Corporate insured annuity strategy

The *corporate insured annuity* strategy provides guaranteed income for life, preserves the value of your estate and may reduce your tax bill at death.

The strategy uses the cash flow from a corporate-owned life annuity to both supplement your retirement income and pay the premium on a corporate-owned life insurance policy that will provide a death benefit. 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 the investment assets in your corporation
- **Life insurance policy** – ensures that the capital you have built up over the years in your corporation will ultimately be available to your heirs

The strategy has its own unique benefits and product requirements. Clients interested in this strategy will want to ensure that their corporation is able to acquire a life insurance policy on their lives *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.

Corporate insured annuity strategy

The corporate insured annuity strategy works in the following way:

1. Some of your corporation's investment capital is used to purchase a life annuity (it's important to secure an offer for life insurance coverage prior to purchasing the annuity).
2. Your corporation purchases a permanent life insurance policy on your life and uses a portion of the income stream from the annuity to pay the insurance premiums. The life insurance policy has an amount of coverage equal to the capital used to purchase the annuity.
3. The remaining portion of the annuity income stream is distributed to you (usually as a taxable dividend) and supplements your retirement income.
4. On your death, the death benefit from the life insurance policy is paid to your corporation as the named beneficiary and then distributed to your estate/heirs as a tax-free capital dividend, or a combination of capital and taxable dividends.

Tax-efficient income for life from a non-prescribed annuity

When a corporation has surplus capital that it doesn't need to operate the business, this capital is often left inside the corporation. For many retired business owners, the surplus capital is invested in conservative investments that generate interest income. 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 interest income is taxed as passive income in a corporation.

To implement the corporate insured annuity strategy your company would liquidate some or all of its fixed-income investments and use the proceeds to purchase a non-prescribed life annuity with you as the annuitant. The annuity

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provides a guaranteed series of payments to your corporation while you're alive. 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.

Non-prescribed annuity taxation

The annuity payment would be a level amount paid to your corporation each year over the life of the annuity and consists of a combination of tax-free capital and taxable interest. The interest component of the payment is taxable as passive income in your corporation. Also, as a non-prescribed annuity is subject to accrual taxation, the taxable interest component of the annuity payment will vary and gradually decrease each year.

The annuity payments are paid to your corporation, and it uses a portion of the annuity payout to pay the premium on a life insurance policy. The corporation may then pay the remainder of the after-tax cash flow to you or others as either as salary or taxable dividend. If the remainder of the life annuity is paid as salary, the recipient must pay tax on the entire amount and the corporation is entitled to a full tax deduction for the amount paid. If the remainder is paid as a taxable dividend, the shareholder can take advantage of the dividend tax credit and the company can receive a refund of any refundable taxes, but the corporation can't claim a tax deduction for the dividend. The net annuity payment (the annuity income, less taxes and the insurance premium) may provide your company, and ultimately the shareholders, with a higher after-tax yield than otherwise could be achieved from a guaranteed investment certificate (GIC).

Enhancing estate value with life insurance

Tax-efficient distribution of the insurance death benefit

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 corporate insured annuity strategy may fund these goals. On your death, Canada Life pays the death benefit, which is at least equal to the premium paid to purchase the annuity, tax-free to the corporation.

Generally, a death benefit paid to a corporation in excess of the policy's adjusted cost basis (ACB) is credited to its capital dividend account (CDA). To the extent that the corporation has a balance in its CDA, it may elect to distribute all or part of the life insurance proceeds as a tax-free capital dividend to its Canadian resident shareholders. This ability to pay out tax-free capital dividends after death can't be achieved with traditional fixed-income investments. This tax-efficient distribution of corporate assets shows how the corporate insured annuity strategy may enhance estate values in comparison to traditional fixed-income investments.

Potentially minimize taxes at death

At death, you're deemed to dispose of your shares in the corporation for tax purposes at fair market value (FMV). The FMV of assets in the corporation are typically used for determining the FMV of the deceased's shares at death for tax purposes. In the case of corporate-owned life insurance, the policy's cash surrender value is used for determining the FMV of the deceased's shares for tax purposes. The type of life insurance policy that's often used in the corporate 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.[i] As this type of policy typically has no cash value, it results in not adding any value to the life insured's shares at death for tax purposes.[ii]

Similarly, an annuity with no guarantee period may also have a nominal contribution to the deceased's share value for tax purposes at death. The combination of both the annuity and life insurance policy contributing nominally to the insured's share value at death for tax purposes may result in substantial tax savings.

canada life

Client profile

The corporate insured annuity strategy is designed for clients who are:

- Generally, age 60 or older
- In good health
- Either the sole shareholder, or a significant shareholder, of a private corporation and the corporation has surplus capital that isn't required to be used in the business
- Attracted to having supplemental retirement income that's guaranteed for life
- Looking to enhance the value of their estate for their heirs or a charity
- Looking to minimize taxes on death and potentially enhancing the value of their estate
- Willing to commit to a long-term planning strategy requiring the loss of some flexibility

An Example – JimCo implements the insured annuity

Jim is a male, non-smoker, standard risk, age 65. Jim owns 100% of the shares of JimCo. JimCo has significant investment assets. Jim is retired and is currently using JimCo to supplement his retirement income through dividends. Jim is concerned about outliving his corporate assets and wants to preserve capital for his heirs. JimCo's corporate tax rate on passive income is 50%, and Jim's top marginal tax rate on non-eligible dividends is 45%. Jim's financial advisor introduces him to the corporate insured annuity strategy.

Jim chooses to implement the strategy by having JimCo liquidate a portion of its fixed-income investments and uses $1,000,000 of the proceeds to purchase a non-prescribed life annuity on Jim's life. The annuity has no guarantee period, and the annuity payments are payable to JimCo. The annual annuity payout to JimCo is $66,000 of which a variable portion is taxable. JimCo also purchases a Canada Life UL Level COI policy with $1,000,000 of coverage on the life of Jim.[iii] The policy will be minimum-funded and has a minimum annual premium of $30,582.

Let's look at the results at Jim's age 90 by comparing the corporate insured annuity strategy to an alternative corporate investment where JimCo uses the $1,000,000 to instead purchase a fixed-income investment yielding 3.5% interest annually over the entire duration of the strategy. Under the alternative investment option, the net annual after-tax investment income is distributed to Jim as a dividend to supplement retirement income. At death, under the alternative, the corporate owned investment (i.e. GIC) is liquidated and distributed as a taxable dividend to the surviving shareholders or estate. A comparison at age 90 is shown below:

	Alternative investment	Corporate insured annuity	Corporate insured annuity advantage
Cumulative personal after-tax cash flow	$388,224	$424,687	**$36,463**
Net estate benefit to shareholder	$550,000	$942,314	**$392,314**

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

In addition, there's a potential reduction in JimCo's share value at death for tax purposes with the corporate insured annuity strategy by approximately $1,000,000, resulting in a decrease in taxes payable by $250,000 on Jim's terminal return. This advantage of the strategy is already reflected in the above table assuming loss carryback post-mortem planning was done in the 'alternative investment' example.

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The corporate insured annuity strategy accomplished the following for Jim and JimCo:

- Guaranteed income for life
- Permanent life insurance protection
- Tax-efficient annuity income
- Estate preservation through the life insurance death benefit
- Tax-efficient distribution of corporate assets following death

Considerations

Clients that are interested in the corporate insured annuity strategy should consult with their 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 that their corporation can obtain life insurance coverage on their lives before purchasing the annuity.
- The strategy is inherently illiquid and inflexible as the annuity and life insurance policy typically don't have a cashable feature or 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.

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[i] That said, as interest rates and product pricing change and products evolve it's important to monitor other types of insurance products which may offer more attractive CDA profiles compared to UL Level COI policies.

[ii] Subsection 70(5.3) of the federal *Income Tax Act*.

[iii] Canada Life UL policy, male, age 65, non-smoker, standard risk, level cost-of-insurance option, 0% interest option. JimCo is owner and beneficiary of policy.

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