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A fine pair

Combine life annuity and life insurance policies for business owners

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An insured annuity can be a powerful tool to help business owners maximize retirement income while minimizing tax. This type of annuity involves simultaneously purchasing a life annuity and a life insurance policy.

After-tax sale proceeds and retained earnings in a holding company create significant tax challenges for a business owner, as double taxation could occur upon the death of the shareholder of the company. In this case, taxes are generally taken first on the deemed disposition of the shares held personally by the shareholder at death and then on the value when the funds are paid to the shareholder or his estate, often by way of a dividend payment.

Insurance proceeds may be paid tax-free to the shareholder's estate (via a tax-free capital dividend) and distributed to the heirs or charity, as directed in the will.

Another challenge facing a business owner who has accumulated savings in his holding company is the need for liquidity from the company to provide for retirement.

In this context, if an owner of a Canadian-controlled private corporation is looking for strategies to maximize income while providing liquidity on death, a corporate insured annuity could be a strategy to consider.

Mechanics of the corporate insured annuity

An operating or holding company purchases a life insurance policy on the shareholder's life, and an annuity on a separate contract. The shareholder is the life insured and the corporation is named as the beneficiary. Generally, the annuity payments are used to pay the life insurance premium and the tax on the annuity. The amount remaining can be paid out to the shareholder as a bonus or a dividend.

On the death of the shareholder, the life insurance proceeds are paid to the company and generate a credit to its Capital Dividend Account (CDA). Under certain conditions, the insurance proceeds may be paid tax-free to the shareholder's estate (via a tax-free capital dividend) and distributed to the heirs or charity, as directed in the will.

Case study

David Arthur, a Quebec resident, owns a Canadian-controlled private corporation. He is male, 70 years of age and a non-smoker. The company has a $1-million GIC earning approximately 3% annually. The corporate tax rate on interest income is 46.57%.

	CORPORATE INSURED ANNUITY*	GIC INVESTMENT @ 3% (INTEREST INCOME)
Funds available to purchase an annuity	$1,000,000	$1,000,000
Tax rate on dividends owned by individuals	33.20%	33.20%
Corporate tax rate on investment income	46.57%	46.57%
Annual annuity payment / Interest income	$85,056	$30,000
Insurance cost	$42,552	$0

YEAR	YEARLY DIVIDEND	NET ESTATE VALUE	YEARLY DIVIDEND AFTER TAX	NET ESTATE VALUE
1	$28,393	$988,791	$16,052	$668,000
2	$25,721	$978,542	$16,052	$668,000
3	$23,379	$969,398	$16,052	$668,000
4	$23,601	$961,459	$16,052	$668,000
5	$23,824	$954,695	$16,052	$668,000
10	$24,712	$936,980	$16,052	$668,000

*Annuity rates will fluctuate. This income is for illustration purposes only. The guaranteed income amount on the date of purchase may be different. This scenario uses a non-prescribed annuity.

The interest income is being paid to the shareholder annually as taxable dividends. The shareholder's personal marginal tax rate on regular dividends is 33.2%. The charts above demonstrate how Mr. Arthur would benefit from having his company purchase a $1-million insured annuity.

Summary of benefits

- The annuity generates a guaranteed income stream and generally provides a higher rate of return than traditional fixed-rate investments.
- In this example, at year 10 Mr. Arthur is earning $24,714 in dividends after tax, versus $16,052 in a traditional fixed-income investment. The net estate value of the corporate annuity is $936,980, versus the GIC investment at $668,000. This represents a difference of $268,000.
- The corporate tax paid on annuity income generates Refundable Dividend Tax on Hand (RDTOH) balances that are available to the shareholder.
- The taxable portion of the annuity is less than the interest earned on the investments, which reduces the amount of corporate tax paid annually.
- The capital used to purchase the annuity is repaid upon death by the life insurance proceeds.
- The potential for insurance proceeds to be paid tax-free to the shareholder's estate upon death.
- The ability to reduce capital gains tax upon death.

The combination of a life insurance policy and an annuity makes the corporate insured annuity a financial and tax planning strategy that offers a powerful alternative to business owners to provide for their retirement, plan for their business succession and transfer their wealth. AER

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