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The *Guaranteed* Fixed Income Strategy

By David Vicic, Senior Vice President, Corporate Planning Associates

These are turbulent times in the financial markets. The stock market bubble has burst, sending stock prices downward. Corporate accounting practices have been called into question in the United States, sending investor confidence spiralling downwards. Interest rates remain at extremely low levels, hurting those individuals who rely on fixed income flows. Economic uncertainty seems to be all around us.

For those of us who have many years to go to retirement, these market fluctuations are to be expected and in fact, can produce opportunities. However, what about those people who are approaching or already in retirement who are worried about diminished cash flows? What if you were told of a strategy that would allow you to "lock-in" an income stream that would be equivalent to one produced by a seven to eight percent GIC? Further, in the event of your death, the capital would pass tax-free to your beneficiaries without attracting probate fees. This strategy, which has been around for years, goes by names such as the "insured annuity" or "back-to-back arrangement".

There are two components that make up an insured annuity arrangement: a life annuity and a life insurance policy. A life annuity is a right to receive fixed periodic payments, based on the life expectancy of the annuitant and on interest rates. Each payment is made up of an interest component (taxable) as well as a return of capital component (non-taxable). In a *prescribed annuity*, the taxable component is level over the course of the contract. A *non-prescribed annuity* has a taxable component that is higher in the earlier years of the annuity and decreases over time.

The first step in the implementation of the insured annuity strategy is to *purchase a prescribed* life annuity. In order to maximize the income stream, an annuity payable for the lifetime of the annuitant is chosen (i.e. payments stop on the death of the annuitant).

Once the annuity is in place, a life insurance policy is purchased. The amount of the insurance purchased should be equal to the capital used to purchase the life annuity. The premiums for this life insurance policy are funded using a portion of the annuity payments received.

Since the need for insurance is permanent and we want to minimize the cost of insurance, the contract should be either a Term-to-100 or minimum funded universal life policy (rather than whole life that tends to be significantly more expensive).

This strategy produces a couple of advantages. While the individual is alive, he benefits from an increased after-tax return when compared to using fixed income vehicles such as GICs. The second benefit of this strategy is its simplicity – once in place, it requires virtually no management to maintain it. Finally, by its very nature, the strategy is conservative and appeals to those who are risk averse.

There are issues/disadvantages that must also be considered. One such issue is that this strategy is meant to be used by those who are at least 60 years of age. Also, individuals need to be healthy enough to qualify medically for both the annuity and the life insurance.

Perhaps the biggest problem with this concept is the fact that once you enter into this arrangement, there is no turning back. If there is a change in market conditions or perhaps in the annuitant's/insured's financial situation, there is no way to completely undo the strategy.

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Now that some of the important issues have been dealt with, an example has been prepared to illustrate some of the points that have been discussed so far.

Problem

Let's assume that our client, Jack, age 70, has GICs worth $1,000,000 that are maturing. He is concerned that with the GIC rates currently being offered, his cash flow will be hurt significantly. The thought of putting more money in the stock market makes him very nervous. As a result, Jack feels that he doesn't have any real options available. He has advised that he has no serious health concerns.

Solution

Jack appears to be a prime candidate for the insured annuity solution. The following outlines the particulars of the arrangement.

First, a life annuity is purchased.

Cost of Annuity: $1,000,000

Type of Pension: Prescribed, life guaranteed for 3 years[1]

Annual Pension Purchased: $102,289

Annual Taxable Portion: $30,347

Assumed Tax Rate: 46.4%

[1] *Life only pension was not available from the annuity issuer.*

Now that the life annuity is in place, a life insurance policy needs to be put in place.

Face Amount: $1,000,000

Type of Insurance: Term-to-100

Annual Premium: $41,505

	Insured Annuity	GIC
Cost of investment	$ 1,000,000	$ 1,000,000
Annual Pre-Tax Income	$ 102,289	$ 50,000
Annual Taxable Income	$ 30,347	$ 50,000
Annual Tax Payable	$ 14,081	$ 23,200
Cost of Insurance	$ 41,505	–
Annual After-Tax Income	$ 46,703	$ 26,800
Annual After-Tax Return	4.7%	2.7%

Let's compare the insured annuity strategy with the GIC strategy that Jack has favoured in the past. We will assume that Jack is able to obtain a 5% return using GICs.

Please note that in order to match the annual after-tax rate of return earned by the insured annuity, the GICs would need to earn approximately 8.7% (before tax). One would be hard-pressed to find a financial institution that would issue a GIC with this rate of return in our current economic environment. The end result is that Jack has more after tax cash flow available to him from the same $1,000,000 investment.

To show that this is not simply a "fluke", we took this example one step further. We kept everything else the same except that we changed the individual's age. We then calculated the hypothetical before tax rate of return that would have to be earned by a GIC to match the return generated by the insured annuity strategy at various ages.

Age	After Tax Rate Of Return, Insured Annuity	Equivalent Pre-Tax Required GIC Rate of Return to Match Insured Annuity
60	4.40%	8.20%
65	4.57%	8.52%
70	4.67%	8.71%
75	4.76%	8.88%
80	3.96%	7.40%

In all of our examples, the insured annuity strategy produces increased after-tax cash flows when compared to the traditional GIC strategy. In the event of death, $1,000,000 of capital is available for distribution to beneficiaries under both scenarios. However, if a beneficiary is named under the life insurance policy, the insurance proceeds will not be subject to probate fees (approximate savings of $15,000).

The insured annuity concept has justifiably experienced a "rebirth" during our recent economic downturn. This strategy should be considered by those who are yearning for guaranteed cash flow, who are looking to maximize return and minimize risk.

Eliminating the cross-border blues

Clients moving to the U.S., or heading back, will need advice on their RRSPs or IRAs

By Monica Townson

What if your client moves to the U.S.? Taking an RRSP along may not be possible, but cashing it in is probably not a good idea, either. And what if your client has been working in the U.S., contributing to an individual retirement account, and is now moving back to Canada? Different rules apply: IRA funds can be rolled into an RRSP, but an RRSP cannot be rolled over into an IRA.

Helping clients sort out thorny cross-border issues is a challenge, and Jamie Golombek, vice president of taxation and estate planning at **AIM Funds Management Inc.** in Toronto, offers some pointers.

• If an RRSP is cashed in before the holder leaves the country, the entire amount will have to be included in income and will be taxable at the holder's top marginal rate. But if the RRSP is cashed in after the holder has become a non-resident of Canada, there will be a 25% withholding tax, probably much lower than the client's top marginal tax rate.

• An RRSP may be left in place in Canada, even though the holder has moved to the U.S. and become a non-resident. But no future contributions may be made to the plan, unless the holder has Canadian earned income on which an RRSP contribution could be based.

• U.S. tax authorities don't recognize the RRSP but consider it simply a pool of investments. But while RRSP funds are not taxable in Canada until they are withdrawn, the U.S. taxes earnings of the RRSP after the holder has become a U.S. resident. However, under the Canada/U.S. tax treaty, the holder may make an election to defer U.S. tax on income earned in an RRSP until it is distributed. The election must be made every year when the U.S tax return is filed.

• When funds from the RRSP are distributed to the holder, the U.S. taxes the money in the same way annuities are taxed: only amounts considered in excess of the individual's investment in the plan will be taxable. That essentially means increases in the value of the plan after the holder became a U.S. resident. Golombek suggests crystallizing accrued gains in the RRSP on the point of departure, before the client becomes a U.S. resident.

One way to do this, he says, is to do a sell/buy transaction: sell the assets in the RRSP and buy them back at current market prices. This bumps up the cost base of the RRSP to current market value, limiting U.S. tax liability when funds are eventually withdrawn. There are no real Canadian tax consequences to this strategy, Golombek says, other than putting the client offside on the foreign-content rules.

• Leaving an RRSP intact may make sense, especially if there's a possibility your client may return to Canada in the future. Golombek says this option has become more attractive since a change in securities regulations allows Canadians resident in the U.S. to trade securities in their RRSPs.

Prior to June 2000, Canadians living in the U.S. were allowed to sell only mutual funds in their registered and non-registered accounts, but they couldn't switch between funds or buy new securities. The Securities and Exchange Commission has granted an exemption for mutual funds purchased by certain retirement accounts, so Canadians can now manage self-directed RRSPs, RRIFs and similar retirement accounts while they are visiting or living in the U.S. (The exemption does not apply to non-registered accounts).

The **Investment Funds Institute of Canada** notes that each U.S. state must adopt legislation for the SEC exemptions to apply, and a formal application must be made to the state by the investor's Canadian broker. There are now 42 U.S. states that have some legislation or policy to permit this.

• Tax-free rollovers to a surviving spouse when the holder of an RRSP dies can be made the usual way, even if both spouses have become non-residents, Golombek says. The surviving spouse becomes the new annuitant, and if a non-resident of Canada, the survivor is subject to the same rules as the deceased. For instance, the 25% withholding tax would apply when funds are withdrawn by the survivor, assuming she or he is a U.S. resident at the time. On RRIF payments or other periodic pension income paid to U.S. residents, the withholding tax is only 15% but foreign tax credits in the U.S. may offset this.

• What if your client has been living in the U.S., contributing to a 401(k) or an IRA, then returns to Canada? Golombek says the rules allow a Canadian resident to transfer funds in an IRA to an RRSP on a tax-deferred basis. Technically, the IRA withdrawal would be included in income on the Canadian tax return, but there would be an offsetting deduction equal to the amount contributed to the RRSP. Only lump sums may be rolled over in this way, but lump-sum withdrawals may be subject to 30% U.S. withholding tax.

• The rules generally don't permit a rollover of a U.S. 401(k) fund to a Canadian RRSP, but a way around this may be to roll over the 401(k) to an IRA, then transfer the IRA funds to the RRSP. Golombek advises clients to consult a U.S. tax advisor.

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"Capital" What is it? What does it mean?

By John R. Ross, Chairman, Corporate Planning Associates

Over the past few months I have met with many of our clients and talked about the stress created when the stock markets are falling. We are subjected to seemingly endless bad news that tends to destroy the spirit and create wild scenarios, mostly of something disastrous. The recurring nightmare of losing our capital can be very real when the media is filled with doom and gloom.

Which leads me to the question – What is capital? Why do we want it? What purpose does it serve?

Too many of us worry about the amount of capital rather than what it does for us. No one wants to lose their capital but I think the loss of capital is different from losing your assets. For example, if all of your capital were invested in Enron, Worldcom and Nortel, you would certainly say that you have lost your capital and your assets. Our clients are generally invested in a diverse portfolio that gives them ownership in hundreds of companies. The fact that at any point in time the "markets" decide that those companies have less value today does not or should not have any effect on the individual. If your portfolio is down 20%, it really doesn't affect the way you live unless you allow it to. Capital has only one important function and that is to provide income that is certain and sustainable.

Start with the premise that you saved your "capital" so that it would one day provide you with income. If so, you will then understand that it is not the amount of capital that you have that is important, it is the amount of certain, sustainable income that it can generate. Perhaps a few examples will make the point.

We were asked by a client many years ago to help a friend's widow arrange her affairs after the untimely death of her husband. She was relatively young, in her early sixties and had not worked outside of the home for many years. She also had very little understanding of financial matters and was extremely worried as to how she would survive. She and her husband lived in a large, expensive home and even though he had been successful in his career he had not provided for his widow because, quite frankly, he had not planned on dying. His widow was left with many bills and some unfortunate investments. After selling the house, cleaning up investments and buying a smaller home, she was able to reorganize her life. It was very important to her that she be able to maintain a comfortable standard of living and to help her children from time to time. If left in fixed income investments, the portfolio would not have adequately provided for her needs because of relatively low returns and income tax. We invested the funds in equity mutual funds and started a Systematic Withdrawal Plan (SWP) providing a monthly income that allowed her, and continues to allow her, to live very comfortably. Yes, she worries about the stock market but when we show her that her capital today exceeds the original portfolio, she realizes that she has survived many "disasters" including the severe market corrections in 1987 and 1991. She truly understands the difference between capital and cash flow. We grow capital and live on cash flow.

Or I think of another client who retired some 5 years ago and was faced with the fact that his pension, while substantial, was considerably lower than his employment income. Establishing a SWP meant that he was able to augment his pension and provide cash flow for some of the luxuries that can be enjoyed when you don't have to go to the office every day. More travel, helping his children and grandchildren and never worrying about money. Does he worry about his capital? Of course he does when the markets are gyrating but he keeps coming back to the fact that his capital may go down but that hasn't affected his cash flow.

Think of your capital as a huge pile of money sitting on your dining room table, then imagine the pile ebbing and flowing so that the pile shrinks one day and grows the next. Your only desire is to extract enough cash each day to look after your particular needs and wants. As long as the pile is sufficient to meet your cash flow needs you shouldn't worry about the overall size. So it is with your stock portfolio. It will go down but it will also go up. The trick is not to spend too much time worrying in the short run.

I hope this helps.

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