

1999 DRAFTING REQUEST

Assembly Amendment (AA-AB133)

Received: **06/2/99**

Received By: **yacketa**

Wanted: **As time permits**

Identical to LRB:

For: **Legislative Fiscal Bureau 6-3912**

By/Representing: **Megna**

This file may be shown to any legislator: **NO**

Drafter: **yacketa**

May Contact:

Alt. Drafters:

Subject: **Public Assistance - med. assist.**

Extra Copies: **DAK**

Pre Topic:

LFB:.....Megna -

Topic:

MA divestment restrictions

Instructions:

See Attached;

Drafting History:

<u>Vers.</u>	<u>Drafted</u>	<u>Reviewed</u>	<u>Typed</u>	<u>Proofed</u>	<u>Submitted</u>	<u>Jacketed</u>	<u>Required</u>
/1	yacketa 06/5/99	gilfokm 06/5/99	martykr 06/6/99	_____	lrb_docadmin 06/7/99		
/2	yacketa 06/12/99	gilfokm 06/12/99	martykr 06/12/99	_____	lrb_docadmin 06/13/99		

FE Sent For:

<END>

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FE Sent For:

*12-6-12-99
brmj*

Krm 6/12

*JA
Krm 6/12*

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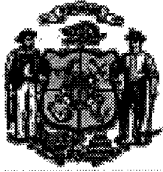
See Attached;

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1?	yacketa	1-6-5-99 kmg	Xm6	Jt6 Xm6			

FE Sent For:

<END>



Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 1, 1999

Joint Committee on Finance

Paper #486

Expanded Divestment Restrictions (DHFS -- Medical Assistance)

[LFB 1999-01 Budget Summary: Page 282, #26]

CURRENT LAW

The purchase of an irrevocable annuity is not a divestment for MA purposes as long as the purchaser receives an expected stream of payments that is equivalent to the amount paid for the annuity and that is provided during the life expectancy of the annuity purchaser. Current law does not require any minimum rate of return or type of payment schedule for an irrevocable annuity.

The purchase of a promissory note or similar instrument is not subject to the requirement that the expected value be received within the life expectancy of the person. Also, promissory notes and like instruments are not subject to any minimum interest payments as a requirement for avoiding divestment penalties.

GOVERNOR

Modify MA divestment restrictions to include the transfer of assets by promissory note or similar instrument in an amount that exceeds the expected value of the benefit as a type of transfer that constitutes a transfer of assets for less than fair market value. One implication of this requirement is that the repayment schedule must be concluded within the life expectancy of the asset owner.

Specify that a transfer to an annuity or transfer by promissory note or similar instrument is not in excess of the expected value only if: (a) the periodic payments back to the transferor include principal and interest that, at the time that the transfer is made, is at least at the prime lending rate, as reported by the Federal Reserve Board in federal statistical release H.15; and (b) the terms of the instrument provide for a payment schedule that includes equal periodic payments, except that the payments may be unequal if the interest payments are tied to the prime lending rate, as reported by the Federal Reserve Board in federal statistical release H. 15 and the inequality is caused exclusively by fluctuations in the rate.

DISCUSSION POINTS

1. Divestment regulations attempt to prevent persons with adequate resources from avoiding some liability for the cost of their medical care in a medical or nursing facility or other long-term care services, which would unnecessarily result in greater state and federal MA costs. In other words, individuals may not dispose of assets or income for less than market value for purposes of becoming eligible for MA.

2. A person may be denied MA coverage of institutional, community-based waiver services and other long-term care services if that person, his or her spouse, or the person's representative disposes of certain assets for less than fair market value. The ineligibility penalty does not apply to physician visits and other short-term care service.

3. The period of ineligibility for long-term care services (penalty period) is a number of months equal to the amount of the divestment (fair market value less actual value received for divested asset) divided by the statewide average monthly costs of nursing facility care (currently \$3,513 per month) for a private-pay patient. For example, if John Smith transfers \$80,800 of stocks without compensation, John Smith would be ineligible for MA supported long-term care services for 23 months (\$80,000 divided by \$3,513).

4. DHFS staff are concerned that annuities and promissory notes are currently used to bypass divestment provisions. Promissory notes can be structured to provide for nominal payments each month with a balloon payment at some distant point in time. Also, some of these promissory notes include a provision that allow for the debt to be extinguished upon the death of the lender, regardless of how much is still owned on the note. Also, although current law requires that annuities provide for repayment within the life expectancy of the person, annuities can still be structured to have a balloon payment as the final payment. The annuities are sometimes structured to waive the final payment if the person dies before the due date of the final payment or to make the final payments to a beneficiary, rather than to the estate of the annuitant. Funds that are not part of the estate are not subject to the estate recovery program under MA.

5. Although the Governor's recommendations address potential gaps in the state's divestment laws, the prime lending rate may not be an appropriate standard for annuities, promissory notes and similar instruments. On May 11, 1999, the prime lending rate was 7.75%. However, conventional annuities currently provide a significantly lower rate of return (4% to 5%) than the prime lending rate. Also, the prime rate may be high relative to what is appropriate for a promissory note between individuals. If one views the loss of interest on a certificate of deposit as the opportunity cost for an individual to lend money to another individual, then the prime lending rate would be too high a standard for a promissory note. CD rates are currently in the range of 5%.

6. The phrase "promissory notes and similar instruments" may allow the Department to apply the divestment requirements for promissory notes to land contracts. Currently, the interest rate for a thirty-year fixed mortgage is approximately 7.4% while for a 15-year mortgage it is 6.9%. Both of these rates are less than the current prime lending rate. Also, it is likely that land contracts,

even between unrelated parties, may be lower than these conventional mortgage rates.

7. Since the prime lending rate does not reflect the market rate for annuities, promissory notes and similar instruments, the Committee could modify the bill to use a rate or rates other than the prime lending rate.

8. An alternative set of rates is the Applicable Federal Rates (AFR) that are published monthly by the U.S. Department of the Treasury in the Internal Revenue Bulletin, as directed under section 1274(d) of the Internal Revenue Code. Three AFR rates are published: (a) a short-term rate for debt instruments of not more than three years; (b) a mid-term rate for debt instruments with a term of more than three years but not over nine years; and (c) a long-term rate for terms exceeding nine years. The May, 1999, rates were 4.79%; 5.10%; and 5.52%, respectively.

9. The AFR rates are used by the IRS for tax purposes in a number of areas. One use is to determine when loans should be treated as gifts and penalized for tax purposes. Another use is to determine unstated interest under an installment sale contract to determine the appropriate amount of payments that should be treated as interest income for tax purposes. In essence, the AFR rates attempt to reflect minimum interest rates that should apply to debt instruments.

10. Although the AFR rates may be suitable for promissory notes and similar instruments, there are some complications in applying the AFR rates to commercial annuities, since annuities do not only provide a return to invested money, but also provide insurance that is funded through a lower rate of return. Annuities can be established to provide a monthly income that is guaranteed for life. There is a risk to the insurance company, since the individual may live longer than the average mortality rate and individuals who are healthier may be the most likely individuals to choose this option. Current commercial annuities with a fixed rate of return do not offer a return of more than 5%, while the long-term AFR rate is 5.52%. In addition to mortality risk, an annuity's rate of return may be lower to account for administrative costs and sales commissions.

11. A second problem with annuities is that there are variable annuities in which the monthly payment is tied to the underlying bond fund or stock fund in which the annuitant's money is invested. In some years, a variable annuity may not pay any positive rate of return if the market is experiencing a down year.

12. There are several possible options for addressing the peculiarities of annuities and a minimum required rate of return. First, annuities could be excluded from any minimum interest rate payments, and instead, only require that annuities return the principle within the person's life in equal periodic payments, including any interest payments, except that interest rate payments could vary if the interest rate payments are tied to a registered mutual fund or a published interest rate at least as high as the AFR short-term rate. The problem with this option, however, is that an individual might establish an annuity with a family member that returns the principle in equal payments over a given period of time, thereby allowing an interest-free loan and the diversion of interest earnings from paying for the individual's care needs.

13. A second option would be to limit the exemption from the minimum interest rate requirement only for annuities that involve a guaranteed life payment (insurance component) or for variable annuities that are tied to a bond fund or stock fund that is registered with the U.S. Securities and Exchange Commission. Since only a licensed insurance company can provide the type of annuity that has an insurance component (guaranteed payment for life) and since variable annuities would have to be tied to a registered stock fund or published interest rate above the AFR short-term rate, this would prevent any abuse arising between agreements between individuals.

14. If there is a concern that individuals who wish to bypass divestment restrictions try to arrange annuities to delay the interest rate earnings so that a beneficiary may be able to capture some part of the benefits of the annuity, then a third option might be to impose a minimum interest rate component on guaranteed life annuities that is an amount less than the AFR to account for the insurance risk. One possibility might be to impose a minimum interest rate for fixed annuities that is equal to the appropriate average of the AFR rates, depending on the expected length of the annuity, less one and a half percent. Thus, for a person with a life expectancy of 10 years, the minimum interest rate, based on current interest rates, would be 3.5% ($0.3 \times$ the short term AFR + $0.6 \times$ the mid-term AFR rate + $0.1 \times$ the long-term AFR, less 1.5% for mortality insurance). A standard of 3.5% today would be reasonable given current market conditions.

15. Insurance companies may oppose the last option, since in individual cases an insurer's assessment of the person's life expectancy could be significantly longer than indicated in general mortality tables, and this difference in risk assessment could lead to an annuity that appears to have a rate of return that is less than the minimum standard when the difference only reflects a difference in life expectancy estimates. There is not a single life expectancy table that is used by the insurance industry, and insurers may try to account for projected changes in the population's life expectancy, rather than simply relying on past experience.

16. In deciding the appropriate option, it should be kept in mind that if, in some individual cases, the individual does not meet the minimum interest rate, the consequence may be limited if the actual interest rate is only slightly below the minimum requirement. The penalty period for any divestment is based not on the amount of the total transfer, but on the difference of the market value of the transferred asset less the actual value received. Thus, if a person pays \$100,000 for an annuity with a return rate of 4.0% but the applicable minimum rate is 4.5%, the amount of the divestment would not be \$100,000, but would be limited to the difference in value resulting from a 4% rate, rather than 4.5%. If the person has a life expectancy of 20 years and pays for 20 years of payments based on a return of 4.0%, the difference in the present value of the payments between 4.50% and 4.0% would be approximately \$4,200. A divestment of \$4,200 would result in a penalty period of one month in which the person would not be eligible for long-term care under MA.

17. Currently, the MA manual instructs eligibility workers to treat any annuity payments beyond the person's life expectancy as a divestment. The manual does not instruct eligibility workers to take the present value of these future payments, which are not as valuable as current payments. In extreme cases, the divested amount may be more than the amount paid for the

annuity. For example, assume that a person pays \$100,000 for an annuity that will provide monthly payments for 20 years but the person's life expectancy is only seven years. Assume the annuity pays a 5% rate of return. The monthly payment would be \$657.22 per month. Under the current system, the divested amount would be \$102,500 (13 years x 12 months x \$657.22), which is more than the amount paid for the annuity. However, the present value of the 13 years of payments beyond the person's life expectancy is only \$53,300.

18. Although the point made immediately above is a separate issue, it does have an impact related to imposing a minimum interest rate requirement. If an annuity or promissory note pays an interest rate below the minimum rate, the most accurate way to determine the divested amount is to take the present value of the difference in interest payments. If DHFS utilized the current procedure of simply taking the difference in payments, without any discount for the fact that the payments are made in the future, the divested amount would be larger than the appropriate amount. For example, in the situation described above in Discussion Point #16, the divested amount, based on the present value of the difference in interest payments was \$4,200. If present values were not used, and only the undiscounted differences in payments were summed up, the divested amount would be \$6,300, which is 51% greater than if present values were used.

19. In today's financial world, there are many complications and variations. The administration's proposal to impose a minimum interest requirement on annuities and other types of debt instruments is an appropriate requirement that would address a potential gap in the state's current divestment restrictions. However, given the complexities of annuities and other instruments, it may be appropriate to require the Department to establish the minimum interest requirements through the rule making process so that complications can be addressed in a more thorough manner. Although this paper addresses issues relating to annuities, there are also other areas where the state may wish to make exceptions in terms of any minimum interest requirements. For example, federal IRS regulations have created special provisions for homes sold by land contract and for farm lands sales of smaller amounts. IRS regulations provide for a cap on the minimum interest rate for these debt instruments, even if the AFR is higher.

ALTERNATIVES TO BASE

1. Adopt the Governor's recommendations.
2. Modify the Governor's recommendation by substituting the Applicable Federal Rate required under section 1274(d) of the IRS code as the required interest rate for annuities, promissory notes and similar instruments. In addition, exempt the following annuities from the minimum interest rate requirement: (a) fixed annuities that involve a guaranteed life payment (insurance component); and (b) variable annuities that are tied to a bond fund or stock fund that is registered with the U.S. Securities and Exchange Commission.
3. Modify the Governor's recommendation by: (a) substituting the Applicable Federal Rate required under section 1274(d) of the IRS code as the required interest rate for annuities,

*P 738 l. 7 : del. "prince" ↑
del ll 8 + 9 {Sub}*

promissory notes and similar instruments; (b) imposing a lower minimum interest rate for fixed annuities with a guaranteed life payment that is equal to the appropriate average of the AFR rates, depending on the expected length of the annuity, less 1.5%; and (c) exempting variable annuities that are tied to a mutual fund registered with the U.S. Securities and Exchange Commission from the minimum interest rate requirement.

4. Modify the Governor's recommendation by deleting the reference to the prime lending rate, and instead, require the Department to establish by rule the appropriate minimum interest rates that would apply to annuities, promissory notes and similar debt instruments.

(5) In addition to Alternatives (1), (2), (3), on (4), require that divestment calculations for annuities, promissory notes and similar instruments discount future payments by the appropriate applicable federal rate that applied on the date the annuity or other instrument was established.

6. Maintain current law.

Prepared by: Richard Megna



(Soon)
State of Wisconsin
1999 - 2000 LEGISLATURE

LRBb0495/1

TAY... King
RM R

LFB:.....Megna – MA divestment restrictions

FOR 1999-01 BUDGET — NOT READY FOR INTRODUCTION

LFB AMENDMENT

TO 1999 ASSEMBLY BILL 133 AND 1999 SENATE BILL 45

1 At the locations indicated, amend the bill as follows:

2 ✓ 1. Page 738, line ⁶ 1: after "1." insert "a."

3 ✓ 2. Page 738, line 7: delete "the prime" and substitute ~~the prime~~ one of the
4 following:".

5 ✓ 3. Page 738, line 8: delete lines 8 and 9 and substitute:

6 "a. For an annuity, promissory note or similar instrument that is not specified
7 under subd. 1. b. or par. (am), the applicable federal rate required under section
8 1274(d) of the Internal Revenue Code, as defined in s. 71.01 (6).

9 b. For an annuity with a guaranteed life payment, the appropriate average of
10 the applicable federal rates based on the expected length of the annuity minus ~~the~~

11 ~~and one half percent.~~ → 1.5% "

5

1 ✓ 4. Page 738, line 12: delete lines 12 to 14 and substitute "payment are tied to
2 the applicable rate specified under subd. 1. and the inequality is caused exclusively
3 by fluctuations in that rate."

3

#. Page 738, line 15: before that line insert:

4 ((SECTION 1432g. 49.453 (4) (am) of the statutes is created to read:

5 49.453 (4) (am) Paragraph (a) 1. and 2. ~~do~~ ^{does} not apply to a variable annuity that
6 is tied to a mutual fund registered with the ~~the~~ Securities and Exchange
7 commission." *that is*

federal AA

8 ✓ 5. Page 738, line 20: after "instrument" insert "In making the calculation
9 under this paragraph, the department shall discount future payments by the
10 appropriate applicable federal rate that applied on the date that the annuity,
11 promissory note or similar instrument was made".

12

(END)

Yacker, Tina

From: Megna, Richard
Sent: Wednesday, June 09, 1999 11:52 AM
To: Yacker, Tina
Subject: divestment and present value

Tina,

Below is my shot at the present value wording:

"In calculating the amount of the divestment when an annuity, promissory note or similar instrument is purchased (executed?), the payment for the annuity or other instrument and the payments from the annuity or other instrument, if paid in a later year(s), must be discounted to the year of purchase by the applicable federal rate at the date of purchase so that an appropriation comparison can be made between the payments for the instrument and the payments received from the instrument."

Hope you like my wording.

Richard



(D-NOTE)
State of Wisconsin
1999 - 2000 LEGISLATURE

LRBb0495/12
TAY:kmg:km

RMR

LFB:.....Megna - MA divestment restrictions

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8 b. For an annuity with a guaranteed life payment, the appropriate average of
9 the applicable federal rates based on the expected length of the annuity minus
10 1.5%."

an interest

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6 49.453 (4) (am) Paragraph (a) 1. ~~which~~ does not apply to a variable annuity that ✓
7 is tied to a mutual fund that is registered with the federal securities and exchange
8 commission."

9 6. Page 738, line 20: after "instrument" insert ". In making the calculation
10 under this paragraph, the department shall discount future payments by the
11 appropriate applicable federal rate that applied on the date that the annuity,
12 promissory note or similar instrument was made".

13 (END)

or a transfer by

a transfer to

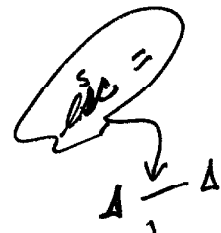
14 " ^(AA) In calculating the amount of the divestment when ^{† †} (an annuity, [←]
15 promissory note or similar instrument, is made, payments made to
16 the transferee in any year subsequent to the year in which the
17 transfer was made shall be discounted to the year ⁱⁿ which
18 the transfer was made by the applicable federal rate specified
19 under par. (a) on the date of the transfer".

two: period

DRAFTER'S NOTE
FROM THE
LEGISLATIVE REFERENCE BUREAU

LRBb0495/2dn

TAY:



Richard Megna:

I changed the language that you sent me only to keep the terminology consistent with the statutes and the bill refer to *transfers to an annuity*, etc., rather than *making* or *purchasing* an annuity, etc. Also, I did not include the phrase beginning with "so that" because, unless I did not fully understand it, it seemed like a justification for all that preceded it, rather than part of the computation.

If I did not quite meet the intent, please let me know and I'll try again.

Tina A. Yacker
Legislative Attorney
Phone: (608) 261-6927
E-mail: Tina.Yacker@legis.state.wi.us

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FROM THE
LEGISLATIVE REFERENCE BUREAU

LRBb0495/2dn
TAY:kmg:km

June 12, 1999

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Legislative Attorney
Phone: (608) 261-6927
E-mail: Tina.Yacker@legis.state.wi.us



State of Wisconsin
1999 - 2000 LEGISLATURE

LRBb0495/2
TAY:kmg:km

LFB:.....Megna - MA divestment restrictions

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