Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Locked-in retirement plans

Understand your locked-in plan to maximize your retirement benefits

What happens to your employer pension plan when you leave your current employer? Quite often, you have an opportunity to take the pension benefits in the form of a lump-sum payment. In many cases, you can transfer all or part of the lump-sum payment to a locked-in retirement plan on a tax-deferred basis. This article explains the characteristics of various types of locked-in retirement plans and their maturity options.

This article may outline strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified legal and/or tax advisor before acting on any of the information in this article.

Locked-in registered retirement savings plans (locked-in RRSPs) and locked-in retirement accounts (LIRAs)

If you are terminating your employment and you are part of the company's Registered Pension Plan (RPP), you may be able to receive a lump-sum payment or the commuted value from the employer pension. If you choose this option, part of or all of this payment may be subject to locking-in provisions to ensure that the funds will be available to you on retirement. Therefore, you may need to transfer part or all of the commuted value to a locked-in RRSP or locked-in retirement account (LIRA). The transferred portion of the commuted value is not taxable until you start receiving income from the plans. Any portion not transferred and taken as cash is taxable.

In addition to the locking-in provisions, a locked-in RRSP or LIRA, is subject to other provisions of pension legislation, such as maximum withdrawal limits.

Funds deposited in a locked-in RRSP or LIRA must come from an employer pension or another locked-in plan (generally governed by the same pension legislation). You cannot make personal contributions to these locked-in accounts.

Locked-in RRSPs and LIRAs have virtually identical attributes. The two terms are sometimes used interchangeably. Federal plans continue to use the term locked-in RRSP. The provinces of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, Nova Scotia, New Brunswick and Newfoundland & Labrador use the term LIRA.

Generally, you cannot withdraw funds from a locked-in RRSP or LIRA. If you wish to receive funds from these plans, you may be able to unlock some or all of the pension funds or choose one of the maturity options discussed below under certain circumstances. If you do not need income from your locked-in plan, you can choose to defer receiving income until age 71. However, you must choose a maturity option by December 31 of the year you turn age 71.

Plan jurisdiction

The pension plan's governing legislation determines what options you have when you leave your employer. The applicable legislation generally depends on where you worked and earned the pension benefits. For example, if you are currently working in the province of Saskatchewan but you are planning to retire in British Columbia your pension will likely be subject to Saskatchewan pension legislation even if you move to British Columbia in retirement.

In some cases, federal legislation governs your pension. If you are part of a federal private pension, your pension funds are subject to the Canada Pension Benefits Standards Act (PBSA). Where you worked and earned your pension benefits would not matter. The PBSA applies to private pension plans for federally regulated businesses such as banking, telecommunications and transportation. It also applies to pension plans relating to employment in the Yukon, Northwest Territories and Nunavut.

Some federal public service pension plans are subject to their own legislation. These include the Public Service Superannuation Act (PSSA), The Canadian Forces Superannuation Act (CFSA) and the Royal Mounted Police Superannuation Act (RCMPSA). Federal public service employees should ask their plan administrator which act governs their pension plan. Information in this article that discusses federal pensions assumes that the member's pension is governed by the PBSA.

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The province of Prince Edward Island (PEI) does not yet have pension legislation in force that deals with locked-in accounts. As a result, locked-in plans do not exist in PEI. PEI residents should refer to their specific pension plan documentation for further guidance.

Locked-in plans are also subject to pension legislation. The governing legislation may affect withdrawal limits, the ability to unlock the plan under circumstances and what happens to the funds on marriage breakdown and on death.

Locked-in plan maturity options

The locked-in plan maturity options that are available to you depend on the legislation that governs your locked-in funds. Appendix 1 summarizes these options categorized by plan jurisdiction. The following sections describe various types of maturity options.

Life Income Fund (LIF)

LIFs are available for federal plans and in Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland & Labrador, Nova Scotia, Ontario and Quebec. A LIF is a Registered Retirement Income Fund (RRIF) which is subject to pension legislation. You will need to receive at least an annual minimum payment. The minimum LIF payment calculation is identical to the minimum RRIF calculation. There is also no minimum payment required in the year you establish a LIF. The formula below determines the minimum payment that applies to a LIF until the plan holder reaches age 71. At age 71, the minimum payment schedule for RRIFs applies (see Appendix 2 for LIF minimum payment percentages).

Minimum payment

$$\text{Minimum Annual Payment} = \text{Plan balance at December 31 of previous year} \times \frac{1}{90 - \text{Age at December 31 of previous year}}$$

A LIF governed by Newfoundland & Labrador pension legislation differs from a RRIF and a LIF in the other jurisdictions in one significant way. If you own a

LIF governed by Newfoundland & Labrador pension legislation, you must convert it to a life annuity by the end of the year in which you turn 80. In contrast, the RRIF can continue throughout your lifetime. This mandatory conversion is not required federally or under any other provincial pension legislation. Further, unlike a RRIF, a LIF has an annual maximum withdrawal restriction based on pension legislation.

The maximum withdrawal restriction varies across jurisdictions. Under federal and some provincial legislation, the maximum withdrawal percentage is based on your age and an interest rate factor known as the CANSIM rate. As the CANSIM rate is reset every year (in November), maximum payment amounts may fluctuate with the change in the CANSIM rate. Due to this fluctuation, you will only be able to estimate future year payouts. Appendix 2 provides the LIF/RLIF (RLIFs will be discussed in the next section) minimum and maximum payment rates in effect for the year. To provide flexibility some provinces, such as British Columbia, Alberta and Ontario, allow the maximum LIF payment to be calculated based on the greater of the rate of return earned on the investments in the LIF in the previous taxation year and the maximum rate listed in Appendix 2.The maximum LIF payment for Manitoba is the greater of the maximum amount calculated using the rate listed in Appendix 2 or the sum of the previous year's income and gains net of losses plus 6% of any amount transferred to the LIF in the current year that was not a transfer from another LIF.

The maximum payment in the first year of the plan is prorated based on the months remaining in the current year, with any part month being equal to a full month. No proration is required in the first year for an Alberta, British Columbia, Manitoba, New Brunswick or Quebec LIF.

Restricted Life Income Fund (RLIF)

The RLIF is available for federally regulated plans. The RLIF has the same minimum and maximum limits as a federal LIF (see Appendix 2 for the rates) and the same restrictions. However, the difference between a federal LIF and a RLIF is that you can unlock up to 50% of the value of the RLIF. You must be turning age 55 or older in the year of unlocking and the unlocking must be done within 60 days of funds being deposited to the RLIF. If you are under the age of 71 and do not need an income stream from the RLIF, you can transfer the funds to a Restricted Locked-in Savings Plan (RLSP), which is similar to a locked-in RRSP. You cannot make personal contributions to an RLSP nor can you make withdrawals. You can transfer the funds in your RLSP to another RLSP or when you need to access the funds, you can transfer the RLSP to RLIF or an annuity. It may also be transferred to a pension plan, if that plan permits.

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Locked-in Retirement Income Fund (LRIF)

An LRIF is only available in Newfoundland & Labrador. LRIFs were available in Alberta prior to January 1, 2008, Ontario prior to January 1, 2009, and Manitoba prior to May 31, 2010. However, due to changes in legislation, they no longer exist in Alberta and Manitoba and you can no longer open LRIFs in Ontario. Rules for existing Ontario LRIF now follow the rules for New Ontario LIFs. Manitoba and Alberta LRIFs were phased out and transferred to LIFs.

Newfoundland & Labrador legislation allows you to transfer funds from your pension (if your pension allows) or LIRA to an LRIF at the earlier of age 55 or the earliest date on which you could receive a pension benefit under the originating pension plan from which money was transferred.

An LRIF is similar to a LIF in that both allow access to the locked-in funds within defined minimum and maximum levels. While the minimum payment is calculated the same for both, the maximum payment calculation for an LRIF is different (see Appendix 2 for LIF/ RLIF minimum and maximum percentages – only the minimum percentages apply to the LRIF). The LRIF maximum payment is calculated as follows:

Maximum Payment

Maximum Annual Payment = Greatest of the following amounts (1,2,3 or 4)

1. The value of the LRIF at December 31 of the previous year less the net amount transferred into the plan since inception.

2. The investment growth in the previous year based on the change in market value (for the previous year, the FMV at the end of the year plus the LRIF payments made in the year less the FMV at the beginning of the year).

3. If the payment is being made in the fiscal year in which the LRIF was established or in the following year, 6% of the fair market value of the LRIF at the beginning of

that fiscal year. The first fiscal year would begin at the time the LRIF was established and must end on Dec 31. If a part of the value at the beginning of a fiscal year corresponds to an amount transferred during the same year from another LRIF or LIF of the purchaser, the maximums shall be deemed to be zero.

4. The minimum payment.

The maximum payment available in the first year of the plan is prorated based on the months remaining in the current year, with any part month being equal to a full month.

One difference between a LIF and LRIF is that an LRIF can continue throughout an individual's lifetime. You do not have to convert the LRIF to a life annuity at a certain age. Whereas, under Newfoundland & Labrador legislation a LIF has to be converted to a life annuity by the end of the year you turn age 80. However, you can transfer any or all the assets (in excess of the minimum payment for the year) in an LRIF to purchase a life annuity at any time, to another LRIF or to a LIF. Before December 31 of the year in which you turn 71, you can also transfer any or all the assets (in excess of the minimum payment for the year) in an LRIF to a LIRA. You can transfer funds in a LIF or another LRIF to a LRIF.

Prescribed Registered Retirement Income Fund (Prescribed RRIF)

A prescribed RRIF is available in Saskatchewan and Manitoba. Under Saskatchewan pension legislation, only annuitants who are at least age 55 (or those who have reached their early retirement age based on the pension plan where the locked-in funds originated) are eligible for the prescribed RRIF. Those who are eligible under Saskatchewan legislation can transfer their entire locked-in plan into a prescribed RRIF. Under Manitoba pension legislation, an annuitant who is at least 55 years old is able to unlock up to 50% of the balance in their LIF and transfer it to a prescribed RRIF.

The main advantage of the prescribed RRIF over the LIF is that there are no maximum withdrawal limits. You will still need to make minimum withdrawals. The minimum amount is identical to the LIF minimum amounts. You cannot convert or transfer a Prescribed RRIF to a regular RRIF.

Considerations when choosing an option

Both a life annuity and a locked-in plan (LIF/RLIF/LRIF/Prescribed RRIF) have advantages and disadvantages. The maturity option you choose to access your locked-in RRSP or LIRA funds depends upon a number of factors. Further, you do not have to choose one option exclusively over another. It is quite possible—and often preferable—

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to "mix and match" different options to create an income stream that meets your individual circumstances. Some major considerations are:

- Your annual income needs;
- Whether you want to actively manage your retirement funds;
- Your estate objectives;
- Flexibility versus guarantees of each option;
- The current rate of return and inflation; and
- Tax implications of each option.

How much annual income do you require?

If the amount of income you need from year to year varies, you may consider purchasing a LIF/RLIF/ LRIF/Prescribed RRIF. This option allows you some flexibility in choosing the amount of income you wish to receive in a year. For example, if you do not require additional income in the current year, you could choose to only withdraw the minimum payment, leaving more funds in your locked-in plan to grow tax-deferred.

You may also consider directly transferring the difference between the minimum and the maximum to a non-locked-in registered account. Such a transfer does not require RRSP contribution room and has no impact on your taxable income. You will have effectively unlocked some of your locked-in plan.

If you do not require flexibility but would rather receive a level income stream, the life annuity may better suit your needs.

Do you want to manage your investments?

By purchasing an annuity, you transfer the management and investment risk of your assets to the annuity provider. If you do not want to manage your retirement funds and would like a guaranteed, level income stream, an annuity may make sense for you.

On the other hand, a self-directed LIF/RLIF/LRIF/Prescribed RRIF will allow you to retain control of the investment of your funds. You have the potential of growing your retirement funds. However, you run the risk of unsatisfactory returns or a decrease in your retirement funds.

Your estate objectives

How important is it to you to leave an estate for your heirs? If this is important, then a locked-in plan is likely a better option for you to preserve your registered retirement assets for your estate. A locked-in plan allows you to continue to accumulate your registered retirement assets on a tax-deferred basis while you enjoy the benefits of a retirement income.

At your death, the assets remaining in your locked-in plan can be transferred to a beneficiary named on the plan or may form part of your estate.

Current rate of return and inflation

By purchasing an annuity, you are locking in a fixed interest rate for life. This has worked well for people who purchased annuities in the eighties, when interest rates were high. However, given today's low interest rate environment, you may want to consider the various investment alternatives that are available to a locked-in plan holder to achieve a higher rate of return. This is especially important when considering the effect of inflation on your purchasing power. Further, locked-in plan funds can always be used to purchase annuities at a later date when conditions may be more favourable for the annuity option.

A level income arrangement may seem ideal for some, but an average inflationary trend could easily erode that income. It is important to keep this in mind when deciding whether to purchase an annuity.

Flexibility versus guarantees of each option

You cannot cash in a life annuity once it has been purchased. It is essentially a one-time decision. In that sense, annuities are relatively inflexible. However, it provides a guarantee to you and you know the amount you will receive for the rest of your lifetime.

Locked-in plans, on the other hand, provide you with the ability to vary the annual payments you receive, as long as the minimum payment requirements are met and subject to maximum withdrawal amounts (depending on the jurisdiction that governs the plan). You may choose from a wide range of investments for your locked-in plan. In addition, a locked-in plan can be transferred between financial institutions after payments have commenced.

> It is important for you to determine how you will use the locked-in plan funds. Is it for extras, such as trips or home improvements? Will it be your primary source of income, or do you intend to leave a large estate to your children?

This allows you to maintain control of the assets in your locked-in plan. You also have the ability to convert your locked-in plan to a life annuity at any time in the future. This option is advantageous if interest rates increase in the future and you no longer wish to manage your own locked-in plan assets.

It is important for you to determine how you will use the locked-in plan funds. Is it for extras, such as trips or home improvements? Will it be your primary source of income, or do you intend to leave a large estate to your children?

Your answer to these questions will dictate the degree of flexibility that you'll need from your locked-in plan funds.

Tax implications of each option

Regardless of the option you select, any income you receive during the year is taxable in the year received. However, you are eligible for a pension income tax credit (a federal credit on the first $2,000 of pension income and potentially a provincial credit) if you are at least age 65 at the end of the year and you are receiving income from a locked-in plan or an annuity. Thus, choosing to convert your locked-in RRSP or LIRA to a LIF/ RLIF/LRIF/Prescribed RRIF or an annuity may help you minimize your personal income tax if you are at least age 65.

In addition, up to 50% of the type of income that qualifies for the pension tax credit may be split with a low income spouse to take advantage of their lower marginal tax rates.

A single individual or widow/widower with no financial dependents, little income and a large locked-in plan may be concerned about paying tax on a substantial portion of their locked-in plan at the highest marginal tax rate on death. You may try to avoid this by accelerating the depletion of the locked-in plan through higher annual locked-in plan payments to take advantage of your lower marginal tax rates during your lifetime. However, this strategy results in a prepayment of tax and you lose the ability to grow your investments in a tax-deferred environment. It is important for you to seek the assistance of a qualified tax advisor in assessing this strategy before implementation.

Another advantage of the locked-in plan is that that the amount paid out of a locked-in plan can be changed from year to year, subject to minimum payment requirements. This means you can further adjust your locked-in plan income to complement your other sources of income, giving you the potential to minimize tax and avoid the claw back of income tested benefits such as OAS.

Unlocking your locked-in retirement plan

In special situations, you may be able to make withdrawals from locked-in plans above the normal maximum limits or to unlock your locked-in plan. If you meet the criteria to unlock, then the amount that is unlocked becomes fully taxable to you unless you are able to transfer the unlocked amount on a tax-deferred basis to a non-locked-in RRSP or RRIF.

Depending on the pension legislation that governs your locked-in funds, you may be able to unlock all or a portion of your locked-in plan under the following situations:

1. Shortened life expectancy;
2. Financial hardship;
3. Small plan balance;
4. Non-residency; or
5. Special one time unlocking.

If you have a spouse or common-law partner, then they will generally need to complete a spousal waiver form in order for you to unlock your plan. Appendix 3 summaries the special withdrawal situations that are available to you.

It may not always make sense to unlock your locked-in plan. Since pension legislation governs assets in a locked-in plan, your locked-in plan assets are generally protected from creditors (other than an order for support payments or equalization on marriage breakdown). If you unlock your locked-in plan, whether you decide to take a lump-sum or transfer to a RRSP/RRIF, these funds may now be exposed to creditors. However, assets transferred to a Prescribed RRIF remain protected by pension legislation. Further, in some cases, such as when you take advantage of the Ontario 50% unlocking rules, you have to receive an income stream from the funds that remain locked-in. If you do not need the income, unlocking may not make sense for you.

Marriage breakdown

Upon marriage breakdown, you may need to transfer a portion of your locked-in funds to your spouse pursuant to a separation agreement or court order. Depending on the legislation that governs your locked-in plan, there may be limits to the amount of funds that can be transferred to your spouse.

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The funds you transfer to your spouse will generally need to remain locked-in. Each jurisdiction sets out how your spouse can access those locked-in funds. In some cases, you may receive locked-in funds from a former spouse due to the marriage breakdown or on their death. If you remarry or enter into a new common-law relationship, your new spouse or partner may not be automatically entitled to your locked-in plan assets on your death. In this case, you may be able to name a beneficiary other than your spouse for your locked-in funds.

Speak with a qualified legal advisor if you require more information regarding your locked-in plans on marriage breakdown.

Death

Generally, the beneficiary of your locked-in funds must be your spouse. If you wish to name a beneficiary other than your spouse, your spouse must complete a waiver form to give up their right to your locked-in funds. If you do not have a spouse, you may name any beneficiary you like.

If you designate a qualifying beneficiary (e.g. a spouse/common-law partner or financially dependent child or grandchild) for your locked-in plan, the locked-in plan may be taxable in their hands on your death rather than on your terminal tax return. They may also be able to transfer the funds in the locked-in plan to a registered plan of their own or to purchase an annuity, on a tax-deferred basis. If you do not name a qualifying beneficiary, on death, the fair market value in your locked-in plan on the date of death will be taxable on your final return.

Depending on the jurisdiction that governs your locked-in plan, the funds may remain locked-in when there is a transfer to your spouse on death (see Appendix 3 for details). Where you have no spouse and the funds in your locked-in plan are left to someone other than a spouse, the funds become unlocked.

Planning for your retirement

Your locked-in funds may represent a significant retirement asset. You should carefully consider the available maturity options. Remember to maintain your flexibility as circumstances are always changing but also look at your needs and risk tolerance.

If you already have a locked-in plan, you may be able to unlock all or part of the plan, providing you with greater access to your funds and flexibility. Speak with a qualified tax advisor to determine if you can unlock your pension funds and if you can, whether it makes sense to do so in your circumstances.

If you already have a locked-in plan, you may be able to unlock all or part of the plan, providing you with greater access to your funds and flexibility.