Taxation of Non-Registered Prescribed Annuities

For advisor use only

All annuity payments are subject to tax, but the tax treatment differs depending on the source of the funds used to purchase the annuity.

- **Registered contracts:** All annuity payments are 100% taxable.
- **Non-registered contracts:** Only the interest portion of the annuity payments are taxable.

Since the taxation of annuities purchased with registered plan assets is relatively straightforward, with all annuity payments being fully taxable, the following discussion will focus only on the taxation of non-registered annuity contracts.

Key tax distinction: prescribed vs. non-prescribed annuities

From a taxation perspective, non-registered annuities can qualify as either prescribed or non-prescribed.

- **Non-prescribed annuities:** Payments are a blend of interest and capital, with the interest portion taxed as it accrues over time. As a result, taxation is higher in early years and decreases over time.
- **Prescribed annuities:** Payments are a blend of interest and capital, with the interest portion taxed on a level basis spread evenly over the life of the annuity contract.

Please note that all RBC® Payout Annuities are classified as prescribed annuities.

Prescribed annuity taxation is generally more favourable than non-prescribed annuity taxation because the tax is averaged over the lifetime of the annuity, providing an element of tax deferral. The taxation of prescribed annuities is on a calendar-year basis, so your clients will receive a tax slip for the interest portion of all payments they receive in a calendar year.

Prescribed annuity contracts

To qualify as a prescribed annuity contract, a non-registered contract must meet all of the conditions set out in the Income Tax Regulations, defined by Regulation 304 of the Income Tax Act:

1. Annuity payments must have commenced in the current taxation year or in a previous taxation year.
2. The owner (holder) of the contract is the Annuitant and must be the person receiving all payments.
3. The annuity is issued by a life insurance company or another prescribed financial institution.
4. The owner must be an individual, a testamentary trust or a specified trust that throughout the year dealt at arm's length with the issuer.
5. The annuity payments are to continue for a fixed term, or:
   a) where the owner is an individual (not a trust), for the life of the owner (first holder) or until the later of the death of the owner (first holder) or the death of the survivor (spouse, common-law partner, brother or sister) of the owner (first holder); or

   b) where the owner (first holder) is a specified trust, for the life of the spouse or common-law partner who is entitled to receive the income of the trust.
6. The guaranteed or fixed term of the payments cannot extend beyond age 90 of the annuitant and cannot extend beyond the time at which the following reach age 90:
   a) for a joint life annuity, the younger of the owner (holder) and the survivor;

   b) for a specified trust, the spouse or common-law partner who is entitled to receive the income of the trust;

c) for a testamentary trust (other than a specified trust), the youngest beneficiary under the trust;

d) for a jointly owned annuity, the younger of the owners (holders).

7. There can be no loans under the contract.
8. The contract cannot be surrendered and payments cannot be disposed of other than on the annuitant's death, or for a specified trust, on the death of the spouse or common-law partner who is entitled to receive income from the trust.
9. All payments to be made out of the contract will be equal annuity payments made at regular intervals, but not less frequently than annually.
10. No payments can be made out of the annuity other than those specified by this Regulation.
11. The terms and conditions of the contract do not provide for any recourse against the issuer for failure to make a payment under the contract.

For additional information, please refer to Regulation 304 of the Income Tax Act.

How taxable income is calculated for RBC Payout Annuities

There are four steps we take to calculate the taxable income portion of your client's non-registered prescribed annuity payments:

- **Determine your client's capital contribution.** This will be the premium paid to purchase the annuity contract.
- **Calculate the number of annuity payments.** For a term certain annuity, this will be the number of years in the term multiplied by the number of payments to be made each year. For life annuities, the number of years of payment is estimated based on your client's life expectancy, using the 1971 Individual Annuity Mortality Table.
- **Determine the total amount of all expected payments.** We do this by multiplying the total number of annuity payments under the life of the contract by the amount of each payment.
- **Determine the capital element of each annuity payment.** We do this by dividing your client's capital contribution (step 1) by the total amount of all expected payments (step 3). We then multiply the annuity payment amount by this ratio to determine the amount of capital in each payment. The remainder that isn't capital is considered taxable interest income.

This process results in a blended payment of capital and interest in the same ratio for the life of the contract. This is more favourable than taxation on a non-prescribed basis since it averages out the amount subject to tax and includes an element of tax deferral.

Example of tax calculation

Let's say your client deposits $100,000 into a 10-year term certain annuity and receives annual annuity income of $15,000.

To determine the taxable amount, we would multiply the $100,000 premium by the total value of all payments over the 10-year period ($15,000 x 10 = $150,000). This would provide a ratio of 2/3 ($100,000/$150,000). We would then multiply the annual annuity payment of $15,000 by this ratio ($15,000 x 2/3) to arrive at the capital amount of $10,000 for each annuity payment. The remainder of each payment ($15,000 - $10,000 = $5,000) would be the taxable interest income.

Tax treatment upon the death of the holder

When your client dies and they are the owner of the annuity, there is no disposition of the contract for tax purposes and no tax consequences for your client's estate.

If your client holds a registered annuity and the named beneficiary is their spouse, the spouse steps into the shoes of your client and continues receiving payments, with the same taxable portion as was calculated for your client while they were receiving annuity payments.

If the beneficiary is someone other than a spouse, or for non-registered annuities, the beneficiary can commute the value of the future payments. This is considered a disposition of the contract. The beneficiary would be required to include any gain in their income.

The "gain" is simply the amount of money the beneficiary receives for the commuted contract minus the adjusted cost base of the contract. The adjusted cost base is generally the premium your client paid to buy the annuity less the capital amounts of all annuity payments that they received.

The taxation of prescribed annuity contracts is quite complex. It is important that your clients understand the implications and consider whether these criteria meet their needs.

For more information regarding RBC Payout Annuities, please:

- Contact your **RBC Insurance Sales Consultant** at **1-866-235-4332**
- Or visit **www.rbcinsurance.com/rbcpayoutannuity**

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84636 (03/2014)