Pensions Update

Checklists and Important Takeaways – An Actuary's Perspective

Kelley McKeating, FSA, FCIA
McKeating Actuarial Services, Inc.
London, Ontario

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OVERVIEW

According to **Section 4(1)** of the **Ontario Family Law Act**, ""property" means … in the case of a spouse's rights under a pension plan, the imputed value, for family law purposes, of the spouse's interest in the plan". In other words, pensions are property for net family property (NFP) purposes.

Section 4(1) of the FLA does not distinguish between:

- Pensions in pay and pensions not yet in pay,
- Registered and non-registered pensions, or
- Pensions registered in Ontario and those registered in other jurisdictions

Thus, it is generally understood that all pensions are to be treated as property for NFP purposes.

Section 10.1 of the Family Law Act prescribes the method and assumptions to be used in the valuation of a pension for net family property purposes. This is accomplished by pointing to Section 67.2 of the Ontario Pension Benefits Act (or to Section 17 of the new Pooled Registered Pension Plans Act). Section 67.2 then sends the reader to **Regulation 287/11 under the Pension Benefits Act** which outlines the specifics of the prescribed valuation methodology and

assumptions. Section 10.1 is understood to apply to all pensions. Section 10.1(1) applies to Ontario-registered pensions. Section 10.1(2) applies to other pensions on the same basis as Section 10.1(1) applies to Ontario-registered plans "where reasonably possible" "with necessary modifications". The 2020 Court of Appeal decision in *Van Delst v. Hronowky* addressed this issue in the context of two federal civil service pensions.

Section 5(1) of the FLA outlines the equalization regime that applies to net family property in Ontario. In the FLA, there are no provisions that explicitly exclude or even mention pensions in an equalization context. Thus, it is generally understood that the rules that apply to other family property also apply to pensions and that the FLA does not require or permit pensions to be excluded from the established equalization regime. This section is also understood to apply to all pensions.

If the parties cannot agree on how to implement NFP equalization and if one party is seeking a pension division, then **Section 10.1(4)** of the FLA gives guidance to the court regarding what issues to consider in deciding whether or not to order a pension division.

Section 67.2 of the **Ontario Pension Benefits Act** requires the pension administrator to determine the Family Law Value of a pension, if asked by either the plan member or the member's spouse. Ontario-registered pension plans are governed by the provisions of the PBA. Pension plans registered in other jurisdictions and non-registered pension plans are not subject to the PBA. Thus, this section (specifically, the requirement for a pension administrator to provide a family law valuation if asked) is understood to apply only to Ontario-registered pension plans.

Sections 67.3, 67.4, 67.5, and 67.6 of the PBA set out the rules by which an Ontario-registered pension may be divided (by lump-sum LIRA transfer or by division at source) to assist with NFP equalization. These rules apply only to Ontario-registered pension plans. The division options available for other types of pension plans may be more flexible or more restrictive than the options for Ontario-registered plans. See the table at the end of this paper.

In totality, the above provisions are generally referred to as the "Ontario valuation rules".

Note that the Family Law Act uses the term "**Imputed Value**". The Pension Benefits Act and its regulations use the term "**Family Law Value**". These terms are interchangeable.

The rules are clear, aren't they? What could go wrong??

POTENTIAL VALUATION ISSUES

Issues that arise can fall into one of three categories:

- Computational errors (a factual issue, should be easy to rectify once recognized)
- Interpretations of the Ontario valuation rules that may not be correct (a legal issue)
- Fact situations that cause the one-size-fits-all Family Law Value of a pension to be very unfair to one of the parties (another legal issue)

How to recognize computational errors?

If the Family Law Value if much higher or lower than you expected, it may be worthwhile to ask an independent actuary for a review of the valuation.

Administrators who are more likely to make mistakes:

- Plan has few members, administrator therefore has little experience with family law valuations
- Administrator is located outside of Ontario, little experience with the Ontario valuation rules (which are very different from how things are done in other provinces and territories)
- Unusual fact situation (company went bankrupt and plan was wound up shortly before or after separation, annuities have been purchased, plan member terminated employment shortly before or after separation, etc.)

When to consider taking a second look at the administrator's interpretation of the Ontario valuation rules?

- Union-sponsored plan (because the Family Law Value may have been reduced in proportion to the plan's funded status)
- Buy-back of credited service in respect of pre-marriage employment that was paid for during the marriage, or in respect of during-marriage employment that was paid for after the separation date
- Plan member is of retirement age (over 50 or 55) at the time of separation, but not yet retired

What fact situations might merit consideration for the fairness (or lack thereof) of the Family Law Value?

- Plan member has a terminal illness (and is or isn't retired)
- Spouse has a terminal illness (and the plan member is retired)

- Plan member is close to retirement and belongs to a federally-regulated pension plan (i.e., employer is in the transportation, communication, or banking sectors, or is a Crown corporation or federal government spin-off like Canada Post or NavCanada)

INCOME TAX ADJUSTMENTS

The Family Law Value is a before-tax amount. An income tax adjustment or contingent tax adjustment is required in order to convert the Family Law Value into an after-tax, cash-equivalent value in the Net Family Property Statement. In other words, selecting the income tax adjustment rate is part of the asset valuation process.

There are two common approaches:

- Lawyers select an arbitrary tax rate
- An actuary is retained to opine on the appropriate tax rate

In deciding what income tax adjustment to apply and whether or not to retain an actuary, here are some considerations:

- Generally speaking, an arbitrary income tax adjustment selected by a lawyer will be higher than the income tax adjustment that an actuary would recommend.

- If one party has registered (pension, RRSP, etc.) assets worth considerably more than the other party, then it may not be reasonable to use the same income tax adjustment for both.

The income tax adjustments that have been commonly used and accepted by the courts for many years are based on the party's <u>average</u> expected income tax rate in retirement. The income in retirement from pension plans, RRSPs, etc. is then projected, and the income tax that would be payable in each year of retirement is projected from the estimated retirement income. The projected tax rate in each year of retirement is then averaged.

It is usual to use the same income tax adjustment for all of a party's registered retirement savings vehicles. The most common of these "registered" or before-tax assets are as follows:

- Pension plans (RPPs)
- Registered Retirement Savings Plans (RRSPs)
- Locked-in Retirement Accounts (LIRAs)
- Deferred Profit Sharing Plans (DPSPs)

Examples of Income Tax Rates

- Retirement age 65
- Pension and RRSP income will be fully indexed to inflation
- Retirement income will be comprised of pension/RRSP income, maximum CPP pension, and OAS pension

Income at age 65 in today's dollars (other than CPP and OAS)	Average tax rate in retirement
$10,000	6.5%
$30,000	13%
$50,000	18%
$70,000	22%
$90,000	26%

Tax-free Savings Accounts (TFSAs) are not before-tax assets, nor are most (but not all) employee savings plans. Income tax adjustments would not be applied.

There are different considerations to selecting the "gross-up rate" to apply when converting a cash equalization obligation into a before-tax amount when the parties agree that some or all of the obligation is to be satisfied by means of an RRSP transfer or pension division (LIRA transfer, internal transfer with a plan, or at-source division). Best to consult with an actuary.

DIVIDING A PENSION TO ASSIST WITH NFP EQUALIZATION

Once the NFP statement is completed (including the after-tax values of any pensions) and it's been determined "who owes who how much", the parties may agree or the court may order a pension division.

When drafting the pension-related sections of a separation agreement or court order:

1. Confirm that the division approach contemplated (division at source, internal lump-sum transfer within the pension plan, or LIRA transfer) is available and permitted by the plan and its governing legislation. If in doubt, check the attached tables or ask an actuary for assistance.

2. Focus on documenting the intent of the parties and providing clear instructions to the pension plan administrator(s).

3. Avoid extraneous narrative information (such as the steps taken to obtain the family law

pension valuation, and definitions that may or may not be relevant). Also avoid duplication of instructions in multiple paragraphs, as this can lead to contradictory provisions and difficulties implementing the agreement or order.

4. It remains advisable to always provide the administrator with a draft copy of the separation agreement, and to obtain their comments, prior to finalizing and executing the agreement.

5. FSRA Forms FL-5 and FL-6 are covering memos to the separation agreement, to be provided to the pension administrator only if the pension plan is Ontario-registered. These forms are executed only by the non-member spouse and would not typically form part of the formal separation agreement.

If there is to be a division by **LIRA transfer or lump-sum transfer within the plan**, the agreement or order would specify details such as:

- The exact lump sum to be transferred and the "as of" date for the transfer. The "as of" date clarifies whether or not interest is to be paid from the separation date to the date of actual transfer.

- The 2014 *Heringer* decision confirmed that paying interest on an equalization payment that originates in a pension plan is neither the default nor is it required. The legal principles regarding the payment of interest in respect of an equalization payment would presumably be the same, whether the equalization payment is made in cash or from a pension plan or RRSP.

- To minimize the possibility of a transfer that is not in accordance with the intent of the parties (or the intent of the court), it is best to specify a dollar amount for the transfer and not to rely on a percentage:

    - If interest is not to be paid, then words such as "$100,000 as of the date of actual transfer" should achieve the parties' intentions.

    - If interest is to be paid, then words such as "$100,000 as of the separation date, with interest to the date of actual transfer" should achieve the parties' intentions.

The agreement or order should also specify:

- The party who is responsible for informing the pension administrator of the agreement.

- The deadline for informing the pension administrator.

- The remedies if the administrator is not informed in a timely manner.

If the administrator is not advised of a pension division in a timely manner, complications may arise. These could extend to the funds no longer being available for division as a result of the member's termination of employment, retirement, or death.

If there is more than one pension, the separation agreement or court order should deal with each pension in a separate section.

If there is to be a **division at source** of the pension (i.e., a division of the monthly pension while it is in pay), the agreement or order would specify details such as:

- The proportion of the member's pension that will be payable to each party (in percentages). The percentages should take into account, amongst other considerations, the value of the spouse's spousal survivor pension and the amount of the equalization obligation to be satisfied by means of the pension division.

- A numerical example based on the member's current pension (to clarify and confirm the intent of the parties).

- The start date of the division. This would often be the separation date but could be a later date. In Ontario, the deemed arrears and required retroactivity provisions of the legislation create complexity if the parties have been informally dividing the pension pending a formal agreement. Some Ontario-registered pension plans will divide the pension as of a current date if the agreement is clear on this point.

- Whether the spouse's portion will revert to the member (with reversion) or continue to the spouse's estate (no reversion) if the spouse predeceases the member. The 2021 Court of Appeal decision in *Meloche v. Costa-Meloche* confirmed, for Ontario-registered pension plans, that both approaches are possible. Generally speaking, both approaches are possible in <u>any</u> instance where an at-source division of a monthly pension in pay is an available pension division option.

The plan member's pension comes into pay on his or her retirement date and continues until his or her death, regardless of whether or not there is a pension division.

Under a "with reversion" pension division:

- <u>If the plan member predeceases the non-member spouse</u>: The member's pension (and the pension division) would cease on the member's death. The former spouse's spousal survivor pension would commence the plan member's death and then continue for the spouse's remaining lifetime.

- <u>If the spouse predeceases the plan member</u>: The pension division would cease even though the plan member's pension continues (because the member is still alive). The spouse's portion of the member's monthly pension would "revert" back to the plan member and the member would receive the full amount of his or her monthly pension from the date the spouse's death until the date of the member's death.

Under a "no reversion" pension division:

- <u>If the plan member predeceases the non-member spouse</u>: The member's pension (and the pension division) would cease on the member's death. The former spouse's spousal survivor pension would commence the plan member's death and then continue for the spouse's remaining lifetime.

- <u>If the spouse predeceases the plan member</u>: The spouse's portion of the member's pension would <u>not</u> revert back the plan member. Instead, the pension division would continue and the spouse's portion of the member's monthly pension would be paid to the spouse's estate after the spouse's death, for the plan member's remaining lifetime. When the plan member dies, the pension, and thus the pension division, would cease.

Actuarially speaking, the "no reversion" approach is the proper approach for an equitable equalization of net family property. If the parties prefer the "with reversion" approach, then it would be equitable to increase the amount that the spouse receives while alive to compensate for the fact that the division will not continue for the member's entire lifetime.

The agreement or order should also specify:

- Whether any ad hoc or contractual indexing increases will be shared proportionately by the parties.

- The party who is responsible for informing the pension administrator of the agreement.

- The deadline for informing the pension administrator.

- The remedies if the administrator is not informed in a timely manner.

If the administrator is not advised of a pension division in a timely manner, complications may arise. These could extend to the funds no longer being available for division as a result of the member's termination of employment, retirement, or death.

If there is more than one pension, the separation agreement or court order should deal with each pension in a separate section.

REMEMBER:
The plan administrator may be reluctant to send a vaguely-worded agreement back to the parties for clarification. There may be a tendency for the administrator to "read between the lines" and interpret the agreement in a way that the parties did not intend. To ensure that the pension division proceeds as the parties intended, it is important to provide clear and unambiguous instructions to the administrator. If in doubt, ask an independent actuary to review your draft agreement. The actuary speaks "pension" and help you see the agreement through the eyes of the pension administrator.

Understanding LIRA Transfers

Although widely used, LIRA transfers may be the <u>least</u> understood of the pension division options. They have been available for decades under federal government employee plans and federally-registered private sector plans. When the Bill 133 regime came into effect in 2012, LIRA transfers became available to members of Ontario-registered plans who were not retired as of their separation date.

LIRA stands for Locked-in Retirement Account. LIRAs are RRSPs with strings attached. The non-member spouse should understand that locked-in means locked-in. With few exceptions, the LIRA can only be accessed in one's retirement years, and never as a lump sum.

The greatest challenge of managing a LIRA is the drawdown decision. Draw down the balance too slowly, and the non-member spouse's heirs will be basking on a beach in the Cayman Islands after his or her death. Draw down too quickly, and the non-member spouse will run out of money before he or she dies. This is referred to as "longevity risk".

The other difficulty with LIRAs is "investment risk", the challenge of replicating the investment return of the professional pension fund managers. Pension plans pay "institutional" investment management fees which are substantially lower than the "retail" investment management fees that most individuals pay when they invest in mutual funds. Will the non-member spouse be able to make the astute investment decisions necessary to replicate the amount of pension the member gave up in order to implement the LIRA transfer? Will the non-member spouse be able to continue to make astute investment decisions as they age into their 80s and 90s and beyond?

In a defined benefit pension plan, the employer takes on the longevity risk (the risk of outliving one's assets) and the investment risk. In a LIRA, the account holder (the non-member spouse) must shoulder both the longevity risk and the investment risk.

To the plan member, a LIRA transfer is tempting because it defers the pain of equalization. But, the transfer will require the member to give up some pension and once it's gone, it's gone forever.

In this actuary's opinion, a LIRA transfer should be viewed as the equalization solution of last resort in most instances.

One exception to the caveat against LIRA transfers is when the plan member is seriously and terminally ill. If this is the case, a LIRA transfer may actually be the optimal equalization strategy.

HELPFUL RESOURCES

- General background on defined contribution (DC) and defined benefit (DB) plans: https://www.canada.ca/en/financial-consumer-agency/services/retirement-planning/employer-sponsored-pension.html
- Guidance for members and spouses: https://www.fsrao.ca/consumers/how-fsra-protects-consumers/pensions/pensions-and-marriage-breakdown-guide-members-and-their-spouses
    - Includes link to FSRA forms
- Guidance to administrators: https://www.fsrao.ca/industry/pensions/regulatory-framework/guidance-pensions/administration-pension-benefits-upon-marriage-breakdown
    - More technical, but useful

AUTHOR'S CONTACT INFORMATION

Kelley McKeating
McKeating Actuarial Services, Inc.
2 – 165 Oxford Street East
London, Ontario N6A 1T4

Tel: (519) 857-3305
Fax: (519) 858-3300
Email: kelley@mckeating-actuarial.com

McKeating Actuarial Services, Inc.

www.mckeating-actuarial.com

Settlement Options Involving Pension Division

Member NOT Retired at Separation

Type of pension plan	**Ontario-registered**	**Federal Gov't Employee**	**Federally-registered**	**Non-registered or Foreign**
Valuation provided by	Plan (usually)	Independent actuary	Independent actuary (usually)	Independent actuary (usually)
Available forms of division	Lump sum to LIRA	Lump sum to LIRA	a. LS to LIRA b. LS within plan c. At source	Depends on plan (often not possible)
Amount assignable to spouse	0 → MTA on page 2 of Form 4	0 → MTA in PBDA estimate statement	Depends on plan, often full value of the pension (including portion accrued pre-marriage)	Depends on plan (often 0)
Compare division options to pre-2012	New option	No change	No change	No change

Notes:

- For federally-registered plans, the member's status at the settlement date determines the division options. For other plans, the status on the separation date is the determinant.
- LS = lump sum
- MTA = maximum transferable amount

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Member IS Retired at Separation

Type of pension plan	Ontario-registered	Federal Gov't Employee	Federally-registered	Non-registered or Foreign
Valuation provided by	Plan (usually)	Independent actuary	Independent actuary (usually)	Independent actuary (usually)
Available forms of division	At source, spouse keeps survivor pension	Lump sum to LIRA, spousal survivor pension is cancelled	a. At source, spouse keeps survivor pension b. Establish 2 lifetime pensions	Depends on plan (often not possible)
Amount assignable to spouse	0 → MTA on page 2 of Form 4	0 → MTA in PBDA estimate statement	Depends on plan, often full value of the pension (including portion accrued pre-marriage)	Depends on plan (often 0)
Compare division options to pre-2012	No change, except for introduction of "deemed arrears"	No change	No change	No change

Notes:

- For federally-registered plans, the member's status at the settlement date determines the division options. For other plans, the status on the separation date is the determinant.
- LS = lump sum
- MTA = maximum transferable amount