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## Promissory Note Decisions: A Note of Certainty In Post DRA Planning

The Deficit Reduction Act (DRA) was enacted so recently, February of 2006, that we are only now seeing the first interpretations. A trio of recent New York State administrative fair hearing decisions<sup>1</sup> has affirmed the use of DRA-compliant promissory notes for individuals who are in imminent need of long term care services.

### TRIGGERING THE PENALTY PERIOD

Elder law attorneys are frequently sought out at a moment of crisis; when a person has just entered a nursing home and wants to preserve assets. Under the Pre-DRA rules the applicant could make a gift of half of his or her assets, trigger the running of the penalty period, and use the remaining assets to pay privately to the nursing home during the penalty period. This was known in the vernacular as the “rule of halves.”

The DRA eliminated the “rule of halves” by changing the point at which the penalty period begins to run. Post-DRA, the penalty period does not begin until three conditions are met: a gift is made, the applicant is in need of long term care services and is determined “otherwise eligible.” “Otherwise eligible” means that the Medicaid application would have been approved except for the uncompensated transfer. This requires that the applicant’s countable resources be less than \$4,200 (2007) and the monthly private pay cost of the nursing home exceeds the applicant’s income. The applicant is required to file an application and have it rejected on

the sole basis of the uncompensated transfer. When the penalty period is over, the applicant is required to file a second application.

The “rule of halves” no longer works because at the time of the gift, the penalty period is not triggered since the individual still has control over the half of the assets that were not transferred. The penalty period will not start to run until the individual has spent down those resources. However, the individual will not have assets to pay privately for the nursing home care through the penalty period that has just commenced. With the elimination of the “rule of halves” by the DRA, elder law attorneys have explored other options for Medicaid planning such as promissory notes, personal service contracts and annuities. It appears that the use of the promissory note is one of the most likely to succeed.

The DRA compliant promissory note permits the protection of assets for individuals who are currently in nursing homes. The applicant makes a gift of half of his or her assets. Simultaneously, the applicant lends the excess resources (those above \$4,200) pursuant to a promissory note which will produce an income stream for the applicant. The applicant is now eligible in all respects other than the gift. The individual files a Medicaid application that is denied on the sole basis of the transfer. Ironically, the denial is good news because it serves as formal notification that the penalty period has commenced. The

monthly repayments under the note are used to pay for the cost of the nursing home during the penalty period. When the penalty period expires, the applicant can file a second Medicaid application that should be approved.

### DRA PROMISSORY NOTE REQUIREMENTS

The DRA allows the use of the promissory note but requires that it (1) be actuarially sound, (2) provide for equal payments with no balloon payments, (3) prohibit the cancellation of the note upon the death of the maker and (4) be non-negotiable. The DRA contains no provision regarding the rate of interest that the note carries.

### FACT PATTERN

On October 19, 2006, Geraldine executed a promissory note with a close family member, in the principal sum of forty thousand dollars. The interest rate was set at five percent. The payments were all of equal amount (\$8,100.20) and were to be made in five monthly payments. The note was not cancelable upon the death of the lender. When she made the loan, Geraldine’s resources fell below the Medicaid level.

Geraldine applied for nursing home Medicaid on November 14, 2006, hoping that the application would be denied on the basis of the gift only and finding her otherwise eligible. The Albany County Department of Social Services denied the application on another

ground, claiming that the note was an available resource which placed her resources above the allowable Medicaid level. (At the fair hearing the agency also argued that it was an uncompensated transfer.) She requested a fair hearing to challenge that determination.

### FAIR HEARING DECISIONS

The three fair hearing decisions concluded that promissory notes which meet the requirements of the DRA are legitimate and must be recognized by the local Medicaid agency. The decisions presented identical issue of law and can be read as one. All three applicants with promissory notes filed Medicaid applications in Albany County and they were all denied on the same day. Their fair hearings were consolidated and argued on the same day, by the same counsel, before the same Administrative Law Judge. The decisions were all rendered on the same day. The decisions rejected every one of the numerous argument that Albany County Department of Social Services raised.

The decision rejected the agency claim that the note was not actuarially sound because the repayment period, at six months, was too short. The tables of the Office of the Chief Actuary of the Social Security Administration calculated Geraldine's life expectancy at 6.4 years. Actuarial soundness is a restriction on a repayment period beyond the life expectancy of the lender. Actuarial soundness can only be breached by a repayment period that is too long, not by a shorter term.

The decision rejected the claim by the agency that the note was a "sham," that it was a gift transferred at less than fair market value for the sole purpose of qualifying for Medicaid. It accepted Geraldine's position that the note was a "prudent financial investment."

The decision rejected the claim that the note was negotiable and accepted a written opinion from an economist who

concluded that the "Note is worthless as a present asset due to the fact that there is no secondary market on which the appellant could resell it."

The decision rejected the claim by the agency that the rate of interest, at 5% was too low, finding that a certificate of deposit would bear a similar or lesser interest rate.

After finding that the note in question met the requirements of the DRA the decision finds: "The DRA has specific criteria that if interpreted correctly, can guide individuals in deciding if a Note is an uncompensated transfer. The Note with a value of \$40,000.00, executed by parties that have a close family relationship, with an interest rate of 5%, is reasonable for any type of promissory note."

### CONCLUSION

The great constant in the elder law practice is the desire of clients for certainty. Centenarians, nonagenarians, octogenarians and septuagenarians seek reassurance from counsel as to how their application will be treated. These three fair hearing decisions will help point the way to planning options that are likely to be approved by local Medicaid agencies. These fair hearing decisions are not binding but they are an indication that the dust is beginning to settle and practitioners may begin to make recommendations with greater assurance in the post-DRA world.

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<sup>1</sup> *Matter of Mary*, Fair Hearing #4733465H; *Matter of Anna*, Fair Hearing #4733471N; *Matter of Geraldine*, Fair Hearing#4733466Z

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