FTR Now

Annuitization of Supplementary Pension Benefits: Less Favourable Tax Treatment Arrives January 1, 2017

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On January 1, 2017, changes to Canadian tax rules come into force that will impact how certain annuity payments are taxed. For prescribed annuities purchased after that date, more of each payment will become taxable as a result of these changes. Accordingly, employers who offer supplementary pension plans and are considering settling supplemental benefits in the coming years may wish to consider annuitizing current and deferred pensioners, where permitted, before year's end with a view to preserving more favourable tax treatment for pensioners and, in some cases, reducing employer settlement costs.

In this *FTR Now*, we discuss these pending changes and their potential impact on employers and pensioners.

Background

In Canada, supplementary pension plans fall outside the regulatory framework that applies to registered pension plans. As a result, employers have broad latitude to determine how they wish to deliver supplemental pension payments. Employers typically either establish a trust from which supplementary pensions are paid, or pay supplementary pensions from general revenues (sometimes with a trust being put in place to secure benefits). In other cases, annuities are purchased to satisfy the benefit promise under supplementary pension plans.

An annuity is a financial product under which a financial institution (typically, an insurer) contractually undertakes to make periodic payments to the annuitant in exchange for receiving the specified premium. Annuity payments can be paid for a fixed number of years, for the annuitant's life, or for the joint lives of the annuitant and another person (typically, a spouse).

This *FTR Now* is relevant to employers who are considering settling supplementary pension obligations by purchasing individual prescribed annuities for pensioners.

Tax Treatment

Very generally, payments from a pension plan are usually taxed in the hands of the pensioner at the time of payment. In relation to registered pension plans, the "annuitization" of pension payments is not a taxable event, either because the annuitization occurs within the pension fund (i.e. the trust, not the member, holds the annuity contract), or due to provisions of the *Income Tax Act* (Canada) (ITA) that provide for tax-free "roll-over" of registered pension plan benefits. In relation to supplementary (non-registered) pension plans, the purchase of an annuity with the employer as the policyholder and the annuity held or deemed to be held within a retirement compensation arrangement, is also a non-taxable event for the individual supplementary pension plan member.

In contrast, the settlement of supplementary pension benefits through the purchase of a prescribed annuity held directly by the member is a taxable event. In such cases, the premium paid to the insurer for the future annuity payments is generally taxable in the hands of the pensioner. Once the annuity is in pay, a portion of each annuity payment is considered a return of capital (i.e. the capital being the premium paid to purchase the annuity). The remainder of each annuity payment represents taxable income to the annuitant. The ITA provides the annuitant/pensioner a deduction for the portion of each payment that is considered a return of capital. As a result, the annuitant/pensioner is only taxed on the net amount – that is, the portion of

each annuity payment that represents income.

The regulations under the ITA prescribe rules for calculating the portion of each payment under a prescribed annuity that represents a return of capital. Under those rules, the same portion of each annuity payment is deemed to represent a return of capital such that the taxable portion of each payment remains level over the period during which the annuity is in pay.

Changes Coming January 1, 2017

The return of capital portion of each annuity payment from a prescribed annuity is calculated based on the annuitant's life expectancy which, in turn, is determined using actuarial mortality tables. For this purpose, the ITA regulations currently incorporate mortality tables established in 1971. Since then, life expectancy in Canada has improved substantially. As a result, the 1971 mortality tables underestimate current life expectancy and overstate the deductible return of capital portion of annuity payments compared to current life expectancy.

Effective January 1, 2017, the ITA regulations will incorporate updated mortality tables, established in 2000, for the purpose of calculating the return of capital portion of payments under a prescribed annuity. The new rules will apply to annuities purchased on and after January 1, 2017. The 1971 mortality tables will continue to apply to annuities once they come into pay, if the terms of the annuity were fixed and determined before 2017, even if payments do not commence until a future date. For example, if an annuity is purchased in 2016 for an employee or former employee whose pension payments will not start until 2017 or later, the return of capital portion of payments made under that annuity will be calculated using the 1971 mortality tables.

One result of this change is that it is expected to be more advantageous to an annuitant/pensioner to have an annuity purchased prior to January 1, 2017. In certain circumstances, the employer's cost of settling supplemental pensions using prescribed annuities may increase after January 1, 2017 because more of each annuity payment will be taxable to the pensioner/annuitant. Specifically:

- where the employer is required to provide a tax gross-up payment to the pensioner/annuitant to mitigate the tax impact to him/her at the time a prescribed annuity is purchased; or
- where the supplemental pension plan provides that commuted value payments must be calculated taking into account the tax consequences to an individual who uses the funds to purchase a prescribed annuity.

In light of this, employers who have been considering settling supplemental pension benefits through annuity purchases in the coming years may want to expedite the purchase in order to allow annuitants/pensioners to take advantage of the current regime and, where applicable, to reduce the costs to be borne by the employer or the supplementary pension plan associated with annuity purchases.

Be Ready

For a host of reasons, annuity purchases can take several months to implement. At the outset, it will be necessary to work with legal counsel to determine whether an annuity purchase is permitted under the terms and conditions of the particular supplementary pension arrangement. Where member consent to an annuity purchase is required, it will be necessary to determine whether members must be given other options in addition to an annuity purchase.

From a governance perspective, it will be necessary to obtain any necessary approvals from the persons or committees authorized to do so. In most cases, an employer (acting on its own, or with the assistance of a consultant) will want to solicit bids from a number of insurers to obtain the most favourable pricing, among other reasons. Where the proposed annuitant population includes former employees, it may take time to locate individuals and obtain current contact information. It will also take time to prepare and communicate options to members, allow them time to seek financial advice regarding their options (if applicable) and complete the required forms.

Conditions in annuity markets necessarily change over time. Insurers who have unused capacity to underwrite annuities may offer annuity purchase rates more favourable than rates offered only months earlier. For this reason, if an employer has decided to annuitize supplementary pension obligations, it can be highly advantageous for an employer to do the “groundwork” in advance, with a view to quick implementation should favourable market conditions materialize.

With four months left in 2016, employers who have supplementary pension liabilities that they wish to annuitize should take prompt action to consider the implications of the changes to the tax rules for prescribed annuities that are coming into force on January 1, 2017.

If you have questions about these changes or would like assistance with a matter, please contact any member of the Hicks Morley Pension, Benefits & Executive Compensation Group.

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