Robin & Peter on LIFE SETTLEMENTS

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A Practical Look at Medicaid Life Settlements

There has been a great deal of news coverage about Medicaid Life Settlements since our article on that topic two months ago. During that time, Texas became the first state to enact such a law, and three more states, California, New Jersey, and New York, have taken up consideration of Medicaid Life Settlements. Based on the inquiries and comments we have received, despite the publicity, there appears to be a need to review the practical implications of these laws.

Consider this situation. You have a long-time female client who is 85 years old and in poor health. So poor, in fact, that she now requires full time care. Although she retired reasonably comfortably years ago on a small pension, social security, and modest savings, the cost of the care she requires has consumed most of her assets. However, she still owns a $100,000 universal life policy purchased almost 30 years ago that has minimal cash surrender value. She is contemplating entering a nursing home and applying for Medicaid assistance.

She would like to qualify for Medicaid so that her family does not have to pay her long term care expenses. In order to qualify, however, she must dispose of the universal life policy. She has the following options:

1. Surrender the policy for its nominal cash surrender value,
2. Attempt to sell the policy as a traditional life settlement,
3. Sell the policy to a family member for its fair market value,
4. Try to sell the policy as a Medicaid Life Settlement.

In all cases, the proceeds must be properly spent down before she can qualify for

Medicaid.

The first option, surrendering the policy, would likely be the quickest way to qualify her for Medicaid. But it seems to be a terrible waste to allow this asset to go for just a nominal amount when her health indicates that it is likely to mature into a death claim in the very near future.

Selling the policy in the traditional life settlement market is a long shot as this market generally seeks larger face amount policies, usually at least $500,000. Although it is still worth a try, if she had a larger face amount policy this might be a very attractive alternative.

Selling the policy to a family member for its fair market value could be the most attractive alternative if a family member has the cash and the desire to own and maintain the policy. After all, if the policy would be an attractive investment to a life settlement investor, it would surely be attractive to a family member even if the death proceeds would become income taxable under the "transfer for value" rules. Caution must be exercised in using this approach as the IRS, as well as Medicaid, will want to verify that the policy was actually sold for its fair market value, which, given the insured's health, could be much greater than the surrender value. Additionally, the proceeds of the sale would have to be used up before she could qualify for Medicaid. However, this approach does provide flexibility in how the sales proceeds could be used so long as the Medicaid qualification rules were not violated. Finally, the family member who purchased the policy could benefit substantially from the death proceeds.

Last, but definitely not least, there is the new alternative of a Medicaid Life Settlement. Unlike the traditional life settlement market, the "sweet spot" for this market is smaller face amount policies (less than $500,000). Under the laws that have been proposed and the one enacted in Texas, the proceeds are put into a trust account that can only make disbursements for long term care. To give policy owners an incentive to enter into this type of transaction, rather than surrendering the policy, upon her death her beneficiaries would be entitled to receive 5% of the face amount or $5,000, whichever is less. Additionally, any unused settlement proceeds that remain in the account at her death would also go to her heirs. Unlike Medicaid which would require her to be in a long term care facility, she could use the proceeds in the trust account for in-home care. Even if it is determined that in-home care is not practical or desired, she could still be considered a "private pay" patient which might substantially increase her choices in picking a facility. In addition to leaving the heirs with some remaining death benefit, this approach also benefits the state and federal government by reducing their expenditures until the life settlement proceeds are consumed. It's win-win-win for the policy owner, the family and the taxpayers.

While at this time only Texas has passed Medicaid Life Settlement legislation, residents of other states are not completely out of luck. The Texas law facilitates Medicaid Life Settlements by providing a blueprint for the transaction and mandating that Medicaid disclose the option to policy owners. Even without specific legislation, similar results can be achieved in most states by selling the policy to a Medicaid Life Settlement provider.

Tax implications should also be considered. Although some of the Medicaid Life Settlement proposals would exempt those transactions from state income tax, the proceeds of a life settlement or a sale to a family member could be subject to federal income tax under Revenue Ruling 2009-13. Under this ruling the sales proceeds could be taxed as a combination of capital gains and ordinary income. There is one important exception to Revenue Ruling 2009-13, however, which is likely to apply to many Medicaid Life Settlement transactions. Under IRC Section 101(g) proceeds paid to a terminally or chronically ill insured may qualify as death proceeds and escape taxation entirely.

While the features of a Medicaid Life Settlement might be aimed at smaller policies, their owners, rather than those that are more affluent, represent a large and under served segment of the population. When family members can't or don't want to buy the policy, a Medicaid Life Settlement could provide an important option for these policy owners and at the same time benefit the taxpayers who are footing the bill for Medicaid. With all these advantages, it is no wonder that more and more states are considering Medicaid Life Settlement laws.

As always, before one of your senior clients lapses or surrenders a policy, it pays to explore all the options as there just might be hidden value in their contract.

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