

FINANCE SETS SIGHTS ON “TRIPLE BACK TO BACK”



THE ISSUE

In a speech to the Conference for Advanced Life Underwriting (CALU) on May 8, 2012, Federal Finance Minister Jim Flaherty labeled insured leveraged annuities as a “loophole” that will be closed with a future amendment to the Income Tax Act.

The annual general meeting of CALU traditionally includes speeches from the Prime Minister and the Finance Minister. This year, CALU was addressed by Prime Minister Stephen Harper on May 7 and by Finance Minister Jim Flaherty on May 8.

Minister Flaherty used his address to announce an intention to amend the Income Tax Act. In his preamble, he discussed the government’s track record of closing “loopholes” in the Income Tax Act. He then cited insured leveraged annuities as a yet-to-be closed loophole.

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WESTWARD’S VIEW

An **insured annuity** is an insurance-based investment strategy for individuals above age 65 that combines a life insurance policy with a life annuity. A one-time up front investment typically produces guaranteed annual income for life in the 6.0% - 8.0% range, and guaranteed capital preservation for the beneficiaries. If purchased by a corporation, the insured annuity investment escapes capital gains tax on death and the beneficiaries can extract the investment tax-free from the corporation.

By adding “**leverage**”, the purchaser either:

- Obtains an interest-deductible investment loan after the purchase to replenish the capital used to purchase the insured annuity (**Post-Leveraged**); or
- Obtains an interest-deductible investment loan in advance of the purchase to fund the purchase of the annuity (**Pre-Leveraged**).

In many cases, the annual after-tax cash flow from the insured leveraged annuity is positive because of the tax recovery from interest and premium deductions. In effect, the purchaser has rearranged her investments to reduce lifetime income taxes and to eliminate the tax cost to extract the capital from the corporation after death, all in compliance with the Income Tax Act.

The Canada Revenue Agency (CRA) has never reassessed a Post-Leveraged insured leveraged annuity. The CRA recently reassessed a Pre-Leveraged variety under the general anti-avoidance rule by attempting to limit the interest deduction to the taxable portion of the annuity income, which is typically very small. The taxpayer is appealing with very strong arguments based on the Supreme Court’s *Lipson* decision.

The Finance Minister did not explain what is offensive about insured leveraged annuities or what specific tax result would be eliminated by legislative change. Our view is that Finance likely seeks legislative amendments to limit the interest deduction on Pre-Leveraged versions, and thereby support the CRA in what is otherwise an ineffective assessing position.

Later in May, CALU expects to receive draft legislation from Finance for comment regarding the Federal Budget proposals affecting life insurance. It is possible that the draft will include proposals related to insured leveraged annuities. We will report on any draft legislation as soon as it becomes available.

