

## Taxation of Personally Owned Non-Registered Non-Prescribed Annuities

An “annuity” is broadly defined in the Income Tax Act (Canada) (ITA), and

“ ... includes an amount payable on a periodic basis whether payable at intervals longer or shorter than a year and whether payable under a contract, will or trust or otherwise.”<sup>1</sup>

While the definition is broad, this document will focus on annuities issued by an insurer. For tax purposes, such annuities are treated as “life insurance policies”.<sup>2</sup> The language contained in the ITA, as it relates to life insurance policies, is extremely complex. In order to understand how annuities offered by insurers are taxed, it is necessary to comb through the provisions relating to “life insurance” and extract the relevant information.

Insurers offer both immediate and deferred annuities. With an immediate annuity, payments commence one annuity period after the annuity is purchased from the insurer. With a deferred annuity, payment is deferred. The tax treatment will vary, depending upon whether or not the (immediate or deferred) annuity contract is a life annuity contract, whether it is acquired on a registered or non-registered basis and whether, in the case of an immediate annuity, it is prescribed or non-prescribed.

This document will focus on the taxation of annuities that are personally owned and are acquired on a non-registered basis. It will include those that are considered “life annuity contracts” and that are non-prescribed. Prescribed annuities will be the subject of a separate document.

When looking at the taxation of annuities, there are two distinct time periods: the accumulation (or deferral) period, and the payout period. These are discussed below, along with such issues as, mortality gains and losses, deductibility of borrowing costs, etc.

As a result of changes in tax rules relating to annuities during the 1980s, income is now taxed on a full accrual basis. This document will address the tax treatment of annuities that are considered to be “last acquired after 1989”. Holders of annuities that were not “last acquired after 1989” should seek professional advice with respect to the tax rules applying to them.

### I. Life Annuity Contracts

#### (a) Definition

The definition of “life annuity contract” is very brief. It is essentially an annuity offered by a Canadian insurer whereby the insurer:

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<sup>1</sup> See definition of “annuity” in subsection 248(1) of the Income Tax Act (Canada) (ITA).

<sup>2</sup> See paragraphs 6 to 12 of Interpretation Bulletin IT-87R2 – Policyholders’ Income from Life Insurance Policies (IT-87R2), dated February 15, 1996 for a discussion of these earlier tax rules.

“... agrees to make annuity payments to an individual (... referred to as “the annuitant”) or jointly to two or more individuals (each of whom is referred to as “the annuitant” ...), which payments are, by the terms of the contract,

- (a) to be paid annually or at more frequent periodic intervals;
- (b) to commence on a specific day; and
- (c) to continue throughout the lifetime of the annuitant or one or more of the annuitants.”<sup>3</sup>

Other provisions in the regulations specify features that a life annuity contract may contain that will not disqualify an annuity from being a life annuity contract:

- (a) the owner or the annuitant may assign the annuity payments;
- (b) the contract provides that the payments will be made for the lesser of: the period ending with the death of the annuitant, or for a specified period of not less than 10 years;
- (c) the contract provides that the annuity payments will be made for a specified period or throughout the lifetime of the annuitant, whichever is longer, to the annuitant and thereafter, if the specified period is longer, to a specified person;
- (d) the contract provides that a payment may be made upon the death of the annuitant, which is in addition to any annuity payments made during the life of the annuitant;
- (e) the contract provides that the date
  - (i) on which the annuity payments commence, or
  - (ii) on which the contract holder becomes entitled to proceeds of disposition,may be changed with respect to the whole contract or any portion thereof at the option of the annuitant or owner; or
- (f) the contract provides that all or a portion of the proceeds payable at any particular time under the contract may be received in the form of an annuity contract other than a life annuity contract.<sup>4</sup>

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

Many insurers offer term certain annuities. With these products annuity benefits would be payable for a finite period, for example, from age 60 to 70. A detailed discussion of these is beyond the scope of this document. We do, however, note that where the annuity is non-prescribed the accrual rules apply.

## (b) Parties to a Life Annuity Contract

With life annuity contracts, the key requirement is that annuity payments be made to an individual (or individuals). The payments must continue throughout that individual’s lifetime (or individuals’ lifetimes).

The commonest situations where one sees such contracts are where, for example, Mr. Smith acquires an annuity based on his own life, or Mr. and Mrs. Parent jointly acquire an annuity on a joint life basis. (Of course, Mr. Parent could himself acquire an annuity on a joint life basis.) Here, the parties receiving the payments are also the owners of the annuity.

We may, however, introduce another party. That is, an owner (or holder) for the annuity may be someone other than the annuitant or the measuring life. For example, Mr. Smith’s son could own an annuity based on his father’s life where the father receives the annuity payments. Later in this document we will discuss the

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<sup>3</sup> See subsection 301(1) of the Income Tax Regulations.

<sup>4</sup> See subsection 301(2) of the Income Tax Regulations.

taxation of the annuity payments. We will see that the “holder” is the party required to report the income inclusions – even though the holder is not the annuitant, that is, the recipient of the annuity benefits!

The final parties we will introduce are the beneficiary and contingent owner. Where the owner and the annuitant are the same, and have died, 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.

Care should be taken when naming a spouse as beneficiary in the province of Quebec. The spouse will be considered an irrevocable beneficiary, unless upon the annuity application it is indicated that the designation is revocable.

Where the owner is different from the annuitant, it is conceivable that the owner could predecease the annuitant. Hence, it may be appropriate to name a contingent owner. This person will acquire ownership of the annuity contract upon the death of the owner.

Care should be taken when acquiring an annuity contract. Certain default provisions will come into play where beneficiaries and/or contingent owners are not named. The purchaser and his or her financial advisor should review the entire contract, including default provisions, so as to be sure that they understand what will happen if certain events take place.

### (c) Third Party Annuities

At an industry forum in 2002, the Canada Revenue Agency (CRA) was asked about “third party annuities”. In the question put to CRA, it was stated that “There are situations where an annuity may be payable throughout the lifetime of an individual but that individual is not the recipient of the annuity payments. The individual may be an employee or a shareholder of a corporation and the corporation is the purchaser and owner of the annuity contract ...”.<sup>5</sup> We note that there are many additional situations in which third party annuities might be acquired (e.g., charitable giving context).

CRA indicated that such annuities did not meet the current definition of “life annuity contract”.<sup>6</sup> As a result, the current legislation required inappropriate income inclusions.

The industry made representations to the Department of Finance (Finance) regarding the need to revise the “life annuity contract” definition, so that anomalies in the legislation could be corrected. As a result, on September 12, 2002 Finance issued a comfort letter recommending certain revisions to the tax legislation. Effective for taxation years that end after 1996, the “life annuity contract” definition in subsection 301(1) of the Income Tax Regulations (Regulations) should “be amended to include life annuity contracts under which the annuitant is a partnership or a person as well as life annuity contracts under which the annuity payments are based on the life of an individual who is not the annuitant.” Finance also proposed certain revisions to the definition of adjusted cost basis, with these changes taking effect for taxation years ending after 1980.<sup>7</sup>

While draft legislation has not yet been introduced, with the issuance of the comfort letters, the insurance industry has the assurance that Finance has recognized that there is an anomaly in the tax legislation.

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<sup>5</sup> See Technical Interpretation # 2002-0127495, dated May 7, 2002.

<sup>6</sup> See above.

<sup>7</sup> See letter from Len Farber, General Director, Tax Legislation Division, Tax Policy Branch dated September 12, 2002.

## II. Taxation of Accruing Income in the Accumulation Period

### (a) Annual Accrual While the Policy is in Force

Under the ITA, for life insurance policies (which by definition include annuity contracts) last acquired after 1989, income must generally be reported on an annual basis, with the amounts being calculated on the policy anniversary, i.e., as at the “anniversary day”.<sup>8</sup> The person “holding” the interest in the annuity (i.e., the owner) will report the income.<sup>9</sup>

“Anniversary day” means “... the day that is one year after the day immediately preceding the day on which the policy was issued, and ... each day that occurs at each successive one-year interval ...”.<sup>10</sup> Thus, if an annuity were acquired on July 1, 2005, the income inclusion would be calculated as at June 30, 2006, June 30, 2007, and so forth. This would be the case even where the first annuity payment has not yet been received. Thus, where an annuity that is subject to the annual accrual rules is being acquired and the annuity payment stream has not yet commenced, the owner will need to ensure that he or she has another source of funds for the payment of any taxes.

By way of background, the annual accrual is a result of changes to the tax laws that were proposed in 1989 (and actually enacted in 1991). While corporations and certain other entities were subject to the annual accrual rules for annuities generally acquired after December 1, 1982, individuals and certain trusts were generally subject to triennial accrual prior to the change in the tax rules.<sup>11</sup>

The amount that must be reported as income on that date is calculated as the amount, if any, by which the “accumulating fund” on that day of the interest in the policy exceeds the “adjusted cost basis” (“ACB”) on that same day.<sup>12</sup> An insurer will issue the appropriate tax information slip reflecting the “taxable portion” of the annuity benefit that must be included in income each year. (Where the annuity is jointly owned, both names will appear on the information slip.) The owner(s) will include the amount shown on the information slip on their tax return(s) proportionately to their share of ownership.

“Accumulating fund” and “adjusted cost basis” are both defined terms. While the definition of “accumulating fund” contained in the regulations is extremely complex, it essentially represents the savings element of the annuity contract.<sup>13</sup> An insurer carries out complex calculations in order to arrive at the “accumulating fund” and “adjusted cost basis”.

The accumulating fund, as calculated by the insurer, will be equal to the maximum tax actuarial reserve (“MTAR”) that the insurer can claim for corporate tax purposes.<sup>14</sup> MTAR can generally be described as the greater of:

- the cash surrender value of the policy less outstanding loans in respect of the policy, and
- the excess of the present value of future benefits over the sum of outstanding policy loans and the present value of future “modified net premiums”.<sup>15</sup>

(Since most insurers do not allow policy loans in the case of annuities, the accumulating fund may be viewed as the greater of: (a) the cash surrender value of the annuity contract, and (b) the excess of the present value of future benefits over the present value of future premiums.)

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<sup>8</sup> See subsection 12.2 of the ITA. Note that there is a specific exclusion from this rule for exempt policies, prescribed annuity contracts and certain other life insurance policies.

<sup>9</sup> See above.

<sup>10</sup> See definition of “anniversary day” contained in subsection 12.2(11) of the ITA.

<sup>11</sup> Subsections 12.2(3), (4) and (4.1) of the ITA, which have been repealed when rules relating to annual accrual were introduced.

<sup>12</sup> See subsection 12.2(1) of the ITA.

<sup>13</sup> See paragraph 307(1)(b) of the Income Tax Regulations.

<sup>14</sup> See paragraph 1401(1)(c) of the Income Tax Regulations.

<sup>15</sup> See paragraph 3 of IT-87R2.

The insurer calculates the ACB using the same general formula that is applied to life insurance policies, except that a deduction for the “net cost of pure insurance” (“NCPI”) is not applicable. Also, with life annuities, “mortality gains” are added to the ACB, while “mortality losses” are deducted from the ACB. (See the discussion of Mortality Gains and Losses under IV. Other Issues.)

The ACB of an annuity contract will in most cases be calculated as the sum of:

- the consideration paid (all premiums paid plus policy loan interest paid or capitalized after 1977 to the extent the interest was not deductible from income)
- amounts previously included in income by the owner, and
- mortality gains

Less the sum of:

- annuity payments previously received by the owner, and
- mortality losses.

The components entering into the calculation of the ACB that are shown above are the more common components. For an overview of all of the elements entering into calculation of the ACB, the reader should refer to the actual definition contained in the ITA.<sup>16</sup> Again, if we assume that most insurers do not permit policy loans, we are left with a relatively simple formula.

There is a special provision in the ITA dealing with negative ACBs. Where at the end of a taxation year a negative ACB arises, the holder will have an income inclusion for this amount.<sup>17</sup> This rule ensures that accrued income is included in income even if, for instance, the contract expired in the year.

#### (b) Policy Gain on Surrender

An insurer may permit the owner to surrender an annuity before payments have commenced. (Surrender is typically not permitted once payments have commenced.) Most insurers will charge a fee that is built into the surrender value received by the owner. For example, the surrender value might be calculated as 95% (or some other percentage) of the lump-sum premiums then chargeable for such an annuity. (An insurer may compare rates in effect at the time the request to surrender the contract is made with those in effect at the time the premium was initially paid, and might choose to use the higher of the two when calculating the lump-sum premium entering into the calculation of the surrender value.)

Most insurers will set out how the surrender value is calculated in the annuity contract, so purchasers (and their advisors) should examine the appropriate documents prior to purchasing the annuity product.

Should an annuity contract be surrendered during the accumulation period, the holder will have an income inclusion to the extent that the proceeds exceed the ACB of the policy.<sup>18</sup> Under this provision the owner will have an income inclusion for amounts not already reported in previous years.

However, where a loss arises (i.e., the ACB exceeds the proceeds of disposition), a deduction will be available to the owner (not the beneficiary) for what is essentially over-accrued income. The deduction is, however, limited to the amounts previously included in income under section 12.2. (Here, amounts reported in previous years as well as the current taxation year are relevant.)<sup>19</sup>

Where there is a partial surrender of the contract, special rules come into play. In calculating the income from the partial disposition, only the ACB of the portion of the policyholder’s interest disposed of is deductible.<sup>20</sup> As stated by CRA:

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<sup>16</sup> See subsection 148(9) of the ITA.

<sup>17</sup> See subsection 12.2(5) of the ITA.

<sup>18</sup> See subsection 148(1) of the ITA.

<sup>19</sup> See subsection 20(20) of the ITA.

<sup>20</sup> See subsection 148(4) of the ITA.

“The ACB of the part interest is the portion of the ACB of the policyholder’s entire interest of the policy or contract that the proceeds of disposition is of the accumulating fund of the entire interest immediately before the disposition.”<sup>21</sup>

Deferred annuities are available on an interest payout basis and are considered by many as being an alternate to certificates offered by banks and other financial institutions. Where the insurer pays the interest on the contract anniversary date, the taxation is straightforward. The interest is simply the accrued interest for the year. However, many investors prefer to receive the interest on a monthly basis. Here, each monthly payment is in fact a partial surrender of the contract. A small portion is taxable as interest income (not accrual). The change in the accumulating fund is then compared to the ACB at anniversary and an accrual is then reported. The end result is something close to but not exactly the “simple” annual accrual.

### (c) Taxation at Death

The owner, the insured or the annuitant may die during the accumulation period. The insurer will typically make a lump-sum payment at this time. The calculation of this amount will be defined in the annuity contract.

Where this happens, there is a deemed disposition of the interest in the annuity contract immediately before death.<sup>22</sup> The owner will have an income inclusion, with this being calculated as the amount by which the proceeds of disposition exceed the ACB of the contract.<sup>23</sup> “Proceeds of disposition” are specifically defined in such instances to be equal to the accumulating fund in respect of the contract, as determined in prescribed manner immediately after the time of death.<sup>24</sup> (The policyholder immediately after death is deemed to have acquired the interest in the annuity contract at this same amount.<sup>25</sup>)

As noted above, it is the owner who has the income inclusion. Thus, the beneficiary named in the annuity contract will receive the lump sum paid from the insurer on a tax-free basis, since the tax liability is that of the owner.

Special rules apply where upon the death of an owner the contract is transferred or distributed to the owner’s spouse or common-law partner. In such cases, the transfer will be for proceeds of disposition equal to the original owner’s ACB immediately before the death. Thus, there will be no income inclusion at that time. (It should be noted that this tax-free rollover would only be available if the transferor and transferee are both resident in Canada at the time of the death.<sup>26</sup>)

The rollover will be deemed to occur, unless an election is made to have these provisions not apply. (There is no specific Canada Revenue Agency (“CRA”) form for this election.) The election is viewed as having been made where the income arising from the disposition is reported on the deceased owner’s tax return.

### (d) Inter Vivos Spousal Rollovers

There are also inter vivos spousal rollover provisions that are similar to those arising at death. Under these rules, the owner is similarly deemed to transfer the interest in the annuity contract at its ACB. Thus, the owner will not include any amount in income at the time of the transfer. These rules may only apply where the transfer is to the policyholder’s spouse or common-law partner, or is to a former spouse or common-law

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<sup>21</sup> See paragraph 20 of IT-87R2.

<sup>22</sup> See paragraph 148(2)(b) of the ITA.

<sup>23</sup> See subsection 148(1) of the ITA.

<sup>24</sup> See part (d) of the definition of “proceeds of disposition” contained in subsection 148(9) of the ITA.

<sup>25</sup> See paragraph 148(2)(c) of the ITA.

<sup>26</sup> See subsection 148(8.2) of the ITA.

partner in settlement of rights arising out of their marriage or common-law partnership. Again, for the tax-free transfer to be permitted, the transferee and transferor must be resident in Canada.<sup>27</sup>

Transfers to spouses will occur on a tax-free rollover basis, unless an election is made to have these provisions not apply.

### III. Taxation of Income in the Payout Period

#### (a) While the Annuitant is Alive

Once the annuity payments commence, income will continue to be determined in the same manner as the period of accumulation (i.e., on an accrual basis). The insurer will report the taxable portion of the annuity payments and will issue the appropriate information slip. The owner(s) will report the amount on the information slip.

In some situations, an individual may have actually received annuity benefits in a taxation year, yet not be required to report any amount of income for the year. Where, for example, an annuity is acquired on June 1, 2006, with monthly payments commencing one month later, the first “anniversary day” will be June 30, 2007. Hence, the first information slip will only be issued in 2007.

It is also possible that in the above example the taxable portion that the insurer calculates in 2007 is nil. Insurers typically offset expenses associated with setting up the annuity against the income that must be reported in the first year(s). Thus, depending upon the cost allocation method followed by the insurer, the taxable portion otherwise calculated could be partially or fully offset.

Where payments have commenced, it is possible to have subsequent income inclusions calculated on a “prescribed basis”, provided certain conditions in the ITA are met.<sup>28</sup> (These conditions are discussed in detail in our separate *Taxing Issues* on this topic (form 5998).

The owner of the annuity contract would want to know the insurer’s procedures for deferred annuities that have matured. Insurers will automatically commence to treat the annuity as a prescribed annuity if the required conditions have been met, unless the owner has explicitly elected to treat the annuity as a non-prescribed annuity. (Most owners will prefer prescribed annuity treatment, as this will allow for equal amounts of interest to be reported for each year of the contract. This is generally preferred to the method in place for non-prescribed annuities, where a higher amount of interest is recognized in earlier years, with the interest then declining over the life of the contract. Prescribed annuity contracts average out the income subject to tax each year, thus providing an element of tax deferral.)

Where, however, the annuity has been acquired with borrowed funds, the owner may prefer to have the annuity taxed on non-prescribed basis. This is because the ITA specifically prohibits a deduction for borrowing costs where the annuity is a prescribed annuity.<sup>29</sup> Please see separate discussion on “Deductibility of Borrowing Costs”.

#### (b) Taxation at Death

As is the case where the death of the owner or annuitant occurs during the accumulation period, there will be a deemed disposition of the interest in the annuity contract immediately before death.<sup>30</sup> Again, the owner will have an income inclusion, with this being calculated in the manner described in c) under II. Taxation of Accruing Income in the Accumulation Period.

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<sup>27</sup> See subsection 148(8.1) of the ITA.

<sup>28</sup> Regulation 304 outlines the conditions that must be met for an annuity to be considered a “Prescribed Annuity”.

<sup>29</sup> See subparagraph 20(1)(c)(iv) of the ITA.

<sup>30</sup> See paragraph 148(2)(b) of the ITA.

Again, it will be the owner who will have the income inclusion, with the beneficiary receiving the amount on a tax-free basis. The rules dealing with transfers to a spouse or common-law partner are described in c) above. Essentially, the surviving spouse will continue to be taxed on the same basis as the deceased spouse.

It should be noted that where there are joint annuitants and one dies, the annuity contract might provide that the annuity is adjusted to what can be afforded on a single-life basis. A death benefit will not be payable in this instance.

#### (c) Commutation

An annuity with a guarantee period may have been acquired, and the annuitant may have died (or the last survivor of the annuitant and joint annuitant in the case of a joint life annuity may have died). Here, the remaining guaranteed payments will be payable to the beneficiary.

If the beneficiary is the estate, the estate will receive the commuted value of the remaining guaranteed payments as a lump sum. If there is a named beneficiary, the insurer may offer the named beneficiary a choice (i.e., taking a commuted value or continuing to receive the payments for the guarantee period).

For tax purposes, a commutation is treated as a disposition. The owner will report any gain (i.e., the value of the accumulating fund minus the ACB of the contract) on his or her terminal tax return. Practically speaking, the lump sum paid will likely equal the accumulating fund. The income inclusion will be equal to the amount by which the proceeds exceed the ACB of the contract.

Since the owner reports any gain and pays the appropriate taxes, the beneficiary will receive any lump sum on a tax-free basis.

#### (d) Inter Vivos Spousal Rollovers

The rules dealing with inter-spousal rollovers are described in d) under II. Taxation of Accruing Income in the Accumulation Period.

### IV. Other Issues

#### (a) Mortality Gains and Losses

A unique tax feature that comes into play with life annuities relates to mortality gains (and losses). "Mortality Gain" ("MG") is defined as:

"... such reasonable amount ... that the life insurer determines to be the increase in the accumulating fund in respect of the interest that occurred during the year as a consequence of the survival to the end of the year of one or more of the annuitants thereunder."<sup>31</sup>

Insurers selling life annuities make estimates as to how long each annuitant will survive. When the annuitant dies, the insurer no longer needs to maintain reserves. Thus, the insurer is able to allocate the funds to the surviving annuitants.

When we look back at the calculation of ACB, we see that the MG is added to the ACB. Since at the policy anniversary day (as well as on death) we would be calculating the income inclusion for the holder (i.e.,

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<sup>31</sup> See subsection 308(2) of the Income Tax Regulations for the definition of "mortality gain".

calculating the excess of the accumulating fund over the ACB), with the MGs being added to the ACB, the MG that is allocated is essentially being paid out on a tax-free basis.

As may be seen from the ACB calculation, should a Mortality Loss ("ML") arise, the opposite will occur (i.e., the ACB will be decreased).<sup>32</sup>

Mortality gains and losses are not applicable to term certain annuities.

#### (b) 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 or payable in the year; there is a legal obligation to pay the interest; etc.), the interest will be deductible to the extent of amounts included in income under section 12.2 of the ITA.<sup>33</sup> A taxpayer will only be allowed to deduct the interest expenses up to the amount of the section 12.2 income inclusion for that year. (It should be noted that the deduction is not permitted where a prescribed annuity is acquired.<sup>34</sup>)

Where a deferred annuity is acquired, the first anniversary day will fall into the subsequent taxation year. Thus, in the year the annuity is acquired, the owner will be denied a deduction, since no income will be reported in that year. Also, if interest is not actually paid in a year, but is instead compounded, a deduction may be available when the compound interest is paid.<sup>35</sup> (With the deduction presumably being limited to the section 12.2 income inclusion for the year.)

#### (c) Pension Income Credit

A taxpayer reporting "pension income" or "qualified pension income" may claim a non-refundable tax credit in respect of the first \$1,000 of such income reported in a taxation year.<sup>36</sup> (The 2006 Federal Budget proposed increasing this limit to \$2,000.) When we look at section 12.2 interest accruals, we see that it is specifically included in the definition of "pension income".<sup>37</sup> Thus, any taxpayer who attains age 65 in the year will be entitled to the non-refundable tax credit.<sup>38</sup>

For taxpayers who have not attained age 65 in the year, the pension credit will only be available where the section 12.2 income is received as a consequence of the death of the spouse or common-law partner.<sup>39</sup> In this situation it is specifically included in the definition of "qualified pension income".<sup>40</sup>

#### (d) Impaired or Enhanced Annuities

Individuals could have medical histories that would have a bearing on their longevity. Where the appropriate medical evidence is submitted to the insurer, the individual could be "rated". Where these individuals are considering acquiring an annuity, the financial advisor should review whether the annuity is to be acquired on a prescribed or non-prescribed basis.

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<sup>32</sup> See subsection 308(3) of the Income Tax Regulations for the definition of "mortality loss".

<sup>33</sup> See subparagraph 20(1)(c)(iv) of the ITA.

<sup>34</sup> An examination of the accrual rules in section 12.2 of the ITA will reveal that prescribed annuities are specifically excluded from the application of these rules. Also see Technical Interpretation # 2000-0009555, dated March 28, 2000.

<sup>35</sup> See paragraph 20(1)(d) of the ITA. Also see CRA document # 9606425.

<sup>36</sup> For federal tax purposes, assuming that measures announced in the 2006 Federal Budget are proceeded with, the non-refundable credit will be calculated as 15.25% of up to \$2,000 of such income. The provinces also provide a non-refundable tax credit, with the rate varying by province. Some provinces have also indexed the \$1,000 (the limit in effect for the 2005 and earlier taxation years), so the credit was available on a somewhat larger amount. It will be necessary to monitor whether the provinces adopt the \$2,000 limit.

<sup>37</sup> See definition of "pension income" in subsection 118(7) of the ITA.

<sup>38</sup> See subsection 118(3) of the ITA.

<sup>39</sup> See subsection 118(3) of the ITA.

<sup>40</sup> See definition of "qualified pension income" in subsection 118(7) of the ITA.

Where a non-prescribed annuity is acquired, the accrued income will be calculated based on their rated age. Where a prescribed annuity is acquired, the taxable portion will be calculated using actual age. Thus, the taxes payable will vary depending upon the type of annuity.

In many cases, a non-prescribed annuity will in fact be more tax-advantageous than a prescribed annuity.

#### (e) Annuities Last Acquired Before 1990

When we look at annuities that were acquired before 1990, we will generally want to establish in which of two periods the annuity contracts were entered into. The first set of rules for pre-1990 annuities relates to contracts acquired before December 2, 1982. The second set of rules relates to annuity contracts entered into after that date but before 1990.

Generally, triennial accrual taxation was introduced for contracts last acquired before December 2, 1982 where payments had not commenced before that date.<sup>41</sup> Such contracts are deemed to have been issued on December 31, 1984, so that the first accrued income would have been reported as at December 31, 1987.<sup>42</sup> The owner of such a contract could make an election to report income on an annual basis.<sup>43</sup>

For contracts issued in the post-December 1, 1982 to December 31, 1989 period, triennial reporting applies.<sup>44</sup> Thus, for a contract issued January 15, 1983, the first income inclusion will be calculated and reported on December 31, 1986. (December 31, 1986 is the end of the third calendar year following the year of acquisition.) Thus, for the first reporting period, the accrual period would be 47.5 months. Thereafter, a three-year cycle will apply.

When we look at annuity taxation we see “last acquired” language. Take care to ensure that the tax treatment does not inadvertently change because a contract is considered to be disposed of and then reacquired. This could happen if a contract is altered.

#### (f) 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 will become a prescribed annuity, assuming of course that the other required conditions are met and that non-prescribed status is not elected.<sup>45</sup> 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.

Annuities acquired before 1990 have an anniversary date of December 31<sup>st</sup>. Thus, where the status changes in the calendar year, accrual taxation ceases. Instead, the annuity is taxed on a prescribed basis for the entire year.

For an annuity last acquired after 1989, where the status changes in a year, taxation will vary depending upon whether the change occurred before or after the anniversary date. By way of example, let's assume

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<sup>41</sup> See former subsection 12.2(3) of the ITA, as well as former paragraph 12.2(11)(b), and rules relating to the application of these provisions.

<sup>42</sup> See former paragraph 12.2(11)(b) of the ITA, and rules relating to the application of this provision.

<sup>43</sup> See former subsection 12.2(4) of the ITA, as well as former subsection 12.2(4.1) with respect to elections regarding such treatment.

<sup>44</sup> See former paragraph 12.2(11)(b) of the ITA, and rules relating to the application of this provision.

<sup>45</sup> See Regulation 304.

that the annuity has an anniversary day in 2005 of June 30<sup>th</sup>, and the status changed on September 1, 2005. Here, since the status changed after the anniversary day, the owner will include two amounts in income for 2005. First, income accrued to June 30<sup>th</sup> (the anniversary day) will be reported. For payments received after the anniversary day, the income inclusion will be calculated on a “prescribed” (or proportional) basis.

If we assume that the change in status occurred April 1<sup>st</sup>, 2005 (i.e., before the anniversary day of June 30<sup>th</sup>), there is no accrual taxation for the year. Instead, the income inclusion will be calculated on a “prescribed” (or proportional) basis.

## **V. Summary**

Annuities are financial products that are appropriate for many individuals. They are extremely flexible products. As with any financial product, taxpayers contemplating acquiring these products are urged to gain an understanding how these products are taxed and what features they offer, so that they may purchase an annuity that is 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.*