ANNUITIES AND INSURANCE

Insured Annuities Can Provide Higher Returns[1]

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Introduction

Insured annuities (also known as back to back annuities) have been offered by the insurance industry for many years, but are often overlooked by financial and investment advisors. This is surprising, given that a properly structured insured annuity can often provide guaranteed after-tax rates of return that are higher than more traditional GICs or term deposits.

This article will provide an overview of the insured annuity concept, discuss the tax treatment of the payments, and review some planning nuances that may be unfamiliar to readers.

Overview of Insured Annuities

With the aging of the baby boomers, and the fallout from recent market volatility, an increasing number of investors are looking at fixed income investments as a way to guarantee their future income. However, these investments are made less attractive by low interest rates and unfavourable taxation (unlike dividends or capital gains, for example, interest income is fully taxable at the investor's marginal tax rate). Inflation will erode investment returns even further.

At the time of the writing of this article, the highest advertised GIC rate the authors could find was 3.25%.[2] A client investing $500,000 at this rate would earn $16,250 per year. Assuming a 46% tax rate, the after-tax income would be an unimpressive $8,775 per year, or 1.75% after-tax. With fixed income investments providing such meager after-tax returns, the question becomes, what other alternatives exist?

Annuities are life insurance products that can provide a guaranteed stream of income for the life of the client (or the client and his or her spouse). Insurance actuaries use a series of factors such as the age and sex of the annuitant(s), payment frequency, the current interest rate environment, the amount of money deposited and type of guarantee to arrive at a stream of income payable under the annuity contract. Each payment the client receives from an annuity is partly return of capital and partly interest income.[3]

In comparison to the GIC example above, an annuity from a major insurance company purchased with $500,000 by a male age 70 would generate annual income for life of $45,938. (assuming a three-year guarantee period).[4] The taxable portion of this payment would be only $9,967, leaving the client with $41,312 after-tax. This is the equivalent to an after-tax yield of 8.26%. Rates of return would decrease with a longer guarantee period.[5]

The downside is that upon death, the principal amount from the annuity will have been depleted (the capital invested in a GIC remains intact and available to the owner and ultimately his or her estate).

The back to back annuity concept deals with this issue by contemplating the purchase of a permanent insurance policy to replace the original principal at death. In this case, a term to 100 policy on the life of a healthy male age 70 (non-smoker) could be acquired for an annual premium of $20,115. This premium would be paid out of the annuity income, resulting in net income of $21,197. The rate of return from the insured annuity program, after taking into account both the payment of tax and the insurance premium, would be 4.24%, a before tax equivalent of about 8%.

The ideal client for this concept will be 60 years or older with a significant amount of assets in non-registered fixed income products, which they are using to provide retirement income. The older the client, the more attractive this concept becomes due to the pricing structure of a life annuity product. But it is recommended that no more than 20-25% of a client's non-registered investments be used in this strategy.[6]

Factors Influencing the Cash Flow Under an Insured Annuity

As mentioned above, each annuity payment is partly a return of capital and partly interest income. While there are tax rules governing the appropriate determination of these two elements,[7] there is some discrepancy in this calculation between different insurance companies. In July 2009, a survey of three insurance carriers indicated that the taxable portion of the payment varied from a high of $9,967 to a low of $8,145 (male 70). This difference becomes even more pronounced as the amount deposited increases. Advisors would be well-advised to survey the market not only for the best rates, but to determine the taxable portion of the annuity payments.

The cash flow from the annuity is also impacted by the frequency of payments a client chooses. In most cases, a client can choose between monthly and annual payments. Using an example from one large insurance company, an annual annuity payment ($500,000 deposit) provides an up-front payment of $41,312 (after-tax), whereas the monthly annuity provides annual after-tax income of $42,545. The reason for this difference is that, in the monthly scenario, the insurance company has the client's money invested for a longer period of time. In addition, if a client passes away while receiving monthly payments, the remainder of that year's payment no longer needs to be paid to the annuitant. The insurance company factors this in when determining the monthly case flow under the annuity.

The next aspect that needs to be considered is the frequency of insurance premiums. With Term to 100 insurance, the monthly premium works out to be more expensive on an annualized basis than the annual premium. The reason for this is that the insurance company uses a modal factor when determining the monthly premium. The insurance company is just passing on the added expense (plus an interest factor) for processing these payments on a monthly rather than annual basis in advance.

Using the example above, the annual premium for $500,000 is $20,115 (male 70, non-smoker). On the other hand, the monthly premium is $1,796, or $21,552 on an annualized basis. This amounts to a difference of $1,437 for the convenience of paying the premiums monthly.

The above analysis illustrates that the most effective way to set up an insured annuity is to purchase the insurance policy with annual premium payments and to purchase a life annuity with monthly payments. This will only work if the client has the cash flow to pay the annual premium. In the case of the 70-year-old male, this method would generate $22,430 of net income, after taxes and insurance charges. This is as much as $1,400 greater than other payment structures. The client would have to invest in GICs earning 8.37% on a pre-tax basis (assuming a tax rate of 46.41%) to generate the same after-tax income.

Front to Back Annuities

Back to back annuities are preferable for older age groups, as annuities for younger clients generally do not provide sufficient returns to justify the strategy. In many cases, however, a front to back annuity is beneficial for younger clients. This involves purchasing insurance at younger ages, when mortality costs are lower, then acquiring an annuity at an older age, when returns are higher.

When clients are in their 40s or 50s, term insurance can be used to cover temporary risks, such as mortgages, future education expenses and income replacement. At later ages, clients start to focus on estate tax liabilities and inter-generational wealth transfer, for which permanent insurance is a more effective tool for protection. Most clients buy term insurance today with the idea that when their needs change, they will convert the insurance to permanent protection.

There are several potential pitfalls in the conversion process from term insurance to permanent insurance. One of these pitfalls is the increased cost of permanent insurance as a client ages. In many cases, by the time a client decides to buy permanent insurance, they can no longer afford the amount they require. In addition, today's lower interest rate environment may lead to significant increases to term to 100 insurance costs in the not too distant future.[8]

Another problem is that clients do not know what permanent insurance products and options will exist at the time of conversion. Permanent products that are available today may not be available at the time of conversion.

Given these considerations, the purchase of permanent insurance by clients in their 40s or 50s could offer many long-term advantages. Consider the example of a male non-smoker, age 50, who has a need for $500,000 of insurance. The cost of a 20-year term policy from one major insurer is approximately $1,950 per year, while the same company would offer a Term to 100 plan for $5,010 per year, a difference of $3,060 per year. Contrast this with the cost of a Term to 100 plan at age 70, which based on today's rates would be $20,115 per year. This is approximately $15,000 more than the cost of the same policy at the client's current age of 50. Even if insurance rates do not increase in the interim, this represents significant additional cost if the client chooses to convert his or her 20-year term policy when he or she reaches age 70.

If the client waited to age 70 to convert, and proceeded with the back to back strategy described above, he or she would be able to generate income of $22,430 per year (after payment of income tax and insurance premiums) for the rest of his life. However, if the client had bought the permanent insurance plan at age 50, he would have been able to generate income of $37,530, an increase of $15,100 per year.

This person would have paid an additional $3,059 per year for 20 years over the cost of the term insurance policy, for a total of $61,180. But by "investing" $3,059 over 20 years to acquire permanent

insurance at age 50, this generates an additional $15,102 of income versus waiting to age 70 to purchase the insurance (life expectancy age 85 for a male age 70). Put another way, the individual would need to earn approximately 9% after-tax on the additional insurance premium of $3,059 over 20 years to accumulate sufficient capital to generate the extra $15,102 of lifetime income starting at age 70.

Conclusion

Insured annuities provide clients with a tax-advantaged income stream for the rest of their lives, backed with the security of a guaranteed, permanent insurance policy. It is a simple, conservative concept that provides peace of mind to both advisors and clients. For these reasons, financial and investment advisors should become more familiar with these types of programs.

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[1] See, also, Gary Keiller, "Combining Prescribed Annuity With Life Insurance (1994) 2 *Insurance Planning*70.

[2]September 1, 2009, ING Bank.

[3] The rules governing prescribed annuities are found in section 304 of the *Income Tax Regulations*. The income from a prescribed annuity is excluded from the accrual rules by virtue of paragraph 12.2(1)(*b*) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement), as amended. Instead, special rules in paragraph 56(1)(*d*) and subsection 60(*a*) spread the income and capital equally over the term of the payments. This results in a lower amount of taxable income in the early years of the annuity in comparison to other fixed income investments.

[4]Quoted annuity rate from Manulife Financial.

[5] The longer the guarantee period provided in an annuity, the greater the likelihood that the insurance company must continue payments even after the death of the annuitant(s). Therefore, the guaranteed income declines as guarantee periods increase.

[6] One concern with a back to back annuity is that it cannot be collapsed and the capital recovered, i.e., there is no surrender value. In order to retain flexibility, therefore, only a portion of a client's portfolio should be used for this program.

[7] See supra note 3.

[8] See John McKay, "Buyer's Market for Level Cost of Insurance Products" (2009) 15 *Insurance Planning*968.

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