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Trading liquidity for certainty with an annuity

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Raise your after-tax cash flow in retirement, preserve your capital, boost your returns after tax and remove interest rate risk from your portfolio

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Perhaps you've heard the story of the elderly gentleman? The story, which varies a little depending on where you first heard it, goes like this: A reporter was sent to interview a man as he turned 100 and find out if there were a formula to his longevity. "Sir, do you have any secrets you can share that have allowed you to maintain such good health for so long?" "Well, I go to bed early, get up at six in the morning, eat lots of vegetables, I don't smoke or drink, and I go for a brisk walk every day," the man replied. "There must be more to it," said the reporter. "I had an uncle who lived the same way and he died at age 60. I'm not sure how to explain that." "That's easy," the man said. "He didn't keep it up long enough."

Everyone is searching for the secret to longevity. The question is: Will you run out of income before running out of retirement? Today, I want to share a retirement income idea that can provide an increase in your after-tax cash flow in retirement, preserve your capital, boost your returns after tax and other costs, and remove interest rate risk from your portfolio. I'm talking about an insured annuity.

The idea

The insured annuity concept involves doing two things: First, purchasing an annuity to provide you with cash flow in retirement, and purchasing life insurance at the same time. Why life insurance? Simple. When you carve out some capital to purchase the annuity, those are dollars that your heirs will never receive. Once you're gone, the annuity payments cease, and whatever capital might have been invested in that annuity is also gone - nothing will generally be given to your heirs (you can purchase a guarantee so that, if you die young, your heirs are guaranteed to receive some minimum amount, but this is not generally done due to the added cost).

The insured annuity idea works well provided that you or your spouse are insurable at standard rates (if you're high risk and the insurance is more costly, the idea may not make sense).

The example

Here's an example that comes courtesy of John Jordan, CFP. Consider Mike and Shannon. Both are 70 years of age and are in good health. They're concerned that their retirement income has been eroded by low interest rates and poor investment returns. The couple has a portfolio that includes \$400,000 in GICs and T-Bills, earning an average of 4.5 per cent annually. Mike and Shannon would like to keep \$150,000 fairly liquid for emergency purposes, but would like to increase their after-tax returns on the other \$250,000.

Currently, the couple will earn \$11,250 annually (4.5 per cent on \$250,000) on the GICs and T-Bills. At a marginal tax rate of 43.41 per cent (the second highest marginal tax rate in Ontario), the couple will pay taxes of \$4,884, and will be left with \$6,366 after taxes annually.

Mike and Shannon have chosen to implement an insured annuity strategy. Here's what they did: They used \$250,000 to purchase an annuity. The annuity will pay them \$20,286 annually. Just \$5,042 of the annuity payments are taxable. Why? Because each annuity payment is partly a tax-free return of their original capital, and partly interest income. The tax owing annually on the annuity payments will be just \$2,189, and they will recoup some Old Age Security benefits in this case as well (\$527 annually) since their taxable income won't be as high, leaving \$18,624 after taxes annually in their hands.

Now, Mike and Shannon will use some of this annuity income to pay for a \$250,000 life insurance policy that will pay out on the second spouse's death. This will replace the \$250,000 that was used to buy the annuity. Their heirs will get this cash upon the second death. The life insurance premium annually is \$6,252 in this case. So, the amount left in their hands annually until the second spouse dies (after taxes and insurance costs) is \$12,372. This is much higher than the \$6,366 with the GICs and T-Bills. In fact, the couple is better off by \$6,006 annually.

Keep in mind that you'll be giving up some liquidity with this idea; you can't pull money out of the annuity except by way of your set monthly payments. So don't invest all of your cash in this strategy. Finally, be sure to apply for the life insurance first; if you're not insurable, you may choose not to buy the annuity.