Income Annuity Purchased by Registered Pension Plan (DB and DC) Funds Frequently Asked Questions (FAQ)

The purpose of this document is to provide advisors with information related to purchasing an income annuity directly from a Defined Benefit (DB) or a Defined Contribution (DC) registered pension plan (RPP). In this document, "pension plan" or "RPP" refers to both DB and DC plans. It will focus on the potential tax implications outlined in Section 147.4 of the Income Tax Act (Canada) and the diligence required when determining client suitability. Also included are requirements and administrative procedures for this transfer.

General information on transfers from a pension plan to an annuity

Q: What are the different ways a plan member can receive income from a pension plan upon termination of employment or retirement?

A : The options depend on the terms of the pension plan and applicable legislation. Some of the more common ones are:

i. Receive pension benefits immediately or on a deferred basis directly from the DB RPP (most DC RPPs do not offer this option).

ii. Transfer the DB RPP "commuted value" or DC RPP "account balance" to a locked-in plan (e.g. LIRA, LIF), and in the case of a DB RPP, take any amount above the Maximum Transferable Amount in cash.[1]

iii. Elect a cash refund of the DB RPP commuted value or DC RPP account balance. This option is limited to circumstances like small benefits, shortened life expectancy, non-residency).

iv. Purchase an immediate or deferred annuity with funds transferred directly from the pension plan, if allowed by the pension plan – **the focus of this FAQ.**

Note: This FAQ does not apply to annuities purchased with funds from a locked-in plan.

Q: If the plan member were to purchase an annuity at termination of employment or retirement, how is the amount transferred from the pension to purchase the annuity calculated?

A: The amount that is transferred out of a DB RPP is called a "commuted value". It is the present value of the future pension income stream that the plan member is entitled to receive using prescribed interest rate and mortality assumptions on a given date.

The amount that is transferred out of a DC RPP is called "account balance". It is the sum of all contributions made by the employee and employer and their associated investment growth on the date of transfer.

Q: Who determines the commuted value or account balance?

A: The pension plan administrator. The plan member can request an option statement that shows the commuted value in the case of DB RPP pension benefit, or the account balance in the case of a DC RPP.

Note: Many DB RPPs do not permit commuted value transfers from the DB RPP if the member terminates employment or retires after becoming eligible to receive a pension from the DB RPP. Some DB RPPs do not permit commuted value transfers for the purchase of annuities.

Q: How can I determine if the pension plan requires unisex vs. sex distinct rates?

A: The pension administrator can advise if the plan is based on unisex or sex distinct rates and the unisex split if that is the case.

Q: How do I determine which federal or provincial pension legislation governs a client's pension benefits?

A: The pension administrator can provide that information.

Q: What are the rights of a member's spouse when pension funds are used to purchase an annuity?

A: The member's spouse continues to be entitled to receive survivor benefits under the annuity. The annuity must be structured as a joint and survivor annuity that pays no less than 60% of the monthly annuity payment to the spouse on the death of the primary annuitant. A spouse may waive their right to survivor benefits with the completion of the applicable provincial spousal waiver form.

[1] More information about the Maximum Transferrable Amount is set out in this question: What are some other factors an advisor should consider when assessing the suitability of an annuity?

Tax treatment of amount transferred from a pension plan to an annuity – materially different test

Q: Is the amount transferred out of the pension plan to purchase an annuity subject to tax?

A: It is not taxable if the requirements of the Income Tax Act set out below are met:

i. The rights provided under the annuity contract are not **materially different** from those provided under the pension plan; and

ii. The contract is purchased with a single premium payment; and

iii. At the time of the acquisition, the pension plan is registered under the Income Tax Act.

The more important assessment is to ensure that annuity is not "**materially different**" from the pension plan. If the annuity is deemed by Canada Revenue Agency (CRA) to be materially different, the amount transferred from the pension plan to the annuity is taxable. Because the plan member is considered to have received a payment from the pension plan equal to the full annuity premium, the value of the annuity contract will be taxable as income to the plan member in the year it is purchased.

However, if the annuity is not **materially different**, the annuity payments are considered to be amounts received under the pension plan and subject to tax only when each annuity payment is paid. As a result, there is no immediate taxation on acquiring the annuity.

Q: Does the materially different requirement apply to both DB and DC transfers?

A: Yes, the requirement applies to both DB and DC RPPs. The terms of some DC RPPs might not have specific forms of retirement benefits and can have general portability provisions. However, the DC RPP plan terms must allow members the opportunity to purchase an annuity from a licensed annuity provider using their account balance.

Q: How does Canada Revenue Agency (CRA) interpret materially different?

A: The CRA "Newsletter 20-1, Registered Pension Plan Annuity Contacts" was issued to clarify the meaning of "**not materially different**" in relation to an annuity purchase that is subject to section 147.4 of the Income Tax Act. In this newsletter, CRA provides differences in an annuity purchase that would not be considered "materially different" from registered plan benefits.

Note: The assessment of **materially different** applies to both the "normal" and ancillary forms of pension. This information along with the amounts are often provided on the plan member's termination or retirement option form. They can also be requested from the pension plan administrator.

Differences that CRA considers to not be "materially different"

Q: If the commuted value is insufficient for the annuity payment to match the pension amount, does CRA treat an annuity that pays less than the DB RPP as materially different?

A: CRA does not consider an annuity that provides less benefit than the DB RPP to be **materially different** provided that the payment of the commuted value is the full satisfaction of the member's benefits under the DB RPP. In this case, the lifetime pension benefits or ancillary benefits may be reduced but without any reconfiguration of the benefits under the DB RPP (i.e. no change to the form of pension or payment date – simply a lower amount of lifetime fixed payments).

Q: What will CRA accept as an alternative to cost-of-living adjustments based on the Consumer Price Index (CPI)?

A: CRA will accept one of the following fixed-rate adjustments in lieu of a full CPI indexation adjustment:

- the midpoint of the Bank of Canada's inflation-control target range at the date of purchase; or
- the spread between the yield of Government of Canada long term bonds and real return bonds in the month of or the month preceding the date of purchase; or
- a fixed rate that is between these two alternatives.

Q: What if a pension plan provides indexation that is less than CPI (e.g. CPI less 1% or 40% of CPI)?

A: To make sure the annuity is not materially different from the pension plan, in this situation you must modify the fixed rate cost of living adjustment appropriately.

Q: What if the pension plan includes cost of living adjustments for specific periods of service or different adjustments for different periods of service?

A: When a pension plan includes these specific cost of living adjustments, you also must adjust the fixed rate cost of living adjustment appropriately for the situations.

Q: What types of annuities does BMO Insurance offer that commonly match up with benefits provided by a pension plan?

1. **Single Life Annuities** for pensioners without an eligible spouse or whose spouse has waived the right to a joint and survivor form of pension.

   Annuitant receives fixed payments periodically for as long as they live.

2. **Single Life Annuities with a Guaranteed Period** for plan members who do not have an eligible spouse or whose spouse has waived the right to a joint and survivor form of pension and where the pension plan offers guaranteed periods.

Annuitant receives fixed payments periodically for as long as they live. If the Annuitant dies before the end of the guaranteed period, payments will continue to their beneficiary or if permitted by the pension plan, the beneficiary can elect a lump sum payment of the present value of the remaining annuity payments.

3. **Joint Life Annuities** (Survivor Benefits) with or without guaranteed periods, for plan members with an eligible spouse.

   Periodic fixed payments will be made while the member (primary annuitant) is living and will continue to their spouse (secondary annuitant) for the spouse's lifetime if they survive the primary annuitant. Payments to the spouse must not be less than 60% of the amount paid to the member.

Q: Which pension benefits do not typically match up with annuity options offered at BMO Insurance?

1. Cost of Living adjustments based on CPI
For most pension plans, cost of Living adjustments (indexing) is based on the Consumer Price Index (CPI). At BMO Insurance, applicants can select a fixed-rate cost of living adjustment (indexing) amount of up to 4%. CRA will accept some specific fixed-rate adjustments in lieu of a full CPI indexation as noted earlier in this FAQ.

2. Bridging benefits
Some pension plans offer members retiring before age 65 temporary monthly payments to bridge between the receipt of "early retirement income" and "retirement income". This is not a feature BMO Insurance supports.

Considerations when assessing suitability of a transfer from a pension plan to an annuity

Q: Why would an advisor recommend purchasing an annuity with funds from a pension plan over other retirement income options?

1. An annuity provides a regular income stream to the Annuitant and is guaranteed to be paid, at a minimum, for the life of the Annuitant. It offers financial peace of mind to the Annuitant that they cannot outlive their income, similar to a DB pension benefit.
2. With an Annuity, no management of investments is necessary. The income from the annuity is sheltered from interest rate and financial market fluctuations.
3. In the unlikely event that the life insurance company fails, the annuity is protected by Assuris, an independent not for profit, industry funded compensation organization. Assuris guarantees that an annuitant will retain their monthly income up to maximum of $2,000 or 85%, whichever is higher.

Q: What should an insurance advisor consider before recommending an annuity?

A: The insurance advisor should first ask the client to provide details of the pension plan to determine if the benefits of the pension plan can be replicated in an annuity. This is to ensure that the annuity is not "**materially different**" from the pension plan. The insurance advisor should seek independent tax advice as necessary. BMO Insurance does not make the **materially different** assessment.

Once issued, an annuity purchase cannot be reversed. It is therefore very important that the **materially different** analysis be done before the annuity is purchased.

Q: What are some other factors an advisor should consider when assessing the suitability of an annuity?

1. How much does an annuity with the same benefits as the pension cost?

   Scenario A: If the cost for the annuity is higher than the commuted value, the plan member would likely stay in the DB RPP.

   Scenario B: If the cost for the annuity is lower than the commuted value, an annuity may be an option if permitted by the DB RPP. In that case, the difference between the commuted value and the premium to fund the annuity will be paid to the plan member in cash and must be included as income for tax purposes in the year received. The difference cannot be left in the DB RPP or transferred directly to a pooled registered pension plan, RPP, RRSP, RRIF of specified pension plan.
2. Is the difference between a DB RPP commuted value and cost of an annuity less than the difference between the commuted value and the Maximum Transferable Amount (MTA) that applies to DB RPP transfers to a locked-in plan? In each case the difference is paid to the plan member and must be included in the taxable income of the plan member in the year it is received. As noted above, an annuity purchase may provide the opportunity for this tax to be deferred.
3. Does the DB RPP have strong prospects of continuing into the future? Examples of pension plans in this category are public sector guaranteed pensions, private sector pensions where the employer has a good credit rating, or a plan that is or is close to being fully funded.
4. Are there concerns about the DB RPP's future? The types of concerns include a plan that is significantly underfunded, an employer in financial distress, or a pension plan that allows for future pension reductions.
5. Are the ancillary plan benefits important to the client? If they are, are they difficult, expensive or impossible to replace? Examples of ancillary plan benefits are bridging benefits or other temporary pension supplements, enhanced death benefits, and indexation.

BMO Insurance administrative processes to purchase an annuity from pension funds

Q: Are there any additional forms required to purchase an annuity directly with funds from a pension plan?

A: The client must complete the "Additional Information Form for RPP Funds (778)" to acknowledge that they understand the potential income tax consequences of funding an annuity with pension funds. It also alerts the client to the importance of seeking independent tax advice before completing the purchase.

Q: When is a special quote required to purchase an annuity with funds from a pension plan?

A: A special quote is used when needing to match the following pension terms:

i. The annuity purchase date must match the pension start date; however, the pension plan transfer will be completed after this date.

ii. The annuity first payment date needs to match the pension plan first payment date; however, the pension plan transfer will be completed after this date.

Q: How does the rate guarantee work for a special quote request?

A: All special quotes will include a reasonable transfer period for the pension plan funds to be received by BMO Insurance. The special quote rate guarantee will only be valid if the funds are received by the date indicated on the quote.

Q: Where can I get a Special Quote Request Form for Pension Funds?

A: Our "Special Quote Request Form for Pension Funds" can be obtained from our advisor website. Send the completed form by email to Insurance.Annuities@BMO.com.

Q: By submitting the Special Quote Request Form, am I guaranteed to receive a Quote?

A: It depends. A quote will not be provided if: (a) the information on the form is incomplete or (b) BMO Insurance does not offer the requested features. A quote may also not be provided if the single premium exceeds $1 million.

Q: What happens if a Special Quote Request Form is incomplete?

A: We will contact the requester to provide the missing information. In some cases, the form must be updated and resubmitted.

Q: Who do I contact if I have questions or need assistance with annuity processing?

A: Please contact the BMO Insurance Annuity Team by email at Insurance. Annuities@bmo.com or call 1-866-382-7401.

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