

The Leveraged Corporate Insured Annuity

The Leveraged Corporate Insured Annuity (CIA) is a very effective planning technique. Where there is value to shareholders in converting Retained Earnings, through the use of the tax-free Capital Dividend Account, into a shareholder's loan, then a CIA is valuable.

During Life, the leveraged CIA will produce an after-tax investment return of 10 to 25+ percent annually.

On Death, retained earnings will convert to shareholder loans, while avoiding both capital gains and dividend tax.

This article breaks the strategy down into three sections:

- The Life Insured Annuity also called an Insured Annuity (I.A.) or a Back to Back.
- Corporate tax issues, during life and at death.
- How leverage can enhance the deduction, almost without risk.

There is a great deal of work to combining all three parts into an effective result for business owners. Their team of advisors will all need to be kept informed, and their tax advisors must be involved at the outset to determine whether an IA will fit or not, and to consult on the degree of leverage that should be employed.

The Insured Annuity

Understanding the mortality and pricing issues is important to understanding the benefits of the whole plan. This is a very good investment on its own, made better by corporate tax rules and leverage. It is a permanent life insurance policy with a death benefit equal to a simultaneous investment in a life 'without guarantee' annuity. Each month, or year, the annuity company pays a blended amount of principal and interest. The pay-

ment is used to keep the life insurance in force, plus create an income for the owner. On death, regardless of timing, the insurance proceeds replace the investment and income ceases.

Life insurance and life annuities appear to be mirror opposites, with one product replacing the investment of the other at death. In actuality, the characteristics of these two products are quite different:

Life Annuity

The annuity payment is principal, repaid over life expectancy, with interest on a declining balance. The older the client is at time of purchase, the sooner the capital must be repaid. Our example assumes an expected mortality of about 10 years, which is the mortality of an average annuitant, who may or may not be insurable. The older the individual, the less interest is paid. The figures below assume a prescribed rate, with interest averaged for the life of the annuitant. The graph illustrates a corporate owned annuity taxed on a decreasing balance until all capital is repaid and no interest is earned or taxed.

Life Insurance

The mortality experience pools are very different for insurable 75 year olds and average 75 year olds. The company providing the life insurance in the example predicts the man will live approximately 15 years because they have the advantage of medical underwriting. Our difference is about 5 years, helping create a net return of almost 5%. There is an added reward for longevity because life insurance is paid up at age 100 while the annuity payments continue for life. For those in the right age range, the Insured Annuity provides an income superior to other guaranteed products, particularly at high tax rates, and is much easier to administer than a GIC portfolio. The drawback is that once the

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RESOURCE UPDATE

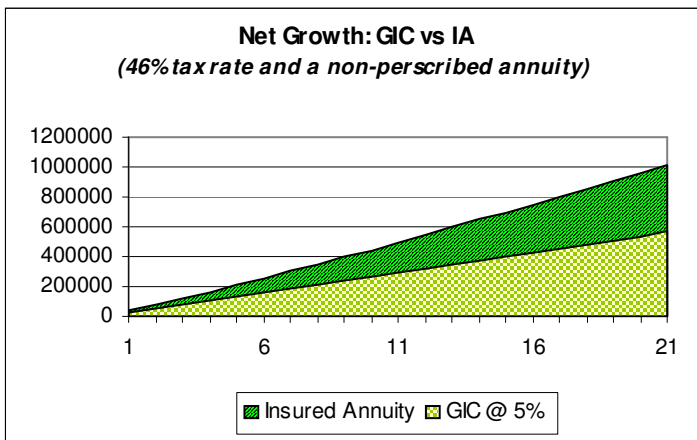
annuity is purchased, it is not liquid. The payment is fixed for life, regardless of future interest rates.

At current rates, how does it compare to other guaranteed investments?

GIC earning 5.0 %		Insured Annuity*	
\$50,000	Annual Income	\$100,000	
-23,000	Tax @ 46%	- 4,920	
<u>0</u>	Life Insurance	<u>- 48,500</u>	
\$27,000	Net Income	\$ 46,580	

This is a 72% increase in spending power.

* These numbers are based on a male age 75, non-smoker, in good health.



Corporate income tax considerations

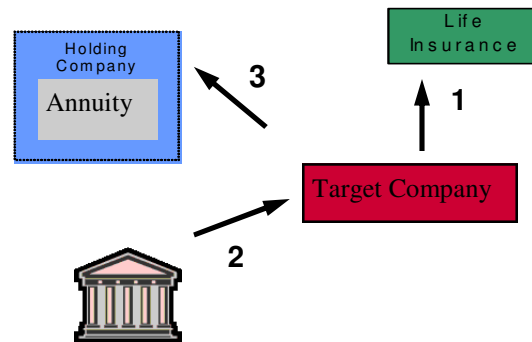
These are the issues to note when reviewing insurance and annuities corporately:

- Premiums are paid in after-tax dollars, unless assigned to an accredited financial institution.
- The book value of life insurance during life, and immediately before death (subsection 70(5.3) of the Act), is the Net Cash Surrender Value (CSV).
- Annuities are booked at their purchase price, and reduced by the capital portion of the payments made. On the death of a shareholder, annuities are valued at CSV, which is generally zero after the first six months.
- The Adjusted Cost Base is the premiums paid, less Net Cost of Pure Insurance. At older ages, the ACB grinds to zero in about 5 years.
- The death benefit, less the Adjusted Cost Base, is credited to the Capital Dividend Account to allow a tax-free dividend to shareholders.
- We are not aware of any Corporate Insured Annuities having ever been sent to the GAAR committee. We believe this is because the Insured Annuity is a profitable investment, and stands on its own merits. This is not a sham or an abuse of any rules. Tax advantages that may be realized from the CIA are because of long-

standing income tax principles, and are not a bending of any part of the Income Tax Act.

So, for companies with trapped Retained Earnings, assuming this amount is liquid, and a shareholder is older and still healthy, the company can purchase a Corporate Insured Annuity, earn a near tax-free income for the life of the shareholder, and on death, the taxable value of the insurance and annuity would be zero for capital gains calculations if, immediately before death, the life insurance and the annuity have no cash surrender value. Shares can be distributed to children or grandchildren without tax. Immediately after the transfer, the death benefit is paid to the company and can be removed tax-free via the capital dividend account created when the life insurance proceeds are received.

In most cases, an insured annuity is used as part of a reorganization. Parents may choose to freeze their shares when using an Insured Annuity because the tax-free income accelerates the Retained Earnings growth. Having new common shares in the children's hands may be prudent.



Leveraging a Corporate Insured Annuity

Most of the businesses we work with do not have all of their assets in a liquid form. To accommodate the client, a life-long, interest only bank loan is arranged.

Life insurance is not normally a deductible business expense; but, if it is assigned to a financial institution as collateral, then leveraging can create a double deduction:

1. The loan interest; assuming borrowing is done for business purposes; and
2. The policy premium, up to the allowable percentage of Net Cost of Pure Insurance (NCPI).

This NCPI is not the actual cost charged by the insurance company; but rather, an artificial sum, thought to mimic the cost of one year, non-renewable or convertible, term insurance.

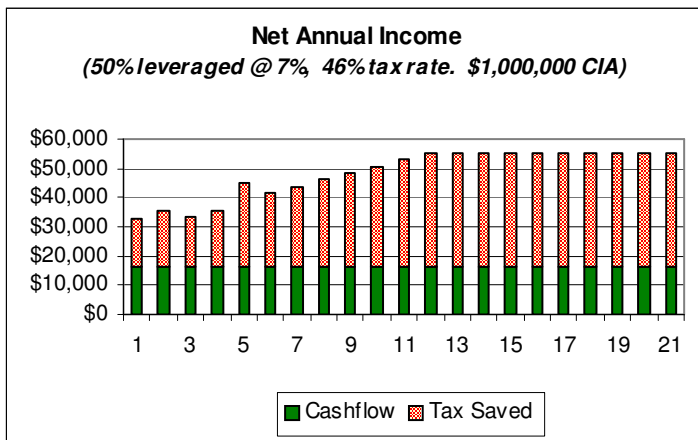
NCPI is very low under age 50, but as age increases the cost of term insurance sky-rockets. For clients above age 70, the NCPI deduction very quickly becomes higher than the cost charged by the insurer, giving rise to a 100% deduction of premiums paid, even if the loan is less than the death benefit.

RESOURCE UPDATE

Interest is not deductible when borrowing to buy life insurance because it is a tax-sheltered investment (much the same way RRSP loans are not deductible). Money must be borrowed for a business purpose; therefore, life insurance must be purchased with funds from the company before the loan is disbursed. Borrowed money should be used to replace operating capital depleted as a result of the investment transaction.

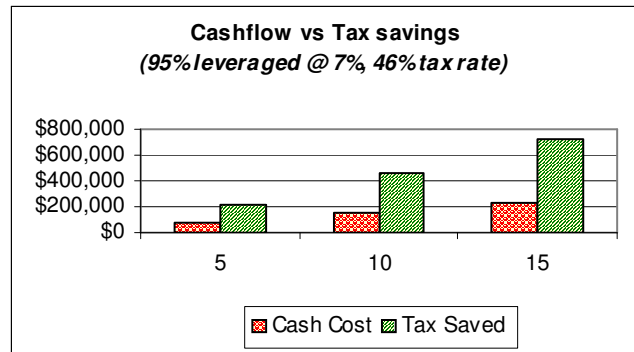
The annuity is usually too large to be funded from cash-flow, even for a short time. This is why the target company must have sufficient 'safe income' to pay an inter-corporate dividend up to a second company, which then purchases the annuity. Where the safe income is not enough to fund the whole annuity, money can be lent from the target company to the holding company at interest. In this latter case, maximizing the deduction requires that interest charged to the holding company does not exceed the taxable portion of the annuity, but at an equal or higher rate than charged by the bank.

Companies that, for different reasons, require both cash flow and tax deductions will choose to borrow a smaller portion of the full investment. When 50% is leveraged the annuity income can pay all of the insurance and interest costs, and leave a net profit before tax. As the following graph illustrates, with the net deductions of insurance and loan interest, less the taxable annuity interest, a very good net income is created. Based on the \$500,000 invested, the 50% leveraged CIA averages a 9 % after-tax yield. Companies that borrow all or almost all of the funds for the Corporate Insured Annuity experience a cash flow shortfall because the annuity cannot pay the insurance and all the interest cost; however, the deductions created are more than enough to offset this shortfall and create a substantial after-tax return on investment. Outside security, usually in the form of a GIC or letter of



credit from another institution, will be required to cover the annual cash shortfall. It is essential to understand that the bank is not going to accept any risk in this transaction, and special provisions need to be built into the life insurance and/or the annuity to make the security palatable to prospective lenders.

Most transactions are leveraged to 95% because it is more desirable to see outside security or a letter of credit than to liquidate existing capital from the core business of the corporation. The following graph illustrates that over time, the deductions are more than adequate to offset the cash flow deficit created from the larger interest payment. Because only \$50,000 of the client's own funds are invested, the return on investment for a 95% leveraged CIA can look astronomical.



To briefly recap the benefits of the Leveraged CIA, one must understand that the Insured Annuity, given the right age, is a very safe, secure, and easily managed investment that provides a superior guaranteed return. The insurance and annuity enjoy different mortality tables and thus create a profit. Life insurance products are very unique from an income tax perspective. The Capital Dividend Account treatment of tax-free death benefits allows life insurance to repay the bank loan, as well as create a tax-free dividend for surviving and new shareholders. Capital gains tax is first deferred while shares are passed to others, and dividend tax is saved on the entire amount of the CIA. Lastly, thanks to the very stable life insurance industry, with the inherent security built into each policy sold, it is possible to secure financing on very good terms to accomplish all of the benefits discussed above while leaving the business assets in place to continue earning profits.

The client receives all of the benefits, with very little risk, and may or may not use their own money to do it.

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