



# step up

Sales Tax Estate Planning Underwriting & Product Newsletter

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## Prescribed Annuities

### Introduction

*There is an increased use of prescribed annuities, either on their own or as part of a strategy like an insured annuity. What exactly are prescribed annuities?*

Prescribed annuities are defined in Regulation 304 of The Income Tax Act (ITA), which exempts certain annuities from accrual taxation where all growth is exposed to tax annually, regardless of whether that growth is paid out to owners of such contracts. While prescribed annuities can include annuity policies that are registered as RRSPs and DPSPs where all plan payments are subject to full taxation as income and income averaging annuities or contracts purchased with monies transferred from certain plans, when most people think of prescribed annuities, they refer to specific types of non-registered or open money contracts. This article will deal with this last type of contract.

Any individually owned annuity can qualify as a prescribed annuity contract. Certain conditions, described in Regulation 304(1)(c)(i)-(v), must be satisfied to create a scenario where taxation occurs:

- only on the payments from an annuity and
- on the basis that part of the payment is a return of capital

In fact, if payments from a non-registered annuity that meets the conditions outlined in the Regulation 304 have begun after 1986, then that annuity is automatically considered to be a prescribed annuity unless the owner notifies the issuer in writing that the contract is not to be treated as such. Income Tax Regulation 304 prescribes that certain annuity contracts be exempted from the accrual rules pertaining to income reporting, hence the term prescribed annuities.

### Terms and Conditions to be a prescribed annuity

1. Annuity payments have commenced in the taxation year or a preceding taxation year
2. The contract is issued by a life insurance corporation, a registered charity or a specified financial institution such as a bank, trust company, credit union or loan corporation other than a mutual fund corporation or a mortgage investment corporation



#### Peter A. Wouters is

Director of Tax & Estate Planning and Risk Product Marketing for the Empire Life Insurance Company.

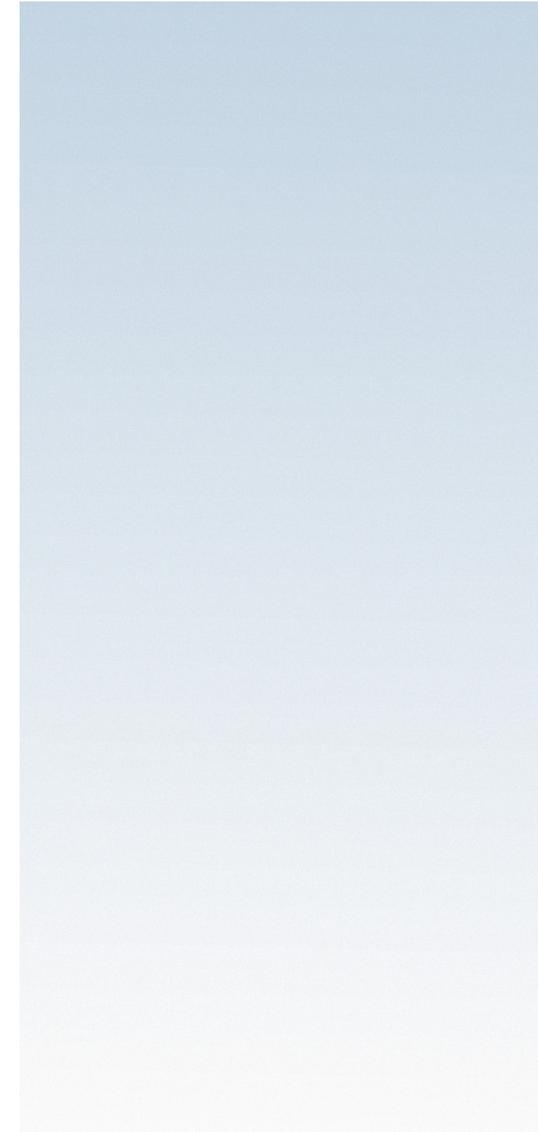
He devotes much of his time working with independent advisors, their affluent clients and other professionals, uncovering needs and presenting information and options aimed at improving their tax and legacy plans and lifestyle priorities.

He heads a team of accredited professionals providing case consultation, technical and advanced marketing support across Canada.

Peter can be reached at [peter.wouters@empire.ca](mailto:peter.wouters@empire.ca)



3. The holder of the contract is an annuitant and an individual, a testamentary trust, or a specified trust described in para. 104(4)(a) of the ITA (including a spousal trust, alter ego and joint partner trust) who dealt at arm's length with the issuer throughout the taxation year
4. Payments are regular, equal and paid not less frequently than annually; with the owner retaining the right to vary the frequency and payment amount in any taxation year as long as the present value of the total payments at the beginning of the year is the same.
5. Annuity payments continue for a fixed term or
  - a. 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 any of the spouse, common-law partner, or former spouse or common-law partner, brothers and sisters of the first holder or
  - b. If the holder is a specified trust, for the life of the spouse or common-law partner entitled to receive income from the trust
6. Where the payments are made over a guarantee period or fixed term, the guarantee period or fixed term cannot extend beyond the 91st birthday of:
  - a. The first holder of the contract
  - b. The younger of the first holder and the survivor in a joint and last survivor contract
  - c. The spouse or common-law partner entitled to receive income from the specified trust holding the annuity contract
  - d. The youngest beneficiary of a testamentary trust holding the contract
  - e. The younger of the holders of a jointly owned contract
7. No loans exist under the contract and the holder's rights cannot be disposed of until the death of the holder or in the case of a trust, not until the death of the spouse or common-law partner entitled to receive the income from the trust
8. No payments other than those described in Regulation 304 can be made out of the contract
9. None of the terms and conditions provide for any recourse against the issuer for failure to make any payment



## Exceptions

Notwithstanding the terms and conditions outlined above, Regulation 304(2) states that an annuity contract will not fail to be a prescribed annuity where the contract provides:

1. A decrease in the annuity payments of a joint annuity from the time of death of one of the annuitants
2. a lump sum amount on the death of the holder who dies at or before age 91 provided that the amount doesn't exceed the total of the premiums paid minus the total annuity payments made

3. a commutation of the outstanding payments of a term certain annuity or an annuity with a guaranteed period if the holder dies during the guaranteed period or fixed term
4. that on Dec. 1, 1982 and all subsequent times, the holder participates in the investment earnings of the issuer and the amount is paid out within 60 days after the end of the year in respect of which the amount is determined



The Department of Finance issued comfort letters on July 29, 2002 and June 27, 2003, addressing legislative inequities concerning the qualification of annuities as prescribed annuities under three scenarios.

1. held by alter ego trusts or
2. set up as joint and last survivor annuities held by joint partner trusts or
3. the annuity is a life annuity held by a testamentary trust.

The letters confirmed that under these scenarios, all other conditions under Regulation 304 being met, these annuities would qualify as prescribed annuities. The Department stated that from a policy perspective, these scenarios are appropriate and that it was prepared to recommend amendments to section 304 of the Regulations to apply after 2001 for alter ego trusts and for the 2000 and subsequent taxation years for both joint and last survivor contracts held by joint partner trusts and life annuities held by testamentary trusts.

## When is the annuitant the holder?

The annuitant under a prescribed annuity is deemed to be the holder of the contract where one of two scenarios exists:

1. The contract is held by another person in trust for the annuitant
2. The annuitant acquired the contract under a group term life insurance policy as a survivor benefit

This is covered under Income Tax Regulation 304(3). The following two sections of this regulation define respectively that an annuitant is an individual who is entitled to receive annuity payments under the contract and a spouse or former spouse is an individual who is party to a void or voidable marriage with the particular individual.

## Taxation of annuity payments

Payments from a prescribed annuity are included in a taxpayer's income in accordance with para. 56(1)(d) and 60(a). Total payments are level for the life of the contract, and the ratio of the capital and interest income portions of the payment remain the same, providing a measure of tax deferral in the early years and a constant, predictable taxable portion.

The determination of the capital portion of the annuity payment is determined under Regulation 300. The capital portion is deducted from income under para. 60(a) of the Income Tax Act. The net amount is reported on a T4A slip prepared by the issuer of the contract.



The capital portion is calculated as follows:

$$\frac{\text{adjusted purchase price X number of annuity payment received}}{\text{total payments}}$$

In the case of term certain annuities, the total payments is the sum of all the payments multiplied by the number of years over which the payments must be made under the contract. In the case of life annuities, the total payments sum is calculated by multiplying the annual payments by the life expectancy of the individual(s) who are the annuitants, using the 1971 Individual Annuity Mortality Table. The end result is that the tax is averaged out over the life of the contract.

## Other tax impacts

Since only the levelized, interest portion of annuity payments are reportable each year, prescribed annuities can trigger other benefits for holders of such contracts.

Compared to fixed income investments like term deposits and bonds, the gross income can be much higher, particularly at older ages, yet with correspondingly lower reportable or taxable income levels. This results in a lower addition to net income on T1 returns and more spendable income. It also means that there can be less of a negative impact to many government benefits that are net income tested, many most keenly felt by people age 65+. Net income tested benefits include Old Age Security, the Age Amount, Guaranteed Income Supplement and the Caregivers Amount. Prescribed annuity income received by people age 65+ is eligible for the Pension credit (ss. 118(3)), currently set at \$2000 (ss. 118(2)). Prescribed annuities also qualify as eligible pension income for income splitting purposes for recipients age 65+ (ss. 60.03(1) and 118(7)).

Finally, the reduction in reportable income as compared to fixed income benefits may serve to drop taxpayers a tax bracket, further improving net cash flows and reducing income taxes.



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