Taxation of Non-Registered Enriched (or Impaired) Annuities

In addition to having a bearing on longevity, an individual's medical history can result in that individual being "rated," which can translate into higher annuity payments. This edition of Taxing Issues deals with the unique features of what Standard Life refers to as "enriched annuities". (Note that other insurers may use different names: "impaired annuities," "accelerated annuities," "enhanced annuities," etc.)

I. Shortened Life Expectancy

When a proposed annuitant has a shorter than normal life expectancy due to illness or disability, he or she should consider obtaining an annuity on an impaired basis. Impaired annuities are available on either a single life basis, or a joint life basis (where one or more annuitants have a shorter life expectancy).

To assess the impact on longevity, the insurer will need medical information. Typically, a medical report from the proposed annuitant's doctor will be required. The underwriting department will use the information relating to the proposed annuitant's medical history and current health to establish an "impairment value."

The "impairment value" is the number of years that will be added to the proposed annuitant's actual age in order to prepare the annuity quotation. Different insurers will not necessarily arrive at identical "impairment values."

It is also possible that an annuitant could have an "impairment value" for purposes of an annuity quote, yet not be "rated" for purposes of acquiring a life insurance policy. Furthermore, an "impairment value" does not necessarily mean that an individual is uninsurable for purposes of acquiring a life insurance policy. The "impairment value" and "rating" can only be determined on a case-by-case basis, once the available medical information has been reviewed and the severity of the medical condition determined.

The insurer typically requires that the proposed annuitant bear the cost of providing the medical evidence. This is money well spent if it results in higher annuity benefits!

Advisors who are considering recommending an impaired annuity should review the policies and procedures that the insurer has in place with respect to guarantees. Some insurers will only issue impaired annuities having a minimum guaranteed period (typically 5 years).

Advisors should also ensure that they understand what happens upon the death of the annuitant. This is especially critical where an annuitant is impaired. The contract will contain the relevant information. For example, if an annuitant dies shortly after purchasing an annuity, but annuity payments have not yet started, the contract may provide that the insurer will refund the premiums, plus a stated interest rate.

Insurers may also offer guarantees. For example, in the case of a single life annuity, there may be a "life cash refund" option. Where this guarantee is purchased, an additional payment would be made if, at the time of death, the annuitant had not yet received annuity payments equal to the annuity purchase price. Here, the payment would be equal to the difference between the premium and the annuity payments already made.

Insurers may also offer "installment refunds." Here, a contract would provide that the sum of the guaranteed annuity payments is equal to the total premium paid with respect to the annuity. If, for

example, the annuity purchase price were $100,000, and payments were assumed to be $10,000 per annum, the annuitant would be guaranteed to receive 10 payments of $10,000 each. (Of course, the payments would continue if the annuitant lived more than 10 years.) If the annuitant died before he or she had received the 10 payments, the insurer would continue to make the $10,000 payments to a named beneficiary, with these payments only ceasing once the full $100,000 had been paid. If there were no named beneficiary, the estate would receive a lump-sum payment for the remaining amount of the guarantee.

II. Prescribed versus Non-Prescribed Annuities

a. General Considerations

Once an "impairment value" is established, the effect is an increase in the annuity payment. However, in addition to determining the appropriate guarantees to seek and so forth, the advisor still has another important decision to make. This is whether the annuity is to be issued on a prescribed or non-prescribed basis.

There are two editions of Taxing Issues you can refer to for more information. The first is *Taxation of Personally-Owned Non-Registered Prescribed Annuities* [PC 5998], which outlines conditions that must be satisfied for an annuity to qualify as a prescribed annuity, as well as with how it is taxed. Aside from the taxation aspects, the advisor will want to make sure that an annuity having the characteristics of a prescribed annuity is appropriate for the client. For example, since prescribed annuities cannot be indexed, is a prescribed annuity appropriate for a not-so-old client? A younger impaired client could still have a life expectancy of some decades and would want the inflation protection offered by an indexed annuity.

For information on non-prescribed annuities, refer to the *Taxation of Personally Owned Non-Registered Non-Prescribed Annuities* [PC 6000].

b. Taxable Portion Calculations

The Income Tax Act (Canada) (ITA) has very specific rules dealing with the calculation of the taxable portion of annuities. Many advisors urge their clients to acquire prescribed annuities because these are taxed on a preferred basis. Each annuity payment is comprised of a capital and interest portion. Once the insurer has calculated the proportions of the capital and interest for the entire contract, these proportions apply to all payments. This results in taxable income being levelized for the life of the contract. It also allows annuitants to predict what their tax liability will be.

When we contrast this with the taxable portions calculated for non-prescribed annuities, we see that the taxable portion varies on an annual basis. It is generally higher in the earlier years, and declines (perhaps to zero) in later years. (Of course, it may be reduced or nil in the first one or two years, as the insurer is offsetting the administrative expenses associated with issuing the annuity against the taxable portion.) Thus, the annuitant has his or her tax liability advanced. Since the taxable portion will vary for each year, the tax liability will also vary.

However, there is another tax requirement that advisors need to be aware of. Namely, when calculating the taxable portion for a prescribed annuity, the actual age and *not* rated age must be used. Thus, with impaired annuities that are prescribed annuities, the taxable portion will always be higher in dollar and percentage terms. You will see this from the following example.

Let's look at some calculations. Attachment 1 describes a 70-year old male. He has $100,000 for the purchase of an annuity. Let's first assume that he is not impaired. Let's further assume that his life

expectancy per the Society of Actuaries table is 13.76 years. Thus, if he were to purchase a monthly annuity with 0 guarantee, commencing in one month's time, his monthly benefit would be $705 ($8,460 annually).[1]

Let's look at the taxable portion calculation, assuming that the annuity is a prescribed annuity. The taxable portion would be calculated as:

$$\text{Annual payment} - \frac{\text{Single premium}}{\text{Life Expectancy}}$$

This works out to: $8,460 - $100,000/13.76, or $1,192. When we look at this as a percentage of the total annuity benefit, it is 14.09%. Thus, with a prescribed annuity we know that 14.09% is the taxable portion of each annuity benefit received.

If this same person purchases a non-prescribed annuity instead, the taxable portion would vary on an annual basis. On the policy anniversary date the insurer would calculate the amount by which the accumulating fund exceeded the adjusted cost basis of the annuity contract.

When we look at the percentage of the annuity benefit that would be included in taxable income over the first 5 years, it would be 22.82% (over 10 years – 30.06%, 15 years – 29.59%, 20 years – 27.16%). Thus, we see that in this particular situation, the income inclusion for the non-prescribed annuity is substantially higher than it would be for a prescribed annuity. Thus, if we were to decide the type of annuity to purchase based solely on its taxable portion, the prescribed annuity would be preferred.

Now let's look at what would happen if this individual were rated by 5 years. First, we see that his monthly annuity benefit would increase from $705 to $831. This is an increase of 17.9%.

Again, let's look at the taxable portion calculations. With a prescribed annuity, we again calculate the taxable portion as:

$$\text{Annual payment} - \frac{\text{Single premium}}{\text{Life Expectancy}}$$

At initial glance, one might think that in looking at life expectancy we could use the shortened life expectancy. However, the tax rules are very specific. The life expectancy must be based on a standard mortality table – the *1971 Individual Mortality Table*, as published in Volume XXIII of the *Transactions of the Society of Actuaries*.[2]

When we do this calculation, we see that the taxable portion goes up. It is important to realize that this will always be the case. The second part of the equation is meant to calculate how much capital is returned each year. We take the premium of $100,000 and divide it by the life expectancy. As stated above, we cannot vary the life expectancy. Whether the annuity is impaired or not, this second portion is calculated as $100,000/13.76, or $7,267. However, since the annual benefit has increased from $8,460 to $9,975, or by 17.9%, when we hold the second part of the equation constant, we see an increase in the percentage of the total annuity benefit that must be included in income to 27.15%.

Let's compare this with the portion that would have to be included in taxable income if the annuity were a non-prescribed annuity. In our case, over the first 5 years it would have been 17.99% (over 10 years – 23.06%, 15 years – 21.78%, 20 years – 18.68%). Thus, we see that in this particular fact situation, the

[1] For purposes of this example, we have assumed an annuity purchase date of January 18, 2007.
[2] See subparagraph 300(2)(a)(i) of the Income Tax Regulations.

income inclusion for the prescribed annuity is higher than it would be for a non-prescribed annuity. Thus, if with our fact situation we were to base our decision solely on taxation, the non-prescribed annuity would seem to be preferred. (We presume here that the client is willing to accept the fact that the taxable portion varies by year.) This may not always be the result. The outcome will vary, depending upon the age of the annuitant, as well as the amount of the impairment. It is necessary to do the calculations in order to arrive at the appropriate decision.

It is also worthwhile to consider what happens if the annuitant lives for many years. With the prescribed annuity, once the taxable portion has been determined, it applies for all years. This would be the case even where the annuitant lives beyond his or her life expectancy. However, with the non-prescribed annuity, the taxable portion could decline to and remain at zero in later years.

c. Why the Taxable Portion Matters

The taxable portion affects the annuitant's net and taxable incomes. The advisor will want to know the annuitant's estimated net and taxable incomes before recommending a prescribed or non-prescribed annuity. What somewhat complicates the decision is the fluctuating taxable portion for the non-prescribed annuity.

Net income is important, especially for taxpayers who are at least age 65, as it affects the Old Age Security (OAS) clawback, and also the availability of certain non-refundable tax credits (e.g. the Age Amount). (For seniors, if the "pension splitting" proposals as announced by the federal government on October 31, 2006 are proceeded with, couples may be able to reduce the OAS and Age Amount claw-backs.[3]) The net income is also important in a number of other calculations (GST rebates, certain provincial credits, etc.)

Where we are dealing with a senior who has a relatively low income, the senior may be able to offset any tax liability with non-refundable tax credits (personal credit, age credit, spouse or common-law partner credit, pension credit, etc.) Hence, while there is not a liability for income taxes as such, it is the net income that drives certain calculations.

We need to remember, however, that an annuity may still be preferred to other guaranteed investments (e.g., GICs). With concepts such as the Insured Annuity we see many seniors paying less tax on an annual basis than would be the case with interest from a GIC. For more information on the Insured Annuity, refer to our *Taxing Issues* document entitled *Insured Annuities* [PC 6062].

III. Summary

Annuities are flexible financial products that are appropriate for many individuals. Where an advisor has a client with a medical history that suggests an annuity may be available on an impaired basis, the advisor should discuss this with the client. The client may willingly incur the costs of providing the medical evidence, especially when there is the likelihood of having the annuity benefit enhanced. Of course this same client should also have a full understanding of the various provisions of the annuity contract relating to the guarantees.

[3] For an overview of the pension splitting proposals, refer to our *Taxing Issues* document entitled *The Proposed Pension Splitting Rules* [PC 6097].

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.

Attachment 1

FACTS:

Gender:	Male
Date of Birth:	January 15, 1937
Life Expectancy:	13.76
Impairment Value:	5 years
Premium:	$100,000
Guarantee period:	Nil
Premium Payment Date:	January 18, 2007
Annuity Commencement Date:	February 18, 2007

No Impairment									
	Prescribed Annuity				*Non-Prescribed Annuity*				
Monthly payment	$ 705				$ 705				
Annual payment	$ 8,460				$ 8,460				
Taxable portion (Annual)	$ 1,192				Varies by year				
Taxable portion (%)	14.09%				Varies by year				
Period	Taxable Portion		Cumulative Benefit	Taxable Portion	Taxable Portion		Cumulative Benefit	Taxable Portion	Difference in Taxable Portion
	For 5-Year Period	Cumulative			For 5-Year Period	Cumulative			
2007-2011	$ 5,862	$ 5,862	$ 41,594	14.09%	$ 9,490	$ 9,490	$ 41,594	22.82%	$ (3,628)
2012-2016	$ 5,962	$ 11,824	$ 83,893	14.09%	$ 15,729	$ 25,219	$ 83,893	30.06%	$ (13,395)
2017-2021	$ 5,962	$ 17,786	$ 126,192	14.09%	$ 12,123	$ 37,342	$ 126,192	29.59%	$ (19,556)
2022-2026	$ 5,962	$ 23,747	$ 168,491	14.09%	$ 8,426	$ 45,767	$ 168,491	27.16%	$ (22,020)

5-Year Impairment									
	Prescribed Annuity				*Non-Prescribed Annuity*				
Monthly payment	$ 831				$ 831				
Annual payment	$ 9,975				$ 9,975				
Taxable portion (Annual)	$ 2,708				Varies by year				
Taxable portion (%)	27.15%				Varies by year				
Period	Taxable Portion		Cumulative Benefit	Taxable Portion	Taxable Portion		Cumulative Benefit	Taxable Portion	Difference in Taxable Portion
	For 5-Year Period	Cumulative			For 5-Year Period	Cumulative			
2007-2011	$ 13,314	$ 13,314	$ 49,046	27.15%	$ 8,823	$ 8,823	$ 49,046	17.99%	$ 4,491
2012-2016	$ 13,540	$ 26,854	$ 98,924	27.15%	$ 13,984	$ 22,807	$ 98,924	23.06%	$ 4,046
2017-2021	$ 13,540	$ 40,393	$ 148,801	27.15%	$ 9,609	$ 32,416	$ 148,801	21.78%	$ 7,977
2022-2026	$ 13,540	$ 53,933	$ 198,678	27.15%	$ 4,696	$ 37,112	$ 198,678	18.68%	$ 16,821