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Co-Editors: Pearl E. Schusheim* and Gena Katz**

A REVIEW OF INDIVIDUAL PENSION PLANS

*Marie-Eve Gosselin*** and Jean-Pierre Laporte*****

There is a general lack of knowledge about individual pension plans (IPPs) in the Canadian tax and pension community. An IPP is essentially a retirement savings vehicle that takes the form of a pension plan in which retirement income can be accumulated on a tax-deferred basis for one or a few individuals. The main benefit of the IPP is the possibility to make greater tax-deductible contributions than are permitted for a registered retirement savings plan. An IPP can be an essential planning tool for small-business owners, incorporated professionals, and senior executives who seek to maximize their retirement nest egg. This article provides an overview of the nature and tax treatment of the IPP.

KEYWORDS: PENSION PLANS ■ INDIVIDUAL ■ RETIREMENT BENEFITS ■ RETIREMENT PLANNING ■ TAX SAVINGS ■ DEFINED BENEFIT

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* Of Couzin Taylor LLP (affiliated with Ernst & Young LLP), Toronto.

** Of Ernst & Young LLP, Toronto.

*** Of Thorsteinssons LLP, Toronto.

**** Of INTEGRIS Pension Management Corporation, Toronto.

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INTRODUCTION

While much has been said and written about the registered retirement savings plan (RRSP), its superior competitor, the individual pension plan (IPP), has not attracted much publicity, and still remains in relative obscurity. An IPP is sometimes referred to as a "supersized" tax-assisted retirement plan for a certain group of individuals, designed to provide greater retirement benefits than the RRSP.

Very generally, an IPP is a defined benefit pension plan that is established by an employer for the benefit of a very small number of employees. The key tax advantage of the IPP is the ability to contribute amounts that are considerably higher than those permitted under the RRSP rules. The contributions made by the employer (and by the employee, if allowed) are deductible in computing income. The pension benefits are then taxable in the hands of the employee when received in retirement.

IPPs may soon become as popular as RRSPs for the right candidates. This article examines the nature and treatment of the IPP for income tax purposes, and then reviews some of the most notable advantages and disadvantages associated with this type of plan. While the focus of the article is on the rules in the Canadian Income Tax Act,[1] it should be noted that IPPs are also subject to additional legal requirements under the governing pension benefits legislation. Thus, the material presented here does not purport to provide an exhaustive review of all the rules applicable to such

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act and the regulations thereunder.

plans, and professional advice is strongly recommended for anyone seeking to understand the legal implications of an IPP in particular circumstances.

DEFINITIONS

Overview of the IPP

Conceptually, an IPP is a pension plan with a defined benefit provision[2] created by an employer for the benefit of a significant employee (such as a majority shareholder) or for a small group of significant employees (such as two or three high-ranking executives). Since the IPP is a defined benefit plan, the annual pension and other ancillary benefits payable under the IPP at retirement will be defined by the terms of the plan and will generally be based on the employment income earned by the member over a certain period of time.

An IPP is generally thought not to be tax-effective for an employee who is not considered a high earner and who is relatively young (that is, under the age of 40). Generally, if the plan member is older and earns a high salary, the tax effectiveness of the IPP will be achieved since there is less time to accumulate the promised pension benefits (which will be based on the member's high earnings with the employer) and, therefore, larger annual tax-deductible contributions will be permitted.

For individuals under the age of 40, especially those with little or no prior service to purchase with the corporate employer, the amount of annual IPP contributions required to fund the promised benefits will be relatively small, since there are many years left before retirement to generate the pension benefits. In fact, the annual IPP contributions may be lower than the individual's RRSP deduction limit, thereby resulting in a lower tax-deductible contribution. Further, owing to the pension adjustment (PA) system (discussed below), a young individual who participates in an IPP will generally be prohibited from contributing fully to his or her RRSP, even though the amounts contributed to the IPP may be substantially less than the individual's RRSP contribution limit. It follows that below a certain age, more money can generally be saved more tax-effectively in the individual's RRSP than in an IPP. Thus, in those circumstances, the RRSP would be the more appropriate, and the more cost-effective, tax-deferral retirement vehicle.

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2 Pursuant to subsection 147.1(1), the Act defines a "defined benefit provision" as being the contrary of a "money purchase provision." Under a pension plan with a "money purchase provision," the pension benefits are based on the amount of funds that are in the plan at any given time. The funds will generally consist of contributions that have been made by the member (and/or another person, such as an employer) plus any investment income earned on those contributions. The best-known example of a money purchase plan is the RRSP.

In contrast, under a defined benefit plan, the benefits are based on the promise or guarantee of specific future pension benefits to the employee. For example, a defined benefit plan will usually provide for an annual pension equal to a percentage of the employee's earnings over a given period. Accordingly, the amount of contributions required today to fund the promised benefits will be determined by actuarial calculations and assumptions, based on certain factors such as the employee's average earnings and length of service.

Legislative Definition of the IPP

Since, by definition, an IPP is a pension plan, it is subject to either provincial or federal pension benefits legislation. For income tax purposes, the definition of an IPP is very broad: generally, it is a registered pension plan (RPP) (that is, a pension plan registered with the Canada Revenue Agency [CRA]) that contains a defined benefit provision and has fewer than four individual members at least one of whom is related to the participating employer.[3]

An individual member will be "related" to the participating employer[4] if

- the individual is connected to the employer by blood relationship, marriage, common-law partnership, or adoption; or
- where the employer is a corporation, the individual controls the employer, or is a member of a related group that controls the employer, or the individual is related to the person who controls the employer or to a person who is a member of a related group that controls the employer.

"Control" in this context means de jure control—that is, ownership of more than 50 percent of the voting shares with the ability to elect a majority of the board of directors.[5]

Most IPPs are established for one individual who is a person related to the employer, such as the controlling shareholder of the employer. An IPP can be established, for example, by a corporation for the benefit of its owner-manager.

The characterization of a pension plan as an IPP will trigger the application of specific tax rules that are designed to limit tax-deferral opportunities for plan members by requiring minimum withdrawals from the IPP once the member reaches 71 years of age. Also, benefits provided under an IPP in respect of past service (as opposed to current service) rendered by a plan member must generally be funded by the member's existing retirement savings before contributions can be made to the plan to fund the past service benefits. These rules, which apply only to IPPs and not to other RPPs, are discussed in more detail below.

These restrictions may provide an incentive to create a pension plan that is similar to an IPP but does not meet the membership requirement in the definition in order to avoid IPP status. For instance, one could create a pension plan with four or more members, or for a group of three or fewer highly paid executives, none of whom are related to the employer. Nevertheless, such a plan may be regarded as an IPP. The regulations provide that a defined benefit RPP will be an IPP if the plan is otherwise a "designated plan" and it is reasonable to conclude that the rights of one or more members under the plan exist primarily to avoid IPP status.[6]

3 Regulation 8300(1), paragraph (a) of the definition of "individual pension plan."

4 Paragraphs 251(2)(a) and (b).

5 *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 SCR 795.

6 Regulation 8300(1), paragraph (b) of the definition of "individual pension plan."

A "designated plan" is a defined benefit pension plan that is comparable to an IPP. It is generally defined as an RPP that contains a defined benefit provision and that is not maintained pursuant to a collective bargaining agreement, where over 50 percent of the pension credits that accrue under the plan in a year are in respect of one or more "specified individuals."[7] In general terms, a specified individual[8] is an individual

- who was, at any time in the year, "connected"[9] with the employer participating in the plan (such as an owner-manager); or
- whose annual remuneration from the employer exceeds 2.5 times the year's maximum pensionable earnings (YMPE) under section 18 of the Canada Pension Plan[10] (CPP).

With respect to the latter condition, under the CPP the remuneration threshold would be equal to $125,250 for the 2012 year, since the YMPE for that year is $50,100. Such highly paid, non-connected individuals are typically referred to as the executives of an employer.

The features of a designated plan bear a close resemblance to those of an IPP in that both types of plan are defined benefit RPPs that are usually established for individuals related to or closely connected to the sponsoring employer (such as the shareholder of a corporate employer). As described below, a designated plan is subject to special rules that restrict the funding of the plan on a going forward basis—that is, rules that limit the amount of tax-deductible contributions that can be made to the plan in respect of an employee's current service. In practice, most IPPs will fall within the definition of a designated plan and thus will be subject to the maximum funding rules discussed below in respect of current service. In addition to these rules, as indicated above, an IPP will be required to comply with specific requirements dealing with annual withdrawals and funding of past service benefits.

TAX TREATMENT OF IPPs

Deductibility of Contributions to Employer

One of the most significant tax advantages associated with the IPP is the deductibility of contributions made by an employer to the plan. The Act expressly provides that employer contributions to an IPP (by virtue of its being an RPP) are deductible in

7 Regulation 8515(1). Pursuant to regulation 8515(2), once a plan becomes a designated plan, it will continue to be a designated plan in subsequent years unless the minister waives the application of this rule in writing.

8 Regulation 8515(4).

9 A person will generally be "connected" with an employer where the person owns at least 10 percent of the issued shares of the employer corporation (or of any other corporation related to the employer), or the person does not deal at arm's length with the employer: see regulation 8500(3). Special deeming rules also apply where shares are held by a trust or partnership.

10 RSC 1985, c. C-8, as amended.

computing income.[11] However, the deductibility of contributions is subject to various conditions,[12] including a requirement that the contribution qualify as an "eligible contribution." Very generally, an eligible contribution is a "prescribed contribution" or a contribution that complies with "prescribed conditions" and is made pursuant to a recommendation of an actuary approved by the minister in writing.[13]

Eligible contributions will be deductible to the employer if made in the year or within 120 days after the end of the year.[14]

Prescribed Contribution

The rules relating to prescribed contributions are applicable only to defined benefit RPPs that are not designated plans. This will exclude most (if not all) IPPs since these plans will generally be considered to be designated plans. As a result, contributions to an IPP will be required to comply with prescribed conditions in order to be deductible. These conditions impose severe funding restrictions on the employer, as described below.

Prescribed Conditions

When an IPP is a designated plan (as will usually be the case), a number of funding restrictions are imposed to effectively reduce the amount of tax-deductible contributions that can be made by the employer. As noted above, in order to be an eligible contribution, and thus be deductible, the contribution must comply with prescribed conditions, and must be made pursuant to the recommendation of an actuary that is based on an actuarial valuation and approved by the minister.[15]

One of the prescribed conditions requires that employer contributions for a year be determined on the basis of a "maximum funding valuation."[16] Generally, a maximum funding valuation is a valuation of the pension plan prepared by an actuary in accordance with certain restrictive assumptions set out in the regulations.[17]

Therefore, regardless of the benefits offered under the plan, the actual funding of a designated plan will always be limited in accordance with a maximum funding valuation based on prescribed assumptions. Despite concerns raised by actuaries that the prescribed assumptions result in insufficient funding for designated plans, the CRA has made it clear that those assumptions were not devised to reflect current

11 Paragraph 20(1)(q) and subsection 147.2(1).

12 These conditions are found in subsections 147.2(1) through (3), regulations 8515(5) through (8), and regulation 8516.

13 Subsection 147.2(2). The actuary's recommendation must be based on an actuarial valuation that meets the specific requirements outlined in this provision.

14 Subsection 147.2(1).

15 See supra note 13.

16 Regulation 8515(6)(a).

17 Regulation 8515(7).

market conditions, but rather are intended to limit the deductible contributions to designated plans.[18] Arguably, the prescribed assumptions will also limit or minimize the extent of tax planning that would otherwise be used with designated plans.

Restrictions on Employer Contributions and Past Service Benefits

Once an IPP is established, the employer will be able to make contributions to fund benefits not only in respect of the employee's current service, but also for his or her past service prior to the establishment of the plan, going back to 1990.[19] As a result, a participating employer might be allowed to make a one-time catchup payment to the IPP in respect of the member's past years of employment. This may provide an excellent opportunity for an employee with few or no funds in an RRSP to significantly augment his or her retirement savings through a single payment. In contrast, if the employee has substantial RRSP assets at the time of establishing the IPP, this advantage will lose its appeal since the past service contribution will be required to be funded first by the RRSP assets (as discussed below).

Both the contributions and the payment of pension benefits in respect of past service are subject to specific requirements. For instance, the funding and payment of past service benefits will require the minister to certify the "provisional past service pension adjustment" (provisional PSPA) of the member.[20]

The provisional PSPA of a pension plan member measures the value of past service benefits that have been credited to the member. Conceptually, the purpose of the provisional PSPA certification is to ensure that the member has sufficient unused RRSP deduction room to accommodate the past service benefits; otherwise, the minister will refuse to issue the certification, and the funding or payment of the past service benefits, as the case may be, will be prohibited. On the other hand, if the minister issues the certification, the provisional PSPA will reduce the individual's unused RRSP deduction room for the year.

The provisional PSPA of a member of an IPP requires that contributions in relation to past service be first funded out of the member's existing RRSP funds and unused RRSP deduction room before new contributions for past service may be made to the IPP.[21] Therefore, if the member contributed to an RRSP during the years of past service and has no unused RRSP deduction room, the individual will be required to transfer all or a portion of his or her RRSP assets to the IPP in order to obtain a certification of his or her provisional PSPA. After the transfer, any additional

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18 Canada Revenue Agency, Registered Plans Directorate, *Actuarial Bulletin* no. 2, October 2010. See also question 8 of "RPP Consultation Session," December 3, 2003 and question 8 of "RPP Consultation Session," November 30, 2005 (www.cra-arc.gc.ca/tx/rgstrd/cnslttns/menu-eng.html).

19 Because it is now rare for an IPP to be created to fund benefits in respect of past service before 1991, the treatment of such cases is not discussed in this article.

20 Paragraph 147.1(10)(a) and regulation 8307(2).

21 Regulation 8304(10).

cost of providing the past service benefits may be funded by deductible employer contributions.

The following example illustrates how the certification of a plan member's provisional PSPA could be obtained in a hypothetical case.

Example 1

David, the 55-year-old owner of a small company, establishes an IPP beginning January 1, 2012. In addition to providing retirement benefits for future employment years, the IPP is designed to provide retirement benefits in respect of David's past 20 years of employment with the company. David's actuary has determined that the cost of providing benefits for the past service is $600,000. To simplify the analysis, this amount is also assumed to be David's provisional PSPA (the value of the past service benefits credited to David). David also has assets in his RRSP with an aggregate value of $850,000, and he has unused RRSP deduction room of $50,000.

In this case, the minister would refuse to certify David's provisional PSPA ($600,000) because David has only $50,000 of unused RRSP deduction room. To obtain certification, David would be required to transfer $550,000 out of his RRSP to his IPP. The amount of the transfer would reduce David's provisional PSPA to $50,000. The minister would then certify this reduced provisional PSPA since it would be covered by the unused RRSP deduction room ($50,000). The certification would, in turn, reduce David's unused RRSP deduction room to nil.

Employer Contributions Not Taxable to IPP Member

The Act provides that an employer's contributions to an IPP will not result in a taxable benefit to the employee.[22] However, following retirement, pension benefits received from the IPP will be fully taxable in the hands of the employee.

Deductibility of Members' Contributions

While most IPPs are fully funded by the employer, an employee can also make contributions.[23] Employee contributions, whether for current or past service, will generally be deductible in computing the employee's income if they are made in accordance with the terms of the plan as registered and the contributions relate to a period after 1989.

However, if the IPP is a designated plan, there is a further restriction on employee past service contributions: the member contributions must be "eligible contributions" as if they were made by the participating employer.[24] As indicated above,

22 Subparagraph 6(1)(a)(i).

23 Paragraphs 8(1)(m) and 147.2(4)(a), and regulation 8502(b)(i). The amount of employee contributions must not exceed specified limits and must meet all applicable conditions under the regulations: see, for instance, regulations 8503(4)(a) and (b).

24 Regulation 8515(9).

eligible contributions must be based on specific assumptions designed to limit the funding of benefits under designated plans. As a result, like employer contributions, employee contributions in respect of past service under an IPP that is a designated plan are limited by the maximum funding valuation assumptions that must be used by the actuary who will recommend the contributions.

Investment Income Not Subject to Tax

A trust governed by an RPP is not subject to tax on its income.[25] Therefore, any investment income earned within the IPP trust will be exempt from tax under the Act.

Reduction of RRSP Deduction Limit to IPP Member

Since the IPP aims at maximizing retirement benefits, the accrual of benefits under the IPP will reduce the amount that members can contribute to their RRSP (or to a spousal RRSP). The reduction is effected through the "pension adjustment" of the member.[26]

In general terms, a taxpayer's PA for a calendar year with respect to an RPP that has a defined benefit provision is the value of the benefits that have accrued under the plan during the year multiplied by 9, minus \$600.[27] The purpose of the PA is to measure the annual retirement savings achieved by the individual in the employer's pension plan.

Once determined, the PA of a taxpayer for a particular year will reduce the taxpayer's RRSP deduction limit for the following year. The PA concept ensures that all taxpayers have access to comparable tax-assisted retirement savings regardless of the type of plan to which they belong.

As a result, in the year of joining an IPP, the member can generally contribute the maximum permissible to his or her RRSP as long as the member was not participating in an RPP in the previous year and is not connected with the employer.[28] For subsequent years, the individual will be able to contribute to his or her RRSP only if the maximum RRSP deduction limit is not fully used with the IPP—that is, the PA arising under the IPP does not fully reduce the member's RRSP deduction limit.

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25 Paragraph 149(1)(o).

26 A plan member's PA is computed on a calendar-year basis and must be reported by the participating employer on the T4 information return ("Statement of Remuneration Paid"): regulation 200.

27 Regulations 8301(6) and 8302. For any given year, the PA of a plan member must not exceed the limits provided in subsection 147.1(8) or (9); otherwise, the plan will become a revocable plan (discussed below).

28 Under regulation 8308(2), a member who is connected with the participating employer will generally not be able to make a contribution to his or her RRSP in the year in which the plan is established. The explanatory notes indicate that the purpose of this rule is to prevent connected persons from doubling their entitlement to tax assistance for retirement saving. See Canada, Department of Finance, *Explanatory Notes to Proposed Legislation Relating to Saving for Retirement* (Ottawa: Department of Finance, July 1991).

Maximum Annual Retirement Benefits

On the basis of a series of formulas and calculations, the regulations limit the annual pension (or lifetime retirement benefits) that an RPP member can receive in a calendar year after retirement.[29] After the first year of retirement, the maximum annual pension is adjusted to reflect increases in the average consumer price index.[30]

If the plan member was connected with the employer in any calendar year after 1990 but before the first year of retirement, a special rule known as the "career average restriction" will apply to further restrict the amount of annual pension benefits that can be paid to the member.[31]

Tax-Free Transfer Between Registered Plans

During the existence of an IPP, it may become desirable or necessary at some point to transfer pension funds out of the plan to another retirement vehicle. This will happen, for instance, if the plan is terminated for some reason, such as the retirement of the individual or the acquisition of the employer by a third party who does not want to assume the plan. In order to ensure that the transfer will not be taxable to the plan member, the Act will allow the transfer to be made on a tax-free basis if certain conditions are met.[32] The rules generally apply to the transfer of a single amount from an RPP to another registered plan, such as an RRSP, a registered retirement income fund (RRIF),[33] or another RPP.

Where an amount (excluding surplus) is transferred from a defined benefit RPP to an RRSP, a RRIF, or a money purchase provision of an RPP, the amount so transferred cannot exceed a "prescribed amount."[34]

In general terms, the prescribed amount determines what portion of the commuted value of the pension can be transferred to another plan, based on the individual's age at the time of the transfer. In general terms, the commuted value represents the retirement benefits that have accrued to the individual as of a particular time. The prescribed amount typically reduces or limits the amount of the commuted value that can be transferred; therefore, the tax-sheltering benefit for the balance transferred

29 Regulation 8504.

30 Regulation 8504(1)(b).

31 Regulation 8504(1)(a)(i).

32 Section 147.3. If the transfer does not comply with this section, the RPP may become a revocable plan and the amount transferred (or a portion thereof) may be included in the income of the individual; however, a deduction will generally be available where the amount is transferred in accordance with the Act. (See the discussion below under "Revocation of Registration.")

33 In most cases, the applicable pension benefits legislation will require the RRSP or RRIF to be locked in, in order to prevent any withdrawal by the annuitant before retirement.

34 Subsection 147.3(4) and regulation 8517.

out of the plan is lost.[35] Any excess over the prescribed amount will be included in the member's income and will be deemed to be a contribution paid by the member to the recipient plan.[36] The transferor plan will also become a revocable plan (discussed further below).[37]

Where the transfer of pension funds involves two defined benefit RPPs, the prescribed amount restriction described above does not apply,[38] and the full commuted value of pension benefits can generally be transferred tax-free, including any actuarial surplus in the transferor plan. (Surplus essentially represents the funds in the IPP that are not required to pay the promised pension benefits.) These favourable transfer rules could prove useful when an employee with an accumulated defined benefit RPP leaves his or her current position to join a new employer. The new employer could establish an IPP for the new employee (ensuring that the plan meets the requirements in the Act) and the employee's existing plan assets could then be transferred to the IPP without adverse tax consequences.

Taxation of Distributions to the Member

At retirement, when the member is entitled to receive pension benefits, there are several ways through which the benefits can be paid. Regardless of the form of payment or the vehicle chosen, the benefits will be taxable in the hands of the recipient.

The pension benefits can be paid directly from the plan by the IPP trust. It is effectively possible to maintain the plan indefinitely until the purposes of the IPP trust are exhausted—that is, until such time as the pension liability of the plan is extinguished (usually at the time of death of the plan member and the member's beneficiary). This strategy not only provides maximum flexibility for the member, but also avoids the restrictive rules described above that would otherwise apply if the pension were commuted and transferred to an RRSP or a RRIF. Any payments

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35 There is, however, an exception for underfunded pension plans in cases of employer insolvency: see regulations 8517(3) through (3.02). These provisions generally allow a larger portion of the commuted value of an underfunded defined benefit RPP to be transferred on a tax-free basis under section 147.3.

36 Subsections 147.3(10) and (11). If the transferee plan is an RRSP and the amount transferred exceeds the individual's RRSP deduction limit, the penalty tax imposed on excess contributions under part X.1 may apply. Some relief may be found in subsection 147.3(13.1), which generally provides for a deduction on the withdrawal of excess contributions. In such situations, however, it may be more advantageous to transfer the excess amount directly to the plan member (resulting in taxation of the transferred amount in the member's hands) instead of into the RRSP (thus triggering an excess contribution subject to part X.1 tax).

37 Subsection 147.3(12).

38 Subsection 147.3(3).

from the IPP trust will be taxable to the recipient as a pension benefit.[39] The form of the payment or distribution, whether it be a periodic pension payment or a lump sum, is not relevant.

It should be noted that until the end of 2011, members of IPPs who were retired and entitled to pension benefits could choose not to receive any payments out of the plan, so that the benefits left in the plan would continue to accumulate and grow on a tax-free basis. Legislative amendments were enacted in December 2011 to limit such tax-deferral opportunities using IPPs.[40]

Beginning in 2012, a minimal amount must now be paid every year from the IPP to each plan member who has attained 71 years of age and who is in receipt of retirement benefits under the terms of the plan.[41] This rule ensures the withdrawal (and thus taxation) of an annual minimum amount from the IPP once a member reaches the age of 71. This rule is similar to the current minimum withdrawal requirements from a RRIF.

On the retirement of the plan member(s), the employer may not wish to keep the plan active for a number of reasons, including, for instance, the continuing liability to fund any deficiency, which may be a risk that the employer is not willing to assume. Instead of distributing the pension benefits to the plan member out of the IPP trust, those benefits (excluding any surplus) could be commuted and then transferred on a tax-free basis to the member's RRSP or RRIF. Once the member begins to receive payments out of his or her RRSP or RRIF, such payments will be taxable to the member.[42]

Another option for the employer would be to purchase an annuity with the plan assets from an insurance company (provided that the terms of the plan allow such a purchase). An annuity will provide a stream of fixed payments to the plan member over a specific period of time once the member retires. In the current low interest rate environment, however, it may be difficult to find a life insurer willing to offer an annuity at a competitive price.

The Act allows an annuity contract to be purchased on a tax-free basis for the benefit of a member of an RPP.[43] However, among other conditions, the rights

39 Paragraph 56(1)(a). Splitting pension income with a spouse is possible under section 60.03, paragraph 56(1)(a.2), and paragraph 60(c). Generally, an individual can allocate to his or her spouse or common-law partner a portion of his or her pension income in accordance with section 60.03 (which will require the filing of a joint election). The allocated pension income will be included in the income of the spouse or common-law partner under paragraph 56(1)(a.2) and will be deductible to the pensioner under paragraph 60(c). The splitting of pension income can also entitle the spouse or common-law partner to a pension credit under subsection 118(3).

40 Bill C-13, Keeping Canada's Economy and Jobs Growing Act; SC 2011, c. 24, given royal assent on December 15, 2011.

41 Regulation 8503(26).

42 Subsections 146(8) (income inclusion in respect of RRSP withdrawals) and 146.3(5) (income inclusion in respect of RRIF withdrawals).

43 Subsection 147.4(1).

under the annuity must not be materially different from those provided under the RPP. If the annuity is purchased in accordance with the Act, the plan member will become subject to tax only when he or she receives payments from the annuity. Any such payments will be included in the recipient's income as a pension benefit or as an annuity payment.

REVOCATION OF REGISTRATION

Most, if not all, of the tax advantages associated with an IPP depend on the plan's registration with the CRA. This requires continuous compliance with various requirements in the Act. Non-compliance can result in revocation or deregistration by the minister, which will generally result in onerous tax consequences for the member.

Grounds for Revocation

The minister can revoke the registration of an RPP, and thus an IPP, if (among other reasons)[44]

- the plan does not comply with prescribed conditions for registration (such as the primary purpose test discussed below);
- the plan is not administered in accordance with the terms of the plan as registered;
- the plan becomes a revocable plan (discussed below);
- the plan administrator or the employer does not comply with the filing requirements under the regulations; or
- the registration of the plan under the provincial or federal pension standards legislation is refused or revoked.

The decision to revoke a plan's registration is at the discretion of the minister.

Primary Purpose Test

One of the prescribed conditions for registration is that the primary purpose of the plan must be to provide periodic payments to individuals after retirement and until death in respect of their services as employees.[45] This test must be satisfied throughout the registration period of the plan.

The primary purpose test has been used on many occasions by the CRA to successfully revoke the registration of non-compliant pension plans. The CRA is concerned that certain business owners are setting up new IPPs without a bona fide employment relationship and without the salaries to support the past service benefits that the owner is, theoretically, buying. The CRA has noticed a trend where an individual

44 Subsection 147.1(11).

45 Regulation 8502(a).

near retirement age leaves his or her public sector employer, incorporates a business, establishes an IPP for himself or herself, and transfers the full commuted value of his or her former pension plan into the new IPP.[46] The IPP also purchases prior service under the former pension plan. The liabilities of the IPP are based on a low salary that the individual "pays" to himself or herself, and once an actuarial valuation is done on the IPP, there is a surplus (as a result of the low salary), which the member can then access.[47]

The CRA is of the view that most IPPs established in the manner described above will not meet the primary purpose test.[48] Arguably, in these circumstances, the primary purpose of the IPP is not to provide retirement benefits to an employee, but simply to facilitate a transfer of pension benefits from a prior plan without being subject to the commuted transfer limits described above (which would apply if an RRSP was used to receive the pension funds instead of an IPP). One should expect the CRA to express doubts about the legitimacy of the employment relationship between an IPP sponsor and a plan member (and whether the primary purpose test is met) where an individual forgoes a substantial retirement benefit with a former employer for a much smaller retirement benefit with a new employer (based on nominal earnings).

The concern of the CRA is also exemplified in a number of Canadian tax cases involving a similar fact pattern.[49] Those cases, in which the CRA was successful against plan sponsors and members, serve as a reminder to employers and small-business owners that an IPP must be established for the primary purpose of providing retirement benefits to employees. In particular, this jurisprudential trend is a cautionary tale about small-business owners who incorporate a new employment relationship for the sole purpose of establishing an IPP that will receive the commuted value of their pension previously accrued with a former employer. In these circumstances, the CRA will likely revoke the IPP's registration on the basis that the primary purpose of the plan was not to provide lifetime retirement benefits to the employee of the new employer. However, if the new employer was established for a reason other than to set up the IPP in order to receive benefits from a prior plan, and there exists a bona fide employment relationship between the new employer and the plan member, and the member's employment income with the new employer is comparable

46 As indicated earlier, the restrictive transfer rules in section 147.3 do not limit the amount of commuted value that can be transferred from one defined benefit RPP to another.

47 Financial Services Commission of Ontario, "Individual Pension Plans Face Revocation, Tax Consequences," *News Release*, September 24, 2001.

48 Canada Revenue Agency, "Registered Pension Plans (RPPs): Frequently Asked Questions" (www.cra-arc.gc.ca/tx/rgstrd/rpp-rpa/fq-eng.html), at question 11.

49 See, for example, *Pension Plan for Presidents of 1346687 Ontario Inc. v. Canada (National Revenue)*, 2007 FCA 262 (leave to appeal to the Supreme Court of Canada denied); *Pension Plan for Presidents of Jordan Financial Limited v. Canada (National Revenue)*, 2007 FCA 263 (leave to appeal to the Supreme Court of Canada denied); and *Pension Plan for Presidents of 1398874 Ontario Inc. v. Canada (National Revenue)*, 2010 FCA 14.

to that paid by the former employer (so as not to unduly create surplus), the CRA will generally consider that the primary purpose test is satisfied.[50]

Becoming a Revocable Plan

Another ground for the revocation of a pension plan's registration with the CRA is that the plan has become a revocable plan. A plan will "become revocable" if, at any time, it does not meet certain specified conditions set out in the Act. Some of the most notable conditions to avoid revocation can be summarized as follows:

- *Regulation 8502(b)*. Each contribution made by the employer after 1990 must be an eligible contribution (discussed above).
- *Regulation 8502(h)*. The investments of the RPP must comply with the restrictions listed in regulation 8502(h).[51]
- *Regulation 8503(3)(a)*. The lifetime retirement benefits provided under the plan must be in respect of an eligible service period, which includes, for example, a period during which the member was employed in Canada and received remuneration from the participating employer (or a predecessor employer).
- *Regulation 8503(4)(b)*. The contributions made by a member in respect of a calendar year must not be paid before that year. This condition effectively prohibits the prepayment of member contributions.
- *Regulation 8503(26)*. A minimal amount must be paid every year from the IPP to each member who has attained 71 years of age and who is in receipt of retirement benefits under the terms of the plan.
- *Subsections 147.1(8) and (9)*. For any given year, the PA of the plan member (that is, the retirement benefits accruing in the year) must not exceed certain limits.

Tax Consequences of Revocation

While the Act does not specify what the tax consequences will be when the registration of an IPP is revoked, it seems clear that any tax burden will be borne by the plan member—that is, any tax payable will be paid out of the plan's assets. In *Boudreau v. Canada (Minister of National Revenue)*,[52] the court stated that the revocation of the registration of a pension plan would not cause the plan to cease to exist; rather, the tax advantages associated with the RPP would be lost. As a result, any contributions made to the plan would no longer be deductible. The income earned on the investments held in the plan would also be taxable. There is also a risk that a transfer of the plan's assets to another registered plan could result in double taxation, since the member would be taxed before the transfer (as a result of receiving the funds

50 Supra note 48.

51 For instance, the property held by the RPP cannot be a "prohibited investment" pursuant to regulation 8514(1). Further, the RPP cannot hold investments that are not permitted under the governing pension standards legislation.

52 2005 FCA 304.

from the now defunct IPP)[53] and again when payments are made out of the registered transferee plan.

In contrast, the CRA appears to take the position that the plan will become a retirement compensation arrangement on the date of revocation.[54] In this case, a 50 percent tax will apply on all contributions held in the plan and on the investment income earned within the plan, with the result that the employer will have to remit to the CRA an amount equal to 50 percent of the plan's assets. This 50 percent tax on contributions and investment income will be refunded to the plan when distributions are made to the member. All distributions out of the plan will be treated as distributions from a retirement compensation arrangement and will be taxable in the hands of the recipient.[55]

However, if an IPP's registration is revoked retroactively to the date on which the plan was established, the tax consequences may even be more punitive, especially if the IPP received the commuted value of the member's pension plan with a former employer. In that case, the CRA may take the position that all of the pension benefits received by the IPP must be included in the member's income in the year of transfer. The resulting tax liability (together with interest and penalties) may well exceed the amount of the individual's pension and thus deplete the individual's lifetime retirement savings.

ADVANTAGES AND DISADVANTAGES OF IPPs

A number of advantages and disadvantages of IPPs that were described earlier in this article will not be reproduced here. Rather, the advantages and disadvantages described below are intended to emphasize a few important features of the IPP that deserve particular attention.

Advantages

Defined Benefit Plan

Because an IPP is a defined benefit plan, the annual pension benefits that will be paid on retirement are defined by a predetermined formula. Regardless of investment performance within the plan, the promised pension benefits will be paid to the plan members. In other words, the pension to be received is determined in advance. This feature distinguishes IPPs from money purchase plans such as RRSPs, and provides for better retirement planning.

Increased Contributions and Maximization of Retirement Income

Within the limits set out by the Act, the contributions made to the IPP by both the employer and the plan member are deductible in computing income for a taxation

53 The receipt of the funds could be taxed as a pension benefit to the member (under paragraph 56(1)(a)) or as a distribution from a trust (under paragraph 12(1)(m)).

54 Canada Revenue Agency guide T4099, "Registered Pension Plan Guide."

55 Paragraphs 56(1)(x) through (z).

year. Further, since the amount of the annual contribution that can be made to an IPP is generally larger than the maximum amount allowed as an RRSP contribution, the IPP contributor can claim a larger tax deduction and thus realize greater tax savings.

For example, in 2012, a contributor to an IPP set up for a 56-year-old individual earning over $132,000 per year would be entitled to claim a tax-deductible contribution of approximately $32,500 ($9,530 more than the maximum permissible under the current RRSP limit). If the corporation sponsoring the IPP pays corporate tax at a 15.5 percent federal-provincial combined rate, the equivalent of $1,477 in additional tax savings is generated. As discussed below, this advantage increases as the plan member ages and earns more, or if the investment return is less than a specific threshold, thereby requiring larger contributions to be made to the plan; the advantage also increases with respect to any administrative fees that the IPP sponsor pays directly. All of these factors peculiar to the IPP will allow the pension fund to grow at a faster pace.

It follows that the total amount of funds sheltered in an IPP can be significantly greater than that available in an RRSP at retirement. For 2012, the annual contribution to an RRSP is restricted to a maximum of $22,970. On the other hand, the annual maximum amount of contributions for an IPP depends on several actuarial assumptions and factors, such as age and earnings, and the assumptions prescribed by the Act. Larger contributions will be required as the individual ages and earns more. As a result of those larger contributions, the individual can accumulate a greater amount of retirement savings than with an RRSP. If we assume a rate of return of 7.5 percent and an investment or management fee of 1 percent (whether within an RRSP or an IPP), an IPP could grow to $8.4 million over a 25-year period as compared with $5.5 million for an RRSP—an advantage of $2.9 million, or a pension that is 53 percent greater. The ability to contribute more money to an IPP than to an RRSP makes the IPP a vehicle of choice to achieve maximum savings for retirement under existing tax laws.

The following example illustrates how an IPP can be used to maximize retirement income in two hypothetical scenarios.

Example 2

John is 40 years old and carries on business as a construction builder through his wholly owned corporation ("Johnco"). He receives a salary of $150,000 per year from his company. Mary is 57 years old and the sole owner of a consulting company ("Maryco"). She earns $230,000 per year from her company. For the sake of simplicity, it is assumed that John and Mary have no other retirement savings (such as RRSPs), and that their respective companies are recently incorporated, such that they are not eligible for a past service purchase. It is further assumed that the rate of return generated on assets held in an IPP or an RRSP, as the case may be, is 7.5 percent, before fees of 1.5 percent. Both Johnco and Maryco are subject to a combined federal-provincial tax rate of 15.5 percent, whereas the combined marginal personal income tax rate applicable to John and Mary is 46.41 percent.

The accompanying table indicates the amount of retirement funds that would be available to John and Mary on retirement at age 65, depending on whether the contributions were made to an IPP or an RRSP.

	IPP		RRSP	
	John	Mary	John	Mary
Age	40	57	40	57
Annual salary	$150,000	$230,000	$150,000	$230,000
Number of years before retirement	25	8	25	8
Annual contribution[a]	$24,074.94 (2012)	$33,129.69 (2012)	$22,970 (2012)	$22,970 (2012)
Total extra tax savings until age 65 above RRSP limit[b]	$13,871	$34,357	na	na
Total additional assets contributed to IPP versus RRSP until age 65	$38,955	$90,336	na	na
Funds available at retirement	$647,014.06	$284,915.30	$608,058.97	$194,578.87

[a] The table shows the applicable contribution amount in 2012. For simplicity, the IPP contribution limit is replicated each year, but in reality, it would grow by 7.5 percent annually.
[b] This would include, for instance, lower personal taxes paid owing to lower salary available once plan expenses and contributions are funded by the corporate employer.

On the basis of the foregoing, it follows that, by contributing to an IPP instead of an RRSP, John would have an additional $38,955 available at retirement, while Mary would enjoy an additional $90,336. This simple comparison understates the IPP advantage since it assumes that the contributions made to the IPP in the current year are held constant over the time period to retirement. In reality, the IPP annual contribution figures would increase at a much greater pace than the RRSP limit, thereby widening the gap over the life of the two plans. In the above scenarios, the accretion to the net worth of the two individuals is based on the superior tax features of the IPP alone, since the rate of return on assets and fees payable are deliberately held constant across the RRSP and the IPP platforms to ensure appropriate comparability.

Variety of Permitted Investments

The list of permitted investments for IPPs is very broad. The only restrictions placed on IPP investments under the Act are

- a "prohibited investment" under regulation 8514(1);[56] and
- any investment that is not permitted under the pension standards legislation governing the IPP, such as an investment of more than 10 percent of the book value of the pension fund in any single security.

56 Under regulation 8514(1), a "prohibited investment" is generally defined as a share in, an interest in, or a debt of a person who is involved in the plan. This would include, for example, a share in, an interest in, or a debt of the participating employer, the member, or certain non-arm's-length persons. An interest in, or a right to acquire, a prohibited investment is also a "prohibited investment" under regulation 8514(1).

Failure to comply with these investment restrictions will result in the IPP becoming a revocable plan.[57]

Another investment opportunity available to IPPs is for several plans to pool their investments through a prescribed small business investment corporation (SBIC), which is exempt from taxation.[58] An SBIC is generally defined as a corporation that is owned by RPPs and invests in small-business securities.[59] Small-business securities include shares of an "eligible corporation," which essentially is a Canadian corporation subject to Canadian income tax that uses its property in an active business carried on in Canada.[60]

By pooling their investments through an SBIC, IPPs can obtain all the benefits that are typically associated with economies of scale available to sizable pension plans, such as higher investment returns, lower administration and management costs, and the possibility to invest in certain sectors that would not otherwise be accessible with limited capital or financial resources.

Flexibility in the Plan Terms

Flexibility in relation to the plan terms is a significant advantage of the IPP over any other tax-assisted retirement savings vehicle in Canada. Most IPPs are tailored to only one member, and the plan terms can be drafted such that the member, the surviving spouse, or the member's estate will benefit from all the funds accumulated within the plan. In contrast, the terms of group pension plans generally apply equally to all members, and it is usually not possible to transfer accumulated pension assets to a member's family, heirs, or estate. On the death of a group member, any remaining funds belonging to the member (other than survivor benefits, if any) revert back to the plan to finance the pension of the other living members. As for RRSP documents, they are boilerplate specimens whose basic terms are not subject to customization at all.

An IPP can provide that any surplus in the plan belongs to the plan member. This can give rise to various estate-planning opportunities. As noted earlier, surplus generally arises when the investment returns are higher than the amount required to pay the promised pension benefits. In retirement, the surplus could be withdrawn by the member on a taxable basis as a way of supplementing his or her annual pension; or, upon the member's death, it could be paid to the member's spouse, heirs, or estate as a taxable death benefit. Alternatively, any surplus that is not paid to the retired

57 Regulation 8501(2)(a).

58 Paragraph 149(1)(o.3) and regulations 5100 through 5104.

59 Regulation 5101.

60 Under the definitions of "eligible corporation" and "qualifying active business" in regulation 5100, the following persons will generally not qualify as an eligible corporation: a securities dealer; a bank; a credit union; a trust company; an insurance corporation; a corporation whose business is lending money, purchasing debt, or earning passive income from property or gains from the disposition of property; or a corporation controlled by one or more non-residents.

member could be used for another plan member, such as a family member who is employed by the business. In this case, the surplus would bypass taxation in the hands of the individual (or his/her estate) and continue to grow tax-free in the plan to fund the pension benefits for the family member.

Before retirement, the surplus could also be used to allow the employer or the employee to take a "contribution holiday" in years when the plan is considered to be adequately funded and therefore does not require any additional contributions.[61] In fact, where surplus exceeds certain limits, employer contributions to the plan will be restricted. On the other hand, in order to preserve the ability to make maximum contributions to the IPP, the surplus could be used to improve the pension benefits or otherwise be distributed to the plan member on a taxable basis, as discussed above.

Further, the terms of the IPP may allow the plan member to participate in the investment decisions of the plan, provided that they comply with the investment rules in the Act and the governing pension standards legislation. In other words, the IPP can be structured in a way that provides for member participation in the investment decisions (similar to a self-directed RRSP).

Creditor Proofing

The assets held within an RPP are generally exempt from execution, seizure, or attachment under the federal or provincial pension benefits standards legislation.[62] It follows that IPP funds cannot be seized by the creditors of the employer or the member, assuming, of course, that the IPP was validly created and was not established in anticipation of an imminent seizure or bankruptcy.

Disadvantages

Setup and Administration Costs

IPPs are complex to establish and administer because they are subject to a considerable level of governmental regulation and require regular actuarial valuations. IPPs must also be registered with both the CRA and certain provincial or federal pension regulatory authorities. The cost to set up an IPP can vary between $1,500 and $5,000.[63] Once the plan is established, administration, investment, and trustee fees will have to be paid annually. These can range from $500 to $2,000.[64]

In addition to the initial actuarial valuation, the plan must be valued by a qualified actuary at least every three years (or four years in certain provinces). An actuarial

61 Note, however, that the RRSP deduction limit of the plan member will continue to be restricted during the years in which no contributions are made to the IPP, since the pension benefits accruing during those years will generate a PA to the member.

62 There is one exception for a claimant under family-law proceedings with respect to the division of net family property.

63 See Peter J. Merrick, *The Essential Individual Pension Plan Handbook* (Markham, ON: LexisNexis Canada, 2007), at 30.

64 Ibid.

valuation report typically costs between $800 and $2,000, depending on the firm providing this service. Such valuation must be filed with the CRA, in order to obtain the deduction of contributions made to the plan; in addition, in some provinces (such as Ontario) it is also necessary to file the valuation with the pension regulators, to confirm that the IPP is sufficiently funded in accordance with the governing pension legislation. Other annual filings with the CRA may also be required, such as the mandatory filing of an annual information return[65] and the issuance of tax slips.[66] Provincial filings also have to be made, adding to the costs of compliance.[67]

Finally, owing to the inherent complexity of IPPs, the expertise of legal professionals is often required, further extending the list of ongoing costs that must be incurred in order to adequately operate and maintain an IPP. While the range of costs varies according to a myriad of factors, IPPs with very small asset bases could be considered uneconomical.

Mandatory Funding

As a sponsor of an IPP, the employer is responsible for the funding of the promised benefits and assumes the associated investment risk. Contributions to the IPP are determined by actuarial valuations and are mandatory, regardless of the employer's ability to pay. Therefore, in times of economic difficulty, those contributions could create pressure on the cash flow of the employer.

Further, if the plan has an unfunded liability or is in deficit (because the investment performance is below the actuarial targets), the employer will be responsible for funding the deficiency by making additional contributions to the IPP. Failure to make the required contributions could expose the employer to regulatory penalties.

On the termination of the plan, the employer may also be required under the pension standards legislation to fund any deficiency that exists at the date of the windup.

The Locking-In Feature

Under pension standards legislation, funds in an IPP are not accessible—and in fact are locked in—until retirement. Most pension statutes allow retirement to occur at age 55. Therefore, in contrast to an RRSP, where funds can be withdrawn at any time

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65 Regulation 8409(1). The prescribed form is form T244 ("Registered Pension Plan Annual Information Return"). However, see infra note 67.

66 Regulation 200. For example, PA amounts for employees who accrued pension benefits in a year must be reported on a T4 slip. If pension benefits are paid to retired members in a year, the amount of the benefits must be reported on a T4A slip ("Statement of Pension, Retirement, Annuity, and Other Income").

67 If a province has developed a harmonized filing agreement with the CRA (as is the case in Ontario), the pension plan is not required to file an annual information return (form T244) with the CRA but only the return that must be filed with the provincial regulatory body. As a result, most plans only file one annual information return with the province, thereby satisfying the CRA's annual filing requirement.

(and taxed accordingly), cash payments to plan members are generally not allowed unless the employment is terminated, the plan is wound up, or the plan member reaches retirement.

Summary

Advantages	*Disadvantages*
■ Defined benefit plan	■ Setup and administration costs
■ Increased contributions and maximization of retirement income	■ Mandatory funding
■ Variety of permitted investments	■ The locking-in feature
■ Flexibility in the plan terms	
■ Creditor proofing	

CONCLUSION

Despite the myriad of benefits that the IPP has to offer to the ideal candidates, this retirement savings vehicle has not yet captured the public attention it deserves. The most significant advantage of the IPP is that, for individuals above a certain age, more tax-assisted dollars can be contributed to this type of plan than to an RRSP, and can be used to fund a larger pension benefit. Therefore, where the right age and income levels are reached, the plan member can benefit from greater tax-sheltered income today and greater retirement income in the future. Another important advantage particular to the IPP is the ability to customize the pension plan so as to meet individual needs by allowing, for example, wealth transfer and participation of the plan member in the investment decisions.

While an exhaustive review of the intricacies of the IPP is a complex exercise, the reader should now have a better understanding of its fundamentals. Readers should also be aware that the IPP, like any other tax-assisted retirement savings plan, is not a solution to all problems. In some cases, the IPP might not be a suitable vehicle, but when the circumstances are right, it should always be considered when designing a retirement plan.