



The pension decision – to commute or not to commute

When leaving an employer, many people are faced with the decision to leave their pension entitlements on a paid up basis with their former employer or to move it to a personal locked-in RRSP or Locked-in Retirement Account (LIRA).

If you belong to a defined contribution or money purchase plan, the decision is relatively easy. The full market value of your entitlement can be transferred to a personal LIRA. The advantage of this is that it will provide you with full and direct access to a more diverse range of investment options, which are typically more limited in the company pension plan.

However, if you belong to a defined benefit pension plan, the transfer to a LIRA is not as straightforward. The purpose of this article is to summarize some of the considerations that will need to be taken into account in order to make the most of the benefits you are entitled to.

1. MAXIMUM TRANSFER VALUE

In many cases, the maximum transfer value imposed by the Income Tax Act will prohibit the full value of your entitlement from being transferred to a LIRA.

Regulation 8517 provides a factor based on age that is multiplied by your annual benefit. Because this factor does not take into account the value of additional benefits such as indexing or early retirement features, the maximum value is often less than the true cost of the benefit provided.

This creates a problem since a portion of the commuted value may not be transferable and must be taken into income as a lump sum taxable amount. You can reduce the

impact if you have available RRSP room and you use some of the taxable amount to make a contribution. However, many people in this situation do not have the necessary room since their RRSP contribution limits have been reduced each year by the value of the benefit received under the pension plan (known as a pension adjustment). A Pension Adjustment Reversal (PAR) may be available under certain circumstances, which is discussed further in section 6.

Maximum transfer values (factor times annual benefit)

Under age 50 = 9	58 = 11	67 = 11.7
50 = 9.4	59 = 11.3	68 = 11.3
51 = 9.6	60 = 11.5	69 = 11
52 = 9.8	61 = 11.7	70 = 10.6
53 = 10	62 = 12	71 = 10.3
54 = 10.2	63 = 12.2	
55 = 10.4	64 = 12.4	
56 = 10.6	65 = 12.4	
57 = 10.8	66 = 12	

(this is the highest it gets and starts to decrease after age 65)

Maximum transfer value example

Assume you have left your current employer at age 50 and your statement indicates that the commuted value of your benefit is \$350,000 and your annual benefit is \$27,000, payable at age 65, indexed at two per cent each year thereafter. If you choose to transfer the commuted value to a personal LIRA, the maximum allowed as a direct transfer under the Income Tax Act will be \$253,800 ($27,000 \times \text{the factor of } 9.4$). The balance of \$96,200 will be paid to you as a taxable lump sum. At a 45 per cent tax rate, you would have an after tax balance of \$52,910.

If you invest both these amounts, the \$253,800 in a LIRA and the after tax lump sum of \$52,910 for 15 years, you will need a rate of return of 3.78 per cent compounded annually to have the \$535,089¹ needed at age 65 to purchase the same \$27,000 indexed pension income. Alternatively, if you decide to spend the \$52,910 and invest the \$253,800, you would need a compound rate of return of 5.10 per cent. Even in a low interest environment, this rate of return may be achievable.

In this example, a person may decide that the transfer is still a good decision despite the large tax bill. This will not always be the case, however. Often when the comparison is between a pension payable immediately, such as taking early retirement from the company, and trying to duplicate the same income by commuting, the up front tax hit on the non-transferrable portion will make the company retirement plan almost impossible to beat.

It will be important for you to use numbers that reflect your own situation before determining the feasibility of transferring the commuted amount. Remember also, that your employer will no longer be assuming the investment risk if you commute, you will.

2. INDEXED BENEFITS

Indexed benefits can add substantially to the amount of dollars needed at retirement to purchase the same pension. This is especially true if there is indexing of your benefits prior to retirement as well as after retirement. The previous example uses a two per cent indexing factor after retirement. If this income was indexed at 1.5 per cent during the 15 years prior to your income date, the amount of annual pension to be purchased at age 65 would increase by 25 per cent to \$33,756 for a cost of approximately 667,715 or 125 per cent of the original amount. The new required rate of return would now be 5.32 per cent if all available dollars are invested and 6.66 per cent, if only the locked-in portion is invested.

3. BENEFITS

Benefits such as health and dental are sometimes offered to employees who are considered to be retired. In some cases the criteria depends on whether or not the pension money is transferred. If you will lose retiree benefits because you take the commuted value and are therefore considered a terminated employee rather than a retired employee, then the additional cost of private coverage will also need to be factored in.

4. THE FINANCIAL STABILITY OF YOUR FORMER EMPLOYER

The financial stability of your former employer can also be a consideration. If you are not sure that your employer will still exist or be financially able to meet its pension promises over the long term, you may decide that you would be better off taking the lump sum now to avoid any uncertainty with respect to your retirement income in the future.

If you are earning benefits governed by Ontario Pension laws, there is some protection provided to employees of insolvent employers through the Pension Benefits Guarantee Fund. However, the maximum benefit is capped at \$1,000 of income per month. There is no protection in any other province.

5. EARLY RETIREMENT AND PENSION INCOME SPLITTING

If your spouse is in a lower tax bracket and you plan to start receiving retirement income before age 65 (except in the province of Quebec, where you must be 65 to split pension income), the pension income received directly from a company pension plan can be split at any age. If you commute the pension and draw income from a Life Income Fund (LIF) you will have to wait until age 65 to take advantage of the tax savings available with pension income splitting.

6. A PENSION ADJUSTMENT REVERSAL (PAR)

A PAR is calculated if you decide to transfer the commuted value of your pension to a LIRA. It is not calculated if you leave the benefits with your former employer.

A PAR results when the Pension Adjustments reported while earning benefits after 1989 are greater than the commuted value actually paid out for those benefits. A PAR restores RRSP room equal to that difference. This restored RRSP room would allow you to avoid taxes on some or all of the lump sum amount not normally transferable under the maximum transfer rules. If you are eligible to receive a PAR your former employer will advise you of the amount.

¹ Based on annuity rates in effect May 2018

7. PARTIAL UNLOCKING

Some provinces and federally regulated plans allow a portion of your benefit to be unlocked (New Brunswick up to 25 per cent, Ontario, Manitoba, Alberta & Federal 50 per cent, and Saskatchewan 100 per cent). However, this is not available if you do not commute. For more information, see Registered Retirement Income – The Facts (MK0591E)

As you can see, there are many factors to be taken into account when making a decision as to whether to take a commuted value or to leave the pension on a paid up basis with a former employer. This article discusses the mathematical factors, but not all factors in your decision will be financially based. Depending on the terms of your termination of employment, you may also have emotional reasons for severing all ties with a former employer.



For more information, please contact your advisor or visit manulife.ca/investments



The commentary in this publication is for general information only and should not be considered investment or tax advice to any party. Individuals should seek the advice of professionals to ensure that any action taken with respect to this information is appropriate to their specific situation. Manulife, the Block Design, the Four Cubes Design, and Strong Reliable Trustworthy Forward-thinking are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.