Charitable Insured Annuity Strategy

Research from Statistics Canada shows that between 2010 and 2013, the total amount donated by Canadians to charitable or non-profit organizations increased by 14% to $12.8 billion.[1] In 2013 alone, the majority of Canadians (82%) made financial donations to a charitable or non-profit organization. In addition to annual donations, many people want to leave a lasting legacy, and cite charitable bequests as an important estate planning goal.

It can be difficult balancing goals of enjoying a comfortable retirement lifestyle with providing an inheritance to your heirs, and leaving a legacy to your favourite charity. Fortunately, there are strategies available that can help you achieve all of your goals. If you are age 65 or older, you may want to consider using a charitable insured annuity strategy.

This strategy, which is implemented by purchasing both life insurance and a prescribed annuity, is best suited to conservative investors who are charitably inclined, and either:

- Receive surplus income from interest-bearing investments such as Canada Savings Bonds, GICs and treasury bills, and would like to reduce their annual taxes; or
- Require a higher level of retirement income because the majority of their investments are generating interest income, which is taxed at their marginal tax rate without any preferential tax treatment.

The charitable insured annuity strategy is designed to achieve two important objectives:

1. Generate an increased tax-efficient income in retirement; and
2. Make a significant donation to a favourite charity(ies) upon your death.

A life insurance policy and a prescribed annuity are used to implement the strategy.

How the charitable insured annuity strategy works

- A life insurance policy is purchased to facilitate a tax-free transfer to a chosen charity upon the death of the insured.
- The life insurance policy can be set up so that the charity is named as the beneficiary of the policy or the charity is named as both the owner and beneficiary of the policy. If the charity is named as the beneficiary, upon death, the charity will receive the proceeds of the policy and the insured's estate will receive a charitable tax receipt for the value of the life insurance proceeds. If the charity is named as both the owner and beneficiary of the policy, the insured will receive a charitable tax receipt equal to the value of the insurance premiums paid each year and, upon death, the charity will receive the proceeds of the policy. In this scenario, no charitable donation tax receipt is issued for the life insurance proceeds at the time of death.
- After the life insurance policy is purchased, a guaranteed life annuity policy is then purchased using non-registered assets. The life annuity generates a higher after-tax cash flow than the interest-bearing investment portfolio because the annuity payments are a combination of taxable interest and non-taxable return of original capital. The annuity will generally pay the insured a higher guaranteed lifetime annual income versus the annual income paid by the interest-bearing investments portfolio. While the annuity income will not change, income from the interest-bearing investment portfolio will fluctuate in line with interest rates.
- It is important to note that the decision to purchase a life annuity cannot be reversed.

Continued

Example[2]

Now let's look at an example of how this strategy works. George is a 70 year old widower, and has already provided for his two children by naming them as beneficiaries of his home, the family cottage and his RRIF account. George recently retired with a $250,000 portfolio of GICs in a non-registered account. He doesn't want to give up the security of GICs but would like to generate a higher after-tax income to meet his retirement expenses.

In addition, he wants to create a legacy for his favourite charity, so it's important that any alternative income strategy meets his higher income requirements and still leaves a meaningful donation to his chosen charity after his death.

George takes the following steps to implement the charitable insured annuity strategy:

- George purchases a life insurance policy on his life which facilitates a $250,000 tax-free donation for his chosen charity upon his death.
- Because George's goal is to increase his cash flow in retirement, he names the charity as both owner and beneficiary of the life insurance policy. This way, George receives a charitable donation tax receipt each year for the amount of the insurance premium paid annually. If George didn't use this strategy, his $250,000 GIC portfolio could still be left to charity and would provide a charitable donation tax receipt for his estate.
- George uses his $250,000 GIC portfolio to purchase a guaranteed life annuity policy. Even after paying the premiums on his life insurance policy, the annuity will pay George a guaranteed lifetime annual income of $6,145 versus the $4,050 annual income paid by the GIC portfolio.
- George's annuity generates a higher after-tax cash flow than his former GIC portfolio could provide because the annuity payments of $6,145 are a combination of both taxable interest and non-taxable return of his original capital.
- If the annual charitable donation tax credit is also factored in, George's annual cash flow will increase to $11,112 annually – representing an 8.23% equivalent pre-tax yield, versus 3% for the GIC portfolio.

	GIC	Charitable Insured Annuity
Initial capital	$250,000	$250,000
Annual investment rate	3%	N/A
Gross annual cash flow	$7,500	$18,333
Taxable portion	$7,500	$3,021
Tax payable (46%)	$3,450	$1,390
After-tax cash flow	$4,050	$16,943
Annual insurance premium	N/A	$10,798
Net annual cash flow	$4,050	$6,145
Equivalent pre-tax yield		4.55%
Charitable Donation Tax Credit (CDTC)*	N/A	$4,967
Net annual cash flow with CDTC		$11,112
Equivalent pre-tax yield with CDTC		8.23%
Estate value	$250,000	$0**

* Charitable donations are restricted to 75%[3] of annual net income. In order to receive the full benefit of the tax credit, additional sources of income are required beyond the annuity. Also, other charitable donations must exceed $200 annually in order to receive savings at the highest marginal tax rate.

** Unlike the GIC scenario, no donation tax credit is available at death for the $250,000 transfer to the charity. The potential tax benefit of a charitable bequest of the GIC upon death to the charity should be considered for a complete analysis.

This chart has been prepared to help you understand how a charitable insured annuity may work. Tax calculations are only estimates and the values shown here are illustrative only and are not a guarantee of the future. Assumptions: a male, age 70, non-smoker, term-to-age-100 life insurance, a prescribed annuity, top marginal tax rate 46% and 3% GIC rate. November 25, 2016.

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While the example was based on a single individual, this strategy is equally attractive for a couple. The difference is that the insurance policy and the life annuity are purchased based upon the lives of both persons. Upon the first death, the life annuity income stream would continue to the surviving spouse. The insurance policy would disburse the proceeds of the policy to the charity upon the second death.

Planning is key

With proper planning you may be able to increase your annual cash flow, reduce your annual tax liability and, at the same time, provide a generous donation to charity.

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For more information about this strategy, please contact your BMO financial professional who will refer you to an Estate and Insurance Advisor (Financial Security Advisor in Quebec) from BMO Nesbitt Burns Financial Services Inc.

Footnotes:

[1] Volunteering and charitable giving in Canada. Martin Turcotte, Statistics Canada, January 30, 2015. statcan.gc.ca.

[2] Please note that the tax legislation governing the income taxation of prescribed annuities is changing, effective January 1, 2017. Prescribed annuity taxable portions will be calculated using an updated mortality table which will result in a higher taxable portion included in the annuity payment, and the age at which the taxable portion of the annuity payments becomes $0 will be increased versus the current calculation. The charitable insured annuity example and taxable portions included in the publication have been calculated using the updated mortality table.

[3] The 2016 Quebec Budget has proposed to remove the 75% limitation for 2016 and subsequent taxation years in calculating the qualifying Quebec provincial donation tax credit.

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