Annuities Offer Peace of Mind and Security

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Fergie Everglades turned 70 this year. He had a successful career, sold his business and retired at 60 with a substantial investment portfolio, a summer place in Canada and a winter one in Florida. Through their 60s, Fergie and his wife, Allie, enjoyed a pleasant retirement with no money worries, good health and confidence that comprehensive free medical care would always be available to them through the Canadian health care system.

Fergie and Allie also wanted to leave a substantial estate. Their goal was to leave $1 million to be used paying any debts that their four grandchildren might run up getting their education.

Every month, when the Canada Pension Plan cheques arrived, Fergie looked at them and realized that this was the only pension—the only guaranteed-for-life, continuing flow of revenue—that he and his wife had. That would get Fergie thinking about plans for the next 10 or 20 years and with the way human life spans seemed to be increasing, about the next 30 or more years.

The worst-case scenario wasn't encouraging. If his substantial investment portfolio went south, he and his wife might not starve, but they might not be spending their winters in Florida. And he didn't have the same confidence he once had in free health care for life. He had already seen friends go to private clinics and pay for needed medical procedures; some had gone abroad to avoid wait times at home.

The CPP cheques reminded Fergie of the "million dollar pensions" that some people who retired from teaching and government jobs were reputed to have. That got him to thinking about creating his own million dollar pension, an investment that would provide a lifetime flow of money, enough to take care of the basic needs of him and his wife, with provision made for additional medical expenses down the road.

During his working life, Fergie had chosen to put money into his business rather than into Registered Retirement Savings Plans, so his pension would have to be created out of non-registered funds. On the plus side, he had the $1 million. He could tie that up in an investment guaranteed to provide income for life and still have money to invest in the stock market or spend on other things.

GICs

Guaranteed investment certificates (GICs) were one solution Fergie considered. Even though interest rates are low, $1 million invested at 5% yields a gross annual income of $50,000. GICs are risk-free and as long as he and his wife did not dip into the capital, the $1 million he invested would still be available for his estate.

Taxation is the downside for investing in GICs. With a marginal tax rate of 46.41%, Fergie and Allie would pay $23,205 to CRA and have an annual net after-tax income of $26,795 from their $1-million investment. That's an annual return of only 2.7%.

Annuities

Fergie's other option for creating a lifetime income flow while maintaining the capital for his estate is putting the $1 million into an annuity.

The Canada Revenue Agency provides favorable tax treatment for purchasers of annuities. CRA treats a portion of the annuity payment as a return of capital and taxes only the portion of the monthly payment that it deems to be interest. That significantly increases the annual rate of return for the purchaser of an annuity as opposed to the holder of a GIC.

But when the annuity holder dies, the initial investment disappears. If Fergie bought a $1 million annuity and died five years later, his estate would receive nothing. Even if he arranged for a 10 or 15-year guarantee on the annuity payments, the $1 million would be gone at the end of the guaranteed period.

For Fergie, one solution is the combination of an annuity and an insurance policy for the amount of the investment. On death, the insurance policy pays out the full original investment tax-free.

The accompanying table illustrates an example of how the purchase of a $1 million insured annuity can increase the return on the investment. The $1 million invested in GICs at 5%, producing a gross income of $50,000 out of which taxes must be paid, yields an annual net income of $26,795.

The insured annuity produces a gross income of $89,220 out of which both taxes on the portion that the CRA deems to be interest and insurance premiums are paid. The result is significantly better—the insured annuity yields an annual net income to $41,762 per year, an increase of 56%. Another bonus is that insured annuities often lower an individual's tax bracket and reduces the tax burden.

With an insured annuity, there is no loss of capital to the estate, no equity or market risk. The holder has the opportunity to creditor proof the principal investment, ensuring that any judgments against the holder do not diminish the capital.

With annuities, the investment is fully guaranteed and managed for the annuity holder, and payments can be deposited in a bank wherever the holder resides.

Insured annuities can be purchased by an individual or can be set up on a joint basis. The illustration above is for a single annuity for a healthy male aged 70 years.

One possible disadvantage of annuities is that once a decision to purchase an annuity is made, it is irrevocable. They can't be cashed in.

Insured Life Annuity for Individuals

Life Insurance Details

Designed for:	Male age 70, non-smoker (in good health)
Insurance:	Gtd T100
Insurance:	1,000,000
Tax Rate:	46.41%

Initial Set-up

Capital Invested:	1,000,000
Initial Insurance Premium:	3315/mth
Balance for Life Annuity:	1,000,000
Annuity Payments:	7434.99/mth

Traditional Investment

Capital Invested:	1,000,000
Gross Interest Rate:	5.00%
Tax Rate:	46.41%

		Cash Flow			Tax Information		Net Results		Cash Flow		
Year	M Age	[1] Annual Annuity Payment	[2] Annual Insurance Cost	[3] Net Annual Income / (Outlay)	[4] Taxable Amount of Annuity	[5] Tax Payable	[6] Net Annual Return	[7] Pre-Tax Gross Yield	[8] Annual Return	[9] Tax Payable	[10] Net Annual Return
				1 - 2		*46% of 4*	*3 - 5*			*46% of 8*	*8 - 9*
06	70	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
07	71	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
08	72	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
09	73	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
10	74	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
11	75	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
12	76	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
13	77	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
14	78	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
15	79	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
16	80	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
17	81	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
18	82	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
19	83	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
20	84	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
21	85	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
22	86	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
23	87	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
24	88	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795
25	89	89,220	39,780	49,440	16,544	7,678	41,762	7.8%	50,000	23,205	26,795

This is an illustration only, all values are subject to verification during the underwriting process. Source: First York.

The insurance side of the annuity creates other considerations. If you are purchasing an insured annuity, health becomes an issue. Yet many 70, 75, and 80-year-olds are insurable, even some men who have been treated for prostate cancer. Insurance payments are not tax deductible but for the individual whose insurability is normal, an insured annuity can be quite appealing. Insured annuities can also be purchased on a joint basis with a spouse, with the annuity payment continuing as long as either spouse is alive.

Conclusion

Few people are going to buy annuities because the tax treatment is favorable. What motivates most annuity purchasers is their priorities.

Investors are most likely to purchase an annuity when they:

- no longer want to risk losing capital investments that are not risk-free because you lack the time and energy to replace it,
- want to retire from active money management,
- want to ensure that you have an income that will take care of basic needs for you and your spouse for as long as you live,
- want to ensure that a longer-living spouse has enough money for basic needs.

Annuities can also provide flexibility in retirement—those who put enough into an annuity to ensure their basic needs are met can be more flexible with their other retirement funds. This contributes to a better overall quality of retirement life.

Some research indicates that people who have secure and guaranteed lifetime incomes tend to live up to five years longer than those who have to watch their expenditures.

As a succession planner, I believe that any investment in annuities should be part of a plan that lays out the most efficient way for individuals to achieve their personal objectives in terms of what they need for themselves and what they want to pass on to their family.

That plan should incorporate the personal answers to a number of questions, including: How much income do we need in retirement? Are we concerned about inflation? How much money do we wish to leave to our estate? How much flexibility do we want in our income? How do we prepare for the possibility that one spouse may outlive the other?

Insured annuities are a useful component of many retirement plans. I recommend that you explore them when you meet with your financial advisors to discuss retirement.

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