Three Cool Tricks with Annuities

As a general rule, annuities are an inferior investment vehicle. You ought to have a really good reason before you purchase one (and the usual one used to market these to physicians, tax avoidance, isn't good enough.) One good reason is to ensure you don't outlive your money. Many investors buy a single premium immediate fixed annuity in their 60s or 70s. This is the "term life insurance" of annuities. It is a commodity that can essentially be bought based on price alone. Unfortunately, like with permanent life insurance, insurance companies like to add on lots of bells and whistles and complicating factors with their associated fees that make it difficult to compare one annuity to another. Also, like permanent life insurance, they are often sold inappropriately. But with those caveats, there are some useful aspects to annuities. I'd like to highlight three of them in this post, hopefully none of which you'll ever need.

Reverse Mortgage/Immediate Annuity Combination

A reverse mortgage is available to those over 62 1/2 who own a home, but don't have enough money to meet their living expense needs. It basically allows the homeowner to spend the equity in their home on their living expenses. Then, when they die, move out, or sell the home, the company that offered the reverse mortgage gets the house and can sell it at full market value. One big issue with reverse mortgages is that the fees can be quite high, often over $10,000. But for those without much in the way of assets, this can be a useful source of income in retirement.

Reverse mortgages can provide payment to you in several different ways. You can get a payment each month from now until you move out or die, a one-time lump sum payment, or a line of credit you can tap at will. There are endless variations on these themes, but the usual issue is that once you move into a nursing home or sell the home for another reason, the payments cease. An annuity can help address this problem.

If you take your reverse mortgage payment as a lump sum, you can then buy a single premium immediate fixed annuity with the lump sum. Then, if you move into a nursing home a year from now, you've still got that stream of income coming in for the rest of your life. You're basically insuring yourself against the possibility of your moving out of or selling the house within just a few years of getting the reverse mortgage. The downside, of course, is that you are adding the annuity fees onto the reverse mortgage fees, both of which can be substantial. But a single premium immediate annuity (SPIA) can be had for quite low fees compared to many types of annuities. And for someone who is already on a very limited income, a SPIA gives you the ability to spend all your income each month without having to worry about running out of money in retirement. Essentially you get a higher safe withdrawal rate from your investments (although no chance of passing them on to heirs.)

Medicaid Annuity

Many of us have had family members or patients who needed nursing home care but had no assets or long term care insurance. As you know, if you have no assets, Medicaid will pick up the cost of nursing home care. Medicaid laws are state-specific, but in general, only some of your assets are considered when evaluating whether you are poor enough to have Medicaid pick up the bill. You cannot have more than $2000 in “countable assets”, which generally include bank accounts, stocks, bonds, mutual funds, and most other investments. In my state, a car valued at $4500 or less doesn’t count, nor does the value of your home. There is no community spouse resource allowance in my state (which in some states is a little over $100K that the spouse not in the nursing home gets to keep without disqualifying the ill spouse from Medicaid.) However, the community spouse’s income doesn’t count at all here.

You can see where I’m going with this. Buying a SPIA with your assets turns the assets into income. Since the assets no longer count, the ill spouse now qualifies for Medicaid. Gaming the system? Of course. But is it any different than trying to legally pay less in taxes? Since everyone’s situation is different, and state laws all differ, consult with an elder law attorney in your state prior to buying a SPIA for this reason. The annuity must be immediate, irrevocable, and actuarially sound, meaning your basic SPIA, not an annuity with a lot of bells and whistles.

Long Term Care Annuity

Finally, there are some people who would like to purchase long term care insurance but cannot do so, or cannot do so at a reasonable price, due to health problems. There are some newer annuities that will issue a rider for long term care expenses. This rider is far from free, of course, and it’s tax treatment is also quite unfavorable. Long term care premiums are generally tax-deductible, but the premiums for the rider deducted from the value of the annuity are not.

This isn’t necessarily the best way to pay for long term care. Long term care insurance is generally bought by those “in the middle.” Those who have portfolios > $1 Million (like most docs should) can probably self-insure against this risk. Even at $8K a month for a nursing home, a $1 Million portfolio would last well over a decade, especially if invested wisely. Those who have little in assets are best spending down to the Medicaid levels. But those in the middle are most likely to benefit from long term care insurance, if they can qualify for it. Since it’s tax treatment is better than an annuity with a long term care rider, those who need this coverage are best buying an insurance policy. The annuity with LTC rider option is really only best for those with disqualifying health problems.

Although rarely a good “investment” the insurance component of an annuity can often be quite useful in financial planning. Beware of high fees, unscrupulous agents, and unnecessary features, but realize there are some areas where an annuity can be very helpful to your finances.