



Insured Annuities

Introduction

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 that is typically attractive to senior citizens. The objective of the arrangement is to provide a better return on investment than traditional fixed-rate investment vehicles, while preserving the capital invested.

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 with a death benefit equal to the capital invested in the annuity. 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.

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 this particular arrangement utilizes 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 often non-commutable and non-transferable, meaning it is a permanent contract for the life of the individual and can not be cashed in or transferred to another party, either as a gift or for consideration.

Life Insurance Characteristics

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 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.

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, the annuity is generally set up as a prescribed annuity contract 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 a deduction equal to the capital element of the annuity payment is claimed 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, a PAC is taxed as if the income expected to be earned during the life of the contract is earned evenly over time. This is often referred to as "level" taxation. (For a further discussion of the conditions a contract must meet to be a PAC, and the taxation of PAC's refer to the Tax Topic entitled "Taxation of Non-Registered Prescribed Annuity Contracts".)

In contrast, 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. 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 few 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 deems the shareholder to dispose 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 a 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.

Despite the above 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.

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 which may be important to understand is how an insured annuity will be handled on the financial statements if the arrangement is corporate owned. When a business prepares its financial statements it is generally required to follow Canadian generally accepted accounting principles (Canadian GAAP). For fiscal years beginning on or after January 1, 2011, "publicly

accountable enterprises" will be required to report using International Financial Reporting Standards (IFRS) rather than Canadian GAAP. Private enterprises will be able to choose to adopt IFRS or, alternatively, they may use a new set of standards called "Accounting Standards for Private Enterprises" (CPE). Canadian GAAP is based primarily on standards as set out in The Canadian Institute of Chartered Accountants Handbook (the CICA Handbook). IFRS and Accounting Standards for CPE will also be located in the CICA Handbook.

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 accounting standards taking into account the interest rate and life expectancy of the individual at the time the contract was entered into. 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 would be recognized as income to the company.

Summary

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.

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