Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Defined contribution pension plans

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

A defined contribution plan is a type of registered pension plan (RPP) that helps employees save for retirement. Employers are required to make contributions and most plans allow or require employees to make contributions as well. The contributions to the plan are then invested on a tax-deferred basis for your retirement. It's called defined contribution because the plan defines what can be contributed to the plan and whatever amounts are contributed to the plan and the growth on those funds, is what is used to provide you with an income at retirement.

A DC plan must meet certain registration requirements under the Income Tax Act (ITA), as well as standards set under federal or provincial pension legislation. For example, these standards set minimum contribution amounts and maximum withdrawal amounts. Beyond these standards, employers can structure their DC 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 DC plan.

At retirement, the funds are most commonly used to purchase an annuity or moved to a locked-in plan where a certain percentage of the funds are paid out annually.

DC plans versus defined benefit plans (DB plans)

A DB plan is another type of RPP that may be offered by your employer. The following are some differences between the two types of RPPs:

- The amount of pension income you will receive from a DC plan is based on the contributions and investment earnings in the plan whereas the amount of pension income you'll receive from a DB plan is based on a set formula. The amount of contributions that need to be made to a DB plan is determined by an actuary to ensure the plan has sufficient funds to meet its pension obligations;
- With a DC plan, the employee bears the investment risk because the amount of pension income is determined by the amount of contributions and investment earnings. Conversely, the employer bears the investment risk of a DB plan, as they need to ensure the plan can pay the set amount of pension income to its plan members; and
- It's generally less costly and easier for an employer to maintain a DC plan than a DB plan. There has been a trend of employers to limit DB plans to existing members and offer DC plans to new employees due to the costs and risk the employer must bear with DB plans.

DC plans versus registered retirement savings plans (RRSPs)

Your employer may also offer a group RRSP as a retirement savings option, or you may have your own RRSP. The following highlights some of the differences between DC plans and RRSPs:

- Funds in a DC plan are subject to the rules and regulations set by the applicable pension legislation, whereas the funds in a regular RRSP are not subject to pension legislation;
- Pension legislation "locks in" your DC plan funds, so you generally cannot make withdrawals from a DC plan, or a locked-in plan that originated from a DC plan, until you reach a minimum age or certain conditions. Conversely, you can withdraw RRSP funds at any time;
- There's usually a maximum annual withdrawal limit for funds held in a DC plan or a locked-in plan that originated from a DC plan, whereas there's no maximum annual withdrawal limit for an RRSP; and

At retirement, the funds are most commonly used to purchase an annuity or moved to a locked-in plan where a certain percentage of the funds are paid out annually.

- Assets inside a DC plan or a locked-in plan that originated from a DC plan are protected from creditors under the relevant pension legislation. Assets in an RRSP are protected under the federal Bankruptcy and Insolvency Act in the event of bankruptcy. Some provinces have their own legislation that may extend your protection outside of bankruptcy. It's important to speak with a qualified legal advisor if creditor protection is a concern for you.

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's 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 DC plan. For more information on RCAs, please ask your RBC advisor for an article on this topic.

Contributing years

Contributions

The amount contributed to a DC plan is generally based on a percentage of your compensation. Your employer will make contributions to the DC plan on your behalf. You may also be allowed to make contributions or you may be required to contribute to the DC plan. For some DC plans, the employer's contributions are made to the DC plan but the plan member's contributions are made to a non-locked-in group RRSP. For others, your employer may provide a matching contribution in addition to the minimum DC plan contribution that

they must make. You will need to check with the pension plan administrator to understand how plan member contributions work for your DC plan.

The maximum contribution that can be made to a DC plan is the annual prescribed limit or 18% of your employment income for a particular year, whichever is less.

The contributions in the DC plan will be invested. The pension plan administrator will typically provide you with a selection of investment options that you can choose from.

Pension adjustment (PA)

There is an upper limit on the amount that Canadians can contribute to tax-assisted retirement savings plans in any given year. 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 such as an RRSP.

The annual PA under a DC plan is the sum of your and your employer's contributions to the DC plan. Your employer is required to calculate the PA and report it to you on a T4 slip. The PA will be reported to you and the CRA annually, and it will reduce your RRSP contribution room in the following year.

Deduction

Contributions that your employer makes to a DC plan are deductible to the employer and are not considered a taxable benefit to you.

The amount you contribute to a DC plan will be reported to you as an RPP contribution, which you can use as a deduction against your taxable income.

Termination and retirement options

If you leave your employer or retire, you can choose from the following maturity options for your vested DC plan funds, provided the DC plan allows for them:

- Transfer the funds to a locked-in retirement plan held by a financial institution. This option allows you to choose how to invest the funds and decide when you want to start receiving payments, subject to some restrictions. The funds can grow on a tax-deferred basis while they're in the locked-in retirement plan. The payments you receive from the plan will be taxable to you as income in the year of receipt. For further information on locked-in retirement plans, ask your RBC advisor for an article on this topic;
- Purchase a life annuity from an insurance company. A life annuity provides you with a guaranteed income stream during your lifetime. The annuity payments you receive are taxable to you annually. Speak with a licensed life insurance representative for more information regarding annuities;
- Leave the funds in the employer's DC plan after termination or retirement and receive retirement income directly from the employer's DC plan. This is often called variable benefits and you can typically take a monthly or annual income stream and potentially request lump-sum payments. Payments are subject to minimum and maximum restrictions. Payments made to you will be taxable to you as income in the year of receipt. It's important to note that not every province or plan allows for variable benefits; or
- Transfer the DC plan funds to a new employer's pension plan, assuming the new employer is willing to accept the transfer.

The maximum contribution that can be made to a DC plan is the annual prescribed limit or 18% of your employment income for a particular year, whichever is less.

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

Vesting

As mentioned earlier, being vested in a DC plan means you're entitled to all your funds in the plan in the event of termination of employment, retirement or death.

If you're not vested in the DC plan, and you leave your employer, you will forfeit the contributions your employer made on your behalf to the plan. You're 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. Alternatively, your contributions plus interest can be transferred in whole or in part, on a tax-deferred basis to your own non-locked-in RRSP or registered retirement income fund (RRIF). You cannot transfer these funds to a spousal RRSP where your spouse is the annuitant. This transfer will not affect your RRSP contribution room.

Under some provincial pension legislation, employer contributions to a DC plan vest after two years of membership. Other provinces have moved towards immediate vesting. You will need to consult with your pension plan administrator to determine when your DC funds vest.

If you are fully vested, 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 funds are locked in, you generally cannot withdraw funds from the plan as a cash payment.

Survivor benefits

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

If you chose to transfer your DC plan funds to a locked-in retirement plan, ask your RBC advisor for an article on locked-in retirement plans for information regarding survivor benefits. If you chose to purchase an annuity, you will need to speak to the annuity provider to determine the survivor benefits.

If the funds are still in the DC plan at the time of your passing, the following sections provide some general information regarding survivor benefits.

Member's death before receipt of pension

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

If you're fully vested, the funds in your DC plan account can be rolled over on a tax-deferred basis to a surviving spouse's RRSP/RRIF. Please note that depending on the applicable pension legislation, the funds may need to be transferred to a locked-in retirement plan. Alternatively, your spouse could use the funds to purchase a life annuity. If your spouse is a member of an employer-sponsored pension plan and their employer agrees to accept the transfer, it may be possible to transfer your DC plan funds to your spouse's pension plan. Any 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 DC plan, any survivor benefits paid out will be taxable to the child or grandchild in the year they receive the payment. 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 DC plan on a tax-deferred basis to a registered disability savings

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

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 DC plan are taxable to them. If you have not named a beneficiary on your plan, the funds will be paid to your estate and are taxable to the estate in the year they're received.

Member's death while collecting pension

If you've already retired and are receiving an income from your DC plan at the time of passing, the remaining funds in the DC plan will be paid to your beneficiary.

If you have a surviving spouse, your spouse will generally be able to select any benefit option that's available to a plan member, which may include keeping the funds in the DC plan, transferring the funds to an RRSP/RRIF or locked-in retirement plan, or using the funds to purchase an annuity. Any 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 DC plan, any survivor benefits paid out will be taxable to the child or grandchild in the year they receive the payment. 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 DC 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 DC plan are taxable to them. If you have not named a beneficiary on your plan, the funds will be paid to your estate and are taxable to the estate in the year they are received.

Conclusion

If you're a member of a DC 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 DC plans operate. However, keep in mind that specific terms in various pension plans can vary greatly. For more information on your particular pension plan, be sure to contact your pension administrator.

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Wealth Management

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