How to Get More Money Out of Your Defined Benefit Pension Plan

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If you're one of the lucky Canadians whose employer has a defined benefit (DB) pension plan, then you should be looking at something called pension matching before you decide to take your pension.

Pension matching is about getting the most retirement income by shopping your DB pension plan to insurance companies that can match or beat the amount of pension income you will receive under your current plan. In other words, you are saying to the insurance company, "Give me your best life annuity income rate and I will consider switching the commuted value of my DB pension to your company."

Pension matching works well for employees of private corporations whose company may be having some financial trouble and can't afford to pay the amount of pension income promised. Public corporations rarely have this problem since they have something called the power of taxation (which means if they can't fund their high-paying DB pension plans, they'll simply go the Canadian taxpayer to get more money). Private corporations don't have this option. They rely solely on their financial stability, earnings, savings, and profit margin to fund the pensions.

Before you decide to pension match your DB plan, you want to comply with the "not materially different rule."

The Income Tax Act allows the transfer to a life annuity on a tax-free basis as long as the life annuity is "not materially different" from the terms provided in your current DB plan. Not materially different implies that the benefits received from your DB pension plan (such as guaranteed periods, joint and survivor options, indexing/inflation protection, and so forth), should not completely differ from those offered under the DB plan. The term not "materially different" also suggests that the life annuity income can differ from the pension income, but not by much.

If the possibility exists that a Canadian insurer can take your pension and stay within the "not materially different" requirement, then this is your chance to shop the pension market and possibly receive a lump sum payment. You can simply call the company directly or use an insurance broker specializing in DB pension plans.

For example, Mr. X has a DB pension plan with a commuted value of $738,000. The DB plan promises to pay him $4,000/month for life. Mr. X is concerned about his employer meeting their obligation to fund his DB pension plan now and in the future. He decides to shop his pension to a highly rated insurance company for two reasons.

The first reason is that the insurance company has more financial stability than his current employer.

The second is to find out whether the insurance company can match his DB payment while requiring less of the commuted value. If that's the case, then he may be able to receive a lump sum of cash.

After Mr. X shops the market, he finds an insurance company that requires only $720,000 to match the $4,000/month DB plan income. The $720,000 value is transferred directly to the life insurance company to buy the life annuity. Mr. X then pockets the remaining $18,000 in cash which is taxable in the year he receives it.

Picking up an extra $18,000 in cash, although fully taxable, is a bonus. In my 23-year career I have seen much larger cash payments being handed out. Two companies immediately come to mind: Hydro One and General Motors. One particular case involved a male employee whose DB pension plan promised him a monthly income amount of $7,000 at age 65. The pension had a commuted value of $2,300,000. After shopping the annuity market, a highly rated insurance company offered him the same guaranteed monthly income for life, yet required a commuted value of only $2,000,000. The difference of $300,000 was given to him as a taxable lump sum payment.

Note: The above examples assume other benefits (survivor benefits, guarantee periods, indexing etc…) are the same for the life annuity and the DB plan. This increases the likelihood that the Canada Revenue Agency (CRA) will agree that the life annuity benefits are not different from the DB benefits. You must consult with your insurance specialist and your tax advisor. The CRA may regard the life annuity income to be "materially different" from the DB plan income since the other benefits mentioned are not available.

The Future of Defined Benefit Plans

In the public sector, DB plans are still commonplace. In the private sector, DB plans are becoming less common as employers prefer to offer defined contribution (DC) plans to reduce their ongoing pension liabilities.

The number one reason DB plans are avoided today is because it sets a promised amount of retirement income employees will receive at a later date, regardless of investment performance. Since employers are responsible for this retirement income, it becomes quite risky to them and their employee if they cannot fully fund the promised monthly income benefit.

Retirees or soon-to-be retirees of private corporations often fail to understand that their DB pension plans are not guaranteed. If the employer cannot afford to pay and fund the plan any longer, then the plan could be wound down and contributions stopped. Worst-case scenario would be if the employer goes bankrupt (and the DB plan isn't fully funded), their employees may end up with less monthly retirement income than they expected.

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