aviso wealth

Commuting a defined benefit pension plan

The why, when and how to your decision

Whether you are headed into retirement or changing jobs at an earlier stage of your life, one of the largest financial decisions you face when you leave an employer is what to do with your retirement savings.

If you have been saving in your own registered retirement savings plan (RRSP), there's not much more to say as it already belongs to you. Even when it is a group RRSP arranged through your workplace, generally the accumulated amount is yours to keep, though you'll likely have to transfer to other investment choices.

If instead your work has a registered pension plan (RPP), there's more involved.

Distinguishing registered pension plan types

You may be allowed to stay in your employer's RPP, move to a new employer's plan, or transfer into a locked-in retirement account. Depending on the type of RPP, that last option can be relatively straightforward, or it can be a multi-part process to arrive at the pension value, including potential immediate tax fallout.

Pensions come in two main varieties: defined contribution (DC) plans and defined benefit (DB) plans. Some plans are hybrid arrangements that have elements of both.

Defined contribution plans

Under a DC plan (also known as a money purchase plan), the employer is obligated to contribute a certain amount to the plan each year. Sometimes there may also be employee contributions. You will be able to choose among the investment options within the plan, with all income and growth tax-sheltered. The accumulated value is what is available to provide your retirement pension, which by default is paid as an annual annuity.

If you leave prior to retirement, the plan may be transferred dollar-for-dollar into a locked-in retirement account, where your investments may continue to grow tax-sheltered. The main feature of being 'locked-in' is that there is a maximum amount you can draw from it each year, which is intended to limit depletion so that it is sustainable through your retirement years.

Defined benefit plans

By contrast, under a DB plan the employer is obligated to provide a retirement pension determined by a formula. An actuary calculates the employer's required contributions, based on the number of plan members and their respective rights. Those contribution amounts are adjusted from time to time according to past investment experience and future economic expectations.

You will be entitled to a retirement pension according to a formula in the plan (more on that below). If you leave before retirement and want to take your funds with you, once again an actuary is needed to determine the value. That's where the complications really set in.

The remainder of this article will deal solely with commutation of a DB plan, first in terms of valuation and tax effects, and then on to how to approach this decision based on your particular needs.

Between you & your employer: Gross commuted value

A DB plan annual retirement pension is determined by multiplying a base income *times* a credit rate *times* years of employment. The base income and credit rate are negotiated between employer and employees. The base could be (for example) the average of your last five years of employment income, or better yet your best three years' income. The credit rate generally ranges from 1% to 2% per year of employment.

If you leave prior to retirement, an actuary has to determine the value of your entitlement in the accumulating pension fund. On the face of it, it's that annual pension discussed above multiplied by a present value (PV) factor. The PV factor is essentially an interest rate, but one requiring numerous inputs to derive, the main ones being current age, assumed commencement date (less any reduction for starting early), continuation provisions (e.g., to spouse), any guarantee period and any annual indexation.

The result is the lump sum current amount that would be required to pay the projected annual pension to you over your expected lifetime. For the sake of the calculation, it is assumed that the lump sum will be invested at long-term interest rates. Accordingly, commuted values tend to be higher when prevailing interest rates are low, and lower when interest rates are high.

Between you & the CRA: Maximum tax-free transfer to a locked-in plan

The commuted value from the actuary's report should not be confused with the amount that can be transferred into a locked-in retirement account.

In structure, the tax rule is similar to the commuted value calculation above. In tax terms, it multiplies your "lifetime retirement benefits" by a PV factor. In this case though, the PV factor is less generous than the commuted-value PV factor outlined above. For example, it doesn't account for any indexing or early retirement benefits. As a result, the tax transfer value is often less than the commuted pension value. In a sense, the tax calculation is what you would have accumulated under the RRSP rules, and therefore that's the amount that you are allowed to transfer into a locked-in retirement account.

The difference or excess amount will be taxable in the current year. While this is obviously not a pleasant prospect, it is applying tax to the more generous terms of the DB RPP, but you still get to keep the after-tax amount. The impact of this may be deferred if you have unused RRSP contribution room and choose to make a corresponding contribution.

Considerations before deciding to commute

Apart from the value of the commuted plan and tax transfer, here are some surrounding issues to review before committing to a course of action:

1. Investment of the commuted value may ultimately deliver a larger retirement income, but this should be balanced against downside investment risk. Some people like to make investment decisions, while others shy away. A conversation with your financial advisor can help you decide.
2. Are you comfortable leaving behind indexing and guarantees that may have been part of the original pension?
3. Do you want to be able to adjust income from year to year, or ever make a lump-sum withdrawal? As locked-in plans put a cap on annual withdrawals, a commuted pension may be needed for this kind of flexibility.
4. Some pension plans allow continued health and dental coverage, at least for some period, which can relieve your budgetary costs in retirement.
5. On the other hand, if you have health concerns that may affect your life expectancy, you may prefer to take the commuted pension as a sure thing to be able to pass on the remaining value to your beneficiaries, especially if you have no spouse.
6. Spousal pension income splitting is available under age 65 from a registered pension plan, but generally only from age 65 for an individual life income fund. Does this affect your income plans?
7. Beyond a spouse, you may wish to leave a legacy to family or charity. Managing a commuted pension amount may provide an avenue for that kind of planning.

For more information, please consult your financial advisor and tax professional.

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