

INCOME TAX ALLOWANCE

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In valuing a person's pension for equalization on marriage breakdown, proper allowance should be made for the income taxes that will be paid when the person receives the pension payments. The amount of the tax allowance taken can affect the values substantially. The higher the income tax rate used, the lower the value will be for equalization.

I have seen many different types of provisions for income taxes in the different valuation reports that I have reviewed. I have seen reports where there were no allowances for income taxes, and it was left to the parties, their lawyers, or the Courts to determine the proper income tax allowance. I have seen tax allowances in reports, based on rates ranging from 15% to 45%. I have seen reports where the valuator used the individual's current average tax rate. I have also seen reports where an attempt was made to establish the average tax rate that the individual would pay after retirement. I have seen allowances based on the marginal rate that the individual was paying at the valuation date. I have also seen attempts to project the marginal rate that the individual will pay after retirement. Many valuation reports are issued using a flat rate of 20% or 25% without any real justification for it. This will rarely be the proper rate. I have seen valuation reports where the valuator tried to allow for anticipated future tax changes. No wonder there is confusion as to how the proper income tax allowance should be calculated when there are so many different approaches used by different pension valuers, many of which produce a low tax allowance or cannot be justified.

Standards

The standards issued by the Canadian Institute of Actuaries attempt to ensure that all income tax allowances are calculated in the same way. The standards require that the anticipated full age 65 pension income be projected ahead to retirement. To this is added the Canada Pension Plan, Old Age Security and other anticipated income (all in current dollars). The valuator then makes a one-time calculation based on all of this income using the average rate of a single tax payer. This average rate is to be the most recent rate that is available **at the time the valuation report is being prepared.**

Having established the person's average tax rate (being total tax over total income) for one year, you apply this rate regardless, of which of the acceptable methods you have used to determine the value of the pension.

These standards leave themselves open to different interpretations. I usually find that someone attempting to follow these standards develops one tax rate that is applied to all values.

In one report that I reviewed recently, the actuary said:

... considering the uncertainties and other factors surrounding the determination of taxes in the valuation of pensions, under the Family Law Act, an arbitrary taxation allowance of 25% has been employed, which often is used in pension valuations under the Family Law Act.

By carrying out full detailed calculations (rather than using an unjustified arbitrary rate) I was able to justify in this man's case that the rate should be 32.5% and not 25%. I was thereby able to reduce the value of his pension by more than \$30,000.

Case Law

There has been very little discussion in reported case law to date. Cases have shown allowances from 0% to 36%, and in many cases the rate has been chosen arbitrarily. I have yet to see a case where the tax rate was questioned or justified.

Survey of Actuaries

In a survey of actuaries some years ago, actuaries were asked to value a person's pension with all of them using the same facts. Some valuation reports showed no income tax allowance, and others showed rates that varied substantially.

Proper Tax Allowance

If it is your client's pension that is being valued, you will want to ensure that the tax allowance is as high as possible. If it is your client's spouse's pension that is being valued, you will want to make sure that the allowance has not been overstated.

In my opinion, the rate of income tax allowance used in a pension valuation should be based on the rates and Income Tax Laws as they stand at the date of valuation (e.g. in Ontario, this would be the date of separation). All other information being used in the valuation is based on the laws and the economy as at the date of valuation. There is no good reason for doing otherwise, just for the income tax allowance.

In my opinion, the tax rate should be based on the full amount of pension benefit that will be paid in retirement, plus Canada Pension Plan and Old Age Security. To this should be added any other income that the member can prove that he will have in retirement (e.g. income from RRSP that existed at the date of separation).

The calculations should allow for any indexing that is provided in the particular pension, and also the indexing that is provided in Canada Pension Plan pensions, and Old Age Security.

Keeping all of the above in mind, the valuator should then prepare extensive tax calculations to determine the income tax that the person can expect to pay on all of their income each year in the future, after retirement. This will involve a line-by-line calculation, for each year, from the assumed retirement date to the end of the normal life expectancy of the person. From these calculations, the valuator should determine a separate income tax rate for each of the values determined in the report. This will produce the highest income tax rate possible to justify (and therefore the lowest value for equalization). It is also a method that can be explained and is difficult to refute, since it is logical.

Summary

Many valuation reports are prepared with an improper allowance for income tax. Sometimes the allowance is too high. Sometimes it is too low.

A proper income tax allowance, calculated as set out above, can be easily justified in a Court of Law. Allowing for other income can substantially reduce the value of the pension for equalization on marriage breakdown.

It is important to ensure that your pension valuator takes other income into account. It is also important that your valuator be able to produce detailed calculations of the tax allowance so that it can be justified in a court of law.