RRSPs at Retirement: Should I Opt for a RRIF or an Annuity?

RRIFs and LIFs

What is a RRIF and How Does It Work?

People saving for their retirements often make use of a Registered Retirement Savings Plan (RRSP). Deposits made to an RRSP and the investment income they generate accumulate tax-free.

RRSPs are not an open-ended tax shelter where funds can be sheltered from taxation for an entire lifetime. By no later than the end of the year that you turn age 71 your RRSPs must be:

a) converted into a Registered Retirement Income Fund (RRIF)
b) used to purchase an annuity (discussed in the next section)
c) converted to cash, with a resulting huge single-year tax bill

or some combination of the above.

A RRIF uses the funds from an RRSP to provide regular income payments during retirement. Just like with an RRSP, the RRIF holder maintains controls of the investments, allowing you to hold a wide array of investments. Investment earnings within the RRIF continue to accumulate on a tax-sheltered basis but withdrawals are required by legislation and are taxed as income.

Once a RRIF is opened, withdrawals must commence in the following year. The Canada Revenue Agency prescribes an annual minimum withdrawal amount, which depends on your age and market value of the RRIF at the beginning of the year. For example, if you are currently age 72 and you hold a RRIF valued at $10,000, then you must withdraw at least $748 or 7.48% from your RRIF during the year. At age 73, you must withdraw at least 7.59% of the start of year balance and so on. The RRIF calculator on the **RetirementAdvisor.ca** site helps you determine how much you must withdraw from your RRIF.

An individual may hold several RRIFs with different financial institutions. At any time, funds held in a RRIF can be used to purchase an annuity from a life insurance company.

What is a LIF?

A Life Income Fund (LIF) is basically a RRIF for funds that were originally held in a locked-in RRSP or a registered pension plan. Like a RRIF, the Canada Revenue Agency prescribes an annual minimum withdrawal, which is based on age and the market value of the LIF at the beginning of the year. Provincial legislation requires that the annual withdrawal does not exceed a maximum based on age, the value of the LIF and long term interest rates.

As with an RRSP or RRIF, funds in a LIF are tax-sheltered until withdrawn.

What is an Annuity?

An annuity is a product that pays a steady stream of income to the investor.

The annuity holder makes an up-front investment. In return, the annuity provider makes regular payments (typically monthly) back to the annuity holder.

There are two major types of annuity:

1. Term-certain (or fixed-term) Annuities

This type of annuity guarantees you a set monthly income for an agreed number of years. If you die before you receive all your payments, then the remaining payments continue to go to your estate.

2. Life Annuities

Life annuities provide you with a guaranteed regular income for the rest of your life, no matter how long you live. A life annuity can be purchased for a single life, or as a joint and survivor life, which is based on the lives of two people. In addition, life annuities can be purchased with or without a minimum guarantee period.

The amount of retirement income you receive will depend on several factors, including age, gender, number of lives involved and whether or not there is a guarantee period.

Why Purchase an Annuity?

Annuities take the uncertainty out of converting your retirement savings into reliable monthly retirement income. Once you have purchased the annuity, you don't have to decide how to invest your retirement savings. You don't have to worry about stock market volatility. You don't have to worry about selecting which investments to sell from your retirement savings portfolio every year. If you purchase a life annuity, then you don't have to worry about outliving your retirement savings because the life insurance company guarantees your monthly annuity payments as long as you live.

What options are available for a Life Annuity?

Joint Life Annuities

The simplest form of life annuity guarantees a monthly payment for as long as that beneficiary lives. However, retirement savings are often accumulated to support a couple in their retirement so there is a special type of life annuity called a Joint-Life Annuity. With a joint-life annuity, the insurance company agrees to continue making monthly payments as long as either spouse continues to live (you may opt to reduce the monthly amount paid by an agreed amount once the first spouse has passed away). There is a cost for this increased security. Based on current quotes, a joint-life annuity will pay 15% to 25% less per month than an annuity on the single life of a man or 7% to 15% less than an annuity based on the single life of a woman. The older the couple is, the greater the payment reduction in purchasing a joint-life annuity compared to a single life policy.

Guaranteed Minimum Annuity Payment Periods

Another concern that people purchasing a life annuity have is: what happens if I die shortly after purchasing my annuity? It may not seem fair to pay a large amount for an annuity and only receive a fraction of that sum back in monthly payments before dying and having the annuity payments expire.

To deal with this concern, insurance companies offer the option of guaranteed minimum annuity payments from 5 years up to 25 years. If you die before the guaranteed period has finished, then the insurance company continues to make annuity payments to your estate until the end of the guarantee period. If you survive longer than the guarantee period, then your annuity payments will continue for as long as you live.

The catch? In order to have the guaranteed minimum payment period for your life annuity, you will receive lower monthly annuity payments. Using current annuity quotes, we compared the monthly annuity payout for a life annuity with and without a guaranteed minimum payment period. The two tables below shows the cost of the guarantee, in terms of the reduction in monthly annuity payments.

10 year Guaranteed Life Annuity: Reduction Compared to No Guarantee

Age when Annuity purchased	Male	Female
age 60	1% reduction	0.5% reduction
age 70	7% reduction	3% reduction
age 80	18% reduction	12% reduction

As the above table illustrates, a guaranteed minimum payment period costs more when you buy your annuity later in life. The longer the guarantee period you opt for, the more it reduces your monthly annuity payments.

Inflation Protection

Another concern for people purchasing an annuity is that standard annuities pay a fixed amount every month for the length of the annuity. Even if inflation were to remain comparatively low for your entire retirement period, your effective retirement income could still be seriously impacted over time.

Someone who purchased an annuity at age 65 and saw an average inflation rate of 2.5% per year would find that annuity payments 20 years later were worth only 61% of what they were when the annuity began. That's nearly a 40% reduction in actual purchasing power. In the event that inflation averaged 5% over the same period, annuity payments would be worth only 38% of what they were in the beginning in real terms. Average inflation of 8% would reduce the payments to 21% in real terms, 20 years on.

To deal with concerns about inflation, some insurance companies offer inflation-protected annuities. With these annuities, you receive an initially lower monthly payment compared to an ordinary annuity but the monthly payments are guaranteed to grow with inflation so the effective value of your payments will not erode over time.

Is An Annuity Really That Safe?

An insurance company selling annuities is making the guarantee to continue the annuity payments for the agreed term. Until recently, few would have thought it possible that a major insurance company would be unable to meet its obligations. With some near failures of major American insurers, the inconceivable has become a real consideration.

In Canada, the life insurance industry has its own association called Assuris to protect consumers in the event of a life insurance company failure. In the event of the failure of your life insurance company, Assuris guarantees that at least 85% of an annuity benefit will be provided by a solvent life insurance company. Please refer to the article on Assuris on **RetirementAdvisor.ca**'s site.

RRIF vs. Annuities

The table below reviews the implications of funding your retirement with a Life Annuity compared to a RRIF.

	Life Annuity	RRIF
Guaranteed Payment	Yes – monthly payments are guaranteed for life. During periods of low interest rates, the guaranteed payments offered may be much less attractive.	No – bonds and especially stock prices are volatile so the value of your investment and eventual payouts are not known with certainty.
Inflation protection	It depends. Most annuities offer equal monthly payments with no inflation protection. If you're willing to accept lower initial payments, then you can purchase an inflation-protected annuity.	It depends on your choice of investment. A well-diversified portfolio will give you the opportunity to keep pace with or beat inflation but it will depend on your investments and their performance.
Withdrawal flexibility	No – once the annuity is purchased and the monthly benefits are set, it does not change.	Yes – you can withdraw funds, subject to your needs and minimum RRIF withdrawal limits. Those holding a LIF will be subject to provincial maximum withdrawals, however.
Conversion	No – Normally not allowed. In the event it is, there would be a significant penalty involved.	Yes – a RRIF can be converted to an Annuity at any time. Certain investment holdings (e.g. GICs) may force you to wait until maturity to access funds or face penalties.
Minimum age	No – there is no minimum age to purchase an Annuity. You must convert your RRSP by the end of the calendar year in which you turn 71.	No – there is no minimum age a person can create a RRIF. You must convert your RRSP by the end of the calendar year in which you turn 71.
Tax Implications	If the annuity was purchased using registered funds, then regular annuity payments are taxed as regular income.	Investment earnings continue to accumulate on a tax-sheltered basis but RRIF withdrawals are taxed as income.
What if I have a short-lived retirement?	With a standard life annuity, payments stop when you die so you may pay more for the annuity than you receive in monthly payments. If you are willing to accept lower monthly payments, then you can buy an annuity that includes a joint-life option and/or a guaranteed minimum payment period.	Upon death, the remaining value of your RRIF can be transferred to your spouse or your estate.
Could I outlive my retirement savings?	No - with a life annuity, payments are guaranteed as long as you live.	Yes - depending on how your assets perform and how much you withdraw each year, you could run out of money.
Spousal protection	It depends. A joint-life annuity must be specified at the time the annuity is purchased and it will reduce your monthly annuity payment.	Yes – Upon death, the value of the RRIF can be transferred to the surviving spouse's own plan on a tax-sheltered basis.

Conclusions

RRIFs and Annuities each have their own advantages and disadvantages.

An inflation-protected life annuity with a guaranteed minimum payment period should provide you a safe guaranteed income with little ongoing effort, once the annuity has been purchased. However, you may find the annuity payments are disappointingly meager, especially in times of low-interest. In order to provide a reliable stream of income to you, insurance companies generally rely on lower-risk and lower-yielding investments and that is reflected in what you will receive in annuity payments.

A RRIF lets you manage your own retirement assets, along with all the associated risks and benefits that implies. If you are confident that your current assets, including your RRIF assets will be more than adequate to fund your retirement, then the flexibility of a RRIF will probably be more appealing to you.

If you find that monthly annuity payments would be inflexible and lower than desired but you're not sure that you want to manage all your own assets in a RRIF, you may decide to allocate some of your funds to purchase an Annuity while retaining other funds in a RRIF for more flexibility and control.

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