Payout annuity taxation

There is renewed interest in payout annuities with the increased popularity of guarantees and the need for certainty or sustainable lifetime income. This often generates tax questions related to annuities.

The tax treatment of an annuity, whether life or term certain, depends on the source of funds and whether the contract meets the requirements of a prescribed annuity contract. Below is a summary of the tax treatment based on registration and annuity type: (registered and non-registered (prescribed and accrual tax treatments).

Registered annuities

Annuities purchased with funds from a registered retirement savings plan (RRSP), spousal RRSP, registered retirement income fund (RRIF), spousal RRIF, locked-in plan or pension plan are considered registered annuities. Every dollar paid to the client is taxable as income in the year it is received.

Non-registered annuities

The taxation of non-registered annuities depends on whether the requirements for prescribed treatment are met. It’s important to note the income payment doesn’t change between prescribed and accrual taxation, just the amount of income that’s taxable each year.

Prescribed tax treatment (also called level tax)

If an annuity qualifies for prescribed treatment, the expected taxable income over the life of the contract, based on life expectancy, is divided equally over each year the contract is in force.

Prescribed taxation is often preferred over non-prescribed because it includes some element of tax deferral, and because the taxable portion of the annuity payment will be level throughout the contract which makes planning easier. Single life, joint life, and term certain annuities may all qualify for prescribed treatment.

The following is a list of some of the requirements to qualify for prescribed treatment:

- Annuity payments must begin in the current year (i.e. no deferral)
- The policyowner(s) and annuitant(s) must be the same person
- The payments must be of equal amounts and made at least annually (i.e. no indexing)
- The payments must continue for a fixed term or until the death of the annuitant (i.e. no commutation)

- Joint annuitants may be spouse, common-law partners or siblings (i.e. no joint ownership with parent and child)
- Guaranteed term cannot extend beyond the youngest annuitant's 91st birthday

The taxable portion of the annuity payments received in a year under prescribed treatment will be reported in box 24 of a T4A slip (Relevé 1 in Quebec). If you are age 65 or older at the end of the year, this amount will qualify for the pension income credit and pension income splitting. Consult line 115 in the general income tax and benefit guide for details.

Accrual tax treatment (also called non-prescribed)

If the non-registered annuity does not qualify for prescribed tax treatment as described above, it will be subject to accrual taxation. Income will be taxable in the year it is earned regardless of amount paid as income. The taxable income portion is higher in the earlier years and declines over time. This is described next, and illustrated later in this article.

Conceptually (to understand the taxation), it can be helpful to consider the similarities to a mortgage. Rather than borrowing the money, think of yourself as a lender loaning money to the insurance company. Keep in mind, this is only a conceptual framework, and annuities are insurance products with fundamentally different legal and contractual differences.

Your first mortgage payment includes interest on the entire amount of the loan; likewise, the first annuity payment under accrual taxation reports the highest amount of income. That first payment also includes some *principal*, reducing the base on which interest is calculated or earned, so the second payment includes less interest. As each payment includes some principal repayment, the interest earned over time gets lower and lower.

Prescribed tax treatment may be preferred because of the consistent taxable amount, which is lower than taxable amount under accrual taxation in the early years. However, a client might prefer an annuity subject to accrual taxation for the other benefits the annuity can offer. Certain features are only available with annuities subject to accrual taxation. Examples include:

- Guarantees that extend beyond age 91
- Payments indexed to help keep up with inflation
- Policyowners who are not the annuitant (this may come into play in corporate ownership or in generational planning)
- Joint annuitants with someone other than spouse, common-law partner or sibling
- Deferred annuities (taxable income will be reported during the deferral period on accrual basis even though income payments have not started)
- Option to commute (receive a lump sum instead of continuing payments)

A full or partial commutation of an annuity would be a disposition for tax purposes and may result in a policy gain or loss. The full amount of a policy gain is taxable; it is not a capital gain. A loss is only deductible up to the total amount previously included in income.

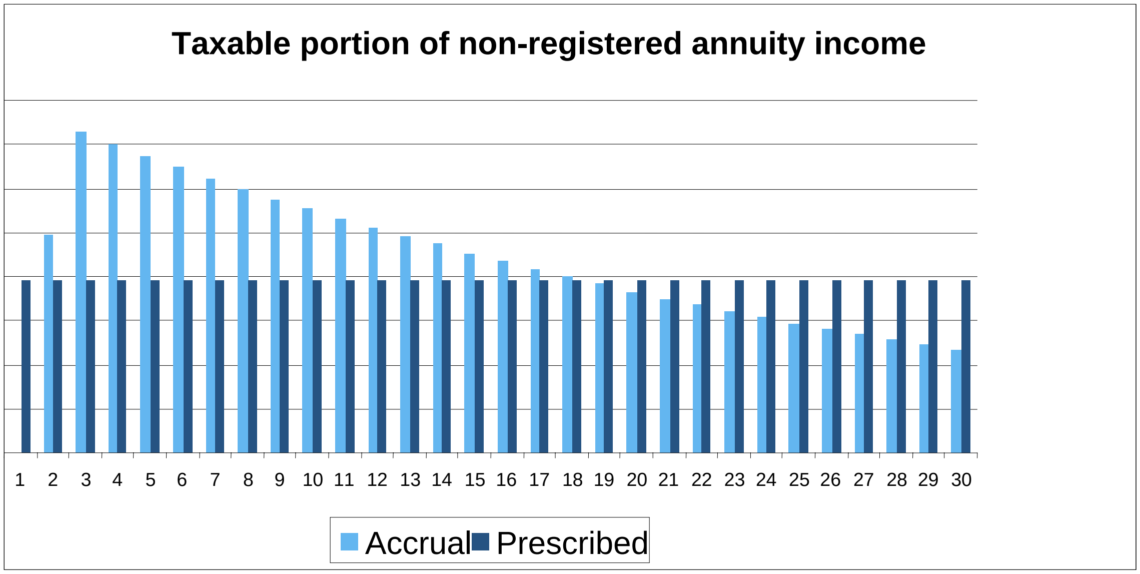
The taxable income under accrual tax treatment will be reported in box 19 of a T5 slip(Relevé 3 in Quebec). If you are age 65 or older at the end of the year, this amount will qualify for the pension income credit and pension income splitting. Consult line 115 in the general income tax and benefit guide for details.

Changes to the tax treatment

It's possible to change the tax treatment of an annuity in certain circumstances. For example, in a prescribed annuity contract where one of the requirements ceases to be met, the annuity may change to accrual taxation (which may entail a disposition and possible tax owing on a policy gain at that time). Due to the contractual nature of annuities this generally does not happen.

Likewise, an annuity subject to accrual taxation can eventually qualify for prescribed treatment. In practice, this is most often seen in deferred annuities. Once a client starts receiving regular payments, the contract may qualify for prescribed treatment. For prescribed treatment to eventually come into effect, all requirements other than deferral will have to be met (i.e. no option to commute).

The following is an illustration of the taxable portion of an annuity under accrual and prescribed tax treatments.



More information about prescribed and accrual tax treatment of annuity income can be found in the *Income Tax Act (Canada)* and the *Income Tax Regulations*. Section 148 of the Act describes the taxation, and regulation 304 contains the list of requirements for prescribed tax treatment.

The information provided is for Canadian residents and is accurate to the best of our knowledge as of December 2010. The information contained in this article is intended to provide general guidelines only. The application and impact of the law can vary widely from case to case based on the specific or unique facts involved. Accordingly, the information is this article is not intended to serve as legal, accounting or tax advice. Users are encouraged to consult with their professional advisors for advice concerning specific matters before making a decision.