



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment
Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Purchasing past service from your defined benefit pension plan

If you're a member of a defined benefit (DB) pension plan, you may be 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 weren't a member of your employer's pension plan. This opportunity 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. This article highlights some of the key 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 for a variety of reasons such as to raise a family, go back to school or travel. 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's 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.

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.

You may also 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.

Some additional reasons to proceed with a past service purchase include:

- **Income for life:** Since a pension is payable for life, a past service purchase is 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.

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.

- **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 your employer.

Some reasons to consider not purchasing past service include:

- **Estate planning flexibility:** If you don't 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) may 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, you can make a lump-sum withdrawal from a registered retirement savings plan (RRSP) or RRIF when 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 can continue to compound on a tax-deferred basis (except for the mandatory minimum payment each year) beyond age 71 if you convert your RRSP to a RRIF. Once you start receiving retirement benefits from the pension plan, the payments must be made to you and are taxable whether you need the funds 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, a PSPA needs to be calculated by the pension plan administrator if the

plan member purchases past service. A PSPA reduces your RRSP room (possibly creating negative contribution room). 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.

The Canada Revenue Agency (CRA) must certify any PSPA greater than \$50. 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 the 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.

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 buy back past service for years before January 1, 1990, you are subject to a maximum deduction of \$3,500 for each of those years.

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.

The Canada Revenue Agency (CRA) must certify any PSPA greater than \$50. 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 the past service.

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's possible to use funds that are held in a spousal RRSP to fund the purchase without triggering the attribution rules if 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's also possible to pay for past service with funds held in a locked-in RRSP or LIRA if the pension jurisdiction governing the locked-in plan and the target pension plan are the same. There are some plans that allow locked-in plans from other jurisdictions to be used to fund the purchase, so consider asking your pension administrator if this is possible for your plan.

Direct transfer using new RRSP contributions

If you're 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 contributing 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 be 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. Note that if payments are made by installments, interest may be charged and you should consider this cost when determining if a buyback makes sense for you.

As mentioned earlier, 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 completing the past service purchase. 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 planning objectives. Speak with your RBC advisor about your specific circumstances if you've been presented with the opportunity to make a past service purchase.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance 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 tax, legal, and/or insurance advisor before acting on any of the information in this article.



**Wealth
Management**

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Wealth Management Financial Services Inc. (RBC WMFS), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI)* and Royal Mutual Funds Inc. (RMFI). *Member – Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies, RBC DI or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. In certain branch locations, one or more of the Companies may carry on business from premises shared with other Royal Bank of Canada affiliates. Notwithstanding this fact, each of the Companies is a separate business and personal information and confidential information relating to client accounts can only be disclosed to other RBC affiliates if required to service your needs, by law or with your consent. Under the RBC Code of Conduct, RBC Privacy Principles and RBC Conflict of Interest Policy confidential information may not be shared between RBC affiliates without a valid reason. ®/™ Trademark(s) of Royal Bank of Canada. Used under licence. © Royal Bank of Canada 2024. All rights reserved.