



Leaving your employer – Should you Commute Your Pension Plan?

Mackenzie Tax & Estate Planning

In past years when an individual changed employers, it was pretty much an accepted practice to leave their defined benefit pension plan with the original employer, knowing that a pension would be received in retirement. With the economic downturn, many pensions are either being discontinued, or may not have ample funding available to pay out all of the expected pension benefits. Many employees who are given the choice to commute or keep their existing pension are giving serious thought to commuting the pension. There are pros and cons to each alternative and therefore there is no one size fits all solution. Rather, the best decision will be based on the plan features and individual circumstances among other factors. This paper outlines some considerations you should discuss with your financial advisor before making a decision.

What is a Defined Benefit Plan?

This type of pension is offered by employers and promises to pay a pre-determined monthly pension benefit when you retire until your death or that of your surviving spouse or common-law partner. This is different from a defined contribution plan or your own Registered Retirement Savings Plan (RRSP) where future benefits are not pre-determined, but rather are dependent on contribution history and investment performance. Pension benefits are determined primarily based on your years of service, average annual earnings, and various assumptions relating to expected lifespan, retirement age, inflation and anticipated investment returns of the plan.

What are your pension options?

When leaving your employer, part of the information provided to you will be available options for your employer retirement plan. If you participated in a Defined Contribution Plan or a Money Purchase Plan where you decided how much of your income would be contributed to your Group Plan, the option will usually be to move the plan to your own personal Locked-In Retirement Account or purchase an annuity that would provide a lifetime benefit. A Defined Benefit Pension is a different issue. Based on your lifestyle and your employment in the future, you may wish to “commute” or take the value of your pension out of the Plan and invest it with your financial advisor. Which option is better depends on your own specific needs.

There are several situations where it would likely make sense for you to remain in the pension rather than taking the commuted value. If you expect to live longer than the average person it would likely be worthwhile for you to remain in the pension because it ensures that you do not outlive your pension. If you were to take the commuted value of your pension and then lived a long time, without ongoing planning it is possible that you could outlive the assets in your account. If on the other hand you remained in the pension your pension benefit is guaranteed until you pass away.

Another situation where it would make sense for you to remain in the pension is if you would feel more secure knowing you will always receive a

fixed dollar amount for life. You know with a pension that the amount you have been promised will generally continue for life. This allows you to budget and know exactly how much you will be receiving on a monthly basis. If you were to take the commuted value your account balance can fluctuate on an annual basis depending on market performance and as a result your monthly income from the account may fluctuate as well. By remaining in the pension you do not have to worry about these fluctuations and know you will have a set income every month.

Another point to consider is market performance. If you do not believe you can consistently earn investment returns greater than what is assumed in the commuted value calculation then sticking with the pension will likely make more sense for you.

If you decide not to commute your pension, it is important to keep in mind that the downside of this decision is there are usually no pension assets to leave your children or grandchildren on your death or that of your spouse or common law partner.

If the factors mentioned above are not a concern for you then you may want to consider commuting your pension. Commuting is a good option for many people, but there are some points you need to keep in mind. To begin with, if you go this route you should be aware that the maximum withdrawals may be lower than the pension benefit would be if you stayed in the plan. This happens because when you commute the pension the proceeds are deposited to a Life Income Fund (LIF) and the minimum and maximum payouts are dictated by your age and the LIF payout tables. Speak with your financial advisor to compare payouts if you are considering this route.

Once you take the commuted value of your pension how the pension performs and the assets you accumulate in your account will be based on market performance. It is possible that you may outlive the assets in your account if you live longer than the average person and/or experience poor market performance. It is necessary to be aware of these risks before you commute your pension.

Now that you are aware of the risks it is important to say that many investors find that having more control over their pension monies outweighs the added risk. If you feel the potential rewards of commuting your pension outweigh the risks it would be worth speaking with your financial advisor about the opportunity to take the commuted value of your pension.

Commuting a Pension – How much can be transferred?

One option that may be provided to you when you leave your employer is to 'commute' your pension and take it with you. The commuted value is the present value of your future pension benefit. Several factors are taken into account when calculating the commuted value of a pension, including your years of service, average salary; your age; supplementary benefits; special allowances; current interest rate and the current inflation rate.

Your employer will provide you with your commuted value when you leave the company. A portion of the commuted value can be transferred on a tax-deferred basis to a Locked-In Retirement Account (LIRA) or a Life Income Fund (LIF). No RRSP contribution room is required in order to transfer these amounts. The maximum that can be transferred is determined by the Income Tax Act, and is known as the maximum transfer value. The formula is as follows:

A x B – This is the maximum transfer to a locked-in plan

Where:

A is the annual retirement benefit

B is a present value factor

(defined by the federal Income Tax Act)

Let's look at an example:

- Bob is age 55
- \$800,000 is commuted value of pension assets
- 35 years of service
- Married – no dependents
- Monthly pension of \$41,000/year

- Jack is age 45
- \$200,000 is commuted value of pension assets
- 23 years of service
- Married – two dependents
- Monthly pension of \$30,000/year

By commuting their pensions, Bob and Jack may have some tax-deferred assets that are transferable to a LIRA but will also likely have a portion that is taxable as income when it is paid out.

How much can each employee shelter based on the formula above?

1. Bob is entitled to \$41,000/year and a Present Value (PV) Factor of 10.4 applies to him based on his age.
 - Taking those factors into consideration the maximum value he can transfer to a LIRA is \$426,400. This is calculated as $\$41,000 \times 10.4$
 - Bob has a commuted value of \$800,000 and \$426,400 of it can be transferred to a LIRA, as a result \$373,600 would be included in income and is taxable. Assuming a 53.5% tax rate he will pay income tax of \$199,876.
2. Jack is entitled to \$30,000/year and a PV Factor of 9 applies to him based on his age.
 - Taking that into consideration the maximum value he can transfer to a LIRA is \$270,000. This is calculated as $\$30,000 \times 9$.
 - Jack has a pension of \$200,000, as a result, based on the calculation above, the full commuted value of his pension can be transferred to the LIRA.

Here are the Present Value Factors depending on age as outlined in the *Canadian Income Tax Act*:

Age	Present Value Factor	Age	Present Value Factor
Under 50	9.0	73	9.8
50	9.4	74	9.4
51	9.6	75	9.1
52	9.8	76	8.7
53	10.0	77	8.4
54	10.2	78	8.0
55	10.4	79	7.7
56	10.6	80	7.3
57	10.8	81	7.0
58	11.0	82	6.7
59	11.3	83	6.4
60	11.5	84	6.1
61	11.7	85	5.8
62	12.0	86	5.5
63	12.2	87	5.2
64	12.4	88	4.9
65	12.4	89	4.7
66	12.0	90	4.4
67	11.7	91	4.2
68	11.3	92	3.9
69	11.0	93	3.7
70	10.6	94	3.5
71	10.3	95	3.2
72	10.1	96 or over	3.0

Unlocking of Pension Money

The LIRA can be converted to a LIF in most jurisdictions at age 55; exceptions are Alberta and British Columbia where it can be converted at age 50, if it falls under pension legislation in Quebec or is federally regulated it can be converted at any age. It is important to note that some plans do not permit members to convert the plan to a LIF prior to age 55 even if the jurisdiction allows it.

All jurisdictions except for Prince Edward Island allow a pension to be unlocked due to a shortened life expectancy. All jurisdictions except Nova Scotia, Prince Edward Island, Newfoundland and Labrador, allow someone who becomes a non-resident of Canada to unlock their pension. All jurisdictions allow a pension to be unlocked in the case of a small dollar balance. Each jurisdiction is slightly different so it is best to speak with your financial advisor to see what applies to your particular situation.

The Income Splitting Opportunity

If you decide not to commute your pension and decide to collect a pension benefit you are able, under the Income Tax Act's pension income splitting rules, to income split up to 50% of your pension income with your spouse or common law partner at the time you take your pension, this is the case in all jurisdictions except for Quebec. If you decide to commute your pension and transfer some or all of your pension to a locked in retirement plan you are able to income split at age 65 rather than when you begin taking your pension. It is important to note that the age restriction to split RRIF, LIF or LRIF payments applies to the spouse who originally receives the income; the spouse with whom the income is being split can be any age. If income splitting is important to you and if you intend to retire prior to age 65 this is something you should consider. If you decide to split your pension income and both you and your spouse or common law partner are over age 65 you both may be able to claim the Pension Income Credit up to \$2,000.

Let's look at an example if Bob splits his eligible pension income with Jane.

	No Income-splitting	With Income-splitting
Taxable Income - Bob	\$70,000	\$50,000
Tax payable – Bob	\$21,000	\$12,500
Taxable income – Jane	\$12,000	\$32,000
Tax payable – Jane	\$3,000	\$8,000
Total Tax Payable	\$24,000	\$20,500
Difference/Tax Savings		\$3,500

*Based on Marginal Tax Rate of 30% & 25% (average in Canada)

By implementing the income splitting strategy Bob and Jane's tax rate is brought down to 25%. This translates to a tax savings of \$3,500. If you are interested in seeing how income-splitting can apply in your circumstances, talk to your financial advisor.

Stability of Employer

Another factor in the decision whether or not to commute has to do with your former employer. Do you feel the company will be able to pay out your full pension benefits in the future? If the company goes bankrupt or is bought by another company, there is a chance that the pension will be reduced or eliminated altogether. In the current economic environment many companies are "underfunded", meaning that if all pensioners took their commuted value the pension plan would not have enough funds to pay out everyone. This is one of the reasons there is a trend towards taking the commuted value. If there are concerns with the financial stability of the company it may make sense to commute the value of your pension. In addition, many companies prefer the commuting route in order to reduce the number of pensioners in preparation for ceasing the defined benefit pension strategy and exchanging it for a defined contribution pension strategy.

Pension Adjustment Reversal (PAR)

A PAR is applicable if the commuted value of your pension is less than the Pension Credits you accumulated while you were employed. The Pension Adjustment (PA) is the total of all pension credits for the year and is used to decrease your RRSP

contribution room when you are a member of a pension plan. When calculating the PA in a DB pension a factor of 9 is used to determine the value of the PA on an annual basis. If you did not stay at the company for long the factor 9 may overstate the PA amount which causes the need for a PAR.

Example: John has been employed at ABC company for 5 years. Over the years the pension credits were \$75,000. It was determined his commuted value was \$65,000, the difference between the two amounts, \$10,000, is John's PAR. This means John will have additional RRSP contribution room of \$10,000.

Other Considerations – Bridge Benefits and Indexing

If your pension has a bridge benefit (this is a temporary benefit payable until age 65 when Canada Pension Plan benefits can start) this needs to be taken into consideration when determining whether to commute your pension or not. With several plans your bridge benefit will stop at age 65 regardless of when you start your CPP/QPP pension. This would allow you to receive bridge benefits and CPP at the same time. This could be an advantage to taking the pension rather than commuting your plan.

If indexing is available on your plan this needs to be considered as well. Some plans have indexing prior to retirement and others are available in retirement as well. Indexing is the automatic adjustment of your pension in accordance with changes in the Consumer Price Index. Indexing can greatly affect your decision to commute your pension because this factor will ensure that your pension benefits do not stay at the same level for the length of time you receive them.

Why is there a taxable amount and what can be done with the taxable amount of the commuted value?

The amount that is taxable upon commuting a pension consists of the never-before taxed employer contributions and the investment income in the pension plan that is over and above the maximum transfer value. Neither of these amounts has been

included in a pensioner's taxable income, so are taxable once the pension is cashed out. When the proceeds have been paid out if you have RRSP contribution room available (or have received a PAR when the commuted value was calculated) you can transfer the taxable amount to the RRSP (up to your RRSP contribution limit) in an effort to offset some of your tax bill.

If you have Tax Free Savings Account (TFSA) contribution room you may want to consider contributing the taxable amount of your pension to your TFSA up to your TFSA limit. Growth in value of the TFSA will be tax free in the future, and the account is flexible enough to fund periodic needs.

If you do not have TFSA contribution room you may want to consider investing the proceeds in corporate class funds within a non-registered account. Mackenzie's corporate class funds are structured as a separate class of shares within a mutual fund corporate structure. This is different from typical mutual fund trusts that are structured as a single entity and investors buy units of the fund. As a result, all corporate class funds are part of the same corporate structure. When you are ready to begin withdrawing money from your corporate class funds you could choose to generate tax-efficient income using Series T. Series T allows you to receive a tax-efficient monthly income and potentially defer taxes on income until a later date. This is because the majority of the monthly cash flows distributed by corporate class Series T funds consists of Return of Capital (ROC), which is not immediately taxable. Tax is deferred on a ROC distribution until the fund's units are sold, or the investor's capital is depleted. The adjusted cost base is effectively lowered by the amount of ROC distributed and any capital gain (loss) is realized when the investment is sold.

Summary

Deciding whether or not to commute the value of your pension plan is a major financial decision that will have a significant impact on your retirement planning. As you can see from this paper, there are many factors for you to consider. If you have recently left a company or anticipate leaving in the near future and currently have a DB plan this is a decision that should be made with the help of your financial advisor to best ensure that your future financial needs are secure.

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