

Individual Pension Plans for Business Owners

Individual Pension Plans (IPPs) are increasingly popular, especially amongst business owners (including incorporated professionals) who own the corporations that employ them. This is no doubt because as tax-advantaged retirement savings vehicles, IPPs can often provide significant advantages over RRSPs.

IPPs are registered pension plans (RPPs) that are subject to the requirements of both the Income Tax Act (ITA) and pension standards legislation. IPPs are typically defined benefit (DB) arrangements, although it is increasingly popular to have an additional defined contribution (DC) component, or perhaps at earlier ages to implement them on a DC basis.

Where the IPP is set up on a DB basis, it typically provides the maximum benefits that such a plan may offer. This drives up funding costs. Business owners find IPPs attractive because they provide enhanced retirement benefits on a tax-deductible basis to their corporation.

While DB RPPs are more complex to administer than DC arrangements, many actuarial consulting firms see the IPP market as having considerable growth and have thus developed standardized packages allowing for the establishment and on-going administration of these arrangements on a cost-effective basis.

Prior to 1991, it was very difficult for business owners to establish IPPs. When the ITA was amended to permit these arrangements, very specific rules were introduced for “connected” persons (in general terms, persons holding 10% or more of any class of shares on a direct or indirect basis, or persons who do not deal with the employer at arm’s length, or persons who are “specified shareholders”).¹ Unless otherwise specified, this document concerns “connected” persons.

Of course, RPPs may only provide a pension for employees, meaning that unincorporated business owners cannot establish IPPs for themselves. (Also, the service recognized for pension accrual purposes for newly-incorporations professionals such as dentists and doctors can only commence at the time of incorporation.)

With IPPs established for “connected” persons, annual T4 income is important, since a pension is accrued annually based on the T4 income for that year.² A “Final Average Earnings” formula cannot be used, as is common for a typical DB RPP set up for other than “connected” persons.

The establishment of new IPPs faltered somewhat in the mid-1990s. Part of the reason was that the government froze the indexation of limits applying to pension plans. This effectively diminished the funding advantage that these plans enjoyed over RRSPs.

Today there is a new vigor to the IPP market. Five main reasons are:

- ✓ More and more business owners are “baby boomers” nearing retirement
- ✓ The government has recommenced indexing retirement limits, meaning that the pension an IPP can provide has increased. In turn, this has increased tax-deductible contributions

¹ See subsection 8500(3) of the Income Tax Regulations (Regulations).

² The formula used in the “lifetime retirement benefits” calculation contained in subsection 8504(1) of the Regulations refers to “compensation”. “Compensation” is defined in subsection 147.1(1) of the Income Tax Act (ITA). Included are sections 5 and 6 incomes, including allocations under an Employee Profit Sharing Plan. As indicated in question 3 of Canada Revenue Agency’s (CRA) *RPP Consultation RPA –2002*, a stock option benefit to which subsection 7(1) of the ITA applies is included as “compensation”.

- ✓ There are more years of past service that may potentially be accrued, since more years have elapsed since 1991
- ✓ The cost-effective packages that many actuarial consulting and others have made available
- ✓ The pension splitting rules that were introduced for 2007 and later taxation years allow life annuities from a pension plan to be split at any age. Thus, life annuities payable from an IPP (at any age) gives rise to potential tax savings (including eliminating or diminishing the clawback of the Old Age Security).

I. Advantages Offered by IPPs

IPPs offer the following advantages:

- ✓ IPPs can provide the “richest” pension benefits that the ITA permits a RPP to provide, thus providing the member with enhanced retirement income
- ✓ A source of income qualifying for pension splitting
- ✓ Potential larger annual tax-deductible contributions than would be permitted to an RRSP
- ✓ Ability to make tax-deductible contributions for past-service
- ✓ Additional contributions available at retirement (terminal funding)
- ✓ Deductibility of interest charges where employer makes contribution with borrowed funds
- ✓ Deductibility of administration and other costs
- ✓ Ability to make additional tax-deductible contributions to the IPP if investment performance is poor
- ✓ Creditor protection
- ✓ Ability for member to own any surplus that may arise under the IPP
- ✓ Possible savings in payroll taxes
- ✓ Helping to preserve access to the \$750,000 capital gains exemption

Each of these is discussed below.

(a) IPPs Can Provide the Richest Pension Benefits that RPPs can Offer

Retirement planners often suggest that retirees needs up to 70% of their pre-retirement income at retirement in order to maintain their lifestyle.³ Many business owners have invested considerable capital in their businesses and may not necessarily have liquid assets. An IPP will provide the business owner (as well as possibly his or her spouse, provided that the spouse was also an employee of the corporation) with the best benefit that a DB RPP may provide. Thus, there will be a ready source of income upon retirement.

When we look at the nature of the pension stream, we see that the maximum accrual rate (2%) is used, with this being applied to indexed wages. (Of course, the accrual for each year of service cannot exceed the “defined benefit limit” for the year the pension commences to be paid. For pensions commencing in 2008, this is \$2,333.33.⁴) An unreduced pension is available as soon as age 60. Once the pension commences to be paid, it is typically indexed to increases in the CPI.

³ An IPP may potentially provide for a pension in excess of 70% of earnings where the member has more than 35 years of service. While *Information Circular IC-72-13R8 – Employee Pension Plans* (IC-72-13R8) governs benefits provided in respect of service before 1991 under defined benefit provisions, and as indicated in paragraph 9(g) pre-1991 pensionable service is limited to 35 years, there are no similar limits with respect to accruals relating to 1990 and later years. Subsection 8504(1) of the Income Tax Act Regulations (Regulations) does not limit service to 35 years.

⁴ The “defined benefit limit” (DBL) is defined in subsection 8500(1) of the Regulations as 1/9th of the “money purchase limit” (MPL). Per subsection 147.1(1) of the ITA, the MPL for 2008 is \$21,000, for 2009 is \$22,000, with the amount being indexed for increases in average wages starting in 2010. Thus, the DBL is \$2,333.33 for 2008, \$2,444.44 for 2009, with the amount being indexed thereafter.

(b) A source of income qualifying for pension splitting

Starting with the 2007 taxation year, many taxpayers will realize tax savings because of the introduction of the pension splitting rules. These rules allow a taxpayer to allocate up to 50% of qualifying income to a spouse or common-law partner at tax preparation time. The potential tax savings may be significant. For an Ontario taxpayer, we estimate that maximum annual savings approximate \$15,000.

Tax savings will arise where the higher-income spouse allocates an amount to a spouse who is in a lower tax bracket. Additional tax savings may arise because the clawback of Old Age Security (OAS) benefits and the Age Amount Credit are reduced or eliminated. Finally, tax savings may arise where qualifying income provides the taxpayer with a source of income qualifying for the Pension Credit. By allocating an amount to a spouse or common-law partner, this person is also able to claim the Pension Credit. (For a detailed discussion of these rules, we refer you to the following items in the Taxing Issues series: *Pension Splitting – An Analysis of the Legislation [PC 6147]* and *Amounts Qualifying for the Pension Credit [PC 6096]*.)

Taxpayers who are age 65 and older have considerably more sources of income qualifying for splitting than do taxpayers who have not yet reached 65. However, a taxpayer of any age who receives “a payment in respect of a life annuity out of or under a superannuation or pension plan” may split this amount with a spouse of any age.⁵

The retirement pension paid under the DB component of the IPP is in fact a life annuity that can be split. Also, any CPP bridging benefits provided to the member until he or she attains age 65 are also deemed to be life annuities qualifying for splitting.⁶ At the same time, amounts paid by supplemental pension plans, whether funded (e.g., by a Retirement Compensation Arrangement) or unfunded, cannot be split. This causes IPPs to be the basic building block for business owners’ retirement arrangements.

See **Section II Defined Contribution Component of an IPP** where we discuss adding a DC component to an IPP. The funds from this DC component may also be used to acquire a life annuity at any age, providing the member with yet additional income qualifying for splitting.

(c) Larger annual tax-deductible contributions than would be permitted to an RRSP

The Cadillac nature of the pension benefit has a direct bearing on its cost. It serves to drive up funding costs. Hence, this is the reason that IPPs are typically established for business owners and other family members who are also employed by the business. Their employers are able to fund Cadillac pensions on a tax-deductible basis.

Let’s assume that the owner-manager wants to accrue the maximum benefit for 2008. He or she will be able to do so provided their T4 income is \$116,667 for the year. (2% of \$116,667 is \$2,333.33, which is the defined benefit limit for 2008.)

For 2008, the maximum that a person could contribute to an RRSP would be 18% of the prior year’s “earned income”, to a maximum of \$20,000.⁷ The \$20,000 is not age-related. IPP funding is age-related. The higher the age, the fewer years to retirement, and the fewer years that the contribution can grow. As may be seen from the below chart, at age 55, the maximum current-service contribution is \$28,900, which is \$8,900 more than the maximum RRSP contribution for the same year. The IPP enjoys a 44.5% funding advantage.

⁵ See definition of “pension income” and “qualified pension income” contained in subsection 118(7) of the ITA.

⁶ See subsection 118(8.1) of the ITA.

⁷ As provided for by subsection 146(1) of the ITA, RRSP room grows by the lesser of: (1) 18% of the prior year “earned income”, and (2) a dollar limit for the year. For 2008 the dollar limit is \$20,000, with this amount increasing to \$21,000 in 2009 and \$22,000 in 2010. Thereafter it will be indexed.

Proportionate Advantage for 2008 - IPPs vs RRSP						
Age	Maximum Current Service Contribution	Funding as a % of Covered Wages	Maximum RRSP Contribution	Maximum RRSP Contribution as a % of Earned Income	Increased IPP Funding	
					\$ Terms	% Terms
40	\$ 21,800	18.69%	\$ 20,000	18.00%	\$ 1,800	9.00%
45	\$ 24,000	20.57%	\$ 20,000	18.00%	\$ 4,000	20.00%
50	\$ 26,300	22.54%	\$ 20,000	18.00%	\$ 6,300	31.50%
55	\$ 28,900	24.77%	\$ 20,000	18.00%	\$ 8,900	44.50%
60	\$ 31,800	27.26%	\$ 20,000	18.00%	\$ 11,800	59.00%
65	\$ 33,800	28.97%	\$ 20,000	18.00%	\$ 13,800	69.00%

1. Assumes 2008 earnings of \$116,667 and hence maximum current service accrual for 2008.

While an IPP could be established up to the end of the year in which the member attains age 71, our chart stops at age 65. At that age, there is a \$13,800 advantage in absolute terms. This represents 69.0% in percentage terms!

Let's look at the percentage terms advantage in another way. Let's assume that John (age 55) did not have sufficient T4 income in 2008 in order to have his corporation make the maximum contribution to the IPP. His earnings were only \$90,000, or approximately 77% of the maximum. While the IPP contribution would be proportionately reduced (that is, it would be approximately 77% of \$28,900, or \$22,300) this is still considerably more than he will be allowed to contribute to an RRSP in the following year (that is, 18% of \$90,000, or \$16,200). (Remember here that "RRSP contribution room" is based on the prior year's "earned income".) Thus, even where a member cannot accrue the maximum pension, IPPs may still make sense for higher-age individuals because of this proportionate advantage. (This ignores advantages associated with setting up a DC component. See discussion in **Section II** below.)

(d) Ability to make tax-deductible contributions for past service

Past service may be recognized under the DB component at the time an IPP is established. Essentially, an unfunded liability is created where the member is credited with service for years prior to the effective date of the plan. This will provide significant tax savings to the corporation establishing the IPP, since the contributions are deductible for tax purposes.

Here it is important to establish how long the member has been employed by the corporation or a related corporation. When we look at recently incorporated professionals such as doctors and dentists, IPPs established by their professional corporations can only accrue past service for years in which T4 slips were issued. Past service cannot be accrued for a period during which they carried on their professional practice as a proprietor or a partner.

The table below assumes that maximum past service benefits are accrued for the 1991 and later taxation years.⁸

IPP Maximum Funding - 2008					
Age	Past-Service (1991-2007)	Current Service for 2008	Total Required Funding	Qualifying Transfer	IPP Funding Net of Transfer of RRSP Assets
	(A)	(B)	(C) = (A) + (B)	(D)	(E) = (C) - (D)
40	\$ 357,800	\$ 21,800	\$ 379,600	\$ 313,400	\$ 66,200
45	\$ 393,000	\$ 24,000	\$ 417,000	\$ 313,400	\$ 103,600
50	\$ 431,700	\$ 26,300	\$ 458,000	\$ 313,400	\$ 144,600
55	\$ 474,200	\$ 28,900	\$ 503,100	\$ 313,400	\$ 189,700
60	\$ 520,900	\$ 31,800	\$ 552,700	\$ 313,400	\$ 239,300
65	\$ 567,800	\$ 33,800	\$ 601,600	\$ 313,400	\$ 288,200

- Notes:
1. Assumes maximum pension accrual
 2. Assumes past service is funded in part by "qualifying transfer".
 3. Calculation of "qualifying transfer" takes into account \$8,000 cushion. (Required amount is only \$305,400.)
 4. Excludes any amounts in DC component

Past service contributions must be supported by an actuarial valuation. The ITA specifically provides that for a contribution to be deductible, "the effective date of the valuation is not more than 4 years before the date on which the contribution is made".⁹ Hence, a triennial valuation is required. The actuary preparing the valuation will have to obtain T4 information for the years during which the member was employed by the corporation (or a related corporation). The Canada Revenue Agency (CRA) may conduct a post-IPP implementation audit of wages used in preparing the valuation. The company sponsoring the IPP will want to be sure that wages can be verified. If this cannot be done, a portion of the liability (and hence contributions to the IPP) may be disallowed.

Let's look at John who is age 55. He has held 10% of the common shares of John Smith Manufacturing Ltd since 1989. Like most connected persons, he will likely only be able to start accruing past service starting with the 1991 taxation year. The actuary examined the wage data and ascertained that for the 1991-2007 taxation years, the past-service liability amounted to \$474,200. (This is the amount shown in Column A of the above table.)

Past Service Pension Adjustment Mechanism

Let's recall that with pension tax reform there is a global limit that applies to contributions to any registered plan for John. John may also have contributed to an RRSP for each of those years. If his employer now contributes to an IPP for the same taxation years, the tax savings would essentially be double what they should have been.

⁸ Paragraph 8(d) of IC-72-13R8 should be referred to for specific rules relating to rules governing the establishment of IPPs for significant shareholders.

⁹ See subparagraph 147.2(2)(a)(ii) of the ITA.

A Pension Adjustment (PA) is calculated once an individual accrues a benefit under a RPP. This PA will reduce the RRSP room for the following year. Thus, a doubling of tax savings will be eliminated on a go-forward basis.

The elimination of the doubling of tax savings for prior years is dealt with through the Past Service Pension Adjustment (PSPA) mechanism. Past service can only be provided where CRA is satisfied that the tax savings are not being doubled. Here the Provisional PSPA certification process comes into play.

The PSPA is the sum of the additional pension credits that would have been included in calculating a Pension Adjustment (PA) if the additional service had been credited in those prior years. Since maximum benefits were accrued for the 17-year period starting with the 1991 taxation year, the PSPA would be \$305,400. (This is the amount in respect of which the tax rules prevent tax savings from being doubled!) Next we will look at the three ways the tax rules eliminate a doubling to the tax savings.

1. *Providing Past Service where Member has Sufficient RRSP Room*

The tax rules allow for a PSPA to be certified, provided the PSPA does not exceed the member's unused RRSP contribution room by \$8,000. Thus, John could have a Provisional PSPA of \$313,400 certified. John will now have "negative RRSP" room of \$8,000, and will not be able to contribute to an RRSP until this room becomes positive!

Let's assume that John never contributed to an RRSP because he chose to invest in his corporation. Here, CRA will certify the \$305,400 (or \$313,400 if desired). The company will be able to fund the full amount of the past service (\$474,200). CRA will reduce the RRSP room shown on John's Notice of Assessment by \$305,400 (or \$313,400). In our example, we see that by establishing the IPP the corporation is able to deduct \$168,800 (or \$160,800) more than would have been the case had the member just participated in an RRSP! Hence from a funding perspective, John (and his corporation) are definitely ahead.

2. *Funding Past Service with a Qualifying Transfer*

Most prospective IPP members will have contributed to RRSPs. Let's assume that John had \$500,000 in his RRSP and his RRSP room was nil. In this case, he will only be allowed to accrue a benefit under the IPP if he does what is referred to as a "qualifying transfer". He would do a plan-to-plan transfer of assets. Again, \$305,400 (or \$313,400 if he wants to make use of the \$8,000 cushion) would be transferred. The company will be able to contribute \$168,800 (or \$160,800) to the IPP. Still, John (and his corporation) are ahead of what could be contributed to an RRSP.

The employer (or consulting actuary acting on the employer's behalf) will calculate the Provisional PSPA and will file *Form T1004 – Applying for the Certification of a Provisional PSPA* with CRA. In the first situation (RRSP contributions not made in the past), the Provisional PSPA would be \$305,400 (or \$313,400). With the plan-to-plan transfer, a Provisional PSPA is drawn down by the amount of the "qualifying transfer". In our example it would be nil. Form T1004 would not be required.

We could have the situation where John contributed to his RRSP for some but not all years. Here, the qualifying transfer would likely be less than \$305,400 (or \$313,400), in which case Form T1004 would need to be filed to show the Provisional PSPA. CRA would then reduce John's RRSP room by this amount.

We note that qualifying transfers need to occur within specific time frames, that is, within 90 days of plan registration of PSPA certification.¹⁰ The qualifying transfer may be from a locked or unlocked RRSP. In most cases the transfer of a locked-in amount will be preferred, since this leaves unlocked RRSP accounts intact and provides the annuitant with greater flexibility.

¹⁰ See paragraph 8303(7)(b) of the Regulations.

3. *Making a Qualifying Withdrawal from an RRSP*

There is one additional way in which the doubling of tax savings might be resolved: “qualifying withdrawals”. With this method, the prospective member withdraws an amount from his or her RRSP and includes this amount in income. The corporation is then able to contribute an identical amount to the IPP. In John’s case, the corporation would be contributing the full \$474,200 to the IPP. This method is the least common. It might be appropriate where the prospective member had non-capital losses that were about to expire. He or she might wish to apply these losses before they expired, and the RRSP income might be the only source of income against which the losses could be claimed.

The doubling of tax savings is eliminated, since the income inclusion to the member equals the deduction that the employer is taking. We can see that there is no doubling of the tax savings! The prospective member would use *Form T1006 – Designating an RRSP Withdrawal as a Qualifying Withdrawal*. CRA will certify the Provisional PSPA once it is satisfied that a qualifying withdrawal has been made.

Other issues relating to Past-Service Accrual

1. *Requirement that Qualifying Transfers and Qualifying Withdrawals be from RRSP for which Member is Annuitant*

Whenever “qualifying transfers” or “qualifying withdrawals” are done, they must be from an RRSP for which the prospective member is the annuitant. If the prospective member had been contributing to a Spousal RRSP, the amounts in the Spousal RRSP cannot be used as part of a qualifying transfer or qualifying withdrawal. Hence, the past-service accrual for the prospective member may be less than it otherwise would be. (Complications may also arise if the investment performance of the RRSP has been poor, and the remaining assets do not allow the full amount of the “qualifying transfer” or “qualifying withdrawal” to take place.) In situations such as this the actuary would have to scale back the past service that may be provided.

2. *Timing of Past Service Accrual*

The employer will want to consider whether all the past service should be accrued at one time. The employer must review the appropriate pension standards legislation to find out how long a period there is for funding the past service (e.g., Ontario requires funding over a 15-year period). Employers will want to consider whether having a large unfunded liability on their balance sheet will cause banks and other interested parties to have concerns, and may thus want to set up a liability on a piece-meal basis (e.g., they may accrue less than the maximum past service now with a view to accruing additional years of past service at a later time).

3. *Tax Avoidance Considerations*

One last note on past service contributions: certain tax avoidance rules. Where, with the consent of an employee, an employer funds pre-1990 past service benefits, and it is reasonable to consider that these contributions were made in place of other remuneration, the registered status of the IPP is revocable.¹¹ On the pension plan application CRA seeks confirmation of the fact that salary or other compensation has not been foregone so that the member may receive pension benefits.¹²

(e) *Additional contributions available at retirement (terminal funding)*

The ITA contains certain rules that may limit the pre-funding of certain benefits. Plans for “connected persons” are “designated plans” and subject to these rules.¹³ As long as the member is actively accumulating pension benefits, a “maximum funding valuation” must be done. Thus, once a member is no longer accruing a pension, the employer has the opportunity to fund certain additional benefits. The

¹¹ See subsection 8503(15) of the Regulations.

¹² See Question d) in Part 14 of *Form T510 – Application to Register a Pension Plan*.

¹³ See section 8515 of the Regulations.

funding that then occurs is often referred to as “terminal funding”. Many employers will have the opportunity to make significant additional tax-deductible contributions at that time.

Items that cannot be funded during the accrual period include the following:

- ✓ Full indexation of the pension benefit once it starts to be paid. (Cost-of-living increases must be assumed to be CPI less 1%.)
 - ✓ Retirement prior to age 65. (This means that at an earlier retirement, CPP/QPP bridging benefits may be funded, as may the additional years prior to age 65 for which the pension will be paid.)
- (f) Deductibility of interest charges where employer makes contribution with borrowed funds

The ITA contains specific rules that provide that a borrower may deduct interest charges relating to borrowings for pension plan contributions.¹⁴ This may be contrasted with the fact that interest charges relating to borrowing for RRSP contributions are specifically prohibited.¹⁵

- (g) Deductibility of Administration and Other Costs

A registered pension plan will lose its registered status if it makes other than “permissible distributions”.¹⁶ While not expressly stated in the ITA, CRA in its Technical Manual for RPPs has stated the following:

“Permissible distributions deal with the payment of member and employer entitlements.

Reasonable administrative, investment and similar expenses are a legitimate cost of the plan ...”¹⁷

Thus, an RPP could pay for such expenses out of its funds. Where this is done, depending upon the investment returns of the plan, it may result in a deficiency for the DB component of the IPP. This deficiency will be reflected in the next valuation prepared by the actuary. Hence, contributions based on that valuation allow the employer to deduct the expenses.

Of course, the employer could pay these expenses directly (that is, out of its own funds). CRA’s long-standing administrative position is to allow an employer a deduction for reasonable expenses related to the administration of an RPP.¹⁸ These are legitimate expenses of a business. This position is reaffirmed in the Technical Notes accompanying certain regulations to the ITA.¹⁹ This latter approach is generally the preferred approach.

- (h) Ability to make additional tax-deductible contributions to the IPP if investment performance is poor

The DB component of an IPP has essentially made a “pension promise”. It has committed to pay the member a certain pension. Thus, the assets (contributions plus investment earnings) of this component must be such that this pension can be paid.

Since an IPP is a “designated plan”, the actuary preparing it must assume a 7.5% investment return.²⁰ If the investment return is less, the next valuation will show a shortfall. Thus, the company(ies) sponsoring the plan will generally be required to make additional tax-deductible contributions to the plan. A person

¹⁴ See paragraph 18(11)(c) of the ITA.

¹⁵ See paragraph 18(11)(b) of the ITA.

¹⁶ See subsection 8502(d) of the Regulations.

¹⁷ See section 8.4 of CRA’s *Registered Pension Plans Technical Manual*. This document may be accessed from CRA’s web site: http://www.cra-arc.gc.ca/tx/rgstrd/mnnt/tch-08-eng.html#P97_7877. See also CRA document # JN91_270.271 dated June 4, 1991.

¹⁸ See *Interpretation Bulletin IT-105 – Administrative costs of pension plans*.

¹⁹ See Department of Finance Explanatory Notes to subsection 8502(d) of the Regulations, as issued on July 31, 1991.

²⁰ See paragraph 8515(7)(b) of the Regulations.

contributing to an RRSP cannot “top up” his or her contributions, should investment returns be poor. Thus, this is an advantage that IPPs provide.

(i) Creditor Protection

Creditor protection is generally dealt with in the pension standards legislation. The actuary will have to review the applicable pension standards to determine whether the funds in the RPP are creditor proof. This determination should review both locked-in and unlocked funds.

Ontario’s legislation is quite broad. It provides that:

“Money payable under a pension plan is exempt from execution, seizure or attachment.”²¹

The creditor protection is generally extended to amounts transferred from the RPP to prescribed retirement savings arrangements (e.g., Locked-in Retirement Accounts) or used for the purchase of an annuity.²² There appropriate legislation will have to be reviewed as it relates to claims under any family law and for support. The appropriate legal advice should be obtained here.

(j) Ability for member to own any surplus that may arise under the IPP

Pension plan documents contain the provisions governing the operation of the plan. These plan documents typically contain provisions as to who owns the surplus. A common provision for an IPP is to have the member rather than the employer own the surplus.

(k) Possible Savings in Payroll Taxes

Contributions to an IPP may result in savings in payroll taxes. For example, Ontario levies a 1.95% Employer Health Tax (EHT), with this amount being applied to “total Ontario remuneration”. An employer can take advantage of an annual exemption of \$400,000. (Associated employers must, however, share the exemption.)

Let’s look at Maria who is age 60. If maximum past service can be provided starting with the 1991 taxation year, taking into account the maximum qualifying transfer and the maximum current service contribution for 2008, her employer could deduct \$239,300. If Marie paid company profits out as a bonus, EHT of \$4,666 would be payable (assuming the employer was otherwise using the \$400,000 exemption). This should more than cover the implementation costs of the IPP!

For Maria, the 2008 current service contribution was \$31,800. EHT savings would arise in subsequent years as well. If we assume that the current service costs increase at the rate of 7.5% per annum, additional EHT savings could be expected to be \$667 (1.95% of \$34,185) in 2009 and \$717 (1.95% of \$36,748) in 2010. Again, these savings would cover a portion of the on-going administration costs of the IPP.

(l) Helping to preserve access to the \$750,000 capital gains exemption

Owners of shares of Qualifying Small Business Corporations are interested in utilizing the \$750,000 capital gains exemption on the sale of their shares.²³ The rules surrounding the use of this enhanced exemption are complex and taxpayers seeking to take advantage of this exemption need professional advice.

Tax legislation contains a number of requirements, including specific requirements as to what percentage of the assets are used in a Canadian active business. Two tests (of the many that come into play) include: a 90% test at the time of disposition and a 50% test for the period (generally two

²¹ See subsection 66(1) of the Pension Benefits Act of Ontario (PBAO).

²² See subsections 66(2) and (3) of the PBAO.

²³ See section 110.6 of the ITA.

years) prior to the disposition.²⁴ These percentages look at the Fair Market Value of assets used in a Canadian active business.

If a corporation has too much in the way of passive assets, the seller of the shares can lose access to the exemption. He or she may preserve the exemption if the assets are diverted to an IPP.

II. Defined Contribution Component of an IPP

When we go back to the 1990s, the typical IPP contained only a DB component. With the evolution of IPPs as retirement planning vehicles, the preferred approach is to also have the IPP contain a DC component. The DC component may be comprised of two parts: locked and unlocked.

The advantages of having a DC component include:

- ✓ Reduced management fees
- ✓ Potential additional tax savings because of the pension splitting rules
- ✓ Deductibility of administrative, investment and similar expenses
- ✓ More streamlined financial planning

Management fees are typically a function of asset volumes. Thus, where a member has consolidated his or her assets in the IPP, many providers will offer reduced management fees.

In the above discussion of the new pension splitting rules, we noted that a life annuity from a pension plan could be split at any age. (In most cases, taxpayers had to wait until the year in which they attained age 65 to have a source of income qualifying for splitting). The assets in the DC component could be used to acquire a life annuity as soon as the applicable pension standards legislation allows for this. Thus, the member will have a source qualifying for splitting before age 65. Of course, the member must have retired in order to benefit from this.

An annuitant of an RRSP cannot make additional contributions to an RRSP in respect of administrative, investment and similar expenses. Annual contributions are capped at 18% of the prior year's earned income, subject to a dollar limit (\$20,000 for 2008). The 1996 Federal Budget introduced measures that specifically prohibit a deduction for administrative fees paid after March 5, 1996. The ITA provides that:

“... any amount paid or payable by the taxpayer for services in respect of a retirement savings plan or retirement income fund under which the taxpayer is the annuitant.”²⁵

Thus, no amount of RRSP and/or RRIF management fees or investment counsel fee is deductible. Contrast this with amounts relating to RPP assets. As discussed above, CRA allows the employer to pay these amounts on a tax-deductible basis. Thus, industry practice is to have an IPP invoice the employer for amounts paid by the plan.²⁶ This potentially results in the DC component's having a larger asset accumulation than it otherwise would.

Financial advisors generally prefer to manage an individual's total assets. This allows for a streamlining of the planning, especially in the payout-phase.

As may be seen from the above discussion, the DC component of an IPP provides the plan member with significant advantages. Prospective IPP members will want to consider having IPPs with plan texts that provide for this. Members will thus be in a position to transfer assets from their RRSPs into these arrangements and to enjoy their benefits.

²⁴ Paragraph (c) of the definition of “qualified small business corporation share” contained in subsection 110.6(1) as well as paragraph (a) of the definition of “small business corporation” contained in subsection 248(1) of the ITA should be referred to here.

²⁵ See paragraph 18(1)(u) of the ITA.

²⁶ See discussion in Chapter 13 of *The Essential Individual Pension Plan Handbook, LexisNexis, 2007* (Peter J. Merrick).

Of course, the provisions of the applicable pension standards legislation need to be considered. Ontario, for example, does not prevent the refund of additional voluntary contributions.²⁷

III. Other Matters

(a) Pension Adjustment (PA) Reporting

A PA will have to be reported for each year for which a pension is accrued under the IPP. For the DB component of the IPP, we essentially multiply the benefit accrual by 9, with the tax rules then allowing an offset of \$600.

As earlier stated, the tax rules cap the benefit accrual. The maximum accrual for 2008 would be calculated as the greater of:

- (A) 2% of compensation, and
- (B) Defined Benefit Limit (\$2,333.33 for 2008).

As earlier stated, wages of \$116,666.67 would provide the maximum accrual for 2008. Thus, the PA for this member for 2008 would be: $(9 \times \$2,333.33) - \600 , or \$20,400. We know that 2009 RRSP room grows by \$21,000 (before taking into account the PA). Thus, a member of an IPP may be expected to have only \$600 of RRSP room on a go-forward basis. (Of course, where the \$8,000 cushion was used in calculating the qualifying transfer or qualifying withdrawal, the member will not be able to contribute anything to an RRSP until the RRSP room becomes positive.)

Let's instead assume that a member had 2008 earnings of \$90,000. Here the PA would be calculated as: $9 \times (2\% \text{ of } \$90,000) - 600$, or \$15,600.

(b) Reduction of RRSP Room in Year Member Joins IPP

When we look at the calculation of RRSP room (referred to as the "RRSP deduction limit" in the ITA) we see that it may be reduced by a "prescribed amount".²⁸ This amount may arise for a person who at any time after 1989 was a "connected person" and joins a RPP or recommences to accrue benefits under the DB provision of a RPP. However, this will not apply if either a reduction applied in a previous year, or PA had been reported for 1990.²⁹

When a connected person joins, the employer must file *Form T1007 – Connected Person Information Return* within 60 days of the person's joining the IPP. CRA will then review its records and calculate any "prescribed amount". This amount is calculated as the lesser of: (1) \$11,500, and (2) 18% of "earned income" for 1990.

(c) Assumed Investment Performance of 7.5%

While valuations are required on a triennial basis, the company(ies) sponsoring the plan could have a valuation prepared at an earlier date. This might be considered where investment performance has been poor and a sponsor is seeking additional tax deductions.

If, however, investment performance has been good, certain tax rules may require that a company(ies) sponsoring a DB RPP take a "contribution holiday". (Here, a pension would still accrue and a Pension Adjustment would still be reported. However, no contributions would be made to the DB provision of the IPP.)

²⁷ See subsection 63(2) of the PBAO.

²⁸ See definition of "RRSP deduction limit" contained in subsection 146(1) of the ITA.

²⁹ See subsection 8308(2) of the Regulations.

Essentially, the tax rules allow an actuary to ignore all or a portion of the actuarial surplus in determining the contribution requirements. The portion of the surplus that can be disregarded must not exceed the lesser of: (1) 20% of the actuarial liabilities of the employer, and (2) the greater of: (a) 2 times the estimated amount of current service contributions required by the employer and employee for the 12 months following the effective date of the valuation, and (b) 10% of the amount of the actuarial liabilities allocated to the employer. Where the surplus exceeds these limits, the excess amount must be used to satisfy the employer's contributions before any deductible contributions may be made.³⁰

(d) Adverse Amendments Permitted for Significant Shareholders

Pension standards legislation (e.g., the Pension Benefits Act of Ontario (PBAO)) may contain special provisions allowing an employer to forego making required contributions. In Ontario, "adverse amendments" are prohibited. Essentially, an amendment to a pension plan is void if, for example, it reduces the amount or the commuted value of a pension benefit that has accrued before the effective date of the amendment or the amount of commuted value of a pension or deferred pension accrued under a pension plan.³¹ However, "significant shareholders" may consent in writing to the non-application of this provision.³²

In this context, a "significant shareholder" means:

"... an individual who alone or in combination with a parent, spouse or child, owns or has a beneficial interest, directly or indirectly, in shares that represent 10 per cent or more of the voting rights attached to the shares of the employer who contributes to the pension plan."³³

We note that a "connected person" may not qualify as a "significant shareholder". One difference is the fact that for a shareholder to be a "connected person", when looking at the 10% requirement we see that it relates to the holding of any class of shares. In the context of a "significant shareholder", the 10% relates to voting rights as they relate to shareholdings in their entirety.

(e) Timing of Contributions to a RPP

The tax rules specifically provide that a taxpayer may deduct contributions made "either in the taxation year or within 120 days after the end of the year".³⁴ Thus, advisors implementing IPPs need to ascertain the fiscal period of the corporation, as the corporation may have other than a December 31st year-end. In the case of past-service benefits, CRA must have "certified" the benefits.³⁵

(f) IPPs Accepting Transfers from Other DB RPPs

In some instances, IPPs are set up for the purpose of receiving transfers of benefits from the RPP of a member's previous employer. CRA recently issued a Compliance Bulletin stating that it intends to review the "primary purpose" of the IPP. The primary purpose of the IPP must be "to provide lifetime benefits to individuals in respect of service as employees with an employer who participates in the plan". CRA expects the new plan sponsor to establish an on-going business income stream, which can then be paid to the plan member as employment income pursuant to a bona fide employer/employee relationship.³⁶

In this Compliance Bulletin, CRA spells out the tax consequences if the "primary purpose" is not met. CRA will in fact revoke the registration of the IPP. Here, the tax costs become punitive. Where the asset transfer took place within the "normal reassessment period" (i.e., within 3 years of the date of original

³⁰ See paragraph 147.2(2)(d) of the ITA.

³¹ See paragraphs 14(1)(a) and (b) of the PBAO.

³² See subsection 48(1) of the Regulations to the PBAO.

³³ See definition of "significant shareholder" contained in subsection 1(1) of the Regulations to the PBAO.

³⁴ See subsection 147.2(1) of the ITA.

³⁵ See subparagraph 147.2(1)(b)(iii) of the ITA.

³⁶ See Compliance Bulletin No. 5, as issued by CRA.

Notice of Assessment for the year of the transfer), the transferred amount will be included in the member's income. An Ontario member could thus owe taxes and interest on this amount, with the taxes being calculated at the top marginal tax rate of 46.41%!

Where the asset transfer took place outside the "normal reassessment period" and the tax return is thus considered statute-barred, and the assets were subsequently transferred to an RRSP, the amount of the asset transfer will not be considered to have been an eligible transfer. A 1% per month penalty (as well as interest and late filing penalties) will apply to this "excess". Amounts subsequently withdrawn from the RRSP will be included in the annuitant's income in the year of the withdrawal. When we look at the top marginal tax rates applying to the withdrawal, plus the 1% penalty tax, this is extremely costly. We are aware of a situation in which a transfer of nearly \$2 million for a single member was contemplated. If CRA were to successfully contend that the "primary purpose" test was not met, the tax costs would be in the \$1 million range!

(g) IPP Life Cycle Considerations

Many advisors focus on the tax savings arising at the time that an IPP is implemented. In order to know whether an IPP is an appropriate retirement vehicle, the "life cycle" of the IPP needs to be reviewed. Here we mean what happens in subsequent years, including at the time of retirement.

The member has a number of options at retirement. In general terms, the IPP may "self annuitize" the DB component (i.e., it pays the promised pension). In this situation, the IPP remains in existence, often in a holding company.

Another option is to have the IPP acquire a life annuity from an insurer. A final option is to transfer the amounts to a locked-in vehicle. However, with the latter, the ITA may place a cap on what may be transferred.³⁷ This may result in a tax liability, unless the member has RRSP room equal to any income inclusion.

(h) Liquidity

Generally, the DB component of the IPP is locked in.³⁸ This should be contrasted with having RRSP assets, where amounts could be pulled out at any time. Thus, a prospective IPP member who does not have sufficient liquidity, that is have other financial assets that he or she could access if emergencies arise, may want to reconsider implanting an IPP.

A prospective sponsor of an IPP might be concerned about having to fund the IPP on an on-going basis, especially if there are concerns about downturns in business cycles, etc. There are a number of ways to address these concerns. These include: paying other than T4 income in order to avoid additional current-service accruals (dividends for example could be paid); amending the plan text so that current-service accruals are no longer required; terminating the pension plan, etc. The appropriate solution depends upon the specific circumstances of the plan sponsor and plan member.

IV. Tax Planning with IPPs

IPPs are powerful tax and retirement vehicles. Some situations in which IPPs are of value include:

(a) Sale of a Business

A shareholder selling their shares could implement an IPP at the time they sell their business. This will let them extract funds from the business and reduce the capital gain arising on the sale of shares. Remember here that an IPP could be implemented as late as age 71!

³⁷ See subsection 147.3(4) as well as section 8517 of the Regulations.

³⁸ See subsection 63(1) of the PBAO.

(b) Have Family Members Join IPP

It is often possible to add members to an IPP with nominal incremental costs, or perhaps even no cost. Thus, consideration should be given to adding a spouse to the arrangement. Of course, the spouse will need to have T4 income. (Needless to say, we are assuming here that wages paid to the spouse are reasonable and thus deductible for tax purposes.) This is especially attractive where both spouses are of an age in which a funding advantage exists, and when there are additional RRSP assets that can be rolled over into the DC component.

Often we may encounter the situation in which an IPP has significant assets. Here the IPP might be used as a wealth maximization tool. Let's look at the situation where the members choose to draw pensions that do not have a guaranteed form. That means that upon their death no further amounts are payable to them or their estates. Thus, upon their deaths, the IPP has no further liability in respect of this pension. Typically, the IPP would have to be wound up. However, if another member (perhaps a child of the business owner) were added to the IPP, the wind-up of the plan is not required upon the death of the original members. While it is possible that no new contributions could be made in respect of the new members because of the excess surplus that the IPP had, there is no requirement to withdraw excess assets from the IPP. Thus, there is a significant tax deferral.

Subject to the applicable pension standards legislation and the provisions of the plan text, it may be possible to withdraw surplus from the IPP. Thus, there may be access to these assets.

V. Summary

As stated at the beginning of this document, we see a new vigor in the IPP market. They are powerful tools. On the most basic level, they are arrangements that will deliver enhanced pensions to business owners. On a more sophisticated level, they are tools that can be used to maximize family wealth.

They are complex arrangements that will not suit all individuals (for example, those having liquidity concerns). However, in the appropriate circumstances they deliver significant advantages. Thus, prospective members are urged to meet with their financial advisors and accountants to see if they are appropriate in their circumstances.

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