

Pension vs. Commuted Value: General Considerations

Members of Defined Benefit (DB) Pension Plans who change employers (and therefore terminate membership in the pension plan) are generally given the option to leave their pension entitlements in their former employer's pension plan with the expectation of future pension payments, or to take the commuted value and managing the proceeds on their own. Taking the commuted value option allows you to transfer all or a portion of the value into a registered locked-in plan. The decision is not a simple one as it entails various financial and non-financial considerations.

To assist with the decision making process, a number of factors are discussed in greater detail.

Leaving the benefits in the pension plan

By leaving your pension entitlements in the pension plan of your former employer, you will be entitled to receive pension income for life beginning at retirement.

Are pension benefits guaranteed?

Pension income is usually guaranteed and known. The pension plan administrator assumes the investment risks and management responsibilities. The former employer is responsible for funding the pension plan where there are deficiencies. To many, this hands-off approach offers a sense of stability and security.

How safe is your pension?

Pension legislation requires pension fund assets to be segregated from an employer's assets and therefore protected from the employer's creditors. The pension plan's ability to make your monthly pension benefit payment depends on how well the pension plan is funded. A well, funded pension plan will have sufficient assets to meet all the pension obligations if the plan was wound up.

Some provinces have taken additional measures to help protect pensioners. In Ontario, for example, if there are insufficient assets to pay all the pension obligations, the Ontario Pension Benefit Guarantee Fund (PBGF) will guarantee the first \$1,000 of your monthly pension income. It is generally a good idea to check your annual pension statement to review the pension's funding position.

What is pension indexing?

Some pension plans offer adjustments to pension payments to account for the rising costs linked to inflation. If your pension income is indexed to inflation, this may provide significant value as it provides



Pension vs. Commuted Value: General Considerations

some protection against inflation throughout your lifetime. Not all pension plans are indexed to inflation while others are indexed at the discretion of the pension plan sponsor.

Pensions can also be partially indexed based on a pre- set formula, such as 75% of the Consumer Price Index (CPI). For example, if the annual CPI is 2% and the pension is indexed to 75% of CPI, your pension income will be adjusted upwards by 1.5%. If your pension is not indexed for inflation, you run the risk of losing purchasing power over time.

Do you require medical benefits?

By leaving your pension benefits with the pension administrator, you may be eligible for retiree medical or dental benefits. These benefits may not be available if you took the commuted value option. Older individuals may value these benefits especially when insurability and higher insurance costs are a concern.

What is pension income splitting?

Canadians residents who receive eligible pension income are permitted to allocate up to one-half of that income to their spouse or common-law partner (Partner) for income tax purposes. Pension income from a defined benefit pension plan may be split at any age; however, if you take the commuted value option, future income from Registered Retirement Income Funds (RIFs), Life Income Funds (LIFs) or annuities are generally only eligible for pension income splitting when you are at least 65 years or older. See our article on "[Pension Income Splitting](#)" for more information.

Is a survivor benefit right for you?

By law, a surviving spouse of a pensioner is automatically entitled to a joint and survivor pension unless this option is waived by the non-member spouse. This means your pension income will end when the last surviving Partner dies. Generally, the survivor benefit will be at least 60% your pension income.

In a joint and survivor pension arrangement, the dollar amount of your pension is generally lower than the amount you would have otherwise received if you did not have a spouse (or if the spouse waived the survivor benefit). This lower pension reflects the longer duration of payments that will continue throughout your lifetime to you and that of your spouse (which therefore costs the employer's pension plan more). If your spouse predeceases you, the pension will continue to be paid at the reduced amount.

To determine if a survivor benefit is right for you and your family, consider your Partner's need for survivor income by evaluating your Partner's ability to fund expenses upon your death or whether your Partner is a member of a defined benefit pension plan from his or her work place.

Is leaving an estate important?

If you take the pension income option, your Partner is entitled to a reduced survivor benefit for life upon your death. The surviving Partner may only be eligible for 60% of your pension income. When the last Partner dies, pension income will stop and no residual value will be offered. On the other hand, if you choose the commuted value option and transfer the eligible portion into a Locked-In Retirement Account (LIRA) or a Life Income Fund (LIF), the balance can be rolled-over to your Partner's registered account without any tax consequences upon your death. Where there is no Partner, you may elect to name someone else as beneficiary of your locked-in proceeds.

If you prefer the pension option but would like to leave an estate, review your pension options as it may offer guarantee payments for a period of time. For example, the pension may offer a five

year guarantee period where it guarantees sixty months of payments, regardless of death within five years of pension commencement.

Take the Commuted Value

The commuted value is equivalent to the lump-sum present value of your future pension entitlements and is based upon interest and mortality rates in effect at your employment termination date.

As indicated earlier, you may elect to transfer the commuted value into a locked-in plan such as a LIRA or a LIF tax-free. In addition, you may also be entitled to a taxable cash payout for surplus amounts that exceed prescribed limits which can be transferred to a locked-in plan. Where you have available contribution room to a Registered Savings Plan (RSP), you may shelter all (or a portion) of the surplus by contributing the proceeds to your RSP.

What are the responsibilities?

By electing to transfer the commuted value you are accepting the responsibility of managing and investing the proceeds to fund your retirement. To many, this may be an attractive option as it offers the opportunity to take control of your assets. However, your desire to take control may depend on the risk you are willing to bear.

When is taking control attractive?

With a LIRA, you can defer withdrawals until age 71 which allows you the ability to manage your withdrawals in a tax efficient manner and increase your eligibility for government income-tested benefits such as Old Age Security (OAS).

The commute option also allows you the flexibility to purchase a life annuity if your position changes on managing your own investments. Purchasing a life annuity will provide a steady flow of income for the remainder of your life.

How does investment risk affect your retirement income?

The commute option transfers the investment risk from the pension administrator to you. Managing your own investments can be stressful given market fluctuations which may leave you short of your “target” rate of return. An underperforming portfolio will affect the amount of income you can withdraw from your portfolio each year. If you leave the pension with your employer, the pension plan will assume the investment risks and your retirement income is known.

What is a one-time lump sum unlocking?

There is an annual withdrawal limit from a locked-in plan and the limit increases as you get older. The main purpose of the withdrawal limit is to ensure adequate retirement income throughout your lifetime. However, this may represent access restrictions when you need more than the maximum limit to fund your retirement expenses. Over the last few years a number of jurisdictions now provide the option of unlocking which allows a portion of the locked-in funds to be transferred into an RSP or RIF. Since there is no maximum withdrawal limit on RSP or RIF, this will offer more withdrawal flexibility. See our article [“Locked-in Plans”](#) for more information.

Final Thoughts

Making the decision between taking the pension versus commuting is not easy and it can be overwhelming as it involves complex topics such as pension and tax. The general considerations mentioned in this article are only part of the comprehensive review which involves other financial considerations such as cash flow projections. To assist with the decision making process, consider seeking the assistance of a professional advisor who could guide you through the necessary planning process to assist you in making a decision that is most suitable to your personal circumstances.



The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading or tax strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Wealth, The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Wealth represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company).

® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.