

## Insured Annuities

An “insured annuity” or “back-to-back” structure is a very familiar concept to most financial planners. It refers to when an individual (or individuals) acquires two separate financial products (a prescribed annuity and a life insurance policy). Pairing these two contracts can help many people (particularly those age 60 or over) achieve significantly enhanced investment returns, as well as increased estate values.

Retirees who are conservative investors often find that they are dissatisfied with the returns provided by fixed-income investments such as bank-issued GICs. If this is the case, they should meet with a financial advisor to review whether an insured annuity structure is appropriate. Note that it is necessary to run quotations and/or illustrations for the insurance and annuity products to determine the amount by which the after-tax cash flows are enhanced each year and by which the estate is potentially enhanced. The results are age sensitive--younger individuals will not enjoy the same advantages as those available to people who are age 60 and over.

Taxpayers who are focused on tax-efficiency will benefit because of the following three reasons:

- The beneficial tax treatment provided for prescribed annuities;
- The tax-free nature of the life insurance death proceeds; and
- The fact that the taxable portion of the annuity income may qualify as “pension income” or “qualified pension income” for purposes of the \$2,000 pension credit.

Each of the above advantages is discussed in greater detail below.

Insured annuity structures may also be set up on a corporate basis. For additional information on corporate arrangements, please refer to *Corporate Insured Annuity* (PC 5648A).

### I. Description of the Arrangement

#### (a) Overview

A taxpayer may have an amount invested in a fixed-rate GIC. With the insured annuity structure, the taxpayer would acquire a life annuity with the capital redeemed from the GIC, thus ensuring that a life-long income stream is provided. The taxpayer would also acquire a permanent insurance policy. This “protects” the capital invested in the annuity, that is, it will be available at the death of the insured. This explains why the structure is referred to as an “insured” annuity. (As stated below, it is important that taxpayers entering into these arrangements actually acquire the insurance before they purchase the annuity.)

The life annuity provides an income stream to the taxpayer, who pays the appropriate income taxes on this income stream. It also provides the taxpayer with a source of funds for the payment of the insurance premiums.

(b) Purchase of the Insurance Contract

As stated above, setting up an insured annuity involves acquiring two separate products. The first step is to acquire the insurance, either on a single life or joint life basis. Typically, this is either a term to 100 (T100) or universal life (UL) policy. The life insurance should be applied for with the policy actually being issued before the prescribed annuity is purchased since an annuity cannot be unwound once it is purchased, even if it becomes evident that the applicant was uninsurable for life insurance purposes.

People who are looking to protect just the capital originally invested in the annuity should consider T100 coverage with minimal or no cash values. A Universal Life (UL) policy may also be acquired. (The UL policy would typically be on a Level Cost of Insurance (COI) basis.) The UL policy is attractive for those who have excess funds and want to contribute amounts to the tax-sheltered investment fund component of the policy.

As noted above, the arrangement could be structured utilizing either a single life or joint lives. Joint life contracts are typically acquired on a joint-last-to-die basis. Using joint lives can enhance the returns because it reduces the cost of the life insurance premiums.

(c) Purchase of the Annuity Contract

As noted above, people should only acquire the prescribed annuity after the insurance has been put in place. Since the arrangement utilizes a life annuity, the taxpayer will have a steady income stream for life. Typically, the annuity does not have a guarantee period, as guarantees reduce the annuity payment. Furthermore, the guarantee period would not be sought since the capital used to purchase the annuity is replenished when life insurance death proceeds are received.

However, in some cases, the purchaser may want to have a guarantee period, especially where the reduction in income (say between an annuity having a 0 guarantee period and an annuity having a guarantee period) is nominal.

Often, the amount used to purchase the annuity is reduced by the amount of the first year's premium for the insurance coverage. Alternately, the first year's premium may be payable out of other cash flow.

With prescribed annuities, each holder (i.e., owner) of the annuity must also be an annuitant. Thus, an individual could acquire an annuity based on his or her own life. Spouses (including common-law spouses) could jointly acquire an annuity on both lives. Since holders of prescribed annuities must be individuals (or certain trusts), a corporation cannot acquire a prescribed annuity.

Prescribed annuities receive preferential tax treatment. The Income Tax Act (ITA) specifies a number of conditions that must be met for an annuity to qualify as a prescribed annuity.<sup>1</sup> For additional information on all of the conditions that must be met for an annuity to qualify as a prescribed annuity, please refer to *Taxation of Personally Owned Non-Registered Prescribed Annuities* (PC 5998).

## II. Taxation of the Insured Annuity

The taxation of each product will be discussed separately. The availability of the pension credit will also be covered.

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<sup>1</sup> See paragraphs 304(1)(a) – (c) of the Income Tax Regulations (Regulations), as well as subparagraphs 304(1)(c)(i) – (vi) of the Regulations.

(a) Insurance Taxation

As stated above, a permanent insurance policy (UL, T100 or other permanent plan) is acquired. The premiums are generally not deductible for tax purposes.

With the UL policy, premiums are paid for two components – the insurance component, as well as an investment fund component. Upon the death of the life insured, the entire proceeds of the policy are paid to the beneficiary (or estate) on a tax-free basis.

Where a UL policy is acquired, the insurer generally undertakes to ensure that the policy maintains “tax exempt” status. Thus, it monitors the maximum premiums that may be deposited to the tax-exempt portion of the policy, as these will be able to grow on a tax-deferred basis. With an insured annuity arrangement, there is typically no intention to withdraw amounts from the policy during the lifetime of the life insured(s). If, however, amounts were withdrawn from the policy, or policy loans were taken, income taxes may be payable. This would only be applicable if the taxpayer deposited funds into the investment component.

With a T100 policy, the tax consequences are largely the same. Life insurance proceeds on death are tax-free. T100 policies may in later years have a cash value. Some insurers may allow access to the cash value through policy loans. The tax aspects of doing so will have to be considered. The death benefit will be reduced by the amount of any outstanding policy loan.

(b) Prescribed Annuity Taxation

With prescribed annuities, each annuity payment is comprised of a capital portion and an interest portion. The capital portion is not subject to tax - only the interest portion is. Once the insurer has calculated the proportions of capital and interest for the entire contract, these proportions apply to all payments. In essence, the taxable income is being levelized for the duration of the contract.

From a technical perspective, for prescribed annuities the owner/annuitant should include the full amount of the annuity in income and then take a deduction for the capital portion of the annuity.<sup>2</sup> Practically speaking, most insurers will issue a tax slip for only the interest portion.

(c) Pension Credit

A taxpayer reporting “pension income” or “qualified pension income” may claim a non-refundable tax credit for the first \$1,000 of such income reported in a taxation year. (The 2006 Federal Budget contained a proposal to increase this limit to \$2,000, effective for 2006.)<sup>3</sup>

The definition of “pension income” includes “... the amount by which an annuity payment included in computing the individual’s income ... by reason of paragraph 56(1)(d) exceeds the capital element ... under paragraph 60(a) ....”<sup>4</sup> Thus, it is clear that any taxpayer who attains age 65 in the year will be entitled to the non-refundable tax credit in respect of the taxable portion of the prescribed annuity.<sup>5</sup>

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<sup>2</sup> See paragraph 56(1)(d) and subsection 60(a) of the ITA.

<sup>3</sup> For federal tax purposes, assuming that measures announced in the 2006 Federal Budget are implemented, the non-refundable credit will be calculated as 15.25% of up to \$2,000 of such income. The provinces also provide a non-refundable tax credit, with the rate varying by province. Some provinces have also indexed the \$1,000 (the limit in effect for the 2005 and earlier taxation years), so the credit was available on a somewhat larger amount. It will be necessary to monitor whether the provinces adopt the \$2,000 limit.

<sup>4</sup> See subparagraph (vi) of the definition of “pension income” contained in subsection 118(7) of the ITA.

<sup>5</sup> See paragraph 118(3)(a) of the ITA.

For taxpayers who have not attained age 65 in the year, the pension credit will only be available where this income is received as a consequence of the death of the spouse or common-law partner.<sup>6</sup> In this situation, it is specifically included in the definition of “qualified pension income”<sup>7</sup>. This would apply where a spouse under age 65 succeeds to an insured annuity arrangement on the death of his or her spouse.

### **III. Additional Considerations**

#### **(a) Permanence of Arrangement**

Back-to-back arrangements should be considered permanent (i.e., they cannot be unwound). Annuities without guarantee periods do not have a commuted value. Thus, the owner cannot have a lump-sum return of the capital invested in the annuity, except at death where the life insurance proceeds come into play. The insurance policy must be kept in force for life (i.e., must not have lapsed) for this to happen. Therefore, the client must have sufficient liquidity on an on-going basis for the continued payment of the life insurance premiums. This will come either from the after-tax annuity payments or from some other source.

The long-term interest rate climate will have a significant bearing on the annuity stream. Anyone contemplating acquiring an annuity should consider whether it is appropriate to acquire an annuity in a low-interest rate environment, as it will not be possible to unwind the arrangement at a later time.

These arrangements are most appropriate for people who will find the payment stream sufficient for the remainder of their lives. Younger taxpayers may not want to be locked into an arrangement for the remainder of their life, whereas older taxpayers may find this suitable. Many financial advisors will recommend that only a portion of the client’s non-registered funds should be allotted to this strategy since the capital invested is not accessible. These arrangements do not suit all taxpayers. It has to be consistent with the client’s overall financial needs.

#### **(b) Acquisition of Separate Products**

The taxation authorities hold that, in certain circumstances, such arrangements might be viewed as the acquisition of a single contract. As a result, the taxpayer would be considered to have acquired a non-exempt life-insurance policy. Here, the taxation authorities are concerned about whether the two products were issued on a stand-alone basis.<sup>8</sup> It is critical that the taxpayer be considered to have acquired two separate financial products, including being viewed as having been separately underwritten for each product. If the taxpayer cannot sustain the position that the contracts would have been issued on a stand-alone basis, the taxation authorities may consider applying the General Anti-Avoidance Rule (GAAR) provisions and denying inappropriate tax benefits.<sup>9</sup>

Some taxpayers address this possible risk by acquiring the insurance contract and annuity contract from separate insurers. A taxpayer might take an alternate approach by arranging to be underwritten for the insurance coverage first. The taxpayer would apply for an annuity only once the policy has been issued. The insurer should make sure that each of the two contracts is underwritten on its own merits. This second approach helps taxpayers avoid a situation in which they acquire an annuity first, only to find next that they are uninsurable and cannot get life insurance.

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<sup>6</sup> See paragraph 118(3)(b) of the ITA.

<sup>7</sup> See definition of “qualified pension income” in subsection 118(7) of the ITA.

<sup>8</sup> See CRA’s Technical Interpretation # 7M12851 dated May 10, 1986.

<sup>9</sup> See CRA’s Technical Interpretation # 9321275 dated September 12, 1993. Also see CRA’s Technical Interpretation # 9606425 dated April 9, 1996.

#### **IV. Summary**

An insured annuity arrangement offers many benefits – enhanced cash flows and enhanced estate values – in the right situation.

The strategy warrants investigation by individuals who have specific characteristics (i.e., they have a desire to retain their capital, prefer conservative investments, have attained a higher age, etc.).

It is of course important the taxpayers contemplating entering into such a transaction obtain independent tax and legal advice.

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