Early Retirement Options: Pension Options

Individuals in career transition who are vested members of a pension plan will be faced with the decision whether to leave the vested pension entitlements on a paid up basis with the company and eventually receive a pension income; or transfer out the pension entitlements (i.e. commute). This article provides a detailed examination of the pension options available on early retirement

Pension Options upon Early Retirement

When a pension plan member leaves his or her employment, the employer is required to provide details of the employee's pension value and options. The employee then has a specified time period within which to respond. These options are typically set out in a pension option statement. Generally, there are 4 possibilities:

1) **Leave the pension benefits with the former employer and receive pension payment in future (Deferred Pension Option).**

   If you are within 10 years of your normal retirement age, you may also be offered the option to start receiving your pension right away but at a reduced amount (immediate reduced pension).

2) **Transfer your pension to a new employer's pension plan.**

   This is an option if your new employer is willing to accept the transfer and take up the additional pension liability. Often this is the case when you move from one public sector pension plan to another one, as there are transfer agreements between the pension plans. It is much less likely for you to have this option if you are in a private sector defined benefit plan.

3) **Transfer the pension value to an insurance company to purchase a deferred annuity.**

   This provides you with a guaranteed lifetime income, but you also lose control of your money.

4) **Transfer the commuted value to a locked-in account.**

   Locking-in: The commuted value can be transferred to a locked-in registered retirement savings plan (RSP) or LIRA. The money is "locked-in", meaning that you cannot start to receive income from those funds until you either use the funds to purchase a life annuity or set up a life income fund (LIF), locked-in retirement fund (LRIF) or prescribed RIF (P-RIF) (depending on which provincial legislation governs the pension plan).

"Commuting" refers to converting your pension benefit to a lump sum. The commute value represents the amount that must be invested today to fund the pension benefits when they are due, and is arrived at based on an actuarial calculation.

Another distinguishing feature of LIFs and LRIFs is the restriction on the maximum withdrawal amount. This cap is meant to ensure that the account will provide a lifetime retirement income for you. (However, the cap does not exist for P-RIFs, which are currently offered only in Saskatchewan and Manitoba.)

Also note that, in certain jurisdictions, the LIF must be converted to a life annuity when you reach age 80. This requirement has however been dropped by many jurisdictions recently.

Exceptions to Locking-in: Many jurisdictions allow you to cash in your pension or locked-in account if it is small. Typically this means the transfer value is less than a certain percentage of the Year's Maximum Pensionable Earnings (YMPE). Also, most jurisdictions allow a cash-out if there is medical evidence of a shortened life expectancy. In some jurisdictions, unlocking is permitted in the event of financial hardship.

As the rules differ from jurisdiction to jurisdiction, the best way to find out is to consult the website of the particular provincial pension authority.

Pension Adjustment Reversal (PAR): If you decide to transfer out the commuted value of your pension, a pension adjustment reversal (PAR) is calculated.

The PAR represents pension adjustments previously reported that are greater than the commuted value actually paid out. The effect of the PAR is to restore RSP room equal to that difference in the year the commuted value is transferred out. The employer is responsible for advising the departing employee of the PAR amount.

Which Option is the Best?

When evaluating which pension option is best for you, many factors should be considered.

Cash flow comparison: One obviously important consideration is the monetary aspect, i.e. which option will provide you with the best cash flow throughout your retirement life? In making this evaluation, accurate information should be obtained as to:

- Whether the pension benefit is inflation adjusted.
- What the survivor benefit is.
- Usually, upon your death, your surviving spouse will receive a reduced pension for the rest of his or her life. However, there are a multitude of possibilities when it comes to surviving benefit options, so the pension option statement should be carefully examined.
- Whether the pension benefit is integrated with CPP/QPP.
- What portion of the commuted value has to be paid as cash if the commute option is selected?
- Since this amount will be taxed in the year of receipt, any future investment income will not be tax-sheltered; the fact that the commuted value has a large taxable cash component can be a huge disincentive to commuting.

Various software programs and calculators are available to help you analyze the cash flows that can be obtained from the different pension options. In order to prepare such a numerical analysis, assumptions must be made in respect of long-term interest rates, investment return rates, inflation rate and life expectancies (for yourself and your spouse). Numbers aside, there are also other important factors to consider:

Why is a portion of the commuted value required to be transferred as taxable cash?

Income Tax Regulation 8517 restricts the amount that you can transfer from pension plans on a tax-sheltered basis. The maximum transfer value is based on your age and the pension benefit amount, but does not take into account the value of additional benefits such as indexing or early retirement features. As a result, the maximum transfer value is often less than the true cost of the benefit provided.

Where the commuted value exceeds this value, the excess is considered income and taxed in the year of receipt. You can reduce the impact if you have available RSP room to shelter all or part of this amount. However, many people in this situation do not have a lot of RSP contribution room since their RSP room has been reduced each year by the Pension Adjustment.

Income Security: An obvious advantage of keeping the pension is that you will receive a guaranteed stream of retirement income for life. This option is especially valuable if the pension benefit is fully adjusted for inflation.

Investment risk: Taking the commuted value means that you assume responsibility for the performance of your investments. While you achieve control over your investments, it can be stressful for those who have limited investment experience or whose risk tolerance is not high.

Control and Flexibility: Commuting may provide you with more flexibility as to the amount, the timing and access to your capital. (Be aware however of the restrictions on the maximum amount that can be withdrawn every year.)

Spousal situation: You may prefer to keep the pension because you are worried about the financial management ability of your spouse, in case you die prematurely.
On the other hand, you may feel that you can afford to commute because your spouse has a good pension, which will serve as a source of guaranteed income during your retirement.

Life expectancy & Estate considerations: The pension option normally provides that, in the event of your death, your spouse is entitled to a reduced survivor benefit for his or her lifetime. If you do not have a spouse, you may find commuting more attractive because the full balance in your portfolio may form part of your estate which can be transferred to your heirs.

All relevant considerations should be carefully weighed before making your decision between receiving a guaranteed pension for life and taking the commuted value of the pension. Please consult with your financial and/or tax advisor to assist you in making such decision.

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