RBC Wealth Management

Annuities and retirement: Top 5 things individuals need to know

Economists call it, "The annuity puzzle."

While annuities can provide guaranteed income for life, many Canadians are still reluctant to purchase them as part of their retirement income planning.

Purchased through a lump sum payment to an insurance company, annuities provide a pre-set distribution of income, usually on a monthly or annual basis.

"It's a good alternative for retirees who want predictability," says John W. Hamilton, Vice President and National Manager of Insurance Services at RBC Wealth Management Financial Securities Inc. in Toronto. "The idea of annuities is still foreign to a lot of people because they don't understand what they are."

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Investors are more familiar with Guaranteed Investment Certificates (GICs), which can be easier to understand and are more widely available; however, annuities can help address several challenges as part of overall retirement income planning.

Here are five things to know about annuities:

1. Annuities have a special tax status in Canada

Prescribed Annuities can provide tax efficiencies as the income is taxed based on a blend of tax-free return on capital and a prescribed portion of taxable income, which is embedded in the product.

"That tax is smoothed out over the life of the contract," says Mike Macoun, Vice President and Estate Planning Specialist at RBC Wealth Management Financial Services Inc. "Your tax on your annuity in year one is the same as in year 20."

For example, a 65-year-old male who buys a $1 million annuity at today's rates generates about $63,000, the majority of which is return on capital (based on an actuarial calculation of the typical lifetime of the annuitant). Of that, $14,000 is taxable each year. That compares to someone who buys a $1 million GIC at three per cent and pays tax on the entire $30,000 in interest income.

"Because it's a lifetime income, your rate of return on your annuity will increase the longer you live, because the payouts are continuing," says Macoun. "When you're calculating retirement income, you're always trying to find the highest income with the most tax-advantaged position. It's a matter of efficiency of the investment product."

Annuities can also be used for income splitting between a husband and wife, creating more tax efficiencies. "Not only are you getting a high income with a low taxation base, but you're also splitting it in two," says Macoun.

2. Annuities can be structured to rise with inflation

While one potential drawback of an annuity is their lack of liquidity, Hamilton notes some insurance companies offer indexed annuities, which means they're able to increase in value with inflation over time. That can lessen the worry some investors have that their annuity investment may erode as they age.

"That strategy offers investors some inflation protection," says Hamilton. Still, he recommends investors only use annuities on a portion of their portfolio, and leave the remainder in more liquid assets.

"Once you purchase an annuity it's a locked-in proposition," says Macoun. "You are releasing capital to an insurance company in exchange for an income stream for life."

3. Annuities can be held by your corporation

Many investors hold annuities in their corporations as a type of self-imposed pension plan.

Entrepreneurs, for example, may not collect a company pension, choosing instead to put their retirement savings into the business.

"Business owners who have retired and have a large amount of wealth in their company are looking for ways to provide a pension for their business assets," says Hamilton. "Annuities provide that vehicle, tax efficiently."

4. Annuities can be used for philanthropy

Annuities can be used to generate income in retirement, as well as support charitable causes as they may offer preferential tax treatment.

Gift annuities offer a fixed income alternative to people who consistently gift cash to charity. By purchasing an annuity a donor can seek to lower their taxable income, guarantee annual gifts and benefit from donation tax credits for those gifts. Only a portion of the payment is taxable, and it can provide a better return than a GIC or bond, says Macoun.

"The donor is able to realize the benefits of their money while living, and sees it being put to good use," says Macoun. "Of course they get a tax receipt, but most people aren't doing it for that reason."

With charitable insured annuities, donors give the ownership of the life insurance policy to the charity, while still receiving guaranteed fixed monthly income payments from the annuity, for life. Donors receive an annual tax receipt for the insurance premiums paid from the annuity. Only the income portion is taxable.

"That provides significant tax savings over a traditional insured annuity and higher annual income over a GIC, while at the same time providing a charitable donation," says Macoun.

5. Annuities offer solutions for estate planning

One key way investors can use annuities in estate planning is to maintain some control on how money is distributed to surviving spouses, children or grandchildren.

Annuities can be purchased for the surviving lifetime of the spouse, which is usually recommended if they are older, or for a specified term for children.

"People want to make sure their money is safe when passed down," says Macoun. "With kids, it gives the mother or father comfort," he says, as children cannot unlock the capital and potentially lose the income."

Purchasing an annuity as part of an estate plan can also be less expensive and logistically simpler than setting up a trust, as there are less active management costs for oversight, says Macoun.

Given the multiple solutions annuities can provide, Macoun says they should be part of the ongoing financial, estate and retirement income planning conversations between wealth managers and their clients.

"People change and so do their investments," he says. "Someone may not appreciate the benefits of an annuity in early retirement, but may feel differently five years later.

"Annuities should be part of any retirement-planning scenario."

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