Pensions – Contingent Income Tax and Income Tax Gross-Ups

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Pension Family Law Value and Income Tax

- The family law value provided by the pension plan administrator is a gross amount (pre-tax).

- The pension plan administrator is not responsible to address any income tax issues.

- Pension plan administrators are accustomed to dealing with gross lump sum commuted values and likely have no knowledge or understanding of the issue of taxation and the family law value.

Contingent Income Tax on Family Law Value

- All assets included in net family property should be after-tax values.
- As a result, the gross family law value needs to be reduced by a deduction for contingent income tax, analogous to RRSPs.
- How should the deduction for contingent income tax be determined?
- If arbitrary deductions are used, they can very far off from reality. As a reasonableness check:
  - A typical long-service public servant (i.e. teacher, police, fire) with 30 years of service and earnings of $90,000 will have a pension worth approx. $700,000 at retirement and have an average income tax rate in retirement of approx. 20%

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Contingent Income Tax on Family Law Value

- A higher paid public service worker (i.e. high school principal, senior civil servant) with 30 years of service and earnings of $120,000-$130,000 will have a pension worth over $1,000,000 at retirement and have an average tax rate in retirement of approx. 25%

- A individual who is age 50 with $200,000 in RRSP is unlikely to have an average income tax rate in retirement in excess of 10%

- Many cases that I review with individuals who have RRSPs only, the contingent income tax rate is far too high.

- Even a small difference in the contingent income tax percentage can make a difference on a valuable pension (i.e. a 1% change in the tax rate on a $700,000 family law value is worth $7,000) – may be worth getting a precise calculation done.

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Contingent Income Tax on Family Law Value

- The change in law did not address the correct way to calculate contingent income tax on the pension family law value.

- I use a method that is consistent with how the pension family law value is calculated.

- Example:
  - Teacher age 49.5, accrued lifetime pension of $32,000 per year at separation.
  - I calculate total projected retirement income in current dollars for each assumed retirement age based on the formula used to calculate the family law value (i.e. commuted value A, B and C).
  - I then calculate expected average income tax rates in retirement using current income tax rates for each retirement age.
  - Weight each average income tax rate based on the weighting applied to commuted value A, B and C.

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Contingent Income Tax on Family Law Value

	Value A	**Value B**	**Value C**	**Total**
Age of retirement	61	65	55.5	
Family law value weighting for commuted value A, B & C (T=6)	6%	37.6%	56.4%	
Projected pre-65 ret income	$46,600	N/A	$41,700	
Projected post-65 ret income	$59,400	$62,700	$55,100	
Projected average tax rate	19.1%	20.2%	17.4%	
Projected average tax rate multiplied by weighting	1.1%	7.6%	9.8%	18.5%

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Income Tax Gross-Up on After-Tax Equalization Payment

- The member's pension does not have to be divided (i.e. equalization payment financed using other assets).

- Alternately, the pension can be divided:

  - If the member was retired at separation, pension payment is divided. Former spouse's portion is taxable income.

  - If the member was not retired at separation, lump sum transfer to the former spouse. The former spouse will be taxed on any withdrawals from the lump sum.

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Income Tax Gross-Up on After-Tax Equalization Payment

- Either way, the former spouse is receiving a taxable asset.
- Typically, the equalization payment is grossed-up to convert it to gross dollars, which can then be satisfied by way of a pension division.
- The intention of the gross-up is to compensate the spouse for the tax consequences of the transfer.
- There are several different ways the gross-up can be done.
- To my knowledge, there is no case law examining the correct gross-up methodology.

Income Tax Gross-Up - Example

- Take the following simplified example.
- Based on pension assets at separation, the projected average income tax rate in retirement is 10% for Mr. Jones and 20% for Ms. Jones.
- After-tax equalization payment owing to Mr. Jones of $100,000.

	Mr. Jones	**Ms. Jones**
Matrimonial Home	$200,000	$200,000
After-tax investments	$200,000	$100,000
RRSP	$200,000	
OMERS family law value		$600,000
Contingent tax RRSP/OMERS (10%/20%)	($20,000)	($120,000)
Net family property	$580,000	$780,000

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Income Tax Gross-Up - Example

- Ms. Jones can simply provide Mr. Jones with her $100,000 of after-tax investments. After-tax equalization payment results in equal net family property (see below).

	Mr. Jones	**Ms. Jones**
Matrimonial Home	$200,000	$200,000
After-tax investments	$300,000	
RRSP	$200,000	
OMERS family law value		$600,000
Contingent tax RRSP/OMERS (10%/20%)	($20,000)	($120,000)
Net family property	$680,000	$680,000

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Income Tax Gross-Up - Example

- But what if the funds come from the OMERS family law value?

- Some lawyers will simply gross-up based on Mr. Jones' tax rate of 10%, resulting in a gross transfer of $111,111:

  - A common error in calculating the gross-up is that the gross-up should be calculated as $100,000/(1-10%) = $111,111 and not $100,000 plus 10%=$110,000.

  - It can easily be verified that $111,111 less 10%=$100,000, the desired after-tax amount, whereas $110,000 less 10%=$99,000

- After a gross transfer of $111,111, Mr. Jones has additional retirement assets and Ms. Jones has less. As a result, Mr. Jones' average income tax rate in retirement increases to 13% and Ms. Jones' average income tax rate in retirement falls to 17%.

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Income Tax Gross-Up – Example – Gross-Up Method #1

- The after-tax value of the gross transfer from OMERS is $96,667 ($111,111 less 13%), which is less than the $100,000 after-tax equalization payment owed.
- After the transfer, the net family property is not equal.

	Mr. Jones	**Ms. Jones**
Matrimonial Home	$200,000	$200,000
After-tax investments	$200,000	$100,000
RRSP/OMERS transfer	$200,000	
OMERS family law value after transfer	$111,111	$488,889
Contingent tax RRSP/OMERS (13%/17%)	($40,444)	($83,111)
Net family property	$670,667	$705,778

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Income Tax Gross-Up – Example - Gross-Up Method #2

- What if Mr. Jones receives a gross-up based on his average tax rate after the transfer. Hence, a gross transfer of $114,943, which is equal to $100,000 divided by (1-13%).
- The after-tax value of the gross payment from OMERS is $100,000 ($114,943 less 13%) but net family property is not equal. The reason for this is because Mr. Jones is not being compensated for the additional tax owing with respect to his RRSPs as a result of his higher tax rate or the tax gain to Ms. Jones as a result of her lower tax rate.

	Mr. Jones	Ms. Jones
Matrimonial Home	$200,000	$200,000
After-tax investments	$200,000	$100,000
RRSP/OMERS transfer	$200,000	
OMERS family law value after transfer	$114,943	$485,057
Contingent tax RRSP/OMERS (13%/17%)	($40,943)	($82,460)
Net family property	$674,000	$702,597

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Income Tax Gross-Up – Example - Gross-Up Method #3

- What if Mr. Jones receives the gross transfer amount necessary to provide both spouses with the same net family property after the transfer. Mr. Jones would need to receive a gross transfer from OMERS of $136,471.

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	Mr. Jones	Ms. Jones
Matrimonial Home	$200,000	$200,000
After-tax investments	$200,000	$100,000
RRSP/OMERS transfer	$200,000	
OMERS family law value after transfer	$136,471	$463,529
Contingent tax RRSP/OMERS (14%/16%)	($47,106)	($74,164)
Net family property	$689,365	$689,365

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Income Tax Gross-Up - Summary

- The example illustrates the following points:

1. Method #1 illustrates that it is often unfair to gross-up the after-tax equalization payment based on the spouse's average tax rate before the transfer.

2. Method #2 illustrates that if the equalization payment is grossed-up based on the spouse's average tax rate after the transfer, the after-tax value of the gross transfer is equal to the after-tax equalization payment owing, but the net family property is not necessarily equal after the transfer.

3. Method #3 illustrates that to ensure the net family property is equalized after the transfer, the net family property statement needs to be redone after the transfer and the gross amount needs to be sufficient to ensure net family property is equal taking into consideration the changing tax rates.

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Income Tax Gross-Up - Summary

- Another possible method would be to equalize all RRSP/pension assets based on their gross value and equalize after-tax assets separately. This isn't an exact method, but is simple and will equalize net family property so long as both spouse's are projected to have the same average tax rate in retirement.

	Mr. Jones	Ms. Jones
Matrimonial Home	$200,000	$200,000
After-tax investments	$150,000	$150,000
RRSP	$200,000	
OMERS family law value	$200,000	$400,000
Contingent tax RRSP/OMERS (15%/15%)	($60,000)	($60,000)
Net family property	$690,000	$690,000

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Income Tax Gross-Up - Summary

- Method #2 can be altered to use Mr. Jones' marginal tax rate and not his average tax rate. This would compensate him for the additional tax owing on his existing retirement assets but does not share the income tax gain to Ms. Jones' as a result of her lower tax rate after the transfer.

- Ultimately the question of the correct gross-up is a legal question.

  - Is the goal of the gross-up to provide the spouse with an amount equal to the after-tax equalization payment owing (Method #2)?

  - Is the goal of the gross-up to ensure that both spouses have the same net family property after the transfer (Method #3)?

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Questions?

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