BMO NESBITT BURNS

Defined Benefit Pension Plans

Your Termination Options

When you leave your employer, whether it is by choice or due to corporate restructuring, you will face a number of decisions. If you have been a member of a company's Defined Benefit Pension Plan (DB Plan), you will need to decide whether to leave your benefits in the pension plan of your former employer, or transfer the commuted value to an individual locked-in registered plan. Some may place a higher value on receiving the lump-sum commuted value amount, especially if they are facing an uncertain employment future. But is this the appropriate choice for you?

Traditionally a DB Plan provides a pre-determined retirement benefit to an employee based in part on the employee's earnings history, years of service and age. Your company pension booklet should clearly outline the formula used for calculating your benefit. The cost of the pension plan is usually funded by employer and employee contributions, although some plans are funded solely by employer contributions. All contributions made to the plan are held in a trust fund that is used to pay employee pension benefits. The pension plan funds are kept separate from the employer's assets to protect them in the event of the employer's bankruptcy.

DB Plan rules can vary and companies will typically elect a pension committee to oversee their plan. The best source of information about your plan is your company's employee pension booklet or your human resources department.

Changes to provincial pension legislation have gained momentum over the last 5 years. For example, in Ontario, there is immediate vesting and locking-in of all pension benefits (replacing the previous requirement of two years of membership in a plan), unlocking of benefits due to small amounts and extending "grow-in" benefits to all employees whose employment is terminated without cause.

Upon termination from your company's DB Plan, if you are fully vested, you can elect to receive either an immediate or deferred pension or the lump sum commuted value.

Deferred Pension

If you elect to leave your pension entitlement in the DB Plan, you would typically be eligible to receive a pension payable at age 65. You could choose to take an immediate pension as early as age 55, however the pension would most likely be subject to a reduction as outlined in the plan's provisions. Depending on your age when you terminate the plan, you may be eligible for an immediate pension and begin receiving your benefit right away.

Commuted Value

The commuted value is a lump sum payment that is based on your years of pensionable service and your best average earnings, and represents the present value of your accrued pension. In other words, it's how much money the DB Plan is going to pay out to you so that you can invest the proceeds to help you meet your future retirement income need.

When terminating from a pension plan, the commuted value can be transferred into a locked plan. The purpose of a locked-in plan is to ensure the funds will be used to provide you with a lifetime retirement income. At retirement, the locked-in funds are rolled into one or a combination of a life annuity, or, if available in your province, a Life Income Fund (LIF), Locked-in Retirement Income Fund (LRIF) or prescribed RRIF (P-RRIF). Different rules apply to locked-in plans depending upon your province of employment. For more information about locked-in plans, ask your BMO Nesbitt Burns Investment Advisor for a copy of our publication *Locked-in Retirement Plans*.

The amount of pension to which you are entitled is calculated at your termination date. Recently the Actuarial Standards Board revised the rules that govern the calculation of commuted values to make them better reflect the current economic value of these benefits.

In technical terms, the commuted value is your monthly accrued pension multiplied by 12 times the annuity factor. The annuity factor is based on many variables such as your age, average life expectancy, interest earnings, inflation and other actuarial assumptions. Generally the higher the current interest rate environment, the lower the commuted value.

Advantages of Taking the Commuted Value

The primary advantage of investing through a registered vehicle is the deferral of income tax on investment income. Therefore, the longer money remains in the registered plan, the longer tax-sheltered compounding works in your favour.

By choosing to take the commuted value, you can transfer the proceeds to a locked-in plan which doesn't require you to begin taking withdrawals until you reach age 71. If your objective is wealth accumulation through tax-deferral, and you don't require a regular income stream from your locked-in plan, the plan can continue to grow tax-deferred until age 71. In addition, some taxation can be further delayed through your choice of maturity option for your locked-in plan. For example, an increasing annuity pays out less income initially and more later on. Or you could vary the amount of your annual withdrawals using a LIF (however you are required to withdraw a minimum amount from the LIF each year).

Disadvantages of Taking the Commuted Value

If the commuted value is greater than the amount that can be transferred to another registered vehicle, the excess amount is immediately taxable upon settlement of the commuted value option. In this situation, the advantage of tax-deferral through transfer of the commuted value to a locked in RRSP may be offset by the loss of tax-deferral on the excess funds. Be sure to confirm with your employer whether your pension plan options are affected by this limit.

When you elect to take the commuted value, you give up all rights to the guaranteed lifetime pension (and associated benefits) that would have been provided under your former employer's pension plan.

Making Your Decision

This publication only provides a high level overview of some of the considerations when deciding whether to leave your benefit in the DB Plan and receive a pension at a future retirement date, or take the commuted value and transfer the proceeds to a locked-in plan where you will take personal responsibility for your ultimate pension.

There are, of course, other considerations that will be unique to your personal situation: financial considerations, tax considerations, family and lifestyle considerations, personal objectives, and so on. You will want to make your decision in the context of your overall personal financial and tax situation.

The choice can be complex and while the impact of some factors is easily quantifiable, the impact of others is not.

Your BMO Nesbitt Burns Investment Advisor has the expertise and tools to help you make sense of your pension plan termination choices.

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