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Pensions

# Leaving your employer: Should you Commute (cash out) your pension?

Pensions

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# Introduction

Until recently, when changing employers, most employees would leave their defined benefit pension plan with the original employer, knowing that they would receive the pension in retirement. With the economic downturn, however, many pensions are either being discontinued or may not have ample funding available to pay out all the expected pension benefits.

Many who are given the choice to commute (cash out) or keep their existing pension are giving serious thought to commuting their pension. There is no one-size-fits-all solution: there are pros and cons for each option. The best decision will depend on the plan features, your individual circumstances and several other factors. This paper outlines some considerations you should discuss with your financial advisor before deciding.

# What is a defined benefit plan?

This type of pension 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. Instead, they're dependent on contribution history and investment performance. Defined 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 the anticipated investment returns of the plan.

# Knowing your pension options

When you leave your employer, you'll be given the 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 options 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 cash out the value of your pension and invest it with your financial advisor. The better option depends on your own specific needs.

# Should you stay or cash out?

There are several situations where it would likely make sense for you to remain in the pension rather than taking the commuted value.

## 1. Do you expect to live longer than the average person?

If you do, it would likely be worthwhile for you to remain in the pension, because it ensures that you do not outlive your retirement savings. If you were to take the commuted value of your pension and then live a long time, without ongoing planning you could possibly outlive the assets in your account. If you remained in the pension, your pension benefit would be guaranteed until you pass away.

## 2. Receiving a fixed dollar amount for life

Another situation where it would make sense for you to remain in the pension is if you'd feel more secure knowing you'll always receive a retirement income for life. You know with a defined benefit 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 could fluctuate annually, depending on market performance, which means your monthly income could also fluctuate. By remaining in the pension, you don't have to worry about these fluctuations, as you'll have a set income every month.

## 3. Market performance

Another point to consider is how the market is likely to perform. If you don't believe you can consistently earn investment returns greater than what is assumed in the commuted value calculation, then staying with the pension will likely make more sense for you.

## 4. Inheritance

If you decide not to commute your pension, it's important to keep in mind that there are usually no pension assets to leave to your children or grandchildren upon your death, or that of your spouse or common law partner.

If the negative consequences mentioned above are not a concern for you, you may want to consider commuting your pension, but there are some points you should keep in mind. To begin with, if you go this route, the maximum withdrawals may be lower than if you'd stayed in the plan. When you commute the pension, the proceeds are deposited in a locked-in retirement account (LIRA) that then converts to a life income fund (LIF). 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, the income generated from it when you retire is no longer guaranteed and is instead determined by market performance. It's possible that you may outlive the assets in your account if you have a long life and/or experience poor market performance. It's necessary to be aware of these risks before you commute your pension.

Now that you understand the risks, it's also important to note that many investors find that having more control over their pension monies outweighs those risks. You should discuss this option with your financial advisor.

# Commuting a pension: How much can you transfer?

As previously mentioned, when you're given the option to commute your pension and take it with you, the commuted value would be the present value of your future pension benefit. Several factors are considered when calculating the commuted value of your pension, including:

- Your years of service
- Average salary
- Your age
- Supplementary benefits
- Special allowances
- Current interest rate
- 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 to transfer these amounts. The maximum that can be transferred (the maximum transfer value) is determined by the Income Tax Act. The formula is as follows:

**A x B = 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)

## Here's an example:

**Dominique**

**55**

The commuted value is **$800,000**

**35** years of service

Married with **no** dependents

Monthly pension of **$41,000/year**

**Jack**

**45**

The commuted value is **$200,000**

**23** years of service

Married with **two** dependents

Monthly pension of **$30,000/year**

By commuting their pensions, Dominique 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 from tax, based on the formula above?

Dominique is entitled to **$41,000/year**: a present value (PV) factor of **10.4** applies to her based on her age.

The maximum value she can transfer to a LIRA is:

**41,000 x 10.4 = $426,400**

Dominique 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 taxable income, (the rates for which vary by province or territory). Assuming a **53.5%** tax rate, she will pay income tax of **$199,876**.

Jack is entitled to **$30,000/year** and a PV Factor of **9** applies to him based on his age.

The maximum value he can transfer to a LIRA is:

**$30,000 x 9 = $270,000**

Jack has a pension of **$200,000**, which is below the maximum value, so he can transfer the full commuted value of his pension to a LIRA.

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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 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 pensions to be unlocked due to a shortened life expectancy. All jurisdictions except Nova Scotia, Prince Edward Island and Newfoundland and Labrador allow non-residents 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's best to speak with your financial advisor to see what applies to your particular situation.

# Advantages of income splitting

If you decide not to commute your pension and instead collect a pension benefit, you can 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 it to a locked-in retirement plan, you can only income split at age 65, rather than when you begin taking your pension. It's important to note that the age restriction to split RRIF, LIF or LRIF payments applies to the spouse receiving the income: the spouse with whom the income is being split can be any age.

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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 may both be able to claim the pension income tax credit of up to $2,000.

Let's look at an example if Dominique splits her eligible pension income and allocates $20,000 to her spouse Mike.

| | No income splitting | With income splitting |
|---|---|---|
| **Taxable income – Dominique** | $70,000 | $50,000 |
| **Tax payable – Dominique** | $21,000 | $12,500 |
| **Taxable income – Mike** | $12,000 | $32,000 |
| **Tax payable – Mike** | $3,000 | $8,000 |
| **Total tax payable** | $24,000 | $20,500 |
| **Difference/tax savings** | | $3,500 |

*Based on marginal tax rates of 30% and 25% (average in Canada)

By implementing the income splitting strategy, Dominique and Mike's tax rate is brought down to 25%. This translates to a $3,500 tax saving. Talk to your financial advisor about how income splitting can apply in your circumstances.

## Is your employer's pension fund stable?

Another factor in deciding whether to commute is 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 for the trend towards taking the commuted value. If you have concerns about 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, so as to reduce the number of pensioners, in preparation for ending the defined benefit pension strategy and exchanging it for a defined contribution pension strategy.

## How a PAR works

A pension adjustment reversal (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 annual value of the PA in a Defined Benefit (DB) pension, a factor of 9 is used. If you didn't stay at the company for long, the factor 9 may overstate the PA amount, which causes the need for a PAR.

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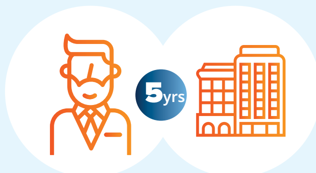
## Here's an example:

John has been employed at ABC company for five years, over which time **the pension credits were $75,000.**




**$10,000**
is John's PAR

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.**

# How bridge benefits and indexing could affect you

If your pension has a bridge benefit (this is a temporary benefit payable until age 65, when CPP/QPP 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 would stop at age 65, regardless of when you start your CPP/QPP pension. This would allow you to receive bridge benefits and CPP/QPP at the same time. This could be an advantage of taking the pension rather than commuting your plan.

You should also consider indexing if it's available with your plan. 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 but increase with inflation.

# How much is taxable and how can you limit your tax bill?

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. These amounts have not been included in taxable income, so they're 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 an RRSP (up to your RRSP contribution limit) to offset some of your tax bill.

If your spouse or common-law partner has available RRSP contribution room, you may want to consider taking the after-tax portion of your commuted pension and gifting it to your spouse. The contribution will become tax-deferred for your spouse, thus lowering their income and your family's overall tax bill.

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

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# Get help before deciding

Whether 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, discuss with your financial advisor the best option for your financial future.

## General Inquiries

For all of your general inquiries and account information please call:

**English:** 1-800-387-0614 416-922-3217
**Bilingual:** 1-800-387-0615
**Asian Investor Services:** 1-888-465-1668
**TTY:** 1-855-325-7030 416-922-4186
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