Individual Pension Plans

Over the past several years, business owners have started to recognize the advantages offered by Individual Pension Plans (IPPs). An IPP may provide higher retirement savings for business owners and their employees who meet specific criteria. For individuals 40 years of age and older, an IPP can be an ideal way to maximize retirement benefits since the amount that can be accumulated within an IPP is generally greater than the amount that can be saved within an RRSP.

An IPP strategy should be considered within the context of a comprehensive financial and estate plan and all individual circumstances should be reviewed carefully, and a proper cost/benefit analysis should be prepared.

What Is An IPP?

Individual Pension Plans are employer-sponsored defined benefit pension plans with typically one or two members. Pension benefits from a defined benefit pension plan are generally calculated according to a formula based on a number of factors, including years of service and salary levels. The employer is fully responsible for providing this guaranteed income stream regardless of the investment climate.

In contrast, a money purchase or defined contribution pension plan has a specific accumulated value made up of contributions to the plan plus tax-sheltered investment earnings. The pension amount received by a plan member is dependent on the accumulated value of the plan at retirement. These types of plans are similar to a Registered Retirement Savings Plan (RRSP).

Who Can Set Up An IPP?

IPPs can be established by a corporation for owners/managers, key executives or professionals, providing that the plan member is an employee of the sponsoring company. The employer can decide which employees will be provided with an IPP, but there are some restrictions on benefits that can be provided to employees connected to the employer. A connected employee is defined as an employee who owns, directly or indirectly, ten percent or more of the company's shares.

Self-employed individuals operating an unincorporated business are not eligible for an IPP; however, their employees may be eligible to establish an IPP.

Who Can Benefit From An IPP?

An IPP can be a valuable retirement savings vehicle if you are:

- 40 years of age or older and an employee of an incorporated business (as a business owner or professional, you must be an employee of your corporation)
- Currently contributing the maximum allowable amount to your RRSP
- Working for an employer who is willing to set up, administer and fund the IPP

Maximum Pension Benefits

The maximum pension benefit that an employee can accrue for each year of service is 2 percent of earnings up to a legislated dollar limit. The legislated limit for 2012 is $2,647 and indexed thereafter.

Earnings from an employer include salary, wages, commissions, and bonuses, as well as the value of taxable benefits, but dividends are not considered earnings for pension purposes.

A non-connected employee can have the pension based on the best three years' average income, which can have the effect of mitigating low-earning years or earnings fluctuations. Benefits may also be earned while on disability or leave of absence, based on earnings before the disability or leave.

The pension for connected employees is limited to an indexed career earnings benefit formula (actual earnings for the year will determine the benefit earned for each year of service). As a result, connected employees can earn a maximum pension only by drawing the maximum earnings required annually and cannot earn benefits while on disability or leave of absence.

IPP Contributions

As a defined benefit pension plan, an IPP must provide a lifetime retirement pension for the employee. An actuary will determine the contributions required in order to fund the promised pension benefit. The actuarial valuation must be completed at least once every three or four years, depending on provincial legislation. Over time, the IPP fund may be in a surplus or deficit position as the actual rates of return may differ from the actuarial assumptions. If the IPP is facing a surplus that exceeds prescribed limits, contributions may need to be halted. Conversely, if the IPP is facing a deficit, additional contributions will be required which are deductible for tax purposes. Pension regulation currently stipulates that the actuarial assumptions include the following:

- Inflation rate of 4 percent
- Post-retirement pension index rate of 3 percent
- Salary increase rate of 5.5 percent
- Income rate of return of 7.5 percent

At retirement, the IPP may be enhanced with additional benefits and contributions. Depending on the actual retirement age, the funding of these additional benefits may help to reduce any surplus in the IPP or may allow for additional tax-deductible contributions to the IPP.

Pension Adjustment (PA)

Generally, your RRSP contribution limit is 18 percent of your previous year's earned income up to a maximum legislated amount, less any Pension Adjustment (PA). A Pension Adjustment is reported by the employer for members of registered pension plans and has the effect of reducing RRSP contribution room. A PA is basically a calculated or estimated value of the accrued pension benefit and, as an IPP is generally structured to maximize retirement benefits, the PA will essentially eliminate RRSP contribution room.

Advantages	Disadvantages
• As a defined benefit plan, retirement income is defined and predictable; • Higher contribution room for individuals over age 40 when compared to RRSPs; • Can make lump sum contributions for past service back to 1991 (or before if certain circumstances are met); • All set-up and administration fees are tax-deductible expenses to the corporation; • Contributions are tax-deductible to the corporation, as well, they are not taxable benefits to the employee (beneficiary) of the plan; • If the corporation has to borrow funds to fund the IPP, the cost to borrow is also a tax-deductible expense.	• Set up fees and ongoing costs; • Has the complexity of a pension plan; • Restrictions on withdrawals; • If investment returns exceed the level required to fund benefits, contribution room may be reduced; • If investment returns are insufficient to fund benefits, additional contributions may be required; • Effectively eliminates RRSP contribution room; • An IPP member cannot contribute to a spousal RRSP.

IPP Contributions For Past Service

When an IPP is established, past-service contributions enable you to catch up for past years that you worked for the company. Past-service contributions are generally allowed from 1991 for connected employees and from the date of hire for non-connected employees. Connected employees may only be offered pension benefits for pre-1991 service if certain conditions are met. A Past Service Pension Adjustment (PSPA) will be created, reducing RRSP contribution room. Under the applicable legislation, if the employee does not have enough RRSP room to absorb the PSPA, a direct tax-free transfer up to the amount of the PSPA may be made from the employee's RRSP to the IPP (this will reduce the PSPA). Alternatively, the employee can withdraw amounts up to the PSPA from his or her RRSP, again reducing the PSPA. If the employee selects this option, withdrawals from the RRSP must be added to income and the employee will be taxed on amounts withdrawn from their RRSP.

The company that sponsors the IPP will be able to make a tax-deductible contribution for the difference, if any, between the value of the past service credited under the IPP and the amount of any RRSP transfer made to the IPP.

Subject to pension legislation, past-service contributions may be deductible as one lump sum or split over a number of years. Required employee contributions for post-1989 service are deductible in the year they are received up to prescribed limits. However, strict restrictions govern the deductibility of employee contributions for pre-1990 service, and an employer is prohibited from paying for pre-1990 service for an employee in lieu of any employee entitlement.

Statement Of Investment Policy And Procedure

Part of the IPP set-up process includes the drafting of a Statement of Investment Policy and Procedures (SIP&P) that outlines how the pension funds will be managed, in accordance with pension legislation.

Vesting

Pension legislation generally requires that pension funds vest after two years of membership, though IPPs are generally structured to vest immediately. When a pension vests, pension benefits become locked-in and must be maintained in such a way that they will eventually provide an income stream for your retirement years. If the IPP is terminated, the funds belong to the employee, but cannot be cashed in. If the IPP is terminated before the end of the year in which the client turns 71 years of age, the funds can be transferred to a Locked-In Registered Plan, or, in some cases, to an RRSP. The Income Tax Act limits the amount that can be transferred tax-sheltered from a defined benefit pension plan to a registered plan. Any excess amounts will be paid out in cash, and are subject to withholding taxes.

An IPP Strategy Versus An RRSP Strategy

Employee:

- 50 years of age
- Plans on retiring at age 65
- Earning a current income of $135,000 per year since 1991.

IPP Versus RRSP (No Past Service)

Using the actuarial assumptions noted earlier in this report:

- $283,896 more can be contributed to an IPP, on a cumulative basis over the contribution period, than can be contributed to an RRSP
- The employee accumulates $453,327 more in his IPP than his RRSP at age 65, assuming a net return of 7.5 percent

Past Service

Past-service contributions, if permitted and made to the IPP, can significantly increase the value of the IPP. Assuming the employee has 21 years of past-service contributions (made as a lump sum payment), and factoring in any effect on his RRSP:

- The additional contribution to the IPP is $174,462
- By age 65, an additional $554,389 would be accumulated in the client’s IPP as a result of the past service contribution

An IPP Strategy Versus An RRSP Strategy - Continued

Additional Benefits (With Past Service)

Upon the employee's retirement, it may be possible to make additional contributions called terminal funding to the IPP. For example:

- If the employee (with past-service) retires at age 60 and the IPP is left intact, an additional $708,187 could be contributed
- If the same employee works until age 71, and the maximum additional contribution is made, assuming a net return of 7.5%, there would be $2,359,808 more accumulated within the IPP than would be available in an RRSP

Options At Retirement

IPP funds belong to the employee, subject to vesting provisions, but, unlike an RRSP, IPP funds are generally locked-in and must be used to provide lifetime retirement income for the plan member.

Receiving Pension Benefits From An IPP

If the pension jurisdiction does not require the IPP to be wound-up, the IPP can be left intact and the employee can receive pension benefits from the plan. In this case, the employer continues to be responsible for the IPP, including administration of the plan, actuarial valuations and ensuring adequate funding.

If the IPP must be wound-up, options include:

- The purchase of a guaranteed life annuity to provide the pension benefit
- The transfer of funds to an income-paying locked-in retirement plan, as applicable based on pension legislation
- In some cases, the transfer of funds to an RRSP

Any excess funds over the allowable limits are paid out in cash and subject to tax.

IPPs At Death: Pre-Retirement

If the plan member dies before retirement, the surviving spouse must be given the option of purchasing a deferred annuity or transferring the commuted value of the IPP to another locked-in registered plan or, in some cases, to an RRSP. If there is no surviving spouse, the IPP funds can be distributed to other beneficiaries or to the estate of the plan member, subject to tax, but preferential tax treatment may be available.

IPPs At Death: Post-Retirement

Upon the death of the plan member after retirement, funds will be distributed based on whether the pension was being paid to the plan member from the IPP, or if the IPP was transferred to another registered plan.

Pension Benefits From The IPP

If the plan member dies after retirement and is receiving pension benefits from the plan, the surviving spouse will continue to receive a pension as a survivor benefit (100% during any guarantee period, usually 66.66% thereafter). If the pension benefits were used to purchase a joint life annuity, the surviving spouse will continue to receive lifetime annuity income, in accordance with the terms of the annuity contract. If you are receiving income from a joint life annuity, there will be no estate value upon the second death, subject to any guarantee periods that may have been purchased.

If there is no surviving spouse, or upon the death of the surviving spouse, any remaining value within the IPP can be distributed to other beneficiaries or to the plan member's or spouse's estate, subject to tax, but preferential tax treatment may be available. Again, if you are receiving income from a life annuity, there will generally be no estate value upon death, subject to any guarantee periods that may have been purchased.

Pension Benefits From Another Registered Plan

If the plan member dies after retirement and the IPP funds were transferred to another approved registered plan, the surviving spouse can roll the full value to his or her own registered plan. Depending on the pension legislation regulating the plan, a locked-in registered plan may or may not be unlocked. The spouse, as beneficiary, may roll the proceeds to an RRSP or to a LIRA (if under age 71), or to another approved registered plan, depending on legislation. It is important to remember that in some provinces, the only option may be a life annuity if death occurred after age 80 (usually this would be a joint life annuity if there is a spouse), and, subject to guarantee terms, there would be no further proceeds upon the death of the surviving spouse.

If there is no surviving spouse or upon the death of the surviving spouse, any remaining value within the registered plan can be distributed to other beneficiaries or to the plan member's or spouse's estate, subject to tax, but preferential tax treatment may be available. It should be noted that, in all cases, a surviving spouse must be the beneficiary of any pension benefit.

Additional Voluntary Contributions

After transferring amounts from your RRSP to fund past service in your IPP, you may have an amount remaining in your RRSP. With an Additional Voluntary Contribution (AVC), you can extend the benefits of your IPP to your retirement savings held outside the plan, including any RRSP amounts remaining after past service transfers. This also allows you to reduce the number of accounts you have to manage, in turn lowering potential annual administration costs.

An AVC is simply an amount contributed to an IPP above and beyond any required contributions. You can transfer funds accumulated in other pension plans, such as an RRSP, a company pension plan or a Deferred Profit Sharing Plan (DPSP), as an AVC to your existing IPP. The funds transferred as an AVC are held in a separate account under the IPP umbrella and are subject to pension legislation. AVC funds are invested in accordance with your existing IPP Statement of Investment Policies and Procedures and can only be invested in IPP-eligible investments.

Advantages Of Additional Voluntary Contributions

- Fees associated with the IPP may be lower than those charged on retirement savings accounts.
- In certain provinces, funds held within an IPP may be protected from creditors (refer to Creditor Protection for more information).
- Some Investment Management Fees payable on AVCs may be considered an expense related to the management of a pension plan, making them a deductible expense for the company.
- Unlike IPP assets, Additional Voluntary Contributions are not locked-in and may be transferred back to an RRSP at any time. This does not apply if the funds were transferred from a locked-in plan.

Creditor Protection For Additional Voluntary Contributions

AVC funds may be creditor protected, depending on the province of registration.

We're Here to Help

Together with your CIBC Wood Gundy Investment Advisor, you can create a retirement plan to help you make the transition from work to a worry-free retirement. To find out how you can gain the unique advantages of an IPP, contact your CIBC Wood Gundy Investment Advisor.

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