Canadian Institute of Actuaries / Institut canadien des actuaires

Revised Educational Note

Reflecting Increasing Maximum Pensions Under the Income Tax Act in Solvency, Hypothetical Wind-up and Wind-up Valuations

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Committee on Pension Plan Financial Reporting

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Ce document est disponible en français

Members should be familiar with educational notes. Educational notes describe but do not recommend practice in illustrative situations. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application (but not necessarily the only application) of the Standards of Practice, so there should be no conflict between them. They are intended to assist actuaries in applying standards of practice in respect of specific matters. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members.

MEMORANDUM

To: All Members in the Pension Practice Area

From: Bruce Langstroth, Chair
Practice Council

Manuel Monteiro, Chair
Committee on Pension Plan Financial Reporting

Date: January 28, 2015

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

This updated educational note is intended to provide guidance to actuaries with respect to reflecting increasing defined benefit maximum pension limits under the Income Tax Act in solvency, hypothetical wind-up and wind-up valuations.

An educational note on this subject was originally published in June 2004. This updated educational note updates the original educational note to conform to the pension specific standards of practice effective February 1, 2014.

As outlined in subsection 1220 of the Standards of Practice, "*The actuary should be familiar with relevant Educational Notes and other designated educational material*." That subsection explains further that a "practice that the Educational 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." As well, "Educational Notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them."

In accordance with the Institute's Policy on Due Process for the Approval of Guidance Material other than Standards of Practice, this educational note has been prepared by the Committee on Pension Plan Financial Reporting and has received final approval for distribution by the Practice Council on January 22, 2015.

Should you have any questions or comments regarding it, please contact Manuel Monteiro at manuel.monteiro@mercer.com.

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The maximum accrual permitted for a defined benefit pension plan under the Income Tax Act is expected to increase every 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 when purpose of work is to report on the entity as it was at the calculation date
- Pension SOP – 3200 – Advice on the Funded Status or Funding of a Pension Plan
    - 3240.05 – hypothetical wind-up section indicating that the actuary may assume that the wind-up date, the calculation date and the settlement date are all coincident
    - 3240.12 – hypothetical wind-up section indicating that the actuary may reflect subsequent events in the valuation provided that doing so either increases the actuarial present value of the projected benefits at the calculation date or reduces the value of the pension plan's assets at the calculation date
    - 3250.01 – solvency valuation section clarifying that a solvency valuation is typically a form of a hypothetical wind-up valuation required by law and indicating that hypothetical wind-up standards of practice apply, unless:
        - otherwise required by law, or
        - permitted by law and stipulated by the terms of an appropriate engagement
- Pension SOP – 3300 – Full or Partial Wind-up Valuation
    - 3310.07 – defining the cut-off date as the date up to which subsequent events are recognized in the valuation

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 in which 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).

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, $2,696.67 for December 31, 2013) is in compliance with the SOP, if in accordance with the terms of the plan. However, reflecting the higher limit that would be effective January 1 of the following calendar year (for example, $2,770.00 on January 1, 2014), 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 Committee on Pension Plan Financial Reporting.
- For an actual wind-up valuation, the SOP is different. The cut-off date would be chosen to be as close as possible to the report date, and subsequent events would be reported up to the cut-off date.