Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Individual Pension Plans

To enhance the retirement income of an incorporated business owner, incorporated professional or key employee, an Individual Pension Plan (IPP) may be a possible solution. An IPP is designed to provide asset diversification, increased retirement savings when compared to a registered retirement savings plan (RRSP), significant corporate tax deductions from contributions, tax deferral and creditor protection. This article discusses the key concepts associated with IPPs.

Any references to a spouse in this article also includes a common-law spouse.

What is an IPP?

As a business owner, professional or an employee of a private company, you may not be part of a registered pension plan. Instead, you may have set-up an RRSP for your retirement savings. An IPP can be thought of as a replacement for your RRSP. Similar to an RRSP, room is earned if you earn employment income from your corporation and funds in the IPP grow on a tax-deferred basis. Also, an IPP is designed to pay out an income stream that is determined by a benefit formula at retirement, much like a registered retirement income fund (RRIF).

An IPP is a defined benefit (DB) registered pension plan established by a corporation for a controlling shareholder or specified individuals. Specified individuals are either connected to the corporation (generally, this means that they, or in combination with someone they are related to, own 10% or more of the corporation's shares) or are non-connected to the corporation (generally key employees who earn more than 2.5 times the year's yearly maximum pensionable earnings (YMPE) limit). Spouses and children of these individuals can also be included in the plan if they work for the corporation. An IPP is limited to three or fewer members but there is no limit to the number of IPPs a corporation can sponsor.

An IPP is intended to offer the maximum pension benefits permitted under the Income Tax Act (the 'Act') and must be created and administered according to the Act, the Income Tax Regulations, as well as federal or provincial pension legislation. The various pieces of legislation may restrict the amount of contributions that can be made to an IPP, the types of investments that can be made in the IPP and the retirement benefits that can be provided by the IPP. All of these items are discussed in more detail further in the article.

Funding an IPP

The corporation that establishes an IPP is commonly referred to as the sponsoring corporation. The sponsoring corporation is responsible for funding the IPP and maintaining sufficient assets in the plan to provide the required retirement benefit.

The funding phase of an IPP mainly happens when a member is working and accumulating service years. The following are the types of funding that may be required:

1. Funding for the current year of service;
2. Funding for past years of employment with the sponsoring corporation;
3. An additional lump-sum funding on retirement called terminal or optional funding; and
4. Shortfall or deficit funding.

In all cases, the amount of funding required is determined by an actuary. Depending on the applicable pension legislation, service and deficit funding may not be mandatory for connected members. For non-connected members, such as key employees with no ownership of the sponsoring corporation, all types of funding is mandatory in most cases.

The corporation is also responsible for obtaining actuarial valuations every three to four years depending on the applicable pension legislation. If there is a shortfall in assets needed to provide the promised retirement benefit, the sponsoring corporation must make top-up contributions. If surplus assets build up in the plan, the corporation may need to take a contribution holiday before making new contributions.

An IPP can be set up using a life insurance deposit administration contract or a pension trust. This article only deals with an IPP setup as a pension trust. As with any trust, an IPP will need a trustee. The trustee can either be a corporate trustee or a group of at least three individuals. At least one of the individuals may need to be independent of the corporation establishing the IPP, depending on the status of the member (connected vs. non-connected) and the applicable pension legislation.

Contributions of cash are allowed in all jurisdictions in Canada. In- kind contributions can be made under federal pension legislation but require pre-approval from the Office of the Superintendent of Financial Institutions (OSFI). Provincial pension legislation may limit in- kind contributions. At the time of writing, British Columbia, Manitoba and Alberta plans only allow in-kind contributions for connected persons. Quebec and PEI plans allow in-kind contributions for connected and non- connected persons. All other provinces only allow for cash contributions.

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Personal contributions to an IPP are possible and you will be entitled to a deduction on your tax return for any contributions you make.

1. Current service funding

Although an IPP can be set up for you at any age between 18 and 71, larger contributions can be made to an IPP than to an RRSP after 40 years of age. Around this age is the point where IPP funding rates and RRSP contribution rates are equal. The annual amount allowed to fund an IPP before this age would be lower than what you could contribute to an RRSP. Annual funding to an IPP after age 40 would be higher than the maximum allowed as an RRSP contribution[1].

As a matter of interest, consider that an IPP has to provide a set benefit at retirement. The older you are when you set up the IPP, the fewer number of years you have until retirement. The less number of years you have until retirement, the fewer the number of years the funding contributions can grow. The less time that contributions can grow, the more funding the corporation must contribute to provide that set level of benefits.

As a designated plan, the maximum amount allowed as a contribution to the IPP is restricted by rules found in the Income Tax Regulations. These rules set out the assumptions that an actuary must use in their calculations and include (not exhaustive):

- Future investment interest rate of 7.5%
- Future inflation rate of 4%
- Future salary increases of 5.5%
- A retirement age no earlier than age 65
- Post-retirement inflation adjustments cannot exceed increases in the Consumer Price Index (CPI) less 1%
- Life expectancy as specified in the 1983 Group Annuity Mortality Table

1) An RRSP has a set maximum annual contribution rate of 18% of earned income (up to the annual limit), regardless of your age.

There is an inverse relationship between many of these assumptions and the required corporate contribution. Looked at another way, if an actuary were to use more conservative assumptions, like a 2% rate of inflation or 4% salary increases, the resulting required corporate contribution would be higher than the required contribution using the existing assumptions. For this reason, these assumptions are also referred to as 'maximum funding restrictions'. As a result of all these assumptions, and a fixed income promise at retirement, larger contributions to an IPP will be required as the individual gets older.

In addition, the actuary must also account for the member's age, years of service, their employment income from the corporation, the formula defined in the IPP and the prescribed maximum annual DB limits when determining the required funding amount. Employment income from the corporation is reported on a T4 or T4PS slip. It is important to note that dividends are not employment income for pension purposes.

IPP contributions can be made for a member with any amount of employment income. However, in order for your corporation to make the maximum current year funding contribution, your employment income must equal or exceed the current year's money purchase (MP) limit divided by 18%. For example, let's assume the MP limit for the year is $26,500. You would divide this by 18% to get the result of $147,222. As such, your employment income must be at least $147,222. Any income above this level will not increase the funding allowed for the current year. Since the MP limit is indexed annually, you will need to review the amount of your employment income annually as well.

2. Past service funding

An advantage of setting up an IPP is the opportunity for the sponsoring corporation to make tax- deductible contributions for past years of service. As the IPP member, you must have had earned employment income in past years from the sponsoring corporation to be credited with service years that occurred prior to the establishment of an IPP. These earnings are used by the actuary to determine the total amount of past service contributions that should be made to the IPP on your behalf. As well, past service cannot be accrued for years where you were operating your business as a sole proprietor or as a partnership.

Once the total amount of the past service contribution is determined, a portion must come from your RRSP, if you have one, with the balance coming from the sponsoring corporation. The amount that comes from your RRSP is called a qualifying transfer. The qualifying transfer is meant to adjust your RRSP contribution room to be the same as if you had contributed to the IPP for those past

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years that you are now receiving pension credits for. A qualifying transfer must be completed within 90 days after official registration of the IPP. Although transfers from a DPSP or a DC pension plan can also be used for the qualifying transfer, generally, most business owners are unlikely to have these. The calculation of the qualifying transfer is complex and beyond the scope of this article. It will be calculated by the actuary as part of the other calculations they must do when setting up an IPP.

The portion of the past service contribution to be funded by the sponsoring corporation may or may not be mandatory depending on the provincial legislation governing the IPP.

3. Terminal funding

At retirement, if you decide to keep the IPP and receive payments from the plan, your corporation can make additional contributions to the IPP. One portion of terminal funding is deficit funding, which is used to fund any remaining shortfall in the plan. More details regarding deficit funding is discussed in the next section. The other portion is called an optional contribution, which is used to fund enhanced benefits. Enhanced benefits can include:

- Early retirement benefits;
- Bridge benefits;
- A fully CPI-indexed pension (limited to CPI-1% during current funding);
- Enhanced survivor benefits by using your spouse's actual age;
- More conservative assumptions for the actuarial valuation.

In order for your corporation to make additional contributions to your IPP to fund the enhanced benefits, the maximum funding restrictions that apply to designated plans (described in the current service funding section) have to be removed by the Canada Revenue Agency (CRA). The designated plan status can only be removed by the CRA when a plan begins payments to all members of the IPP. Therefore, if you have a younger spouse as a plan member, and you are considering taking advantage of the terminal funding option, it may be best to have separate plans for each of you. This will allow the designated plan status to be removed from your plan should you wish to retire before your spouse.

An actuary will usually help with applying to the CRA to remove the designated plan status as part of calculating the terminal funding needed. If the IPP has a surplus at retirement, then that surplus needs to be used first to fund the additional liability created by the enhanced benefits before the sponsoring company can make any terminal funding contributions.

It is important to realize that by increasing the retirement benefits of the IPP by terminal funding of enhanced benefits, the funding risk to the sponsoring corporation may increase on an ongoing basis. The IPP will require an ongoing corporate sponsor to ensure that the plan is properly funded and administered in future, even during retirement.

Since a terminal funding payment could be quite large, it can provide for a great opportunity to purify your corporation. Purifying your corporation generally involves removing passive investments that prevent you from qualifying for the capital gains exemption if you decide to sell the shares of your corporation. Alternatively, the terminal funding payment could reduce the taxable income in your corporation if you sell the assets of your corporation. Note that if you are planning on selling the shares of your corporation, and wish to receive payments from your IPP, you will likely need to create a new corporation with sufficient assets to assume ownership of, and continue funding the IPP, since it is unlikely that a new owner would want to fund your IPP on an ongoing basis. Keep in mind that the new corporation will need to have the ability to fund your IPP.

Tax implications while funding the IPP

For the corporation

The sponsoring corporation can deduct the IPP contributions it makes in a tax year, or up to 120 days after the tax year end, from their net income. In order for the contributions to be deductible, the contributions must relate to service in the current tax year or a previous year. Contributions that relate to service after the end of the tax year would not be deductible.

If you pay investment management fees, these may be considered tax deductible if they are paid outside the IPP and by the sponsoring corporation. The corporation's tax advisor should always be consulted about any corporate deductions.

Investment management fees can be charged to and paid from the IPP directly. This could result in a deficit within the plan. At the time of the required actuarial valuations

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(every third or fourth year depending on the province), if the investment management fees have created a "deficit", the actuary will notify the plan sponsor if they must make up this "deficit" with an additional contribution. The additional contribution may be deductible to the corporation as a contribution, needed to bring the plan to where it should be from a funding perspective.

For the plan member

As with all pension plans, the funds your corporation contributes to an IPP are not taxable to you as the plan member. However, you will receive a pension adjustment (PA) that acts to reduce your RRSP contribution room for the following year. The PA is reported to you on a T4 slip. The purpose of a PA is to reflect the value of the tax-deferred benefits that an employee is receiving by being a member of a registered pension plan. Due to the way the PA is calculated, assuming you have no carry forward RRSP room and assuming you are maximizing your pension benefits, you will be left with $600 of RRSP contribution room per year.

Investing the funds in the IPP

Allowable investments

An IPP can invest in securities similar to those allowed in an RRSP, such as stocks, bonds, mutual funds, pooled funds, GICs, term deposits, but is subject to some further restrictions due to federal or provincial pension legislation.

The trustees of the IPP has a duty to invest the assets in the IPP in a manner that a "prudent investor" would in similar circumstances. In addition, no more than 10% of the market value of the plan, at the time it is being invested, can be invested in any one corporation's securities (which includes their shares, bonds and other equity). There are exceptions to the 10% rule for mutual funds, pooled funds and government bonds.

Where an IPP is set up as a pension trust, and the trustees desire to use managed funds (for example, mutual funds or pooled funds), the IPP trust agreement must contain provisions to allow the trustees to delegate their investment powers.

IPP at retirement

At retirement, an IPP can either begin to make pension payments or the commuted value of the IPP can be transferred to a retirement savings plan.

Payments from the IPP

For an IPP to remain in force during retirement, the IPP must continue to be sponsored by a corporation. Payments from the IPP are paid out for life. The retirement income payments will be taxable to you as you receive them in retirement. These payments are eligible for pension income splitting and the federal pension income tax credit at any age. Please note that for Quebec provincial tax purposes, you must be age 65 or older in order to be eligible for pension income splitting.

Required funding contributions assume that an IPP is to begin paying out at age 65. In fact, you can start taking your pension as early as age 55 (could be earlier, depending on the legislation that governs your pension), or as late as the year after the year in which you turn 71. After age 71, a minimum payment is required to be paid that is the greater of:

- The retirement benefits payable under the plan terms; and
- The IPP minimum amount.

The IPP minimum amount is the same amount that would be paid out if the plan was a RRIF and the plan member was a RRIF annuitant. The CRA will revoke an IPP's registration if the greater of the two amounts is not paid. If revoked, the plan will be treated as a retirement compensation arrangement (RCA) which may result in immediate tax consequences.

The lifetime retirement benefits payable under the plan terms is the formula in the IPP limited by the DB limit (1/9th of the MP limit) multiplied by the number of years of service earned. The benefit formula is based on a percentage of earnings during the service years, from the same employer, and cannot be greater than 2% for each year. For example, if you earned $120,000 during a service year, your pension will provide you with $120,000 x 2% or $2,400 of pension benefit in retirement for that year. The calculation becomes complex when multiple years are involved.

The Act has different rules and restrictions on the IPP benefits formula for calculating the retirement benefits for connected and non-connected persons. A non-connected person's benefits can be based on an indexed, best 3-year average earnings for all years of service. A connected person's benefits are calculated differently for pre-1991 and post-1990 service. Service before 1991 can use the same formula as a non-connected person but service after 1990 must use an "indexed earnings" formula contained in the Act.

The actuary will use the member's status (connected or non-connected), the formula in the plan plus any additional terminal funding options chosen to determine the retirement benefits payable under the plan. The Act requires that this calculation be done by an actuary.

An alternative to receiving retirement benefits from an IPP is to collapse the IPP and transfer the value of the plan to another retirement option.

Commuting the value of the IPP

An alternative to receiving retirement benefits from an IPP is to collapse the IPP and transfer the value of the plan to another retirement option. The present value of all the future pension benefit payable that can be paid out to you when leaving an IPP is known as the commuted value. Only an actuary can perform this calculation using the assumptions and discount rates provided by the Canadian Institute of Actuaries, the formula specified in the plan and the month of termination. If the commuted value exceeds the amount of the IPP assets, the employer may have to fund the shortfall.

In cases where a pension plan winds up, such as when the sponsoring corporation is sold, a commuted value can be paid out to you. If the pension has already started to pay a retirement benefit, the legislation governing the IPP may limit your options to transferring your plan to another sponsor or buying an annuity that provides similar benefits.

If no retirement benefits have been paid to you before transferring the commuted value of your IPP upon terminating your employment or taking early retirement, a Pension Adjustment Reversal (PAR) may be calculated by the IPP actuary and reported to you on the CRA form, T10. The PAR is simply an increase in your RRSP deduction room to restore your RRSP room that was reduced by PAs in previous years. The amount of the PAR will depend on where you transfer the commuted value and if you take any amounts in cash.

You have three options when commuting the value of your IPP.

Transfer to locked-in plan

Transferring to a locked-in plan is a very common option for commuting a pension. However, Income Tax Regulations limit the amount of the commuted value that can be transferred to a locked-in plan on a tax-deferred basis. This means that some of the commuted value may have to be paid in cash to you which is immediately taxable. If you have adequate unused RRSP deduction room, you can defer the tax on this cash payment by contributing the funds to your RRSP. The IPP actuary is responsible for calculating the commuted value and the amount that can be transferred to the locked- in plan.

Using the commuted value to purchase an annuity

It is possible to use the IPP commuted value to purchase an annuity. The amount of the commuted value needed to purchase an annuity, that provides the same amount of benefits as the IPP would have, can be transferred on a tax-deferred basis to the annuity provider. Amounts not used to purchase the annuity will have to be taken in cash but are usually less than the amount of cash received when transferring to a locked-in plan.

If an annuity providing similar benefits costs more than the value of the IPP, the company may need to make additional contributions to fund the annuity purchase. If the annuity is materially different from the expected IPP retirement benefits, the transfer may be denied.

You are taxed on the annuity payments in the years you receive them. You will need to contact a life licensed insurance representative to determine how much can be transferred to an annuity.

Transferring to another DB plan

You may be able to transfer all or part of the IPP to a new employer's DB plan.

If your new employer is willing to accept the full commuted value to buy service in the new plan, then the entire commuted value can be transferred to the new DB plan on a tax-deferred basis. Generally, the portion of the commuted value that is not accepted for buying service in the new plan is treated as an additional voluntary contribution. An additional voluntary contribution is extra funds contributed to a pension plan that is above the amount needed to provide the new employers pension benefits.

If your new employer is only willing to accept the portion needed to buy pension service in their plan, that portion can be transferred on a tax deferred basis. The amount that is not accepted will be paid out in cash to you and taxed as ordinary income.

IPP at death

Beneficiary designation

A spouse is automatically entitled to the pre- or post-retirement death benefits from an IPP according to pension legislation. A spouse can waive their entitlement to the death benefit by signing a waiver in some cases. A waiver can usually be revoked at any time while the member is alive. A beneficiary can be named to deal with a situation where the spouse predeceases the member.

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Member's death before receiving a pension

If an IPP member dies before retirement and while still employed by the sponsoring corporation, a death benefit, equal to the commuted value of the member's accrued pension payable at age 65, will be payable to the member's spouse, if there is one. The spouse may have the option of taking the commuted value of the pension plan and may be able to transfer all or a portion of the commuted value to a locked-in plan, RRSP/RRIF, or purchase an annuity on a tax-deferred basis. There may also be a taxable lump-sum cash payment. If there is no spouse, the commuted value will be paid as a lump-sum cash payment to the non- spouse beneficiary and the payment will be taxable to the beneficiary.

Member's death while collecting a pension

An IPP will specify the types of death benefits payable when a death occurs after the IPP is in pay. The option you choose can affect the benefits your survivor or beneficiary will receive.

If the sponsoring corporation is still in existence after the member's death and the member had a spouse, the minimum survivor pension that your spouse must receive unless they waive their entitlement, is 60% of the member's pension. Your surviving spouse would be taxable on the payments they receive after death. On the death of the surviving spouse, there may be a residual benefit payable to any remaining survivors or the survivor's estate.

If the corporation is wound up, your spouse may need to purchase an annuity with the IPP's funds or transfer them to a locked-in plan.

If you do not have a spouse on death, your beneficiary will inherit the funds in the IPP as a lump-sum cash payment taxable to them upon receipt. You may be able to name a beneficiary on the plan or alternatively, you can name a beneficiary in your Will.

Surplus

Generally, IPPs are designed so that any surplus left in the IPP following the member or their spouse's death, is payable to their estate or to their designated beneficiary. The surplus that is paid out would be taxable to the recipient.

Advantages and considerations of an IPP

Here are some advantages and considerations to keep in mind when determining if an IPP makes sense for you.

Advantages

- An IPP is designed to maximize tax- deferred retirement savings under the Act. This can be a powerful retirement savings tool for owner- managers, especially if you are close to retirement with inadequate retirement savings. The IPP allows the use of pre-tax corporate income to help you catch-up/increase your retirement savings.
- An IPP may allow you to remove money from your corporation on a tax deferred basis.
- Since the IPP is a separate legal entity for tax purposes, funding the IPP can reduce the amount of passive assets in your corporation potentially allowing your corporation to continue benefit from the small business deduction (SBD). The SBD reduces the corporate tax rate on active business income. Your corporation's access to the SBD may be affected if the corporation earns over $50,000 of passive income.
- There are generally two ways to sell your business. You can either sell your shares of the corporation that houses the business or the assets of the business. Selling assets could result in the corporation having large capital gains or recapture of income. A large terminal funding, done at the time of an asset sale of the business, will provide a large deduction against the income inclusion.
- Setting up an IPP can help to get surplus assets out of the corporation before a sale happens. If your corporation is a Canadian controlled private corporation (CCPC), an IPP helps to qualify your corporation as a qualifying small business corporation (QSBC) by removing passive assets from it. This may help you qualify for the lifetime capital gain exemption (LCGE) in the event you sell the shares of your corporation. Generally, at least 90% of the assets in the corporation must be used for business purposes at the time of a sale in order for the corporation to be considered a QSBC.
- Placing funds in an IPP helps diversify where you hold your assets. Since the IPP is a separate tax entity, you would be splitting your investments between your corporation and your IPP, getting some of the assets out of the corporation without immediate tax consequences.
- Placing funds in an IPP may help you protects the assets from creditors. This protection is provided under federal and provincial pension legislation.

> The IPP can be a useful tool to help incorporated business owners, incorporated professionals or your key employees save for retirement.

- You can set-up an IPP for one or more key employees to enhance employee benefits in a tax-efficient manner.

Considerations

- Mandatory funding requirements will generally require a corporation to make contributions. You will want to consider whether meeting these funding requirements will be an issue for your corporation.
- Funds are locked-in. Once the corporation transfers funds into an IPP, those funds and the growth on them are locked-in under federal or provincial pension legislation and may only be used for retirement purposes. The funds cannot be transferred back to the corporation for the corporation's use.
- IPPs require an ongoing commitment from the corporation. When setting these up for key employees, there may be other strategies that are cheaper and easier to implement.
- An IPP may need to be wound up if the corporation is sold at retirement.
- IPPs require periodic evaluations by an actuary which adds to the cost of administering such plans.

Conclusion

The IPP can be a useful tool to help incorporated business owners, incorporated professionals or your key employees save for retirement. Ask an RBC advisor for more information or for a personalized illustration to see if an IPP makes sense for you or your employees.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.