Insured annuity strategy

The *insured annuity* strategy gives you tax-efficient income that's guaranteed for life and preserves the value of your estate.

The strategy uses the cash flow from a life annuity to both supplement your retirement income and pay the premium on a life insurance policy that will provide a death benefit paid to your named beneficiary. The death benefit replaces the capital used to purchase the annuity. The strategy uses a combination of a:

- **Life annuity** – ensures that you don't outlive your assets
- **Life insurance policy** – ensures that the capital you have built up over the years will be available to your heirs

The insured annuity strategy has its own unique benefits and product requirements. Clients interested in the strategy will want to ensure they can obtain life insurance before purchasing the annuity. Any life insurance-based strategy should be reviewed with the client's tax and other professional advisors to ensure it clearly meets the client's needs.

Insured annuity strategy

The insured annuity strategy uses a combination of a life annuity and a life insurance policy in the following way:

1. Some of your investment capital is used to purchase a life annuity (important to secure an offer for life insurance coverage prior to purchasing the annuity).

2. You use a portion of the income stream from the annuity to pay the premiums for a permanent life insurance policy on your life with an amount of coverage equal to the capital used to purchase the annuity.

3. The remaining portion of the annuity income stream supplements your retirement income.

4. On your death, the death benefit from the life insurance policy is paid to the named beneficiary and the annuity payments stop.

Tax-efficient income for life from a prescribed annuity

As individuals approach or enter retirement, their focus often shifts from wealth accumulation to wealth preservation and leaving a legacy for their family. To support this shift, their financial portfolio typically includes more GICs, bonds or other fixed-income investments.

The interest generated within these investments can be used to supplement clients' retirement income while leaving the principal intact. While the relative stability of these investments may satisfy their need for security, clients may be missing opportunities for efficiently managing tax as fixed-income is subject to tax as regular income.

To implement the insured annuity strategy you would liquidate some or all your fixed-income investments and use the proceeds to purchase a prescribed life annuity with you as the annuitant. The annuity provides a guaranteed series of payments to you while you're alive. The annuity payment would be a level amount paid to you each year over the life of the annuity. The income from the annuity will be a combination of tax-free capital and taxable interest. As a prescribed annuity, the interest component of the payment is taxable as regular income. Also, as a prescribed annuity. each annuity payment has the same level amount of tax-free capital and taxable interest over the life of the annuity.

The annuity usually has no guaranteed period, or at least a short guarantee period, to maximize the annuity payments. The annuitants may be on a single or joint basis and should match the insured lives under the life insurance policy used in the strategy.

The annuity payments are paid to you and you use a portion of the annuity payment to pay the premium on a life insurance policy. The net annuity payment (the annuity income, less the insurance premium) may provide you with a higher after-tax income than you otherwise would have from the same amount invested in a guaranteed investment certificate (GIC).

Preserving capital for your heirs with life insurance

Estate planning ensures an individual's personal property is managed effectively while they're alive and that their wishes – such as distribution of assets and minimization of taxes – are carried out following their death.

The goals of estate planning may include preserving wealth by taking advantage of tax planning opportunities, conserving assets, or for supporting dependants and/or ensuring equity in estate distribution. A life insurance policy used in the insured annuity strategy may fund these goals. The beneficiary of the life insurance policy receives the death benefit tax-free. The beneficary may be a family member or a charity thereby bypassing the policyowner's estate. If the beneficiary is the policyowner's estate then probate fees may apply (depending on the province) and the insurance proceeds would be exposed to any creditors of the estate.

The type of life insurance policy that's often used in the insured annuity strategy is a minimum-funded universal life (UL) insurance policy with a level cost of insurance (Level COI), as the objective is to achieve the lowest premium cost for the coverage. The amount of permanent coverage on your life would equal to the annuity premium. As a result, the death benefit will replace the capital originally intended for your heirs.

Client profile

The insured annuity strategy is designed for clients who:

- Have retirement assets invested in fixed-income investments
- Are interested in preserving capital for their heirs
- Want to maximize after-tax retirement income
- Willing to commit to a long-term planning strategy requiring the loss of some flexibility
- Generally, age 60 or older
- In good health

Example – Jim implements the insured annuity

Jim is a male, non-smoker, standard risk, age 65. He's retired and currently using his GICs to supplement retirement income. Jim's concerned about outliving his savings and wants to preserve capital for his heirs. His marginal income tax rate is 50%. Jim has heard of the insured annuity strategy and has approached his financial advisor to show him what the strategy might look like for him.

To implement the strategy, Jim liquidates a portion of his GICs and uses $1,000,000 of the proceeds to purchase a prescribed life annuity with no guarantee period and with the annuity payments payable to him. Jim is the annuitant, owner and payee of the annuity. The annual annuity payment to Jim is $66,000 of which $15,000 is the annual taxable portion. He also purchases a minimum-funded UL Level COI insurance policy with $1,000,000 of coverage. The annual premium for the policy is $30,582. Jim is the owner of the policy and he designates his children as beneficiaries.

Lets look at the results below:

Gross annual annuity income	$66,000
Annual taxable income from annuity	$15,000
Annual tax payable	$7,500
After-tax income	$58,500
Annual insurance premium	$30,582
Annual net cash flow net of premium	**$27,918**

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

The rate of return required for a GIC to generate the equivalent after-tax cash flow is **5.58%**.

The insured annuity strategy accomplished the following for Jim:

- Guaranteed income for life
- Preferential tax treatment of annuity income
- Estate preservation through life insurance proceeds paid to beneficiaries tax-free at death
- Permanent life insurance protection
- Elimination of estate administration fees on death benefit with named beneficiary other than the estate (not applicable in Quebec)

Considerations

If you're interested in the Insured Annuity strategy, you must consult with your financial, legal and tax advisors to consider:

- Strategy suitability to ensure your current and future needs are met.
- Clients implementing the insured annuity strategy must ensure they can obtain life insurance before purchasing the annuity.
- The strategy is inherently illiquid and inflexible as the annuity and life insurance policy typically have neither a cashable feature nor cash value, as the case may be.
- Life insurance must be obtained without any reference or linkage to purchasing the annuity. If this isn't done, the Canada Revenue Agency may view the life insurance and life annuity as a single non-exempt life insurance policy.
- There must be a need for life insurance.
- Assets liquidated to purchase the annuity may result in a taxable capital gain or a foregone interest payment, or both.