Wealth
Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Purchasing past service from your defined benefit pension plan

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If you are a member of a defined benefit (DB) pension plan, you may 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. This is referred to as purchasing past service. Making the right decision about an offer to purchase past service may help you maximize your retirement income and provide you with security and peace of mind. This article highlights some of the main issues to consider before proceeding.

Any reference to a spouse in this article also includes a common-law partner.

Purchasing past service

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

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

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

Retirement pension = Number of years of pensionable service *multiplied by* a certain % for each year of service *multiplied by* average of final or best earnings over a 3-year to 5-year period.

In this calculation, the number of years of pensionable service is important because it's probably the only variable that you have any direct control over to increase the amount of your retirement pension. Further, by purchasing missing years of past service, you may be able to retire early with an unreduced pension.

As such, where the cost is reasonable, it may make sense for you to purchase past service in order to increase your years of pensionable service. However, beyond just the cost, it is important to review how the past service purchase will affect your overall financial plan, including what other potential uses there may be for the funds you would use to pay for the past service purchase.

Analyzing a past service purchase

Prior to making your decision, you should look at whether or not the expected incremental retirement benefit from purchasing the past service exceeds the cost of the purchase. When looking at the cost, you will need to determine the foregone retirement income stream (e.g. registered retirement income fund (RRIF) or annuity payments) or investment income stream (i.e. non-registered funds) 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.

In addition to looking at the cost, you will want to consider your health and life expectancy. This will impact the amount of total benefits you receive from the pension, as the pension will continue to payout for your entire lifetime. Where you have an average life expectancy, you may want to purchase past service 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; and/or
- 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.

Qualitative consideration in a past service purchase

While the amount of expected retirement income and the cost are often the most important variables when considering past service purchases, there are other issues that may drive your decision as well.

Prior to making your decision, you should look at whether or not the expected incremental retirement benefit from purchasing the past service exceeds the cost of the purchase.

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. If you have a spouse, you may wish to provide lasting retirement income to your spouse who may have a 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 rests with the pension fund.

Some reasons to consider not purchasing past service

- **Estate planning flexibility:** If you do not have a spouse or you wish to leave assets to someone other than your spouse (i.e. your adult child), retaining your investment assets or registered retirement assets (rather than using them to pay for a past service purchase) will enhance your ability to leave assets to others.
- **Flexibility to access funds:** You can generally liquidate your non-registered investments at any time and use the funds as you wish. Likewise, registered retirement savings plan (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 not available for DB pension funds.
- **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 on a tax-deferred basis (except for the mandatory minimum payment each year) beyond age 71. Once you start receiving retirement benefits from the pension plan, the payments must be paid and are taxable whether the funds are needed or not.
- **Financial stability of the pension plan:** 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 may get less than your full pension entitlement.

Tax implications

Past service pension adjustment (PSPA)

Since 1990, all taxpayers are subject to a maximum amount that may be tax sheltered for retirement saving purposes. Because of this maximum, for years of past service occurring after December 31, 1989, a PSPA needs to be calculated by the pension plan administrator if the plan member purchases this service. Any PSPA greater than $50 must be certified by the Canada Revenue Agency (CRA).

A PSPA reduces your RRSP room (possibly creating negative contribution room). Certifying a PSPA allows the CRA to ensure that you do not have an opportunity to tax shelter more funds than other taxpayers by purchasing past service.

Whether the CRA will provide 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 room may be insufficient to allow certification of the PSPA. In this case, the CRA may allow you to have up to negative $8,000 in RRSP room. If you have negative RRSP room, you would be unable to make additional RRSP contributions until your RRSP room reaches a positive value again. The negative room created by the PSPA alone will generally not result in an RRSP over-contribution.

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.

Typically, if you are transferring funds from your RRSP instead of non-registered cash to the pension plan, the PSPA is reduced or eliminated. If you feel you may not have sufficient RRSP room to allow certification of the PSPA, you may wish to consider funding your past service with a direct tax-sheltered transfer from your RRSP. This payment method is discussed in more detail later on in the article.

Deductibility of past service purchase

If you use non-registered cash to buy back past service occurring after December 31, 1989, the amount of the purchase is fully tax deductible to you in the calendar year of purchase. The deduction cannot be carried forward to a future tax year. Your ability to use the full amount of the deduction will depend on your taxable income for that year.

If you are considering a past service purchase but do not have sufficient assets in your RRSP to be able to contribute the entire lump-sum payment, you can consider making a contribution to your RRSP to make up the shortfall. To do so, you need to have sufficient unused RRSP room available to make the contribution.

If you buy back past service occurring before January 1, 1990, you are subject to a maximum deduction of $3,500 per year.

Purchases made through a direct transfer from registered vehicles such as RRSPs, locked-in RRSPs or locked-in retirement accounts (LIRAs), and registered pension plans are not tax deductible to you. However, the transfer will happen on a tax-deferred basis.

Past service purchase payment options

There are several ways you may be able to pay for a past service purchase.

Direct transfer using existing RRSP funds

Funds held in your RRSP may be used to fund a past service purchase. This can be done by way of a direct tax-sheltered transfer from your RRSP to the pension plan.

It is possible to use funds that are held in a spousal RRSP to fund the purchase without triggering the attribution rules as long as the pension plan member and annuitant of the spousal 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 or LIRA as long as the pension jurisdiction governing the locked-in plan and the target pension plan are the same.

Direct transfer using new RRSP contributions

If you are considering a past service purchase but do not have sufficient assets in your RRSP to be able to contribute the entire lump-sum payment, you can consider making a contribution to your RRSP to make up the shortfall. To do so, you need to have sufficient unused RRSP room available to make the contribution.

Direct transfer from a former employer pension plan

It may be possible to pay for past service by transferring funds from a former employer's pension plan of which you were a member. Your current pension plan administrator would have to be willing to accept the funds and may require that the funds being transferred and the target pension plan are governed by the pension legislation of the same jurisdiction. You should contact your former employer or pension plan administrator and the current pension plan administrator to determine if this option is available to you.

Purchase using non-registered funds

You may choose to fund the cost of past service benefits by making a lump-sum or installment payments with non-registered funds, including payroll deductions.

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 detailed 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 qualified tax advisor 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 your retirement pension and to make early retirement possible. In other situations, it may not make sense to move forward with the purchase. Like all financial decisions, it's critical to consider your personal situation and estate objectives. Speak with your RBC advisor about your specific circumstances if you've been presented with the opportunity to make a past service purchase.

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