Insured Annuities

Introduction

A key concern of senior citizens is maximizing stable sources of retirement income without impacting what they can leave to their children and grandchildren or other estate beneficiaries. Often guaranteed investment certificates (GIC's), term deposits and the like are used in this context. A better solution may be an insured annuity.

An insured annuity is an arrangement that involves the purchase of two contracts: a life annuity and a life insurance policy. When viewed together, the combination of these contracts creates the equivalent of a locked-in, fixed return investment vehicle. The objective of the arrangement is to provide a better return on investment than traditional non-registered fixed-rate investment vehicles like GIC's by increasing guaranteed cash flow and reducing taxable income while preserving the capital invested. Additional benefits of insured annuities can include creditor protection and avoidance of probate taxes that come with life insurance products that name the appropriate beneficiaries.

How Does it Work?

A capital sum is invested into an annuity that provides a regular payment stream to the investor as long as the investor is alive. The investor also purchases a permanent life insurance policy. Normally, the life insurance policy would have a death benefit equal to the capital invested in the annuity and a portion of the cash flow from the annuity is used to pay the life insurance premiums. At death the annuity payments typically cease (although they may continue for a specified guarantee period depending on the terms and conditions of the contract), and the life insurance death benefit is paid to the estate (or the named beneficiary) to replace the capital originally invested. The net result is often a larger lifetime income flow as compared to other fixed-rate investments, while still leaving an estate for heirs.

Some variations on this can occur. For example, one may fund the life insurance policy with a single deposit. That deposit would be sufficient to pay all future insurance premiums. Excess funds are typically invested in guaranteed fixed rate investment accounts within the life insurance policy. This results in a lower amount of capital available to purchase the annuity contract but no need to fund continuing premiums under the life insurance policy from annuity payments, resulting in all of the after-tax income from the annuity being available for retirement purposes. Depending upon the age, sex and lifestyle habits of the individual, this variation can provide even higher after-tax cash flows to the investor than the traditional insured annuity structure described previously. It should be noted that to ensure the life insurance policy is an "exempt policy" under the Income Tax Act, not all of the single deposit will "fit" into the policy. Amounts that do not "fit" within the exempt policy would be subject to annual accrual taxation until such time as the amounts could be paid into the exempt policy. In calculating the comparative benefits of insured annuities and GIC's, this accrual tax in the early years should be reflected in the analysis.

Annuity Characteristics

An annuity is a contract that provides for a steady stream of equal payments in exchange for a lump sum purchase price. Some annuities provide payments for a fixed term, but insured annuities utilize a life annuity which provides a payment stream until the death of the annuitant. The payments may or may not be guaranteed for a period of time (e.g. some contracts provide that the payments will continue to the end of a guaranteed period even if the annuitant dies before the end of that period). The annuity is non-commutable and non-transferable, meaning it is a permanent contract for the life of the individual and cannot be cashed in or transferred to another party, either as a gift or for consideration.

Life Insurance Characteristics

Under the traditional insured annuity structure, the purpose of purchasing life insurance in this arrangement is to ensure that when the individual dies, the capital used to purchase the annuity is replaced. That is, at death, the capital that was invested in the annuity is recovered. Hence the label "insured annuity". As noted earlier, the premiums on the life insurance policy are funded out of the annuity payment stream. The life insurance policy must be some type of permanent insurance since the insurance need is for life. Often the life insurance product has guaranteed premiums so that the owner is not subject to future price fluctuations. Generally, there is no need for the insurance product to provide cash values. The annuity payments will fund the life insurance premiums for the individual's lifetime, therefore the life insurance premium payments can be structured to continue for life. There is no need to "pre-pay" the premiums in earlier years (thus creating cash value) so that the policy becomes self-funding at some future point in time.

A term-to-100 or level cost of insurance universal life insurance policy normally meets these requirements: it provides a level death benefit without cash values for a constant amount of annual cost, and premium payments continue until age 100 when the premiums normally cease while the insurance coverage continues. Universal life insurance with yearly renewable costs may also be structured to provide a level cost stream suitable for insured annuities.

Where the insured annuity structure uses a single deposit to the life insurance policy in conjunction with the purchase of a life annuity, the premiums are "pre-paid" in the early years (thus creating cash value). A level cost of insurance or yearly renewable term cost universal life insurance policy may be used in this context.

Taxation of Insured Annuity Arrangements

Annuity Taxation

In theory, a portion of each payment from the annuity is a return of the original capital invested, and the remainder of each payment is investment income. Under the Income Tax Act (the "Act") non-registered annuity contracts entered into after November 12, 1981 are taxed in one of two ways: as a *prescribed annuity contract* (PAC) or as a *non-prescribed annuity contract*. To qualify as a PAC, the contract must meet the requirements outlined in the definition of this term contained in Regulation 304 of the Act. There are numerous conditions listed in the definition, but one of them is that the contract must be owned by an individual or certain trusts. As a result, a corporate-owned annuity cannot be a PAC.

If the insured annuity is personally owned, it is generally set up as a PAC because the tax treatment is more advantageous than the tax treatment of a non-PAC contract. If the contract is a PAC, each payment is included in income under paragraph 56(1)(d) of the Act, and then the "capital" element of the annuity payment is deductible under paragraph 60(a). The capital element is calculated according to a formula in Regulation 300(1), and is the same for all annuity payments received out of the contract. As a result, the PAC is taxed each year as if the income were earned evenly during the life of the contract. This is often referred to as "level" taxation. (For a further discussion of the eligibility requirements of a PAC, and its taxation refer to the Tax Topic entitled "Taxation of Non-Registered Prescribed Annuity Contracts".)

Prior to January 1, 2016, all testamentary trusts could purchase a PAC under clause 304(1)(c)(iii)(A) of the *Income Tax Regulations*. Since January 1, 2016, this provision has been amended and only trusts that have testamentary spousal or common-law partner trust or QDT status during the taxation year in which the annuity is set up are eligible to purchase a PAC.

The amended Regulations also allow testamentary trusts existing prior to January 1, 2016, and whose annuity was set up prior to that date, to purchase a PAC and benefit from PAC tax treatment. While graduated rates no longer apply to the taxable portion of the annuity, the annuity retains its PAC status. (For a further discussion of the rules applicable to testamentary trusts since January 1, 2016, refer to the Tax Topics entitled "Trusts – Just the Basics" and "Trusts as a Planning Tool.")

In contrast to the PAC, a non-PAC is taxed on an accrual basis. The payments themselves are not included in income: instead, on each yearly anniversary of the contract, the income the contract earned in that year is determined, and this amount is included in the holder's income under subsection 12.2(1) of the Act. The income from the contract is determined as the amount, if any, by which the accumulating fund on the anniversary day exceeds the adjusted cost basis of the interest in the contract. For PACs issued after 2016, the Annuity 2000 Basic Mortality Table will be used (instead of the 1971 Individual Annuity Mortality Table). Using a more modern table will have the effect of increasing the total expected payments and consequently, increasing the taxable portion and reducing the capital element of annuity payments from a PAC. The accumulating fund is a measure of the savings accumulation within the contract, and is calculated in accordance with Regulation 307 of the Act. In general, the taxable income from a non-PAC will vary from year to year, and will typically decrease each year as the "capital" in the contract is diminished. Since corporate-owned annuity contracts are by definition non-PAC's, if the insured annuity arrangement is owned by a corporation, the annuity contract will be taxed on an accrual basis.

Under a life annuity, when the annuitant dies the annuity payments cease and the annuity contract terminates. This triggers a disposition of the contract. In the case of a PAC, there is no gain or loss on the contract since there are no proceeds received. In the case of a non-PAC, there may be a gain on disposition equal to the excess of the accumulating fund immediately after death (paragraph (d) in the definition of "proceeds of the disposition in subsection 148(9) of the Act) over the adjusted cost basis of the contract. The gain is income (i.e. it is not a capital gain), and is effectively a "catch-up" accrual for any unreported income arising since the last anniversary date up to the date of death.

Life Insurance Taxation

The premiums on the life insurance contract purchased as part of the insured annuity arrangement will generally be a non-deductible expense to the investor. At death, the death benefit proceeds of an exempt life insurance policy are received by the beneficiary tax-free. (The definition of "disposition" of a life insurance contract under subsection 148(9) of the Act specifically excludes a payment under an exempt life insurance policy in consequence of the death of any person whose life was insured under the policy). If the beneficiary of the policy is a private corporation, the corporation will receive a credit to its capital dividend account equal to the excess of the death benefit proceeds over the corporation's adjusted cost basis (ACB) in the contract (pursuant to paragraph (d) of the definition of capital dividend account in subsection 89(1) of the Act). (For a detailed discussion of the Capital Dividend Account, refer to the Tax Topic entitled "Capital Dividend Account"). Typically, the ACB of the type of policy used for insured annuity arrangements, is relatively small, and after a number of years into the contract, the ACB is reduced to nil. Thus a corporate owned insured annuity will normally allow for most, if not all, of the death benefit proceeds to be extracted from the corporation by a shareholder without personal tax. (For a discussion of ACB refer to the Tax Topic entitled "Disposition of Life Insurance").

Insured Annuity Arrangement Taxation Issues

In the past the Canada Revenue Agency (CRA) has indicated that if the terms of a life insurance policy and an annuity contract were such that neither contract would be issued without the other, (especially where both contracts are issued by the same insurer) it might be possible to conclude that they represent the issue of one non-exempt life insurance policy (see technical interpretation #9606425). If it were considered a non-exempt life insurance contract it would be subject to annual accrual taxation. In addition, the ACB of the contract would include the ACB of both the insurance policy and the annuity, accordingly the CDA credit would be less than if they were separate contracts.

It is very unlikely that the annuity contract and life insurance contract would be treated as one contract where the annuity and life insurance contracts are written by separate carriers. Even where one carrier issues both contracts it is unlikely CRA would be successful in taxing both contracts as a single non-exempt policy provided each is subject to separate underwriting and pricing.

Investment Attributes and Risks of Insured Annuity Arrangements

An insured annuity provides a guaranteed income for life which may result in an increased after tax annual return compared to other long-term guaranteed investments. It is a conservative investment strategy requiring little or no management. On the other hand, an insured annuity is locked in for life. Should investment market conditions or the owner's financial situation change dramatically, the insured annuity generally cannot be undone, except perhaps to cancel the life insurance portion. The owner generally has no contractual right to commute the annuity.

Since an insured annuity is a lifetime investment, it is generally more appropriate for those individuals who are age 60 or over. This means that the expected length of the investment might be approximately 25 years or less. It would be an inappropriate investment for a 30-year-old where the expected length of the investment could be, 50 years or more. Further, because an insured annuity reduces taxable income levels it is particularly appropriate for individuals who have non-registered funds available for investment purposes that would otherwise be taxed at high marginal tax rates.

In order to implement an insured annuity arrangement, individuals must be in sufficiently good health to obtain the necessary life insurance. Generally, the annuity contract used for these arrangements cannot be "cashed in" or surrendered for value. As a result, it is prudent to acquire the life insurance policy prior to purchasing the annuity contract so that the return of capital invested in the annuity contract at death is secured prior to entering into the annuity contract. In addition, the issue of the life insurance contract cannot be contingent upon the purchase of the annuity contract. Both the annuity and the life insurance contracts must be underwritten as separate contracts; otherwise, as noted earlier, CRA could suggest that the life insurance policy and the annuity contract are all one contract and hence non-exempt and subject to accrual taxation.

Corporate-owned Insured Annuity Arrangements – Valuation at Death for Tax Purposes

If a corporation enters into an insured annuity arrangement, another tax issue that arises is the valuation of the shares of that corporation for purposes of the deemed disposition at death (subsection 70(5) of the Act). Typically the corporation purchases the annuity contract and the life insurance contract on the life of a principal shareholder. When that shareholder dies, subsection 70(5) of the Act provides that the shareholder disposes of his shares in the company at their fair market value immediately before death. The death of the shareholder will also trigger payment of the life insurance proceeds, and will usually terminate the annuity contract based on his life. Then the question is: What is the fair market value of the annuity contract and the life insurance contract immediately before death? (for the purpose of valuing the shares of the corporation at death under 70(5))?

Some assistance may be found in subsection 70(5.3) of the Act which indicates the fair market value of the shares immediately before death "...shall be determined as though the fair market value at that time of any life insurance policy under which the particular individual … was a person whose life was insured, were the cash surrender value… of the policy immediately before the particular individual died…".

Thus, where the life insurance policy has no cash surrender value, which is normally the case with term-to-100 policies, section 70(5.3) can be relied on to support the position that the life insurance contract adds no value to the company's shares for the purposes of the deemed disposition immediately before death. Should the life insurance policy have a cash surrender value, this must be taken into account in determining the fair market value of the shares.

The effect of the life annuity on the valuation of a private company's shares immediately before death is not as clear. One school of thought is that the life annuity adds no value to the company's shares. There are two main arguments in support of this position.

The first argument is that where the life annuity is non-commutable and non-transferable, these restrictions mean the annuity cannot be offered for sale to another party for consideration. One accepted measure of fair market value is based on the value at which arm's length parties would normally transact. If another person cannot purchase the asset, it is arguable that its fair market value is nil.

The second argument is that subsection 138(12) indicates a "life insurance policy includes an annuity contract..." As a result, there is an argument that the annuity should be treated in the same fashion as the life insurance policy for

the purpose of subsection 70(5.3). Since the annuity is generally non-commutable (i.e. it cannot be surrendered for value), subsection 70(5.3) should deem the annuity to have nil value.

CRA disagrees with this interpretation as outlined in a technical interpretation letter (#9321275) dated September 20, 1993. Their position in this interpretation is that subsection 70(5.3) does not apply to annuity contracts because, although it is a life insurance policy under the Act, it is not "a life insurance policy under which the taxpayer was the person whose life was insured". (Although the wording in subsection 70(5.3) has since been changed to "a life insurance policy under which a taxpayer was **a** person whose life was insured", this wording change does not seem to affect this particular argument.)

The question centers around the meaning of the phrase "person whose life was insured". There is no definition of this phrase in the Act. The same phrase is used throughout the Insurance Act, but it is not a defined term there either. The closest thing which is defined in the Insurance Act is the term "life insurance". An annuity would meet the definition of life insurance found in the Insurance Act, and several cases involving creditor protection clearly support this view. (For example, see the Supreme Court of Canada's decision in Ramogtra: Royal Bank of Canada v. North American Life Assurance Company and Balvir Singh Ramgotra, (1996), 1 S.C.R. 325).

The Act does not contain a detailed definition of the term "life insurance"; it only indicates that the term "life insurance policy" includes an annuity contract (subsection 138(12)). As a result, the Insurance Act definition may provide the best available guidance on the use of these terms in the Act. In addition, when an annuity contract is excluded from a particular provision in the Act which applies to life insurance policies, it is usually done so explicitly by specifying annuities as an exception to the particular rule. (For example, the collateral insurance deduction provided in paragraph 20(1)(e.2) of the Act specifically applies to "a life insurance policy (other than an annuity contract)")

CRA has also commented on the meaning of the phrase "person whose life was insured" in a technical interpretation on another matter dated September 11, 2000 (#2000-0033885). In this interpretation CRA stated that in determining whether a life is insured under a policy for purposes of the death benefit exclusion from the definition of "disposition", there is no express requirement that the insurer bear a mortality risk in respect of all or a portion of the benefit payable.

All of this leads to some fairly strong counter-arguments to CRA's view in the 1993 technical interpretation that an annuity is not "a life insurance policy under which the taxpayer was the [now "a"] person whose life was insured". First, by CRA's own admission the lack of mortality risk in respect of a benefit payable does not preclude there being a life insured under the policy, so it is at least possible that the annuitant under an annuity could be considered a "person whose life was insured". Secondly, annuities are not specifically excluded from the application of 70(5.3) as they are in other provisions of the Act pertaining to life insurance policies. Finally, if an annuity is life insurance, as defined in the Insurance Act, it follows that there must be a life insured under the contract – presumably the annuitant.

It should also be noted that new subsection 70(5.31) of the Act (enacted by Bill C-4 which received Royal Assent on December 12, 2013) deems the value of the annuity under a leveraged insured annuity to be the purchase price of the annuity. For non-leveraged corporate insured annuities, it is unclear if the introduction of this deeming rule can be taken to confirm that the normal rule (value of the annuity otherwise is at cash surrender value pursuant to subsection 70(5.31)) prevails, or whether the above CRA commentary must be considered when interpreting the application of the normal rule.

Despite the previously mentioned arguments there is a risk CRA could attribute a value to the annuity contract and hence a value to the shares immediately before death. In determining a value for the annuity, CRA could ascribe a value based on an estimate of the individual's life expectancy immediately preceding death (without foreknowledge of such death). Such a calculation would likely be based on a present value estimate of future annuity payments. This value would decrease over time, as the estimated number of future payments is reduced with the age of the individual. A similar type of valuation approach was confirmed by the CRA in the context of the valuation of a life estate on the death of the holder in technical interpretation 2011-0409961C6 dated August 8, 2011.

It cannot be said with certainty that a corporate owned annuity has no value for purposes of the subsection 70(5) deemed disposition rule immediately before death. It is, however, fair to say that if there is a value to be ascribed to an annuity contract in these circumstances, as the individual ages the value of the life annuity should decrease over time, and accordingly the fair market value of a private company's shares, if any, attributable to the annuity for the purpose of this deemed disposition would similarly decline.

Accounting for Corporate-owned Insured Annuities

The previous discussion has focused on the tax treatment of insured annuities. One other factor that is important to understand is how an insured annuity will be handled on the financial statements if the arrangement is corporate owned. "Publicly accountable enterprises" will be required to report using International Financial Reporting Standards (IFRS). Private enterprises will be able to choose to adopt IFRS or to use the new "Accounting Standards for Private Enterprises" (ASPE).

Under ASPE, when the company purchases the annuity, the company would record an asset on the balance sheet equal to the capital invested in the annuity. Each year the annuity payments received from the contract would be recorded partially as income and partially as a reduction of the asset. The allocation between income and capital would be determined based on ASPE taking into account the interest rate and life expectancy of the individual at the time the contract was entered into. Where the asset has been reduced to zero, for example where the annuitant has "outlived the capital", any further annuity payments would represent income to the corporation. The insurance premiums would be expensed each year as they are paid. At death, any balance from the annuity remaining on the balance sheet would be written off (since the contract terminates at that time), and the proceeds from the life insurance net of any accounting value for the insurance asset would be recognized as income to the company.

Under IFRS, when the company purchases the annuity, it is a financial asset and the company would record an asset on the balance sheet equal to the fair value of the annuity. This fair value will usually be the fair value consideration given. Each year, the annuity payment would be recorded partially as a reduction of the asset. The allocation between income and capital would be based on IFRS taking into account the interest rate and life expectancy of the individual at the time the contract was entered into. Additionally, the annuity will be required to be revalued at fair market value for each reporting period. Any changes in value will be required to be recorded through income. Because of this annual revaluation, while the annuitant is alive, the asset will not be reduced to zero where the annuitant has "outlived the capital" based on the original life expectancy. The insurance premiums would be expensed each year as they are paid. At death, any balance from the annuity remaining on the balance sheet would be written off (since the contract terminates at that time), and the proceeds from the life insurance net of any accounting value for the insurance asset would be recognized as income to the company.

Conclusion
An annuity combined with a life insurance policy can be an attractive arrangement for older individuals looking for long-term, guaranteed returns. The arrangements can be structured with personal or corporate ownership of the contracts. Corporate ownership of the contracts may provide opportunities for additional tax benefits.

Last updated: January 2016

Tax, Retirement & Estate Planning Services at Manulife writes various publications on an ongoing basis. This team of accountants, lawyers and insurance professionals provides specialized information about legal issues, accounting and life insurance and their link to complex tax and estate planning solutions.

These publications are distributed on the understanding that Manulife is not engaged in rendering legal, accounting or other professional advice. If legal or other expert assistance is required, the service of a competent professional should be sought.

This information is for Advisor use only. It is not intended for clients. This document is protected by copyright. Reproduction is prohibited without Manulife's written permission.

Manulife, the Block Design, the Four Cubes Design, and strong reliable trustworthy forward-thinking are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.