Financial Planning With An Insured Annuity

CIBC Wood Gundy

SNIDERMAN – AGOPIAN
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Most Canadians depend on their registered assets (RRSP/RRIF), pension and government benefits, to provide income during their retirement years. But for many, the income from these sources will not be enough to fully support their lifestyle. Often they look to supplement their income with interest from bonds and GICs purchased with their non-registered capital. While these products ensure the return of principal, their after-tax returns can be unattractive during periods when interest rates are low. An insured annuity is an alternative investment vehicle, which provides substantially higher guaranteed after-tax income, even when interest rates are low, along with the safe return of capital.

What is an insured annuity?

An insured annuity combines a life annuity with a permanent life insurance policy. The annuity provides a lifelong pension and the life insurance returns all of the invested capital directly to your estate or beneficiaries. This is similar to a bond where you receive regular cash flow and the return of principal except that the latter occurs on your death with an insured annuity, rather than having a fixed term.

When purchased with non-registered assets, the payout from a prescribed annuity receives preferential tax treatment since a large portion of the cash flow is considered non-taxable return of capital rather than taxable interest. This treatment is fixed for the entire duration of the annuity providing both tax deferral and tax savings.

The advantage of receiving non-taxable income is especially beneficial for those in higher tax brackets, particularly those who are not receiving their full Old Age Security (OAS). By employing an insured annuity strategy, they are able to lower their taxable income and thereby qualify for higher OAS benefits.

The insured annuity can be based on a single life or joint lives by adding a spouse or partner. Funding for the life insurance policy can be from personal non-registered capital or from corporate capital with the latter providing some additional tax benefits, including the potential to flow the insurance proceeds out of the corporation and into the hands of the beneficiaries tax-free.

Who should consider an insured annuity?

Insured annuities work best for those who:

- Are age 65+
- Are in good health
- Have non-registered savings subject to annual taxation
- Seek guaranteed cash flow
- Are in a high marginal tax bracket
- Would like to proactively address the effect of taxation on their estate

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What type and amount of insurance is appropriate?

An insured annuity is a long-term investment vehicle, which is essentially fixed and non-cancelable. Accordingly, it is important to carefully consider your personal and financial circumstances and goals. Before we provide specific recommendations, our process involves:

1. Analyzing your current sources of income and their after-tax yield
2. Identifying which of these carry lower yields or generate higher taxes
3. Quantifying the increase in net cash flow from utilizing an insured annuity strategy
4. Recommending the amount and source of capital to dedicate to an insured annuity appropriate for your financial circumstances and goals.

What are the benefits of an insured annuity?

An insured annuity is attractive for a few key reasons:

- It provides guaranteed predictable cash flow with no volatility or re-investment risk
- Cash flow from the annuity is taxed at a significantly lower rate than interest and dividends
- The after-tax return for the strategy is typically much higher than other guaranteed sources of income
- Proceeds of the insurance policy:
  - provide cash for heirs tax-free without the delay or fees associated with probate
  - help avoid the forced sale of valuable or illiquid assets in order to pay taxes due on death
- If a preferred beneficiary is named, the insurance policy and proceeds are creditor protected
- It allows you to plan and pay for future obligations in a very tax-effective way

Case Study

Donna is 71 years old and has substantial retirement savings but is concerned that current interest rates are too low to allow her to maintain her lifestyle without dipping into capital. This is of concern since she would like to leave a legacy to her children and grandchildren.

After speaking to her Investment Advisor, she decides to implement an insured annuity strategy using $500,000 of capital. The life annuity provides an after-tax monthly income of $2,947. She uses $1,576 of this to pay the monthly premiums for a $500,000 insurance policy*. This leaves her with a net disposable income of $1,371 per month. Because she is in a high tax bracket, she would have to earn more than 6% from a $500,000 bond or GIC to provide the same net income, about twice as high as current interest rates. Using an insured annuity, Donna receives a substantially higher guaranteed after-tax income and still ensures that the full $500,000 of capital is paid to her estate for the benefit of her family.

* The annuity rate used is based on a single life annuity with the first payment being received one month after the purchase date. The life insurance premium quoted is based on standard non-smoker rate. All insurance and annuity rates are based on those in effect as of December 27, 2012.

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