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Making the most of your registered plans in retirement

Introduction: there are many ways to fund retirement

As we approach retirement, we often start dreaming of our "retirement story." How will we spend our time in retirement? We may also think about how our retirement will be funded, and the security of those funding sources.

The majority of Canadians have access to some or all of the various government funded programs: Canada Pension Plan (CPP)/Quebec Pension Plan (QPP), Old Age Security (OAS) and Guaranteed Income Supplement (GIS). These programs may provide us with a base level of income.

And, through our working years, we may have set some money aside for retirement – contributing to a registered retirement savings plan (RRSP) and/or tax-free savings account (TFSA). We may have also been able to set some money aside in non-registered investment accounts. These savings may supplement our cash flow needs in retirement. However, they carry potential risks: market, performance, inflation, and longevity risk.

Some Canadians may benefit from an employer pension plan, also known as a registered pension plan (RPP). The RPP could be a defined benefit (DB) plan or a defined contribution (DC) plan. These Canadians want to know with confidence that their RPP will be there when they need it, to play out their retirement story. They may also wish to leave some of it to loved ones when they are gone.

If an employee left an employer with an RPP, prior to retirement, they may have transferred what had already accumulated in their retirement plan to a locked-in retirement account (LIRA), a locked-in retirement savings plan (LRSP)[1] or to locked-in fund (LIF). These, too, will be drawn upon in retirement and carry similar risks to an RRSP, TFSA or non-registered investment account.

For retirees with some or all of the above plans in hand at retirement, it can lead to some level of complexity. Also, there may not be a clear plan as to how to generate a continuous, secure, and tax efficient cash flow in retirement. That said, there are options available to the retiree that may help simplify their affairs, provide flexibility, are forward looking, and goals based. Let's review some of these options, that could help you make the most of your registered plans in retirement.

Background: legislation provides a framework and options

Federal[2] and provincial[3] pension legislation and the *Income Tax Act* (Canada) (ITA) work together to provide Canadians with retirement savings options. They provide the framework that employers operate within to offer their employees an RPP. They also provide the framework for the options that individuals use to save for retirement during their working years, such as an RPP, RRSP, or TFSA, and withdraw from in retirement, such as a registered retirement income fund (RRIF) or payout annuity.

Some of these options are better understood than others. As individuals planning for our retirement, how do we best access these various retirement and savings plans and when?

[1]Alternatively, the employee may have had the opportunity to transfer to another workplace pension plan.
[2]Pension plans in the Yukon, Northwest Territories and Nunavut are governed by Federal pension plan legislation.
[3]Prince Edward Island does not have pension legislation, as of the writing of this article.

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Things to consider when you retire with a DB plan

In the case of a **DB plan**, once you notify your employer of your intention to retire, you will receive a report that may outline the following with respect to your RPP:

1. Accrued pension benefits (i.e., your monthly pension entitlement under the plan and payment options)
2. Lump sum commuted value[4] of the pension and transfer options, if eligible
3. Indexation rules for retirement income, if any
4. Survivor benefits, usually regarding a surviving spouse, common-law partner, or other's entitlement within the plan
5. Death benefit, generally, only applies prior to retirement or in the case of a form of pension that includes a guaranteed period
6. Financial position of the plan, including an overview of the results of a recent actuarial review completed to determine if the plan's assets are sufficient to meet its liabilities (i.e., accrued pension benefits)

A review of the document may raise these concerns:

- Will the plan provide adequately for my loved ones after I am gone?
- Is the level of funding within the plan sufficient to secure my pension into the future?

How might you solve for these concerns? You could consider purchasing a payout annuity, sometimes referred to as a "copycat"[5] annuity, provided the requirements of the ITA can be satisfied.

Another option that may be available is a lump sum transfer to a LIRA[6] or LRSP; however, this may not address concerns related to market, performance, inflation, and longevity risk. And, there may be tax implications.

Things to consider when you retire with a DC plan

In the case of a **DC plan**, your retirement income is dependent upon:

1. Amounts contributed to the plan by the employer and you, and
2. How the plan performed, based upon your investment decisions.

At retirement, the opportunity to save further is most likely reduced. What you have accumulated to that point will have to be accessed with intention. You will need to think beyond investment selection and more about when and how much to withdraw and from which sources. You'll also need to address concerns related to market, performance, inflation, and longevity risk.

How might you solve for these concerns?

You could consider purchasing a payout annuity, using all or a portion of the underlying DC plan assets. The other option is to transfer the lump sum amount to a LIRA, LRSP, or locked-in RRIF (LIF)[7]; however, this may not address the concerns we've identified.

[4]An actuarial calculation of the net present value of future pension obligations. Note: if eligible for the commuted value.
[5]While the term "copycat" is sometimes used to reference a payout annuity that is purchased to replace the income from a DB plan, it should be noted that the copycat annuity might not provide all of the same features as a DB plan. However, the copycat cannot be materially different from the DB plan.
[6]A locked-in retirement account (LIRA) is another option; however, it does not differ from a risk perspective from a RRIF, RRSP, or DC Plan, nor does it address the other concerns outlined above.
[7]You may be able to take the money from your pension plan in cash if it is below a specific amount. Depending on your age and the terms of your pension plan, you may also be able to reinvest some of this money in another financial plan, such as an RRSP or RRIF that is not locked-in. Your pension plan administrator will usually provide you with your options when you retire. Source: https://www.canada.ca/en/financial-consumer-agency/services/retirement-planning/employer-sponsored-pension.html.

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Another thing to consider: age

After December 31 of the year you turn 71, you can no longer have an RRSP, LIRA, or LRSP. So, what are your options? There are three options and you can choose any one or a combination of each in varying amounts (the combination cannot exceed the amount of your RRSP, LIRA or LRSP at that time).

1. Withdraw the savings within the plan: the full amount of the withdrawal is included as income for tax purposes in the year of withdrawal. This may result in a significant tax liability – likely not a preferred outcome.
2. Direct transfer of the savings within the plan to a RRIF or LIF. The amount that is transferred to a RRIF or LIF is not taxable in the year of the transfer, assuming it is a direct transfer. That sounds better, but any concerns related to market, performance, inflation, and longevity risk remain.
3. Purchase a payout annuity. The amount that is used to purchase a payout annuity is not taxable in the year of purchase. That sounds better, but this is not a well understood option.

Remember, when it comes to your RRSP, LRSP, or LIRA, these decisions must be made and completed by December 31 of the year you turn 71, so planning should begin earlier that year.

What is a payout annuity?

A payout annuity is an income-generating insurance contract. In exchange for a lump-sum amount (in the realm of insurance, it is referred to as a *premium*), you receive a series of guaranteed income payments for one lifetime, two lifetimes or a specified period.

What are the different types of payout annuities?

There are four types of annuities:

Life annuity: the owner receives income for life, based on the life of the annuitant.

For registered annuities, the owner and the annuitant need to be the same person. For non-registered annuities, the owner and the annuitant don't have to be the same person.

Joint life annuity: the owner receives income for life and at death, the income transfers to the surviving annuitant for the balance of their lifetime.

For registered annuities, the surviving annuitant must be their spouse or common-law partner. For non-registered annuities, the surviving annuitant can be their spouse or common-law partner or another individual.

For life and joint life annuities, choosing a guaranteed period provides a death benefit to beneficiaries if the annuitant or, in the case of a joint life annuity, both annuitants die during the period selected.

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Term certain annuity: provides guaranteed payments for a specified chosen period. If the last surviving annuitant dies before all the payments are made, a death benefit is paid to beneficiaries.

For registered annuities purchased with premiums from an RRSP or RRIF, the guaranteed payments must be to age 90.

Enhanced annuity: where certain conditions are met, if you have a life-shortening condition[8] (known as a health impairment), you may be able to benefit from higher income payments than would otherwise have been received from an annuity for someone of the same age and sex with no health impairment.

How much can be purchased?

Did you know that the amount used to purchase an annuity is called a *premium*?

When purchasing a payout annuity within an RRSP, LRSP, LIRA, LIF, or deferred profit-sharing plan (DPSP), you can choose the amount, but your choice is limited at the top end by the balance in the account. The amount that you choose will be based on a number of factors, including how much in guaranteed income you are seeking and the period of time over which you wish to receive them (for registered annuities, the guarantee must pay to age 90).

When purchasing a payout annuity with funds from a DC plan, again, you can choose the amount, but your choice is also limited at the top end by the balance in that account. The amount that you choose is based on factors similar to the above.

When purchasing a payout annuity with funds from a DB plan (a "copycat" annuity), the amount purchased (the premium) is based on the full commuted value of the RPP[9]. As well, certain additional considerations must be satisfied[10]:

- The rights provided under the payout annuity contract cannot be materially different from those provided under the DB plan,
- At the time the payout annuity contract is purchased, the registration of the RPP cannot be revocable[11], and
- The payout annuity contract must be purchased directly from the DB plan.

Effectively, the legislation provides that the retiree will be in a position that is not unlike what they would have been in had they received a pension under the former employer's DB plan.

[8]Life-shortening conditions are usually severe, permanent, and progressive. A medical evaluation is required to determine if you qualify. You're responsible for all costs associated with providing medical evidence.
[9]A government DB pension is usually CPI indexed, whereas a payout annuity is generally not; however, in some cases a methodology is in place where it's possible to replace the indexing depending on the formula provided in the plan.
[10]If not satisfied, the purchase cannot be completed on a tax deferred basis and the commuted value of the RPP would be included in income in the year it was received.
[11]Unless waived by the Minister of Finance.

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Why choose a payout annuity?

What are some reasons to consider purchasing a payout annuity when you are a **member of a DB plan**?

- Avoids the risk of an underfunded pension plan becoming insolvent and, therefore, not being able to continue with the pension income you expected.

> Payout annuities can only be purchased from an insurance company, which makes them eligible for protection from Assuris, a not for profit organization that protects Canadian policyholders if their life insurance company fails. Please refer to assuris.ca for further information.

- In certain circumstances, you may receive a separate excess lump sum amount if the premium required to purchase the payout annuity is less than the cash surrender value available from the plan. Although taxable, you may not otherwise have received it. If you have available RRSP contribution room, you could choose to contribute to your RRSP at that time[12] and minimize the associated income tax.

[12]The RRSP contribution must be made within the year that the lump sum amount is received or within 60 days after the end of that year, if you wish to claim it as a deduction to offset the associated income (i.e., the lump sum amount received).

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Hypothetical case scenario 1

Example: DB plan to a life annuity – commuted value greater than annuity premium

DB plan commuted value	$738,000
DB pension payment	$4,000/month
Life annuity payment*	$4,000/month
Premium required to match the DB Plan income*	$720,000

- $720,000 of the commuted value is transferred directly, tax-free, to the life insurance company to buy the life annuity.
- The annuitant must take the remaining $18,000 in cash and it will be taxable in the year it's received.

Rates and information are hypothetical.

*Assumes other benefits (survivor benefits, guarantee periods) are the same for the life annuity and the DB plan. This increases the likelihood that the Canada Revenue Agency will agree that the life annuity benefits are not materially different from the DB plan benefits.

In this scenario, the employer's pension was matched by the purchase of a life annuity. In addition, the individual received a separate excess lump sum payment[13] of $18,000 that they could contribute to an RRSP if they had available RRSP contribution room.

What are some reasons to consider purchasing a payout annuity when you are a member of a DC plan or have other registered retirement plans?

- You are not interested in making ongoing investment decisions in retirement.
- You wish to eliminate investment risk.
- There is a history of longevity in the family.
- You are seeking guaranteed income for life.
- The income from a payout annuity is protected by Assuris[14].
- The income from a payout annuity may be eligible for pension income splitting at the federal level before the age of 65.

[13]A separate excess lump sum payment may not result in all situations; it is case specific and can only be determined following careful review and analysis of the DB plan options, etc.
[14]Refer to assuris.ca for details.

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Hypothetical case scenario 2

Example: DC to an annuity – commuted value greater than annuity premium

DC pension plan balance	$200,000
Monthly annuity income	$700
Premium required to generate $700 per month	$180,000

- $180,000 is transferred directly to the insurance company, tax-free, to buy the life annuity.
- The annuitant must take the remaining $20,000 and transfer it directly to a LIRA otherwise the amount will be included in income for tax purposes in the year received.

In this scenario, the retired employee will receive a monthly income for life. In addition, the remaining amount was transferred directly to a LIRA (refer to the discussion above titled *Another thing to consider: age* for an overview of options with respect to a LIRA).

What else might you consider when deciding to purchase a payout annuity?

- ***I want my money to grow*** – to balance a desire for market growth with the need for guaranteed income, consider allocating a portion of your retirement savings to a payout annuity. Other products in your portfolio that have market exposure can be used for growth potential.
- ***Interest rates are too low*** – interest rates are only one factor that determines the income. Other factors are age at purchase, gender, type of annuity, and whether a guaranteed period is added and for how long.
- ***Loss of liquidity and perceived lack of flexibility*** – you receive what is, essentially, a personal pension plan with lifetime guaranteed income. And again, you can consider allocating a portion of your assets earmarked for retirement to purchase a payout annuity, leaving other assets to provide liquidity and flexibility.
- ***I may not live long enough to benefit*** – a guaranteed period can be added to ensure that payments continue to a beneficiary should you die during the chosen period. Another option is to purchase a joint life annuity. This ensures payments will continue to your spouse or common-law partner[15].
- ***Payout annuities generally don't offer Consumer Price Index (CPI) indexing*** – although they can offer fixed indexing instead.

[15]For registered plans, the joint annuitant must be your spouse or common-law partner; however, in the case of non-registered investments, the annuitant can be another individual other than your spouse or common-law partner.

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How are payout annuities taxed?

Similar to any pension income or a withdrawal from a registered account, such as an RRSP, RRIF, or LIF, payout annuity income payments are taxed as regular income in the year received when purchased with funds from a registered retirement plan.

The section **"How are payout annuities taxed"** speaks to the option of purchasing an annuity with registered money and the resulting taxation.

However, it's also possible to purchase an annuity with non-registered money and there may be tax advantages in doing so. Speak to your advisor for details.

If the payout annuity is purchased with money from an RPP or DPSP, a mandatory amount of tax will be withheld at source, based on a formula, when payments are made to you. This is remitted to the Canada Revenue Agency (CRA) – not unlike tax withheld at source when amounts are withdrawn from an RRSP or RRIF. It's important to note that the amount withheld may or may not be reflective of the amount of tax you owe when you file your annual T1 tax return. In addition to the mandatory withholdings, you can request that additional tax be withheld and remitted to the CRA.

Payout annuity income[16] is considered eligible pension income for income tax purposes, with two associated benefits.

1. A Federal pension credit[17] up to the $2,000[18] can be claimed
    - At any age, if purchased with pension fund amounts (e.g., the value of a DC plan or the commuted value of a DB plan)
    - At age 65 or older, if purchased with registered funds (e.g. RRSP, RRIF, DPSP)
    - With respect to the above points, if the amounts received by the individual are a consequence of the death of a spouse or common-law partner
2. Income splitting -- an individual can allocate up to 50% of the amount received from the payout annuity to their spouse or common-law partner, for tax purposes. And, they, in turn, may be able to claim up to $2,000 of the Federal pension credit[16].

As a result, less tax is likely payable as a family and, with careful planning, there may be an opportunity to minimize or eliminate the claw back of OAS.

We encourage you to consult with a qualified tax expert if you have questions about the taxation of a payout annuity.

[16]In addition, the interest component of a payout annuity purchased with non-registered funds has the benefit of also being able to claim the Federal pension credit up to $2,000 (refer also to footnotes 17 and 18) if age 65 or older.
[17]Non-refundable tax credit.
[18]Lesser of $2,000 and the total of eligible pension income received by the individual for the year and amounts received by the individual on account of a retirement income security benefit payable to the individual under Part 2 of the *Veterans Well-being Act*.

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In conclusion

Planning for your cash flow needs in retirement is important. You will likely be looking to incorporate some level of flexibility, some level of security, and maybe some level of risk to take advantage of any upside potential in the market. From a security standpoint, a payout annuity is a sound investment option to consider in helping to meet your need for guaranteed retirement income. It can be a valuable component of your retirement plan, towards fulfilling your "retirement story".

For more information, speak to your advisor or:

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