Wealth Management

RBC Wealth Management Services

Orlando Lopez CFP, CIM, CIWM
Investment Advisor & Financial Planner
orlando.lopez@rbc.com
416-699-0185

45 Wicksteed Avenue Suite 210
Toronto, ON, M4G4H9

www.rbcds.com/orlando.lopez

Purchasing past service in a defined benefit pension plan

Understanding the impact on your overall retirement plan

You may be a member of a defined benefit pension plan and have been presented with the opportunity to buy back years of service for absences that occurred while you were an employee or for periods in which you were not a member of your employer's pension plan.

Making the right decision about an offer to purchase past service may help you to maximize your retirement income and may provide you with security and peace of mind. This article details how to make the best decision possible and some of the main issues to consider before proceeding.

Purchasing past service (buying back pension)

During your ordinary working life, you may have taken time off work to raise a family, go back to school, travel, or taken a leave of absence for a variety of other reasons. You may have also previously deferred joining your current employer's pension plan. During your leave of absence or while you were not a member of your current employer's pension plan, you may not have accumulated years of service in your current pension plan.

Purchasing past service involves paying a fixed amount of money in exchange for these years of missed "pensionable service". The additional years of service purchased will result in an increased retirement pension.

Most retirement pensions for "defined benefit" pension plans are calculated according to a formula similar to the following:

> Retirement pension = (# years of pensionable service) multiplied by
>
> (a certain % for each year of service) multiplied by
>
> (average of final or best earnings over a 3-5 year period)

In the above calculation, the # of years of pensionable service is an important variable for the following reasons:

- It is probably the only variable that you have any direct control over to increase the amount of your retirement pension.

While the amount of expected retirement income is often the most important variable around past service purchases, other issues that may drive your decision need to be considered as well.

- By purchasing missing years of past service you may be able to retire early with an unreduced pension.

Where the cost is reasonable, it may be attractive for you to purchase past service. **Once the transaction has been committed to, it is not possible to reverse it. Therefore, it is essential that you review the cost/benefit tradeoff before committing to the transaction.**

In addition, it is important to review how the past service purchase affects your overall financial plan including what other potential uses there may be for the funds that you will use to pay for the past service purchase.

Analyzing the decision and making a comparison

Probably the most important consideration that needs to be looked at is the cost/benefit tradeoff. This involves calculating whether or not the expected incremental retirement benefit to be received as a result of the past service purchase exceeds the foregone retirement income stream (i.e., RRIF or annuity payout) that could have been produced with the funds used to pay for the buyback. This comparison should be performed based on the time at which the pension payments begin. Alternatively, if you use non-registered assets to purchase past service, the analysis would be similar in that you would compare the incremental retirement benefit received as a result of the past service purchase to the after-tax income stream that could have been produced with the funds used to pay for the buyback.

Example

Jane is 50 years old and is a member of the federal public service pension plan. She has accumulated 20 years of pensionable service as of January 1 of this year. She has been offered the opportunity to purchase 5 years of past service for $100,000. Jane expects to live until age 90.

Jane's current salary is $50,000 and she expects to continue to receive cost of living increases (3% per year) until she retires 5 years from now at age 55. Jane's pension plan has a Normal Retirement Date (NRD) of age 60. The NRD is generally the age at which you can retire from your employer with no early retirement reduction or penalty to your pension. The early retirement penalty generally ranges from 2% to 6% per year prior to the NRD. Jane's pension plan has an early retirement penalty of 5% per year.

For years of past service occurring after December 31, 1989 that are being purchased, a past service pension adjustment (PSPA) needs to be calculated by the pension plan administrator and any PSPA greater than $50 must be certified by the Canada Revenue Agency (CRA).

Forecasted retirement pension without past service purchase:

$19,909 / yr. including a bridge benefit,indexed until age 65

$18,913 / yr. indexed for life beginning at age 65*

Note that the forecasted retirement pension amounts above have been reduced by 25% since Jane did not have the required number of years of pension plan membership to receive an unreduced pension at age 55.

Forecasted retirement pension with past service purchase:

$31,855 / yr. including a bridge benefit, indexed until age 65

$30,262 / yr. indexed for life beginning at age 65*

A. Incremental retirement pension resulting from the past service purchase:

$11,946 / yr. indexed from age 55 until 65 and

$11,349 / yr. indexed from 65 onwards

B. Income stream that could have been produced with $100,000 RRSP funds:

$7,248 / yr. indexed until age 65

$9,741 / yr. indexed for life beginning at age 65

(Assumptions: 7% rate of return, 3% annual indexation)

Conclusion: In this case, since the **incremental retirement pension** (A) resulting from the past service purchase exceeds the **retirement income that could have been produced** (B) with the funds used to pay for the past service purchase, Jane should proceed with the past service purchase (based on the amount of expected retirement income alone).

While it is not always the case, the key factor in this example is that the past service purchase provided Jane with the additional years of pension plan membership needed for her to avoid what would have been a 25% reduction to her pension. Also, the additional years of service and slightly higher income in the years ahead both contributed to an enhanced retirement pension.

Does purchasing past service make sense for you?

If you have what is considered an average life expectancy, there are two situations when the purchase of past service can generally be expected to deliver the greatest financial benefit:

1. If you expect to remain a member of your pension plan for several more years and expect to have significantly higher earnings later in your career.
2. If you, by purchasing the missing years of service, will be in a position to retire with a pension that is unreduced, or that is reduced to a lesser extent.

If you fall under **both** situations above, you will usually receive an increase in your pension that exceeds the income that could have been produced with the amount of money used to pay for the past service purchase.

You should note however, that there are many considerations other than the expected impact of the past service purchase on the amount of your retirement pension. Some of these other considerations are outlined in the next section.

* Some pension plans are integrated with "bridge benefits" such as CPP/QPP and/or OAS. This means that if you start receiving your pension prior to age 65, you will initially receive a higher benefit than you would with a non-integrated pension. Jane's pension plan is integrated with bridge benefits from age 55-65, which is why the pension amount is reduced at age 65 in both scenarios above. The reduction at age 65 appears minimal as the reduced bridge benefit was partially compensated by inflation that occurred from age 55-65.

Cash contributions paid by you to buy back service occurring after December 31, 1989 are fully tax deductible in the calendar year the contribution is made.

Other qualitative considerations

While the amount of expected retirement income is often the most important variable around past service purchases, other issues that may drive your decision need to be considered as well.

Some additional reasons to proceed with a past service purchase:

- **Income for life:** Since a pension is payable for life, a past service purchase is relatively attractive if you are concerned about outliving your money, or you wish to provide lasting retirement income to your spouse who may have a significantly greater life expectancy.

- **Delegation of investment decisions**: You may prefer to have a low level of involvement in making investment decisions. Since your pension will be based on a formula and not determined by investment performance, investment responsibility and the risk of poor performance will be transferred to the pension fund for any funds that are used to pay for a past service purchase.

- **Potential access to group insurance** plans: Some pension plans will provide members having a certain minimum number of years of service the opportunity to participate in, or to receive medical, dental or extended health insurance coverage. This could be an important consideration if you become eligible to participate in such plans as a direct result of the past service purchase.

Some reasons to consider not purchasing past service:

- **Survivor benefits:** As a pension plan member, your death may leave your survivor with a reduced pension income whereas this would not be the case with retirement funding assets such as a RRSP or RRIF. Retaining the RRSP or RRIF ensures full protection to your survivor with respect to these funds.

- **Diversification:** In the same way that it makes good sense not to place all investments into the same security position, if you have a surviving spouse, it also may not make sense to concentrate your retirement funding income into a single source that could be reduced in the case of your premature death.

- **Estate planning flexibility:** If you do not have a spouse or you wish to leave retirement funding assets to someone other than your spouse (i.e., your adult child), retaining your investment assets (rather than using them to pay for a past service purchase) will enhance your ability to leave assets to others. Pension plans do not have the same level of flexibility in this area.

- **Flexibility to access funds:** RRSP or RRIF funds may be withdrawn in a lump sum when they are needed in retirement or even prior to retirement. This flexibility is lost when non-locked in RRSP funds are used to pay for past service.

In many cases, a past service purchase can be an attractive way to enhance a retirement pension and to make early retirement possible.

- **Deferral of income and continued tax-free growth**: RRSP funds can remain completely tax sheltered until the end of the year in which you turn 71 and then continue to compound tax deferred (except for the mandatory minimum payment each year) beyond age 71. Income from a retirement pension must be paid and is taxable whether the funds are needed or not in any given year.

- **Financial stability of the pension plan:** There is a solvency risk for the amount paid to purchase past service, as there is for the entire pension. In severe market downturns or in the case where your employer becomes bankrupt, if the pension plan is underfunded and your employer cannot top off the shortfall in the pension assets, the full amount of the pension may not be payable and you make get less than the full value of your pension.

For a more comprehensive assessment of whether or not it makes sense to move forward with a past service purchase in the context of your particular situation, it is recommended that you complete and review the personal assessment checklist in the appendix of this article together with your advisor.

Tax implications

Past service pension adjustment rules

Since 1990, all taxpayers having the same level of earned income are subject to the same total limit of funds that may be tax sheltered by way of RRSP contributions or by earning entitlement to a future pension. As such, for years of past service occurring after December 31, 1989 that are being purchased, a past service pension adjustment (PSPA) needs to be calculated by the pension plan administrator and any PSPA greater than $50 must be certified by the Canada Revenue Agency (CRA). A PSPA has the effect of reducing your RRSP deduction room (or possibly creating negative contribution room) and therefore certifying a PSPA allows the CRA to ensure that individuals purchasing past service do not have an opportunity to tax shelter additional funds, relative to other taxpayers.

The CRA must certify the PSPA before benefits relating to the past service purchase can be paid to you. You can generally begin to make contributions to fund the additional benefits as soon as you have applied for the certification, however, if the CRA does not approve the certification, any payments you may have made will be refunded to you.

If you do not have a spouse or you wish to leave retirement funding assets to someone other than your spouse (i.e., your adult child), retaining your investment assets (rather than using them to pay for a past service purchase) will enhance your ability to leave assets to others.

This certification generally depends on whether the PSPA exceeds your unused RRSP room at the end of the previous year by more than $8,000. If you have made maximum RRSP contributions over the years, your RRSP deduction room may be insufficient to allow certification of the PSPA associated with your past service. In this case, the CRA may allow up to a negative $8,000 RRSP deduction room to certify a PSPA and you would be unable to make additional RRSP contributions until your RRSP deduction room reaches a positive value.

You should note that the amount you pay for the past service benefit will not likely equal the PSPA calculated, since the PSPA is based on the value of the past service benefits rather than the cost to fund them.

Normally, a direct transfer of funds from your RRSP to the pension plan reduces or eliminates the amount of the PSPA reported to the CRA. If you feel you may not have sufficient RRSP room to allow certification of the PSPA, you may wish to consider paying your past service with a direct tax-sheltered transfer from your RRSP. This payment method is discussed in more detail below.

Deductibility of registered pension plan contributions

Cash contributions paid by you to buy back service occurring after December 31, 1989 are fully tax deductible in the calendar year the contribution is made. The deduction cannot be carried forward to a future tax year. Your ability to use the full amount of the deduction depends on your taxable income in the year you make the contribution, meaning that there is no limit to the tax deductibility of the contributions provided you have equal taxable income for that year.

The tax deductibility of contributions paid by you to buy back service occurring before January 1, 1990 is subject to a maximum deduction of $3,500 per year.

Payments made through a direct transfer from registered vehicles such as RRSPs, locked-in RRSPs, registered pension plans, deferred profit sharing plans (DPSPs) and locked-in retirement accounts (LIRAs) are transferred on a tax sheltered basis.

Payment options

There are several ways to pay for a past service purchase:

Direct transfer using existing RRSP funds: Funds held in your RRSP may always be used to pay for a past service purchase. This can be done by way of a direct tax sheltered transfer from your RRSP account to the pension plan.

It is possible to use funds that are held in a spousal RRSP without triggering the attribution rules as long as the pension plan member and annuitant of the RRSP are the same person and the payment is made by a direct tax sheltered transfer to the pension plan.

It is also possible to pay for past service with funds held in a locked-in RRSP as long as the pension jurisdiction governing the locked-in RRSP and the target pension plan are the same.

In order to buy back service using RRSP funds without having income tax deducted, you will need to complete Area 1 of Form T2033 – *Direct Transfer under subsection 146.3(14.1) or paragraph 146(16)(a) or 146.3(2)(e)*. This form is available on the CRA's website.

Direct transfer using new RRSP contributions: If you are considering a past service purchase but do not

When purchasing past service with non-registered funds, there are different rules around the amount of money that you may contribute and how much can be deducted, depending on whether the past service being purchased occurred before or after December 31, 1989.

have sufficient liquid assets held in your RRSP to be able to contribute the entire lump sum payment, you can make a lump sum contribution to your RRSP to make up the shortfall, provided you have sufficient unused RRSP deduction room, and then proceed with a direct tax sheltered transfer to make the full payment to the pension plan.

Direct transfer from your former pension plan: It may be possible to pay for past service by transferring funds from a former pension plan of which you were a member. Your current pension plan provider would have to be willing to accept the funds and may require that the funds being transferred are governed under the rules of their pension jurisdiction. As a result, some pension plan administrators might be reluctant or unwilling to transfer your funds. It is recommended that you contact your former employer or pension plan administrator in order to obtain more information on their transfer requirements.

In order to transfer funds without having income tax deducted, you will need to complete Form T2151 – *Direct Transfer of a single amount under subsection 1547(19) or section 147.3.* This form is available on the CRA's website.

Contributions using non-registered funds: You may choose to fund the cost of past service benefits by making a lump sum contribution or installment contributions with non-registered funds, including payroll deductions. As mentioned above, when purchasing past service with non-registered funds, there are different rules around the amount of money that you may contribute and how much can be deducted, depending on whether the past service being purchased occurred before or after December 31, 1989.

The CRA requires that you have sufficient contribution room to certify the PSPA. Where there is insufficient room, it may be necessary to remove funds from your RRSP before the past service purchase may be completed.

The rules and process around paying for past service purchases with non-registered funds, certifying PSPAs, and removing funds from a RRSP to allow a PSPA to be certified can be complex and are beyond the scope of this article. You should seek the assistance of a financial advisor and a qualified tax professional, if appropriate, before committing to pay for a past service purchase with non-registered funds.

Conclusion

In many cases, a past service purchase can be an attractive way to enhance a retirement pension and to make early retirement possible. In other situations, it may be best not to move forward with the transaction.

Like all complex financial decisions, it is critical to discuss your personal situation with your advisor and to consider all of the other specific circumstances and unique financial planning opportunities that each situation presents.

Appendix: Past service purchases – personal assessment checklist

The following checklist provides a list of the key considerations relevant to the majority of people who are faced with a decision on whether or not to move forward with a past service purchase.

While it is not possible for this type of decision to provide any certainty that the eventual outcome will be better one way or the other, completing this list together with your advisor should help you better understand whether or not the past service purchase seems to make sense in the context of your personal situation.

Key consideration	Yes	No
You intend on remaining with your current employer for most, or all of your remaining career	O	O
It is important to you to have the opportunity to retire as early as possible with an unreduced pension, with payments beginning immediately after retirement	O	O
It is likely that your earnings will increase significantly between now and the end of your career	O	O
You wish to have a known amount of regular income for your entire life, and are willing to sacrifice some flexibility in order to have this	O	O
You and/or your spouse have a normal, or longer than normal life expectancy	O	O
Your pension plan allows you the option to choose enhanced survivor benefits for your spouse at retirement	O	O
At retirement, you expect that you will have accumulated a sufficient amount of other retirement funding assets to provide you with the flexibility you will require to meet any unforeseen lump sum expenses	O	O
You have funds available to pay for the past service purchase that have already been set aside to fund your retirement goal (i.e. there is no other immediate competing use for these funds)	O	O
The funds available to pay for the past service purchase would otherwise be invested by you in a very conservative manner	O	O
It is expected that completing the past service purchase will enhance the ability for you and your spouse to save income tax through the use of "pension income splitting" prior to age 65 (your advisor can explain how this works if you are not familiar with these tax rules)	O	O

Interpreting the results

Please review the responses to the considerations above with your advisor to determine which key considerations are of the greatest importance in the context of your overall retirement plan.

- A "yes" response to any of the questions is an indication of a potential favourable outcome that may result by proceeding with the past service purchase.
- A "no" response to any of the questions is an indication of a potential unfavourable outcome that may result by proceeding with the past service purchase.

Please contact us for more information about the topics discussed in this article.

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