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TAX*STRATEGY*

A Corporate Insured Annuity: maximize your income and leave more to your family

Ideal exit strategy

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Over the next decade, more than $1 trillion of net worth in Canada will transfer to future generations.

But if you don't have a proper succession plan for your business, the fruits of your labour may be unnecessarily consumed by taxes instead of going to your family or favourite charities. A Corporate Insured Annuity is one of several strategies that can eliminate this problem.

The Corporate Insured Annuity (also known as a corporate back-to-back annuity) is ideal for anyone 60 years or older who is a major shareholder of a private corporation with surplus capital not required to operate the business.

In the right situation, it will maximize your after-tax retirement income on a guaranteed basis and enhance your estate value in favour of your heirs.

How it works

This financial planning strategy consists of two steps: the purchase of a corporate-owned life insurance policy, and the purchase of a corporate-owned life annuity.

This powerful combination, when set up properly, can guarantee higher after-tax investment returns and a larger tax-free payout to your estate upon death.

Your company's current investment portfolio probably includes a variety of interest-bearing investments such as term deposits, GICs, bonds, bank accounts, etc. Like most people, you use the interest earned on those investments to supplement your own income.

☛ **Step one:** Your corporation will need to purchase a term-to-100 or a minimum-funded universal life policy, with you listed as the life insured and the corporation as the beneficiary.

At the outset, the permanent life insurance policy has no cash value on the shareholder's life, with the death benefit being equal to the amount of capital used to purchase the annuity in step two.

☛ **Step two:** Your corporation would liquidate the interest-earning investments described earlier and use those proceeds to purchase the life annuity contract.

The cash flow generated from the annuity pays the life insurance premium and the tax payable on the annuity income. Remaining funds are used to supplement your income on a higher, guaranteed, after-tax basis versus a traditional investment.

Upon death, your company will receive the guaranteed tax-free death benefit from the life insurance policy. The excess of the death benefit over the adjusted cost basis of the policy gets credited to the corporation's capital dividend account.

Your corporation then uses the proceeds to pay a dividend to your estate. This dividend is a tax-free capital dividend up to the amount available in the corporation's capital dividend account. Your estate can then gift the funds received as directed in your will to your heirs or charities.

The result of the strategy is that your corporation will enjoy substantial tax savings. At death, the annuity has a "nil" value on the balance sheet and is not subject to any taxes upon withdrawal as the annuity ceases to exist.

The life insurance also has a "nil" value at death as the proceeds come out of the company tax-free through the capital dividend account. For example, the beneficiaries of a corporation with $1 million of traditional investments would otherwise be liable for $330,000 of taxes

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based on Ontario rates. The tax bill can be zero using the Corporate Insured Annuity

This strategy can also be structured as a Leveraged Corporate Insured Annuity (also known as a "Triple Back-to-Back") that provides enhanced results while also allowing the shareholder to still have full access to the investment assets for business or investment requirements.

The program can be further enhanced by naming the shareholder's spouse as the successor annuitant and by purchasing a joint last-to-die policy.

Who should consider the Corporate Insured Annuity?

✓ age 60+ and in good health
✓ a shareholder of a private Canadian corporation
✓ affluent, with capital that exceeds lifestyle requirements
✓ company's investment portfolio includes conservative investments, such as GICs, bonds and bank accounts
✓ interest income from investments is currently used to enhance shareholder's lifestyle
✓ shareholders want to leave a bigger legacy at death

The Mechanics

✎ The non-prescribed annuity generates a higher return than traditional fixed-rate investments.

✎ The corporate tax paid on annuity income generates Refundable Dividend Tax on Hand (RDTOH) balances that are available to enhance the shareholder's income.

✎ The taxable portion of the annuity amounts to less than the interest earned on the investments, which reduces the amount of corporate tax paid annually.

✎ The payment from the annuity includes a combination of interest and principal, while the fixed rate investment returns interest only.

✎ The insurance proceeds replace all the capital used to purchase the annuity.

✎ When the shareholder dies, the life insurance proceeds are paid to the company and generate a credit to the Capital Dividend Account (CDA).

✎ The insurance proceeds can then be paid tax free to the shareholder's estate (via a tax free capital dividend) and distributed to heirs or charity, as directed in the will.

A recent case

This table shows an active business owner/manager of a private Canadian company. He is healthy, 71, and a non-smoker. The company has $500,000 of interest-bearing investments earning five per cent. The interest income is paid as a taxable dividend to the shareholder annually. The shareholder's personal dividend tax rate is 30 per cent. The corporate tax rate on interest income is 50 per cent.

	Corporate Insured Annuity	
Total funds available	$500,000	
Annual Income	$49,339	
Insurance Premium	$21,305	
Summary of benefits	**After-Tax Cash**	**Net Estate Value**
Year 5	$16,177	$498,541
Year 10	$16,826	$500,000
Year 20	$17,903	$500,000
Year 25	$18,311	$500,000

	Alternative Investment	
Total funds available	$500,000	
Annual Income	$25,000	
Insurance Premium	$0	
Summary of benefits	**After-Tax Cash**	**Net Estate Value**
Year 5	$13,125	$351,463
Year 10	$13,125	$352,926
Year 20	$13,125	$355,852
Year 25	$13,125	$357,315

Tax Considerations

From a CRA perspective, the annuity and the life insurance contract must each be subject to a separate underwriting process. Otherwise, CRA may consider the two contracts as a single, non-exempt contract, which would significantly impair the effectiveness of this strategy.

The corporate-insured annuity strategy should be considered for business owners who wish to implement a succession plan that will lower the value of their corporation at time of death for tax reduction purposes, while providing tax-free capital to heirs, surviving shareholders or favourite charities.

Implementation

This type of strategy should be based on your need for insurance coverage, estate liquidity and overall estate planning objectives. It's best to deal with a Certified Financial Planner or Trust & Estate Practitioner with experience in this area. Your accountant and tax advisor can assist in this process. ❑

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