EDUCATIONAL NOTE

Educational Notes do not constitute standards of practice. They are intended to assist actuaries in applying standards of practice in respect of specific matters. Responsibility for the manner of application of standards in specific circumstances remains that of the practitioner.

REFLECTING INCREASING MAXIMUM PENSIONS UNDER THE INCOME TAX ACT IN SOLVENCY, HYPOTHETICAL WIND-UP AND WIND-UP VALUATIONS

COMMITTEE ON PENSION PLAN FINANCIAL REPORTING

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MEMORANDUM

TO: All Fellows, Associates and Correspondents of the Canadian Institute of Actuaries

DATE: June 24, 2004

FROM: Serge Charbonneau, Chairperson
Pension Plan Financial Reporting Committee (PPFRC)

SUBJECT: **Educational Note on Reflecting Increasing Maximum Pensions under the Income Tax Act in Solvency, Hypothetical Wind-up and Wind-up Valuations**

The Pension Plan Financial Reporting Committee (PPFRC) has developed the attached educational note on reflecting increasing defined benefit maximum pension limits under the Income Tax Act in Solvency, Hypothetical Wind-up and Wind-up Valuations.

In accordance with the Institute's policy on Due Process, this educational note, *Reflecting Increasing Maximum Pensions under the Income Tax Act in Solvency, Hypothetical Wind-up and Wind-up Valuations*, has been approved by the PPFRC, and has received final approval for distribution by the Practice Standards Council (PSC).

Section 1220 of the current Standards of Practice (SOP) prescribes that "the actuary should be familiar with relevant educational notes and other designated educational material." It further explains that "a practice which the notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation."

Questions should be addressed to me at my CIA online directory address.

SC

The maximum accrual permitted for a defined benefit pension plan under the Income Tax Act increased to $1,833.33 from $1,722.22 per year of service, effective January 1, 2004. The maximum accrual is expected to further increase each subsequent calendar year. This raises the question of whether a solvency, hypothetical wind-up or wind-up valuation performed as at December 31 of a calendar year should reflect the maximum in effect on December 31 of that calendar year, or the higher limit that would be effective the following day.

The relevant sections of the current Standards of Practice (SOP) are:

- General SOP – 1110 – Definitions
    - 1110.10 – Calculation Date
    - 1110.43 – Report Date
    - 1110.49 – Subsequent Event
- General SOP – 1520 – Subsequent Events
    - 1520.15 – wording on subsequent event changing entity after calculation date, but purpose of work is to report on the entity as it was at the calculation date
- Pension SOP – 3700 - Wind-up, Hypothetical Wind-up, or Solvency Valuation
    - 3720.09 – wind-up valuation defining calculation date as the date to which subsequent events are reported in the valuation
    - 3740.05 – hypothetical wind-up section indicating that the actuary should assume that the wind-up date, the cut-off date and the settlement date are all coincident
    - 3740.10 – hypothetical wind-up section indicating that the actuary may reflect subsequent events in the valuation provided that doing so either increases the liabilities or decreases the assets
    - 3750.01 – solvency valuation section clarifying that a solvency valuation is a hypothetical wind-up valuation that has been prescribed by legislation
    - 3750.02 – solvency valuation section indicating that hypothetical wind-up standards of practice apply, unless:
        - otherwise required by legislation, or
        - permitted by legislation and called for by the terms of the engagement

This issue affects some pension plans differently, depending on the plan’s provisions. We have classified the difference in plan provisions into two broad categories as follows:

1. Pension plans that provide for the maximum pension test to be applied at the time of pension commencement (for example, a deferred pension expected to commence at the member’s age 65 would apply the maximum pension test in the calendar year that the member attains age 65).

2. Pension plans that provide for the maximum pension test to be applied at the relevant calculation date (for example, a deferred pension expected to commence at the member’s age 65 would apply the maximum pension test in the year of the member’s termination of employment, or in determining commuted values, the year of the settlement of the pension obligation).

In the opinion of the Pension Plan Financial Reporting Committee:

- For pension plans with provisions generally described under section #1 above, the values determined under a hypothetical wind-up valuation or solvency valuation would not be affected by whether or not the valuation was performed on December 31 or January 1, since the actuary would be estimating the maximum pension as at the assumed date of pension commencement.

- For pension plans with provisions generally described under section #2 above, the issue of whether or not to use the current calendar year pension limit, or the following calendar year pension limit does affect the calculation.

  - For hypothetical wind-up valuations being performed as at December 31 in a calendar year, reflecting only the maximum accrual limit for that calendar year (for example, $1,722.22 for December 31, 2003) is in compliance with the SOP. However, reflecting the higher limit that would be effective January 1 of the following calendar year (for example, $1,833.33 on January 1, 2004), thus increasing the actuarial liability, is also in compliance with the SOP.

  - For solvency valuations performed as at December 31 of a calendar year, the SOP for hypothetical wind-up valuations also applies, unless otherwise required by legislation. The interpretation of what will be required by the various pension regulators is outside the mandate of the PPFRC.

  - For an actual wind-up valuation, the SOP is different, and the calculation date should be chosen to be as close as possible to the report date, and subsequent events should be reported up to the calculation date.