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Actuarial Soundness, the Meaning of "Commensurate," and a "Sniff Test"

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Case Note
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By Professor Thomas E. Simmons

About the Author

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I. Introduction

When the Deficit Reduction Act of 2005 (DRA) went into effect in 2006, it imposed wide-ranging changes to Medicaid eligibility rules.[1] The DRA, among other things, created or altered "look-back and penalty periods for the gifting of assets, undue hardship protections, limitations on residence exclusion, special rules for continuing care retirement communities, limitations on annuities, proof of citizenship, and incentives to purchase long-term care insurance."[2] Significantly, the DRA defined a "safe harbor" for annuities in the context of Medicaid eligibility determinations. To fall within the safe harbor, an annuity must be irrevocable and nonassignable, provide for equal payments, qualify as actuarially sound, and name the state as a remainder beneficiary in the event the annuity stream is not exhausted prior to the annuitant's death.[3] This article uses the recently decided *Zahner* case as a framework for discussing the nonassignability and actuarial soundness prongs of the Medicaid annuity safe harbor rules.[4]

The use of annuities in connection with Medicaid planning typically looks something like this: An individual in need of long-term care with $50,000 in excess countable resources makes a gift of $25,000 to her son and purchases an immediate short-term annuity with the other $25,000. If the cost of nursing home care is $5,000 a month, the $25,000 gift will result in a 5-month period of ineligibility for Medicaid long-term care benefits. If the individual is otherwise eligible for Medicaid on the date of the gift, however, the period of ineligibility will run from that date.[5] The annuity company then pays the annuitant $5,000 per month for 5 months, which she can use to pay her nursing home bill. After 5 months, the annuity has been consumed, the period of ineligibility has run, and the individual qualifies for Medicaid. This "gift and annuity" Medicaid planning strategy results in the individual's ability to shelter a $25,000 gift while accelerating her Medicaid eligibility by 5 months. Today, this strategy might be used by a single Medicaid applicant. In the *Zahner* case, however, the strategy was deployed in a community spouse context, in which the Medicaid applicant was married and his or her spouse did not require long-term care.[6]

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1 *See generally* Morris Klein, *Medicaid Eligibility After the 2005 Deficit Reduction Act*, 41 Md. B.J. 32 (March/April 2008).

2 *Id.* at 34.

3 *See infra* nn. 15–16. If the annuitant is married, the state may be named as a contingent beneficiary as long as the community spouse is named as the primary beneficiary. *See infra* n. 15. "Until enactment of the DRA, the community spouse was free to name anyone he or she wanted to name as beneficiary to receive any remaining payments if the community spouse died before the annuity payments were completed." Klein, *supra* n. 1, at 36. The concept of "actuarial soundness" is discussed *infra* at nn. 53–64 and accompanying text.

4 *Zahner v. Sec. Pa. Dept. of Human Servs.*, 802 F.3d 497 (3d Cir. 2015).

5 42 U.S.C. § 1396p(c)(1)(D)(ii); *see also* 42 U.S.C. § 1382b(c) (describing the "penalty period" or Medicaid ineligibility consequences of a transfer for less than fair market value). "Otherwise eligible" means eligible without regard to the gift. The gift renders the donor ineligible; therefore, the question is whether the individual is eligible for Medicaid if the gift is ignored. Eligibility for Medicaid, in shorthand, means that the applicant has less than the state's resource limit — typically $2,000 or less in countable resources — while also qualifying under the "income test."

6 *Zahner*, 802 F.3d 497. When the planning was undertaken in this case (2011), Pennsylvania did not permit all of a couple's excess resources to be used by the community spouse; therefore, a portion of the couple's excess resources

The gift and annuity strategy is reminiscent of the traditional pre-DRA "half-a-loaf" Medicaid planning strategy.[7] This strategy is often described as the "reverse half-a-loaf" strategy.[8] The pre-DRA half-a-loaf strategy involved a gift of about half of one's excess resources coupled with the retention of the other half.[9] With the gift and annuity strategy, roughly half of the excess resources is devoted to a gift, which

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was allocated toward a gift. Both spouses then purchased respective Medicaid-compliant annuities. *Id.* at 499. A second plaintiff, a single individual, also used the gift and annuity strategy. *Id.* at 500. Today, spouses are counseled to employ the gift and annuity strategy and consider converting 100 percent of their excess resources to a Medicaid-compliant annuity. Email from Dale M. Krause, CEO, Krause Financial Services, to author, (Feb. 14, 2017, 3:15 p.m.) (copy on file with author).

7 *See* Jennifer A. Ward, *Doctor's Orders: The Third Circuit Approves Short-Term Annuities as a Viable Planning Tool in* Zahner v. Secretary Pennsylvania Department of Human Services, 61 Vill. L. Rev. 729, 742 (2016) (referring to the gift and annuity strategy as "half-a-loaf planning").

8 *See* Jeffrey A. Bloom & Harry S. Margolis, *Elder Law* vol. 56, § 12.17 (Massachusetts Practice Series) (Thomson West 2016) (observing, "Essentially, the reverse half-a-loaf strategy is the same as the half-a-loaf strategy, in that about one-half of the applicant's excess assets are gifted."). Some attorneys prefer promissory notes to annuities. ElderLawAnswers, *Using Reverse Half-a-Loaf: Findings From the DRA Implementation Survey*, http://www.elderlawanswers.com/using-reverse-half-a-loaf-findings-from-the-dra-implementation-survey-6667 (last modified Dec. 28, 2007). This author prefers the term "gift and annuity" to "reverse half-a-loaf gifting" both because it is more descriptive of the mechanics of the strategy and because the DRA eliminated the option of the traditional half-a-loaf strategy. Thomas D. Begley Jr. & Andrew H. Hook, *Medicaid Planning Is More Challenging After Recent Reforms*, 33 Est. Plan. 3, 4 (May 2006). Labeling a planning strategy something that sounds like a DRA-outlawed strategy may cause confusion among Medicaid eligibility caseworkers. Moreover, the term "reverse half-a-loaf" is sometimes used to describe gifts followed by partial cures:

> *Reverse half-a-loaf.* Under this strategy, the parent transfers assets, immediately applies for Medicaid, and is rejected. The child then retransfers roughly half the assets to the parent. The parent reapplies and is rejected because of the remaining outstanding transfer. The parent pays for that period of ineligibility from the retransferred funds.

Id.

9 *Pfeifer v. St., Dept. of Health & Human Servs., Div. of Pub. Assistance*, 260 P.3d 1072, 1074–1075 (Alaska 2011). The Alaska Supreme Court explained, "Because the penalty period began running roughly at the time of the asset transfer, prospective beneficiaries were able to 'calculat[e] how long they would be ineligible for Medicaid benefits after a transfer and reserv[e] enough personal assets to pay for their care until the penalty period had run.'" (citation omitted). *Id.* at 1075. The DRA eliminated this planning option by reconfiguring the start date for the penalty period associated with gifts. Before 2006, the penalty period essentially ran from the date of the gift. 42 U.S.C. § 1396p(c)(1)(D) (amended 2006). Now, however, the penalty period commences the latter of "the first day of a month during or after which assets have been transferred for less than fair market value, or the date on which the individual is eligible for medical assistance under the State plan and would otherwise be receiving institutional level care … but for the application of the penalty period … ." Pub. L. No. 109-171, § 6011, 120 Stat. 4, 61–62 (2006) (codified at 42 U.S.C. § 1396p(c)(1)(D)(ii)). Because the ticking of the penalty period clock is now deferred until the individual has depleted his or her countable resources to Medicaid eligibility levels, the traditional half-a-loaf planning strategy is now unavailable. The gift and annuity strategy depends on accelerating the eligibility date for Medicaid assistance so that the penalty clock begins to tick at about the time the annuity is purchased; this, in turn, depends on the annuity itself being a noncountable asset.

intentionally triggers a transfer penalty; the other half is devoted to achieving an annuitized income stream, which exhausts itself at the penalty period's expiration.[10] To get the divestment penalty clock running, the gift and annuity strategy is designed to achieve "otherwise eligibility" for the applicant when the gift is completed. For annuity planning to work in this context, two important prerequisites must be met:

1. The annuity must be a noncountable resource so that the individual is otherwise eligible for Medicaid and the period of ineligibility runs from the date of the gift.

2. The purchase of the annuity must not be characterized as a divestment, which would trigger a lengthier period of Medicaid ineligibility.

It is worthwhile to consider the consequences to the Medicaid applicant if either prerequisite is not met. First, if the annuity is a countable resource, eligibility will be deferred because of excess resources. Second, and perhaps less obviously, if the purchase of the annuity is characterized as a divestment, the transaction will be treated as a gift. Treating the purchase of an annuity from a large company as a gift is counterintuitive. When one purchases a life insurance policy, one may later regret the decision but seldom views the transaction as a gift. Yet this is the result of the DRA annuity rules; if an annuity fails to fall within the safe harbor, its purchase is treated as a divestment — at least to the extent that the annuity is not also counted as a resource.

A second Medicaid planning strategy that uses annuities takes the form of converting a countable resource into noncountable income received by a community spouse.[11] This strategy relies on the rule that although the Medicaid applicant's excess income can result in Medicaid ineligibility, the community spouse's income is irrelevant in determining the applicant's eligibility.[12] In other words, the community spouse's income does not count. Converting a resource into income can therefore advance Medicaid eligibility. This strategy is called the "resource-to-income" strategy. The proper use of an annuity in this context might take place as follows: Following one spouse's admission to a long-term care facility, a couple realizes that they have excess resources of $50,000; they are typically expected to consume those excess resources on care costs and other living expenses before achieving Medicaid eligibility. Instead, the community spouse uses the excess $50,000 to purchase an immediate annuity. (Generally, states calculate available resources as of the first day of the month; therefore, the annuity should be purchased just before the date on which coverage is sought.) Because the community spouse's income is ignored in the Medicaid eligibility context, a qualifying

10 The author uses the term "excess resources" (the dollar amount at which the Medicaid applicant's net worth exceeds Medicaid eligibility levels) synonymously with the Medicaid "spend down" amount. The term "spend down" or "spend-down" recurs in much of the Medicaid literature. *See* Jan Ellen Rein, *Misinformation and Self-Deception in Recent Long-Term Care Policy Trends*, 12 J. of Law and Politics, 195, 210 (2006) (explaining that "a single individual can get assistance through Medicaid provided she spends down to her last $2,000 in non-exempt assets.").

11 *See generally James v. Richman*, 547 F.3d 214 (3d Cir. 2008) (applying pre-DRA law); *see also Geston v. Anderson*, 729 F.3d 1077 (8th Cir. 2013) (applying the DRA).

12 *See* 42 U.S.C. § 1396r-5(b)(1) (providing that no income of the community spouse is deemed available to the institutionalized spouse in the Medicaid eligibility context).

annuity essentially shields $50,000 and preserves it for the community spouse's future support.[13] This strategy is restricted to situations involving a Medicaid applicant who has a community spouse. The resource-to-income strategy is less complicated than the gift and annuity strategy because only one transaction is involved: the properly timed purchase of an annuity.[14] The gift and annuity strategy requires a second element: a gift. The two principal prerequisites to ensure the effectiveness of the resource-to-income strategy, however, are identical to those of the gift and annuity strategy:

1. The purchase of the annuity must not be characterized as a divestment.

2. The annuity must not be a countable resource.

Federal law fairly clearly articulates the required elements for meeting both the first prerequisite[15] and the second.[16] Some

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13 *Id.*

14 In some states, the "name-on-the-check rule" allows for a related strategy in which, for example, an institutionalized spouse's IRA purchases a Medicaid-compliant annuity payable to the community spouse. *See* Roger A. McEowen, *Estate Planning for Farm and Ranch Families Facing Long-Term Health Care*, 73 Neb. L. Rev. 104, 112 (1994) (describing the name-on-the-check rule). Not all annuity companies are willing to send annuity payment checks to an IRA account holder's spouse.

15 42 U.S.C. § 1396p(c)(1)(F). When an individual purchases an annuity, it "shall be treated as the disposal of an asset for less than fair market value unless —

> (i) the State is named as the remainder beneficiary in the first position ...; or
> (ii) the State is named as such a beneficiary in the second position after the community spouse ... .

Id. Alternatively, a minor or disabled child may be named as the primary beneficiary. *Id.; see also e.g. Hutcherson v. Ariz. Health Care Cost Containment Sys. Administration*, 667 F.3d 1066 (9th Cir. 2012). Thus, it is relatively easy to qualify an annuity for the safe harbor from divestments (by getting the beneficiary designations correct), but it is more onerous to qualify an annuity for the safe harbor for noncountable resources. *See infra* n. 16 (discussing the annuity safe harbor for noncountable assets).

16 42 U.S.C. § 1396p(c)(1)(G). The *Zahner* court explained in a footnote:

> The relevant section of § 1396p reads:
>
> [T]he term "assets" includes an annuity purchased by or on behalf of an annuitant who has applied for medical assistance with respect to nursing facility services or other long-term care services ... unless ... the annuity ... (I) is irrevocable and nonassignable; (II) is actuarially sound (as determined in accordance with actuarial publications of the Office of the Chief Actuary of the Social Security Administration); and (III) provides for payments in equal amounts during the term of the annuity, with no deferral and no balloon payments made.

42 U.S.C. § 1396p(c)(1)(G)(ii); *see also* 42 U.S.C. § 1396p(c)(1)(F) (explaining that annuities can be used to dispose of assets if "the State is named as the remainder beneficiary ... for at least the total amount of medical assistance paid on behalf of the institutionalized individual ... ."). *See generally Morris v. Okla. Dept. of Human Servs.*, 685 F.3d 925, 928 (10th Cir. 2012) ("A separate provision states that an annuity is not treated as an available resource for purposes of Medicaid eligibility if the annuity meets certain requirements." (citations omitted)); *Zahner*, 802 F.3d at 501–

confusion does persist in distinguishing the separate safe harbor provisions for achieving noncountability and the nondivestment treatment of an annuity, but case law seems to have largely sorted matters out.[17] Moreover, even absent a relevant statutory text, a nonassignable annuity has no fair market value because — being nonassignable — the amount that any arm's length third-party purchaser would pay for an annuity contract that would not pay him or her anything is zero.[18]

A third and a fourth prerequisite should be added to the two identified previously. The third prerequisite is that the annuity must not be capable of being construed as a trust.[19] If an annuity is construed as a trust, it must comply with the requirements of 42 U.S.C. § 1396p(d)(4), and it may be impossible to comply with the self-settled trust rules when the individual is 65 or older.[20] A trust may include "any legal instrument or device that is similar to a trust but includes an annuity only to such extent and in such manner as the [Department of Health and Human Services (HHS)] Secretary specifies."[21] The plaintiffs in *Zahner* had to contend with the state Medicaid agency's argument that even if the annuities succeeded as annuities, they failed as trusts.

The fourth, and less obvious, prerequi-

502 n. 4; *see also e.g. King v. Sec., La. Dept. of Health & Hosps.*, 956 So. 2d 666 (La. App. 2d Cir. 2007), *writ denied*, 963 So. 2d 1001 (La. 2007), *cert. denied*, 552 U.S. 1184 (2008).

17 42 U.S.C. § 1396p(c)(1)(F) (Subsection (F)) governs the *divestment* safe harbor (which governs whether "the purchase of an annuity shall be treated as the disposal of an asset for less than fair market value"), whereas 42 U.S.C. § 1396p(c)(1)(G) (subsection (G)) explicates the safe harbor for whether an annuity is an asset for purposes of Medicaid eligibility calculations. However, technically, subsection (G) is phrased in terms of whether an annuity constitutes an asset "with respect to *a transfer* of assets …" (emphasis added). *Compare* 42 U.S.C. § 1396p(c)(1)(F) *with* 42 U.S.C. § 1396p(c)(1)(G). However, *Zahner* seems to clarify that subsection (G)'s three-part safe harbor relates to whether an annuity is an asset. *See supra* n. 16 (quoting the three-part statutory annuity safe harbor test at subsection (G)); *accord Morris*, 685 F.3d at 928 (describing subsection (G) as providing "that an annuity is not treated as an available resource for purposes of Medicaid eligibility if the annuity meets certain requirements."). *But see Cook v. Glover*, 761 S.E.2d 267, 269 (Ga. 2014) (noting, "CMS [Centers for Medicare & Medicaid Services] has interpreted the interplay between these subsections as requiring that all annuities comply with both (F) and (G) in order to avoid the imposition of a penalty."); *see also Hughes v. McCarthy*, 734 F.3d 473, 477 (6th Cir. 2013) (characterizing both subsections (F) and (G) as addressing "whether the purchase of certain annuities should be deemed transfers for less than fair market value."). Indeed, the *Cook* and *Hughes* decisions do adhere more closely to the statutory text, although it is difficult to comprehend why Congress would enact two safe harbor provisions for divestment penalties; no court has interpreted subsections (F) and (G) as providing alternative safe harbors from divestment penalties.

18 *See* Social Security Program Operations Manual System (POMS) SI 01110.115 (explaining that, for example, jointly owned stock subject to an enforceable agreement by which neither owner will sell without the consent of the other owner is not an asset (unless the co-owner consents to its sale)); *see also* 20 C.F.R. § 416.1201(a)(1) (2016) (providing that "if an individual has the right, authority or power to liquidate the property … it is considered a[n] (available) resource."); 20 C.F.R. § 418.3415(b) (2016) (explaining that "the equity value of an item is defined as the price for which that item, minus any encumbrances, can reasonably be expected to sell on the open market in the particular geographic area involved.").

19 42 U.S.C. § 1396(d)(6); infra pt. II(C)(2).

20 *See* 42 U.S.C. § 1396p(d)(4)(A) (describing self-settled trusts).

21 42 U.S.C. § 1396p(d)(6).

site for any type of Medicaid planning — one that was not present in *Zahner* — is one of reasonableness. Only a relatively modest amount of wealth can be protected with either the gift and annuity strategy or the resource-to-income strategy. For example, with excess resources of $500,000, the gift and annuity strategy, with a gift of half that amount, would result in a penalty period of 50 months, assuming an average cost of nursing home care of $5,000 a month.[22] Fifty months is generally too long to wait for eligibility to make aggressive planning worthwhile. And with a half a million dollars in excess resources, the resource-to-income strategy would typically generate an annuity with monthly annuity payments so high that they might not be capable of being consumed each month, leading to an accumulation of excess cash and therefore disqualifying resources.[23] Thus reasonableness is a kind of inherent constraint, which is essentially hardwired into any kind of Medicaid planning involving divestments.

II. The *Zahner* Decision

In 2015, the Third Circuit Court of Appeals issued its decision in the *Zahner* case. The *Zahner* decision represents a favorable ruling for elder law attorneys and their clients living in the Third Circuit's jurisdiction and suggests approaches that may also achieve clients' Medicaid planning goals in other states.[24] State Medicaid law varies widely across the nation, and it is nearly impossible to speak in general terms about eligibility requirements,[25] although the discussion in this article attempts to do so. It is also important to note that not all annuities qualify as DRA-compliant annuities. Indeed, the unplanned purchase of an annuity can actually interfere with meeting long-term care cost challenges if the annuity income stream is inadequate to cover the monthly costs of care. This occurs because the typical annuity contract — constituting a countable resource — can disqualify an applicant for Medicaid assistance. An individual might purchase an annuity for income security in retirement. Long-term care needs might have been unanticipat-

22 A penalty period is calculated by referring to the average cost of nursing home care; a penalty period of 1 month is imposed for every sum equal to this cost. 42 U.S.C. § 1382b(c). Thus, for example, if the average cost of nursing home care in the jurisdiction is $5,000 a month, a gift of $10,000 will trigger a period of ineligibility of 2 months. *See id.* "[T]he transfer penalties are the price willingly paid so that [Medicaid applicants] can provide for their families as best they can." Br. for Amicus Curiae National Academy of Elder Law Attorneys, Inc. (NAELA), *Zahner*, 802 F.3d 497 (Nos. 14-1328, 14-1406), at 19. "The amounts actually transmitted to children and others incurring penalties have never been great." *Id.*

23 This is not to suggest that $500,000 in excess resources represents a hard-and-fast benchmark for individuals who will not benefit from strategic Medicaid eligibility planning. It is also important to note that post-eligibility, the community spouse's accumulation of excess wealth is irrelevant to the continuing Medicaid eligibility of the institutionalized spouse. Post-eligibility, the community spouse could win the Powerball Lottery; it would not matter insofar as the institutionalized spouse's Medicaid eligibility. Shorter-term annuities are especially attractive if the circumstances justify their use. In addition, because of their shorter terms, they generate minimal federal income tax consequences.

24 The Third Circuit states are Pennsylvania, Delaware, and New Jersey.

25 *See* Cynthia L. Barrett, *Advising the Elder Client: Trusts and Medicaid Eligibility*, 47 Prac. Law. 57 (Oct. 1997) (observing that Medicaid's "strict income and resource requirements ... vary in many particulars from state to state.")

ed. If the individual's income is insufficient to cover the costs of nursing home care and the existence of the annuity contract (as a countable resource) disqualifies the individual from Medicaid, the annuity becomes a problem, not a solution.[26] The annuity's existence prevents Medicaid eligibility. This kind of scenario is an ugly one and typically resolves itself with the individual surrendering the annuity, who then incurs financially painful surrender fees. The *Zahner* plaintiffs, in contrast, used DRA-compliant annuities to conform to federal Medicaid requirements and thereby soften the blow of financial hardship from long-term care costs.

A. Background

Two sets of plaintiffs' cases were consolidated in the *Zahner* case.[27] The first plaintiff, Donna Claypoole, was admitted to a Sligo, Pennsylvania, nursing home in 2010.[28] She and her husband Donald made gifts to their son Mitchell and his wife Terri exceeding $100,000.[29] In 2011, Claypoole's husband purchased an annuity for $45,000, which resulted in 60 monthly payments of $760.20. She herself purchased an annuity for $84,874.08 in exchange for 14 monthly payments of $6,100.22.[30] At the time, Claypoole was 86 years old and her life expectancy was 6 years. She died 2 years later, in 2013.[31]

The second plaintiff, Connie Sanner, who was not married, entered a Franklin, Pennsylvania, nursing home in 2011.[32] She purchased an annuity for $53,700.[33] The annuity guaranteed her 12 monthly payments of just under $4,500. She made a gift to her children at the same time.[34] When she purchased the annuity, Sanner was 77 years old.[35] (A third plaintiff, the eponymous Anabel Zahner, withdrew from the proceedings on appeal.[36]) In both Sanner's and Claypoole's cases, the Pennsylvania Medicaid agency reasoned that the annuity purchases resulted in a period of ineligibility and denied the applications for Medicaid long-term care assistance.[37]

B. The District Court's Decision

Sanner and Claypoole brought 42 U.S.C. § 1983 actions against the Pennsylvania Medicaid agency in federal district court; their cases were consolidated.[38] On cross-motions for summary judgment, the court ruled that the annuity purchases were sham transactions entered into for the sole purpose of shielding as-

26 Alternatively, and perhaps even worse, is in instances in which the purchase of the annuity can be construed under Medicaid law as a gift, resulting in the imposition of a period of ineligibility for Medicaid assistance if the purchase occurred within 60 months of the Medicaid application.

27 *Zahner*, 802 F.3d at 499–500; Br. for Pls., *Zahner*, 802 F.3d 497 (Nos. 14-1328, 14-1406), at 2–3.

28 *Zahner*, 802 F.3d at 499; Br. for Pls., *supra* n. 27, at 2.

29 *Zahner*, 802 F.3d at 499.

30 *Id.*

31 *Id.* at 507.

32 *Id.* at 500.

33 *Id.*

34 *Id.*

35 Br. for Pls., *supra* n. 27, at 4.

36 *Id.* at 4 n. 4. "Mrs. Zahner had applied for Medicaid under the Pennsylvania home and community based PDA waiver program and never received any long-term care Medicaid benefits … ." *Id.*

37 *See Zahner*, 802 F.3d at 500 (explaining that the Medicaid agency construed the annuities as "'resources' in calculating a new period of ineligibility."). *Id.; see also* Br. for Pls., *supra* n. 27, at 4 (stating that the Medicaid agency treated the annuity purchases "as transfers of assets for less than fair market value.").

38 *Zahner ex rel. Zahner v. Mackereth*, 2014 WL 198526 at *1 n. 1 (W.D. Pa., Jan. 16, 2014); 42 U.S.C. § 1983.

sets from Medicaid resource calculations and, alternatively, that the annuities were trust-like instruments.[39] The annuities actually lost money and their terms were not "commensurate with the reasonable life expectancy of the beneficiary," meaning that they were not actuarially sound, the court reasoned.[40] The annuities' terms

39 *Zahner ex rel. Zahner*, 2014 WL 198526 at **13–15.

40 *Id.* at *12 (quoting Ctrs. for Medicare & Medicaid Servs., *State Medicaid Manual,* Transmittal 64 § 3258.9B (Jan. 30, 2004) [hereinafter Transmittal 64]. Strangely, the district court determined that based on a reading of statute and the *State Medicaid Manual,* "The Plaintiffs' life expectancies were all greater than the terms of the annuities by a large margin, therefore the annuities may be considered actuarially sound under 42 U.S.C. § 1396p(c)(1)(G)(ii)(1)." *Id.* Then, despite having resolved the issue, the court concluded, two paragraphs later, "The relation of life expectancy to the annuity term of years does not pass the 'sniff-test' for any of the ELCO [the insurance company] annuities at issue." *Id.* § 3258.9B of the *State Medicaid Manual* is worth presenting:

> B. Annuities. Section 1917(d)(6) of the Act provides that the term "trust" includes an annuity to the extent and in such manner as the Secretary specifies. This subsection describes how annuities are treated under the trust/transfer provisions.
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> When an individual purchases an annuity, he or she generally pays to the entity issuing the annuity (e.g., a bank or insurance company) a lump sum of money, in return for which he or she is promised regular payments of income in certain amounts. These payments may continue for a fixed period of time (for example, 10 years) or for as long as the individual (or another designated beneficiary) lives, thus creating an ongoing income stream. The annuity may or may not include a remainder clause under which, if the annuitant dies, the contracting entity converts whatever is remaining in the annuity into a lump sum and pays it to a designated beneficiary. Annuities, although usually purchased in order to provide a source of income for retirement, are occasionally used to shelter assets so that individuals purchasing them can become eligible for Medicaid. In order to avoid penalizing annuities validly purchased as part of a retirement plan but to capture those annuities which abusively shelter assets, a determination must be made with regard to the ultimate purpose of the annuity (i.e., whether the purchase of the annuity constitutes a transfer of assets for less than fair market value). If the expected return on the annuity is commensurate with a reasonable estimate of the life expectancy of the beneficiary, the annuity can be deemed actuarially sound.
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> To make this determination, use the following life expectancy tables, compiled from information published by the Office of the Actuary of the Social Security Administration. The average number of years of expected life remaining for the individual must coincide with the life of the annuity. If the individual is not reasonably expected to live longer than the guarantee period of the annuity, the individual will not receive fair market value for the annuity based on the projected return. In this case, the annuity is not actuarially sound and a transfer of assets for less than fair market value has taken place, subjecting the individual to a penalty. The penalty is assessed based on a transfer of assets for less than fair market value that is considered to have occurred at the time the annuity was purchased.
>
> For example, if a male at age 65 purchases a $10,000 annuity to be paid over the course of 10 years, his life expectancy according to the table is 14.96 years. Thus, the annuity is actuarially sound. However, if a male at age 80 purchases the same annuity for $10,000 to be paid over the course of 10 years, his life expectancy is only 6.98 years. Thus, a payout of the annuity for approximately 3 years is considered a transfer of assets

were too short. Moreover, the court went on, a "subjective ultimate purpose inquiry" is appropriate when considering the purchase of annuities in connection with Medicaid eligibility.[41] This "sniff-test" (the district court's term) asks whether an annuity purchase serves a primary legitimate purpose "and not simply to abusively shelter assets for eligibility for Medicaid."[42] The court then applied a similar analysis to the "trust-like" arguments of the Pennsylvania Medicaid agency, emphasizing that "the law may view an annuity as a trust-like device" and concluded that the annuities could also be construed as trusts or at least trust-like.[43] The court, however, also determined that a Pennsylvania statute purporting to make all annuities assignable was pre-empted.[44]

An appeal followed. The state's appellate brief characterized the case as one turning on pre-emption; that is, whether the Pennsylvania legislature could prohibit anti-assignment provisions in annuities.[45] The plaintiffs' brief, in contrast, framed the issues on appeal as turning entirely on the subjective motivation test adopted by the district court.[46] Both parties recognized their strongest points: The plaintiffs' ability to jettison a judicially created sniff test seemed relatively assured, but the state could still prevail as long as it achieved a reversal of the district court's pre-emption holding.

C. Decision and Analysis

The Third Circuit's three-judge panel reviewing the *Zahner* district court decision split, with two judges, in an opinion authored by Chief Judge Theodore McKee, in the majority and one judge, Circuit Judge Marjorie Rendell, dissenting.[47] The majority affirmed the district court's pre-emption analysis but otherwise reversed its conclusions.

1. The Annuity Safe Harbor

The court recited the four elements for determining whether an annuity falls within the Medicaid Act's statutory safe harbor: "The annuity must 1) name the State as the remainder beneficiary, 2) be irrevocable and nonassignable, 3) be actuarially sound, and 4) provide for payments in equal amounts during the term of the annuity, with no deferral and no balloon

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for less than fair market value and that amount is subject to penalty.

Statistical life expectancy tables — one for males, one for females — follow this discussion in the *State Medicaid Manual*.

41 *Zahner ex rel. Zahner*, 2014 WL 198526 at *14.

42 *Id.*

43 *Id.* at *13–14.

44 *Id.* at *10.

45 Def.'s Br., *Zahner*, 802 F.3d 497 (Nos. 14-1328, 14-1406), at 2–3.

46 The plaintiffs framed its Statement of Issues as:

I. Does a subjective test not found in the statute justify treating an annuity as a trust-like device? The court below answered "Yes."

II. Does a subjective test not found in the statute justify treating the purchase of an annuity as a transfer of assets for less than fair market value? The court below answered "Yes."

Br. for Pls., *supra* n. 27, at 1.

47 *Zahner*, 802 F.3d at 515 (Rendell, J., dissenting). Judge Marjorie Rendell reasoned that a subjective inquiry was called for (i.e., a sniff test) and that annuities must be much closer to an individual annuitant's statistical life expectancy to qualify for safe harbor treatment. *Id.* She wrote, "[A]n annuity that is a tiny fraction of life expectancy has no investment purpose and operates only to shield assets." *Id.* at 516. Therefore, Judge Rendell emphasized, she "would affirm the District Court's ruling on the grounds that the annuities … were not purchased for an investment purpose, but, rather, were purchased in order to qualify for benefits." *Id.* at 515.

payments."[48] The state claimed that the annuities did not qualify for safe harbor treatment because they were assignable as a result of a Pennsylvania statute invalidating nonassignability clauses (the terms of the annuities themselves notwithstanding). The state also claimed that the annuities were not actuarially sound because their terms were too short and the cost of the annuities exceeded their return.

First, in support of its assertion that the annuities' terms were too short, the state argued that Transmittal 64, in describing the annuity safe harbor, refers to an annuity as "a right to receive fixed, periodic payments, either for life or a term of years."[49] The state emphasized the plural form of the term "year." The annuities in question were less than 2 years in duration.

The court dismissed these assertions. A "term of years" is typically defined as a fixed period of several years or less than a year.[50] It is a term of art.[51] Other relevant Medicaid authorities also fail to identify a "floor" on annuity terms, although the court did speculate that an annuity with a two-second term might constitute a sham transaction (assuming that the state regulatory authorities would even approve a "two-second annuity").[52]

The state also argued that the annuities were not actuarially sound because their cost exceeded their return.[53] Both Sanner and Claypoole paid their annuity brokers a $1,000 "start-up fee."[54] When that fee was factored in, the annuities boasted a negative return. Claypoole paid $85,874.08 and received $85,403.08; Sanner paid $54,700 and received $53,900.04.[55] The court rejected the state's poor return argument because of the lack of any authority requiring annuities to provide a certain rate of return — or any net return. In addition, the court reasoned, it was unclear whether the start-up fee should even be factored into the analysis. In this case, the $1,000 fee was "a cost entirely separate from the purchase price paid to the annuity company … ."[56] Like attorney's fees paid to an elder law attorney to develop a Medicaid eligibility plan, this fee related to avoiding litigation and ensuring that the annuities were Medicaid-compliant. Therefore, it would be inappropriate to net out these fees in calculating whether the annuities provided a positive return, even if this were required. Nothing in the safe harbor statutory text requires a particular return from an annuity investment. The court, therefore, declined to impose any such requirement.

Next, the state argued that the annuities were not actuarially sound because

48 *Zahner*, 802 F.3d at 501 (citing 42 U.S.C. §§ 1396p(c)(1)(F), (G)(ii)).

49 *Id.* at 503 (quoting *Transmittal 64* § 3259.1(a)(9)).

50 *Id.* at 504–105 (quoting *Black's Law Dictionary* 1599 (10th ed. 2014); *Black's Law Dictionary* 1470 (6th ed. 1992); *Black's Law Dictionary* 492 (5th ed. 1981)).

51 *See* Jesse Dukeminier et al., *Property* 443 (8th ed., Wolters Kluwer 2014) (explaining, "A term of years is an estate that lasts for some fixed period … [and t]he period can be one day, two months, five years, or 3,000 years.").

52 *Id.* at 503–505. ELCO, which issued Sanner's annuity, will apparently issue 2-month annuities and has written annuities used in Pennsylvania with 4-month terms. Def.'s Br., *supra* n. 45, at 20.

53 *But see* Def.'s Br., *supra* n. 45, at 40 (conceding that although actuarial soundness in the context of an annuity typically "means that there are sufficient assets in the bank to pay for the future funding stream" in the Medicaid context, "actuarial soundness relates to the length of the annuity.").

54 *Id.* at 503.

55 Def.'s Reply Br., *Zahner*, 802 F.3d 497 (Nos. 14-1328, 14-1406) at 35.

56 *Id.*

their terms — which were significantly less than the statistical life expectancies of the annuitants — were not commensurate with life expectancy as required by Transmittal 64. Although Congress required Medicaid-compliant annuities to be actuarially sound, it did not define "actuarially sound."[57] Transmittal 64, however, indicates that if "the expected return on the annuity is *commensurate with* a reasonable estimate of the life expectancy of the beneficiary, the annuity can be deemed actuarially sound."[58] The district court had reasoned that "the word commensurate indicates a reasonable relatedness of the term of the annuity to the beneficiary's life expectancy."[59] A beneficiary's life expectancy is determined by referring to Social Security tables. Transmittal 64 states, "The average number of years of expected life remaining for the individual must *coincide with* the life of the annuity."[60] Both the plaintiffs and the state agreed that Transmittal 64 imposes a maximum term for an annuity — the statistical life expectancy of the beneficiary. But the state asserted that if an annuity's term is to be commensurate with and coincide with statistical life expectancy, Transmittal 64 logically imposes a minimum term for annuities as well. The state cited Centers for Medicare & Medicaid Services (CMS) approval of North Dakota's state Medicaid plan amendments establishing an 85 percent life-expectancy floor on annuities for them to qualify as actuarially sound.[61]

The court, using a statutory construction analysis, rejected the state's annuity term floor arguments. Congress did not require any minimum term in the safe harbor provisions; it only required actuarial soundness (in addition to nonassignability/irrevocability, equal payments, and Medicaid agency remainder beneficiary status). To prohibit annuities that pay out to heirs after the annuitant's death, Transmittal 64 specifies that actuarial soundness requires that the return be "*commensurate with* a reasonable estimate of" the annuitant's statistical life expectancy.[62] It also provides two examples: 1) An annuity with a 10-year term purchased by a beneficiary who is expected to live 6.98 years is not actuarially sound (i.e., the annuity term exceeds the annuitant's life expectancy). 2) That same annuity, however, if purchased by a beneficiary who is expected to live 14.96 years, *is* actuarially sound (i.e., the annuity term is less than the annuitant's life expectancy).[63] Because neither

57 *Zahner*, 802 F.3d at 505 (citing 42 U.S.C. §§ 1396p(c)(1)(F), (G)(ii)). The statutory text provides that the annuity be "actuarially sound (as determined in accordance with actuarial publications of the Office of the Chief Actuary of the Social Security Administration) … ." 42 U.S.C. § 1396p(c)(1)(G)(ii)(II).

58 *Zahner*, 802 F.3d at 505 (quoting *Transmittal 64* § 3258.9(B)) (emphasis in original).

59 *Zahner ex rel. Zahner*, 2014 WL 198526 at *12.

60 *Zahner*, 802 F.3d at 505 (quoting *Transmittal 64* § 3258.9(B)) (emphasis in original).

61 Def.'s Br., *supra* n. 45, at 41–42. The state Medicaid agency argued, "This state plan amendment could not have been approved if Transmittal 64 was intended to mandate that States accept annuities that have no relationship at all to life expectancy." *Id.* The court pointed out, however, that 1) CMS had not approved Pennsylvania's rule and 2) even if it had, CMS approval did not "necessarily establish compliance with legal requirements." *Zahner*, 802 F.3d at 508 n. 12 (citing *Geston v. Anderson*, 729 F.3d 1077, 1079 (8th Cir. 2013)). The court also noted that even the Transmittal 64 example (a 10-year annuity for an annuitant with a 14.96-year life expectancy) would not have satisfied the North Dakota 85 percent rule. *Id.*

62 *Zahner*, 802 F.3d at 505 (quoting *Transmittal 64* § 3258.9(B) (emphasis in original)).

63 *Id.* at 506 (citing *Transmittal 64* § 3258.9(B)).

the DRA nor its regulations provide an example in which an annuity's term is too short, the court declined to impose any kind of "floating floor" for an annuity's term.[64]

The court was also sensitive to Donna Claypoole's circumstances. She had purchased an annuity with a 14-month term at age 86, when her statistical life expectancy was more than 6 years.[65] Despite what the actuarial tables told her, the court observed, "[F]ew people who reach the age of 80 could be faulted for measuring life expectancy in months rather than years and not assuming that they would live long enough to see their 92nd birthday."[66] Indeed, Claypoole did not have 6 more years to live; she died just 5 months after her 14-month term annuity expired.[67] Thus, her short-term annuity was, as it turned out "far more commensurate with her actual life expectancy than the actuarial predictions contained in the SSA [Social Security Administration] tables."[68] The court emphasized that it was not suggesting that short-term annuities must reflect actual longevity of an annuitant, but rather that Claypoole's circumstances revealed that determining whether to impose an annuity term floor invokes the types of policy concerns best left to legislatures.[69] The illustration of an 80-year-old projecting her anticipated remaining life span also revealed the majority's sensitivity to an elderly individual of limited means selecting an annuity term and making deeply personal calculations about her own longevity.[70] For a court to second-guess these kinds of calculations — especially because Donna Claypoole had been right! — would have been troubling.[71]

Finally, the panel turned to the preemption issue, on which the state had lost before the district court. The state claimed that Pennsylvania's statute purporting to make all annuities assignable by statutory fiat was an effective legislative act.[72] (Although not an issue in *Zahner*,

64 *Id.* at 506. The court noted that the Pennsylvania Medicaid agency failed to identify "just how much shorter the annuity can be and still be considered actuarially sound." *Id.* It concluded that "fashion[ing] a rule that would create some minimum ratio between duration of an annuity life expectancy would constitute an improper judicial amendment of the applicable statutes and regulations."

65 *Zahner*, 802 F.3d at 507.

66 *Id.*

67 *Id.* "Despite actuarial predictions, Claypoole did not have six more years to live." *Id.*

68 *Id.*

69 *Id.*

70 *See id.* at 507 (quoting Benjamin A. Templin, *Social Security Reform: Should the Retirement Age Be Increased?* 89 Or. L. Rev. 1179, 1199 (2011) (noting that *"individuals can often access their own longevity"*) (emphasis in original)); *see also id.* at 506 (noting that the Social Security Administration tables have relatively little predictive force as applied to any one individual because the tables depend only on the twin variations of age and gender while omitting other factors such as "race, medical history, and income").

71 *See also Zahner*, 802 F.3d at 508 n. 14 (emphasizing that shorter-term annuities are especially important for individuals with less wealth). "Being able to purchase an annuity for multiple years requires a large upfront cost that aging, low-income individuals may not have access to." *Id.* (citing Br. for Pls., *supra* n. 27, at 19-20, n. 8; NAELA's Br., *supra* n. 22, at 19–20, n. 37, 24–25). In fairness, Donna Claypoole had probably not engaged in self-reflection about her own longevity projections but had simply followed the advice of counsel in selecting an annuity product that satisfied Medicaid requirements. The Third Circuit also dismissed the idea of considering her motive in purchasing the annuity. *See infra* pt. II(C)(3).

72 *See Zahner*, 802 F.3d at 511 (quoting Pa. Stat.

the Pennsylvania statute also imposed a presumption that "there shall be a rebuttable presumption that any annuity ... is marketable without undue hardship."[73]) The state argued, rather convincingly, that there is a general presumption against pre-emption of state laws and that the presumption is even stronger in areas traditionally regulated by states, such as annuities.[74] Moreover, the very structure of Medicaid is based on "cooperative federalism" in which states are accorded considerable latitude.[75] The Medicaid Act "literally abounds" with options that permit states to tailor their particular Medicaid programs.[76] The very wording of the annuity safe harbor does confirm that not all annuities fall within the safe harbor provisions. An annuity that is assignable, for example, does not qualify for the exception from divestment penalty treatment.[77]

If the Pennsylvania statute were not pre-empted, the purchase of an annuity would always result in divestment penalties for a Medicaid applicant in that state. The Third Circuit affirmed the district court on this point, noting that states voluntarily participate in the Medicaid program.[78] The Medicaid Act permits states to establish more liberal eligibility requirements than federal law articulates, but they may not impose more restrictive requirements.[79] The court reasoned that although Congress intended that annuities not meeting the safe harbor requirements could be considered resources, "[I]t is equally clear that Congress did not intend that all annuities be considered."[80] In addition, Congress expressed its intention to shield the community spouse's income, including income from an annuity, as long as the annuity meets the safe harbor requirements.[81] Citing *Marbury v. Madison*, the court concluded that Pennsylvania's attempt to undermine this intent amounted to an attempt to change federal law with respect to Medicaid annuities.[82]

Ann. tit. 62, § 441.6(b) (West 2011) ("Any provision in any annuity ... owned by an applicant or recipient of medical assistance ... that has the effect of limiting the right of such owner to sell, transfer or assign the right to receive payments thereunder or restricts the right to change the designated beneficiary thereunder is void."). Thus, the nonassignability statute was not a general statute relating to the assignability of a particular form of property or contractual right; it specifically applied only to annuities owned by Medicaid applicants. The state Medicaid agency, however, attempted to recharacterize the statute as "an extension of Pennsylvania's general public policy against restraints on alienation of payment streams ... ." Def.'s Br., *supra* n. 45, at 11, 29 (citing 13 Pa. Consol. Stat. § 9408(a) (West 2013)). It also conceded, however, that the Pennsylvania legislature enacted the statute in response to the Third Circuit's decision in *James*, in which the court approved the strategy of converting joint countable resources into uncapped community spousal income. *Id.* at 17 (citing *James v. Richman*, 547 F.3d 214 (3d Cir. 2008)). The Pennsylvania statute also purported to apply to annuity contracts owned by community spouses. Pa. Stat. Ann. tit. 62, § 441.6(b) (West 2011). It is unclear whether a choice of law provision in the annuity contract (specifying, for example, New York law) would avoid the statute's application.

73 Pa. Stat. Ann. tit. 62, § 441.6(c) (West 2011).

74 Def.'s Br., *supra* n. 45, at 32.

75 *Id.*

76 *Id.* (citing *Doe v. Beal*, 523 F.2d 611 (3d Cir. 1975), *rev'd on other grounds*, 432 U.S. 438 (1977)).

77 *See* 42 U.S.C. § 1396p(c)(G)(ii)(I) (requiring annuities to be "irrevocable and nonassignable").

78 *Zahner*, 802 F.3d at 512.

79 *Id.* (citing 42 U.S.C. § 1396a(a)(10)(C)(i)(III)).

80 *Id.* at 513.

81 *Id.* at 514.

82 *Id.* (citing *Marbury v. Madison*, 6 U.S. 137

Pennsylvania also advanced a secondary pre-emption argument, one that neither the majority nor the dissent voiced in the published decision, probably because the state had not argued it before the district court. Pennsylvania's version of Article 9 of the Uniform Commercial Code (UCC) generally renders anti-assignment provisions in contracts and promissory notes invalid.[83] The state did not argue directly that the annuity anti-assignment provisions were rendered ineffective by the UCC but did note that there is authority for construing annuities as "general intangibles" and therefore annuities could be within the scope of this provision.[84] The state simply argued that the UCC demonstrated Pennsylvania's general policy favoring alienability.[85] If the state had adequately preserved its UCC argument, perhaps a different outcome regarding pre-emption would have followed.[86]

2. Annuities as Trust-Like Devices

The court also considered whether annuities could be construed as trust-like devices. Because transfers to a trust (other than to revocable trusts or (d)(4) trusts) result in divestment penalties, the state could have prevailed with its assertion that the annuities were trust-like even if its pre-emption and other arguments failed.[87] Although the Medicaid Act indicates that a trust includes "any legal instrument or device that is similar to a trust," it also specifies that annuities are trusts only "to such extent and in such manner as the Secretary specifies."[88] Thus, two prerequisites must occur before an annuity can be construed as trust-like: First, it must be "similar to a trust," and second, it must be construed as trust-like "in such manner as the Secretary specifies."

First, the court reasoned that "these annuities cannot be equated with trusts because there is nothing akin to a fiduciary relationship between the annuitants" and the annuity companies that issued the annuity contracts.[89] A trust typically refers to "a fiduciary relationship in which one person holds a property interest, subject to an equitable obligation to keep or use that interest for the benefit of another."[90] An annuity, in contrast, involves a contractual relationship. Although courts occasionally refer to trusts as contracts, the duties imposed upon a trustee "traditionally are seen not as based on a contract but rather on the effect of a conveyance."[91] In

(1803)).

83 13 Pa. Consol. Stat. § 9408(a).

84 Def.'s Br., *supra* n. 45, at 30 (citing *U.S. Natl. Bank v. Custom Coals Laurel*, 258 B.R. 597 (Bankr. W.D. Pa. 2001)); *In re Newman*, 993 F.3d 90 (5th Cir. 1993).

85 Def.'s Br., *supra* n. 45, at 30 (citing *U.S. Natl. Bank v. Custom Coals Laurel*, 258 B.R. 597 (Bankr. W.D. Pa. 2001)); *In re Newman*, 993 F.3d 90."]]

86 *E.g. Food Servs. of Am. v. Royal Heights, Inc.*, 871 P.2d 590, 593 (Wash. 1994) (en banc) (finding that the federal Food Security Act did not pre-empt Washington state law governing perfection of security interests); *Bank of N.Y. v. Nickel*, 789 N.Y.S.2d 95, 100–101 (N.Y. App. Div. 1st Dept. 2004) (holding that federal regulations pertaining to transfers of assets from Serbia and Yugoslavia did not pre-empt New York's code provisions regarding electronic fund transfers); *but see Crespo v. WFS Fin., Inc.*, 580 F. Supp. 2d 614, 623 (N.D. Ohio 2008) (holding that the federal Home Owners' Loan Act pre-empted aspects of Ohio's code).

87 *See* 42 U.S.C. § 1396p(c) (delineating transfers to trusts as divestments).

88 42 U.S.C. § 1396p(d)(6).

89 *Zahner*, 802 F.3d at 511.

90 Amy Morris Hess, George Gleason Bogert & George Taylor Bogert, *Bogert's Trusts and Trustees* § 1 (Thompson Reuters 2016) [hereinafter *Bogert*].

91 *Id.* at § 17.

addition, a trust involves a bifurcation of ownership in which the trustee holds legal title to the same assets in which a beneficiary holds equitable title.[92] Both these key characteristics are missing with an annuity. As long as the annuity company fulfills its contractual obligations, it is under no fiduciary duty to account to the beneficiary or to invest wisely.[93] As a result, the *Zahner* court "readily reject[ed]" the contention that an annuity could be characterized as some form of a trust.[94]

The *Zahner* court also considered whether the Secretary had specified the manner in which an annuity might be construed as trust-like and concluded that the Secretary had not. The state argued that Transmittal 64 — although predating the annuity safe harbor rules — contained the Secretary's reply to the statutory invitation to specify when annuities could be characterized as trusts.[95] Transmittal 64, however, simply recites the actuarially sound requirement for annuities. In addition, an HHS brief filed in the Second Circuit Court of Appeals took the position that "the Secretary has not so specified."[96] The Eighth Circuit has reached the same conclusion.[97] Accordingly, the *Zahner* court concluded that the HHS Secretary had not specified any manner in which an annuity could be characterized as a trust and therefore rejected the state's trust-like argument.[98]

Then, taking a second swing at the same pitch, the Pennsylvania Medicaid agency argued that if the annuities in question were not trust-like, they were not annuities.[99] "What Congress had in mind when it used the term 'annuity' was an investment product," argued the agency, and short-term annuities "are plainly not investments."[100] The state again emphasized that the annuities cost more than they returned to their investor-annuitants and claimed that the short annuity terms must not have been selected for investment purposes "but to help pay for the penalty period that resulted from Plaintiffs' half-a-loaf gifting scheme."[101]

Because the DRA failed to provide a definition of an annuity, the court turned to a definition from a 1995 U.S. Supreme Court decision dealing with whether the National Bank Act permits national banks to serve as agents for the sale of annuities. In the *NationsBank* case, the Supreme Court provided this definition for annuities: "contracts under which the purchaser makes one or more premium payments to the issuer in exchange for a series of payments, which continue either for a fixed period or for the life of the purchaser or

92 *Id.*

93 *Zahner*, 802 F.3d at 511. *See also Bogert, supra* n. 90, at § 17 (emphasizing, "The proprietary nature of a beneficiary's rights gives the beneficiary the right to maintain an action for an accounting of the trust assets, while the ordinary creditor has no right to require the debtor to furnish a similar report."). "The debtor is not a steward for the creditor." *Id.*

94 *Zahner*, 802 F.3d at 511.

95 *Id.* at 510 (quoting 42 U.S.C. § 1396p(d)(6)).

96 *Id.* (quoting Br. for the Amicus Curiae U.S. Dept. of Health & Human Servs., *Lopes v. Dept. of Soc. Servs.*, 10-3741-cv, at *11, n. 5 (2d Cir. 2011) (emphasis in original)). The federal reporter citation for Lopes is 696 F.3d 180 (2d Cir. 2012).

97 *Geston*, 729 F.3d at 1085.

98 *Zahner*, 802 F.3d at 511.

99 Def.'s Br., *supra* n. 45, at 34–38.

100 *Id.* at 34.

101 *Id.* at 35–36. The district court had held that annuities may be viewed as trust-like devices but that "the analysis under a trust-like evaluation is the same as the annuity evaluation … ." *Zahner ex rel. Zahner*, 2014 WL 198526 at *13. The Third Circuit agreed that the analysis was "circular" but declined to treat annuities as trusts. *Zahner*, 802 F.3d at 510.

a designated beneficiary."[102] The *Zahner* court reasoned that the annuities at issue met this definition. Both annuities involved an exchange of a sum of money for a series of payments that continued for a fixed period.[103]

3. A Sniff Test

Finally, the Third Circuit made rather short work of the district court's sniff test. The district court reasoned that it was appropriate to engage in a subjective ultimate purpose inquiry in determining whether an annuity falls within the statutory safe harbor.[104] It emphasized that the purpose of Transmittal 64 would be frustrated were a sniff test not adopted considering the manner in which Medicaid eligibility constantly develops "new and innovative ideas for asset-sheltering … ."[105] Therefore, a sniff test was required.[106] The two-judge majority in *Zahner* correctly noted that the district court had failed to cite any legal authority for its sniff test and dismissed the relevance of motive,[107] although the dissent engaged in a close reading of the *State Medicaid Manual* in support of its conclusion that it is, in fact, appropriate to consider whether an annuity was purchased for investment purposes or to simply qualify for Medicaid assistance.[108] The manual mandates a consideration "with regard to the ultimate purpose of the annuity (i.e., whether the purpose of the annuity constitutes a transfer of assets for less than fair market value)."[109] The *State Medicaid Manual* represents "the official HHS interpretation of the law and regulations."[110] It emphasizes that annuities might be purchased in order to shelter assets and achieve Medicaid eligibility.[111] Judge Rendell reasoned that the court could not ignore the manual and, given the short payback periods and negative returns of the annuities, was willing to conclude that the annuities were not investments; they lacked any economic purpose, aside from qualifying for Medicaid.[112]

III. Conclusion

The *Zahner* decision has been rightly hailed as a victory for the clients of elder law attorneys.[113] The decision roundly rejects any minimum term for Medicaid-compliant annuities. It convincingly jettisons the contention that annuities can be construed as trust-like devices. It vanquishes the consideration of the broker fees, total returns, or investment performance of an annuity product. Perhaps most important, it dismantles the district court's creation of a subjective inquiry when an annuity is purchased — a self-styled sniff test — which was wholly lacking in statutory support. But where the Pennsylvania Department of Human Services' brief was at its strongest — and where the Third Circuit's reasoning was at

102 *Zahner*, 802 F.3d at 502 (quoting *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 245 (1995)).

103 *Id.* at 503.

104 *Zahner ex rel. Zahner*, 2014 WL 198526 at *14.

105 *Id.*

106 *Id.*

107 *Zahner*, 802 F.3d at 508.

108 *Id.* at 515 (Rendell, J., dissenting).

109 *Id.* (quoting *Transmittal 64* § 3258.9(B)).

110 *Id.* (quoting *Pa. Dept. of Pub. Welfare v. U.S. Dept. of Health & Human Servs.*, 647 F.3d 506, 509 (3d Cir. 2011)).

111 *Id.* (quoting *Transmittal 64* § 3258.9(B)).

112 *Id.*

113 *See* Ward, *supra* n. 7, at 732–733 (emphasizing, "[T]he Third Circuit's *Zahner* decision is a win for elder law attorneys and their clients, as it solidifies the viability of the use of short-term annuities in Medicaid planning.").

its frailest — was in the pre-emption context. If a second round can be predicted in *Zahner*, not with Connie Sanner and Donna Claypoole but with other elderly Medicaid applicants of limited means, it will be with state statutes that invalidate nonassignability provisions — at least outside the Third Circuit. If states can regulate assignability provisions in annuities, a traditional area of state regulation, all pre-emption assertions by Medicaid applicants may not be guaranteed the same success as enjoyed by the *Zahner* plaintiffs.