

Corporate Insured Life Annuity

a) *The Objectives of the Strategy*

The Corporate Insured Life Annuity (CILA) allows the corporate shareholder to achieve the following results:

- Superior after tax rates of return
- Conversion of taxable corporate values to non-taxable values
- Opportunities to reduce capital gains tax
 - on the sale of the company or
 - in the client's estate

b) *The Client Profile*

- Older corporate shareholder
 - Generally over age 60
- The corporation has high tax earnings
 - Already the company is probably bonusing down to the low corporate rate
- As part of the shareholder's exit strategy at retirement the company will be
 - Sold in the foreseeable future
 - Inherited by children
- There is a desire for higher after tax earnings from corporate investments
 - The client is generally less risk averse in investment choices

This strategy is designed for the client who is planning for retirement or is already retired. It works better the older the client becomes and can be implemented at any age up to age 85. The strategy provides two key tax effects for the retired shareholder. Firstly, it provides superior rates of return on net invested capital to maximize the retirement income of the client. Secondly, it provides an opportunity to eliminate taxes in the estate. In certain circumstances it is possible to eliminate both the capital gains tax on transfer of the shares to the next generation as well as the potential tax on a dividend upon withdrawing assets from the company.

c) *The Strategy Works by Combining*

- A Life Annuity
 - To provide high, tax-preferred income
- A Life Insurance Policy
 - To replace in the estate the capital used in the annuity purchase
- A Loan may be used
 - To reinvest the capital used in the annuity purchase
 - This will be repaid at death from the life insurance proceeds





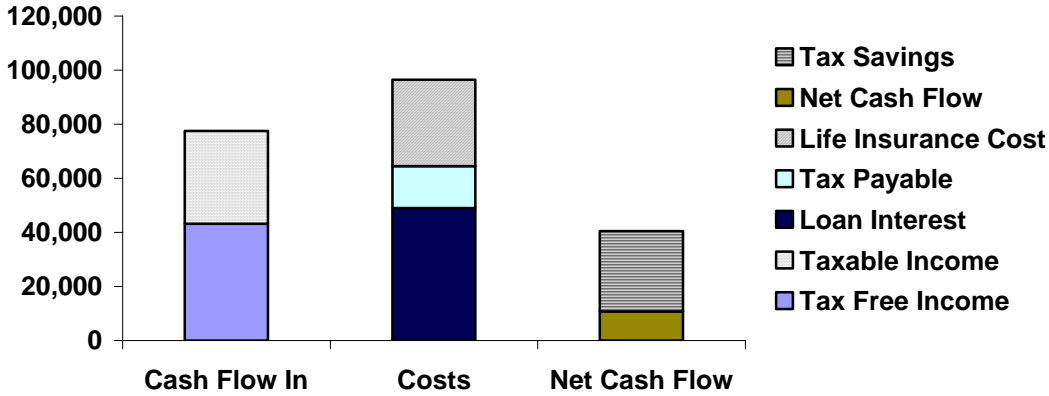
The concept depends upon the arbitrage between the pricing of a life annuity and the cost of a life insurance policy.

The purchase of the annuity produces high cash flow as it represents both an element of earnings and a return of capital over a relatively short expected period of time. It also ensures the income will continue throughout the life of the annuitant(s) until the life insurance is paid to replace the capital expended in the annuity. The annuity income is sufficient to pay taxes and the life insurance cost and still leave a substantial after tax cash flow.

If the client wishes to retain an investment portfolio or there is a business purpose to being able to borrow and reinvest capital the annuity cash flow and the life insurance can be assigned to the lender to secure a loan. Some amount of down payment will probably be required unless other collateral is provided. The cash flow from the annuity minus the life insurance cost and loan interest plus the tax savings available through the loan interest and the deductible element of the life insurance cost to secure the loan, produces a net after tax income that represents an even higher rate of return on the down payment supplied by the company.

Here is a sample of the cash flow elements when the annuity is purchased and a loan is obtained through the assignment of the annuity and the life insurance policy.

Cash Flows in Year 5



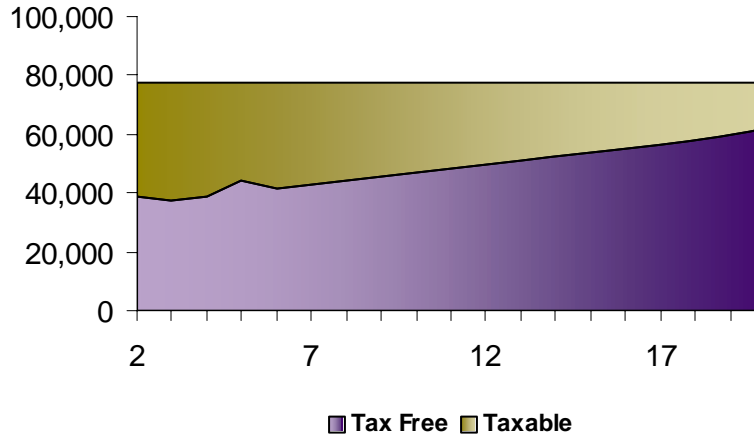
d) Taxation of the Annuity

The annuity income is a blend of interest and capital. Where the company owns the annuity, the amount of interest will be a relatively higher amount in the early years and will reduce over time.

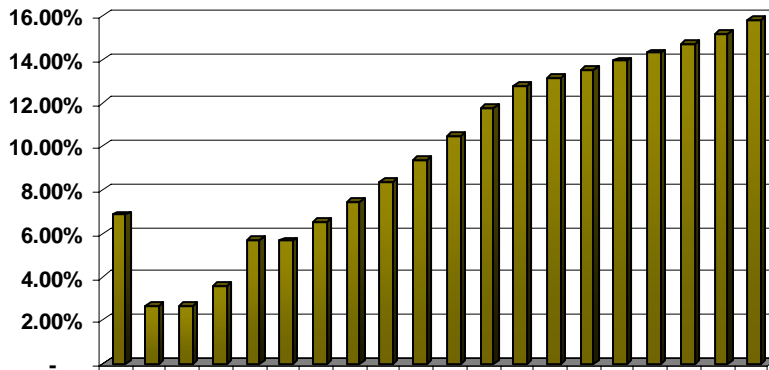




Taxable Portions of Annuity Income



This means the effective after tax yield will improve the longer the annuitant/insured lives. Here is a sample case and the equivalent pre-tax returns experienced on the net down payment.



e) The Life Insurance Policy and the Tax Effect

When the life insurance death benefit is paid to the company it creates a unique tax advantage. Firstly, all the proceeds are received tax free by the company. Next, the receipt by the company of the death benefit creates a substantial credit to the company’s Capital Dividend Account. This follows paragraph 89(1)(b) of the Income Tax Act. Lastly, as per subsection 83(2) of the Act, dividends paid from the Capital Dividend Account (CDA) are tax-free to the shareholder.

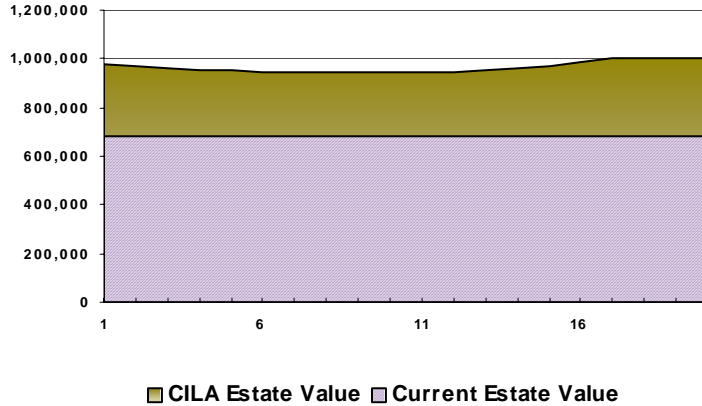
The CDA credit does not follow the cash. Even though the proceeds may immediately be used to repay the loan, the CDA credit remains in the company.

This allows all of the proceeds to be paid out tax free to the next generation and increases the effective after-tax value of the company to the next generation.





The following graph illustrates this effect.



f) The Elimination of Taxes in the Estate

Capital Gains Tax on Common Shares at Death

Values are assessed ‘immediately before death’ for purposes of calculating the capital gains tax that may be payable. It is argued the annuity has little or no value immediately before the death of the annuitant. This is further supported by the interpretation of an annuity as a life insurance policy and subsection 70(5.3) of the Income Tax Act specifically provides the only value of a life insurance policy owned by a company is its cash value. A life annuity has no cash value unless there is a minimum guarantee period remaining. In most cases this strategy is applied using an annuity with no guarantee so there should be no cash value.

The life insurance has limited or no cash value and will therefore have no value.

Therefore, the sum total of the values in the company have been reduced by the expenditures on the annuity purchase. This alone will reduce the value of the shares for the purposes of capital gains tax valuation. It should be noted that unless the common shares owned by the deceased are 100% of the company the valuation for the estate will only be proportionately reduced.

If a loan has been negotiated the loan probably will not further reduce the value of the company. Although the loan is still outstanding it is probably represented by the value of the investment made from the proceeds of the loan.

Capital Gains Tax on Preferred Shares at Death

Where fixed value preferred shares are owned by the annuitant (usually as the result of an estate freeze and establishment of a Family Trust) reductions in the value of a company will probably not affect the value of preferred shares. Instead the strategy would be modified to utilize Joint First to Die life insurance and annuity policies on the lives of parents. While the cost of the life insurance increases fairly dramatically, the income from the annuity will increase also and will receive lower tax treatment also. Thus the cash flows are stabilized.

However, we now have the opportunity to create wills which leave the shares to the survivor of the two spouses. There is no capital gains tax when assets are passed between spouses. Meanwhile, the death of the one spouse has ended the annuity but has triggered the death benefit



payable to the company. This has also created a credit to the CDA. The preferred shares are now offered up to the company for redemption. When shares are redeemed by a company the sale is deemed to take place at the Paid Up Capital Limit of the shares, normally a nominal amount. The balance of the proceeds are a 'deemed' dividend to the shareholder. However, the company can now declare this dividend to be a capital dividend. This dividend would be received tax-free. Therefore, up to the amount of the capital dividend, the shares will have been repurchased for no tax consequence. They will have disappeared from the estate of the survivor and be replaced by either cash from the company or a note representing the payment from the company. There is no tax on cash or a note.

This strategy avoids the application of the 'stop loss rules' under section 112 of the Income Tax Act (designed to prevent the elimination of both the tax on a dividend and the capital gains tax) because the shares are passed free of capital gains tax between the spouses. Therefore, no capital gain has been triggered so there is no need for a loss and therefore none to stop.

Preparing for the Sale of an Operating Company

If a holding company does not already exist, a new one is created to hold some of the shares of the current operating company. A dividend is then declared and paid from the operating company to the holding company. If cash to do this does not already exist, this can be accomplished by way of a loan, and usually is.

A dividend paid from one company to a parent will not be subject to tax (otherwise a double tax situation would arise). Further, even under recently revised Canada Revenue Agency (CRA) guidelines, the interest on the loan to pay the dividend will be a tax deductible expense to the operating company. This is subject to the limitation the dividend cannot exceed the retained earnings (net book value) of the company.

When the operating company eventually is sold it will be sold for its value net of the loan, which will be acquired by the purchaser of the company. Thus the price will be reduced which also reduces the capital gains tax payable on the sale of the company.

Meanwhile, the proceeds can be expected to flow out of the holding company tax free to the next generation. Meanwhile, the annuity provides a very healthy income to the now retired shareholder. The arbitrage between the annuity return and the life insurance cost can be further increased if advanced planning occurs to purchase the insurance policy at a younger age while deferring the purchase of the annuity until the company is actually sold.

g) The Risks of the Strategy

The primary risk of the strategy is the 'locking in' of current interest rates for the purposes of the annuity income.

Low Interest Rates for Life

Interest rates are currently at historical lows. For the client in their early 60s this may seem rather a long time for which to set a low interest rate. This is a concern of Lawton Partners also and we are able to provide you with an illustration that purchases the life insurance policy today, pre-funds it, and then shows the impact of purchasing the annuity at an older age





and with reduced capital (the pre-funding costs of the life insurance policy have been subtracted). This illustration assumes interest rates do not increase.

This increases the arbitrage between the cost of the insurance and the returns from the annuity. The insurance is purchased at a younger age and the annuity is purchased at an older age. There are other factors that also assist in this process.

The net impact is that returns usually remain the same or are increased.

Fixed Annuity Rates Versus Variable Loan Rates

While loan rates can be negotiated that are locked in for a number of years the possibility, in many cases the likelihood, is that loan renewals will occur prior to the death of the annuitant(s) creating the possibility of much higher interest rates.

Lawton Partners' unique method of structuring this strategy enables the client to control the costs of life insurance to offset the increasing interest rates. While not a perfect match, the structure allows the trends in the interest earned in the policy to reflect the trend in the loan interest rates.

