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## *FINANCIAL*PLANNING

## *Insured annuities: great, guaranteed returns when interest rates are low*

# 'Annuity+'

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Economists tell us that Canada's low interest rates will continue to prevail as the "new normal." That's good news for a young person buying real estate with long-term financing, but awful news for aging Baby Boomers on the cusp of retirement who need security of income and also want to leave an estate to their family and/or charity.

### Annuities—the basics

Annuities have long been recognized as one of the best secured investments available. An annuity pays income at regular intervals, usually monthly, starting either immediately or at some date in the future. Some annuities pay out for a specified number of years, while a life annuity makes payments for as long as you live. A joint life annuity makes payments for as long as either you or your spouse lives. But after death, the money is no longer available to give to heirs—and this last detail presents an unwelcome challenge for people who are unaware of the insured annuity strategy.

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### Insured annuities —some key advantages

An insured annuity provides a unique combination of an annuity plus permanent life insurance. This type of annuity includes a number of attractive features: 1) you receive regular payments while you are alive; 2) you cannot outlive this particular source of retirement income; 3) you maintain your estate for your beneficiaries; 4) you increase your after-tax income; 5) you are assured of the security that characteristically comes with an annuity investment; 6) your estate will be able to bypass probate; and 7) you can use it as an effective solution for yourself or your corporation.

### Insured annuities also offer tax advantages

An insured annuity is also very tax effective. Annuity payments consist of two parts: interest income plus a return of capital. The capital part is not taxed. And while the interest portion is taxed, the tax hit is often much less than with interest income, which is always taxed at a relatively high rate.

### Insured annuity vs. GIC

Here's an example that compares a guaranteed investment certificate (or GIC) plan with an insured annuity strategy.

### The GIC approach

Take Norman. He's 70 years old, with $500,000 invested in GICs at the bank. He earns two per cent interest, which provides income of $10,000 a year.

Norman has other investments, such as a Registered Retirement Savings Plan (RRSP), Tax-Free Savings Plan (TFSA), Canada Pension Plan (CPP), plus non-registered investments, which give him a marginal tax rate of 46 per cent. This means he pays $4,600 in tax on his GIC income, leaving him with only $5,400 of the $10,000 the bank paid. Interest income is highly taxed so it doesn't leave Norman with very much for his lifestyle expense needs.

Norman likes GICs because there is no volatility, an assured income, and peace of mind knowing his $500,000 will be preserved to leave for his family.

## The insured annuity approach

Then there's Helen. Helen is 70 years old, too, and also had $500,000 invested in GICs, generating the same $5,400 each year, after taxes, as Norman. She too has other investments, including an RRSP, her CPP and some other, non-registered investments.

## Higher income, lower taxes

With the help of a certified financial planner, Helen changed tactics when the GIC came due, and re-invested her $500,000, instead, in an insured annuity. The annuity pays her $33,252 a year—a good deal more than the GICs. Helen is taxed on just a portion of the annuity ($2,196) amounting to tax of $1,010 a year. After taxes, Helen is now left with $32,242. ($33,252 – $1,010), considerably more than she was receiving with the GICs.

In contrast to Norman's situation, however, the capital is coming back to Helen. If she had opted for a regular annuity instead of an insured annuity, the payments would stop on her death and the money would revert to the insurance company that manages the annuity. However, Helen, like Norman, wants to leave some money to her children and other heirs.

## Ensuring an inheritance for family and heirs

Her financial advisor implemented an easy fix to help Helen with this issue: now, every time she receives the annuity payment, she uses a portion of the money to pay the premiums on a term-to-100 life insurance policy that will pay her family $500,000 when she dies via an insured annuity. This matches the amount Norman plans to leave his family. Yet Helen now enjoys a much higher after-tax income than she could with the GICs, even after paying the insurance premiums.

## For inheritance, insured annuities offer tax-advantages and protection from creditors

The insurance payout at end of life is not considered part of Helen's estate and gets paid directly to her named beneficiaries, bypassing probate fees and saving other associated costs. The money is also protected from creditors.

Conventional GIC versus Insured Annuity
Helen, 70, Non-smoker

| Variables | GIC | Insured Annuity |
|---|---|---|
| Total invested | $500,000 | $500,000 |
| Annual Income | $10,000 | $33,252 |
| Taxable portion of income | $10,000 | $2,196 |
| *Tax payable | $4,600 | $1,010 |
| After-tax income | $5,400 | $32,242 |
| Insurance cost | $0 | $18,267 |
| Net annual income | $5,400 | $13,975 |
| Net effective return | 1.08%<br>(2% pre-tax) | 2.8%<br>(5.18% pre-tax) |
| Amount to estate | $500,000 | $500,000 |
| Subject to probate | Possibly | No |

Helen now nets $13,975 annually compared to Norman's $5,400: she more than doubled her available after-tax income while enjoying considerable estate planning benefits that accompany this strategy.

The main drawback of an insured annuity is the loss of liquidity. Investors need to have other funds set aside for emergencies and must qualify for the life insurance coverage.

## Insured annuities for corporations

Insured annuities are also available to corporations. Meet Joan and Peter, a couple whose portfolio is held within a corporation, their holding company. They accumulated assets from the income of their family business and ultimate sale of the operating company. They faced a number of challenges as they plan their long-term goals.

As risk-averse and very conservative investors, they have arranged their portfolio so that it consists entirely of interest-bearing investments, including GICs; however, these don't meet their income needs. The interest income is fully taxable at the corporate rate. Net income from these investments is paid out from the company to them and taxed again as taxable dividends. If the corporation is wound up on their death, the proceeds are paid as taxable dividends to their beneficiaries.

An insured corporate annuity works very much like a personal insured annuity, in that the couple switches out of the GIC-like investments and the funds are moved into an annuity, using the income to buy a corporate owned insurance policy.

From a tax perspective, a corporate insured policy provides greater after-tax income than other fixed-income investments held within a corporation.

## Corporate vs. personal insured annuities

But a corporate insured annuity also differs from its personal counterpart in that the corporate annuity must be bought on a non-prescribed or accrual basis. Effectively this means the taxable amount of the annuity income is higher in early years, then starts to fall, with the positive result that the after-tax income increases over time.

The net cash flow from the annuity is used to buy the corporate-owned insurance policy to replace the assets on death. Because of the way the policy is set up, beneficiaries or shareholders receive funds as tax-free dividends, usually providing a higher net income than fixed-income investments held within a corporation.

## A great idea, but ask for help

A personal insured annuity should be considered an integral part of a larger diversified plan. Don't do this alone—seek the advice of an experienced financial advisor and trust and estate practitioner to help you determine your retirement and estate planning needs.

Now that people are living longer, it's no surprise that one of the biggest concerns among aging Canadians is the genuine fear of outliving retirement savings. Most people would prefer to leave a legacy of some sort to their families and other beneficiaries as well.

An insured annuity may be a good solution for you. ❐

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