NATIONAL POST

FINANCIAL POST

NOVEMBER 7, 2013

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Preserving income through insured annuities

Increased life expectancy has investors searching for alternatives

Increased life expectancy has investors worrying that they will outlive their retirement assets, and their anxiety is magnified by concerns about preserving the assets through future market gyrations. This nervousness is reasonable and understandable but there are ways to address it. One is the insured annuity, an attractive and complementary portfolio option for those over age 60 and in good health.

An insured annuity is comprised of a life annuity contract and a life insurance policy, purchased simultaneously with the annuitant as the life insured. The annuity generates the cash flow to pay both the life insurance premium and taxes.

When retirement funds are used to purchase an insured annuity, the conservative side of a portfolio gains a stable income stream with tax advantages. Only part of the income received is taxable and, generally, the older the annuitant the larger the payment. When non-registered funds are used, preferential tax treatment can be significant. Because a smaller portion of the income is deemed to be taxable, Old Age Security clawbacks also may be lowered or eliminated.

As well as maximizing after-tax income, insured annuities preserve capital and provide tax-free transfers to beneficiaries. The insurance payment at end of life is not considered part of the estate and therefore is paid directly to a beneficiary, bypassing probate and avoiding costs associated with estate administration. It is also protected from creditors. And, of course, lifetime payments address the issue of outliving retirement funds.

Essentially, this creates a personal pension and therefore presents a range of components to be weighed in the decision. Among them are such things as interest rates, fees, the quality of the insurer, the amount of the portfolio to be kept liquid, and the investor's particular desires. Age is another important factor.

Consider a 70 year-old female with a marginal tax rate of 43.70% who purchases a $500,000 insured annuity at current rates.

Her insured annuity pays out $39,222 per year at prescribed terms. She pays insurance premiums but, because her annuity payment includes return of capital, only part of it is taxable. With these deductions the annual net cash flow would be $17,985 per year or 3.60% after-tax and expense yield.

If our subject purchased a $500,000 GIC with a 3.00% rate of return, the results would be much less generous. Although she would only pay taxes, they are much higher. The annual net cash flow from the GIC would be $8,445 a year or 1.69% after-tax and expense yield.

For this senior, the insured annuity has an annual net cash flow 112.97% higher than the GIC. To

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achieve the same income with a GIC, she would require a pre-tax equivalent yield of 6.39%.

The insured annuity is a unique product that can provide lifetime income and, at the end of life, return the capital to one's heirs. It is a wise strategy. Although the concept seems straightforward there will be variables in the rules and annuity rates. Investors should seek qualified advice to ensure they fully understand it and get a product that best meets their needs.

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