



THE USE OF ANNUITIES IN THE PRE AND POST RETIREMENT PROCESS

CONTINUING EDUCATION ON THE WEB
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WHAT IS AN ANNUITY?

It is extremely important to truly understand exactly what an annuity is before considering its use and application in the insurance industry.

- The term “annuity” is defined in the Canadian Law Dictionary in the following manner:

“A yearly payment of a certain sum of money for a definite number of years or for life. The term is also used to refer to payments that are recurrent at shorter intervals than a year, such as monthly payments as in annuity policies of insurance where an insurance company in consideration for a lump sum paid to it, agrees to pay to the other party to the agreement, equal payments, monthly or yearly for a definite number of years or until his death.”

“An annuity is a series of periodic payments (i.e. monthly, annually), which the person has purchased or arranged for with a sum of money or other assets of a capital nature. Annuities may be for life or may be terminated on the death of the investor or at the expiry of other terms. The annuitant has no further property in the fund or source from which he receives the payments other than a claim for payment of his annuity.”

BACKGROUND INFORMATION – KEY POINTS

- Key point of definition is that an annuity is purchased with a sum of capital, which is subsequently exhausted.
- Two types of annuities sold by life insurance companies are life annuities and term certain annuities.
- Annuities (either life or term certain) can be bought on an immediate basis or a deferred basis.
- When an immediate annuity is purchased, the individual is giving capital to the insurance company in exchange for income for life or for a specified period (term certain).
- Immediate annuity can be purchased with Registered proceeds (accumulated value of RRSPs), or Unregistered capital, however, the taxation of annuity income differs.
- Generally older individuals, at or close to retirement purchase immediate annuities.

- It should be clearly understood that the individual has given their capital to the insurance company, and cannot subsequently ask the insurance company for a return of their capital, once the contract has been issued. (Unless the contract provides for such a contingency – very few do.)
- The Deferred Annuity is the vehicle used by life agents when a client wishes to invest capital for medium or long term capital appreciation, registered as a Registered Retirement Savings Plan (RRSP) or from after-tax dollars, or for example through an inheritance (unregistered proceeds).
- Recognize that a life agent is **NOT** permitted to sell mutual funds or securities, as they are not classified as life insurance. When an agent is selling a client an investment product (i.e. segregated funds), in essence the agent is selling an annuity – a deferred annuity. It should be noted however, that many representatives today have both a Life and Mutual Fund license.
- After a period of uncertainty in the 1960s and 1970s, Provincial Insurance Acts were amended to include the term annuity within the definition of life insurance.
- Definition of “insurance money” and “life insurance” clearly provide that any type of annuity issued by an insurer (i.e. life only, term certain, or variable annuity) is considered to be life insurance.
- The Ontario Insurance Act provides the following:

“Insurance money” means an amount payable by an insurer under a contract and includes all benefits, surplus, profits, dividends, bonuses and annuities payable under the contract.

“Life insurance” means an undertaking by an insurer to pay insurance money.

Which includes:

“An undertaking entered into by an insurer to provide an annuity or what would be an annuity except that the periodic payments may be unequal in amount and such an undertaking shall be deemed always to have been life insurance.”

- Notwithstanding the fact that insurance companies have investment products where each and every dollar can be invested in stocks, bonds, etc. (segregated fund) or in guaranteed investment products, when these products are sold, the insurer is selling the client a deferred annuity.
- At the maturity date, the deferred annuity contract specifies that the accumulated value of the contract can be used to provide annuity income for life or on a joint life basis in lieu of taking the accumulated value in a lump sum.

VARIABLE DEFERRED ANNUITIES – (SEGREGATED FUNDS)

- A life insurance agent does NOT have the authority to sell mutual funds or securities.
- License allows the sale of products classified as life insurance.
- As previously mentioned, the term annuity is defined in the Insurance Act as constituting life insurance, because of the annuity options, contractually guaranteed in the contract.
- Today, life agents sell investment contracts similar to mutual funds, where the future value of the client's investment is dependent upon the market value of the specified group of assets.
- In essence, these specified groups of assets are separated or segregated from the life insurance company's general portfolio, Hence, the term segregated funds.
- Capital can be invested in a lump sum, on a periodic basis, or whenever the client has capital to invest in one of many segregated funds offered.
- The choice of which segregated fund to invest in involves many factors, the most important being the client's **Risk Tolerance** level.
- Regardless of which fund the client invests in, what is important to understand is the contract the client receives is a Deferred Annuity contract, specifically a VARIABLE DEFERRED ANNUITY contract, also called an Individual Variable Insurance Contract (IVIC).
- Variable because the **future value** of the segregated fund **cannot be guaranteed**. Future values depend on the performance of the fund.
- Variable Deferred Annuity contracts do provide contractual guarantees in the event of **death** of the owner prior to maturity, as well as **maturity** date guarantees.
- Variable contracts contain a guarantee that at least 75% (some insurance companies guarantee 100%) of the gross premiums paid will be paid at **death** or returned to the owner at **maturity**. **In addition, it is noteworthy to understand that in order for the maturity guarantee to be applicable, at the point of sale the maturity date MUST be at least ten years into the future. If under ten years, the maturity guarantee is not available.**
- With these guarantees, variable contracts are exempted from securities law and regulation.
- To summarize, when an agent sells an investment contract, the contract issued by the insurance company is a Variable Deferred Annuity.

- The contract provides that at the maturity date, which could be 10, 20 or 40 years into the future, the accumulated value of the client's units can be used to buy a life, or joint and last survivor annuity. However, the client is not compelled to use the accumulated value to purchase an annuity.
- By contractually including the annuity options at maturity, the contract is constituted to be a life insurance contract within the meaning of the Insurance Act.

EXAMPLE:

Kevin Kennedy, age 29, recently inherited \$100,000 and wishes to invest the capital for long-term application. He decides to invest the capital in ABC Life Insurance Company, specifically their Canadian Equity Fund.

What Kevin has bought is a Deferred Annuity, a variable contract with a maturity date that could be 10, 15 years or longer.

The contract clearly states that at maturity, the value of the contract can be used to buy a life or term certain annuity, and because of these provisions is considered to be a life insurance contract. However, Kevin is **NOT** compelled to use the accumulated value to secure an annuity. At any time prior to maturity, or at maturity date, Kevin can take a portion or all of the accumulated value in a lump sum.

Today, many Canadians are concerned about having enough capital available when they retire to enjoy life to the fullest. The amount of capital required will obviously vary from individual to individual.

The pre-retirement process can start at any age depending on the client's priorities. The life insurance professional dealing in this market prior to making any recommendation will generally go through the following process:

- Establish retirement objectives
- Gather background data
- Develop strategies
- Implement the plan
- Monitor the plan and make changes as required
- Document the plan

One thing that we know is that Canadians are living longer than ever, and with increased longevity, the need for sufficient capital to enjoy their retirement is critical.

The important point to make is that whenever a life insurance professional is involved in pre-retirement planning, when products are sold, the agent is selling a deferred annuity either with a short term guarantee (we call them guarantee interest annuities rather than a guaranteed investment certificate or the client wishes to go into an investment fund, the agent can sell a variable deferred annuity (also called an Individual Variable Insurance Contract. IVIC), which has many similarities to a mutual fund.

Because the future value of segregated funds and short term funds cannot be guaranteed in the future, the insurance professional must provide their potential client with an Information Folder before the point of sale.

THE INFORMATION FOLDER – ITEMS TO REVIEW

- What an agent is REQUIRED to do prior to selling a Variable contract is to provide the potential client with an Information Folder or Summary of the Information folder and make sure the prospective client understands the contents prior to any sale.

The Information Folder or summary MUST include the following:

- The benefits that are guaranteed and those that are not guaranteed but fluctuate with the market value of the segregated fund supporting them.
- A statement in bold print warning that the contract includes benefits that are not guaranteed.
- The method of determining the benefits related to the market value of the fund, and the amount of the surrender value of those benefits.
- The amount of the premium allocated to the fund.
- Any charges if the contract is surrendered, prior to maturity.
- The method used to determine the value of the units.
- How often the units of the fund are valued (daily, weekly, monthly).
- What the objective of the particular fund is, who manages the fund, and the method of marketing the fund.
- The charges against the fund for taxes, management expenses such as the transfer of units in one fund for units in another, and when these charges will be deducted.
- The income tax consequences for the contract holders.
- The maximum management fees expressed as a percentage of the net assets if the fund and all other expenses, with an explanation as to how they are calculated and to whom they will be paid.
- A five year statement of unit values (if applicable) and a schedule of investment holdings for the last year.

PRE-SALE PROCEDURE – DEFERRED ANNUITIES

- Specific guidelines have been established to assure that prospective clients understand the risks involved when investing in a variable contract.
- The concept of Full and Adequate Disclosure prior to the point of sale is critical.
- Accordingly, prior to selling a variable contract, the agent should:
 - a) Deliver an information folder or summary of the information folder, prior to taking an application.
 - b) Secure from the prospective client, a signed written statement acknowledging receipt of the folder.
 - c) Use proposal forms prepared by the insurance company. By so doing, the agent is secure in the knowledge that the Superintendent of Insurance of his/her province of residence has approved these forms.
 - d) **MOST IMPORTANT**, the agent should not make any promise regarding the future value of the fund. No individual or corporation knows what the value of any segregated fund will be one month, one year, or ten years from now. The potential client should clearly understand that their capital is at Risk.
 - e) If illustrations are provided to the client, showing growth rates of the fund, reasonable and clearly expressed assumptions should be used. As well, it is wise to show at least three realistic projections to emphasize the fact that the illustrated growth rates are being presented on a theoretical basis.
 - f) The illustration must be accompanied by a statement in bold print similar to the following:

ANY PART OF THE PREMIUM OR OTHER AMOUNT THAT IS ALLOCATED TO THE FUND IS INVESTED AT THE RISK OF THE POLICYHOLDER AND MAY INCREASE OR DECREASE IN VALUE ACCORDING TO THE FLUCTUATIONS IN THE MARKET VALUE OF THE ASSETS IN THE FUND.
 - g) If an illustration of growth rates is based on past performance of a particular fund, the potential client should be clearly aware that past results are not indicative of future performance.

THE USE OF VARIABLE DEFERRED ANNUITIES

Whenever a prospect invests in a life insurance segregated fund or guaranteed investment annuity, their investment is either registered as a Registered Retirement Savings Plan (RRSP), or the proceeds come from after-tax investments or inheritances for example.

In many instances, it is through RRSPs. As millions of Canadians invest annually in individual and group RRSPs, a basic understanding of Section 146 of the Income Tax Act is a must.

The following outlines the merits of an RRSP.

WHAT IS A REGISTERED RETIREMENT SAVINGS PLAN?

It is a savings plan registered with the Canada Revenue Agency (CRA) under section 146 of the Income Tax Act. It is essentially a trust set up for an individual (referred to as the annuitant) and the issuer of the plan to hold certain investments with the purpose of providing a retirement income. First introduced in 1957, RRSPs are an essential investment vehicle for the retirement planning objectives of an individual.

Some of the advantages of contributing to an RRSP are:

- Contributions are **deductible** up to an allowable annual maximum, based on the previous years earned income.
- Investment return is tax-sheltered and accumulates tax-free within the plan until funds are withdrawn.
- A wide array of investment opportunities are permitted (in our industry, segregated funds or short term guaranteed investment annuities).
- Contributions to a spousal plan can minimize income tax at retirement through "income splitting".

Each year, close to 6,000,000 individuals contribute billions of dollars into RRSPs.

TYPES OF RRSPs

Traditional	Offered by financial institutions such as insurance, bank, trust and investment companies.
Group	Becoming increasingly popular as an alternate to Registered Pension Plans (RPPs) and are usually set up by an employer, a union, professional association, etc. and managed by a financial institution on their behalf.
Self directed	Generally for the individual who has investment expertise, and who makes investment decisions. An account (trust) is entered into with an investment dealer or other financial institutions.

WHAT IS THE MAXIMUM CONTRIBUTION LIMIT?

For taxation year 2010, the maximum contribution to an RRSP is 18% of **earned income** to a maximum of \$22,000 **minus** Pension Adjustments (PA) **minus** Past Service Pension Adjustment (PSPA).

It should be noted earned income is based on previous years' income, calculated by Canada Revenue Agency (CRA), and provided on your Notice of Assessment form.

WHAT IS EARNED INCOME

Earned Income includes salary, wages, net commissions, fees, taxable benefits (e.g. personal use of company provided automobile, premiums paid for group life insurance by an employer), taxable alimony/family support payments, CPP/QPP disability income payable, supplementary unemployment benefits, royalties and net research grants. In addition, it also includes net business income and net rental income of property.

Deductions from earned income are employment expenses (self-employed / salesperson's expenses), union dues or professional association fees as well as alimony /family support payments. It should be noted that **dividends, interest, capital gains, scholarships** and **bursaries**, are **NOT** regarded as earned income for RRSP purposes.

WHAT IS THE PENSION ADJUSTMENT (PA)

For individuals who participate in RPP or DPSPs, the Income Tax Act requires that the allowable RRSP maximum contribution limit be **reduced** to reflect the tax-sheltered savings of these plans.

This is referred to as the PA. Essentially, the maximum contribution is based on the previous year's earned income **less** the pension adjustment from participating in either an RPP or DPSP in the previous year.

The pension adjustment in its simplest form is the total contribution of both employee and employer to the pension plan.

WHAT IS THE PAST SERVICE PENSION ADJUSTMENT (PSPA)

A past service benefit increases a member's pension benefits due to the granting of certain additional past service benefits by an employer in a defined benefit plan.

Plan members who incur a PSPA will have their RRSP contribution room reduced by the amount of the adjustment.

CARRY FORWARD OF CONTRIBUTIONS

Many people do not have enough money to contribute the maximum to their RRSP every year.

The government allows the carry forward of unused RRSP contributions for an **indefinite period**.

To keep track of taxpayers' carry forward amount, Canada Revenue Agency provides this calculation each year when you review your "Notice of Assessment." This includes a Contribution Limit Statement outlining how much the taxpayer can contribute to an RRSP and deduct from income for the current year.

CARRY FORWARD OF RRSP DEDUCTIONS

An individual could make an RRSP contribution in 2010 but then not report the tax deduction because of low earnings. In some future year (when marginal rate of tax is higher) he can then make use of available RRSP contribution room to take tax deduction in respect of the 2010 contribution.

OVER-CONTRIBUTIONS

Current legislation allows an over contribution to an RRSP to a maximum of \$2,000. To discourage over contributions, a tax penalty of 1% per month on amounts in excess of \$2,000 is imposed.

LOCKED IN RETIREMENT ACCOUNTS (LIRAs)

A member of a Registered Pension Plan (RPP) has the **option** of transferring the accumulated or commuted value of his/her **vested** pension to a LIRA when he/she leaves an employer.

A LIRA is essentially an RRSP, the value of which is **“locked in”** to provide the holder with pension income either from a life annuity or a Life Income Fund (LIF). Unlike a regular RRSP, the holder **cannot** withdraw funds from a LIRA. While funds generally are “locked in” some provinces will allow “hardship cases to withdraw funds from their LIRA.” In addition, some provinces will now allow up to 50% of the proceeds from a LIRA to be transferred to an RRSP at the time of retirement. The advantage of doing so is flexibility in that any amount can be withdrawn from an RRSP, notwithstanding that the proceeds are taxable as income.

These restrictions are imposed by Provincial or Federal Pension Benefits Standards Act, not by the Income Tax Act.

LIFE INCOME FUNDS (LIFS)

A life income fund (LIF) is a maturity option for locked-in retirement funds and for pension funds and is similar to a RRIF, except that the LIF is subject to both minimum and maximum withdrawal limits and is designed to provide the annuitant with an income for life.

What distinguishes a LIF from a RRIF is the source of the funds used to establish the plan: funds from either a locked-in retirement account, or received directly from a registered pension plan or another LIF. It is because the LIF funds are derived from pension plans that they are subject to more stringent rules than funds held in RRIFs, rules that tend to parallel the provincial restrictions on the maturity of pension funds.

LIFs, like RRIFs, provide for a minimum annual payout to the annuitant, but they also restrict the maximum that may be withdrawn from the plan annually.

Being, essentially, creations of provincial pension legislation, LIFs are not specifically described in the Income Tax Act. Rather, they are, for tax purposes, treated exactly the same as RRIFs. Both LIFs and RRIFs are subject to the same minimum withdrawal rules and qualified investment restrictions.

There is no restriction on the number of LIFs that a taxpayer may own at any given time.

Setting up a LIF

A taxpayer may establish a LIF by transferring funds from:

- A locked-in retirement account (LIRA).
- Another LIF; or
- A pension plan.

Funds originally transferred from a pension plan and now held in a LIRA must, by the end of the taxation year in which the annuitant of the LIRA attains age 71, be used to purchase a life annuity, or be transferred to a LIF or locked-in retirement income fund (LRIF) (see below).

Most provinces prohibit the establishment of a LIF prior to the annuitant's age 55 – this parallels the age (55) at which most provinces permit a member or a registered pension plan to mature his or her interest in the plan into a retirement income stream.

LOCKED IN RETIREMENT INCOME FUNDS (LRIF)

A LRIF is a form of a LIF that is available to members of pension plans. Currently Ontario, Saskatchewan, Manitoba and Alberta provide this option. Like a LIF, there is a minimum and maximum withdrawal restriction, however the maximum withdrawal amount is based upon the plans investment earnings,

FOREIGN CONTENT

<p>The Federal Budget of February 2005 did away with the old 30% foreign content rules. Contributors are now able to invest up to 100% into qualified foreign investments.</p>
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ADVANTAGES OF RRSPs

- Contributions are tax-deductible generally during high taxation years (peak earning years).
- Investment return accumulates on a tax-sheltered basis until funds are withdrawn. Funds must be withdrawn by the end of the calendar year the individual attains age 71, however funds can be withdrawn in any amount prior to that date.
- Deferment of some income taxes until later years when contributor is presumably in a lower tax bracket.
- Certain lump sum payments can be sheltered from immediate taxation through a tax-free transfer into an RRSP.

- Can be used to split retirement income between spouses, resulting in lower taxation of combined income, as well as enabling both spouses to take advantage of the \$2,000 pension income credit at age 65.
- The opportunity to use a portion of RRSP to finance home ownership (up to \$25,000) for a new first time homeowner or an individual who has not owned a home in the last 5 years.
- Funds can be withdrawn tax-free in order to enrol in continuing education or adult training programs.
- However, funds must be repaid over a specified period of time. If not, income tax on the amount not paid is exigible.

SPOUSAL RRSP

- A taxpayer can contribute a portion of their entire annual contribution limit into an RRSP in the name of their spouse.
- The accumulated value of the spousal plan is taxable income to the spouse, not the contributor, since the spousal RRSP is property of the spouse in whose name it is registered.
- However, **any** contribution to a spousal plan made
 - (a) in the year the plan is de-registered (cashed in), and
 - (b) in the two calendar years preceding the year of de-registration is taxable in the hands of the contributor rather than the spouse.
- For example, currently Federally, at age 65 a taxpayer is entitled to the following Non-refundable Tax Credit, a basic credit of \$10,320, an age credit, depending on net income of up to \$6408 as well as a pension income credit of \$2000. Through proper planning, a spouse can have income of over \$15,000 per year without paying any income tax.
- Contributions into a spousal plan provide excellent opportunities to minimize income tax, and provide husband and wife with more after tax dollars.
- As previously mentioned, contribution to an RRSP is not permitted after the calendar year the contributor reaches age 71. However, a contributor may contribute beyond age 71 provided the contributor still has “earned income”, and provided the spouse’s age is 71 or under. Any contribution is tax-deductible to the contributor; however, the RRSP is the property of the spouse.

PENSION INCOME SPLITTING

As a consequence of a recent Federal Budget, a taxpayer can transfer up to 50% of qualified retirement income to their spouse or common law partner. The advantage of so doing is a reduction of overall Federal Income Tax.

WHAT CAN BE DONE

- For individuals under age 65, income received from a Registered Pension Plan (RPP) or received because of the death of a spouse or common law partner qualifies for pension income splitting.
- For individuals 65 or over, income from all other registered plans such as RRSPs, RRIFs, Annuities Deferred Profit Sharing Plans (DPSPs) qualify.

In addition, other income splitting techniques still available include:

- The Canada Pension Plan splitting of income. Provided both spouses are at least 60 years of age, they can share up to 50% of the benefits earned while they were married or living in a common law relationship.

It should be recognized with pension income splitting, the merits of a spousal RRSP might have diminished as a tax planning vehicle.

It must be remembered however, that the spousal RRSP provides income splitting at any age and is not restricted to the 50% level.

TAXATION OF REGISTERED RETIREMENT SAVINGS PLANS

- When funds or a portion thereof are withdrawn from an RRSP, the amount withdrawn is fully taxable in the year of withdrawal. In addition, the plan sponsor is required to withhold a percentage of the amount withdrawn and remit the amount to Canada Customs and Revenue (this serves as a pre-payment of income tax).

<u>Amount Withdrawn</u>	<u>Withholding Tax Rate</u>
Up to \$5000	10%
\$5000 to \$15000	20%
15000 and up	30%

- It should be noted that RRSP funds can be transferred tax-free from one plan to another plan, provided the transfer is direct from one carrier to another. Appropriate government forms (i.e. normally a TD-2 or T 2033) have to be completed.
- The latest the accumulated value of an RRSP can be tax-sheltered is the end of the calendar year the owner attains age 71.
- Prior to that date, three options are available other than receiving a lump sum payment.
- Proceeds can be used to purchase a life annuity.
- Proceeds can be used to purchase a term certain annuity up to age 90.
- It should be noted that guaranteed period on both a life annuity and term certain annuity could be based on the age of the spouse if younger.
- Proceeds can be used to purchase a Registered Retirement Income Fund to provide annual income for life.
- Of the three options, the one most frequently used is the Registered Retirement Income Fund Option (RRIF). It is estimated that over 75% of funds accumulated in RRSPs are transferred to RRIF.
- The RRIF allows the individual to maintain control of their capital and still make investment decisions.
- However, once the RRSP has been transferred to an RRIF, a minimum amount (but it could be any amount required by the taxpayer), has to be withdrawn from the RRIF each year.
- The reason for the minimum withdrawal is to ensure that the government receives income tax payments, as the amount withdrawn is taxable.
- It should be noted that an individual could have more than one RRIF, life annuities and/or term certain annuities.

MINIMUM PAYMENTS REQUIRED FROM AN RRIF

<u>AGE</u>	<u>PERCENTAGE</u>	<u>AGE</u>	<u>PERCENTAGE</u>
69	4.76	82	9.27
70	5.00	83	9.58
71	7.38	84	9.93
72	7.48	85	10.33
73	7.59	86	10.79
74	7.71	87	11.33
75	7.85	88	11.96
76	7.99	89	12.71
77	8.15	90	13.62
78	8.33	91	14.73
79	8.53	92	16.12
80	8.75	93	17.92
81	8.99	94 (and up)	20.00

EXAMPLE

Mary McCabe, age 71 has \$200,000 in her RRIF fund with ABC Insurance Company, invested in the Canadian Equity segregated fund. Mary must withdraw a minimum of \$14,760 this year and include it as income. However, if \$20,000, she obviously can withdraw that amount and pay tax thereon.

It should be noted that Mary could use her husband's age if younger, if her intention was only to withdraw the minimum amount. If her husband were age 65, only 4% or \$8,000 would have to be withdrawn and included as income in Mary's return.

TAXATION OF DEFERRED ANNUITIES – NOT REGISTERED

- The majority of variable deferred annuities sold today are registered as retirement savings plans.
- Accordingly, no tax consequence results during the accumulation period.
- However, when funds are withdrawn, regardless of what option is used (i.e. Life or Term Certain Annuity, RRIF payments), any amount received is taxable as income in the year received.
- If variable deferred annuity is purchased with unregistered funds, insurance company will T5 the client annually, and the amounts shown are reportable (i.e. interest income, dividend income, capital gains).
- On disposition of the contract, T5 is issued and owner is responsible to report amounts shown either as interest income, dividend income and/or capital gain or capital loss.

INVESTMENT FUNDS – OUR COMPETITION

Two main categories of investment funds in the marketplace are:

- (a) Close-end funds.
- (b) Open-end funds, more commonly known as mutual funds.

CLOSE-END FUNDS:

Very few in existence today, once the closed-end fund has raised capital to be invested on behalf of shareholders, the fund is “closed off” insofar as raising capital in the future.

If a person wants to buy shares of a closed-end company, they buy them from other shareholders, either through the stock exchange or through the over-the-counter market.

Unlike mutual funds, shares or units are not bought from the Investment Company, and the capital paid for closed-end funds goes to the seller rather than the company.

MUTUAL FUNDS (OPEN-END FUNDS)

Mutual funds are the favoured investments (registered or unregistered) of many Canadians who do not have the time, expertise, or inclination to invest on their own.

By investing their capital in a mutual fund, their money is invested in a diversified group of securities by investment managers whose mandate is to secure the best possible return for investors.

The distinguishing characteristic of a mutual fund (as contrasted with a closed-end fund) is that the price of the mutual fund shares (units) has at all times a definite relationship to the net value of the funds portfolio. Because the fund guarantees to redeem its own share on demand at net asset value per share unit.

Financial planners, salespeople and sales staff of various financial institutions, sell mutual funds. However, in order to sell mutual funds, the provincial securities commission must license the individual.

Like segregated funds (sold by Life agents, our investment products, which compete against mutual funds), mutual funds can be bought with a lump sum, whenever the investor has capital or on a periodic basis (monthly, semi-annually).

The principal of dollar cost averaging is one that is constantly brought to the attention of investors.

DOLLAR COST AVERAGING

Dollar cost averaging is the investment of a fixed sum of capital at regular intervals (usually monthly) over a long period of time, regardless of the current price of shares or mutual fund units to be purchased.

Normally, this results in the average cost of shares (units) being less than their average price.

Dollar cost averaging is generally profitable because, on average, more shares (units) are bought when prices are low than when prices are high. However, it should be clear that dollar cost averaging **CANNOT** guarantee that the client will make an investment profit. However, through utilizing dollar cost averaging, past performance has shown a return more favourable than the average performance of the selected investments over a given period.

DIFFERENCES BETWEEN SEGREGATED FUNDS AND MUTUAL FUNDS

1. Mutual Funds are sold by prospectus whereas a segregated fund issues an Information Folder or Summary of an Information Folder.
2. Calculation of net asset values upon redemption is outlined in the mutual fund prospectus, in a segregated fund it is detailed in the contract. (i.e. the variable deferred annuity contract.)
3. Mutual fund unit holders have a right to vote on significant changes to the funds, whereas for the most part policyholders do not have a say on how their segregated funds are administered.
4. Stockbrokers and mutual fund salespeople licensed by the provincial Securities Commission sell mutual funds, whereas only licensed life insurance agents can sell segregated funds.
5. Mutual fund units must be valued daily whereas segregated fund units have to be valued a minimum of once a month. As a matter of practice however, most segregated funds are valued on a daily basis, as the insurance industry competes with mutual funds.
6. In a segregated fund, the investor shares in the earnings of the fund based on the length of time during the calendar year the investor holds the interest in the segregated fund.

In a mutual fund, with a few exceptions (money market funds), distribution of earnings are made to unit holders of record at the end of the calendar year.

COMPARING MUTUAL FUNDS WITH SEGREGATED FUNDS

	Mutual Fund	Segregated Fund
Benefits payable	No	The guarantees specified in the policy contract
Consumer protection	When sold by an investment dealer, insured by Canadian Investor Protection Fund.	Provided by Assuris up to \$60,000, or 85% which ever is greater (only death benefit and maturity date guarantee).
Creditor protection	Due to the recent changes, named beneficiary has creditor protection	Named beneficiaries are protected; in case of bankruptcy, fund must have been held longer than one year
Death benefit	None	75% of initial deposit (less any withdrawals) as a minimum. Some companies – up to 100%.
Maturity guarantees	None	75% of deposits (less any withdrawals) as a minimum after 10 years; no maturity guarantee before 10 years. Some companies – up to 100%.
Disability waiver	None	If deposits are made on a periodic payment schedule to the fund, they will be continued by the insurer to a maximum amount if the contract holder is disabled
Disclosure documents	Prospectus: law stipulates that the document includes details on objectives, risks, sales charges, and calculation of the net asset value	Information folder: can vary among companies; guidelines exist as to what the information folder must include but they are not governed by their provincial securities commission
Distribution of income	Only to unit holders on record at end of calendar year	Time-weighted so that income is received proportionate to the length of time during the year that units are held
Estate planning issues	Proceeds become part of the estate and subject to probate fees	Proceeds bypass probate unless estate named as beneficiary
Frequency of valuation	Daily and possible weekly	Monthly and possibly daily
Nature of units	Unit holders have rights to vote and received distributions	Units are notional; they determine the value of benefits payable; no voting rights
Ownership of assets	Assets are owned by the fund	Assets belong to the insurer
Partial withdrawals	Yes	Yes
RRSP eligibility	Yes	Yes
Sales and licensing requirements & product approval & regulation	Regulation and product approval through provincial securities legislation, license from the Investment Funds Institute of Canada required for sales	Regulation and product approval through provincial insurance legislation, life insurance license required for sales
Taxation of non-registered contracts	Income received as interest, dividends, and capital gains; capital losses are not received by investors until units sold	Income received as interest, dividends, and capital gains; capital losses are received by investors

ADVANTAGES OF SEGREGATED FUNDS COMPARED TO MUTUAL FUNDS

1. **Maturity Guarantee:** 75% of gross premium paid at death or maturity, provided maturity date is at least 10 years. Most companies guarantee 100% of gross premium today.
2. **Designation Of A Beneficiary:** By designating a named beneficiary, proceeds paid by the insurance company in a matter of weeks (in most instances) are not subjected to probate, executors' and solicitor charges or fees.
3. **Credit Proof:** Unlike mutual funds, segregated funds might be creditor-proof both while the holder is alive and at death if the beneficiary is a member of the **protected class**. Members of the protected class are spouse, child, grandchild or parents.

At death, the designation of any beneficiary makes value of the segregated funds in most situations creditor-proof. The designation of any person as an irrevocable beneficiary makes the proceeds creditor-proof both during lifetime and at death.

4. **Minimization of Fees and Charges at Death:** By designating a beneficiary, no probate fees, solicitor and executors' charges to estate. Depending on the amount in the segregated fund, the savings could be substantial.
5. **Disability Waiver or Premium on Contractual Plans:** As previously indicated, many Canadians utilize the principal of dollar cost averaging when investing in a segregated fund. Some insurance companies allow the owner to apply for disability waiver. In the event of total disability, the disability waiver will continue the contractual deposits.

A CHANGING MARKETPLACE

Because mutual funds and segregated funds have many similarities, a number of Provincial Regulators have mandated that a life insurance agent **cannot** sell segregated funds in that province unless the agent has passed an investment course approved by the Council.

In time, agents entering the life insurance business as well as securing a life license will probably have to secure a Mutual Fund license as well. For example, with both London Life and Clarica Life, it is mandatory to have a mutual fund license.

IMMEDIATE ANNUITIES

This form of annuity is generally used by individuals to provide a “stream of income” during their retirement years.

The process is to give up their capital from registered or unregistered funds in exchange for income for life or for a specified period of time (term certain).

The type of life annuities offered by life insurance companies are identified in the following paragraph.

Recognize however that it is the insurance professional’s role to identify the client’s specific needs and objectives, and if a life annuity is paramount in the planning process, to recommend the appropriate type of life annuity.

TYPES OF LIFE ANNUITIES

- **Single Life Annuity:** Provides an income for as long as the annuitant is alive. At death, the annuity terminates unless it contains a guaranteed period. A “straight life” or “life” annuity are annuity payments that contain **No Guaranteed** period in the event the annuitant dies. Very few life insurance companies sell straight life annuities, due to unfavourable publicity when an annuitant dies shortly after payments commence.
- **Single Life Annuity with a Guaranteed Period:** Provides a life income with a guaranteed number of payments in the event the annuitant dies, which could range from 5, 10, or 20 years. Assures that in the event the annuitant dies prematurely, heirs, relatives or friends will continue to receive payments until the guaranteed period ends. The annuitant generally at the time of purchase designates a beneficiary, as well as a secondary beneficiary.
- **Joint and Last Survivor Annuity:** The most popular of the annuity option. This type of annuity provides payments during the lifetime of two annuitants (generally husband and wife), with a guaranteed period, normally 10 years. With an annuity of this type, payments continue to the survivor when the first annuitant dies, generally in the same amount. However, flexibility does exist to arrange (at the time of purchase) for a reduction in the amount of annuity payments after the death of the first annuitant. For example, the survivor’s annuity payments might be 75% of the original annuity payments.
- **Installment Refund Life Annuity:** Annuity contract that pays an income as long as the annuitant is alive. If the annuitant dies before annuity payments received equal the amount of the purchase price, the annuity payments are continued to the beneficiary until total payments equal the purchase price.

- **Cash Refund Life Annuity:** Annuity is similar to installment refund annuity except that if the annuitant dies, the difference between the purchase price and total of the annuity payments made are paid in one lump sum.
- It should be noted that all annuity payments from the above options are level (the same) for the duration of the annuity payments.
- **Variable Annuity Option:** A new arrival on the annuity scene (mainly as the result of inflation), this is an annuity where payments vary in accordance with the current market value of a segregated fund supporting the contract. Designed for the individual who still has a high “risk tolerance” and accepts the fact that annuity payments will vary each month depending on the value of units held.
- **Term Certain Annuity:** When a “stream of income” is not required for life, a term certain annuity or annuity certain as it is also called, might be considered. The term certain period might be for example, 15 years. If the annuitant dies during that period, the designated beneficiary will receive the remaining guaranteed payments.

COMMENCEMENT OF IMMEDIATE ANNUITY PAYMENTS

All annuity payments are made “in arrears”. If the contract calls for monthly payments, the first will be made one month after the purchase date. This principle applies also to annuity payments arranged on a quarterly, semi-annual, or annual basis.

MARKETS FOR IMMEDIATE ANNUITY

Middle age, but mostly older people at or near retirement who have capital available and whose present and future income appears inadequate for their needs. Capital could be from registered funds (RRSPs) or unregistered funds, however, the taxation of annuity payments will be different.

HOW MUCH LIFE AND TERM CERTAIN ANNUITIES PAY

- The amount of monthly income an individual receives depends on such factors as length of annuity payments, age of annuitant, sex, type of annuity requested, and health of the annuitant.
- When purchasing a life annuity, generally health questions **ARE NOT ASKED**. If however, the proposed annuitant is in bad health, the insurance company, based on the severity of the health problems may give an IMPAIRED RATE. Not all insurance companies offer higher (impaired) rates.
- Annuity rates are based on investment returns the insurance company anticipates. As interest rates/investment returns are constantly changing, rates offered by insurance companies are reviewed on a daily basis.
- It should be noted that among life insurance companies that sell both life and term certain annuities, rates could vary significantly.

ADDITIONAL COMMENTS:

- Age for age, women receive lower monthly income than men do when purchasing a life annuity, because women live longer than men do.
- Interest rates and investment returns vary on an ongoing basis. Because interest rates on both short and long term investments were significantly higher in the late eighties and early nineties, this was reflected in the monthly income paid both males and females at that time.
- Annuity rates vary from company to company. A recent annuity quote on a Joint Life Annuity (both male and female exact age 65) purchased with \$50,000 of RRSP proceeds showed \$322.11 per month from the first ranked company to \$313.86 per month from the company in number 10 position. Further, monthly income for companies not ranked at that time would still be lower.
- Accordingly, many factors have to be considered when purchasing a life annuity.

TAXATION OF IMMEDIATE ANNUITY – FROM REGISTERED FUNDS

- If proceeds used to purchase an immediate annuity are from Registered funds, the annuity income is taxable to the annuitant as received each year.
- At death, prior to the termination of annuity payments, provided a surviving spouse has been designated as beneficiary, annuity income is taxable in surviving spouse income for the year, as received.
- If proceeds are left to beneficiary other than spouse, dependent child or grandchildren, or dependent infirm child or grandchild. The commuted value of the unpaid annuity payments are taxable in the final return of the deceased taxpayer.
- If left to dependent child or grandchildren, commuted value taxable in their tax return, however, a term certain annuity not exceeding 18 years minus the child's age may be purchased to lessen the tax impact.
- The term commuted value is the present value of the future payments. A discounted rate is used because it is paid to the beneficiary in a lump sum at a date that is earlier than would be the case if the annuity payments were allowed to continue.
- If left to dependent infirm child or grandchild of any age, the commuted value taxable in their tax return, however, the proceeds can be transferred into an RRSP, thereby deferring income tax.

TAXATION OF IMMEDIATE ANNUITY – FROM UNREGISTERED FUNDS

- Purchase of immediate annuity with capital accumulated over the years is generally done by sophisticated investor, who has substantial capital, is in a high **marginal** tax bracket, and is looking for ways and means to **minimize** income tax on an ongoing basis.
- When periodic income is received (i.e. annuity payments), the annuity is classified automatically as a prescribed annuity, and is subject to **level** taxation based on a formula contained in Regulation 304, Federal Income Act.
- By being classified as a prescribed annuity contract, the capital portion of the payments is distributed **evenly** over the expected payment period. The balance of each payment, the interest portion, is also distributed **evenly** over the expected payment period.
- Contracts not classified as a prescribed annuity are taxed similar to mortgage repayments, with a large taxable interest element in the early years.

- It should be understood that during the lifetime of the annuity, the amount includable as income is the same; it is the timing that is different.

Quote for Prescribed Annuity -	December 1, 2009
Amount – Non Registered Funds	\$100,000
Male – Age 65	
Type of Annuity – Life Annuity – Guaranteed 10 Years	
First Annuity Payment	January 1, 2010
Monthly Annuity Payments	\$688.36
Amount Taxable	\$230.85

COMMENTS:

1. Life Annuity will provide \$8259.32 annually for life, of which only \$230.85 per month or \$2769.20 on an annual basis is taxable as income each year.
2. The balance \$457.51 per month or \$5490.12 on an annual basis is deemed to be a return of capital, and is not taxable.
3. However the trade-off for the tax benefits is relinquishing of capital (i.e. in exchange for \$100,000 of capital, the insurance company guarantees income for life of \$688.36 per month).
4. Client could have used \$100,000 and invested in a 5 year Guaranteed Investment Certificate (GIC). By so doing, capital is preserved. If GIC pays 5% compounded annually, each year any interest earned is taxable as income, but the client has still retained capital of \$100,000.
5. Accordingly, the use of a Prescribed Annuity generally has application for individual whose priority is tax minimization and is prepared to give up capital.