INSURANCE

The Truth About Annuities

Annuities are one of the least known, least understood and most underutilized financial instruments. Yet as Paul Goldstein explains, in certain circumstances annuities should be considered as part of your retiring clients' overall financial planning strategy.

In the broadest sense, an annuity is defined as the right to receive fixed annual payments over a period of time. More recently the term "annuity" has been extended to include other payment frequencies as well as variable payments.

When annuities are paid for life, they are referred to as "life annuities" and are offered only by life insurance companies. When they are payable for a defined number of years, they are called "term certain annuities." These can be offered by life insurance companies and by other financial institutions such as banks and trust companies.

Statistics show that only a small percentage of registered retirement money goes to annuities. Most retirees think of a life annuity as a bad deal that leaves the issuer keeping the bulk of their investment should they die prematurely. However, in order to understand whether or not they are right for your clients, it's important to know about the different types of annuities, the role they can play in a client's retirement and estate planning, and the tax considerations involved in different annuity types and applications (see sidebar "Types of Annuities").

TYPES OF ANNUITIES

ANNUITY TYPES	TAX CONSIDERATIONS	ANNUITY PAYMENTS TYPE
Registered Annuities:		
(RRSP, RPP and DPSP)	All income payments fully taxable	Level, Indexed, Structured, Impaired
Non-registered Annuities:		
Prescribed: Individuals only	Partial level taxation: Reg. 304, Reg. 300 and Paragraphs 56 (1)(d) & 60(a)	Level, Structured, Impaired
Non-prescribed: Individuals & Corporations	Accrual taxation: Paragraph 12.2(1)	Level, Indexed, Variable, Impaired
Eligible annuity for financially dependent child or grandchild of deceased's registered plan holder.*	All income payments fully taxable. A 60 (L) receipt issued to child to offset the lump sum payment.	Level only

*Whereas all other annuities can be for life, this one is limited to the duration of not more than 18 years minus the child's age at the time the annuity was bought, with the minimum term of three years. The transfer and purchase must be completed in the year or within 60 days after the end of the year the refund of premiums is received. The payments from the annuity have to start no later than one year after the purchase.

The largest category of people for whom annuities apply is retirees (65 and older) who have converted their RRSP funds to registered retirement income funds (RRIFs). An RRSP holder who reaches age 71 has to convert his or her plan to income starting in the following year. Typically, this RRSP holder will have a spouse around the same age and would like to see their retirement income last as long as one of them is alive.

Case Study: RRIF versus Life Annuity

For illustration purposes, let's assume we are dealing with a male, age 71, and his spouse, age 69. Let's look at what his options are for retirement income.

If this retiree has a zero risk tolerance and wants to avoid seeing his retirement nest egg depleted in the face of a severe market downturn (remember 2008?), the best interest rate he can get on his money, if he opts for a RRIF, is around two per cent. Interest rates have been stuck at this level since the end of 2008, and it doesn't look like there will be a significant increase in the foreseeable future.

If the retiree wants to receive the minimum RRIF payments to make the income last as long as possible, he will have to withdraw 4.76 per cent in year one, based on his wife's age, five per cent in year two, and 7.38 per cent in year three, increasing annually thereafter.

Assuming that he has $1,000,000 to start with, with a RRIF his income would go from an annualized income of $47,767 in year one, to $48,744 in year two, to $69,750 in year three, and would reduce every year thereafter by an average of 4.5 per cent to $26,413 when he reaches age 95.

By comparison, in March 2013, a life annuity with a minimum guaranteed payout of 16 years, reducing thereafter by 50 per cent on the first death, would produce a level annualized income of $67,906 as long as both annuitants are alive.

This comparison shows that regardless of how long the annuitants live, they will always receive more income from the annuity. The minimum payment from the RRIF income falls behind the annuity payment starting in year one, and the income advantage of the annuity increases every year thereafter.

Should at least one annuitant live past year 16, the total annuity payments they receive will add up to $1,086,506 versus $847,178 from the RRIF. This is $239,328, or 28 per cent, more income from the annuity during the 16 years.

If both of them are still alive by year 20, they will have received total payments of $1,358,133 under the annuity versus $990,162 under the minimum income RRIF. In other words, they would receive $367,971, or 37 per cent, more from the annuity than from the RRIF.

If both of them are still alive by year 25, they will have received total payments of $1,697,667 under the annuity versus $1,135,741 under the minimum income RRIF. In other words, they would receive $561,926, or 49.5 per cent, more from the annuity than from the RRIF.

This income advantage of the annuity keeps growing regardless of how long they live, even if past age 100. If both are still alive in year 25, they will still receive $67,906.68 per annum from the annuity versus $26,413 from the minimum income RRIF. Five years later, at his age 100, the RRIF income would be down to $11,065 while the annuity income will still be $67,906.68.

It is clear that the longer these retirees live, the greater the advantage of the annuity over the minimum income RRIF. This case study shows that longevity can present a significant challenge with a RRIF, while it is an advantage with the annuity.

What would the comparison be like if the annuitant opted for a level income paying RRIF instead of minimum payments? As we have seen, based on current rates they could acquire a life annuity paying $5,658.89 monthly for an annual income of $67,906.68, guaranteed for 16 years, with payments reducing by 50 per cent on the first death after the guaranteed period. This means that as long as both annuitants are alive, they would continue to receive $67,906.68 per year.

By comparison, a RRIF paying the same level income would, based on today's interest rates, be depleted at the male's age 87, which would be his spouse's age 85.

Living Longer

On October 25, 2012, Sun Life Financial and the Canadian Association of Retired Persons (CARP) released the results of a poll that found that when it comes to longevity and retirement planning, 88 per cent of CARP members expect to live past age 80, with almost one-third expecting to live past age 90.

At that age, their income requirements usually increase due to the expensive elder care many may require. The poll also found that half of the respondents had not factored long-term care costs into their retirement plan, and approximately 40 per cent worried about outliving their savings.

While a RRIF might expire long before those polled do, an annuity, on the other hand, could provide them with a steady income for life.

Common Objections

The most common objection to the annuity is that in the event of death, there is nothing left for the surviving spouse. With the RRIF, however, there could be a substantial amount remaining for the estate. This has been the main reason why most people avoid annuities, opting instead for the RRIF.

The objection implies that all annuities terminate on the death of the annuitant. In reality, annuities can include guarantees that can be tailored to fit any specific retirement scenario.
Annuity payments can be guaranteed for a number of years, up to the annuitant's age of 90 for registered annuities. In our example, where the spouse is 69 years old at the start of the annuity payments, this guarantee could be for up to 21 years.

By using an annuity with a guaranteed period, you ensure a substantial refund in the event of the annuitant's death during that guaranteed period. In our case study example, we have chosen a joint life annuity guaranteed for 16 years.

If our 69-year old joint annuitant were to die at her life expectancy — i.e., age 86, when the guaranteed payments under the annuity have run out — and assuming that her husband predeceased her, there would be no further payout from the annuity. The RRIF, on the other hand, would have a balance of $338,353 payable to the estate. While this may appear to justify the objection, consider that the only reason there is still $338,353 left under the RRIF is because the RRIF payments during the previous 17 years were substantially lower than from the annuity (i.e., a total of $885,352 under the RRIF versus $1,154,413 from the annuity for a total difference of $269,061 in favour of the annuity.)

If we factor in the tax considerations, we have to apply the top income tax rate to the $338,353 as it is received in one lump sum and added as the deceased's income in the year of death. This would leave an after-tax balance of $181,323 for the heirs.

The extra annuity payments totaling $269,061 that were paid annually during the 17 years would have attracted a lower rate of tax, say 30 per cent, leaving a total net payment balance of $188,343, which is $7,020 more than under the RRIF.

If we also consider the fact that during those 17 years the couple enjoyed substantially more income from the annuity, and that this extra income was received long before the refund of premium from the balance remaining in the RRIF came into play, we can see that the annuity comes out as a superior solution even if both annuitants are deceased by year 17.

It's important to note that the annuity advantage over the RRIF increases with the age of the annuitant(s) when the annuity is purchased. For example, a 75-year old with $1,000,000 in RRIF assets would have to withdraw minimum annual payments starting at $78,500. These payments would reduce every year thereafter because of the high required withdrawal percentage that keeps eating into the capital. By year five, the RRIF income would be down to $67,800, by year 10 to $56,300, by year 15 to $46,550 and so on, while the annuity keeps paying $100,000 for life.

Income for Life

The main reason why life annuities generate the highest guaranteed lifetime income of all financial instruments is a unique feature called "insurance credits." It is possible to predict how many people in a large age group will survive each year. This predictability of annual deaths allows insurance companies to take on the risk of guaranteeing lifetime income. This concept is at the basis of all life insurance pricing. The life insurance industry has life expectancy tables for every type of annuity: single, joint, with and without guarantees.

The three components that make up each annuity payment are: interest, return of capital and insurance credits. Insurance credits derive from the fact that from the large pool of annuitants, some pass away before the average life expectancy. The unused balance of their annuity funds stays in the pool to fund those policy holders who live longer than the average life expectancy. For example, a 65-year old man who invests $100,000 today will receive an annual income of $6,446 for the rest of his life, of which 38 per cent is attributed to insurance credits. Without the pool, this would be impossible. You could not fund an annuity for life for one person only as you don't know how long that person will live.

So far we have shown that annuities can play a vital role in retirement planning when it comes to registered funds; the same can be said for non-registered funds.

Prescribed Annuities

A prescribed annuity is structured like any other annuity, and can be for a term certain or for life. It can be issued on a single life or joint life basis for spouses and siblings only. It is like a mortgage in reverse — in such instances, the lender is the policyholder and the borrower is the issuer of the annuity. The guaranteed payment period cannot exceed the single annuitant's or youngest joint annuitant's age 91.

Prescribed annuities are available to individuals only and not to corporations.

The Department of Finance changed the structure of an annuity for tax calculation purposes only. These changes were originally intended to provide a break for retirees 60 and over, by giving them a tax treatment that was different from the normal treatment of financial products. Rather than following the irregular downward slope of a non-prescribed annuity, the taxable income portion was changed to a level amount for the duration of the contract.

This level amount is the difference between the capital element and the actual annuity payment. The capital element is based on the actuarial duration of the annuity as determined by the 1971 Individual Annuity Mortality Table published in Volume XXIII of the Transactions of the Society of Actuaries.

For example, if the annuity premium is $1,000,000 — the annual annuity payments $70,000 and the prescribed duration 20 years — the capital element would be $1,000,000 divided by 20 (i.e., $50,000 per year). The difference between the capital element of $50,000 and the actual payment of $70,000 becomes the level taxable portion of $20,000.

As a result of this formula, the taxable portion becomes smaller as the annuitant gets older at the time of purchase. Eventually, around age 75, the taxable portion becomes zero, even though the annuity still contains an interest element. It is this artificial — but totally legal — tax and life expectancy treatment that makes it possible to create after-tax income levels that are otherwise impossible to achieve.

When it comes to the types of client who should consider prescribed annuities, generally it should be individuals or couples in their mid 60s or older who:
• need the confidence that their income will last for life;
• don't have the time horizon or the resources to recover from years of negative market performance;
• may want to protect their income against inflation with an automatically increasing income stream;
• may want to fund their life insurance coverage up front;
• may want to obtain the maximum income for life while preserving the capital for their estate, by combining the annuity with a life insurance policy; or those who
• may want to provide a steady income for dependent relatives who cannot be expected to handle their money responsibly.

Prescribed annuities can provide the highest guaranteed after-tax income of all retirement products, and can be constructed to fit any income objective funded by personal assets.

It's important to ensure your clients who are in the market for an annuity obtain the best return for their money on any given day. There is a general misconception that because all life expectancy tables should be the same and all financial institutions are facing the same long term interest rates, annuity income payments should be similar between different carriers given the same amount of premium. This is simply not the case. Carriers will base their annuity income levels, on any given day, on their need or desire to raise large amounts of capital. To achieve this they will raise their annuity rates. Once they reach their target, they will lower their annuity rates to discourage future annuity purchases. While finding the best annuity for a particular situation can take time, it can make a significant difference in the amount of income the client will receive.

All it takes to turn annuities into unparalleled financial benefits is a thorough knowledge of estate planning, a complete knowledge of annuities, an in-depth awareness of the relevant tax considerations — and the creativity to apply this arsenal effectively in particular situations. f

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TRUE STORY:
The Case for
Non-prescribed Annuities

On the surface, it might appear that non-registered, non-prescribed annuities have no place in financial planning as they don't benefit from the prescribed annuity tax treatment and they carry the general burden of the anti-annuity bias. This is why only two per cent of all non-registered annuities purchased in Canada are non-prescribed.

In our office, however, the number of non-prescribed annuities we have implemented is close to one-third of our annuity portfolio. Two years ago, we started a case where the client was 73 and his spouse 65. He had an active, incorporated business as well as a holding company with approximately $4,000,000 in real estate assets.

During one of our meetings, the client expressed an interest in estate and retirement planning. His mindset was that when he liquidates his corporate holdings, he will have about $4,000,000 of investable assets in his holding company. If I can get only two per cent on his money then he would only end up with only $43,500 of spendable income. The client felt they actually needed $120,000 of after-tax income from this money and wanted to preserve as much of the capital as possible for the estate while taking as little investment risk as possible.

The only way to achieve the client's objective was to turn the traditional investment paradigm on its head. One quarter of the $4,000,000 was allocated to acquiring a corporate-owned insurance policy for $4,000,000. This not only assured the client that the capital was preserved in the company but also that, if the second death occurred at life expectancy, the $4,000,000 would come out of the corporation on a tax-free basis. If the $4,000,000 had been left as a fixed income investment in the company, it would, on the second death, net only $2,700,000 to the beneficiaries ($2,697,200 at 32.57 per cent tax on non-eligible dividends).

Once the life insurance was in place, the strategy was secured. The balance of $3,000,000 has been used, as it became available, to purchase non-prescribed annuities, the payments from which will flow to the shareholders as taxable dividends.

The net result was that an after-tax income of $126,000 for life was generated for my clients, with $4,000,000 going tax-free to their children on the second death. The conventional way would have required a guaranteed lifetime, before-tax rate of return of 13.35 per cent in the corporation, to achieve the same results.
— Paul Goldstein