



## CESTNICK

### TAX MATTERS

*A prescribed annuity contract can brighten your golden years*

I'll be 40 this year. I've already noticed that my short-term memory isn't as good as it used to be. I don't know, maybe it's genetic. I visited my grandmother last week. "Tim," she said, "right now I'm having amnesia and déjà vu at the same time. I think I've forgotten this before."

As Canadians get older, two of the biggest challenges we face are memory loss, and how to generate income. I can't help much with the first problem. But let me share an idea that might just result in more income for you in retirement. This idea is a cousin to the idea I shared in my article on July 15 that applied to those with holding companies. This idea is called a "back-to-back prescribed annuity" because it involves buying an annuity and insurance "back-to-back."

#### The idea

Let's consider an example. Suppose you're age 65 and you have \$100,000 invested outside of your registered retirement savings plan or registered retirement income fund. Suppose also that you need an income from this money and you invest conservatively in interest-bearing investments, earning 4 per cent annually. Your income from the investment would be \$4,000 annually, before taxes. After tax, you'd be left with \$2,800, assuming a marginal tax rate of 30 per cent.

Now, let's increase your after-tax income with our strategy. You could take the \$100,000 and use it to purchase a prescribed annuity contract (PAC). The annuity will pay out a monthly income to you for life. In our example, the income paid out annually will be approximately \$7,135. Under a PAC, a portion of each payment is taxable, and a portion is a return of your original capital, which is not taxed. In this example, the taxable portion of the annuity will be about \$1,641 annually, giving rise to a tax bill of \$492 each year. After tax, you'd be left with \$6,643 (\$7,135 less \$492) annually. This is much higher than the \$2,800 you'd

have with the interest-bearing investment we spoke about. In fact, it's about 137-per-cent higher.

#### The insurance

Now, there's one problem with this idea. Your kids won't like it much (not that you should care). Why not? The \$100,000 will not be available at your death to pass on to your kids, because the annuity works so that your original capital is paid out to you over your lifetime. You are spending it. If you don't like this, there's a solution.

You could purchase a \$100,000 life insurance policy with the extra cash flow you're receiving on the annuity each year, to replace the capital. In our example, a \$100,000 policy will cost about \$3,025 annually. So, do the math. The annuity pays out \$6,643 annually after taxes. Now use \$3,025 of this to pay for the insurance annually. You're still left with \$3,618 after taxes and insurance costs. This still beats the \$2,800 from the interest-bearing investment, by almost 30 per cent.

#### Other thoughts

Another twist on this idea is to purchase a term-certain annuity, which won't last your lifetime, but will make payments to you over a certain term — say, 10 years. This will provide greater income over that specific term. This may make good sense when interest rates are low because annuity rates (and your monthly payments) will also be low in this situation.

A PAC can help to reduce clawbacks of Old Age Security benefits because the taxable portion of the annuity is less than the taxable interest from an interest-bearing investment.

Finally, PAC payments will qualify for the pension credit if you're age 65 or older, saving you more tax.

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