dividing the amount of the gifts within the look back period by the average monthly cost of nursing home care. The penalty or waiting period started on the date of the gift. For example, if the average monthly cost of nursing home care was $5,000 and an individual gave $50,000 to her children in January 2003 and applied for Medicaid before January 2006, her period of ineligibility would be the 10 months following the date of the gift.

The rules enacted in DRA 2005 impose a look back period of five years for any gifts, whether made outright or in trust. In addition, under the new rules, the period of ineligibility doesn't start until the later of the first day of the month when:

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- the individual applies for Medicaid,
- the individual is receiving institutional level care, and
- the Medicaid application would be approved but for imposition of a penalty period at that time.

Under the new rule, an applicant who gives $50,000 in July 2006 would trigger the start of a penalty period if she otherwise meets the requirements and applies for Medicaid at any time before July 2011. For example, if she applies for Medicaid in January 2011 and the average monthly cost of nursing home care is $5,000, she will have to wait 10 months after applying for Medicaid before receiving any benefits.

Annuities: In the past, the purchase of annuity was not considered a gift that triggered a look back period as long as the annuity met certain requirements. Immediate annuities were used to provide an income stream to the spouse and to continue to children. For a single person, the income stream was provided to the applicant with the hope that the annuity payments would continue beyond the applicant's life and then be available to children.

Under DRA 2005, an immediate annuity can still be an effective technique to convert countable assets to an income stream for the spouse (because the spouse's income is still not considered when determining Medicaid eligibility) or, in the case of a single person, for the applicant. However, the new rules provide that the purchase of an annuity will not be a gift if (1) the state is named as primary beneficiary for at least the amount of medical assistance paid; or (2) the state is named as contingent beneficiary after the applicant's spouse, minor child or disabled child. In addition, the state must be given priority if the spouse or a representative of the minor or disabled child disposes of any remainder interest in the annuity for less than fair market value. This provision protects the financial security of the spouse or dependent child but forecloses the opportunity to use an annuity to pass assets to independent adult children without paying a toll to the state for the Medicaid assistance provided to the parent.

Hardship Waiver: While the new rules may seem onerous, they do include a provision which mandates that each state have a process for seeking a hardship waiver of the period of ineligibility where its application would deprive an individual of medical care that would endanger health or life, or deprive the individual of food, clothing and shelter. The law requires the states to notify Medicaid applicants who are subject to a period of ineligibility of their right to request a waiver, and it requires states to provide for a timely process for determining whether hardship exists.

Comment: Although the purchase of annuities can fit in a plan for Medicaid eligibility, the rules are exceedingly complicated. If asked about planning for Medicaid eligibility, a Financial Representative should refer the client or prospect to a professional who specializes in that area of the law.

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A New York StOLI State of Mind: The Beginning of the End?: Office of the General Counsel, Opinion 05-12-15 (December 19, 2005)

The Office of General Counsel, representing the New York State Insurance Department, opines that no insurable interest is present, at policy application, for so-called "StOLI" policies and expresses concern that these arrangements may involve rebating.

For those uncertain as to what "Stranger-Owned Life Insurance"[1] is, or how it came about, here's a down-to-earth tale:

> You are part of a big money investor group looking for a very good "guaranteed" rate of return. Somebody "blue sky's" this: "I got it! Let's buy gobs of insurance on a whole bunch of people. They'll die by the numbers, and we'll make a killing!" Another snorts, "Yeah? So we insure a bunch of 30 year olds and never live to see the profit?" Ok, so you start to build a profile for the "bunch": must be at least age 60 with a net worth of over $5 million (to get a good initial face amount) and must be … insurable *and* not really need or want insurance.
>
> "Still no good" says another. "I happen to know that you can't insure just anybody. First, they have to *know* – have to sign as insured on the application. Second, insurance companies don't let you own insurance on somebody else's life unless you have an 'insurable interest': you gotta be blood or marriage – related, or you have to suffer significant economic loss if that person dies – like in a business relationship."
>
> The initial blue-skier's brow is clouded in thought. The clouds clear, and he blurts, "No problem! We'll entice our target group to buy the insurance to begin with, then we'll buy it from them." Someone with legal knowledge pipes up, "Nice going, but buying the policy turns the death benefit into taxable income under the 'transfer-for-value' rule. Besides, who will shell out cash for premiums up front even if we buy them out with a kicker?" The ringleader responds, "No sweat. As to the initial premiums, we'll front that money as a loan. When we buy the policy, say in two years, we make sure that the insured ends up paying nothing: we'll buy the policy for the lent premiums plus any interest! As to the death proceeds being taxed, who cares? Crunch the numbers and we still have a __% return."
>
> "OK, Einstein, but where do we find this target group?"
>
> "Wherever. Hit charities. They have long lists of donors. We'll throw in some booty for the charity. Otherwise, we'll hit insurance companies looking for premium dollars with products priced to fly off the shelves, and market the thing hard to independent brokers looking for a win-win-win (gosh even I hate that term) sale."

[1] Also known as "IOLI," "CHOLI" or "LILAC."

Facts of Proposed New York Transaction: The insured applies for and owns a policy on his life, naming his personal beneficiary. A "loan provider" (the investment group) lends the first two premiums to the insured. Insured, after two years, can exercise a "put" option – compel a "third party" hedge fund to buy the policy for an amount roughly equal to the lent premiums plus interest thereon. If the "put" is not exercised, insured must repay the loans in full plus interest and is responsible for all future premiums. The loan provider's relationship with the insured, and any policy interest, would terminate.

New York State Insurance Department's Opinion:

> … [B]ased on our review of the transaction it appears that the arrangement is intended to facilitate the procurement of policies solely for resale. It is our view that a plan of this nature does not conform to the requirements of the New York Insurance Law. First, the policies obtained by the Clients herein are arguably not obtained "on [their] own initiative" as required by N.Y. Ins. Law § 3205(b)(1). Secondly, the potential transferees do not appear to have a legitimate "insurable interest" in the lives of the Clients.

This holds, even though New York law allows an immediate transfer of an issued policy, irrespective of insurable interest, because:

> While it is true that N.Y. Ins. Law § 3205(b)(1) expressly allows an individual to procure and immediately transfer or assign to another a policy on his own life, irrespective of the existence of an insurable interest in the assignee, … it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity … is contrary to the long established public policy against "gaming" through life insurance purchases.

The opinion also expresses a concern that the transaction involves the rebating of premiums because it is designed from the outset to provide free insurance to the initial buyer for two years.

Analysis: The issue with StOLI has never been whether federal tax law allows it: it does. The question has always been, does the arrangement meet state law insurable interest standards? We have always concluded that it does not.

Many states require, like New York, that no person shall cause insurance on another to be procured unless the death benefit is payable to someone with an insurable interest at the time the policy is issued. Taken literally, these plans seem to comply with this requirement (at policy issue, the insured is the policy owner and the insured's blood relative is the named beneficiary).

But New York has quite properly chosen to view this as a cardboard and grease paint façade. This is not a matter of New York just disregarding the letter of its own law. Rather, it sees through the transparency of the guile. These policies are caused to be issued with the

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inducement, premeditated design and overriding plan that, right from the start, the *intended* and *ultimate* takers of the policy proceeds will *not* have an insurable interest – that the issuance of these policies is engineered by big money investors purely as an investment.

What Does This Mean? We don't exactly know. For example:

- Will policies already issued in New York be subject to this standard?
- If so, will the policies be deemed absolutely void from their beginning, with premiums to be refunded?
- Will New York enforce its concern about rebating?
- What sanctions can be brought against insurance companies and/or agents who knowingly facilitate these plans (e.g., prohibition from doing insurance business in New York, or loss of agent's New York insurance license)?
- Will there be a heightened "due diligence" standard for insurance companies or agents to inquire about whether investor financing is behind the purchase?
- Since a number of states maintain reciprocity regarding, for example, New York's determination to ban a company or agent from doing insurance business in New York, can an insurance company be banned, in practical effect, from conducting its business on a nationwide basis?

Warning For Professionals In New York: StOLI transactions do not meet insurable interest standards and are not permissible under New York law and may constitute rebating. Although not certain at this time, companies, organizations, or individuals who participate in them could be subject to sanctions or, at the least, have insurance policies sold under these pretexts voided.

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Escrowed Buy Sell – Undercover Cross Purchase!

Bree, Gabrielle, Lynette and Susan are equal shareholders in Wisteria Lane Publishing Inc. (WLP), an S corporation. Being astute businesswomen, they want to have a buy-sell arrangement. They are primarily interested in funding any sale which would occur at the death of any of them. Having looked at all the pros and cons of the entity purchase and cross purchase arrangements, they decide that the cross purchase arrangement gives them the advantages that they are looking for. Nevertheless, there are a couple of disadvantages that they want to eliminate if they can.

The first disadvantage is that they need 12 life policies to fund the arrangement (as opposed to four policies in an entity purchase arrangement), with each of them owning three policies, one on each of the others. An escrowed buy sell arrangement provides a way around this. In an escrow arrangement, a third party, known as an escrow agent, handles all the administrative details on behalf of the business owners. He nominally owns life insurance policies on the business owners, collects the death proceeds and uses the funds to purchase the business interest of the deceased owner on behalf of the surviving owners. For all intents and purposes, an escrowed arrangement is a cross purchase arrangement, but with only one policy per person.

The ladies decide to name their trusted attorney, Karl, as the escrow agent. (None of the insureds should be the escrow agent to avoid estate inclusion.) Karl, as escrow agent, will be the owner and beneficiary of the four policies on behalf of the shareholders. He will keep an internal account for each owner and allocate a partial interest in each policy to the account of each shareholder who is not the insured on a given policy. For example, Bree's account will have a one-third interest in the policies on Gabrielle, Lynette and Susan; Bree's account will not have any interest in the policy insuring her life.

Let's say Bree dies. Karl collects the proceeds from the policy on her life. These proceeds are owned by Gabrielle, Lynette and Susan and are allocated to their accounts. Karl uses these funds to buy Bree's stock for the three surviving owners. Bree's estate receives the cash in this sale.

The second disadvantage is the transfer for value problem, under either a traditional cross purchase or escrow arrangement. The transfer for value rule converts the income tax free death proceeds into taxable income.[2] Again, let's say Bree dies. What happens to the interests that she owns in the policies on the other ladies? Because each surviving owner now has more stock, each should have more insurance on the others. So, Bree's interest in the policy on Gabrielle can be sold to Lynette and Susan and reallocated to their accounts; Bree's interest in the other two policies can also be similarly sold and reallocated. However, these transactions are transfers for value. If Gabrielle, Lynette and Susan are partners in a partnership (or co-members in an LLC taxed as a partnership) *at the time* these sales and reallocations take place, they have no transfer for value problem; a transfer to a partner of the insured is an exception. (A transfer to a co-shareholder of the insured is **not** an exception.)

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[2] If a life insurance policy or any interest therein is transferred for valuable consideration, the death benefit less basis is subject to income tax. Several exceptions to this rule exist. § 101(a).

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But forming a partnership or an LLC is not a flip suggestion on our part; we know that an entity with a valid business purpose must be created, books must be kept and income tax returns must be filed. Many clients, including our ladies here, don't want to be bothered with this paperwork – at least, not until the time when they really need the partnership to exist, i.e., after Bree's death and just before the sale and reallocation of the policies.

There is another alternative. They can solve this problem with some rather creative writing; the buy-sell agreement provides that if there is no partnership existing when this sale and reallocation is to take place, then Bree's interests in the policies are sold to WLP. After Bree's death, Gabrielle, Lynette and Susan can do one of two things.

1. Gabrielle, Lynette and Susan can form a partnership after Bree's death but before the sale and reallocation of the policies. Then the policies will be sold and reallocated among the survivors' accounts within the escrow arrangement, making sure not to allocate any interest in a policy to the insured's account. This meets the "transfer to a partner of the insured" exception to the transfer for value rule.

2. On the other hand, if they decide not to set up a partnership, Bree's interest in the policies will be sold to WLP. This meets another exception to the transfer for value rule – a transfer to a corporation in which the insured is a shareholder. In this instance, a combination plan now exists – part entity purchase and part cross purchase. So, let's say Gabrielle dies next. WLP receives 1/3 of the death proceeds and Karl as escrow agent receives 2/3. Gabrielle's estate sells her interest in WLP to Karl (on behalf of Lynette and Susan) and to WLP. True, the ladies now do not have purely a cross purchase arrangement, but they are the ones who get to decide that by deciding whether to form a partnership just after Bree dies.

Those with an eye toward simplicity might ask, why go to the complexity and cost of setting up an escrow arrangement? Why not just have the three non-insureds jointly own a policy on the insured (i.e., Gabrielle, Lynette and Susan jointly owning a policy on Bree's life)? You can do that and achieve precisely the same results – with the same transfer for value concerns – because the escrow plan is a joint ownership arrangement. But the escrow plan may offer two advantages: having Karl as escrow agent centralizes management and administration of the plan, freeing the four ladies to concentrate on the business, and; Karl's control safeguards the integrity of the transaction which could be compromised if Lynette balks and stymies the transaction by her power as a named joint owner of the policy.

For further information on buy sell planning, see:

- The Northwestern Mutual Guide to Business Continuation Planning
- Buy Sell Agreements Funded with Life Insurance
- The Escrowed Buy Sell Plan

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Transfer for Value
Private Letter Ruling 2006-06-027 (February 10, 2006)

The Service issues another Ruling confirming that the transfer of life insurance policies between two trusts that are grantor trusts with respect to the same individual is disregarded and, therefore, is not a transfer for value. See also, Sale of Policy to Grantor Trust is not a Transfer for Value, *Advanced Planning Briefs* No. 51, (January 3, 2003) and A James Bond Insurance Grantor Trust Ruling – Same Ingredients, But "Shaken, with a Twist", *Advanced Planning Briefs* No. 55 (May 9, 2003).

Gift Taxation
Private Letter Ruling 2006-08-011 (February 24, 2006)

Taxpayer is a member of Club, a country club which is a tax exempt (but not charitable) organization. Taxpayer gives money to Club. Clearly Taxpayer is not entitled to a charitable income tax deduction. But is the transfer a gift? And if so, is it a present interest that qualifies for the annual exclusion or a future interest? Generally, a transfer of property from an individual to a corporation is a gift from the individual to the shareholders of the corporation. Because Club operates for nonprofit purposes and not for the economic benefit of its members, the Service rules that a different rule applies – the transfer is a gift to the Club as a single entity rather than to its members. See Treasury Regulation § 25.2511-1(h)(1). Is this good or bad? Both. The Service concludes here that the gift is of a present interest and qualifies for the annual exclusion – good. But since it is a gift to Club as a single entity, there is only one recipient to count for annual exclusion – bad.

Accident and Health Plans
Speltz v. Comm'r, T.C. Summary Opinion 2006-25 (February 14, 2006)

Wife operates Daycare business as a sole proprietorship and provides Husband, a part-time employee, medical benefits. I.R.S. contests the excludability of the medical benefits from Husband's income and their deductibility by Daycare. Held: The benefits are excluded from Husband's income because they were received under a detailed written plan of which Husband had notice and knowledge. §§ 105 and 106. The court also found the benefit payments deductible because the amount was reasonable relative to Husband's duties at Daycare. Finally, Husband's participation in a separate health plan subsidized by his full-time employer does not affect deductibility of the benefits offered to him by Daycare. Only Wife, because she is self-employed, would not be able to deduct benefits when participating in a subsidized health plan. See § 162(l). Planning tip: Document, document and document some more to establish the legitimacy of an employer-employee relationship when family members are involved.

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Advanced Planning Bulletin – March 2006

Selected Provisions from the Deficit Reduction Act of 2005
Public Law No. 109-171

1. Financial Aid Methodology
Background: Federal needs-based aid for college generally depends on how much parents and their child can afford to spend and how much it costs. The amount each party can afford, known as their expected contribution, is based on their income and assets. As reported in a devilishly complex form known as the Free Application for Federal Student Aid (FAFSA), students are required to contribute a greater percentage of their income and assets to college costs than their parents. Under this new law, the calculation has changed, generally giving families a better chance to qualify for aid.

- A student's income protection allowance increases from $2,000 to $3,000 and expected contribution from assets decreases from 35% to 20% (effective July 1, 2007).
- Prepaid 529 plans are no longer a resource which reduces aid dollar for dollar (effective July 1, 2006).
- Section 529 accounts and Coverdell education savings accounts are not counted as student assets (effective July 1, 2006). Observation: Unfortunately, there is no guidance on how these accounts are now counted in the FAFSA. Stay tuned for additional information provided by the Department of Education—if we are lucky.

2. Pension Benefit Guaranty Corporation
- The per-participant premium charged to sponsors of defined-benefit pension plans increases for single-employer plans from $19 to $30. The per-participant premium for multi-employer plans increases from $2.60 to $8.00 (effective for plan years beginning after December 31, 2005 and indexed for wage growth).
- There is a new premium for sponsors of plans that are terminated on an involuntary or distressed-termination basis, payable for three years after the termination. The annual premium payment is $1,250 per participant. The premiums would not apply to firms liquidated by a bankruptcy court or to terminations after December 2010.

Circular 230
REG-122380-02 (February 2, 2006)

As we described in our July 2005 AP Bulletin, the Treasury Regulations that govern practice before the I.R.S. (Circular 230) create standards for written tax advice by practitioners. Not only are these standards potentially onerous, their applicability has been unclear because it is uncertain who exactly qualifies as a "practitioner" or what constitutes "practice before the I.R.S." For example, does it cover only those attorneys litigating cases or signing tax returns, or does it also reach those who simply write tax articles for mass consumption? Under newly proposed regulations (intended to give effect to amendments to Circular 230's enabling statute, 31 U.S.C. § 330 by the American Jobs Creation Act), practice before the I.R.S. now includes rendering written advice with respect to any entity, transaction, plan, or arrangement having a potential for tax avoidance or evasion. This is potentially sweeping because "advice" and "tax avoidance" are still undefined, so just writing "a §1035 exchange is tax free" might be advice that has tax

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avoidance potential. It gets worse. These regulations also call for *monetary penalties* to be imposed upon the practitioner (not the taxpayer) for violating the Circular. It's all a headache – and if you put something in writing, it's your headache – but remember all this can be largely avoided by inserting a disclaimer into your writings.

This publication is not intended as legal or tax advice; nonetheless, Treasury Regulations might require the following statements. This information was complied by the Advanced Planning Division of The Northwestern Mutual Life Insurance Company. It is intended solely for the information and education and/or promotional purposes of Northwestern Mutual Financial Network Representatives and advisors with whom they work. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Financial Representatives do not give legal or tax advice. Taxpayers should seek advice based on their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

- To comply with Circular 230

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