The Insured Annuity

An income enhancement strategy

RBC Dominion Securities

How do you make sense of all the financial planning strategies there are to choose from? Like most Canadians, you want to maximize the earning potential of your money, live the retirement lifestyle you've imagined and leave a legacy that lasts. A powerful strategy to consider —the insured annuity.

The insured annuity can:

- Maximize after-tax retirement income without increasing investment risk
- Earn a pre-tax equivalent yield, likely unattainable with today's fixed income investments
- Lower taxes and increase your chances of securing government benefits
- Create a guaranteed income that lasts an entire lifetime
- Eliminate the inconvenience of reinvestment

First of all, what are annuities?

An annuity is a contract that binds an issuer to deliver a steady stream of income payments in return for a lump sum deposit. These payments can be set up to last an entire lifetime (a life annuity)—or for a set period of time (a term certain annuity).

Each payment is a combination of a return of the original capital and interest income. The steady cash flow of an annuity can help you avoid the need to liquidate other investments.

Understanding an insured annuity

An insured annuity combines two individual products: a life annuity contract and a life insurance policy.

A life annuity usually provides a much higher level of income than other types of investments because, as described, it combines your original capital with interest. However, that means there is no more capital for your family when you pass away.

By using a portion of each annuity payment to pay premiums on an insurance policy, you can ensure that an amount equal to your original capital is restored when you die. Therefore, you receive a guaranteed stream of income plus a return of your initial deposit, as you would with a fixed-income investment like a GIC or bond, but with greater return potential.

Tax advantages mean increased income

With the insured annuity, only the interest portion of each payment is taxable every year. In comparison, when you purchase a GIC, any income, whether it is received or reinvested, is considered to be taxable.

In many cases, even after paying the insurance premiums, the resulting income is higher than the net income achieved by a GIC or similar investment. And since the taxable income is lower, you may still be eligible for government-sponsored benefits, such as old age security.

Earn a higher pre-tax equivalent yield

Avoiding probate

With an insured annuity, insurance proceeds can be issued directly to a named beneficiary or beneficiaries, without cost or delay. Regular investments form a part of your estate and must go through the entire probate process before they are distributed. This can mean additional costs, such as probate and executor fees, and delays in allocating your money according to your wishes.

If you are a healthy individual between the ages of 65 and 85, you can potentially reap the benefits of an insured annuity. The example below compares the monthly income earned by a joint life annuity, insured annuity and a GIC.†

Maximize after-tax retirement income*

Initial investment: $250,000
GIC rate of return: 4.5%
Marginal tax rate: 40%

	GIC	LIFE ANNUITY	INSURED ANNUITY
Gross Monthly Income	$940	$1,740	$1,740
Taxable Portion	$940	$300	$300
Taxes Payable	$375	$120	$120
Insurance Premium	N/A	N/A	$551
Net Monthly Income	$565	$1,620	$1,070

The net income generated by the insured annuity is equivalent to a 8.55 per cent pre-tax yield—a difficult rate to achieve using today's traditional fixed-income vehicles. Rates of return will vary by age and gender, as well as by the amount of money that is invested.

Think long term

Keep in mind that this rate of return is guaranteed for life. That means you avoid the hassle of shopping for the highest rate at renewal time. One thing to remember is that your capital remains locked in; once you invest your money in an annuity, it cannot be withdrawn. For this reason, it's wise to invest only a specific portion of your total capital—an amount you are comfortable with and know you will not need access to.

The charitable insured annuity

If your financial plan includes charitable giving, the charitable insured annuity may be ideal for you. This is a strategy whereby a charitable organization becomes the owner of the insurance portion of an insured annuity. In this case, any premiums paid by the individual qualify for a tax credit, effectively reducing the premium cost by your marginal tax rate.**

† Based on a couple both age 75 and non-smokers.

* Rates effective Dec /04 using T-100 insurance from Manulife Financial and annuity rates from Standard Life.

** Actual credit will vary by province.

Consider the previous example. By designating the charity as owner of the insurance policy, the couple would receive a tax credit of approximately $200 (in Alberta). That would increase their net income even further—up to $1,270 in comparison to the $565 they would get from a GIC yielding at 4.5 per cent rate of return. That's a 10.14 per cent equivalent pre-tax yield. What's more, the charity they designate would receive $250,000 when they die.

Corporate insured annuity

As a small business owner, you may find the insured annuity appealing for a variety of reasons. First, the corporation's net income can be significantly enhanced, just as described for an individual. However, there are additional estate benefits for small business shareholders.

Minimizing capital gains

At death, the deemed disposition of the shares of your company will more than likely trigger a capital gain, depending on the value of its assets. However, due to the way insurance policies and life annuities are valued, those products may hold very little value at the time of death.

By depositing a lump sum into an annuity contract, and by purchasing an insurance policy with little to no cash value, you may be reducing the overall value of the business significantly, and therefore, limiting the capital gains liability.

Capital dividend account

When a corporation receives the proceeds of an insurance policy, it creates room within its capital dividend account. The purpose of this account, which is only available to Canadian-Controlled Private Corporations (CCPCs), is to

pay tax-free dividends to shareholders, which in this case would be either the shareholder's estate or family members. Normally, assets are paid out as a taxable dividend.

Create a guaranteed income that lasts an entire lifetime

The net result of the corporate insured annuity strategy can be an increased rate of return on corporate assets during your lifetime as a shareholder, a reduced tax liability to your estate upon death and an increased estate value for remaining shareholders.

To learn more about the insured annuity and how it can maximize the performance of your personal or corporate financial plan, call us† today.

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