Commuting your pension? Review these considerations with your advisor

If you're leaving employment where you have a defined-benefit pension, your employer's pension administrator may provide you with two choices. These choices include receiving a monthly pension (whether now or deferred to a later date), or taking a lump sum known as the commuted value. Staying in the existing pension plan provides you with a monthly amount for the rest of your life. Each defined benefit pension plan has its own unique features such as indexing, survivorship options, and guarantees. Your other choice is to take the commuted value and cash out your pension benefit. Your employer will offer a lump sum amount representing the present value of the expected monthly benefit. The present value is an actuarial analysis based on your pension terms and industry standards. Although it is tempting to take a lump sum, the choice has tax and non-tax implications. The decision is irreversible and may affect your lifetime cash flow, tax, and estate planning. Therefore, we recommend you consult your financial advisor before deciding. Below is a guideline to help you make this decision. The commuted value payout is generally split into two pots of money:

1. the maximum transfer value (MTV); and
2. cash or 'the excess'.

Commuted value checklist

Provide your financial advisor with the following information to analyze your pension options.

- ✓ Commuted value info:
  - Commuted value total
  - MTV
  - Cash or 'excess' portion
- ✓ Defined benefit info:
  - Defined benefit lifetime amount
  - Bridge benefit
  - Indexing information
  - Survivor benefits
  - Guarantee period
  - Governing jurisdiction (federal or which province)
- ✓ Other info:
  - Age
  - RRSP contribution room
  - Other estimated income for the year

You can find much of this information on a detailed commuted value statement from your employer's pension administrator.

MTV

The Income Tax Act (ITA) imposes an MTV when taking the commuted value. Why does this number matter? You can transfer the MTV on a tax-deferred basis to a registered account or annuity allowing you to defer taxes until you make withdrawals. The ITA provides an age-based factor that's multiplied by your annual lifetime retirement benefit to determine your MTV. This amount doesn't take into consideration the value of other benefits such as indexing or early retirement features. So, the MTV is often less than the true cost of the benefit provided. See Appendix A for more information on how the ITA calculates the MTV.

The pension plan's governing jurisdiction determines where you can transfer the MTV when you leave your employer. Your pension plan may be either federal or provincial. Each jurisdiction has its own set of rules regarding transferring a commuted value. These may include transferring to:

- another registered pension plan (if the plan and jurisdiction allows it);
- a locked-in registered retirement savings plan (e.g., a locked-in retirement account (LIRA), life income fund (LIF), or locked-in RRSP, locked-in retirement income fund (LRIF) or prescribed registered retirement income fund (PRRIF); or
- a life insurance company to buy an annuity.

Cash or 'the excess'

The excess represents the amount above the MTV. You will pay tax on the full excess received in the year. One way to defer taxes on the excess portion is to contribute to your RRSP. However, you can only contribute to your RRSP if you have unused RRSP contribution room. You can find your unused RRSP contribution room on your most recent Federal Notice of Assessment. For any amounts you don't transfer to your RRSP, your pension administrator may withhold only a percentage for taxes (e.g., 30%). They submit the withheld amount to the Canada Revenue Agency on your behalf. However, the amount of taxes withheld often isn't enough to cover the entire tax liability for the excess portion. This is because receiving a large taxable amount in one year may push you to a higher marginal tax bracket. We recommend you work with your advisor and accountant to estimate your taxes owing. You can then set this amount aside to pay your taxes when you file your tax return.

Income Splitting Tip: For future income splitting purposes, consider using your unused RRSP room to contribute the excess to a spousal RRSP. Note, you can't contribute the cash portion to your spouse's RRSP using their unused RRSP contribution room.

Non-tax considerations

Many non-tax considerations also come into play when deciding on your pension options. These considerations are just as important.

Consideration	Commuted value	Defined benefit pension
Retiree extended health care benefits	You may lose access to any retiree extended health care benefits your employer offers. Review and consider whether you can replace them with affordable personal extended health care. Factor this additional cost during retirement into your plan. Depending on pre-existing health conditions you may not be able to replace the plan.	You often have the option to keep access to any employer's retiree extended health care plan. Your employer may subsidize the cost. Or you may have access to reduced group rates. Review your options with your employer before deciding.
Market risk	You take on any market risk associated with ongoing investments and burden of performance. However, you have control of how to invest the funds for your needs. You can structure your investments based on your goals, objectives, and risk tolerance. This means your monthly benefit may go up or down depending on how your investments perform.	The pension's fund managers decide how to invest the funds. Therefore, investment risk and burden of performance remains within the pension plan and its fund managers. If the market goes down or up, you're still guaranteed the same monthly benefit if the plan remains solvent.
Need for funds	You have flexible access to the money in your investments. Keep in mind your pension plan's governing jurisdiction limits how you can 'unlock' the money in your locked-in portion. You can access the excess portion of the commuted value.	You have little flexibility regarding accessing funds in the plan. You simply receive your monthly income.
Life expectancy	Health issues or shortened life expectancy may affect your decision. A commuted value may provide more to your surviving spouse since you receive a lump sum upfront. If you don't have a spouse, you can leave the remaining funds to your children or other beneficiaries, including charity.	Good health or family longevity may affect your decision. A defined benefit plan continues to provide you with monthly benefits during your lifetime. However, ancillary benefits such as survivor benefits and guarantee periods vary by pension plan. They may also affect your monthly amount. If you don't have a spouse, there's typically no survivor benefit for adult children outside a guarantee period. Note, some pension plans provide a survivor benefit for adult children with a disability.
Income splitting	The registered portion generally doesn't qualify under eligible pension income spitting rules with a spouse or common-law partner until age 65. Keep in mind eligible pension splitting only applies to when you convert it into an income stream.	You can allocate up to 50% of your income with your spouse or common-law partner at any age. This provides you with income splitting strategies prior to 65 federally and provincially (other than Quebec).
Behavioural risk	Have you ever managed a lump sum of money before? Large withdrawals, especially in the early years, can reduce your monthly income throughout your retirement.	Are you uncomfortable with setting and sticking to a set budget? Or, would you be uncomfortable with market volatility? Since you can't access lump sums from the pension plan, you have peace of mind that your benefit will continue without having to make hard decisions.
Employer's financial stability	Is your employer and the pension plan financially stable and solvent? An employer's ability to continue funding its pension promises may be in question. If so, consider commuting the pension or reviewing options for a '**copycat annuity**' with a life insurance company.	Your employer and pension plan may be financially stable and solvent. Many pension plan statements provide solvency funding ratios for you to assess this risk.

Appendix A

Example of how to use this table:

Income Tax Regulation 8517 provides a present value (PV) factor your employer uses to calculate the MTV. The factor depends on your exact age on the date of transfer. For example, assume you are 60 years old. Your annual lifetime retirement benefit is $55,000 at normal retirement age (i.e., age 65). Therefore, your PV factor is 11.5. When you multiply the PV factor by the annualized pension (11.5 x 55,000) it gives you an MTV of $632,500. Now, assume the total commuted value of your pension is $900,000. This means you could transfer $632,500 to your jurisdiction's prescribed registered account on a tax-deferred basis. You pay tax on the remaining $267,500 unless you have sufficient unused RRSP contribution room.

*Note: Between ages 49 and 64, the ITA interpolates the PV factor. For example, assume you've attained age 55.5, the PV factor is 10.5 (the amount between age 55 and 56).

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

You may not have a lot of time to make your decision. Reach out to your advisor as soon as possible to review your options.

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