Understanding IPPs

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The 2011 Federal Budget (“Budget 2011) set out a number of proposals that would have substantially altered the regulations affecting Designated Pension Plans, known more commonly as Individual Pension Plans (IPPs). The Designated Plan regulations grew out of the recommendations of the Blenkarn Committee and became law in January of 1991. Under a Designated Plan, “connected” employees could participate in Registered Pension Plans while at the same time eliminating the tax driven “top hat” plan that had been growing in popularity.

Gone are the days of the painless creation of tax black holes which one could spiral vast amounts of tax deductible capital. Gone too is the unchecked creativity of the pension actuary.[1]

The Budget, in addition to seeking a reclassification of IPPs as a separate class of pension made two sweeping proposals:

1. The IPP will be required to pay out to a member, each year after the member attains 71 years of age, an amount equal to the greater of:

   The regular pension amount payable to the member in the year pursuant to the terms of the IPP; and the minimum amount that would be required to be paid from the IPP to the member if the member´s share of the IPP assets was held in a RRIF of which the member was an annuitant.[2]
2. To limit unintended tax deferral opportunities, Budget 2011 proposed to require that terms of past service under an IPP first be satisfied from transfers of RRSP assets belonging to the IPP member or a reduction in the member´s accumulated RRSP contribution room before new past service contributions are permitted.[3]

The first proposal was ostensibly directed at certain uses of IPPs that could be characterized as aggressive. Transfers of existing pension plans into new IPPs where there was no employment relationship with the sponsoring company and no fulfillment of the “primary purpose” test has been successfully litigated by CRA.[4] By forcing a minimum withdrawal consistent with RRIF rules newly engineered surpluses would now be subject to withdrawal and taxation, thus eliminating an unintended deferral.

The second proposal would have seen the virtual elimination of past service contributions and the associated deductions from income that had attracted so many to the IPP platform. Had this recommendation been adopted those with substantial RRSP assets would have seen their deduction severely reduced or eliminated and replaced with a new requirement to simply roll over their RRSP assets to the IPP to fund past service contributions. Individuals with shorter periods of service, like many of the newly created professional corporations would have been prevented from funding past service as many professionals had dutifully contributed to their RRSP long before they had decided to incorporate.

It was also this specific proposal that lead some in the accounting profession and financial media to declare in their budget summaries that the IPP had lost much of their luster.[5] Indeed certain national publications declared the IPP to be dead.

The signing of the IPP´s death certificate was premature. A number of actuaries banded together to point out to the relevant ministers that these proposals were capricious and patently unfair. CALU presented a thorough review of the Budget proposals and challenged many of their foundations and assumptions.[6] The clarion call was also sounded by Catherine Swift of the Canadian Federation of Independent Business (CFIB) and Jonathan Chevreau of the *National Post*.

Throughout the summer of 2011, in meetings with Department of Finance officials, the case against the budget proposals was put forth. Both minimum withdrawals and curtailed past service funding were roundly attacked. The arguments can be summarized as follows:

1. The issue of minimum withdrawals, while it would effectively end the aggressive use of IPPs to create indefinite deferral of surplus, would likely create a future problem for IPPs that did not "wind up" upon the retirement of the plan member. For those plans that had elected to instead pay out a benefit (making them subject to the much higher RRIF withdrawal requirements) would likely create substantial funding shortfalls in later years and deprive the annuitant of the very security and predictability they sought by establishing the IPP in the first place.[7]
2. The requirement to force an expanded RRSP rollover and thus reduce or eliminate any additional contribution from the sponsoring company was patently unfair. For those individuals who had prudently avoided risky investments and had contributed to their RRSPs each year, they could see the ability to have past service contributions made on their behalf eliminated. For those who had suffered market losses over the years, or had skipped a few years of contributing, the corresponding lack of RRSP assets assured the ability to fund and deduct past service. Finance also did not consider that the Martin government had altered the Past Service Pension Adjustment (PSPA) rules to mandate larger RRSP rollovers and reduced company contributions.

In October 2011, after considerable discussions, the revisions to the original budget proposals were introduced and passed before the Christmas recess. The first proposal to force a minimum withdrawal schedule upon the IPP was left intact, although discussions still continue with Finance concerning potential pitfalls.[8] The second proposal concerning past service funding was substantially amended.

Replacing the original proposal is a proration factor applied to existing RRSP balances.[9] While the initial unfunded liability (total value of the IPP at establishment) will be unchanged, the amount of past service funding will be based on the age of the individual and their period of service with the company. For most, this means that the amount of deductible past service that can be contributed will be unchanged by the new IPP regulations. In cases where the individual is much older, in their mid-60´s for instance, or their RRSP balance is considerable (in excess of $700,000) they may see some reduction in past service funding. For a more detailed explanation please refer to Example 1 below.

Example 1

With the exception of the unused RRSP room, the IPP qualifying transfer will be subject to a proration factor using the formula:

Years of past service / (lesser of 35, age – 18)

The full unused RRSP room would be added to this amount. This prorating is the main difference between the original proposal in the June 6, 2011 Federal Budget and the actual changes implemented. This formula has significantly less impact on new IPP´s than the original proposal.

For example, a 55 year-old who qualifies for maximum service with $600,000 in RRSPs, would be eligible for $216,700 of past service and an RRSP qualifying transfer of $398,120. If this same individual had an RRSP worth $850,000, their past service would be reduced to $137,100 and the RRSP qualifying transfer would rise to $477,714, as consequence of the proration formula.

Business owners and incorporated professionals who had decided to forgo an IPP due to the perceived loss of past service funding may now wish to reconsider that decisions. These plans continue to have the ability to create a sizable retirement nest egg and to insulate assets from substantial market risk. For these reasons, they remain worthy of consideration.

About the Author

Trevor Parry, MA, LL.B, is the Executive Vice President and National Sales Director for Gordon B. Lang and Associates Inc. (GBL). Trevor travels across Canada working with other GBL regional representatives helping entrepreneurs and incorporated professionals and their trusted advisers design and implement compensation and retirement plans. Trevor has contributed several chapters to The Essential IPP Guide and T.A.S.K. He has been in The Bottom Line and Advocis´ Forum magazine, and has made several appearances on BNN. He is currently working on a book on risk-focused financial planning. Trevor holds undergraduate and graduate degrees in History from the University of Toronto, a Bachelor of Law degree from Queen's University and is completing a Master of Law degree in Taxation Law at Osgoode Hall. Trevor was called to the Ontario Bar in 1996. He can be reached at trevor.parry@gblinc.ca.

Endnotes

[1] Marcel Theroux & Brad Rowse. The Individual Pension Plan: A complete guide. Income Tax and Goods and Services Tax Planning for Executive Compensation and Retirement, 1991 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1992).

[2] Budget 2011. Annex 3. Tax Measures: Supplemental Information and Notices of Ways and Means Motions (June 6, 2011).

[3] Ibid.

[4] *1346687 Ontario Inc. v. MNR*. 2007 DTC 5482.

[5] Jamie Golombek, "Service Cut off: New tax treatment curtails the advantage of Individual Pension Plans". Sept. 13, 2011. Jamiegolombek.com.

[6] A copy of the CALU Finance Submission on the IPP legislation can be found on the CALU website (www.calu.com). CALU representatives also appeared before the House Finance Committee and Senate National Committee on Finance to express member concerns about the overly broad and unintended impacts of the proposals.

[7] Joint Submission of Actuaries to Hon. Jim Flaherty & Hon. Ted Menzies. May 31, 2011.

[8] Department of Finance Erratum, Nov. 4, 2011: English explanatory note for subsection 8304(11) of the Income Tax Regulations (Clause 92) added to Explanatory Notes relating to the Oct. 3, 2011 Notice of Ways and Means Motion (now Bill C-13), 8500(1).

[9] The new rules call for the plan member´s years of service to be divided by their age less 18 (and this denominator can be no more than 35). This factor is multiplied against the current market value of RRSPs to determine how much of the unfunded liability must be made up of a RRSP rollover. Department of Finance Erratum, Nov. 4, 2011: English explanatory note for subsection 8304(11) of the Income Tax Regulations (Clause 92) added to Explanatory Notes relating to the Oct. 3, 2011 Notice of Ways and Means Motion (now Bill C-13), ITR 8304(10).