The Prodigal Daughter (and the Annuity)

By Kerry Pechter *Thu, Feb 11, 2016*

An elderly woman's remaining wealth was being eroded by a feckless daughter and granddaughter. Could an advisor solve a family mess with an annuity?

Would it make sense to use a life annuity to protect an old woman's income and prevent her feckless daughter and granddaughter from consuming her $2 million estate—and endangering a son's inheritance?

As we hiked along a snow-and-ice encrusted trail through a state park last week, an advisor-friend told me about a dilemma that one of his clients faced. She was 88 years old, in relatively good health, and had recently paid $500,000 for a sunny unit in an assisted living facility in Florida. (At her death, the facility would buy back the unit from her heirs for the same price). The facility charged an additional $6,000 a month for meals, housekeeping and support.

The widow of a successful attorney, the woman was fairly well fixed. There was $250,000 in an IRA and roughly $1.5 million in a revocable trust. The trust's primary beneficiaries were her 56-year-old son and 51-year-old daughter. Her son served as trustee. The money was invested in a diverse mix of domestic and international equity ETFs and bond funds.

There was just one problem. To put it bluntly, the daughter was spending her mother's money at an alarming rate. Divorced from a man who had had a nervous breakdown and lost his business, the daughter depended on her mother for income. In addition, her daughter, a 23-year-old unable to work because of an autoimmune disease of unknown origin, was receiving $3,000 a month to cover her living expenses.

The mother was unable to say no to her daughter's requests for money, and the son had been disbursing the money from the trust accordingly. But now the son was worried. If his mother lived long enough and if his sister and niece continued to spend at their current rate, his inheritance might be paltry.

"Sounds messy, but not uncommon," I said. He had called me because he thought he might solve their problem by recommending an immediate income annuity for the mother. The annuity would protect the income she required for life. For a $500,000 premium, he said, he could buy a life-only contract paying $83,000 a year. Did that make sense? [The quote is from memory, so please don't hold me to it.]

The purchase of an annuity often calls for a serious family decision. Here was a case where a serious family decision seemed to call for an annuity. As the advisor saw it, the $250,000 IRA and $250,000 from the trust could go into the annuity. Then, after an additional $250,000 was set aside for the mother's unexpected needs, a fair one-time payment of $500,000 could be made to the daughter, giving her responsibility for managing the money for herself and the ailing granddaughter. The son would receive the remaining $500,000, and the two siblings would share the reimbursement of the $500,000 from the assisted living facility equally.

This was his plan, but it was still fluid. My advisor friend, who charges by the hour, would gain nothing from an annuity purchase nor lose any fees from "annuicide." So compensation was not an issue. But he found himself a bit bewildered by all the contract options, and needed my help sorting them out.

We debated the pros and cons of various strategies for an hour or two. Would a life annuity make more or less sense than a period certain contract with a cash refund? What if the elderly woman were hit by a jitney while crossing Collins Avenue in Miami Beach? But wouldn't the son be drawn to the larger rate of implied return offered by the life-only annuity? (The woman's life expectancy was about five years.)

I could see that analysis paralysis, a common side effect of the annuity purchase process, was eroding his original enthusiasm for the guaranteed solution. I tried to think of something concrete, some sort of heuristic, to prevent him from retreating into the comfort zone of a balanced investment solution. It was like seeing someone bitten by a viper and trying to think of an antidote in time to save his life.

Finally, I suggested that, instead of picking a target premium and comparing payouts from different types of contracts, it might be more useful to pick a target payout and then compare the prices of different types of contracts. He and his client could eyeball the prices and—using the common sense that most people use when weighing the purchases of vacation insurance or appliance insurance—decide if the peace of mind of a refund seemed worth the higher price.

That notion didn't seem to galvanize him, so I tried something else. "Look," I said. "Don't agonize about a difference of a few tens of thousands of dollars. A person should buy an annuity to solve a problem, not to make a financial bet. You buy an annuity to take certain kinds of risk off the table. And this annuity can stop the family from drifting and bring some clarity to the situation. Isn't that what they want?" He didn't reply, but after we had scraped the mud off our shoes, climbed into his Subaru, and started driving back toward the city, I thought I could see the serum working.