

## Chapter 16: Retirement Planning

**Retirement planning** is the process used to ensure that sufficient financial resources are available to provide support when paycheques stop.

The retirement benefit as a percentage of pre-retirement salary is called the **replacement ratio**.

When a retirement plan qualifies for favorable tax treatment, it is called a **registered plan**. The two important aspects of the *Income Tax Act* that have the greatest influence on the accumulation of retirement savings are:

- contributions to registered plans are tax deductible at the time they are made
- investment earnings on assets held in registered plans are not taxed until they are received

The **Old Age Security (OAS)** system is financed from the federal government's general tax revenues. Eligibility for the OAS is limited to persons considered residents of Canada under Canada's *Income Tax Act* and its benefits are fully indexed to inflation. Recipients must include the basic OAS pension in their taxable income when determining the amount of federal and provincial income tax they pay. Some of the largest tax implications in the existing OAS system are found in its **clawbacks** – income tested benefit reductions for higher income taxpayers.

The **Guaranteed Income Supplement (GIS)** is a welfare program designed to support low income seniors.

The **Canadian Pension Plan (CPP)** is the primary element of the social insurance for most Canadians. This federal program provides monthly retirement benefits, benefits to dependents of deceased workers, and disability benefits.

Funds held by CPP are managed by the **Canadian Pension Plan Investment Board (CPPIB)** and invested in a diversified portfolio consisting of equities, fixed income and inflation sensitive assets.

In a **defined benefit plan**, an employer promises employees a monthly retirement benefit that is defined by a benefit formula. A special type of defined benefit plan is an **Individual Pension Plan (IPP)**. They are registered plans that are designed for an individual person rather than a group.

Employees' pension assets may or may not be **locked in**; i.e. restricted from being taken in any form except retirement income.

One of the most common types of defined contribution plans is a **money purchase plan**, in which the employer make an annual contribution on behalf of the employee regardless of the firm's profits. A **profit sharing plan** is another type of defined contribution plan; the employer's contribution to a profit sharing plan depends on the firm's profit.

A new type of defined contribution plan called the **Pooled Registered Pension Plan (PRPP)** is being implemented to target the millions of middle-income private sector workers who are employed by mid-sized or smaller firms and not members of the employment-based pension plans. The intent is to

improve access to professional plan administration and asset management for this group while reducing the associated fees to an amount closer to what is paid by the largest pension plan.

Often the benefit formula in a defined benefit plan is structured so that benefits are strongly backend loaded. The backend loading of benefits implies that employees can suffer large losses in the value of their retirement benefits if they leave the firm or if the firm terminates the plan prior to retirement. It also discourages turnover, which provides greater incentives for employers to make investments in training employees and provides employees with incentives to put forth greater effort.

**Registered Retirement Savings Plans (RRSPs)** were enabled by the government to encourage individuals to save for their own retirement, but in order to qualify, several restrictions and rules must be followed. First, an individual must have earned income to be eligible to contribute to an RRSP. Contributions to RRSPs are deductible for income tax purposes and income generated within an RRSP accumulates on a tax-deferred basis. The contribution limit for tax deductibility is tied to a worker's earned income and to the maximum pension permitted under registered pension plan rules.

Under a **group RRSP** arrangement, separate accounts are established for each participating employee, and both employees and employers are permitted to make contributions.

Individuals can contribute to an RRSP until the end of the year in which they turn age 71, at which time they must either 1) turn it into a **Registered Retirement Income Fund (RRIF)** whereby the funds are withdrawn in future years to provide retirement income or 2) use it to purchase a life annuity or 3) consume the income. If individuals use a RRIF, they are able to withdraw as much as desired in any year, but there is a minimum withdrawal required.

When pension assets are less than pension liabilities, the plan is **underfunded**; otherwise it is **overfunded** and is said to have a **surplus**.

Ontario created the **Pension Benefits Guarantee Fund (PBGF)** to insure employees' promised benefits in defined benefit pension plans against a loss of benefits if a firm terminates an underfunded plan. It will pay promised benefits up to a maximum amount if a pension plan is terminated with insufficient funds to pay promised benefits.

## Questions

**There are two major types of employer sponsored pension plans. Describe each of them and indicate which you as an employee would prefer.**

**ANS:**

### Defined Benefit Plans

- retirement benefits defined by a formula (often a function of years of service and salary)
- employer and perhaps workers contribute to a fund

- contributions + investment earnings are accumulated to pay the promised benefit
- employer bears most of the investment risk (preferred by employees)

### **Defined Contribution Plans**

- employer and perhaps workers contribute to a fund based on a formula
- retirement benefit = accumulated value of contributions + investment earnings
- workers bear most of the investment risk

M/C, S/A: What are 2 distinct differences between a defined benefit pension plan & a defined contribution pension plan?

M/C, S/A: What are the 3 tax advantages of registered retirement savings plans?

S/A: A pension plan in which both the employer and employee contribute 4% of the employee's salary annually into a fund from which the employee receives the deposits plus interest earned is an example of

- a) A defined contribution plan.
- b) An individual pension plan.
- c) A defined benefit plan.
- d) A registered retirement savings plan.
- e) A profit sharing plan.