Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Defined benefit pension plans

In order to plan for your retirement, it's important to understand your sources of retirement income. If you are an employee, you may be a member of a defined benefit pension plan (DB plan). This type of plan may be a significant source of your retirement income. This article gives an overview of how a DB plan works.

As pension legislation differs across the various provinces and each pension plan has its own unique terms, there may be situations where the information in this article will not apply to a specific employer retirement plan. Therefore, it's imperative to consult with your pension plan administrator on any questions you may have relating to your employer retirement plan.

Please note that any reference to a spouse in this article also includes a common-law partner. Please also note that provincial pension and tax legislation have different rules on whether an individual is considered to be your common-law partner.

What is a DB plan?

A DB plan is a type of registered pension plan (RPP) that provides guaranteed periodic payments to a plan member during retirement. The payment amount is determined using a formula stipulated by the plan, subject to certain limits. A plan member can only receive funds from the plan upon retirement or in special circumstances.

A DB plan must meet certain provisions under the Income Tax Act (ITA), as well as standards set under federal or provincial pension legislation. Generally, the ITA imposes limits on the benefits you can receive and federal or provincial pension legislation specifies minimum benefits a plan must provide. Beyond these standards, employers can structure their DB plans to meet their needs, so it's important to consult with the pension plan administrator if you wish to understand the exact terms of your particular DB plan.

Supplemental executive retirement plans (SERPs)

Pension plans are generally designed to provide a retirement income equal to 70% of your pre-retirement earnings. However, due to the limits imposed by the ITA, highly paid individuals may find that their pension plans fall short of meeting this target. In these cases, companies may pair your pension plan with an additional non-registered plan called a SERP. A SERP is meant to accumulate additional funds so that you're able to achieve a retirement income that is close to 70% your pre-retirement earnings.

There are various options in terms of the design and funding of a SERP. In certain cases, your employer may promise to pay additional benefits at retirement. In other cases, your employer may agree to set aside funds to guarantee the payment of these additional benefits either in a non-registered account or an arrangement known as a retirement compensation arrangement (RCA). Investment income earned within a non-registered account or RCA does not experience the same tax-deferral benefits that are offered within a DB plan. For more information on RCAs, please ask your RBC advisor for an article on this topic.

Contributing years

Benefit accrual

DB plans are employer-sponsored RPPs, meaning the sponsoring employer must make contributions to fund the plan. A member of a DB plan must be an employee of and receive pensionable earnings (e.g. salary, wages) from the sponsoring employer in order to earn pension benefits.

While you're working and earning employment income, you can start to accrue benefits (also known as pension credits) under the DB plan. Under the ITA, the maximum annual benefit you can generally accrue is 2% of your salary up to a maximum of 1/9th of a prescribed limit known as the money purchase limit. This limit is indexed annually to increases in the average wage. If the average wage decreases in a year, the limit will remain the same as the previous year.

Contributions

A DB plan is either "non-contributory" or "contributory". If a DB plan is non-contributory, only the employer makes contributions to the plan. A contributory plan allows you to make contributions along with the employer. Your contributions to the plan will increase the pension amount you will receive in retirement.

Employer contributions to a DB plan are mandatory. The contributions may be deductible by the employer. In order for a company to be able to deduct the contributions for tax purposes, the contribution amount must be determined by an actuary following the restrictions in the ITA, federal and provincial pension legislation, plan terms and actuarial assumptions and principles. Actuaries are generally called upon at minimum every three years to prepare an up-to-date actuarial valuation report. The report lets the company know how much they need to contribute to ensure you will receive your retirement benefit.

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An administrator of the DB plan decides how the funds contributed to the DB plan are invested. You will not be given a choice of investments. The performance of the investments within the plan can lead to the plan having too much or not enough funds to meet pension payment obligations. Pension surpluses and deficits are discussed in more detail near the end of this article.

Contributions made by your employer to a DB plan are not taxable to you. Instead, the future benefit that accrues to you is reported as a pension adjustment (PA).

The amount you contribute to a DB plan will be reported to you as an RPP contribution, which can be deducted from your income. The amount you contribute is also factored into the PA calculation.

The maximum amount you can contribute to a DB plan for each service year is the lesser of two amounts:

- 9% of your compensation for the current year, and
- $1,000 plus 70% of your PA.

PA

There is an upper limit on the amount that Canadians can contribute to tax-assisted retirement savings plans. The concept of a PA was introduced to ensure that pension credits earned in an RPP will reduce the amount you can contribute to another tax-assisted retirement savings plan like a registered retirement savings plan (RRSP). The PA will be reported to you and the CRA annually, and it will reduce your RRSP contribution room in the following year. Your PA is your total pension credits for the year with a specific employer. If you are only a member of a DB plan, your PA will be equal to the pension credit.

The formula for calculating the pension credit for a DB plan is as follows:

Pension credit = (9 x benefit earned) – $600

The benefit earned will vary by plan type and the provisions of the plan. The pension benefit can be zero but never negative. If the result is negative, it will be deemed to be zero.

The $600 offset in the formula means that no matter how great a pension plan is, a DB plan member will generally accrue at least $600 of RRSP contribution room for the following year.

Optional ancillary benefits

Your DB plan may allow you to make optional ancillary contributions to the plan. These contributions are in addition to those you may make as a contributory member of the DB plan. They do not generate a PA, but you still get a deduction for the amounts contributed.

These contributions are used to provide optional ancillary benefits that are meant to enhance your pension benefit. Some examples of enhancements that are possible are:

- Early retirement benefits, including being able to start receiving your pension sooner or with less penalty for doing so;
- Indexation of retirement benefits;
- Increased survivor benefits; and/or
- Bridging benefits.

If you terminate your membership in the DB plan, the amount returned to you is taxable as income and cannot be transferred directly to another registered plan on a tax-deferred basis.

Options at termination or retirement

The following options may be available to you when you leave your employer or retire, provided the DB plan allows for them:

- Start receiving retirement benefits from the DB plan;
- Leave the funds in the DB plan and receive a future pension when you retire;
- Commute the value of the DB plan;
- Purchase an annuity; or
- Transfer the DB plan to a new employer's DB plan.

Vesting of pension benefits

Being vested in a DB plan means you're entitled to the pension benefits under the plan in the event of termination of employment, retirement or death.

If you're not vested in the DB plan, and you leave your employer, you will forfeit the contributions your employer made to the plan. You are entitled to a refund of contributions made by you to the plan, if any, plus interest. This refund is taxable to you in the year you receive the payment. Your employer will also be responsible for calculating a pension adjustment reversal (PAR) that will restore some of your RRSP contribution room. For more information regarding the PAR, ask your RBC advisor for an article on this topic.

In general, DB plans are designed and funded to start paying a lifetime retirement benefit (LRB) at age 65. This is commonly known as the normal retirement date (NRD) and is generally the age at which you can retire from your employer with no early retirement reduction or penalty to your pension. The pension must generally begin to pay LRBs by the end of the year in which you turn age 71.

Although pension legislation generally requires that a pension vest with the employee within two years of plan membership, many plans have shorter vesting periods. If you are fully vested, you're entitled to the promised pension benefit outlined in your DB plan. Your contributions and interest, along with your employer's contributions, are generally locked into the plan and are to be used to provide a lifetime retirement income. Once your pension benefits are locked in, you generally cannot withdraw funds from the plan as a cash payment. You should speak to your pension plan administrator to determine when you are vested in your plan.

Retirement benefits from a DB plan

In general, DB plans are designed and funded to start paying a lifetime retirement benefit (LRB) at age 65. This is commonly known as the normal retirement date (NRD) and is generally the age at which you can retire from your employer with no early retirement reduction or penalty to your pension. The pension must generally begin to pay LRBs by the end of the year in which you turn age 71.

LRBs are periodic payments which, once commenced, will continue to be paid until death. The amount of the benefits is based on a formula discussed earlier in the article. In general, the annual pension benefit under a DB plan is based on the following three factors:

- A percentage of your salary per year of service, up to 2%;
- Your years of service; and
- Your annual earnings over a certain period of time.

The relevant period of time for determining your annual earnings can vary based on your specific pension plan. For example, the DB plan formula may use your average annual earnings over your career, over the final five years of your employment or your five highest-paid years.

For example, assume your employer has a DB plan with the following pension formula:

Annual pension = 2% x years of service x average annual earnings of your last five years of employment

In this example, if you retire with 20 years of service and $60,000 as the average annual earnings of your last five years of employment, you will receive an annual pension of $24,000 per year for life [2% x 20 x $60,000].

Keep in mind that pension plan formulas are rarely this basic and benefits need to be calculated according to the exact terms of the pension plan. Further, in addition to the basic retirement pension, there are additional options that may affect the amount of pension benefit you'll receive. For example, you may be able to select a guarantee period or varied amounts of survivor benefits. These options are discussed in more detail later in the article. You should consult with the pension plan administrator for assistance with estimating your pension benefit entitlement.

The periodic payments you receive from a DB plan are taxable as income in the year you receive them. If you have a spouse, you may be able to split this income with them for tax purposes. Ask your RBC advisor for an article on pension income splitting for more information.

Early retirement date

The early retirement date (ERD) is the earliest age at which you can start receiving a monthly benefit from your pension plan. Most pension legislation allows for an ERD that is at least ten years earlier than the NRD, or age 55. This date can be even earlier if the terms of the pension plan allow for it. The terms of the DB plan will indicate the ERD as well as whether the pension benefits will be reduced or not as a result of taking the pension early.

Generally, if you take an early pension that's subject to a reduction, the benefit is reduced for the entire payout period. The benefit is usually reduced by a percentage for every month or year you receive your pension before reaching the NRD. The reason for this reduction is that by receiving a pension prior to the NRD, you will be receiving more payments than if you had waited until the NRD to start collecting your pension.

The terms of the DB plan may specify cases where an unreduced early pension is available. For example, if your age plus years of service equals a certain number, or if you've worked for a company for a certain number of years, you may be able to start receiving your full pension before the NRD.

Bridging benefits

Some DB plans are coordinated with the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) and/or old age security (OAS). These types of plans provide a bridging benefit that's generally paid in addition to your regular retirement benefit until age 65 when you would normally begin to receive CPP/QPP and OAS benefits.

The periodic payments you receive from a DB plan are taxable as income in the year you receive them. If you have a spouse, you may be able to split this income with them for tax purposes. Ask your RBC advisor for an article on pension income splitting for more information.

The Income Tax Regulations (ITR) limit the amount of bridging benefit that can be paid from the pension plan. The main limit is that the bridging benefit cannot exceed your maximum entitlement to CPP/QPP and the maximum OAS at age 65. Your maximum entitlement to CPP/QPP is calculated using the rules in the ITR, which are different from how CPP/QPP is calculated under CPP/QPP legislation. This means your bridging benefit will not necessarily equal the amount of CPP/QPP and/or OAS you receive from the government at age 65. The ITR do not allow a bridging benefit to continue past age 65. The bridging benefit can be indexed to inflation.

If you're entitled to a bridging benefit, you can still choose to receive your CPP/QPP benefits before age 65 without your bridging benefit being affected. Keep in mind that your CPP/QPP is reduced by 0.6% for each month you receive CPP/QPP before age 65.

Deferred pension

You may retire before you reach your ERD or if you have reached your ERD, you may not want to start receiving your pension because your pension benefits will be reduced due to early retirement. In these cases, you may be able to start receiving your pension at a later date. This is referred to as a deferred pension option.

When the pension payments begin at a later date, they are still treated as regular pension benefits, and are taxable to you in the year you receive them.

Commute the pension

If you are allowed to and choose to commute your pension, the DB plan administrator will work with an actuary to calculate the payment to which you are entitled. The payment is a lump-sum amount that represents the present value of all future pension payments that would have been paid to you had you remained in the plan.

The pension legislation that governs your plan will determine where you can transfer the funds to. One option may be a locked-in retirement plan. For more information regarding locked-in retirement plans, please ask your RBC advisor for an article on this topic.

The ITR limit the amount of the commuted value that can be transferred to a locked-in retirement plan on a tax-deferred basis. This limit is often referred to as the maximum transfer value (MTV). The amount of the commuted value that is greater than the MTV is called the excess amount. The excess amount cannot be transferred to a locked-in retirement plan. It will be paid to you in cash and is taxable in the year you receive it.

Some pension plans restrict your ability to take the commuted value if you're retiring or leaving the employer within 10 years of your NRD or if your age plus years of service is greater than a specific factor. In these cases, you will need to leave the funds in the plan to receive an immediate or deferred pension.

Annuity

If you decide to take the commuted value of the pension but like the idea of a guaranteed income stream, you may be able to use the commuted value of the pension plan to purchase an annuity from a licensed annuity provider. The amount that can be used to purchase an annuity on a tax-deferred basis is still limited to the MTV. The excess amount is paid to you and is taxable to you in the year you receive the payment.

Another option is to use the commuted value to purchase an annuity that provides benefits that are not materially different than the benefits provided by the DB plan. These are often referred to as copycat annuities. The annuity provider will need to determine the cost of the annuity, which may be more or less than the commuted value that's payable to you. If the annuity costs less than the commuted value amount, the difference will be paid to you in cash and will be taxable to you in the year you receive it. The cost of the annuity is not immediately taxable to you. If the annuity costs more than the commuted value amount, the benefits and income provided by the annuity can be reduced and you can still qualify for the tax-deferred transfer, as long as the full commuted value is used to purchase the annuity.

A payment from the annuity purchased with the tax-deferred portion of your commuted value is fully taxable to you in the year you receive the payment.

Speak with a licensed life insurance representative for more information regarding annuities.

Transfer to a new employer's DB plan

If you terminate your employment with one employer and start working for another that provides a pension plan, you may be able to transfer your service entitlement to the new employer's plan. Your new employer can let you know if they are willing to accept funds from the DB plan provided by your old employer and, if they do, how much they will accept. In some cases, you may still receive a taxable payout from the DB plan.

If you decide to take the commuted value of the pension but like the idea of a guaranteed income stream, you may be able to use the commuted value of the pension plan to purchase an annuity from a licensed annuity provider.

For more information on pension plan options when you leave your employer, ask your RBC advisor for an article on this topic.

Phased retirement — partial pension

A phased retirement allows your employer to offer you a partial pension of up to 60%, including bridging benefits, while you continue to work and accrue additional benefits under the DB pension plan.

In order to qualify for phased retirement, you must be:

- At least 60 years of age; or
- At least 55 years of age and eligible for an unreduced pension because of your age, pensionable service or a combination of both your age and pensionable service.

Phased retirement is an emerging benefit of DB plans and not all jurisdictions have updated their pension legislation to allow them. Your plan administrator can advise if phased retirement is available to you.

Survivor benefits

What happens to your accumulated pension benefits on death depends on a number of factors including who you have named as the beneficiary of your plan, whether you have started receiving retirement pension benefits and, if you're already receiving pension benefits, the option you selected when you left the employer.

Your spouse has special rights to your pension plan benefits under federal and provincial pension legislation. Spouses are automatically entitled to a survivor benefit without being named as a beneficiary of the plan. If a spouse does not waive their rights (in some jurisdictions, it is possible for the spouse to waive their rights to your pension benefits prior to your passing), they will be entitled to your pension plan benefits even if you name someone else as a beneficiary. However, it may still be prudent to name a non-spouse beneficiary in the event your spouse pre-deceases you and you do not have the requisite mental capacity to update your beneficiary designation.

Member's death before receipt of pension

If you pass away before you start receiving pension benefits, and you are not vested in the plan, your DB plan will specify the death benefit payable. Generally, pension plans will, at a minimum, provide your spouse or estate a refund of your contributions plus interest.

If you are vested and you have a spouse, your spouse's options will vary depending on the plan terms as well as the legislation that governs the plan. Possible options include a survivor pension or a lump-sum commuted value that may or may not be locked-in, depending on the applicable jurisdiction. Your spouse may be able to transfer the lump-sum payment on a tax-deferred basis to an RRSP, RRIF or locked-in plan. Any pension payments or lump-sum amounts that are not transferred to a tax-deferred vehicle and are paid out in cash will be taxable to your spouse in the year they receive the payment.

If your child or grandchild is the beneficiary of your DB plan, any survivor benefits paid out will be taxable to the child or grandchild in the year they receive the payment. Survivor benefits may be in the form of a lump-sum payment or payments over a period of time. If your child or grandchild of any age was financially dependent on you because of an impairment in physical or mental functions, it may be possible to transfer the lump-sum payment from your DB plan on a tax-deferred basis to a registered disability savings plan (RDSP), RRSP or RRIF. If your child or grandchild is a minor and financially dependent on you at the time of your passing, they may also be able to defer taxes on the lump-sum payment by using the payment to purchase a term-certain annuity. The annuity must have a term that does not exceed 18 minus the minor's age when they purchase the annuity. Please note that if the beneficiary is a minor or does not have the requisite mental capacity, these opportunities for tax deferral may only be possible if the beneficiary has a power of attorney for property (protection mandate in Quebec) or court appointed guardian of property.

If your named beneficiary is not your spouse, child or grandchild, the survivor benefits paid from the DB plan are taxable to them. If you have not named a beneficiary on your plan, the benefits will be paid to your estate and taxable to the estate in the year they are received.

Member's death while collecting pension

Before you start collecting your pension, the DB plan administrator will provide you with various pension options. The option you choose may affect whether your survivors will receive benefits from the DB plan and, if they can, the amount of benefits they will receive.

> If your child or grandchild is the beneficiary of your DB plan, any survivor benefits paid out will be taxable to the child or grandchild in the year they receive the payment. Survivor benefits may be in the form of a lump-sum payment or payments over a period of time.

Under federal and provincial pension legislation, if you have a spouse at the time of retirement and you choose to receive LRBs from the plan, you'll generally need to select an option that provides your spouse with a survivor pension of at least 60% of your pension. Your spouse may be able to waive their entitlement to the pension. If your spouse waives their entitlement to your pension, you may be able to receive a higher LRB. Some plans may allow a surviving spouse to receive a survivor pension that is greater than 60%. If you select this option, your LRB will be reduced to offset the higher potential survivor benefit.

Some plans may offer survivor pensions to dependent children for a set period of time.

If you chose an option that includes a survivor pension, the payments to your survivor will start after your passing and will be taxable to them in the year they receive the payments.

Guarantee period

A guarantee period is an option offered in some DB plans that may be chosen upon retirement to ensure that, in the event of an early death, your survivors can receive retirement benefits until the end of your chosen guarantee period. The selected guarantee period may be a cost that reduces your LRB.

If you choose a guarantee period at retirement and you pass away within the guarantee period, your spouse will continue to receive your pension payments until the end of the guarantee period. After the guarantee period has elapsed, your spouse will continue to receive a survivor pension.

If you do not have a surviving spouse, you can name a beneficiary who will receive your pension payments until the end of the guarantee period. They may also be able to receive a lump-sum payment instead of the periodic pension payments.

If you do not name a beneficiary, and you pass away within the guarantee period, payments will be made to your estate.

Any amounts received by a surviving spouse, beneficiary or your estate will be taxable to them in the year of receipt.

Pension deficit and surplus

Market conditions can affect the funding of a DB plan, leaving many members with questions when a plan is not fully funded or has a surplus.

Pension deficits

If the investments in the pension fund have not performed as expected, the pension plan may not have enough assets to meet its pension payment obligations. This is known as a funding deficit. When a DB plan has a funding deficit, the employer may need to make greater contributions to the DB plan until the plan is fully funded again. The plan administrator and employer will work with an actuary to determine the plan's funding status.

Employees of companies experiencing financial difficulties often ask if their pension will be affected if their employer becomes insolvent. In such a case, the DB plan will generally be wound up unless the company finds a buyer who is willing to assume the pension plan. The funds that are already in the DB plan will not be affected, as pension funds are not considered an asset of the company. The creditors of the employer cannot seize the accumulated funds in the plan.

Problems can arise if a company becomes insolvent at a time when there's a pension deficit. If the company has insufficient funds to make up the pension deficit, the current members of the DB plan and possibly even existing pensioners may see a reduction in their promised benefits.

If you haven't started receiving retirement benefits at the time a DB plan is wound up, you will usually be offered the same transfer options discussed in the termination/retirement section of this article. If you've started receiving pension payments, the funds used to pay your pension will be used to buy an annuity from an insurer.

Pension surplus

In general, while a pension plan is ongoing, the pension plan assets may exceed its obligations, creating an overfunding situation called a pension surplus. If your DB plan is overfunded, you will not get an increase to your pension entitlement. You will only get the promised pension benefit that was calculated based on the pension formula.

If you haven't started receiving retirement benefits at the time a DB plan is wound up, you will usually be offered the same transfer options discussed in the termination/retirement section of this article. If you've started receiving pension payments, the funds used to pay your pension will be used to buy an annuity from an insurer.

Most jurisdictions allow the pension surplus to be used to reduce your employer's current contributions (sometimes called a contribution holiday). If the pension plan document specifies and the governing pension legislation permits, the surplus in the pension plan may be refunded to the employer on plan windup. In most jurisdictions, it may be necessary for the employer to share the surplus with the plan members. Any surplus that's payable to a plan member will be paid as a lump-sum cash payment and will be taxable in the year it is received.

Conclusion

If you're a member of a DB plan, it's important to understand how the plan works to ensure you properly account for it in your retirement and estate planning. This article provides some high-level information on how DB plans operate in general. However, keep in mind that specific terms in various pension plans can vary greatly. If you need more information on your particular pension plan, be sure to contact your pension administrator.

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