# Promissory Notes

**By Susan I. Jean**

**The Heritage Law Group**

**York County, Williamsburg, Gloucester and Poquoson**

**What is a Medicaid Compliant Promissory Note?**

- A loan is a transfer of a resource from a lender to a borrower, in exchange for the borrower's promise to repay. A Medicaid-compliant Promissory Note is a written promise to repay a loan that contains specific terms that will prevent it from being evaluated by the Department of Social Services as a countable resource.

**What makes a Promissory Note Medicaid Compliant?** According to the Virginia Medicaid Manual, Sections M1450.540(B) and S1120.220:

- **The note must be actuarially sound**
    - The Note must be paid out over a time that does not exceed the Medicaid-determined life expectancy of the lender.
- **The note must be irrevocable and unamendable**
    - The Note may not be revoked or amended during the term of the Note.
- **The note must be non-transferable and non-assignable**
- Most Promissory Notes can be sold, or used as security for a loan, or the right to the income from the Note can be assigned to another person in exchange for cash. As a

result, the resource has a value assigned to it. However, if the Note specifies that it cannot be sold or assigned or used as security for a loan, it does not have a value assigned to it.

- **The note must be repaid in equal installments with no deferral and no balloon payments**
- **The loan cannot be cancelled on death**
    - If the lender passes away before the term of the Promissory Note is up, the payments are payable to the estate of the lender. For married couples using this strategy, if the estate planning documents are properly structured, the remaining payments will be distributed to a testamentary trust for the benefit of the institutionalized spouse created in the lender's Will, or directly to other beneficiaries.

**Why is a Promissory Note not treated as a gift under Medicaid rules?**

- A loan is not a gift because there is a legal requirement that the loan be repaid. A Medicaid compliant note must be paid out in an actuarially sound fashion, in equal installments, and the loan cannot be cancelled on death. An actuarially sound loan must pay out over a time that does not exceed your Medicaid-determined life expectancy. A note that meets these requirements, by statute, is not a gift and is not subject to the five year look-back requirement.

**How does it work, in practical terms?**

- A particular spend-down amount is loaned to someone, usually a family member. The lender and the borrower each sign the Promissory Note, which sets the terms under which the loan is made and the funds will be repaid. The lender owns the note and receives the repayments. If written correctly, the Promissory Note doesn't count as a resource because the lender has no right to sell it for cash. The note converts resources which would otherwise be countable into an income stream.
- A properly designed Medicaid-compliant Promissory Note is not assigned a value by Medicaid because you cannot recover the money you have invested, except as repayments of the loan. If you could demand your investment back, the Note would be a resource for Medicaid purposes.
- One reason a Medicaid-compliant Promissory Note is so useful is because it does not need to be executed until about one month before you want the institutionalized individual to qualify for Medicaid. Because for Medicaid purposes this is considered a transfer for fair value, there is no need to buy it before Medicaid qualification is actually desired. You can wait until a month before you actually want the individual to qualify, loan the money in exchange for a Medicaid-compliant Promissory Note, and the applicant can qualify for Medicaid in the next month.
- Although the lender cannot demand that the borrower repay early, or in full, the borrower has the right to repay the full amount of the loan after Medicaid qualification is achieved. In the case of a married couple, since the community spouse's assets cannot be reviewed again by the Department of Human Services, it will not cause the resources to exceed the CSRA limits.

**What are the drawbacks of using promissory notes in Medicaid Planning?**

- The interest earned on the loan will count as income (and thus will be subject to income tax) In addition, for a community spouse with an entitlement to an allowance from the institutional spouse, the interest counts as income and will reduce the amount of the allowance.
- There are legal fees associated with a Medicaid-compliant Promissory Note.

**Challenges by DMAS to the use of promissory notes**

- There have been several instances of Virginia Departments of Human / Social Services across the state denying Medicaid eligibility for individuals who have used Promissory Notes to reduce their resources to eligibility levels. Generally, DHS' position has been to analyze the purpose of the promissory note; if it appeared the note was being done for the purpose of attaining eligibility for Medicaid, DSS was treating the note as an uncompensated transfer.
- Transmittal #99, dated 1/1/14, contains a revision to M1450.400(B) which may be useful to add to arguments when appealing Medicaid denials based on the use of promissory notes. M1450.400(B) has been revised to remove the provision that transactions in which the Medicaid applicant made an asset unavailable would be considered "to have been made with the intent of becoming or remaining eligible for Medicaid payment of LTC services" and would be regarded as uncompensated transfers. The section now states that transfers for less than fair market value will

result in a penalty period, but the institutionalized individual must be given the opportunity to rebut this assumption.

**Authority which Supports Promissory Notes are Exempt Assets and are also not transfers subject to the five-year lookback**

- The following authorities can be used to support a Medicaid appeal in the event of a denial due to a Promissory Note:
  - M1450.540
    - Funds used to purchase a promissory note are not uncompensated transfers when the note has an actuarially sound repayment term; provides for payments in equal installments during the terms of the note with no deferral and no balloon payments; and prohibits cancellation of balance upon death of lender
  - Medicaid Manual S1120.220
    - Promissory notes properly drafted are bona fide, non-negotiable notes, and payment against principal are income, not conversion of a resource.
  - 12VAC30-40-300
    - Promissory notes must be actuarially sound, with payments in equal installments and with no deferral or balloon payments and cannot be cancelled upon death of lender. If the Promissory Note doesn't satisfy these requirements, the note is treated as an asset, and the

outstanding balance due as of the date of the Medicaid application is used as the value of the asset.

- See also Defecit Reduction Act of 2005, Section 6016 (c) and 42 U.S.C. 1396p(c)(1)(I).