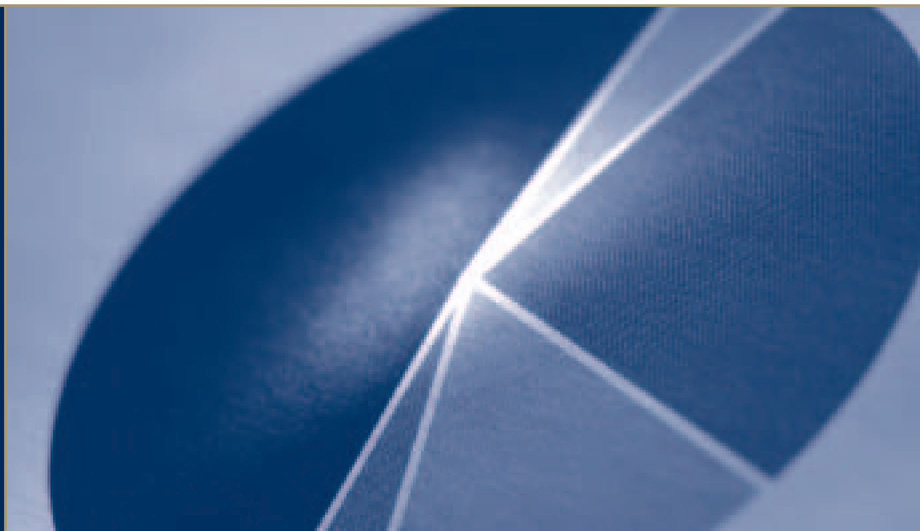

Early Retirement and Your Options

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1 › Introduction

Early retirement is something many of us may strive for, when it is our decision. However, in recent years, early retirement has become an increasingly important issue for many people due to corporate restructuring and downsizing.

If you are presented with an early retirement proposal, there are a number of issues you must consider. This publication will address some of these issues and provide you with information that will hopefully help you make your decisions on a more informed basis.

2 › Voluntary versus Involuntary Retirement

The difference between a voluntary and an involuntary early retirement is relatively straightforward. A voluntary retirement is a decision you have consciously made and have probably been planning for years, whereas an involuntary retirement is a decision your employer is asking you to make, perhaps sooner than you might have intended.

This publication will focus on the issues surrounding involuntary retirement, although many of the issues discussed will be relevant to all individuals evaluating retirement packages.

Please note that we have used the term retirement package, which can be interchanged with the term severance package, throughout this publication.

3 › Issues to consider when examining a retirement package

SIFTING THROUGH "THE PACKAGE"

It is important to recognize that the options available to you will vary from one employer to another, and perhaps, from one employee to another within the same organization.

The reasons for these differences can be numerous, but usually result from the length of your tenure and the level that you are at within the organization. Due to the complexity of many retirement packages, individuals are often left in a state of bewilderment as to which options they should choose.

Individuals must make decisions with respect to pension options, severance payments and company benefits, as well as deal with the emotional effects of unexpected change.

The discussion that follows will hopefully help you deal with some of the issues that you will be faced with.

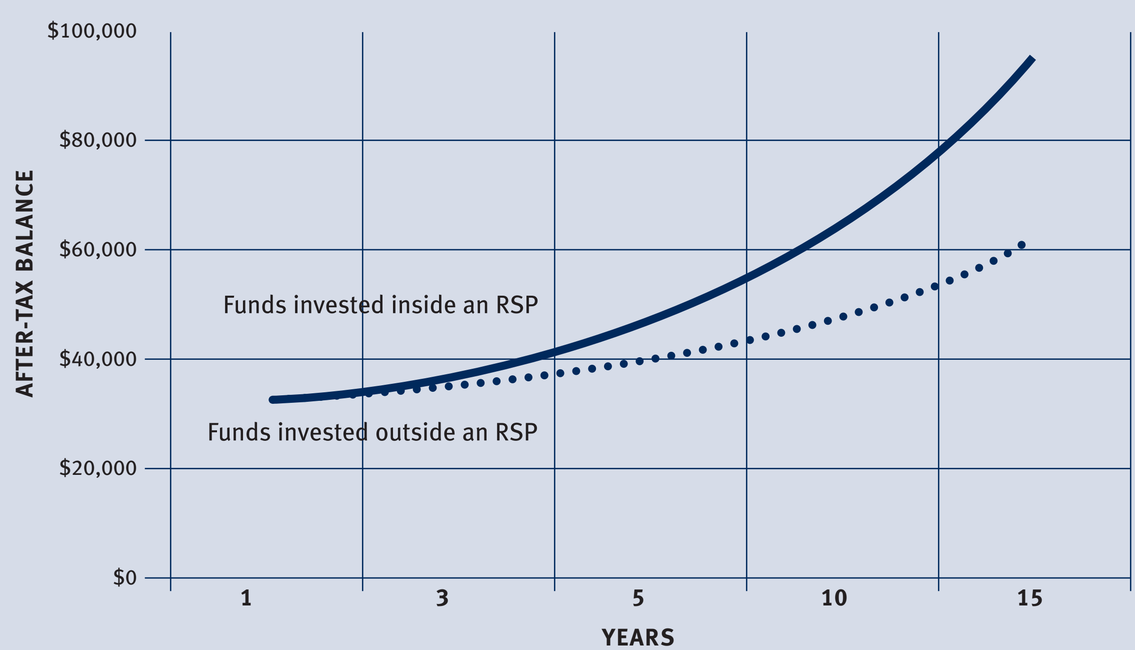
THE BENEFITS OF TAX-DEFERRED COMPOUNDING

Consider the following example. Mrs. Johnson will receive a lump sum retiring allowance of $50,000, and she has been informed that she can transfer all of the allowance to her RSP by making a retiring allowance rollover. See page 4 for details on retiring allowances.

Mrs. Johnson is unsure whether to transfer the payment to her RSP or take the payment as income and pay the tax.

If Mrs. Johnson transfers the retiring allowance to her RSP, there will be no tax liability until the RSP is deregistered. Assume these funds are then invested within the RSP earning an average investment return of 8% per year. Alternatively, she could receive the payment directly, pay tax at her marginal rate of approximately 40%, and then invest the remaining funds at 8% per year.

FIGURE 1



RETIREMENT PLANNING TIP

Since your RSP contribution is based on your prior year's earned income, you can make at least one final RSP contribution in the year following retirement.

In order to assist her in making this decision, **Figure 1** has been prepared to compare her two options. In order to make a valid comparison, it is assumed that at the end of each year the RSP is deregistered and the 40% tax is paid. This allows the comparison of the two options on an after-tax basis.

Conclusion: Even if Mrs. Johnson will require all of the $50,000 from her RSP after one year, there is still an advantage to making the transfer to the RSP. In this example, she would have an additional $960 by transferring the retiring allowance to the RSP for one year. If the funds are needed at a later time, the advantage of making the transfer could be even larger.

EVALUATING A CASH PAYMENT

Retirement packages often include a cash payment (usually based upon the length of your service with the company) that can be taken as a lump sum or as a continuation of salary (to equate to the value of the lump sum payment).

For many people, the prospect of continuing to receive a salary is appealing. However, this may not be the most beneficial method of payment. In order to evaluate whether to take the lump sum or the continuation of salary, consider the following criteria.

Tax deferral

The timing of your payments, whether as a lump sum or as a continuation of salary, can provide some tax deferral.

For example, if you left your position on November 1, 2004, and your employer agreed to defer your payment until January 1, 2005, the payment you receive would be included in your 2005 tax return that would be filed in April 2006, providing approximately 16 months of tax deferral on any additional tax in excess of tax withheld. If the payment was received in November 2004, any additional tax in excess of the taxes withheld would be due in April 2005.

Depending upon the size of the cash payment, the continuation of salary could also provide a reduction and a deferral of tax since the payments you receive would be spread over several tax years (2004 and 2005 in the previous example).

Additional tax deferral can be achieved if the cash payment is considered as a "retiring allowance" and transferred to an RSP. Retiring allowances are discussed in more detail in the next section. In most cases, a lump sum cash payment will be considered as a retiring allowance. Conversely, in many cases the employer will treat salary continuance as regular employment income (reported on a T4 slip), and therefore it will not be considered as a retiring allowance.

Note that while tax deferral is an important issue, it should not be your only concern. Flexibility of the payment option should also be considered.

Flexibility

The concept of flexibility is dependent upon your particular circumstances.

For some people, salary continuation will be more flexible simply because it is easier to deal with since it will provide cash flow to fund ongoing expenses.

An advantage of receiving a lump sum payment is that if you have debt, you may be able to repay it sooner.

You can also use a lump sum payment in the same manner as a continuation of salary to provide cash flow to support your ongoing expenses.

You may also want to receive a lump sum payment to ensure that you receive all the money you are entitled to. For example, if the company you are leaving is in any financial difficulty, it may be advisable to receive your whole payment now.

Other Considerations

In many cases, company benefits such as drug, dental, life insurance and pension service will continue during salary continuance. However, these benefits may possibly not continue if a lump sum cash payment is chosen.

Another consideration is that salary continuance reported on a T4 slip will be considered as earned income for purposes of creating new RSP contribution room for the following year. Conversely, a retiring allowance reported on a T4A slip is not considered earned income and therefore no new RSP contribution room will be created.

RETIRING ALLOWANCES

If a payment is made by the employer as a retiring allowance (i.e. reported as income on a T4A slip due to loss of office), you can transfer a portion or perhaps all of this payment to your RSP (this is called a retiring allowance rollover).

The maximum amount that can be transferred to an RSP is calculated as the lesser of the retiring allowance received or the amount determined by the following formula:

- $2,000 per year of service, for years of service up to and including 1995 (note that part years count as a full year for purposes of this calculation)

plus

- $1,500 for each year of service up to and including 1988 that you have non-vested pension credits (i.e. years that you have not been given credit for the company's contribution to your pension plan) or you were not a member of the pension plan

The amount of the retiring allowance that is transferred to the RSP based on the above calculation, does not impact the regular unused RSP contribution room reported on your Notice of Assessment

The rollover can either be made directly from your employer to your RSP, or it can be paid to you and you may contribute it in the year of receipt or in the first 60 days of the following year.

It may be advantageous to have your employer pay the retiring allowance directly to your RSP, since no tax will be withheld on the transfer.

For example, Mr. Smith was terminated by his employer on September 12, 2004, through an early retirement program. As part of the program, he received a retiring allowance of $35,000. Mr. Smith started working on December 29, 1979, and joined the company pension plan January 1, 1981.

Mr. Smith can rollover the lesser of the actual retiring allowance received (in this case $35,000), or the amount calculated by the formula as shown below:

1979 to 1995	= 17 years @	
	$2,000 per year =	$34,000
1979 to 1980	= 2 years @	
	$1,500 per year =	$3,000
Calculated amount		= $37,000

The lesser of the retirement allowance received ($35,000) and the calculated amount ($37,000) is the amount received of $35,000. The maximum retiring allowance that can be transferred to an RSP, without affecting your unused RSP contribution room, is the limit of $35,000 in this example.

In most cases, the best course of action is to make the retiring allowance rollover.

If you do not make the rollover within the allowable time period, you cannot carry it forward to a future year.

If you are unsure whether you will require the retiring allowance to support your current expenses, there may still be some value to making the rollover while you can, and then deregister RSP funds, as necessary. This was demonstrated in the example on page 2.

The benefits of this strategy are that the funds can be invested in a tax-deferred environment until needed. If and when you require additional funds to support your needs, simply deregister the amount necessary.

Note: A retiring allowance rollover based on the above years of service formula can only be made to the RSP of the individual receiving the retirement package. There is no ability to make the rollover to a spousal RSP. However, if unused RSP contribution room is being utilized to tax shelter some of the retiring allowance, then this portion of the retiring allowance may be transferred to a regular or spousal RSP if permitted by the employer.

In addition, unused vacation and pay in lieu of notice payments on terminations are not considered as retiring allowances. However, unused sick leave credits can be considered as a retiring allowance.

PENSION PAYMENT OPTIONS

When considering a retirement package, you are generally given four options regarding the pension plan:

1. To remain in the company pension plan (with no further contributions) and receive payments from the plan at a future date

Depending upon factors such as the pension's indexing to inflation, remaining in a plan may be advantageous.

Sometimes, early retirement packages will offer pension inducements (i.e. will give you added years of service) depending upon your age and position. This can make the pension option more appealing.

2. Transfer the vested pension (lump sum) amount to a new employer's pension plan

The vested portion of a pension is an amount that is considered to be owing to you. The transfer of pension benefits to a new employer's pension plan will be limited by a new employer's willingness to assume additional pension liability.

3. Use the lump sum pension amount to purchase a deferred annuity

The income provided by the purchase of a deferred annuity should be compared with the projected income provided by the other available options. Remember that when you purchase an annuity, you will not have any control over the management of your money, which, depending upon your wishes and ability to manage money, may or may not be a disadvantage.

4. Transfer the commuted (lump sum) value to a Locked-in RSP or Locked-in Retirement Account (LIRA)

For some people the transfer of the lump sum value to a Locked-in RSP or a LIRA is often considered to be the most advantageous of the available options. However, in some cases for defined benefit pension plans, not all of the commuted value may be allowed to transfer to a Locked-in RSP on a tax-deferred basis due to legislated limits. That is, some of the funds may have to be paid in cash and taxed in the year of receipt.

This option allows you to retain control of the investment of these funds and allows the flexibility of deciding when you would like to begin accessing this capital (within certain restrictions). It may be possible to achieve higher rates of return since you can invest the funds yourself, versus a defined contribution pension plan that is investing for all its members and has a more limited number of investment options, or a defined benefit plan where your annual income is generally fixed regardless of the investment returns.

RETIREMENT PLANNING TIP

When drawing money out of a RIF, if you have a younger spouse, inform your advisor that you will be using his/her age to determine the minimum payment prior to the first payment being made from the account. This will help to reduce the amount of taxable income that must come out of the plan each year.

RETIREMENT PLANNING TIP

If your income is unexpectedly low in a particular year, consider making your RSP contribution, but defer taking the deduction until a future year when your income is higher. This strategy will result in a larger tax savings.

Speak to your advisor for further information on Locked-in RSPs and LIRAs, and the options to convert these plans to income-producing vehicles.

HOW DO YOU CHOOSE?

When analyzing which pension option is best suited for you, there are a number of factors that must be considered. Essentially, what you are trying to determine is which option will provide you with the best cash flow throughout your retirement at a risk level that allows you to sleep at night.

In many cases, you will also want to choose the option that will provide the largest benefit to your spouse or to your estate upon your death. For instance, if the commuted value is transferred to a Locked-in RSP (LIRA), any remaining assets in the plan upon your death can be transferred to a named beneficiary or your estate. If you decide to remain in the company's pension plan and it is a defined benefit pension plan, then upon your death, your spouse will generally receive a reduced annual pension for the rest of his/her life. If you have no surviving spouse upon your death, then it is possible that no further payments will be made to your estate. However, every pension plan is different; therefore, it is important to determine what the survivor benefits are under the different pension options and weigh this information when choosing your option.

In order to assess the available options, you must make a number of assumptions, such as long-term interest rates, investment rates of return, inflation indexing of specific options, and your life expectancy. There are various software programs and calculators that can be used to analyze cash flows from the different pension options that can help you in making the best decision. You can also speak with your advisor about the Horizons suite of planning tools.

PENSION ADJUSTMENT REVERSAL (PAR)

If you choose to transfer the commuted (lump sum) value of your pension to a Locked-in RSP (LIRA), to a new employer, or to purchase a deferred annuity, you may end up with more RSP contribution room than you previously thought. You may be able to recover some of the RSP contribution room that was lost in previous years. The recovery of RSP contribution room is called a Pension Adjustment Reversal (PAR).

If the amount you received upon withdrawing from a defined benefit pension plan related to years of service since 1990 was less than the sum of all of the pension adjustments reported on your T4 slips for all years of employment since 1990, then the difference is your PAR. For a defined contribution pension plan or a Deferred Profit Sharing Plan (DPSP), a PAR is only created when unvested contributions to the plan are forfeited due to early termination. The PAR will increase your regular unused RSP room in the year the pension monies are transferred out. If the PAR applies, then the reporting of this difference will be done by your former employer shortly after your withdrawal from the pension plan.

Since the PAR is an increase to your unused RSP contribution room, it can be carried forward indefinitely. Furthermore, a contribution to a spousal RSP can be made based on the PAR room.

COMPANY BENEFITS

Another item to consider when you are faced with early retirement is your company benefits and whether they will continue into your retirement.

Many companies continue some form of benefits for their retirees. However, they are generally not as generous as they were when you were employed.

Other companies, when offering an early retirement program, will offer benefits for a specified period of time.

Generally, employees who have opted to transfer their pension out from the employer will not be eligible for company benefits during retirement.

Make sure you determine what your benefits will be in retirement and evaluate whether or not you will need to enhance your coverage to suit your lifestyle. For example, if you travel out of the country, will you have out-of-country coverage from your previous employer?

One area that is usually of concern to many employees is the issue of life insurance. Upon leaving a group plan, you are usually eligible to convert your group coverage to private coverage.

The benefit of this option is that the conversion can usually be done without a medical exam. Individuals for whom a medical examination is not an issue would simply compare the cost of private coverage to the cost of the converted group coverage to determine which is most beneficial (assuming that the same types of coverage are being compared). It is also important at this point to assess just how much life insurance coverage you actually require. All of these issues can be discussed with your life-licensed representative.

The importance of company benefits is illustrated by the fact that the cost to an employer can range anywhere from 20% to 40% of payroll costs, depending upon the company and types of benefits provided.

Don't overlook their importance when you leave an employer or when you retire.

OTHER CONSIDERATIONS

When considering an early retirement package and whether or not to return to the workforce, the first thing you will want to do is ensure that you have the cash flow to support your lifestyle.

Cash-flow concerns

If you are not ready to retire, the cash flow you receive, combined with the other assets you have, will have to provide you with sufficient income until you are re-employed. Note that the cash received from your package, whether transferred to an RSP or not, will delay the receipt of any Employment Insurance (EI) benefits.

The main issue to consider is not to underestimate the time required to find a new job.

Another factor to consider is your registered and non-registered funds. Generally, you should utilize your non-registered funds first and allow your registered assets (RSPs) to continue growing tax deferred. However, your individual circumstances must be considered.

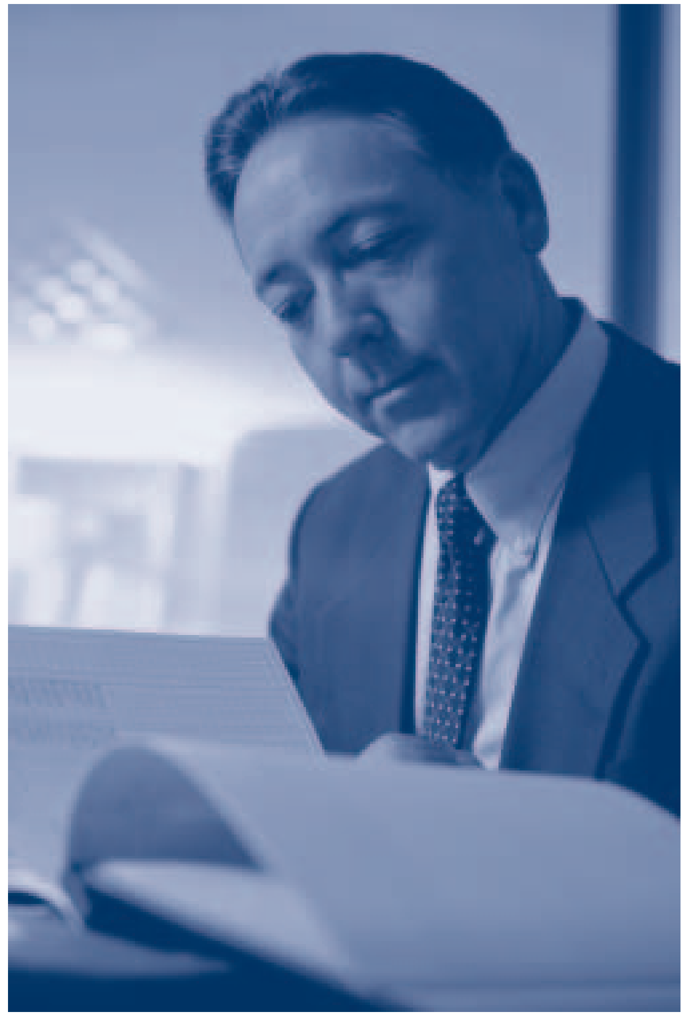
You may wish to consider investing your registered funds in a manner that will allow liquidity, so that these funds can be easily accessed should the need arise.

Alternative Minimum Tax

The 1998 Federal Budget introduced changes to the calculation of Alternative Minimum Tax (AMT). The deduction of RSP contributions will no longer be an "add-back" for calculating AMT. Thus, the transfer of a retiring allowance of any amount to an RSP or even regular RSP contributions based on unused RSP contribution room will no longer cause a potential AMT liability in the year of the transfer.

4 › Summary

Careful planning can go a long way to ease the transition from employment to retirement. Take the necessary time to understand your options and plan for your retirement. Remember to maintain your flexibility since circumstances are always changing. You want to ensure that you can take advantage of any opportunities that may arise.



Your advisor can assist you in addressing many of the issues outlined in this publication.

For more information, speak with an Investment Advisor
from RBC Dominion Securities Inc.

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ERETOPTS (10/2005)