<u>Pension Valuation for Equalization - Learning to Read the Bottom Line</u>

Pension Battle Lines
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Contents

I Introduction

The pension asset can be the largest item of property owned by a couple undergoing a marital breakdown, even larger than the family home. Pension valuation is a particularly complex subject and has often been very contentious. The value of the pension asset can differ by 100% or more depending on the assumptions and methodology used in the calculation.

There are various factors which affect the valuation of a pension for purposes of equalization of assets under the Family Law Act of Ontario. There is often a great deal of confusion with respect to the methods used. Many family lawyers and plan members do not recognize the difference between the pension value for equalization purposes and the value the member would be entitled to upon termination of employment, which is often provided by pension plan administrators. Even after reviewing an actuarial pension valuation, family lawyers may still wonder what value to attach to the pension asset.

Pension standards legislation in Ontario prevents a payment of any of the pension value out of the pension fund at the date of separation. (Federally regulated pension plans are somewhat more flexible.) In many cases, to avoid a large equalization payment from other assets or to avoid having to choose a value for the pension asset, lawyers develop “If and When” agreements. These provide for sharing of the actual pension benefit when the plan member spouse reaches retirement or termination of employment. These agreements have their own set of pitfalls; I will address some of these as well.

All of the comments are presented from an actuarial perspective rather than a strictly legal perspective. As such, concepts and methods are usually discussed rather than specific case references. Examples are provided where appropriate to illustrate the concepts, with limited actuarial lingo. Many of the comments apply to pension entitlements whether or not they are established under a pension plan registered under the Income Tax Act and a federal or provincial Pension Benefits Act.

II Valuation Methodology

a) Standards of the Canadian Institute of Actuaries

Every Fellow of the Canadian Institute of Actuaries (F.C.I.A.) must follow numerous standards as well as Rules of Professional Conduct which dictate his or her professional obligations. If an F.C.I.A. fails to do so, he or she may have to face a disciplinary tribunal and risk losing the professional designation. In this paper, when I refer to an "actuary", I am referring to a Fellow of the Canadian Institute of Actuaries.

In the context of pension valuations in cases of marriage breakdown, the Canadian Institute of Actuaries has produced the Standard of Practice for the Computation of the Capitalized Value of Pension Entitlements on Marriage Breakdown for Purposes of Lump-Sum Equalization Payments (the "Standard"). When an F.C.I.A. performs a pension valuation, "the report on the valuation should include a statement that the present value has been computed in compliance with this standard of practice. If the actuary is unable to so state, the report must disclose those areas in which the valuation did not comply and reasons for noncompliance."[1]

The most important elements of the Standard are the requirements for the actuary to be an objective, unbiased expert, to avoid conflicts of interest, to disclose any appearance of a conflict of interest, and to take into account applicable statutory and case law in the relevant jurisdiction. The Standard also provides important direction with respect to the assumptions (such as mortality and interest rates) to be used, the methods to be employed, and other areas of disclosure.

An actuary is not a "hired gun" who will produce a pension value which is high if requested by the spouse and low if requested by the member. The results should be independent of who has engaged the actuary to complete the valuation. This is really in the best interests of both parties; if an actuary acts as an unbiased expert and can state that the Standard has been followed, there is less need for multiple reports, court appearances, and the resulting costs.

It is worth noting that trends in some parts of Canada are towards requiring greater impartiality of expert witnesses in order to assist the court in arriving at a result, rather than biased assistance for one party against the other. In the past, experts' partiality would simply be a factor in assessing the credibility of an expert witness after the presentation of evidence. This is normally still the case, but courts in Quebec, for example, are increasingly calling for impartial testimony which is independent of the party who has engaged the expert.[2] The actuarial profession has mandated impartiality in the context of pension valuations on marriage breakdown for a long time.

b) Defined Benefit vs. Defined Contribution Pension Plans

Pension plans which require an actuarial valuation are of the "defined benefit" type, where the monthly or annual retirement pension payable is based on a benefit formula, such as a percentage of average earnings or a flat dollar amount, multiplied by credited service in the pension plan. This differs from pension plans of a "defined contribution" type in which the amount of pension is determined by the accumulated balance in a member's individual investment account. In both cases, the plans may or may not be plans registered under the Income Tax Act and under a federal or provincial Pension Benefits Act.

For defined contribution plans, the asset valuation is relatively straightforward. Similar to a Registered Retirement Savings Plan (RRSP), the value of the member's pension is simply the account balance on a given date, whether that date is the date of marriage or the date of separation. One must consider for all "registered" assets (i.e. tax sheltered/deferred assets) that all eventual distributions to the member or owner are taxable income in the hands of the recipient. Accordingly, if these assets are to be offset against the value of tax-free property (such as a matrimonial home or cash in a bank account), an adjustment must be made to account for the eventual taxes. Ordinarily an actuary is not required to assist in valuing a defined contribution asset, although an actuary can assist in determining a reasonable tax adjustment where circumstances warrant.

Determining the value of a defined benefit pension plan asset is a much more complex process. The monthly or annual pension earned up to the date of separation must be determined, based on salaries (if applicable) and service in the pension plan up to this date. The characteristics of the pension plan must be reviewed, such as early retirement rights and inflation indexing. The total actuarial present value of the pension is calculated according to prescribed methods and assumptions, with a subsequent deduction for the portion attributable to the period before the date of marriage (if applicable). An adjustment is then made for the income tax which will eventually be payable, based on the projected average tax rate at retirement.

Determining the actuarial present value of an individual's future pension requires the calculation of the probability that the individual will survive to receive each payment. Each contingent payment must be reduced to its present value by discounting at the assumed rate of interest. The longer the time period is until the payment, the lower the present value of that payment. The resulting total value is the amount which, if invested at the date of separation, would be sufficient to provide for the promised monthly pension amounts. For any given individual, however, an actuarial present value would likely not prove to be the amount necessary to provide the monthly pension amount; it will be either too high or too low. The concept is that for a large enough group with the same characteristics, circumstances, and amount invested, the total amount would be sufficient to provide the pension payments for the entire group.

I will address the elements of the valuation methodology which in many cases have the largest impact on the valuation of a defined benefit pension for equalization purposes.

c) Pre-Marital Service

The treatment of premarital service was a particularly contentious issue, before the judgment articulated by the Supreme Court of Canada in Best v. Best in 1999[3]. The essence of the issue is how to determine the portion of the total pension value at the date of separation which is attributable to the period before the date of marriage. In other words, the question is how to value the pension at the date of marriage in the determination of the equalization balance sheet. The argument was generally centered on whether to use the “value added” method or the “pro rata” method.

The value added method values the pension asset at the date of marriage independently of its value at the date of separation, just like other assets such as a bank account. Many interested parties felt that a literal reading of the Family Law Act of Ontario would lead to this method as the logical choice.

With the pro rata method, the pension benefit is effectively valued only once at the date of separation. The value at the date of separation is then prorated based on service before the date of marriage divided by total service at the date of separation, to arrive at the value at the date of marriage. This method therefore assigns equal value to each year, including the pre-marital years. The method has the interesting result of causing the value at the date of marriage to vary drastically depending on the date of separation.

The Supreme Court ruled that the pro rata method was more appropriate for defined benefit pension plans, given their special nature, although it did leave open the possibility of using another method in some special circumstances where the result would be more equitable. The circumstances were not specifically identified.

The above methods can best be illustrated in an example, as shown in Appendix A. Note that the pension value attributable to the period of marriage is more than 50% lower when one uses the pro rata method as opposed to the added value method, in this example. This clearly favours the spouse who is a member of the pension plan. The extent of the difference depends largely on the number of years of marriage and the number of years of premarital service.

d) Retirement Age Scenarios

Pension plans generally include a provision which is known as a "normal" retirement age. In many cases the normal retirement age is 65, but other ages are common as well. The normal retirement age is by no means the only age that a member can retire and begin receipt of his or her pension. Pension plans allow for retirement when a member is within 10 years of normal retirement, and in some cases earlier. Depending on a number of factors, however, the pension received at an earlier retirement age may be discounted on account of its early receipt. This is normally the case when a member terminates employment before the earliest age of retirement permitted under the terms of the pension plan and elects to receive a deferred pension. The reduction also applies if a member retires from active service before he or she has reached what is often referred to as "unreduced early retirement" based on his or her age and service. An example would be a ½% per month reduction in pension for each month that the member's early retirement age precedes age 65.

A pension plan provision which allows a member to retire early with a pension that is not discounted due to early retirement can be very valuable. Pension plan members may have sacrificed employment income and other benefits in order to gain the right to these early retirement benefits. (This can be seen most visibly in union negotiations.) Perhaps not surprisingly, a plan member undergoing a divorce may still argue that these rights have no value for purposes of family property equalization.

Note that a pension that is "not discounted" or "unreduced" for early retirement is not usually the maximum pension the member could earn under the pension plan. "Not discounted" or "unreduced" simply mean that no early retirement penalty is applied to the member's monthly pension amount. If the member were to work for additional years after the unreduced age and earn additional credited service in the pension plan, the member's pension would still increase.

When conducting a pension valuation for equalization purposes, an actuary will generally provide pension values based on numerous retirement age scenarios. The equalization value depends heavily on which retirement age is chosen as the most likely, given the facts and balance of probabilities, as determined at the date of separation. The earlier the retirement age, the higher the value due to the additional pension payments the member will receive, and in some cases, due to the additional supplementary "bridge" benefits which some pension plans provide from early retirement to age 65.

An actuary will normally report values based on the following retirement age scenarios:

- the normal retirement age of the pension plan,

- the earliest age at which the member could retire with a pension that is not discounted for early retirement, assuming the member continues in uninterrupted active service beyond the date of separation,
- the earliest age at which the member could retire with a pension that is not discounted for early retirement, assuming the member terminates employment at the date of separation, and
- the age at which the member will reach the maximum service permitted under the pension plan (for example, 35 years) assuming the member continues in uninterrupted active service beyond the date of separation.

The actuary will usually provide one or more additional scenarios based on intermediate retirement ages, if the above scenarios do not provide a thorough selection of possibilities. In addition, the actuary will refer to the value of the deferred pension that a member would receive if he or she were to terminate employment at the valuation date, although this value may be very close to one of the values indicated above. Note that not all of the above scenarios will be applicable in all cases. For example, many pension plans do not have a maximum service limit, and in many cases a member will not be able to retire before the normal retirement age with a pension that is not discounted for early retirement without earning additional service beyond the separation date.

Appendix B demonstrates how the pension value can differ depending on the retirement age assumed.

e) Interest Rates and Inflation Indexing

The interest rates to be used by an actuary in a pension valuation are prescribed in the Standard. The assumed rates are based on the valuation date and whether benefits provided under the pension plan are indexed, partially indexed, or not indexed to account for inflation.

Most public sector pension plans in Ontario (such as the Ontario Teachers' Pension Plan and the Ontario Municipal Retirement System) provide pension benefits which are fully indexed to inflation, based on the increase in the Consumer Price Index. The increases are granted to pensions in payment, and to deferred pensions (for members who terminated employment) during the deferral period as well. Indexation of benefits is extremely valuable, particularly if also applied to deferred pensions.

Most private sector plans do not contractually provide for any form of indexation. However, in many cases, companies regularly provide for inflationary increases to pensions in payment on an "ad hoc" basis. These are rarely provided for deferred pensions which are not yet in payment, and are not reflected in the calculation of the commuted value a member could elect to transfer out of the pension plan upon termination of employment (in lieu of a deferred pension). If there is a consistent history of ad hoc increases provided for pensioners, actuaries will take these into account in the pension valuation for equalization purposes.

Appendix C demonstrates how the pension value can differ depending on the existence of inflation indexing.

f) Vesting Issues

When a member has an unconditional right to a benefit under a pension plan, the member is said to be vested in that right. In the context of pension valuations for marriage breakdown purposes, the issue of vesting has in some respects diminished but in other ways has become more important.

In the case of "unreduced" early retirement rights, a member will likely not be vested in these rights under a pension plan until he or she has reached the particular age and service criteria outlined in the pension plan. In other words, if the member terminates employment, he or she will normally not be entitled to receive his or her earned pension benefits without a discount for early retirement at the same age as if he or she had continued in active service until retirement (unless the plan does not have subsidized early retirement rights under any circumstances). For marriage breakdown purposes, the actuary normally assumes that the member remains in active service until the "unreduced" early retirement date as one of several scenarios and presents it in his or her report. In essence, the member is assumed to be vested in the early retirement right for the purposes of the scenario; whether the scenario is deemed the "correct" one or not is a separate matter.

Due to pension reform in Ontario in the late 1980s (and at various other times in other provinces), vesting in pension entitlements under registered pension plans (i.e., registered under the Income Tax Act and a provincial Pension Benefits Act) normally occurs after 2 years of plan membership. This refers to vesting in the right to receive a deferred or immediate pension, rather than vesting in other entitlements such as early retirement rights, for example. Before pension reform, vesting could occur much later. Due to pension reform, vesting in this sense has become much less of an issue for pension valuations in cases of marriage breakdown as the member need only attain 2 years of membership to be fully vested in his or her post reform accrued benefits.

The issue of vesting is still very relevant in the case of supplemental plans which pay benefits in excess of the limits imposed by the Income Tax Act on benefits payable from registered pension plans. These plans are often referred to as Supplemental Employee Retirement Plans or "SERPs". In the past, these were more commonly referred to as Supplemental Executive Retirement Plans, but more and more employees who are below the executive ranks are becoming entitled to these additional benefits. The tax limits have been frozen for many years while employees' earnings have risen with productivity and inflation increases. Registered benefits have thus become increasingly affected by the limits. The most recent Federal Budget tabled by the Minister of Finance has provided some additional registered room; however, many employers will still have SERPs in place to cover the shortfall caused by the registered plan maximums artificially limiting the benefits that registered pension plan formulas would otherwise dictate. Lawyers should be aware of the potential disclosure issue in the case of SERPS, particularly when representing the spouse of a plan member with earnings in excess of $100,000 per year. It may not be immediately evident that the plan member is covered by a SERP.

Many SERPs, particularly in the private sector, have severe vesting rules which may eliminate benefits altogether for a member who terminates employment before reaching the earliest retirement age under the SERP and corresponding registered pension plan. In marriage breakdown cases, the choice of scenario becomes even more important. Actuaries assume full vesting in calculating the values based on various retirement age scenarios. The actuary will also disclose the value under a scenario that assumes that the member will terminate employment before the earliest retirement age and will not be entitled to the SERP benefits. The change in value could be very large, depending on the proportion of total benefits represented by the SERP.

According to the Standard, an actuary cannot apply an arbitrary discount to the reported pension values to account for the possible forfeiture of benefits. The circumstances of the particular case will dictate which scenario is appropriate i.e., whether the member is most likely to terminate employment before retirement or to remain in active employment until the earliest unreduced retirement age, for example. In some cases when agreement cannot be reached as to which scenario is appropriate, judges have applied their own somewhat arbitrary discount to a pension value reported by the actuary.

g) Taxes

As discussed previously, all payments from a registered plan are taxable in the hands of the recipient. If the pension value is to be offset against the value of an asset which is not tax deferred such as a bank account or the matrimonial home, a tax adjustment must be applied to the pension asset.

According to the Standard, the actuary must estimate a projected average tax rate at retirement when accounting for the taxes that will eventually be payable upon the member's receipt of pension payments. There are some differences in the way that actuaries apply this principle, which can lead to some differences in the tax application which are normally relatively small; however, the key is that actuaries must use a projected average tax rate rather than some form of marginal tax rate at retirement. An average tax rate calculation uses the total income and the total tax payable to arrive at the tax rate. If a marginal tax rate were to be used, the tax rate would typically be significantly higher, as lower tax brackets and significant credits could be overlooked (i.e., if the lower tax rates and the tax credits are assumed to apply to other income such as Canada Pension Plan and Old Age Security benefits, and the higher tax rates are assumed to apply to the pension benefits).

h) Excess Contributions

Pension plans often require member contributions in addition to employer contributions. In Ontario and most other jurisdictions in Canada, "excess" contributions result when accumulated member contributions with interest exceed certain thresholds in comparison to the pension value at retirement or termination of employment. To the extent that any excess contributions have been made by the member, these amounts are included in the valuation results at the date of separation. Excess contributions become particularly important for younger members who are far from retirement and whose pension values are therefore low.

i) Gender

The sex of the pension plan member affects the value of the member's pension for equalization purposes. As females statistically live longer than men, the value of their defined benefit pension benefits is higher than the values for males, all else being equal. More specifically, a female is assumed to be more likely to survive to receive each potential payment.

III Marriage Breakdown Value vs. Value at Termination of Employment

Pension plan administrators are required to provide members with annual statements which outline their pension entitlements earned to the date of the statement. The statements include the accrued pension the member has earned, based on credited service and earnings (if applicable) before this date. In some cases, the statement also includes an estimate of the value the member would receive from the pension plan if he or she had terminated employment at the statement date and elected to transfer the value of his or her deferred pension out of the plan (the "termination value").

When asked to provide pension information in cases of marriage breakdown, some plan administrators provide the termination value in addition to details regarding the member's pension earned to the date of separation. This termination value should not be viewed as the value of the member's pension entitlements for purposes of determining a lump sum equalization payment.

There are many reasons why the termination value should not be deemed to be the appropriate value for equalization purposes, including those outlined below.

a) Pre-marital Service

The termination value does not contain any adjustment to account for pre-marital service. When preparing a valuation for equalization purposes, the actuary will indicate the necessary adjustment to the pension value if there is pre-marital service.

b) Retirement Age

The termination value is normally the present value of the member's deferred vested pension, payable at the normal retirement age, or payable at an earlier retirement age but reduced according to the terms of the pension plan. Most pension plans will apply a larger penalty (reduction) on account of early retirement for deferred members in comparison to members who retire from active service. The difference is even larger when age and service criteria must be met for eligibility for unreduced retirement. If a member terminates employment early, he or she will likely not have met the service criteria necessary for unreduced early retirement, whether or not the plan provides this extra benefit for deferred vested members.

Pension valuations for equalization purposes will incorporate numerous scenarios, not merely assuming literal termination of employment at the date of separation. This difference can have a huge impact on the potential value of the member's pension entitlements. Consider the extreme example in Appendix D. The member is age 54 years and 11 months at the date of separation. The termination value incorporates the assumption that the member receives a deferred pension at age 65, based on the terms of the pension plan. For marriage breakdown purposes, various scenarios would be presented including retirement at age 55, as the member is entitled to a pension that is not discounted for early retirement at that age. If the member is considered to be most likely to retire at age 55 based on the circumstances of the case (as shown in the example), the appropriate value would then be 74% higher than the termination value.

In this example, considering that the member is only 1 month from this early retirement date, it would be difficult to argue that the member will never be entitled to take advantage of this plan feature, should he or she so choose. This does not necessarily mean that the member will elect this option. The member could still be considered more likely to choose to retire at a later age, given the circumstances of the case.

c) Vesting

As discussed earlier, the member is vested in his or her deferred pension in a registered pension plan after only 2 years of membership. As such, unless the member has less than 2 years of membership in the pension plan, vesting would not be a significant issue. In most cases, however, the termination value would not incorporate the value of potential SERP benefits as the member is normally not vested in these benefits if he or she terminates employment before retirement age. (Regardless, the SERP benefits are technically not part of the registered pension plan, so a registered pension plan statement may not include the value of the non-registered benefits.) As mentioned, however, SERP benefits may be a significant component of the overall pension value for equalization purposes, particularly if they are close to the payment stage.

d) Ad hoc Inflation Increases

In private pension plans, inflationary increases are often provided on an ad hoc basis to pensions which are in payment. If a member terminates employment and elects to transfer the value of his or her pension entitlements out of the pension plan, the potential for non-guaranteed ad hoc inflation increases is not reflected in the termination value. A consistent history of ad hoc increases is reflected, however, in pension valuations for equalization purposes. The difference can be significant depending on the level of pension increases and other circumstances of the case.

e) Taxes

The termination value reported by plan administrators does not include any adjustment for taxes which will eventually be payable when the member commences to receive payments from the pension plan. In performing a pension valuation for marriage breakdown purposes, the actuary will provide this adjustment in case the pension asset will be offset against an asset which is not tax deferred. The effect of taxes can be very significant. For example, if the member is assumed to have total income after retirement of $45,000 (in 2002 dollars) annually after age 65, the tax adjustment would be in the area of 20%, based on 2002 tax rates.

f) Post-Retirement Survivor Benefits

In Ontario, pension plans must pay a “joint and survivor” form of annuity to members who have a spouse at retirement, meaning that a percentage of the member’s pension continues to his or her spouse after the member’s death. In some cases, this form of pension is the “normal form” of pension under the pension plan which means that no actuarial reduction is applied to the member’s lifetime pension benefit to effectively pay for this additional survivor benefit. In these cases, if a member does not have a spouse at retirement, he or she may receive a form of pension which is less valuable (such as a pension payable for the member's lifetime, for example). The termination value will ordinarily at least partially reflect the value of the post-retirement survivor benefit potentially payable to the spouse.

For the purposes of calculating the pension value for equalization, the member is considered to be single as of the separation date. As such, the value of a survivor benefit which is payable only to a spouse is not considered. The exception to this principle occurs when the member has already commenced receipt of a joint and survivor benefit as at the date of separation, with the survivor benefit thereby irrevocably payable to the non-member spouse. In this case, the survivor benefit payable to the non-member spouse will have to be valued as an asset belonging to the non-member spouse.

g) Mortality Rate Assumption

Pension legislation in Ontario (and in many other jurisdictions) requires that termination value calculations result in equivalent values for males and females, assuming that all other personal data and circumstances are identical. The actuary acting for the plan sponsor will therefore use a unisex blend of male and female mortality rates (for example, 50% of each) when calculating the termination value. For marriage breakdown calculations, actuaries use "sex distinct" mortality rates which are based on the actual sex of the member. Since females are statistically expected to live longer than males, the assumption of unisex mortality serves to reduce females' termination values and increase males' termination values.

<u>IV Bottom Line – What is "The Value"?</u>

Once the actuary has delivered a pension valuation report, lawyers may still have questions regarding the implications of its contents. What is the value to be assigned to the pension in the equalization process?

a) Agreement on Retirement Age

Perhaps the most common and important issue relates to the choice of the retirement age scenario. The actuarial report will contain a summary of results which outline the pension values based on a number of retirement age scenarios. As noted in Section II, the difference can be very significant between the value for the earliest retirement age and the value for the normal retirement age. The question of which retirement age is appropriate is a legal matter to be discussed among the parties, not to be answered outright by the actuary performing the valuation.

In the Kennedy v. Kennedy case, the Ontario Court of Appeal noted that the choice of retirement age should not be a mechanical exercise, in which either the unreduced retirement age or the normal retirement age is automatically chosen based on a general principle. Rather, the retirement age chosen is "a question of fact to be determined on a case by case basis upon consideration of all of the relevant evidence."[4]

The retirement age choice was also an issue in the landmark Best v. Best decision. In this case, the judgment stated that "the presence of an early retirement provision will almost always be relevant to the choice of a likely retirement age."[5] This does not mean that the earliest retirement age should always be chosen, but rather that the early retirement provision is an important consideration when deciding on the member's choice of retirement date. The court also stated that "post-separation evidence should not be used in determining a likely retirement date unless the evidence reflects facts that were within the employee spouse's contemplation at the time of separation."[6] This is a very important point. Even if the member has not yet retired by the time a case goes to court, the court could decide that the most likely retirement age, from the perspective of the date of separation, is an early retirement age which has already passed. The retirement age is determined based on the retirement intentions of the member at the date of separation, without the benefit of hindsight.

In other cases, a retirement age somewhere in between has been chosen, such as the midpoint between the earliest retirement age and the normal retirement age. This approach could be used if there is conflicting evidence regarding when the member is most likely to retire.

What factors are relevant in assessing the likeliest retirement age? In addition to the early retirement provisions of the pension plan, the following are some of the other factors to consider.

- Has the pension member stated intentions before or at the date of separation which indicate a likelihood to retire at particular date? For example, the member may have stated a desire to retire as soon as he or she reaches the earliest age at which he or she can retire with a pension that is not discounted for early retirement, in order to start a small business.
- What is the pension member's attitude about his or her work or career? Has the individual stated a desire to leave his or her job as soon as possible? Is there an indication, such as enrolment in a training program unrelated to the member's current career, that the member will be leaving employment within a certain timeframe?
- How large is the member's projected pension at retirement and what are the other economic circumstances? Does the individual have significant financial obligations such as children to support? Consider a situation where the member's salary is $75,000 per

year, but the projected annual pension the member would receive at the earliest retirement date would be only $10,000. One might argue in many cases that the member could not afford to retire at the earliest retirement date, given the large reduction in income this would cause. The same situation could be viewed differently if the individual has significant other assets.

- Is the pension plan fully indexed for inflation? This affects the affordability of early retirement as well. The member may be less likely to retire early if the purchasing power of his or her pension will be reduced significantly over time.

The possibility certainly exists that agreement cannot be reached regarding the retirement age and corresponding value of the pension asset at the date of separation. Consideration may be given to the construction of an "If and When" agreement rather than equalization of the pension asset at the date of separation. Issues related to this alternative are discussed in Section V.

b) Tax Issues

The issue of taxes was discussed earlier in this paper. The key is that payments from the pension asset will be taxed in the hands of the recipient, whereas most other assets such as a house or bank account are not tax deferred. RRSPs and similar tax deferred retirement arrangements, on the other hand, are similar to registered pension plans in terms of the tax issues. If a transfer of assets will be occurring, the tax implications need to be taken into account for all tax deferred assets.

V Dividing the Pension Asset: Equalization vs. "If and When"

There are various reasons why an equalization of the pension asset at the date of separation may not be desirable for one or both of the parties. The alternative is the construction of an "If and

When" agreement. There are significant issues which need to be considered before an "If and When" agreement is chosen as the method of division. Many would argue that an "If and When" agreement should only be chosen as a last resort.

a) What is an "If and When" Agreement?

Most of the discussion thus far has centered on valuing the pension asset at the date of separation for the purposes of including the value in the equalization balance sheet. In this case, the spouse with the larger amount of marital assets must pay an equalization payment to the spouse with lesser assets. In Ontario regulated pension plans, the pension asset cannot be accessed at the date of separation if the member is still working; as such, if the member spouse is required to make an equalization payment, he or she must use other assets. If the member spouse does not have enough other assets to liquidate, he or she may be able to make the equalization payment in installments over several years if the parties agree (or a court imposes this payment structure).

Alternatively, an "If and When" agreement allows for the pension to be split if and when the member retires, terminates employment or dies and can receive payments from the pension plan. According to the Best v. Best judgment, the "If and When" approach "should not be declared the default rule for equalization payments involving pensions."[7] In Best v. Best, an equalization payment (in instalments) was ordered, at least in part due to the inherent problems of "If and When" agreements.

b) Pension Legislation

The specific details of the "If and When" agreement must take into account the pension legislation in the relevant jurisdiction, especially if direct payment to the non-member spouse from the pension fund is contemplated. Family lawyers may wish to consider having a pension lawyer review an "If and When" agreement before it is finalized. Agreements are often constructed without proper consideration of pension law. For example, in Ontario regulated pension plans, a maximum of 50% of the member's pension benefit earned during the period of marriage can be assigned by domestic contract or order, to be payable directly from the pension fund to the spouse at termination of employment or retirement. The "50% test" is usually calculated at the date of separation, and is calculated "in accordance with the terms of the pension plan at that date and without consideration of future benefits, salary or changes to the plan but with consideration for the possibility of future vesting."[8] An improperly worded agreement may be unenforceable by the pension plan administrator if it is not in compliance with the Ontario Pension Benefits Act and Regulations. (Federally regulated pension plans have different rules.) This can cause severe problems for the non-member spouse many years after the separation date.

c) Financial Ties

One of the problems with "If and When" agreements is that the non-member spouse retains a financial connection to the member for many years after the date of separation, and possibly for life. The non-member spouse will not be able to access his or her portion of the pension asset until the member terminates employment, dies or retires. Furthermore, if the member later retires from the pension plan, the non-member spouse's pension benefit is payable based on the lifetime of the member. If the member dies soon after retirement, the non-member spouse's pension payments will cease immediately (or soon thereafter if the pension is guaranteed for a limited period).

If the member or spouse dies prior to retirement, there are other serious complications. A complete discussion of the issues is beyond the scope of this paper. There are several key issues to consider. Upon death of the member, some of the member's pension value may be lost, and therefore the spouse's share is lost as well. The spouse may have difficulty recovering his or her interest in the actual death benefit, particularly if the member remarried after the date of separation. If the non-member spouse dies before the member retires, there may be problems settling the non-member spouse's estate.

A life insurance policy should be seriously considered as part of an "If and When" agreement to protect the non-member spouse's interests. A lawyer for a non-member spouse would not want to face the prospect of his or her client receiving less than expected from the agreement many years after its drafting.

d) Equity - Winners and Losers

The positive aspect of an "If and When" agreement is that speculation regarding the "true" value of the pension benefit can be eliminated. The pension value at the date of separation may become irrelevant since the actual retirement pension or termination value can be split when the event occurs. The retirement date and future contingencies no longer have to be determined at the date of separation. This could be viewed as more equitable to both parties. Problems arise, however, due to the complexities of pension plan design and legislation.

For example, if an equalization payment is made based on a pension value with an assumed retirement age of 65, but the member later retires at age 55, the non-member spouse arguably will not have received his or her fair share of the pension value. If instead an "If and When" agreement was created at the date of separation, the non-member spouse could start to receive his or her share of the pension benefit when the member reaches age 55 if the member chooses this retirement age. What happens if the member dies at age 56 in this case? The non-member spouse's pension may cease immediately or soon after, as mentioned earlier. As a result, the spouse may receive far less under the "If and When" agreement than if an equalization payment had occurred with respect to the pension asset, even if the pension valuation was based on an assumed retirement age of 65. On the other hand, if the member retires at age 55 and lives to 100, the non-member spouse would benefit from the “If and When” agreement, in comparison with equalization.

VI Conclusion

Pensions are a very important and complex area in the context of the division of assets upon marriage breakdown. Each pension plan is different, and the specific provisions of a particular plan can have a significant impact on the pension value at the date of separation.

Family lawyers need to be aware of the factors which have an impact on the pension value, and on the choice of methods for dividing the pension asset.

VII Disclaimer

The information included in this paper is provided for educational purposes only. Readers should obtain expert advice before acting on any of the information provided. No person or firm involved in the preparation or distribution of this information accepts any liability for the results of any actions taken on the basis of this information.

Appendix A
Pro Rata vs. Value Added

The following is an example demonstrating the difference between the pro rata method and the value added method in determining the pension value attributable to the marriage. Values are shown before any adjustment for income taxes.

<u>Membership Information</u>

Date of Valuation/Separation	December 31, 2002
Date of Marriage	January 1, 1994
Sex of Member	Male
Member Date of Birth	December 31, 1952
Member Age at Date of Valuation	50 years
Pension Plan Entry Date	January 1, 1978
Credited Service at Date of Separation	25 years
Pre-Marital Service	16 years
Accumulated Member Contributions with Interest as at Date of Separation and Date of Marriage	$0 (not required by pension plan)
Highest Average Earnings at Date of Separation	$50,000
Highest Average Earnings at Date of Marriage	$30,000
Retirement Age for Equalization Purposes	55 years

<u>Amount and Characteristics of Pension</u>

The amount of accumulated pension is based on the following benefit formula:

2.0% of Highest Average Earnings (highest 5 consecutive years of member earnings) multiplied by credited service.

The accumulated annual pension based on the formula described above is:

At Date of Separation: $25,000 annual lifetime benefit payable at retirement
At Date of Marriage: $9,600 annual lifetime benefit payable at retirement

The pension is fully indexed to increases in the Consumer Price Index both before and after retirement (including in the deferral period for deferred vested members).

The following table presents the approximate valuation results (before any adjustment for income tax) using the two methods of calculating the pension value at the date of marriage.

Method	**Total Value at Date of Separation Before Tax Adjustment**	**Total Value at Date of Marriage Before Tax Adjustment**	**Value Allocated to Marriage Before Tax Adjustment**
Pro Rata	$330,000	$211,000	**$119,000**
Value Added	$330,000	$90,000	**$240,000**

Appendix B
Retirement Age Scenarios

The following is an example demonstrating the differences which result based on the retirement ages assumed in the pension valuation. Values are shown before any adjustment for income taxes.

<u>Membership Information</u>

Date of Valuation/Separation	December 31, 2002
Date of Marriage	January 1, 1982
Sex of Member	Male
Member Date of Birth	December 31, 1952
Member Age at Date of Valuation	50 years
Pension Plan Entry Date	January 1, 1978
Credited Service at Date of Separation	25 years
Pre-Marital Service	4 years
Accumulated Member Contributions with Interest as at Date of Separation and Date of Marriage	$0 (not required by pension plan)
Highest Average Earnings at Date of Separation	$50,000
Retirement Age Scenarios for Equalization Purposes	55, 60 and 65 years

<u>Amount and Characteristics of Pension</u>

The amount of accumulated pension is based on the following benefit formula:

2.0% of Highest Average Earnings (highest 5 consecutive years of member earnings) multiplied by credited service.

The accumulated annual pension based on the formula described above is:

At Date of Separation: $25,000 annual lifetime benefit payable at retirement

The pension is fully indexed to increases in the Consumer Price Index both before and after retirement (including in the deferral period for deferred vested members).

The following table presents the approximate valuation results (before any adjustment for income tax) under the various retirement age scenarios considered.

Retirement Age	**Total Value at Date of Separation Before Tax Adjustment**	**Total Value at Date of Marriage Before Tax Adjustment**	**Value Allocated to Marriage Before Tax Adjustment**
55	$330,000	$53,000	**$277,000**
60	$250,000	$40,000	**$210,000**
65	$180,000	$29,000	**$151,000**

Appendix C
Inflation Indexing

The following is an example demonstrating the differences in value which result based on whether or not a pension plan is indexed for inflation increases, and to what degree. Values are shown before any adjustment for income taxes.

Membership Information

Date of Valuation/Separation	December 31, 2002
Date of Marriage	January 1, 1977
Sex of Member	Female
Member Date of Birth	December 31, 1952
Member Age at Date of Valuation	50 years
Pension Plan Entry Date	January 1, 1978
Credited Service at Date of Separation	25 years
Pre-Marital Service	0 years
Accumulated Member Contributions with Interest as at Date of Separation and Date of Marriage	$0 (not required by pension plan)
Highest Average Earnings at Date of Separation	$50,000
Retirement Age for Equalization Purposes	60 years

Amount and Characteristics of Pension

The amount of accumulated pension is based on the following benefit formula:

2.0% of Highest Average Earnings (highest 5 consecutive years of member earnings) multiplied by credited service.

The accumulated annual pension based on the formula described above is:

At Date of Separation: $25,000 annual lifetime benefit payable at retirement

The following table presents the approximate valuation results (before any adjustment for income tax) under several possible inflation indexing scenarios. The level of indexation taken into account in a pension valuation will depend on the terms of the pension plan, or the history of ad hoc increases granted in the past.

Indexing Scenario	**Total Value at Date of Separation Before Tax Adjustment**	**Total Value at Date of Marriage Before Tax Adjustment**	**Value Allocated to Marriage Before Tax Adjustment**
No Indexation	$170,000	$0	**$170,000**
50% Indexation After Retirement Only*	$185,000	$0	**$185,000**
Full Indexation Before and After Retirement**	$285,000	$0	**$285,000**

* based on the increase in the Consumer Price Index
** includes indexation during the deferral period for deferred vested members

Appendix D
Termination Value vs. Value for Equalization

The following is an example demonstrating the potential difference between the "termination value" payable from a pension plan to a member upon termination of employment, and the value for equalization purposes. Note that the assumed retirement ages in both cases are examples. The actual retirement ages will depend on various factors, as previously mentioned. Values are shown before any adjustment for income taxes.

Membership Information

Date of Valuation/Separation	December 31, 2002
Date of Marriage	January 1, 1973
Sex of Member	Male
Member Date of Birth	January 31, 1948
Member Age at Date of Valuation	54 years and 11 months
Pension Plan Entry Date	January 1, 1973
Credited Service at Date of Separation	30 years
Pre-Marital Service	0 years
Accumulated Member Contributions with Interest as at Date of Separation and Date of Marriage	$0 (not required by pension plan)
Highest Average Earnings at Date of Separation	$50,000
Retirement Age Assumed in Termination Value	65 years
Retirement Age for Equalization Purposes	55 years

Amount and Characteristics of Pension

The amount of accumulated pension is based on the following benefit formula:

2.0% of Highest Average Earnings (highest 5 consecutive years of member earnings) multiplied by credited service.

The accumulated annual pension based on the formula described above is:

At Date of Separation: $30,000 annual lifetime benefit payable at retirement

The pension is fully indexed to increases in the Consumer Price Index both before and after retirement (including in the deferral period for deferred vested members).

The following table presents the approximate valuation results for equalization purposes, and the termination value provided if the member were to terminate employment at the date of separation (both before any adjustment for income tax).

Value	**Total Value at Date of Separation Before Tax Adjustment**	**Total Value at Date of Marriage Before Tax Adjustment**	**Value Allocated to Marriage Before Tax Adjustment**
Termination Value	$270,000	$0	**$270,000**
Value for Equalization	$470,000	$0	**$470,000**

Note that the assumptions used in the calculation of the termination value are not identical to those used in the calculation of the pension value for equalization purposes.

[1]Canadian Institute of Actuaries, Standard of Practice for the Computation of the Capitalized Value of Pension Entitlements on Marriage Breakdown for Purposes of Lump-Sum Equalization Payments (September 1, 1993), p. 14.
[2] Karim Renno, "Quebec courts demand impartiality from experts" The Lawyers Weekly (Markham, Ontario), January 24, 2003, p. 17
[3] *Best v. Best* [1999] 2 S.C.R. 868
[4] *Kennedy v. Kennedy* [1996] O.J. No. 764
[5] *Best v. Best* [1999] 2 S.C.R. 868
[6] *Best v. Best* [1999] 2 S.C.R. 868
[7] *Best v. Best* [1999] 2 S.C.R. 868
[8] *General Regulation* - *Pension Benefits Act*, R.R.O. 1990, Reg. 909, s. 56