Navigating the Pension Minefield
Five Years Post Bill 133

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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 <u>all</u> 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 <u>all</u> 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".

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 are understood to apply only to Ontario-registered pension plans.

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??

a. Administrators may make mistakes.

b. Certain elements of the Ontario valuation rules are subject to interpretation, and different administrators interpret the ambiguous provisions differently.

Some common causes of error or inconsistency include:

- Most pension administrators and independent actuaries, as well as the Financial Services Commission of Ontario (FSCO: the regulator of Ontario pension plans) interpret the Ontario valuation rules as requiring inclusion of the value of the spousal survivor pension in the net family property of a member who is not yet retired, based on the wording of Section 2(3) of Regulation 287/11 under the Ontario Pension Benefits Act. However, some pension administrators exclude the value of the spousal survivor pension. This required inclusion of the value of the spousal survivor pension in the member's net family property is arguably one of the most unfair aspects of the Ontario valuation rules.

- The Family Law Value of a pension is based on the weighted average of the pension value based on three different commencement ages. If an incorrect commencement age is used, the Family Law Value will be incorrect. If two administrators interpret the commencement age rules differently, the Family Law Values may differ even if the underlying plan provisions are similar.

- The rules related to the mortality assumption are confusing, and some administrators have occasionally used the wrong table. In some instances, the correct mortality table is a legal issue.

- There is inconsistency amongst actuaries and plan administrators regarding the treatment of service buy-backs in a family law valuation.

The financial impact of errors or inconsistent interpretations of the Ontario rules can be significant. Here are some recent examples. In each case, the basis for disagreement was partially a matter of administrator error and partially an issue of interpretation of the rules (which is a legal issue):

Issue	Administrator's FLV	"Arguably Correct" FLV	Difference
Commencement age	$540,000	$440,000 or $480,000	$100,000 or $60,000
Spousal survivor pension	$1,510,000	$1,650,000	($140,000)
Mortality table	$1,510,000	$1,620,000	($110,000)
Buy-back	$450,000	$430,000	$20,000

An actuary can review an administrator's Statement of Family Law or a family law valuation prepared by another actuary.

c. Lawyers and individuals may rely on pension values that are not Family Law Values (aka Imputed Values) under the Ontario valuation rules.

At any point in time, a house may have a number of different "values":

- Sale price
- Insured or "replacement" value
- Appraised value for property tax purposes
- Appraised value for mortgage lending purposes

Pensions are no different. Although it may be tempting to rely on a pension value provided by the pension administrator (at no cost!), one of the parties will be disadvantaged if the relied-on value is significantly greater than or less than the prescribed Family Law Value.

Here are some recent examples:

Type of Plan	Administrator "Value"	Correct FLV	Difference
Federal government employees (Armed Forces, RCMP, civil servants)	$410,000 $320,000 $75,000	$370,000 $370,000 $35,000*	$40,000 ($50,000) $40,000
Federally-registered	$1,100,000 $640,000	$5,000** $260,000	LARGE!! $380,000

* In addition, the administrator did not mention the contingent spousal survivor pension with a Family Law Value of $80,000!

** The administrator did not mention the fully vested spousal survivor pension with a Family Law Value of $100,000!

The crux of the explanation for the large discrepancies in value is that the administrator "value" is typically the "maximum transferable amount". This is the maximum amount that legislation would allow the member to assign to the former spouse after a marriage breakdown. These amounts can differ significantly based on the governing pension legislation. They were <u>never</u> intended to serve as proxies to the Family Law Value of a pension (either before or after passage of Bill 133).

The most common "value" provided by the administrators of **federal government plans** is the **Pension Benefits Division Act (PBDA)** maximum transferable amount estimate.

The PBDA is the legislation that outlines how federal government employee pensions can be divided on marriage breakdown. Under the PBDA, a maximum of 50% of the "value" of the pension earned during the marriage may be transferred to the former spouse's Locked-in Retirement Account (LIRA). It may therefore be tempting to double this PBDA amount and assume that it is a reasonable estimate of the FLV. However, the examples above prove that this is frequently an incorrect assumption. The "PBDA x 2" amount will almost certainly differ from the correct FLV of the pension because it is calculated differently. The key differences are as follows:

PBDA (federal gov't employees)	FLV
Current valuation date	Valuation date is the separation date
Current mortality and economic assumptions	Mortality and economic assumptions in effect on the separation date
Commencement at the retirement age used for termination of employment purposes	Weighted average of 3 retirement ages, one of which will be the PBDA age

The most common "value" provided by the administrators of **federally-registered plans** is the maximum transferable amount specified by the **Pension Benefits Standards Act** or by the plan's own provisions if less "generous".

The PBSA is federal legislation that governs federally-registered pension plans. The PBSA permits the plan member to assign their entire pension entitlement to a former spouse. In other words, the PBSA permits a maximum of 100% of the member's entire pension (including the portion that was earned prior to the marriage) to be transferred to a former spouse. This "maximum transferable amount" will almost certainly differ from the correct FLV of the pension because it is calculated differently. The key differences are as follows:

PBSA (federally-registered plans)	FLV
Current valuation date	Valuation date is the separation date
Current mortality and economic assumptions	Mortality and economic assumptions in effect on the separation date
Commencement at the retirement age used for termination of employment purposes	Weighted average of 3 retirement ages, one of which will be the "termination of employment" age
Total pension accrued to the separation date is valued (including the pre-marriage portion)	Only the pension accrued during the marriage is included

Federally-registered pension plans are easy to identify. Most fall into one of these categories:

- Employer is in the transportation, communication, or banking sector
- Employer is a crown corporation or other government spin-off (Canada Post, etc.)

Some, but certainly not all, federally-registered plans may provide properly-determined FLVs to their employees as an HR benefit even though they are not legally required to do so.

An actuary can review the administrator "value" and advise as to whether the correct FLV would be more or less than the value under consideration.

d. Supplemental (Non-registered) Pension Plans

As noted above, the PBA applies to Ontario-registered pension plans. The requirement that the administrator determine the Family Law Value of a pension (if asked) does not extend to a non-registered supplemental top-up pension plan that a highly-paid employee may belong to.

Based on information in my files, here are the current policies of the major Ontario public sector pension plans:

Pension Plan	Policy
OMERS	They do <u>not</u> determine the FLV of the supplemental pension and they do not disclose its existence on the FSCO Form 4.
Ontario Teachers' Pension Plan	They determine the FLV of the supplemental pension, but they only provide the value to the member (not to the spouse). They do not disclose the existence of the top-up pension to the non-member spouse.
Ontario Public Service Pension Plan	This is the pension plan for non-unionized provincial employees. The Ontario Pension Board (the administrator) determines the FLV of the supplemental pension and includes it in the FCSO Form 4 along with the FLV of the registered plan. They do not explain or disclose the inclusion.

In the private sector, most employers do NOT provide FLVs for supplemental pensions. However, some do. In most of the latter cases, the FLV of the supplemental pension is provided in a letter and not on a FSCO Form 4. Some employers who do not provide FLVs will disclose the existence of the supplemental pension entitlement, perhaps in a letter. Others will not.

The vesting rules for supplemental pensions may differ from the rules that govern the associated registered plan. The Ontario valuation rules pertaining to unvested or partially vested pensions are subject to interpretation. Thus, errors and differences of opinion may be more common with respect to supplemental plan FLVs than with respect to registered plan FLVs.

An actuary can assist in the following ways:

- Reviewing the FSCO Form 4 (Statement of Family Law Value) and advising as to whether or not the value of the supplemental top-up pension has been included
- Preparing a family law valuation of the supplemental pension that the administrator is not obliged to value

Any individual earning more than about $150,000 per annum may have a supplemental plan entitlement.

e. Income Tax Adjustments

The Family Law Value is a before-tax amount. An income tax adjustment should be applied in order to convert the FLV of the pension to an "after-tax" value for NFP purposes.

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.

- If an actuary determines the Family Law Value of the pension, they will probably provide an opinion as to the appropriate income tax adjustment to apply.

The income tax adjustments that have been commonly used and accepted by the courts for many years are based on the average expected income tax rate in retirement. It is usual to use the same income tax adjustment for all registered retirement savings vehicles.

The most common of these "registered" or before-tax assets are as follows:

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

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.

f. How to do a gross-up? What tax rate to use? What is the formula?

If $50,000 of the cash equalization obligation is to be paid by a transfer of pension or RRSP assets and the agreed-on tax rate is 20%, then the correct formula for applying a tax gross-up would be as follows:

$50,000 / (1 – 20%) = $62,500

This can be verified by working backwards. If one applies a 20% tax rate to $62,500, the resultant after-tax amount is $50,000 ($62,500 x 80%).

A common error is to multiply $50,000 by 1.20:

$$\$50,000 \times 1.20 = \$60,000$$

If one works backwards and applies the 20% tax rate to $60,000, the resultant after-tax amount is $48,000 and the error is caught.

The correct tax rate to use for the gross-up calculation is a legal issue.

There are three general approaches:

A. Use the payor's tax rate. The payor is therefore indifferent to paying by cash or by LIRA/RRSP transfer.
B. Use the recipient's tax rate.
C. Use a compromise middle-ground tax rate.

In my opinion, if the parties wish to satisfy some or all of the equalization obligation by means of a lump-sum transfer from a pension or RRSP, the most appropriate approach to grossing-up the after-tax equalization obligation would be to use the income tax rate that was applied to the payor's pension and/or RRSP for NFP purposes (Approach A). To do otherwise is akin to revaluing the pension to take into account a post-separation event: the agreed-on settlement mechanism.

In the 2016 *Fawcett v. Fawcett* decision, the court determined that Approach B was appropriate because "the rate needed now for the gross-up … is to adjust for the equalization payment being taxed in the respondent's hands". Based on the evidence presented at trial, the court determined that the appropriate income tax rate to use for the gross-up was the recipient spouse's expected tax rate in retirement, determined without taking the equalization payment and resulting additional retirement income into account. The judge suggested in his reasons that, if evidence regarding the average tax rate in retirement of the recipient spouse – taking the equalization payment into account – had been presented, he may have applied this higher income tax rate in the gross-up calculation.

As noted earlier, the correct approach to take regarding the gross-up is a legal issue. Although I find it easiest to argue for Approach A, I acknowledge that deference should be given to legal precedent.

g. Pension Division Options and Restrictions

The table at the end of this paper presents an overview of what division options are permitted for different categories of pension plans.

As noted earlier, there is no requirement to divide a pension for net family property equalization. In fact, the default is for no division to occur.

There are three major approaches to pension division. Each approach is not necessarily always available to the parties (see the table at the end of the paper).

LIRA transfers may be the least understood of the division options. They have been available for years under federal government employee plans and federally-registered private sector plans. Thanks to Bill 133, access to this option has been extended to non-retired members of Ontario plans.

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.

The other difficulty with LIRAs is 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 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 my 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.

Many federally-registered pension plans permit a **lump-sum transfer within the plan**. With this type of pension division, there is a lump-sum transfer (akin to a LIRA transfer) but the lump sum is used to establish a pension in the non-member spouse's name. That pension would be for a pre-determined monthly amount. It would commence at the retirement age of the spouse's choosing (subject to some conditions) and would continue for the spouse's entire lifetime. Thus, the pension plan continues to shoulder both the longevity risk and the investment risk.

A **division at source** involves dividing each monthly pension payment "if and when" it is made. This type of division is typically implemented if the plan member retired prior to separation. The member's pension (which ends on the member's death) is divided. The division ends when the pension ends. If the former spouse is entitled to the spousal survivor pension, the survivor pension would commence on the member's death and continue for the spouse's remaining lifetime. Taken together, the divided pension and the spousal survivor pension provide the spouse with monthly payments throughout their remaining lifetime.

h. If the pension-related paragraphs of a separation agreement or Order are incomplete or ambiguous, the administrator may send the agreement or Order back because it cannot be implemented as written (bad) or they may decide to <u>guess</u> the intent of the parties (worse).

Example 1:

"The parties agree that the pension will be divided at source".

- In what proportions? 50%/50%? 80/20%?
- Starting when?
- If the spouse predeceases the member, will the division continue (with the spouse's payments going to the spouse's estate) or will the division cease (with the spouse's payments reverting to the plan member)?
- If there are indexing increases, are they shared proportionately?
- Whose job is it to tell the administrator about the agreement?

Example 2:

"The parties agree that 30% of the Family Law Value of the pension will be transferred to the spouse's Locked-in Retirement Account."

- When is this transfer to occur?
- Will interest be paid from the date of separation to the date of transfer?
- Whose job is it to tell the administrator about the agreement?

In addressing the issue of interest, the parties may wish to consider whether or not interest would be paid if the equalization payment was being made in cash. The 2014 *Heringer* decision confirms that there is no obligation to pay interest on an equalization obligation simply because the obligation is being satisfied by means of a LIRA transfer rather than by cash.

Example 3:

"The parties agree that Sally will be named as the beneficiary for pre-retirement and post-retirement death benefits under Joe's pension plan."

- For Ontario-registered and federally-registered plans, the member can name anyone of their choosing as beneficiary. However, the person who satisfies the legislation's (and the plan's) definition of "spouse" will always take precedence over a named beneficiary. So, if Joe acquires a new spouse (common-law or legally-married) and then dies, the new spouse will receive the benefits despite Sally being the named beneficiary.
- The separation agreement or Order cannot require the administrator to provide benefits in a manner that is contrary to the pension plan provisions and/or the governing legislation.

Checklist for Separation Agreements and Orders

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. Also, it may be helpful to think of the FSCO Forms 5 and 6 as covering memos to the separation agreement. These forms are not intended to be stand-alone documents and they do not typically form part of the formal separation agreement. Remember that the FSCO forms would only be used if the pension plan is Ontario-registered.

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 effective "as of" date for the transfer
- Whether interest is to be paid from the "as of" date to the date of actual transfer. The *Heringer* decision confirmed that interest is neither the default nor is it required. The rules regarding equalization payments are the same, whether the payment is made in cash or from a pension plan or RRSP.
- 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 to be a division at source of the pension, 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)
- 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 or continue to the spouse's estate if the spouse predeceases the member. The latter is the proper approach for an equalization of net family property. If the parties prefer the reversion approach, then it would be equitable to increase the amount the spouse receives while alive to compensate for the fact that the division will not continue for the member's entire lifetime
- 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 providing the agreement to the pension administrator
- The remedies if the administrator is not informed in a timely manner

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

i. Waiving a spousal survivor pension

It is rarely, if ever, sensible for an eligible spouse to waive entitlement to a spousal survivor pension without compensation.

Under most public sector and many private sector pension plans, it is the employer and not the plan member who "pays" for the spousal survivor pension. In most instances, if the spouse waives entitlement to a survivor pension the amount of the member's pension will not change.

Spousal survivor pensions are payable to the person who meets the pension plan's definition of "spouse". These survivor pensions commence on the member's death and continue for the remaining lifetime of the "spouse". If nobody meets the plan's definition of spouse, then no spousal survivor benefits would be paid.

Sometimes the plan member asks the former spouse to waive their entitlement to the spousal survivor pension because the member wants a new spouse to receive those benefits on his or her death. It should be understood that the new spouse cannot receive the spousal survivor pension unless they satisfy the plan's definition of "spouse". Thus, the former spouse's waiver may not benefit the new spouse as had been intended.

j. Spouses versus beneficiaries

A plan member is free to name anyone as his or her beneficiary for pre-retirement or post-retirement death benefits. However, it should be understood that the death benefits payable to a beneficiary would normally only be paid <u>if there is no "spouse"</u>.

If someone satisfies the plan's definition of "spouse" on the date of determination (which could be the member's retirement date or the member's date of death), then the identity of the beneficiary is irrelevant. Spousal survivor benefits would be paid to the spouse and no benefits would be paid to the beneficiary.

If there is no spouse on the date of determination (the date of the member's retirement and/or death), then death benefits (if any) would be paid to the designated beneficiary.

Final Words

Pensions are complicated. The Ontario valuation rules are complicated. After five years, there are few, if any, legal decisions that address the more contentious and ambiguous aspects of the legislation.

Family law lawyers should not hesitate to seek the assistance of their favourite actuary if and when required.

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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

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