



The ScotiaMcLeod Wealth Planning Series

Early Retirement Options Handbook



ScotiaMcLeod™

Building Relationships for Life

ScotiaMcLeod's Wealth Planning Services Early Retirement Options Handbook

Most of us will accumulate assets during our working years in the form of RRSPs or pensions. At some point we begin to consider whether or not these assets will support our retirement goals or whether there may be sufficient assets to provide for an early retirement. As well, in today's changing business environment, we may find ourselves in the position of being forced to take early retirement as a result of "re-organization" or "downsizing."

This booklet will help explain some of the factors you should consider when looking at an early retirement decision and ultimately deciding whether or not it is right for you. This information however is not meant as a substitute for professional advice. As such, it is important to consult with your Investment Executive, Accountant, Lawyer or other professionals when assessing your personal situation.

Contents

What is Retirement Planning?	2
Why is Planning Important?	2
Early Retirement Packages & Your Options	2
Severance Payments	3
Flexibility	4
Tax Deferral	4
Retiring Allowances	4
Pension Options	6
Types of Pension Plans	6
Remaining In The Pension Plan	7
Receiving a Commuted Value	7
Using Your Commuted Value to Purchase An Annuity	8
Transferring to a Locked-In Plan	9
How Much Can Be Transferred	10
Converting Your Locked-In Plan	10
Pension Adjustment Reversal	12
Transferring Pension Benefits To A New Employer	12
Other Considerations	13
Investing Your Locked-In Funds	13
Company Benefits	13
Summary	14

What is Retirement Planning?

The process of retirement planning is relatively straightforward. A good retirement plan will accumulate enough assets to provide you and your spouse with the income that you need to live the lifestyle that you want. A perfect retirement plan would result in you spending the last dollar that you have as you pass away. Besides being very difficult to achieve, it also does not represent very good estate planning. For an outline of Estate Planning refer to our “Estate Planning Handbook.”

Why is Planning Important?

Your financial goals and circumstances will change over the years. Assessing the financial impact of those changes, will be easier if you have already established a plan. For example, if you have developed a financial plan assessing your retirement, it will be easier to determine whether or not you will achieve your overall goals, if you are presented with an early retirement package.

Early Retirement Packages and Your Options

Early retirement packages (sometimes referred to as severance packages) are usually somewhat complicated and will offer a bewildering variety of options, yet little, if any, guidance on how to assess those options. In addition to this, you will likely be dealing with all of the emotional issues surrounding this unexpected change in your life.

Severance packages are never the same from one company to another, and may well differ from one employee to another in the same company. Some of the key components contributing to your package include length of service with the company, annual income and your level of responsibility in the organization. The information that

follows will provide you with an outline of the various retirement vehicles as well as guidelines to assist you in determining the most suitable course of action for your situation. Please keep in mind that flexibility is a very important ingredient in your decisions. If you receive a package, take the time to comprehensively review the information provided to you. There is no one central place of reference that will contain all the information you will require, and there may even be times when you will receive conflicting information.

When you receive an early retirement package, you should first obtain and carefully review any and all written documentation that your employer is able to provide. Generally speaking, your employer should outline your arrangement, including your options (if any) for handling accrued pension credits, and the standing of any other benefits (such as life insurance and medical/dental coverage) that you were entitled to as an employee.

We have divided the financial aspects of an early retirement package into two main areas of discussion based on the key factors found in most packages: severance payments and pensions.

Severance Payments

The first item you will have to deal with is how you want to handle any immediate payments offered to you as part of your package. As mentioned earlier, severance pay is based on a variety of factors with the length of your employment usually being the most important. The longer you have been with a company, the higher the severance payment.

You effectively have two choices with respect to this type of payment in terms of the timing of when you receive it. The choices are as a continuation of salary or as a lump sum payment. Deciding which to take comes down to a couple of factors.

Flexibility

For some people, continuing to receive a regular salary as they have been in the past is the easiest option, simply from a cash management perspective. In some cases, as long as the salary continues, so does the access to other company benefits, including pension benefits, if applicable. However, depending upon the likelihood of re-employment, lump sum payments can be used to pay off debt or to provide on-going income. Lump sum payments may also be preferable if there are any concerns about the company's ability to meet the on-going salary continuation.

Tax Deferral

If the timing of your payment allows, you can use a salary continuance to defer income and taxes until the following year. For example, if you terminated your employment on Nov. 1, 1999 and your employer agreed to continue part of your severance payment as salary paid after January 1, 2000, the salary would be included in your 2000 tax return, which will be filed in 2001. This will provide you with approximately 16 months of tax deferral. If the payment was received in November, 1999 as a lump sum, the tax on it would be due in April of 2000.

Retiring Allowances

If your severance pay is made as a "retiring allowance", it may be eligible for preferred tax treatment. Subject to the restrictions outlined in the shaded box on page 5, a retiring allowance can be rolled into your RRSP tax-free without affecting your regular RRSP contribution limit. If you have no immediate need for these funds, this form of tax deferral can provide a significant financial advantage over the long term. Even in the event where you think you may need the payment, rolling it over to your RRSP is probably still the most prudent decision, as you can always withdraw money from your RRSP in the event of an emergency. The payment would then be taxed at the time of withdrawal.

If your severance payment exceeds the maximum retiring allowance, you may have to take the remaining amount as either a taxable lump sum or a continuance of salary over a pre-determined period. Again, personal circumstances and financial objectives will dictate which option is most suitable.

Retiring Allowance: Calculating The Maximum Tax-Free Rollover To Your RRSP

The Income Tax Act defines a retiring allowance as “a payment in respect of a loss of employment or a payment upon or after retirement in recognition of long service”. This includes unused sick-leave and damages for loss of employment (severance pay) but does not include any pension benefits.

The maximum amount that can be transferred to an RRSP (tax free) is calculated as follows:

- \$2,000 per calendar year (full or partial years) of service prior to 1996; plus
- \$1,500 for each year prior to 1989 (providing you made no “vested” pension contributions in the year and did not receive credit for any company contributions to a pension plan).

Note: Service during 1996 and subsequent years does not contribute to this calculation.

It's worth paying attention to the timing of the roll-over into your RRSP. Remember, if you take a continuance of salary as described above, your official termination date will be the point at which your salary continuance ends. You can also take your retiring allowance directly in cash and then pay it into your RRSP immediately or within the first 60 days of the following year. Either way, this payment must be made into the RRSP of the person receiving the retirement package and cannot be transferred to a spouse/spousal RRSP.

Pension Options

While lump-sum severance payments may seem attractive and important in the short run, if you have been working for a company for any amount of time it's likely that a far more significant sum of money is tied up in your company pension. If you participated in a company pension plan, you will need to choose how you manage your pension assets going forward.

Each person's individual circumstances will differ greatly and many other factors will figure into selecting a pension option that is right for you. Whatever your personal situation, however, you should consider the following three main issues when deciding how to handle your pension:

- Who controls your plan's investments?
- What are the implications if you take control?
- Will you have control over annual cash flow at retirement?

Other factors that should be considered are taxation, life expectancy, group benefits, death benefits, inflation, other sources of income, and estate issues.

Types of Pension Plans

There are two types of pension plans:

Defined Contribution (also known as money purchase)

With this type of plan you would normally receive an annuity when you retire based on the value of the money you've contributed plus the plan's tax-sheltered investment earnings (much like an RRSP). At early retirement, therefore, your plan will have a specific accumulated value. You have the option of immediately rolling this value into a locked-in RRSP plan of your own or receiving a pension.

Defined Benefit

With this type of plan your pension income is calculated according to a formula based on your final average employment earnings and

the number of years of service. Your employer must provide this guaranteed income stream regardless of the investment climate or the performance of the pension fund.

If you're a member of a defined benefit plan, early retirement will present you with a range of pension options:

1. remain in the company pension plan and receive a pension according to the pension plan or;
2. receive a lump sum (referred to as the "commuted value") of your plan. The commuted value can then be rolled into a locked-in RRSP, transferred to a new employer's pension plan, or used to purchase a deferred annuity.

Remaining In The Pension Plan

Remaining with your existing pension allows you to receive payments starting at a pre-determined date without making additional contributions to the plan. It's not uncommon for long-term employees facing termination to receive an incentive to make this option more attractive. Added years of service or a pension "bridge" amount received between the early and regular retirement dates may enhance what you would otherwise be entitled to receive. Other factors such as indexing the pension benefits to match inflation and spousal benefits can also make this option appealing.

Before opting out of any pension plan, you should determine if doing so will forfeit other group benefits (such as dental, health, and life insurance coverage). Be sure to factor the loss of these benefits into your decision.

Receiving a Commuted Value

The commuted value of a defined benefit pension should roughly equal the amount of money you would need to invest in order to replace the income or value of your deferred pension. To calculate this, an actuary makes various assumptions to arrive at a present value for your future pension benefits. These assumptions may include future interest rates, life expectancy, retirement age, marital status, and any indexing to inflation promised in your existing pension plan.

Using Your Commuted Value to Purchase An Annuity

Should your employer permit you to roll your pension's commuted value to an annuity or a deferred annuity, you should closely examine the annuity options. There are different types of life annuities available, each with different features.

Individual or single life annuities guarantee an income that will be paid, usually monthly, as long as the annuitant is alive.

A deferred annuity begins payments at a defined point in the future, but the guaranteed amounts of the payments are established at the purchase date. Because annuity rates are based on long-term interest rates, this option is usually not advisable when rates are low. Under such conditions it's better to roll your commuted value into a locked-in RRSP investment plan and then purchase an annuity at a later date when interest rates are more favorable.

Annuities are quoted in monthly income paid per \$1,000 or per \$100,000 invested. For example, if an individual was quoted \$753 per month per \$100,000 and the investment was \$300,000, this annuity would pay \$2,259 per month.

You can also add a guaranteed minimum payment to your life annuity to protect your estate in the event of premature death. Usually you can select a specific number of years. Most providers offer 5, 10, and 15 year guarantees, but generally longer guarantee periods will offer lower monthly incomes.

Under pension legislation, if you are married, you must provide an income from your pension to your spouse after your death. The only exception to this is if your spouse "signs off" this benefit. (effectively disinheriting themselves, which in most cases is not advisable). Joint and last survivor annuities will continue to pay income as long as the annuitant or the annuitant's spouse lives. Again, you should expect to receive less income from a joint annuity than a comparable single life annuity with guarantees.

Life Annuities and LIF's Compared

(Incomes Based on Male age 65 and Female age 61 and \$100,000 Capital Sum)

Life Annuity/No Guarantee = \$753/mo.

Life annuity/joint & last survivor = \$618/mo.

LIF = \$615/mo. to \$836/Annuity = \$711/mo. J&LS

Age: 65/61

80/76

Life

LIF income based on 8% annual rate of return. Payments are "maximum" and start at \$615/mo increasing to \$836/mo by age 79, then annuity based on Male age 80 Female age 76 joint last to die purchased with remaining LIF balance of \$80,178.00

**Incomes are based on rates effective Jan 01, 2000 and are not guaranteed in the future.

Transferring to a Locked-In Plan

The commuted value of your pension plan may be transferred to a locked-in RRSP or locked-in retirement accounts (LIRA). Basically, a LIRA is an RRSP that is subject to provincial or federal restrictions. Your investments in this account can grow tax-free until you reach age 69. You (and your investment advisor) can choose any qualified investments within the plan, depending of course on your investment strategy and the amount of risk you are comfortable with.

As with a regular RRSP, the locked-in plan will mature at age 69 and the funds invested must be:

1. Transferred to a Life Income Fund (LIF)
2. Transferred to a locked-in retirement income fund (LRIF)
if allowed by legislation, or,
3. Used to purchase a life annuity.

In general, you may not withdraw funds from a locked-in RRSP or a LIRA. Thus, the only way you can draw income is by first rolling them into an annuity or a LIF to create income - this can be done prior to age 69 if necessary. Pension legislation stipulates the minimum age you must reach before the locked-in account can be converted to a LIF, LRIF, or an annuity. Provided you are

under the age of 69, you can roll any remaining assets in a LIF or LRIF back to a LIRA or locked-in RRSP if your situation changes and you find yourself not requiring immediate income.

How Much Can Be Transferred?

There are set limits within the Income Tax Act for the maximum amount of money you can transfer tax-free from a defined-benefit pension plan to a locked-in plan. Amounts in excess of this set limit are referred to as “excess transfer amounts” and are usually paid directly to employees as fully taxable income. In most cases your employer will notify you in your termination documents if the commuted value of your pension exceeds the maximum limits. Because this excess transfer amount is immediately taxable as income, the commuted-value option may be less attractive than a deferred pension if the value of the lump sum significantly exceeds the amount that you will be allowed to roll into a tax-sheltered locked-in RRSP.

Please consult your tax advisor about special procedures and tax treatment before initiating the rollout procedure.

Converting Your Locked-In Plan To a Life Income Fund (LIF)

A LIF is a registered plan that requires you to draw out a regular income, in a similar fashion as a RRIF. Just like a RRIF, a LIF will have a minimum annual payout based on your age and the value of your account on January 1 of every year. Unlike a RRIF, LIF's also have a maximum annual payout. This payout is arrived at by using a formula that takes into account your age, the size of the plan, and the CANSIM rate (which is adjusted annually to reflect current interest rates). LIF payments cannot be calculated using the age of the younger spouse.

For each year until age 80, your desired LIF income must fall within the range set by the minimum and maximum LIF payments. At age

80, any remaining value must be used to purchase a life annuity. A knowledgeable advisor can assist you in preparing projections of your anticipated LIF payments and final annuity purchase. These projections can greatly assist you in understanding the level of income you can reasonably expect from your LIF in the future.

Converting Your Locked-in Plan To A Locked-in Retirement Income Fund – LRIF

(Applies To Rollouts from Alberta, Manitoba and Saskatchewan Pension Plans. At the time of writing, draft legislation was pending in Ontario)

An LRIF works almost identically to a LIF but doesn't have a mandatory conversion rule (at age 80). The plan may be converted to an annuity, but this option rests solely in the hands of the person who owns the plan.

Choosing LIF's or Annuities

Consider a LIF if:

- Your income needs may change and you want the flexibility to vary your income.
- You want to determine how your money is invested.
- You're concerned about negative effects of inflation on future income.
- It's important for you to leave an estate to children or grandchildren.

Consider an Annuity if:

- You want a fixed income guaranteed for life.
- You don't want to make investment decisions.
- You want to lock in your investment at current rates.
- You're not concerned about leaving an estate to children or grandchildren.

Pension Adjustment Reversal (PAR): Getting Back Your Lost RRSP Room

When an individual is a member of a Registered Pension Plan (RPP), the employer reports an annual pension adjustment (PA) that reflects the individual's participation in the plan and reduces their ability to contribute to an RRSP.

If you leave your registered pension plan before retirement, and if the termination benefit paid by the pension plan is less than the total pension adjustments reported by your employer over the years you were paying into the plan, a mechanism called the pension adjustment reversal (PAR) is available to restore the appropriate amount of RRSP contribution room.

The PAR ensures that RRSP deduction room given up as a result of belonging to a Registered Pension Plan is not permanently lost. Pension plan members leaving their jobs are eligible to get adjustments back to the beginning of 1990. This may result in an opportunity to deposit non tax-deferred severance pay into your RRSP.

Plan administrators or trustees will report the pension adjustment reversal to Revenue Canada by the end of the year in which employment is terminated. The PAR amount will be added to the deduction room for the year of termination, and will be indicated on a client's Notice of Assessment from Revenue Canada.

To find out if you are entitled to any PAR adjustments, contact your plan administrator.

Transferring Pension Benefits To A New Employer

If you start a new job following early retirement, you may be able to transfer your pension benefits to the new employer's pension plan. While this option is not universally available, if your new employer allows it, a transfer may be to your advantage. If you choose to pursue this option, you may require professional actuarial advice.

Other Considerations

Investing Your Locked-In Funds

Providing the kind of comprehensive investment advice needed to invest locked-in funds goes beyond the scope of this publication. However, managing this important investment should be a key issue for anyone considering a rollout of his or her plan's commuted value. Along with the flexibility and increased potential return that can be derived from controlling your investments comes the responsibility to manage them prudently. A qualified investment advisor can assist you in creating a strategy tailored to your personal goals and to your tolerance for market fluctuations.

Company Benefits

An important point to consider when deciding between early retirement alternatives is the continuation or forfeiture of any existing benefits. It's not unusual for companies to extend some form of medical, dental, and life insurance coverage to their retired employees. Some companies offer benefits but only for a specific, limited period of time following early retirement.

Before making a decision, determine what benefits you will be eligible for and whether or not you need to enhance your coverage to suit your lifestyle.

Another area of concern for many people is life insurance. When you leave a group plan you are usually allowed to convert your group coverage to private coverage (within a short period of time). The benefit of this option is that the conversion can usually be accomplished without a medical exam. If a medical exam is not a problem, you can also compare the cost of private coverage with converted group coverage to make sure you get the best possible price. (Remember to compare similar types of coverage.)

It's also important to assess how much and what type of life insurance you actually require. This will depend on your personal circumstances, financial objectives, assets and estate goals. Generally speaking, the older you are, the less likely you are to require "term" (temporary) life insurance.

Summary

Retirement as a result of downsizing can be a challenging experience, which can result in financial and emotional catastrophe if not managed in a thoughtful and systematic way. On the other hand, it can be one of the best things to happen from a financial perspective. Remember there is knowledgeable advice available and ScotiaMcLeod Investment Executives are prepared and experienced in helping clients co-ordinate this advice to ensure sound and appropriate decisions are made.

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