

Taxation of Personally Owned Non-Registered Prescribed Annuities

This document explains the unique features of non-registered prescribed annuities. For a detailed discussion of non-registered non-prescribed annuities, please refer to our Taxing Issues document on that topic [PC 6000].

Under the Income Tax Act (Canada) (ITA), there are three categories of prescribed annuities: (1) annuities purchased pursuant to certain registered plans; (2) income averaging annuity contracts, qualified trust annuities or contracts purchased with funds transferred from certain plans, and; (3) non-registered annuity contracts that meet specific conditions.¹

This document examines the last category, with an emphasis on conditions that annuities must meet in order to qualify for the tax advantages enjoyed by prescribed annuities. It also covers tax consequences, including the fact that prescribed annuities (whether life annuities or term certain annuities) are a source of income qualifying for splitting under the pension splitting rules that are effective starting with the 2007 taxation year.

Where an annuity contract qualifies as a prescribed annuity, the tax treatment is considerably simpler than for non-prescribed annuities, as they do not have the complexities associated with the accrual taxation rules. Moreover, as is discussed below, (taxable) income inclusions do not vary over the life of the contract. Hence, the owner/annuitant enjoys a certain predictability when it comes to cash flows. The challenge with these annuities is ensuring that the criteria for qualifying are met and continue to be met.

I. Prescribed Annuity Contracts

(a) Definition

The Income Tax Regulations (Regulations) contain a lengthy list of conditions that an annuity must meet to qualify as a prescribed annuity. These are:

1. Payments must have commenced in this taxation year or in a previous taxation year.
2. A person specified in the regulations must issue the annuity. Acceptable issuers include (but are not limited to) life insurance corporations, registered charities, trust companies, and credit unions.
3. Each holder (i.e., owner) of the annuity must be:
 - a. An individual human being, a testamentary trust, or a “specified trust” (i.e., a trust described in paragraph 104(4)(a) of the ITA),
 - b. An annuitant under the contract, and
 - c. Dealing with the issuer at arm’s length throughout the taxation year.
4. From the time the contract otherwise qualifies as a prescribed annuity:
 - a. All payments must be equal and made at regular intervals (at least annually) (except that the owner may change amount and frequency of the payments made in a taxation year

¹ See paragraphs 304(1)(a) – (c) of the Income Tax Regulations (Regulations), as well as draft legislation contained in Bill C-10 (currently before the Senate) for proposed revisions to paragraph 148(1)(e) of the Income Tax Act (Canada) (ITA).

- so long as the present value at the beginning of the year of the total payments made in the year does not change),
- b. The annuity payments must continue for a fixed term, or
 - i. If the holder is an individual (other than a trust), for the life of the first holder or until the later of the death of the first holder and the death of the survivor (i.e., any of the spouse, common-law partner, former spouse, former common-law partner, or brother or sister) of the first holder, or
 - ii. If the holder is a specified trust, for the life of the spouse or common-law partner who is entitled to receive the income of the trust.
 - c. Where the annuity payments are to be made over a period that is guaranteed or fixed, the guaranteed or fixed term cannot extend beyond the time at which
 - i. In the case of a joint and last survivor annuity, the younger of the first holder and survivor,
 - ii. If the holder is a specified trust, the spouse or common-law partner who is entitled to receive the income of the trust,
 - iii. If the holder is a testamentary trust other than a specified trust, the youngest beneficiary under the trust,
 - iv. Where the contract is held jointly, the younger of the first holders, or
 - v. In any other case, the first holder, would, if he survived, attain age 91.
5. No loans can exist under the contract.
 6. The owner's rights under the contract cannot be disposed of, except upon the owner's death, or if the owner is a specified trust, on the death of the spouse or common-law partner who is entitled to receive the income of the trust.
 7. The only payments made under the annuity can be as specifically permitted by the regulations.
 8. The terms and conditions of the annuity contract cannot provide for any recourse against the issuer for failing to make any payment under the annuity.
 9. Where annuity payments commenced before 1987, the owner has notified the issuer in writing before the end of a taxation year that the contract is to be treated as a prescribed annuity.
 10. Where annuity payments commenced after 1986:
 - a. the owner has not notified the issuer in writing before the end of the taxation year in which the payments commenced that the contract is not to be treated as a prescribed annuity, or
 - b. the owner has notified the issuer in writing before the end of the taxation year in which the payments have commenced that the contract is not to be treated as a prescribed annuity, and the holder has rescinded the notification before the end of a subsequent taxation year.²

As you can see, the requirements are complex. If the conditions are not all met, the annuity cannot be considered a prescribed annuity and the appropriate characterization for tax purposes will have to be determined.

As may be seen from the above conditions, a prescribed annuity does not have to be a "life annuity." It may be for only a fixed or specific term (i.e., be a "term certain" annuity).

The prospective purchaser will have to consider whether all of the conditions relating to prescribed annuities are to their liking. For example, guarantees are only available to the 91st birthday, payments cannot be indexed, etc. These prospective purchasers may in fact seek longer guarantees, or may want indexed benefits.

It is interesting to note that, as permitted by item 10, there is essentially a one-time election to have a non-prescribed annuity changed to a prescribed annuity. This may be used, for example, where an annuity would have initially qualified as a prescribed annuity, but the owner wanted to deduct interest

² See subparagraphs 304(1)(c)(i) – (vi) of the Regulations.

charges relating to the purchase of the annuity. Hence, the annuity was initially treated as a non-prescribed annuity. Once the loan is retired, the owner may wish to have the annuity become a prescribed annuity for tax purposes, since interest deductibility is no longer a concern. The election to treat the annuity as a prescribed annuity would be made at that time.

In addition to the above list of requirements, there is another list of conditions, that if present in the annuity contract, will not disqualify an annuity from being a life annuity contract:

1. Where a contract provides for a joint and last survivor annuity or is jointly held, there may be a decrease in the annuity payments upon the death of one of the annuitants.
2. Where the owner dies before attaining age 91, the contract may terminate and a payment made may be made. (The payment may not, however, exceed the amount by which total premiums paid under the contract exceed total annuity payments made under the contract.)
3. Where the contract provides that annuity payments are to be made over a period that is guaranteed or fixed, and the owner dies during this period, the payments that would have been made in this period may be commuted into a single payment.
4. Where the terms and conditions, as they read on December 1, 1982 and at all subsequent times, provide that the owner participates in the investment earnings of the issuer and the amount of such participation is to be paid within 60 days from the end of the year.³

The Regulations also contain a definition of “spouse.” As is indicated in this definition, “spouse of a particular individual includes another individual of the opposite sex who is a party to a void or voidable marriage with the particular individual.”⁴ This definition is in addition to the regular definition of spouse and common-law partner under the ITA.⁵

Questions were raised as to whether annuities held by “alter ego” trust could qualify for prescribed treatment. A strict reading of the legislation suggested that this was not the case. However, the Department of Finance (Finance) issued a “comfort letter” in 2002 in which it stated:

“... From a policy perspective, it appears appropriate to permit an *alter ego* trust to be eligible to hold a prescribed annuity treatment if all the other conditions of section 304 of the Regulations are met ... Consequently, we are prepared to recommend to the Minister of Finance that amendments be made to ... the Regulations ... Further, we intend to recommend that the amendments apply to taxation years beginning after 2001.”⁶

Finance, in a similar “comfort letter” issued in 2003, confirmed that it would also recommend that last and survivor annuity contracts held by specified trusts would be accorded prescribed annuity treatment if all the other conditions in the regulations were met and the last survivor is the person who established the trust or the survivor as defined in the regulations. This tax treatment was to be available for the 2000 and subsequent taxation years.⁷

The same 2003 “comfort letter” indicated that Finance would recommend that the regulations be amended to provide for the situation where testamentary trusts (which are not specified trusts) hold annuity contracts that do not continue for a fixed term. Here, the amendment would be to allow for

³ See paragraphs 304(2)(a) – (d) of the Regulations.

⁴ See definition of “spouse” in subsection 304(4) of the Regulations.

⁵ See definition of “common-law partner” in subsection 248(1) of the ITA, as well as the “extended meaning of spouse and former spouse” in subsection 252(3) of the ITA.

⁶ See letter from Brian Ernewein, Director, Tax Legislation Division, Tax Policy Branch (Department of Finance), dated July 29, 2002.

⁷ See letter from Brian Ernewein, Director, Tax Legislation Division, Tax Policy Branch (Department of Finance), dated June 27, 2003.

payments to continue for the life of any beneficiary entitled to receive income from the testamentary trust. Again, this tax treatment would be available for the 2000 and subsequent taxation years.⁸

Purchasers of annuities should review the contract provisions of annuities they are contemplating acquiring in order to understand all of the features. Features offered by various insurers will vary.

(b) Parties to a Prescribed Annuity Contract

With prescribed annuity contracts, the key requirement is that each holder (i.e., owner) must also be an annuitant. (This is quite distinct from the requirements for non-prescribed annuities.)

The regulations deem an annuitant to be a holder where “the contract is held in trust for the annuitant”.⁹ (Where another person holds the annuity in trust for the annuitant, the annuitant is deemed to be the holder. For tax reporting purposes, the income will be generally reported on a tax slip issued to the deemed holder (i.e., annuitant), and not the person holding the annuity in trust.)

The regulations contain a definition of “annuitant,” which provides that this “... means a person who, at that time, is entitled to receive annuity payments under the contract.”¹⁰

The most common examples of these contracts are where, for example, Mr. Roy acquires a term certain annuity, with a guarantee period. Or Mr. and Mrs. Parent could jointly acquire an annuity on a joint life basis. Of course, siblings could jointly acquire an annuity on a joint life basis.

The final parties to consider are the beneficiary and/or contingent owner. Where the owner(s)/annuitant(s) have died, a beneficiary may be entitled to payments for the remaining guarantee period, where such exists. In the alternate, a death benefit may become payable.

Where there is a named beneficiary, the death benefit will be payable to this person. Naming a beneficiary is advantageous in jurisdictions levying probate (estate administration) fees, since life insurance proceeds (including death benefits payable under annuity contracts) fall outside probate.

Take care when naming a spouse as beneficiary in the province of Quebec. The spouse will be considered an irrevocable beneficiary, unless the annuity application indicates that the designation is revocable.

II. Taxation of a Prescribed Annuity

a) Taxation While the Owner/Annuitant is Alive

Where a payout annuity is acquired, and provided it so qualifies, it will automatically be treated as a prescribed annuity. The owner could, of course, elect in writing to have non-prescribed treatment apply. Most insurers have an area on their application where the owner(s) can elect to have non-prescribed treatment apply.

It's also possible for deferred annuities to become prescribed annuities. For example, a deferred annuity may have been acquired that otherwise meets all the conditions required for prescribed annuity status, except that annuity benefits had not yet commenced. When the deferred annuity matures and annuity payments commence, the annuity could then become a prescribed annuity. (Here, the one-time election process referred to above could be used if prescribed status is desired.)

⁸ See above.

⁹ See paragraph 304(3)(a) of the Regulations.

¹⁰ See definition of “annuitant” in subsection 304(4) of the Regulations.

With prescribed annuities, each annuity payment is comprised of a capital portion and an interest portion. The interest portion is subject to tax. The capital portion is not.

The capital portion would be calculated as follows:

$$\frac{\text{purchase price (or adjusted purchase price)}}{\text{total payments under the contract}} \times \text{annuity payments} = \text{capital portion}$$

Generally, the premium paid (or purchase price) to acquire the annuity contract is used in the above calculations. However, where a deferred annuity is being annuitized, the “adjusted purchase price” calculation under the ITA comes into play. The “adjusted purchase price” is the Adjusted Cost Basis (ACB), as determined under subsection 148(9), without any deduction for the capital element of the annuity payments.¹¹

Thus, if we have a purchase price of \$100,000, with total payments under the contract being \$133,333, and annual annuity payments of \$8,000, the capital portion would be $\$100,000/\$133,333 \times \$8,000$, or \$6,000.

The taxable portion would then be calculated as follows:

$$\text{Annuity payments} - \text{capital portion} = \text{taxable portion}$$

Thus, of the \$8,000 annuity benefits received each year, only \$2,000 would be taxable. In other words, only 25% of each annuity benefit is included in taxable income. (If monthly annuity payments commenced July 1st, and only \$4,000 were received over the 6-month period, 25% of this amount, or \$1,000, would be included in taxable income.)

From a technical perspective, for prescribed annuities the owner/annuitant should include the full amount of the annuity (i.e., \$8,000) in income and then take a deduction for the capital portion (i.e., \$6,000) of the annuity.¹² Practically speaking, most insurers will issue a tax slip for only the interest portion (i.e., the \$2,000).

The life expectancy from the 1971 Individual Annuity Mortality Table determines the total number of payments to be made under the contract.

The taxable portion for non-prescribed annuities will vary each year, and will be highest in the early years. The taxable portion will decline over time as more and more capital is being returned to the annuitant year over year, and thus less capital is earning interest. With prescribed annuities, there is an element of tax deferral, as they are being taxed on a proportionate basis. The ratio between the capital portions and taxable portions is fixed throughout the annuity payout period.

As stated above, non-prescribed annuities may become prescribed annuities. If this occurs, a new adjusted purchase price must be calculated. The generally accepted method within the industry is that this would be the adjusted purchase price at the time the annuity payments initially commenced, adjusted for accrued income, mortality gains, annuity payments and mortality losses (if any) from the date the annuity payments commenced. Also, where there is a life contingency, the total payments expected to be made under the contract would be determined by taking the attained age of the annuitant(s) at the time that the prescribed annuity payments commence, and the remaining guaranteed period (where a guaranteed period exists).

For post-1989 non-prescribed annuity contracts, accrued income is reported at each policy anniversary. Because of this, when a non-prescribed annuity becomes a prescribed annuity, it's important to make

¹¹ See subsection 300(2)(b) of the Regulations.

¹² See paragraph 56(1)(d) and subsection 60(a) of the ITA.

note of the date. If the election is before the policy anniversary, no accrued income is reported for that year. Instead, the accrued income is carried over to the prescribed annuity. However, the annuity benefits should start no later than the end of the calendar year following the year in which prescribed status was elected.

Let's assume that a non-prescribed annuity had been acquired five years ago (i.e., on June 1, 2001) and the appropriate accrual had been calculated as at May 31st of each year. However, prior to May 31, 2006, the date on which \$2,000 of accrued income would otherwise have been reported, the owner elected to have prescribed annuity treatment apply. Since this election is being made prior to the anniversary day, no accrued income will be reported for 2006. Instead, the \$2,000 will be added to the income that will spread over future taxation years. Thus, there is an element of tax deferral.

However, if the election is made on or after May 31, 2006, prescribed treatment will apply for all annuity payments received in the year. Thus, once insurer has calculated what portion of payments are capital and what portion is interest, this same proportions are applied to payments that had already been received in the year.

b) Taxation at Death

The tax consequences at death will vary, depending upon whether the contract is transferred to a beneficiary or is terminated. (We could also have the situation where the annuitants die before the annuity benefits commence.)

If there is a named beneficiary and there is a remaining term for the annuity payments, the beneficiary essentially steps into the shoes of the deceased. For insurance contracts (which annuities are), the general rule is that there is a deemed disposition at death. However, there is a specific exception for prescribed annuities.¹³ Thus, the beneficiary would continue receiving annuity payments for the remainder of the guarantee period. Assuming that the other conditions for prescribed annuities continue to be met, the taxable portion would be the same as it was for the deceased (i.e., the taxable percentage remains unchanged).

If, however, the beneficiary received a lump-sum amount, that is, commutes the value of the future annuity benefits, there is an actual disposition for tax purposes.¹⁴ The beneficiary will have an income inclusion to the extent that the proceeds of disposition exceed the ACB of the contract. From a practical perspective, the commuted value will typically be less than the ACB, and no taxable income will arise.

This may not be the case if a non-prescribed annuity becomes a prescribed annuity before the first accrual date, or where the prescribed annuity was purchased with proceeds of a life insurance policy issued prior to 1982 that had a taxable amount carried over the term of the annuity. In this case, unreported accrued interest would become taxable. When annuitants die before annuity payments start, the insurer will typically pay a lump-sum death benefit. The calculation of the amount will be defined in the annuity contract (e.g., premiums paid for the annuity, plus interest at a stated rate.)

III. Other Issues

a) Deductibility of Borrowing Costs

The ITA has specific rules governing the deductibility of interest costs where the borrowed funds are used to acquire an annuity. Provided the other conditions laid out in the legislation are met (the interest is paid

¹³ See paragraph 148(2)(b) of the ITA.

¹⁴ See subsection 148(9) of the ITA.

or payable in the year; there is a legal obligation to pay the interest; etc.), the interest will be deductible in to the extent of amounts included in income under section 12.2 of the ITA.¹⁵

Since section 12.2 is the section applicable to non-prescribed annuities, it is clear that the ITA specifically prohibits a deduction for interest charges relating to the acquisition of a prescribed annuity.

Where the purchaser is seeking interest deductibility, he or she will have to determine whether foregoing prescribed status is appropriate. (Of course, prescribed treatment could later be elected, provided the annuity then meets the conditions prescribed in Regulation 304.)

b) Pension Income Credit

A taxpayer reporting "pension income" or "qualified pension income" may claim a non-refundable tax credit for the first \$2,000 of such income reported in a taxation year.¹⁶ (For the 2005 and earlier taxation years, the credit could only be claimed for the first \$1,000 of such income.)

The definition of "pension income" includes "... the amount by which an annuity payment included in computing the individual's income ... by reason of paragraph 56(1)(d) exceeds the capital element ... under paragraph 60(a)"¹⁷ The definition also refers to "the total of all amounts ... included in computing the individual's income by reason of section 12.2."¹⁸ Thus, it is clear that any taxpayer who attains age 65 in the year will be entitled to the non-refundable tax credit in respect of the taxable portion of an annuity included in income in the year whether that annuity is prescribed or not.¹⁹

For taxpayers who have not attained age 65 in the year, the pension credit will only be available where this income is received as a consequence of the death of the spouse or common-law partner.²⁰ In this situation, it is specifically included in the definition of "qualified pension income."²¹

For a detailed discussion of the pension credit rules, refer to *Amounts Qualifying for the Pension Credit* [PC 6096].

c) Pension Splitting Opportunities

In October 2006, the government announced that starting with the 2007 taxation year couples would be allowed to split certain types of income (specifically income qualifying for the pension credit). These measures were included in Bill C-52, which received Royal Assent on June 22, 2007.²²

Since, as discussed in b) above, the taxable portion reported for the prescribed annuity represents "pension income" for a policyholder who has attained age 65, this is a source of income qualifying for splitting. (The spouse of common-law partner to whom the income is allocated could be of any age.) Hence, married couples (including common-law partners) may realize tax savings. For a detailed discussion of these new rules, please refer to *Pension Splitting – An Analysis of the Legislation* [PC 6147].

As stated above, with prescribed annuities, once an insurer has established what portion of each payment represents capital and interest, each payment is apportioned on this basis. Thus, income qualifying for the pension credit, and hence splitting, could be created in the current taxation year. For

¹⁵ See paragraph 20(1)(c)(iv) of the ITA.

¹⁶ See subsections 118(3) and (7) of the ITA.

¹⁷ See subparagraph (vi) of the definition of "pension income" contained in subsection 118(7) of the ITA.

¹⁸ See subsection (b) of the definition of "pension income" contained in subsection 118(7) of the ITA.

¹⁹ See subsections 118(3) and (7) of the ITA.

²⁰ See above.

²¹ See definition of "qualified pension income" in subsection 118(7) of the ITA.

²² See subsection 60.03(1) of the ITA.

example, if a prescribed annuity were acquired on July 1, 2008, the payout (monthly or annual) could begin immediately.

d) Impaired or Enhanced Annuities

If individuals have medical histories that have a bearing on their longevity, they could be “rated.” If they are considering acquiring an annuity, the financial advisor should review whether the annuity is to be acquired on a prescribed or non-prescribed basis.

With a non-prescribed annuity, the accrued income will be calculated based on their rated age. With a prescribed annuity, the taxable portion will be calculated using actual age. Thus, the taxes payable will vary depending upon the type of annuity. With rated individuals, the advisors should compare the total annuity benefits and taxable portions for prescribed and non-prescribed annuities. In many situations, non-prescribed annuities may be more appropriate for people who are rated..

For more information, refer to *Taxation of Non-Registered Enriched (or Impaired) Annuities* [PC 6193].

e) Deferred Annuity Becomes a Prescribed Annuity

The status of an annuity contract (i.e., whether it is “prescribed” or “non-prescribed”) is determined on the anniversary day of a contract. As indicated above, a deferred annuity (i.e., non-prescribed annuity) is always subject to accrual taxation during the deferral (or accumulation) period. When annuity payments commence, it may become a prescribed annuity, assuming of course that the other required conditions are met.²³ At that time, there is no disposition of the contract and the accrual rules cease to apply.

The income that must be reported in the calendar year that the status changes will vary, depending upon whether the annuity was last acquired before 1990 or last acquired after 1989. These rules are discussed in our document dealing with non-registered non-prescribed annuities.

f) Collateralization of Prescribed Annuities

For an annuity to qualify as a prescribed annuity, among the conditions that must be met is that the holder’s rights under the contract may not be disposed of otherwise than on the holder’s death.²⁴ At a recent industry event, the Canada Revenue Agency (CRA) was asked whether this meant that such an annuity could not be collaterally assigned. CRA responded as follows:

“Provided that the assignee is unable to force any disposition of the policy by the holder, but has only the right to the annuity payments that continue to be constructively received by the holder, in our view, the collateral assignment of an annuity contract does not affect the requirements under clause 304(1)(c)(iv)(D) of the Regulations that the holder’s rights under the contract not be disposed of otherwise than on the holder’s death”.²⁵

This response was consistent with a response given at an earlier tax forum in Quebec.²⁶ CRA then indicated that where a moveable hypothec was granted on a prescribed annuity, this would not cause prescribed status to be lost.²⁷

²³ See Regulation 304.

²⁴ See Regulation 304(1)(c)(iv)(D).

²⁵ See Question # 12, CRA Roundtable, CALU Annual Meeting (April 2008)

²⁶ See CRA document # 2006-0197041C6 for comments made at the 2006 APFF Annual Conference – Round Table on Taxation on Financial Strategies and Financial Instruments.

IV. Summary

Annuities are flexible financial products that are appropriate for many individuals. Taxpayers contemplating buying an annuity should learn how these products are taxed and what features they offer, so that they purchase the annuity best suited to their needs.

This document is intended for general information only. It should not be construed as legal, accounting, tax or specific investment advice. Clients should consult a professional advisor concerning their situations and any specific investment matters. While reasonable steps have been taken to ensure that this information was accurate as of the date hereof, The Standard Life Assurance Company of Canada and its affiliates make no representation or warranty as to the accuracy of this information and assume no responsibility for reliance upon it.