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Pension vs. Commuted Value – What to Choose?

If you have a corporate defined benefit pension plan you might be facing a dilemma – should you agree to the company pension or should you take a commuted value? Not an easy choice! There is no single answer for everybody. It is very important to work with the numbers, incorporate your personal financial and lifestyle circumstances and eventually, create a plan that allows you to choose between pension or commuted value payout.

Firstly, lets understand what a corporate pension is. In a nutshell, it is the corporate promise to pay you a set amount of money per month for your lifetime upon retirement. Often pension provisions contain a spousal guarantee where your spouse has the right to receive a certain amount of your pension (67%, 75%, sometimes even 100%) if you pass away first. And it demonstrates the main advantage of the corporate pension – it is fully guaranteed. Sometimes the payout is even indexed with inflation.

In fact, the corporate pension is an annuity. An annuity is a financial product that transforms the initially invested lump sum into a guaranteed stream of income. Which means that from a financial standpoint your choice is:

1. Take the corporate promise and accept their guarantee
2. Take the initial lump sum as a commuted value and invest it yourself

Each selection has its own pros and cons. Let's review them.

CORPORATE PENSION

As already mentioned, it is fully guaranteed. Payouts will continue for life, might be indexed to inflation, and your spouse could continue receiving payments if you die first.
On a flip side, you give up everything that relates to flexibility:

1. You cannot change your monthly payout.
2. You cannot take a lump sum withdrawal.
3. If both spouses die, the pension disappears. Nothing could be left to your children, the estate, or donated to charity.
4. Since nothing is left for the estate, pension funds cannot help in paying taxes for the estate tax liabilities, which could be substantial.

You should take into consideration the stability of your employer's pension plan. At the end of the day, a pension is a promise. And the promise is as good as the entity giving it.

COMMUTED VALUE

The fact that the commuted value approach requires investing concerns many people. And it is true – every calculation surrounding the commuted value assumes future rates of return, inflation, your life expectancy, and a few other things. However, the pension approach is not free from assumptions either. The entire calculation of your future pension payout is based on the internal rate of return. In other words, your pension administrator should estimate what rate of return they should provide to you to sustain the payout for your expected lifetime. Obviously, the lower this rate is, the lower your promised payout is going to be. Currently we have a historically low interest rate environment. In reviewing the pension packages for my clients I have never seen the rate of return exceed 1.7% and it has been as low as 1.3% per year. Even if interest rates go higher in the future, the pension payout will never change.

Let's get back to the commuted value. Here are some advantages that people consider while selecting this option:

1. Fully flexible – you can:
    - Select investments you are comfortable with
    - Change your monthly payout
    - Take a lump sum withdrawal if needed
2. If you die first, your spouse assumes the entire balance of your investment account. There is no reduction.
3. You can bequeath your pension account to your children or to the charity of your choice. Even though this approach might trigger some tax implications, it is available.
4. Your executor may use the balance of your pension account to pay estate liabilities if needed.
5. You can transform your commuted value or a part of it into a fully guaranteed annuity.

Let me elaborate on the last point. As we discussed earlier, a pension is an annuity. If you would like to have flexibility with your money but at the same time keep some guaranteed payout in place – just purchase an annuity with part of the commuted value. Every insurance company in Canada will be happy to help you with that.

The decision between a guaranteed pension and flexible commuted value should be evaluated using numbers. It would be a good idea to show your pension package to a Certified Financial Planner and review a few alternative scenarios before making the decision.

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