

## California's Implementation of the Annuity Provisions of the Deficit Reduction Act of 2005

by Timothy Millar, CFP®

On September 27, 2008, then Governor Arnold Schwarzenegger signed SB 483 (Kuehl), California's implementation of the Medi-Cal provisions of the Deficit Reduction Act of 2005 (DRA 05). SB 483 provides not only that implementation will not occur until regulations are adopted and filed, but also that each of the ten sections modified by the act will apply prospectively, stating:

*It is the intent of the Legislature that the provisions .... shall apply prospectively to any individual to whom the act applies commencing from the date regulations adopted pursuant to this act are filed with the Secretary of State.*

As a result, even after SB 483, implementation of changes required under DRA 05 has yet to occur. Further, with a clearly stated guarantee of prospective implementation if and when regulations are adopted, how should we be advising clients today? Is planning undertaken today protected from eventual implementation? And more specifically for this article, how should this affect the use of annuities as a Medi-Cal planning tool?

### Some confusion about retroactive implementation

The requirement that SB 483 be implemented prospectively may not protect planning undertaken today at least regarding annuities. The reason for this is that while SB 483 will not be implemented retroactively, it does address actions undertaken prior to its enactment. Specifically, when implemented it provides that the new provisions on annuities apply to:

- Annuities established on or after February 8, 2006, or
- Annuities established before February 8, 2006, but subjected to a transaction (e.g. conversion from deferred to immediate, change in payment options, etc.) that occurred on or after February 8, 2006 [14009.6(b)]

So, even though the provisions of SB 483 as they relate to annuities cannot be applied retroactively, an annuity established prior to implementation, but on or after February 8, 2006, would still fall within the act, and could still potentially subject a beneficiary or spouse to the new rules.

For example, an annuity purchased on March 10, 2007 could not be subjected to the provisions of SB 483 before new regulations were filed. However, once filed, the annuity could be covered by its provisions. Thus, even with a ban on retroactive enforcement, planning steps taken today must consider the impact of SB 483 and be made with the assumption that the new provisions will apply.

### Annuities before SB 483

The financial criteria for determining eligibility for Medi-Cal benefits is fundamentally based on measuring the level of countable assets held by an applicant and, if applicable, the spouse.

While excess assets will disqualify an applicant from Medi-Cal eligibility, income has no impact on eligibility for Long Term Care (LTC) Medi-Cal. (Of course, income does have an impact in Medi-Cal planning in terms of its effect on Share of Cost.)

This distinction, assets vs. income, creates some interesting conflicts in the eligibility picture. For example:

- One might assume that the financial criteria for eligibility would be based on the relative financial strength of the applicant. However, Medi-Cal criteria are biased in favor of income (which, after all, is not even a component of eligibility determination for LTC Medi-Cal) and against assets. Thus, an applicant who was employed in a field where compensation was skewed away from direct compensation (future assets) toward a generous pension benefit (future income) is likely to find it much easier to gain eligibility for Medi-Cal benefits even though they may be in a financially more secure position
- Even an applicant without a direct pension but who was fortunate enough to work for a company that provided defined contribution benefits (e.g. 401(k), 457, 403(b)) is more likely to be found eligible since these accounts, if in proper distribution, are also counted as income and will be ignored in eligibility determination.
- On the other hand, applicants who worked in a field with no or limited pensions or retirement benefits, or who worked for less generous employers will find themselves disadvantaged. First, they are more at risk of having inadequate funds for retirement or to pay for care in the first place. Second, any funds they were able to accumulate on their own, except for the limited amounts they may have been able to make in the form of IRA contributions, would be ineligible for the tax-advantaged treatment available to qualified retirement plans. But finally, any assets they do accumulate to survive during retirement would be fully counted against them in determining their eligibility for Medi-Cal coverage.

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### **Enter Fixed Immediate Annuities**

Fixed Immediate Annuities, as a financial tool, provide a substitute for people not fortunate enough to have a traditional retirement account. And while there are advantages and disadvantages of using annuities as a financial tool, they are designed specifically to provide a secure level of income during retirement. In a fixed immediate annuity, an insurance company, in exchange for a deposit of assets, guarantees the payment of income (usually monthly) to an annuitant either for a set period of time, for the lifetime of the annuitant, or for some other period, thus converting what would be an asset, into a stream of income.

Medi-Cal has also historically allowed the use of annuities in the same way. By purchasing an immediate fixed annuity (while following regulations governing Medi-Cal eligibility), an applicant can effectively convert otherwise countable assets to non-countable income. While the cost of care might be impacted as a result of an increased Share of Cost, the applicant's financial security can be better preserved both for his/her wellbeing or that of a surviving spouse.

Under the current rules, it is fair to summarize the treatment of annuities in the following manner:

- (1) Immediate Annuities are treated as income, not assets.
- (2) Deferred Annuities are treated as assets, not income even though they may make distributions similar to immediate annuities.
- (3) Annuities established with guarantee periods longer than life expectancy are treated as partial transfers and therefore may result in a period of ineligibility for benefits.
- (4) Annuities purchased prior to September 1, 2004 are not subject to recovery. Annuities purchased on or after September 1, 2004, are subject to recovery. However, annuities (or any other asset) not owned by the beneficiary at death are not subject to recovery.

### **Annuities after SB 483**

SB 483 does not fundamentally change the existing rules regarding the treatment of annuities. Immediate annuities, properly structured, are still unavailable assets for eligibility purposes. The effect of the law is to make it more likely that the state will be able to recover against an annuity after the applicant and spouse's death.

### **Exclusions from the annuity provisions**

The new law carves out many annuities as exempt from most of the new provisions of SB 483. First, as mentioned above, the new rules only apply to annuities established on

or subjected to a transaction after February 8, 2006.

Further, the law exempts the following annuities:

- (1) Annuities that are part of the CSRA, or [14009.7(a)]
- (2) Annuities purchased by the Community Spouse after eligibility has been established, or [14009.7(b)(1)]
- (3) Annuities that are inside of a qualified retirement account, or [14009.7(b)(1)]
- (4) Annuities that meet all of the following requirements [14009.7 (b)(3)]:
  - Irrevocable and Non-Assignable
  - Actuarially sound
  - Make only level payments with no balloon payments

Some have misinterpreted these rules to mean that annuities not meeting these requirements are no longer available as a planning option. This is not the case. The rules only state that annuities that do not meet one of these exemptions are subject to the new requirements under this section of SB 483. If a contract does meet one or more exemptions, it is not subject to the new rules.

### **New provisions of SB 483**

So what are the new requirements for annuities that do not fall under one of the exemptions? Well, maybe less than might be expected. The new law requires that any interest in any annuity be disclosed in the application process. [14006.41(a)] However, full disclosure of financial assets in the application process has always been required. In fact, it is difficult to think of a situation under current law where an interest in any annuity would not be required to be disclosed at the time of application. Annuities that would be disclosed today will continue to be disclosable after SB 483 is implemented.

State as a Remainder Beneficiary: If, however, an annuity does exist that does not fall into one of the exemptions, SB 483 provides that the state be named as a remainder beneficiary (in the second position after a community spouse, or otherwise in the first position) to the extent of any post death Medi-Cal claim, [14009.6(a)] and further, that a refusal to affect this change will result in the annuity being treated as a transfer of assets. [14009.6(d)]

Keep in mind that this does not change the amount of the claim, nor the right of the state to recover from the estate. Nor does this change any current exemption against enforcement of a claim. The provision only allows the state

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an additional method to secure their right to recover against an annuity.

### **So which annuities are likely to become subject to SB 483?**

Most annuities which would be appropriate to use today for Medi-Cal planning will fit under one of the exemptions to DRA 05. Consider the case for a single individual and for a couple:

**Single Individual:** Annuities purchased to shelter assets for Medi-Cal eligibility purposes for a single individual are subject to estate recovery. As a result, annuities are usually not the planning tool of choice when planning for a single individual. Unless there is an unrelated exemption to recovery, funds saved by using an immediate annuity will likely be claimed by the state at death. And under SB 483 annuities used to shelter assets for single individuals may be even more likely to be subjected to a claim.

**Couple:** Unlike for single individuals, annuities remain a very viable tool where a couple is looking for eligibility for one spouse. Annuities can still effectively shelter assets, create eligibility, and preserve income and assets for the beneficiary, the surviving spouse, or others. In most cases, these contracts will not be subject to the additional requirements of SB 483 since they will meet the requirements of the exemptions.

**How about Balloon Annuities?** Annuities with a lump-sum payment at the end of the guarantee period (commonly referred to as a balloon annuity) are specifically mentioned in SB 483. While they would be exempt if part of a retirement account, purchased with part of the CSRA or purchased by the well spouse after eligibility is established, they fail the fourth, general exemption, since by definition they do not make level payments.

However, treatment of a balloon annuity for eligibility purposes is not changed by the new provisions. Rather, by naming the state as a remainder beneficiary, SB 483 would only serve to facilitate any existing right to recovery.

**A New Risk:** Estate recovery has always been limited to recovery against assets of the beneficiary. However, with the implementation of SB 483, the state is to be named a remainder beneficiary of all covered annuities. Covered annuities could include not only contracts owned by the beneficiary, but contracts owned by the community spouse, even those purchased with separate property of the community spouse. Thus unlike any other asset, these annuities could be subject to recovery even though not owned by the beneficiary at death.

Even if this were the interpretation, the impact will likely be small. First, the purpose of this planning is usually to preserve assets for the surviving spouse. Nothing in the new law changes any aspect of the use of annuities for this purpose. Recovery is not available while the community spouse is living. Second, even if the state chooses to and is able to assert a right against assets not in the ill spouse's name at death, that right would disappear once the annuity reached maturity. In other words the claim would only be effective if (1) the institutionalized person passes away before the annuity came to maturity, (2) the surviving spouse passes away prior to the annuity reaching maturity, and (3) no other exemption against recover exists.

The broader question is whether or not by allowing the states to expand recovery against annuities not owned by the Medi-Cal beneficiary, DRA 05 signifies a desire on the part of the federal government to expand the right of a state to recover against other assets not in the beneficiary's estate at death. Such recovery is, of course, currently prohibited.

### **Other Annuities**

Some have also feared that implementation could also result in other annuities, those not being used to shelter assets, becoming subject to an estate recovery. This is certainly not the case. First, in order for eligibility to exist, any "other annuity" would have to be either part of the CSRA (or part of the \$2,000 property reserve). The law provides that the new provisions do not apply to the portion of annuities which that are part of the CSRA [14009.7(a)]. Second, annuities purchased by the community spouse after eligibility has been established are also not covered by SB 483. [14009.7(b) (1)]

### **Conclusion**

While SB 483 prohibits implementation of DRA 05 until final regulations are filed, the provisions of the law will potentially apply to certain annuity transactions that take place prior to implementation. However, most annuities will not be subject to the new provisions due to broad exemptions under the law.

In general, the impact of SB 483 is to give the state an additional tool to secure their existing right to recover against certain annuities. However, and for the first time, though under limited circumstances, the law may expand the state's right to recover against certain annuities that are not owned by the Medi-Cal beneficiary at death.

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