Pension Buybacks: Employee Buybacks of Pension Plan Credits

An employee may consider the buyback of pension credit for past service to maximize the value of his or her pension, with a view to retiring earlier or to retire with a higher retirement income stream.

Employee pension buybacks may be initiated for the following reasons:

1. Buybacks of past service eligibility
2. Employment transfer

Buying additional pension credit may affect an individual's registered retirement savings plan (RSP) contribution room via the Past Service Pension Adjustment (PSPA) created.

Pension Buyback for Past Service Eligibility

An employee may be eligible for a 'buy back' of service for years after 1989, where he has not accrued the maximum pension benefit. The buyback of service may be to cover a period of time the employee was not participating in the pension plan due to a leave of absence. Canada Revenue Agency (CRA) must certify the provisional PSPA calculated by the employer or pension administrator. The employer/pension administrator will forward a *T1004 'Application for Certification of a Provisional PSPA'* to CRA to seek certification. An actual PSPA is not created until CRA has certified the request.

Consider the following buyback for past service:

Joanne, a 52-year-old school teacher, has received permission from her school board to take a two-year leave of absence to complete her master's degree.

Joanne has the option to continue to participate in the pension plan during her absence, or buyback the past service on her return to work. The cost to purchase pension credit for the leave is $19,500. The following outlines Joanne's options with and without the purchase of additional pension credits:

	With Pension Buyback	**Without Pension Buyback**
Added Credit	2 years	0
Cost to purchase pension	$19,500	0
Additional Annual Pension	$ 2,325	0
Annual Pension at age 60	$40,000**	Unreduced Pension N/A
Annual Pension at age 61	$42,325	$40,000**

**Qualified for maximum unreduced pension

By purchasing the two years of pension credit:

- Joanne can retire one year sooner, at age 60, rather than wait until age 61 to receive the same pension benefit ($40,000); or
- Joanne could retire one year later, collecting a greater pension of $42,325.

In making the decision as to whether or not she should participate in the buyback, Joanne should calculate the growth of her capital investment (the funds used to purchase the buyback) to her proposed retirement date. This establishes the income stream this asset would provide, and can be compared against the additional pension she can purchase.

Consider:

Capital Required to fund buyback	Annual income derived from RIF @ 61	Annual income Pension @61	Annual Difference in income
$19,500	$1,900	$2,325	$425

Assumptions used:

- RSP funds used to purchase buyback
- RSP to RIF conversion at age 61
- 2% inflation
- 6% investment rate of return before and during retirement
- All incomes pre-tax
- Lifespan to age 90
- Pension benefit is indexed at 2% annually

In conclusion, there may be greater value in initiating the pension buyback than maintaining the RSP, after all other issues have been considered. Comparatively, the pension will provide an increase in annual income of $425.

Since this increase in pension benefit is only applicable to Joanne, she will have to apply to CRA via her employer, to seek certification for the PSPA created due to the proposed buyback.

Assume:

- Joanne's pension buyback generates a $27,000 provisional PSPA.
- If Joanne transfers $19,500 from her RSP to purchase the buyback, a $7,500 PSPA is issued to CRA for certification. i.e. $27,000 - $19,500 = $7,500
- Joanne's RSP contribution room will be reduced by only $7,500.

Pension Buyback Resulting from Employment Transfer, for service after 1989

Another form of pension buyback may occur with employment transfer. When changing employers there may be a 'reciprocal agreement' that will allow the transfer of pension credit from one plan to the other. This often arises in the civil service. If the new pension has greater benefit than the old pension

plan, it may give rise to a PSPA on transfer, dependant on the time period the pension transfer will cover.

Pension transfers that occur for periods of eligible service prior to 1989 may not be impacted by a PSPA.

Consider the following employment transfer:

Susan, who is currently a member of the ABC Pension Plan, was a participant in the XYZ Pension Plan from 1991 to 2000. Susan is able to transfer her 10 years of qualifying service from the XYZ Pension to the ABC Pension.

The cost to purchase the 10 years of service in the ABC based plan is:	$240,540
The amount transferable from the XYZ plan is:	<u>$158,900</u>
Susan will have to fund the difference in capital amounts:	$81,640

Since the ABC Pension is a more costly pension than the XYZ Pension, it will give rise to a PSPA that is greater than the pension adjustment (PA) that was considered for the purchase of service in XYZ Pension Plan. As a result the PSPA may require certification with CRA.

Susan can compare:

(a) The pension payment from ABC Pension

To

(b) The pension income that would have been received from XYZ pension

Plus

(c) The income stream that would have been derived from the capital used to purchase the pension buyback.

ABC Pension Income Annually @ 65 based on Buyback	$15,000

Annual Income @65 years		
XYZ Pension Maintained	RIF Income XYZ	Pension Income + RIF Income
$12,000	$6,855	$18,855
Annual Difference in Income = $18,855 - $15,000		$3,855

From a pure income perspective, there may not be value in initiating the buyback since the existing XYZ Pension plus the assets available to help fund the buyback ($81,640) may provide a greater income stream at age 65 than ABC Pension Plan.

Other factors to consider are pension indexation and survivor benefits, as they may differ between both pension plans.

Assumptions used:

- RSP funds used to purchase buyback
- Assume Susan is currently 60 years old
- RSP to RIF conversion at age 65
- 2% inflation
- 6% investment rate of return before and during retirement
- All incomes pre-tax
- Lifespan to age 90

Note: The employer or the pension plan administrator should be the first source of information. A tax specialist may need to be consulted. CRA also provides details on the certification process in Guide T4040 RSPs and Other Registered Plans for Retirement.

Considerations when engaging in a Pension Buyback

Advantages in Engaging in a Pension Buyback	**Disadvantages in Engaging in a Pension Buyback**
Provides the opportunity for increased pension income at retirement or the potential of retiring earlier.	Reduces available RSP contribution room by creating a PSPA. Participation in the pension buyback may mean forfeiting the opportunity to grow the capital at a rate of return that potentially outperforms the income payment established by the pension.
Increased pension benefits can be a reduced risk approach, providing a fixed income stream at retirement.	Reduces the opportunity for income splitting, as this does not permit spousal savings via a spousal RSP. However, individuals have the opportunity to split up to 50% of their pension income with their Canadian resident spouse or common-law partner.
Passive strategy to ensure a steady income stream in retirement.	Reduces the flexibility of having access to the funds in case of emergency. An individual can always withdraw from an RSP and pay tax on any amount withdrawn. Once the pension buyback has occurred, the funds are no longer accessible until an income stream is initiated at retirement.
Funds are creditor proof if they are part of the pension plan.	Pension plans typically have a 60% survivor benefit (although greater survivor benefits can often be purchased). RSP plans allow for direct rollover of all remaining assets on death to the surviving spouse. On death of the surviving spouse, the balance of the registered assets can pass to a direct beneficiary or the estate (on an after-tax basis). However, with a pension plan, there is no further payout to a beneficiary on the death of the surviving spouse.

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