An 8% Guaranteed Rate of Return

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If your bank or financial institution was offering an 8% guaranteed investment certificate (GIC), would you accept the offer? Of course you would! Who wouldn't want that guarantee? The problem is that no institution in their right mind could make such an offer considering the current interest rate environment. Today, GICs are ranging anywhere from 2.0 % to 2.65% for a 1-year term. Or you can lock in for 5 years and get 4%-4.5% interest depending on the financial institution's rate at the time.

While GICs ensure safety of principal, their after-tax returns are generally low. My retired clients are always asking me, "Rino, how am I going to earn a higher interest rate without having to take any risks?" My answer to them has been the same for the last 15 years, "It's possible with an insured annuity." The insured annuity is a more attractive solution than traditional GICs since it will allow you to increase your after-tax return without eating away the capital available to your estate.

The insured annuity concept works best for people age 60-80 either on a single-life or joint-life basis as the investment yield is directly related to life expectancy. It also works best for people who are in a higher marginal tax bracket, anywhere from 35.15% to 46.41%.

The Challenge for Seniors

If you are retired or near retirement you are focused on both investment safety and returns for your investments. You want these investments to supplement your retirement income, so you want to obtain the best return while assuring your capital is guaranteed. This will often lead you to invest your money into guaranteed investment certificates. These provide a guaranteed rate of interest and secured capital. The drawback of this investment is the low rate of interest received and all interest income is fully taxable.

Low interest rates have been a concern for several years now and there is no sign of rates returning to the high levels of the 70s and early 80s. This is distressing for older investors who need additional retirement income but are locked into relatively low returns from GICs. This has led some seniors into the equity markets looking for higher returns but at the same time risking their principal.

Market volatility creates fluctuating investment returns. If you are retired and receiving income from your market-based registered retirement income fund (RRIF), the last thing you want to see is your retirement savings being eroded. Most retirees would prefer to receive a steady stream of dependable income during retirement. They don't want to worry about the negative effects the stock market will have on their RRIF income stream.

There are a number of tax issues driving the increasing levels of anxiety among seniors. Many are producing a significant amount of income which is taxed at their highest marginal tax rate. Pension clawbacks are reducing or eliminating their income from sources such as the OAS. If your income exceeds $64,718 per year (2008) the government will reduce your OAS payments by 15%. They will eliminate your OAS pension if you earn over $105,226 per year.

Increased living costs are a concern as well. Seniors are noticing that more and more of the health costs formerly picked up by the provincial governments are now items that they have to pay for themselves.

Retirees are even more cautious with their capital than other investors and most want to preserve their wealth for their children and grandchildren.

So how can you produce a reliable source of income, without risk, and without depleting your capital?

Solution: The Insured Annuity

An insured annuity is a combination of two products: A fully guaranteed single life prescribed annuity - Please note annuities can also be purchased from registered money such as your RRSP or RRIF. However, the tax-advantaged prescribed annuity is only available with unregistered money.

A fully guaranteed permanent life insurance policy - When you purchase an annuity, you give up a lump sum of cash to a life insurance company in return for a guaranteed series of payments for life. You cannot outlive these payments. The income from the annuity will be a combination of capital plus interest with the taxable amount of interest averaged over the life of the annuity.

Revenue Canada has allowed the issuer to level the interest-capital blend over the contract's expected life, otherwise early payments would be almost all taxable interest. This effectively lowers the "taxable" portion of your investment income. Because only a part of the income you receive is taxable, the net income you receive is higher than what you could receive from the same GIC investment.

With the GIC, your capital was preserved so that you could pass it on to your family, heirs, or favourite charity. In contrast, when you purchase an annuity, your capital is no longer available. The solution is to use some of the additional income provided from the insured annuity to purchase a permanent life insurance policy. The insurance policy will replace all the capital you intended to leave to your heirs. Even after purchasing the insurance, you're after-tax income can increase significantly.

The combination of these two products delivers extraordinary results. The annuity generally delivers a higher gross income than that produced by the GIC and is payable and guaranteed for life. You pay less tax on the income since prescribed annuities pay a blend of interest and capital as income, whereas a GIC pays out interest income only, which is fully taxable. The proceeds from the life insurance policy replace the capital used to purchase the annuity and are paid out to the beneficiaries, free of probate, legal, and executor fees. Even after paying the insurance premium, you will have more net income than would be produced by investing the capital in GICs. The best way to demonstrate this is by inputting the numbers using specific examples comparing an insured annuity investment versus investing in a GIC.

Situation 1 - Lump Sum Inheritance

Lauren is a 65-year-old female non-smoker. She is married, retired and in a high marginal tax rate. Lauren has recently inherited $500,000 and would like to maximize her after-tax income.

The chart below shows how Lauren would compare investing in an insured annuity versus investing in a GIC returning 4% interest.

Insured Annuity	vs.	GIC @ 4%
$500,000	Principal	$500,000
$38,472	Annual Income	$20,000
$13,350	Taxable Portion	$20,000
$6,195	Tax Payable @46.41%	$9,282
$32,277	Net After-Tax Income	$10,718
$11,075	Life Insurance Cost	N/A
$21,202	Final Net Income	$10,718

Source: Industrial Alliance and Equitable Life of Canada.

With the insured annuity, Lauren's net spendable income increases by 100.71% or $10,484 per year. To generate the $21,202 in income produced by the insured annuity, she would need an 8.03% GIC. Her husband would receive full payment of her principal investment of $500,000 upon her death. Of course, purchasing the life insurance is optional, Lauren could choose to replace a smaller amount or none at all.

Some important points to consider in this example: Since different insurers provide more or less competitive rates, you need to shop around for the highest annuity rate possible and the lowest insurance price possible. In this example, I compared the annuity rates and insurance costs of highly rated insurance companies in Canada. In Lauren's case, Equitable Life of Canada and Industrial Alliance respectively were her best options. Of course, in order to qualify for the life insurance Lauren would have to prove her insurability by completing a mini-physical.

Situation 2 - Widower

A similar comparison can be made with Lauren's older brother William who is 74 years old and a non-smoker. He is also retired but recently widowed. With the death of his wife he became the beneficiary of a 1 million dollar life insurance policy. He would like to use this money both to draw an income and become part of his estate preservation plan.

Once again the chart below shows the investment comparison. This time we set the GIC rate at 5%.

Insured Annuity	vs.	GIC @ 5%
$1,000,000	Principal	$1,000,000
$110,129	Annual Income	$50,000
$20,945	Taxable Portion	$50,000
$9,425	Tax Payable @46.41%	$23,205
$100,704	Net After-Tax Income	$26,795
$50,095	Life Insurance Cost	N/A
$50,609	Net Income	$26,795

Source: AIG Life Canada, using the best rates from AIG.

In this example William receives 84% more after-tax income from an insured annuity over a GIC. That's equivalent to an annual pre-tax yield on a GIC of 9.2%. At John's death the total amount of 1 million dollars would be passed on to his children or estate tax free. He also benefits from a taxable income reduction of 58%. This tax savings could increase his Old Age Security benefits.

Situation 3 - Pensioners

Mark is 71; Linda is 68. Both are non-smokers. They are retired and living from their pensions. They recently sold their large home and moved to a condominium to be closer to their grandchildren. The sale of their home produced $700,000 in excess funds that can be used to generate more income and leave the rest to their children and grandchildren.

In this example the Crawford's earned 50% more after-tax income from an insured annuity over the GIC. That's equivalent to getting an annual pre-tax yield of 7.5% on their GIC.

Insured Annuity	vs.	GIC @ 5%
$700,000	Principal	$700,000
$53,713	Annual Income	$35,000
$18,756	Taxable Portion	$35,000
$7,502	Tax Payable @ 40%	$14,000
$46,212	Net After-Tax Income	$21,000
$14,623	Life Insurance Cost	N/A
$31,589	Net Income	$21,000

Source: Sun Life Financial, using the best rates from Sun Life.

The income from the prescribed annuity would continue without reduction until the second death. This is known as a joint life annuity. The Crawford's joint life annuity was backed by a joint last-to-die life insurance policy. A portion of their annuity income was used to cover the insurance cost. The full $700,000 from the life insurance policy would be paid tax free to their children and grandchildren upon the second death.

Situation 4 - Charitable Urge

Helen Thompson is a non-smoker, age 64, widowed, with no dependants. She recently sold some real estate holdings worth $500,000 that her late husband maintained. She would like to use this money to increase her cash flow and also leave a legacy to her favourite charity. In this example, Helen has assigned the ownership and beneficiary of her life insurance policy to the charity.

The chart below compares the insured annuity versus a GIC, but this time the non-refundable charitable donation tax credit kicks in.

Insured Annuity	vs.	GIC @4%
$500,000	Principal	$500,000
$36,678	Annual Income	$20,000
$11,978	Taxable Portion	$20,000
$5,558	Tax Payable @46.41%	$9,200
$31,168	Net After-Tax Income	$10,800
$12,600	Life Insurance Cost	N/A
$5,796	Charitable refund	N/A
$24,364	Net Income	$10,800

Source: Sun Life Financial, using the best rates from Sun Life.

Since the life insurance policy is assigned to her charity, the charity can then issue a receipt to Helen for her life insurance premium payment of $12,600 every year. Helen can then claim a non-refundable tax credit of $5,796 toward her tax payable every year she pays for the insurance policy. Note that a tax credit reduces your tax owing dollar-for-dollar regardless of your marginal tax bracket.

For Helen, the insured annuity strategy accomplishes two things: It provides her with a higher income than a traditional GIC and she can leave a legacy to her favourite charity of $500,000 tax free upon her death. This strategy gives her an equivalent pre-tax yield of 9.0%.

Key Benefits

- ✓ Everything is fully guaranteed.
- ✓ Preferential tax treatment of annuity income, which could increase your OAS payments.
- ✓ Maximizing your retirement income while preserving the value of your estate.
- ✓ Life insurance (capital preserved) payable to loved ones tax free, avoiding probate fees, executor fees, and legal fees.
- ✓ Qualifies for the pension tax credit.
- ✓ Free from worry about future interest rates because the income stream is guaranteed for life.

Things to Consider Before You Purchase

The annuity is permanent. Once implemented it cannot be changed. It's vital to pick a sound insurer and keep the monthly payment within the $2,000 coverage limit for the insurance industry's Assuris protection plan in case a company becomes insolvent.

The annuity is not liquid. There is no access to funds other than the income stream.

Apply for the life insurance first to determine if you are insurable.

With insured annuities you give up liquidity and some flexibility, therefore, it should be considered as an important component of a larger investment plan.

You need the services of an independent insurance broker who can shop the market and get you the highest annuity income and the lowest insurance cost. A career agent who represents one company is limited to that company's rates.

Summary

The insured annuity concept is a low-risk strategy which is very appealing to seniors who are risk adverse and are looking for better returns than traditional GIC products. This extra income will allow them to leave their RRSPs and RRIFs to grow tax-sheltered as long as possible.

The insured annuity strategy is also tax effective. In some situations it can minimize the Old Age Security (OAS) clawback by keeping your total income lower than it would be with a non-registered fixed-income investment. Remember, only a portion of the annuity payment is taxable. For people age 65 and older, not producing any other pension income, the annuity payments will qualify for the pension credit.

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