
Life Annuities – an Income Solution for Life

If your financial objectives include retirement planning, you are likely concerned with not only the portion of fixed income investments in your portfolio, but also with how much income these investments will generate for you in retirement. It is important to analyze the cash flow these fixed income investments will generate and how they will integrate with the rest of your retirement strategy. That being said, product allocation can be as important as asset allocation when it comes to ensuring you will have enough in retirement to achieve your financial goals and needs.

Guaranteed Lifetime Retirement Income

In retirement you will likely face three key risks:

1. The risk that you will outlive your retirement savings.
2. The risk that market downturns will irreparably reduce your wealth.
3. The risk that inflation will reduce the buying power of your income.

A life annuity is one of the few ways that investors can guarantee lifetime income, with potential tax benefits and possible protection from inflation. An annuity is purchased as a one-time deposit with an insurance company. In exchange for the deposit, the insurer makes regular payments to you that include both interest and principal. In the case of a life annuity, you will receive payments until your death. The amount of income provided by a life annuity is generally determined at time of purchase and depends on a number of factors including:

- > The amount of money deposited;
- > Current interest rates and long-term bond rates;
- > If payments are to be indexed;
- > Sex, age, and, gender;
- > The number of years for which the income payments are guaranteed;
- > If Joint Annuitant is selected (usually setup between spouses);
- > If payments have been set up to reduce;
- > If there is a deferral period before the insurance company is to start providing income payment.

If you choose a payment guarantee option and if the annuitant should pass away before the end of the guarantee period, your beneficiaries will receive one of the following benefits depending on the type of contract:

1. Payments until the end of the guarantee period; or
2. A commuted value will be paid. However, choosing a longer guarantee period will reduce the amount of income produced.

Other Benefits of Life Annuities

Opting to Receive a Commuted Value of your Pension

It is important to have a full review completed in regards to the income you will receive from your pension at retirement. Many pension plans give their members the right to leave the pension plan and receive a commuted value. A life annuity is one investment option for the commuted value of your pension that may better help meet your retirement objectives.

Taxation of Annuity Payments

For life annuities purchased with non-registered assets, only a portion of the income you receive is considered taxable interest income - this is due to a portion of the annuity payment being considered a return of your original capital. For those individuals who are age 65 and older, the taxable income from an annuity generally qualifies as pension income and therefore may qualify for the Pension Income Tax Credit and for income splitting between spouses.

Inheritance Management

An annuity can be used to allow the gradual transfer of an inheritance through pre-scheduled payments, rather than your beneficiary receiving the inheritance in a lump sum.

Concerns with Life Annuities

Loss of Capital

The purchase of a life annuity cannot be reversed. No capital is returned at the end of the contract, unless you select a cash refund option which will provide a lump sum payment to your beneficiary (equal to your original investment less the income you have already received) or have chosen a guaranteed period.

Loss of Control of Assets

Although investing in a life annuity will mean you lose the capital that is used to purchase the annuity, you gain the benefit of a guaranteed stream of lifetime income, which will not be affected by market fluctuations. Investing a portion of your fixed income assets in a life annuity can help to provide financial security without the need for ongoing investment decisions.

Inflation

A level payment life annuity will not keep up with inflation, so if inflation is a concern, you may wish to index your annuity so that your income payments could increase to assist in offsetting inflation.

Security of Annuity Guarantees

It is understandable that you may be wary of any financial product offering a guarantee. There are many safeguards in place for insurance policy holders in Canada. Since an annuity is an insurance product, the income payment has a degree of protection beyond the stability of any given insurance company.

All life insurance companies operating in Canada must adhere to the guidelines imposed by the Office of the Superintendent of Financial Institutions (OSFI) regarding capital reserve requirements to ensure the insurance company has sufficient resources to satisfy obligations to its policy holders. However, if despite OSFI's best efforts a Canadian insurer does file for bankruptcy, other insurers would likely purchase the bankrupt company's assets and take over administration of their contracts.

Assuris, a not-for-profit corporation funded by the life insurance industry itself and of which all life insurance companies in Canada must be a member, also protects Canadians against the loss of benefits due to the financial failure of a member company. Assuris guarantees that Canadian citizens and residents with policies from Assuris member companies will retain at least 85% of the promised benefits under a variety of products and also provides 100% protection when benefits are below certain dollar values. Full details can be found on Assuris' web site at www.assuris.ca.

How much to Annuitize and When

Determining how much of your conservative fixed income assets in your portfolio should be annuitized depends on a number of factors. Assess your projected cash flow in retirement by comparing your retirement income from fixed sources, including defined benefit pension, CPP, and Old Age Security, to your living and lifestyle expenses. If you determine there is a gap, you may wish to consider a life annuity.

If you are retiring now and due to the current market conditions you are concerned with the prospect of using your assets to purchase a life annuity, you may wish to annuitize a smaller portion of your fixed income portfolio now to guarantee some income and consider annuitizing more of it later, when markets are more favourable. You may also wish to wait until you are older before receiving annuity income, for the older you are the higher the income you will receive, or wait until you are 65 to potentially take advantage of the Pension Tax Credit and income splitting opportunities.

Product Diversification with Life Annuities

Life annuities are an investment option that can provide diversification to your fixed income product allocation in retirement, providing guaranteed income to help you live the retirement you planned. Life annuities can assist in managing your living and lifestyle expenses – for the rest of your life.