Using Annuities to Create a Retirement Paycheque

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Under current Canadian tax rules, your age and immediate income requirements are the key drivers as to what will happen to your Registered Retirement Savings Plan (RRSP) in retirement. One of your options is to purchase an annuity.

Annuities are insurance products that provide protection against longevity risk – that is the risk that you may outlive your retirement savings. A life annuity pays you equal periodic amounts for as long as you live. You effectively ensure that you will receive a retirement paycheque for the rest of your life. In addition to being used as an option for a maturing RRSP, annuities can also be purchased with non-registered assets.

Annuities work like a life insurance policy in reverse. Instead of paying regular premiums to an insurance company that pays a lump sum upon your death, you give the insurer a lump sum of cash in return for regular income for a specific period of time (called a term annuity), or until you die (called a life annuity).

Annuities are more appropriate when you have fewer options and a lifetime need for income. Generally speaking, the decision to annuitize is a permanent decision and cannot be reversed. Therefore, it must be carefully considered. On the other hand, you no longer have to make investment decisions on an ongoing basis, and you cannot outlive your retirement fund.

An annuity can offer more than just a guaranteed lifetime income, it also allows you to draw a higher annual income from your assets than you might manage on your own, even if you earned the same rate of return. How is that possible?

The answer is that while you must base your payments on a single life – your own – insurers can base annuity payments on a pool of thousands of people. And they know that while some of these people will survive to their life expectancy and beyond, many others will not. So insurers can boost their payments by, in effect, transferring the money of those who die early to those who live longer.

Annuities may offer another advantage – tax effectiveness. While only the interest portion of the annuity payment is taxable, for certain annuities, this portion can be reported on a "prescribed" basis. Since a portion of the prescribed annuity payment is considered a non-taxable return of capital, this is attractive to taxpayers as it allows for the deferral of taxes on non-registered assets.

For clients who hold a significant portion of their portfolio in interest-generating investments and may be subject to the clawback of Old Age Security benefits, reducing taxable income could avoid some or all of that clawback.

There are, of course, some disadvantages. Annuity payments are usually fixed, leaving you vulnerable to inflation. Annuities aren't for people who require liquidity of capital since your capital is locked up and can't be accessed during the specified annuity term.

There is also the possibility that you can buy an annuity and die soon after. If that happened, your initial investment would be gone and you would have received very little income in return. Because of that risk, annuities are more suitable for those who expect to live long after the annuity purchase.

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There is a way to benefit from the advantages of annuities while minimizing the impact of the disadvantages. The key is to purchase annuities with only a portion of your portfolio, such as 20 to 40% of your assets, so that it provides an income stream for the rest of your life to help cover a part of your essential living expenses. The rest of your portfolio can be structured to provide growth potential and additional income as required. This approach can protect you from leaving yourself exposed to some of the risks mentioned earlier.

DIFFERENT TYPES OF ANNUITIES

There are many variations of annuities sold with varying degrees of complexity, but the following categories cover the basics:

Life Annuities

A life annuity pays you equal periodic amounts for as long as you live. In simple terms, you deposit a lump sum amount with an insurance company and, in exchange, they agree to pay you regular payments for as long as you live. Typically, these payments are made on a monthly basis, although they could be made quarterly or annually. You may choose to have a guaranteed period for your annuity, usually five, 10 or 15 years long. However, you can choose any number of years to a maximum of 90 less your current age. If you die before the guaranteed period has expired, the amount of the periodic payments you were receiving will continue to be paid to your beneficiary to the end of the guaranteed term, or it can be paid out to the beneficiary in one discounted lump sum payment. Typically, your beneficiary can choose the payment option that is most advantageous to them.

It is important to understand the guarantee on life annuities. These guarantees do not mean that all of your RRSP funds will be paid out over five, 10 or 15 years. The annuity payments will be made for the guaranteed period or your lifetime, **whichever** is longer. You cannot outlive a life annuity. The monthly income from an annuity is related to three major factors – your age, your sex, and the current rate of interest at the time of purchase.

Joint and Survivor Annuities

A joint and survivor annuity will pay you and your spouse an amount for as long as either of you is living. On your death, income will continue to be paid to your spouse until they pass away. With this type of annuity, if both you and your spouse die before the end of the guarantee period, your beneficiaries will have the choice of accepting a lump sum payment, or receiving periodic payments for the balance of the guarantee period. However, if the joint and survivor annuity is purchased as an RRSP settlement option, the only option for the beneficiary is the discounted lump sum payment. The income from a joint and survivor life annuity can remain constant for both lifetimes. However, you can choose to have the annuity payments reduced by a specified amount on the death of one of the annuitants. This will have the effect of increasing the initial payments (before the first death) to a higher level than if the annuity payments were non-reducing. This might well coincide with the reduced living costs of the surviving spouse.

Please consult your licensed insurance advisor for more information on annuities and how they can work in your retirement income plan. RBC has a lineup of retirement solutions to help you make your savings last, so you can retire with confidence.

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