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TAX MATTERS

Consider an insured annuity to increase cashflow in retirement

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Perhaps you've heard of Aubrey de Grey. He's a scientist who believes that the first human being who will live to be 1,000 years old is already alive today. And he's not just predicting this, he's devoted his work to help this become a reality by trying to identify aging factors and eliminate them. Mr. de Grey has his critics. Some point out that he's a computer scientist, not a biologist or a medical doctor.

The fact is, if any of us are destined to live for 1,000 years, it's going to throw a lot of retirement income planning out the window. But whether you're planning to live that long or not, we can all agree that finding more income in retirement, for longer, is a good thing. With that in mind, I want to talk today about the concept of an insured annuity.

The opportunity

It's a common thing to find seniors who have investment portfolios that are conservatively invested in GICs and fixed-income investments. The stable income – however small it might be – is preferred to the volatility of the equity

markets for many. The problem? The interest income generated by your GICs, in particular, is not very high – especially after taxes. And it's possible we could see further interest-rate cuts by the Bank of Canada in 2025, which would in turn push down the GIC rates on offer.

Is there another strategy that could increase the cash in your pocket after taxes? Sure. It's called an insured annuity and involves taking some of the money you currently have invested in GICs, or other very low-yielding investments, and purchasing an annuity. Annuities generate regular payments to their holders, and they could provide a higher stream of income for the rest of your life.

If you do this, the capital you've invested in the annuity won't generally be available to your heirs once you're gone. To offset that, you can also take some of the additional cash flow received from the annuity and buy a life insurance policy to replace all or some of the capital.

The easiest way to understand how this works is by looking at an example.

The example

Consider my friend Greg, who is 70 years old. Greg has invested \$250,000 in GICs earning him 3.5 per cent. The GICs aren't all the investments he owns (he also has money in his RRSP, TFSA and some additional non-registered funds). The GICs provide him with \$8,750 annually before taxes. At a marginal tax rate of 35 per cent, Greg keeps \$5,688 in his pocket annually.

Greg is thinking about an insured annuity. He learned that he can purchase an annuity with the \$250,000 that will make monthly payments to him for the rest of his life. These payments will amount to \$17,212 annually before taxes. Now, an annuity is sort of like a mortgage, but backward, in that a portion of each payment he receives is interest, and a portion is a tax-free return of his original capital. In his example, just \$2,506 of the payments are taxable annually, resulting in \$877 of taxes paid each year. This means that Greg keeps \$16,335 (\$17,212 less \$877) of cash in his pocket after taxes each year with the annuity.

Did you catch that? The annuity provides Greg with \$16,335 of after-tax cash annually while the GIC provides just \$5,688. That's \$10,647 more from the annuity. The big difference with the annuity, of course, is that part of the cash you're getting is a return of your original money, which means there won't be much, if anything, left for the kids when you're gone.

This where the insurance comes in if you want to leave more to the kids. You may be able to purchase a life insurance policy to partly – or fully, depending on

your age and insurability – replace the capital used to buy the annuity when you die. In Greg's example, he could use, say, \$5,000 of the \$10,647 of additional cash annually to purchase a life insurance policy that will pay out when he's gone. In Greg's case, \$5,000 of insurance premiums annually could buy between \$75,000 (for a whole life policy) and \$340,000 (for term insurance which expires at the age of 85).

In Greg's case, \$5,000 of insurance premiums annually could buy about \$100,000 of life insurance.

The nuances

If you're going to consider the insured annuity idea you should do this with non-registered investments. Using the assets in your RRSP or RRIF to buy an annuity isn't going to provide the same after-tax cash flow as our example above since funds withdrawn from these plans are fully taxable. We're trying to minimize tax here.

The annuity in Greg's example has a 10-year guarantee period so that, if he dies in the first 10 years of the annuity, his heirs will still collect what would have been paid to him in the first 10 years. Annuities can come with even longer guarantee periods – but it will cost more.

Speak to an insurance professional for more about insured annuities.

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