

ANNUITY SALES - THE TAIL WAGS THE DOG

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As an attorney with a busy elder law and estate planning practice, I often advise clients about purchasing financial products. Unfortunately, I sometimes see clients who have already purchased the wrong product. One such product that continually emerges is the deferred annuity. Very often, the deferred annuity has been represented to the client as a means of sheltering his or her assets from the cost of long term care. Much to the disbelief and dismay of many clients, the annuity does not always perform as advertised

The Medicaid rules for eligibility for nursing home assistance determine what assets a person is allowed to have in order to qualify for such assistance. In general, all assets are counted. Notable exceptions include one's home, prepaid funeral arrangements, a life insurance policy if the cash value is less than \$1,500, and when the Medicaid applicant has a spouse, an automobile, and up to \$99,280 in other assets for the couple. Annuities are not among the exempt assets.

What does this mean to the person facing nursing home expense who has purchased an annuity? In the case of a couple, the annuity will either be included in the \$89,280 of assets the non-nursing home spouse (community spouse) is allowed to keep, or it will have to be cashed in. This is where the biggest blow occurs. Most, if not all annuities are sold with a provision that if the funds are withdrawn within a set period of time, an early withdrawal penalty will be applied. The length of the period and amount of the penalty varies from product to product, but the penalty is often substantial. The periods are very often in the range of ten to twelve years and penalties are often graduated, starting with something like 10 percent in the first year and going down incrementally over the next ten years or so, until there is no longer a penalty for withdrawing the funds. For example, if a person purchased an annuity with \$100,000, it might have an early withdrawal penalty of 10% in the year following the purchase. If the buyer found that he had to cash the annuity in that year, he would have to forfeit \$10,000 to the annuity company to recoup their investment. Thus, not only is the annuity not sheltered from nursing home expense, but in many cases, it will have to be cashed in and a substantial percentage of the proceeds forfeited to the annuity company in the form of an early withdrawal penalty

Why then are annuity sales so prevalent? This was probably summed up best at a recent Maine Bar Association Seminar on retirement planning by one of the speakers who happened to be an insurance salesperson himself. His answer to this question was that it represents the classic case of the tail wagging the dog; that the commissions on annuities are so lucrative that many annuity sales people can not resist the temptation to sell annuities whenever possible, even when they are inappropriate to meet a client's financial planning objectives.

Even if the elderly persons buying the annuities don't have the misfortune of requiring nursing home care during the pendency of the term during which early withdrawal penalties apply, the annuities are very often not particularly attractive in terms of their returns when compared with other financial vehicles, such as stocks, bonds and mutual funds in a well balanced financial portfolio. But, again, the biggest detriment in these deferred annuities is the lack of flexibility inherent in the early withdrawal penalties. Once the purchase is made, and the redemption period

has expired (generally 30 days from the date of purchase) the purchaser is contractually locked into the terms of the annuity, no matter how punitive.

So from where does the myth that annuities are exempt assets in the context of Medicaid eligibility stem? There is one limited instance in which annuities can be an effective planning device in protecting assets from long term care expense. This applies only when one spouse is going into a nursing home and the other will remain in the community. In such instances, the income of the community spouse is not counted in determining eligibility of the nursing home spouse, and the community spouse may keep all of her income, regardless of the amount. When the couple has more than the \$99,280 in countable assets which they are allowed under the Medicaid rules, the community spouse can purchase an immediate annuity with the excess assets, thereby turning a countable asset into an uncountable stream of income. A very important distinction is necessary here - between an immediate annuity and a deferred annuity. An immediate annuity is one in which the annuitant (the person purchasing the annuity) locks into receiving a stream of income for life and/or a term of years. The contract is completely inflexible, i.e. the annuitant may never redeem the corpus of the investment, but rather is only entitled to receive the stream of income. Two things are worth remembering in this regard. First, this type of annuity may be purchased when one is on the brink of going into a nursing home; in other words, there is no need to rush into it until nursing home care is imminent. Second, this type of planning only works only in cases of married couples and not with single individuals.

This is not to say that there are not instances in which annuities can be useful financial planning devices. The typical deferred annuity allows one to accumulate the income generated by the annuity without paying income tax until withdrawals are made. For persons in higher income tax brackets, this can be an attractive option. Annuities can also be very useful for individuals, generally retired, who need to generate more income than their Social Security and pension benefits afford them. Thus, they can put some or all of their assets into an immediate annuity to create a lifelong stream of necessary income. There are many honest and trustworthy insurance sales people. It is important that you know who is selling the product and that the company is reputable. If this is so, they should be happy to answer your questions about why an annuity is an appropriate investment choice given the inflexibility. And a consultation with an independent financial planner or elder law attorney is always a good idea before purchasing an annuity.

In summary, annuities have become extremely popular financial planning devices of late. Ironically, however, many of the annuities sold are less than desirable financial planning vehicles with little or no advantage over other investment products. They are inherently inflexible, carrying lengthy and expensive early withdrawal penalties. In the circumstance in which an annuity will shelter assets for the spouse of a person going into a nursing facility, the purchase of the annuity can be made at such time as nursing home care is imminent. If the purpose in purchasing an annuity is to create a stream of income or to defer income, an annuity may be a sound investment choice. It is important to have a solid understanding of the annuity product and how it will meet your financial planning objectives.