



## IPP - Terminal Funding

Tuesday, December 28, 2010 by [Ken Robinson](#)

Individual Pension Plans (IPPs) are an excellent vehicle for business owners to save for retirement on a tax effective basis. [Kim Drever](#), one of my fellow tax partners, has blogged on this topic in the past, so I recommend her [two-part blog](#) to your attention. I plan to focus on one particular benefit of IPPs, referred to as terminal funding. This is a large contribution opportunity which arises when the business owner retires. But first I'll briefly summarize how IPPs work and what other benefits they offer.

IPPs were introduced 20 years ago as an alternative to [RRSPs](#). While RRSPs are "defined contribution plans", that is the contributions are defined and regulated under the [Income Tax Act](#) (ITA), IPPs are "defined benefit plans", where as the pension benefits are defined and regulated under the ITA. With an RRSP, you contribute in your plan based on the contribution limits and draw out a pension when you retire based on what you've been able to accumulate through contributions and investment earnings; with an IPP, you contribute based on a pre-defined pension you will be entitled to draw. The ITA stipulates that the contributions must be determined by an actuary, with strict limitations on their assumptions (investment yield, inflation, mortality, early retirement, survivorship benefits, etc). Even with these restrictions, IPP annual contributions typically exceed RRSP contribution limits by thirty to forty percent. In addition, the rules allow you to give credit for past service, again subject to certain restrictions. In a nutshell, they compare what you could have contributed under an IPP to what you have contributed under an RRSP during your period of past service and allow you to make a lump sum past service contribution. For a business owner in his/her 50's with 20 plus years of service to their company, this contribution is often in excess of \$150,000. The past and current service contributions get larger as you get older.

The purpose of the ITA restrictions on actuarial assumptions is to prevent excessive tax deductible funding by business owners (and highly compensated employees) through aggressive assumptions. Hence, there are specific rules for "designated plans"; that is, the IPPs of "connected" shareholders, individuals related to connected shareholders or highly compensated employees. One last opportunity exists for business owners and highly compensated employees. When the individual retires, the IPP is no longer a designated plan. This frees the actuary from the restrictions they had to operate under through the duration of the IPP, which include:

- retirement no earlier than 65
- Post-retirement inflation adjustments not exceeding CPI increases less 1%
- Spouse is the same age as the IPP member
- Investment yield of 7.5% per annum
- Salary increase and wage index increase of 5.5% per annum
- Inflation (CPI) of 4.0% per annum
- Mortality rates equal to 80% of the average of the male & female rates set forth in the 1983 Group Annuity Mortality Table

After retirement, the actuary can take a conservative approach in their assumptions about anticipated investment yield, the plan can be amended to provide full CPI indexation and early retirement benefits, and, the spouse's actual age can be considered for purposes of funding for survivorship benefits. The resulting terminal funding contribution could easily be in the magnitude of \$500,000.

A tax deductible contribution of this size opens up a number of tax planning opportunities, for example:

- In the context of a sale of a business it could shelter large gains and recapture on the sale of assets
- It could shelter future investment income on the proceeds of a business sale
- It could be used to purify the shares of a company for capital gains eligibility on a tax deferred and tax deductible basis
- It could be used as a tax effective way of extracting corporate retained earnings for an individual planning to cease Canadian residency

The current low yield on long term low risk investments provides business owners close to retirement age with an excellent opportunity to maximize their terminal funding. Retirement and ceasing work don't have to go hand in hand. For example, a business owner could cease drawing a salary and "retire" but continue managing his company and draw dividends.

Now is the time for anyone over 45 to firstly consider an IPP if they don't already have one, and secondly, for the "freedom 55" crowd to look into triggering terminal funding.

Original Posted Article and Comments:

<http://www.mnp.ca/media-centre/blog/2010/12/28/ipp-terminal-funding>