

With an aging, wealthy population, many Canadians are currently contemplating early retirement. In addition, many individuals are being laid-off, presented with voluntary early retirement packages or in certain cases, forced into early retirement. This article has been prepared to help you identify those strategies that can help you deal with an early retirement.

There are many different factors which affect your retirement planning including life expectancy, inflation and rates of return on your retirement investments. In addition, you will require a basic understanding of The Income Tax Act as well as Federal/Provincial pension legislation. Due to the complexity, and importance, of these decisions we recommend that you consider employing various individuals to help you with your retirement decisions including tax accountants, lawyers, actuaries, financial planners and investment professionals.

SEVERANCE

Generally when an employee is asked to retire early they are offered a severance payment. Depending upon how it is structured as well your employment history with your current employer, your severance may be considered a "retiring allowance". The benefit of receiving a retiring allowance is that a portion of it may be eligible for a tax-free rollover to your RRSP, subject to certain limits.

RETIRING ALLOWANCE

For tax purposes, a retiring allowance generally includes payments in respect of a loss of employment or in recognition of long service. Payments that qualify are eligible for a tax-free rollover to your Registered Pension Plan or RRSP (excluding spousal RRSPs) subject to the following limits.

- 2,000 per year of employment up to and including 1995; plus
- An additional \$1,500 per year of employment up to and including 1988, where your employer's contributions to a Registered Pension Plan or Deferred Profit Sharing Plan did not "vest".

TYPES OF EMPLOYER PENSION PLANS

There are generally two types of pension plans that employers provide to their employees. Defined Contribution Pension Plans and Defined Benefit Pension Plans.

DEFINED CONTRIBUTION

If you are a member of a defined contribution pension plan then your pension generally consists of contributions made by you and your employer plus the investment earnings on those contributions. Generally, at retirement, you will be given the option of rolling the accumulated value to a locked-in plan or alternatively your employer will continue to manage the plan.

DEFINED BENEFIT

If you are a member of a defined benefit pension plan your pension generally consists of a formula based on a number of factors including your average employment earnings, the number of years worked and a pension factor. As an employee you will be guaranteed a consistent income stream subject to the pension's and your employer's financial stability. Your pension income may be adjusted based on a number of choices including your age you want to begin receiving your pension income as well as your decision to guarantee pension payments for your spouse or your estate. Upon retirement you will typically be given the option of maintaining your entitlement to your annual defined benefit payment or alternatively, in certain instances, you may be allowed to transfer a lump-sum ("commuted value") to a locked-in plan.

COMMUTED VALUE

The commuted value is the lump-sum amount that you may be entitled to instead of your benefits under your employer-provided pension. Generally it reflects the amount of money required to replace your pension. An actuary uses assumptions to calculate the "present value" of your future pension benefits including projected investment returns, mortality rates, your retirement age, marital status, and expected inflation rate.

TRANSFERRING TO ANOTHER EMPLOYER OR PURCHASING A DEFERRED ANNUITY

In certain instances you may be able to transfer locked-in benefits to a new employer's pension plan or alternatively you may be able to use the commuted value to purchase a "deferred" annuity. An annuity provides future annual income based on current interest rates.

LOCKED-IN ACCOUNTS¹

Locked-in accounts are subject to restrictions under specific Federal and Provincial pension legislation. Similar to an RRSP, locked-in accounts are generally allowed to grow tax-free until age 71. Subject to Provincial legislation, the funds may need to be converted to a life annuity or rolled to a Life Income Fund (LIF), Locked-In Retirement Income Fund (LRIF), or Saskatchewan or Manitoba RRIF (SK RRIF/MB RRIF).

Locked-in accounts are very similar to RRIFs in that you retain investment control and must withdraw a minimum amount from your plan each year. However, unlike a RRIF, locked-in plans have a maximum annual withdrawal (except for SK RRIFs or MB RRIFs).

With a LIF, any remaining funds must be transferred to a life annuity at age 80 whereas with an LRIF or SK RRIF/MB RRIF, you do not. The maximum annual-payout formulas are also different. For a LIF, the maximum withdrawal is based on the November CANSIM Rate. For an LRIF, the maximum-payout formula is based on investment earnings. For additional discussion please see our article "**Retirement Income Options**".

EXCESS TRANSFER AMOUNTS

The Income Tax Act sets limits on the amount of pension that can be transferred tax-free from a defined benefit pension plan to a locked-in plan. Amounts that cannot be transferred tax-free to a locked-in plan are called "excess transfer amounts" and in most cases are taxable to the employee. We recommend that you consult with your professional tax and investment advisors about your specific situation.

PENSION ADJUSTMENTS

Pension Adjustments (PA) ensure individuals have access to similar tax-deferred pensions, regardless of the type of pension plan they belong to. The PA reduces your RRSP contribution room as it reflects the value of pension benefits earned from an employer sponsored pension plan.

A Past Service Pension Adjustment (PSPA) occurs where your pension benefits increase as a result of being credited with additional pensionable service, or where the plan is being amended to retroactively increase your pension benefit.

PENSION ADJUSTMENT REVERSALS

A Pension Adjustment Reversal (PAR) on the other hand restores contribution room as a result of lost RRSP contribution room. This may arise where you are a member of a defined benefit pension plan and your pension has not vested when your employment terminates. If you receive a commuted value that is low relative to the RRSP room given up while a plan member, the PAR should largely restore your lost RRSP contribution room

RRSP CONTRIBUTION LIMITS

Your RRSP contribution limit is 18% of your previous year's earned income up to the maximum amount for the current year; minus the total of your PA and PSPA; plus your Pension Adjustment Reversal (PAR).

PENSION INCOME SPLITTING

Pension Income Splitting is a tax measure that allows any Canadian resident who receives income that qualifies for the existing pension income tax credit to allocate to their resident spouse up to one-half of that income regardless of the age of the spouse receiving the income allocation.

For individuals aged 65 years and over, eligible pension income includes prescribed annuity payments, lifetime annuity payments under a registered pension plan, a registered retirement savings plan or a deferred profit-sharing plan and payments out of or under a registered retirement income fund.

For individuals under 65 years of age, eligible pension income includes lifetime annuity payments under a registered pension plan and certain other payments received as a result of the death of the individual's spouse or common-law partner.

For income tax purposes, the amount allocated will be deducted in computing the income of the transferor (the person who actually received the pension income) and included in computing the income of the transferee (the person to whom the pension income is allocated).

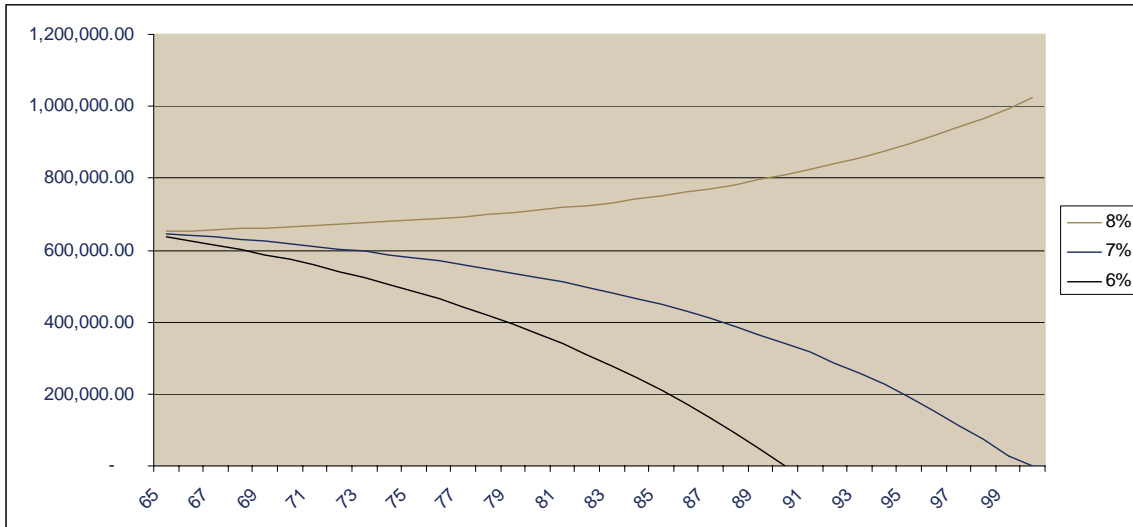
The pension income splitting allocation will be available for 2007 and subsequent taxation years, and will be made on an annual basis where both spouses agree to the allocation in their tax returns for the year.

¹ Effective April 2002, LIF and LRIF legislation was repealed under Saskatchewan pension legislation. The SK RRIF was introduced to replace the LIF/LRIF options. Effective May 2005 Manitoba pension legislation introduced the option of transferring up to 50% of a MB LIF/LRIF to a MB RRIF. Effective August 2006, Alberta discontinued the LRIF option. BC pension legislation specifically states that the annuitant must convert their LIRSP to a LIF or a Life Annuity by age 69. LRIFs are currently available only for Manitoba, Ontario and Newfoundland/Labrador pensions.

PENSION PLAN VS COMMUTED VALUE

The decision to transfer a commuted value from a Defined Benefit Pension Plan is one that needs careful consideration. There are benefits to both and you need to consider which is most important to your particular situation. The overriding decision will become an issue of whether you can replace the pension income and death benefits (as well as any other benefits you would receive by staying in the plan) with the income and capital realized from receiving the commuted value.

For example, assume that you were entitled to an annual pension of \$50,000 per year commencing at age 65 and there were no inflation or indexing provisions. If your commuted value was \$650,000 then the following simple financial analysis may help you in your decision.



The analysis above compares three rates of return (6%, 7% and 8%) on an investment of \$650,000. Each year \$50,000 is withdrawn from this account to provide an equivalent income as the defined benefit plan. The analysis above shows that an 8% return on \$650,000 (\$52,000 per year) is higher than the annual pension income provided by the defined benefit plan. At 7% there is sufficient income and capital to pay \$50,000 per year until age 100 when the capital is fully eroded and finally, at 6% the capital is fully eroded by age 90.

Pension Plan	Commuted Value
<ul style="list-style-type: none"> • Employer provides guaranteed lifetime income according to pension formula (usually based on average earnings) • Survivors pension for spouse • Pension Income Splitting opportunities prior to age 65 • Limited continuing benefits for estate (non-spouse) • Option to delay pension past age 65 • Possibility for inflation and indexing provisions • Possible continuation of group benefits 	<ul style="list-style-type: none"> • Investment flexibility • Potential for additional tax-deferred wealth accumulation • Spouse and estate receive remaining pension after planholder's death. Spouse can roll entire value of locked-in plan at planholder's death • Pension Income Splitting opportunities limited to individuals aged 65 and older

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