

Terminal Funding for an Individual Pension Plan (IPP)

Version 2011-01

Definition of a Designated Plan

If an IPP is primarily for the benefit of Specified Individuals, it is a Designated Plan as defined in Income Tax Regulation 8515. Specified Individuals include Connected Persons and Highly Compensated Employees. Connected Persons are defined as 10% or more shareholders of any class of shares or not dealing at arm's length with such persons. Highly Compensated Employees are defined as individuals with annual remuneration of more than 2.5 times the YMPE. YMPE is the Year's Maximum Pensionable Earnings as defined in the Canada Pension Plan. The YMPE for 2011 is \$48,300 so any individual with more than \$120,750 ($\$48,300 \times 2.5$) of annual remuneration in 2011 is considered a Highly Compensated Employee and is therefore a Specified Individual.

Funding Restrictions for Designated Plans

For ongoing funding valuation of a Designated Plan, actuarial basis and assumptions prescribed in the Income Tax Regulation 8515 must be used. The valuation is called a "Maximum Funding Valuation" and the prescribed actuarial basis and actuarial assumptions are referred to as the "Maximum Funding Basis" or the "Maximum Funding Restrictions". The major assumptions include:

- ◆ The member would retire and commence to receive pension benefits no earlier than age 65;
- ◆ Post-retirement inflation adjustments cannot exceed increases in the Consumer Price Index (CPI) less 1%;
- ◆ Spouse is the same age as the IPP member;
- ◆ Interest rate of 7.5% per annum;
- ◆ Salary increase and wage index increase of 5.5% per annum;
- ◆ Inflation (CPI) of 4.0% per annum; and
- ◆ Mortality rates equal to 80% of the average of the male & female rates set forth in the 1983 Group Annuity Mortality Table.

The Maximum Funding Basis for Designated Plans is introduced by the government to exercise control over the level of contributions to such plans. The actuary for an IPP that is a Designated Plan will not be able to increase the ongoing funding contributions by using ultra-conservative actuarial assumptions such as a very low interest rate, a very early assumed retirement age, a spouse who is much younger, etc. Note that it is not the assumed interest rate alone but the interest rate, salary increase rate and the inflation rate in aggregate that would have significant influence over the amount of funding into the pension plan.

Removal of the Funding Restrictions for Designated Plans

The Maximum Funding Restrictions can be removed if the IPP member has retired and pension benefits have commenced; and/or the Canada Revenue Agency has approved in writing that the IPP is no longer a Designated Plan. Therefore IPP Terminal Funding comes in two parts and stages – Part I and Part II. Part I Terminal Funding is triggered by pension commencement and is attributable to the recognition of the actual age at retirement, actual age of the spouse as well as the improvement to the early retirement lifetime pension amount, the payment of a bridge benefit prior to age 65, and improvement to the post-retirement indexing. Part II Terminal Funding is triggered by the switch from the prescribed set of actuarial assumptions to fund the IPP on a much more conservative basis upon CRA's approval to remove the IPP from the Designated Plan category.

Due to the restrictions in the Maximum Funding Basis, the costs associated with the items below can not be contributed during the asset accumulation phase; they have to be funded after pension benefits have commenced and/or the Canada Revenue Agency has confirmed in writing that the plan is no longer a Designated Plan.

- (1) Early retirement benefits;
- (2) Bridge benefits;
- (3) Cost of a fully CPI-indexed pension vs. CPI less 1%;
- (4) Actual age of a younger spouse;
- (5) For purposes of the actuarial valuation, use more conservative actuarial assumptions in the going-concern basis or the prevailing annuity yield proxy rates in the solvency basis.

Items #1 to 4 above are under Part I Terminal Funding and available shortly after pension commencement. Item #5 is under Part II Terminal Funding and only available after CRA's approval to remove the IPP from the Designated Plan category.

Upon pension commencement for the IPP member, the employer or pension plan sponsor potentially can achieve a significant amount of catch-up or **terminal funding** if they wish to enhance benefits under the IPP and to fund the IPP in a more conservative manner to trigger the additional contribution room.

Early Retirement Benefits

If the member is not yet age 65, the employer can amend the IPP to provide unreduced or subsidized early retirement. The unreduced retirement date under tax legislation is defined as the earliest of the following three dates:

- ◆ Attainment of age 60;
- ◆ Completion of 30 years of service; and
- ◆ The member's age plus service equal at least 80 years.

If the member is not yet eligible for unreduced pension, the minimum reduction is 3% per year (i.e. 0.25% per month) for each month the actual retirement date precedes the unreduced retirement date. Without any terminal funding, the reduction factor for early retirement is based on an actuarial equivalent basis which would be slightly more than 7.5% per year prior to age 65. Subsidized early retirement benefits would result in additional actuarial liability and thus terminal funding room.

Bridging Benefits

The IPP can be amended to provide a bridging benefit to a retired member for the period prior to age 65 to generate additional terminal funding room. The bridging benefit is equal to the government benefits (CPP & OAS) subject to certain maximum amounts based on the member's years of service and lifetime pension amount.

Fully CPI-Indexed Pension vs. CPI less 1%

The employer can amend the IPP to improve post-retirement indexing from CPI less 1% to full CPI to create further terminal funding room.

Actual Age of Spouse

Due to the fact that the IPP has been funded by assuming that the spouse is the same age as the member, the pension benefits are adjusted downward to reflect the cost of the survivor pension if the spouse is younger than the member. If the spouse is much younger than the member, the reduction can be quite significant. The employer can pay for the cost of the survivor pension for a much younger spouse by waiving the usual adjustment to account for the age difference.

Using More Conservative Actuarial Assumptions

The actuarial liability for a retired member is the actuarial present value of future expected pension benefits. Changing the interest rate assumption from 7.5% per annum to a more conservative rate such as 5.5% per annum will lead to a higher actuarial liability and thus more terminal funding room.

The other assumptions such as inflation may also need to be revised so that the real rate of return will be reasonable in aggregate. Please note that using different actuarial assumptions does not change the member's benefit entitlement. Using a more conservative set of assumptions would only result in a higher actuarial liability under the plan and hence additional contributions can be made to the plan to provide better benefit security.

Terminal Funding – Considerations

The IPP client should factor the following into consideration with respect to their terminal funding planning:

- ◆ By doing terminal funding, the client effectively makes a decision to contribute additional funds into the IPP to pay for enhanced benefits and better benefit security. It is implicitly assumed that the client will choose the option of receiving a monthly pension paid from the IPP fund at retirement rather than transferring a lump sum commuted value of pension benefits to a locked-in vehicle such as a Life Income Fund (LIF). Terminal funding puts so much more assets into the IPP that all of the terminal funding contribution will be towards the amount in excess of the maximum transfer limit if the lump sum option is taken, which is immediately taxable to the member. Therefore, terminal funding should only be considered if the client is planning on receiving a monthly pension from the IPP over their lifetime, not taking the lump sum commuted value at retirement.
- ◆ CRA will only remove the Designated Plan status if all members of the pension plan have commenced pension benefits. If the client is planning on having terminal funding done for one member without triggering pension commencement for the other member, it is important that these two members (e.g. husband and wife) be put in separate plans rather than in the same plan.
- ◆ The terminal funding room is created by enhancing the member's benefits. Any surplus in the IPP prior to the benefit enhancement would cut into the terminal funding room as the costs of the enhancements are paid by the existing surplus and not by new contributions. There may not be any terminal funding room if the IPP already has a significant amount of surplus at retirement.

- ◆ The employer will be able to pick and choose certain improvements to fit their budget or objectives. Terminal funding contributions can either be paid in a lump sum or amortized over a period of time. If the plan is not exempt from registration under federal or provincial pension legislation, certain minimum funding requirements would apply. The employer or pension plan sponsor should bear in mind that as a result of terminal funding increase significantly the actuarial liability under the plan, the risk exposure to the employer may also increase. Any adverse plan experience such as investment return lower than the assumed interest rate will lead to higher minimum contributions required by the pension legislation in the future.

Terminal Funding – Case Study

Consider the following information for an IPP as at January 1, 2011:

Member Information:

Gender:	Male
Date of Birth:	January 1, 1951
Pensionable Service:	20 years (Jan. 1, 1991 to Dec. 31, 2010)
Date of Birth (Spouse):	January 1, 1956 (5 years younger than member)
Accrued Annual Pension:	\$51,044.40 ⁽¹⁾
IPP Accumulated Assets:	\$719,589

- ⁽¹⁾ Maximum Pension Limit of \$2,552.22 of annual pension for each year of pensionable service times 20 years of pensionable service. It is assumed that the IPP member had maximum employment income for pension purposes for each year of service.

If the IPP member were to retire early at age 60 on January 1, 2011, his annual pension would have been reduced from \$51,044.40 to \$43,890.24 to take into account the reduction for early commencement as well as the 5-year age difference between the member and the spouse. However, the employer (pension plan sponsor) can provide full unreduced pension and enhance other benefits to trigger terminal funding as follows:

Benefit Enhancement / Change	Terminal Funding
Improve early retirement pension from \$43,890.24 per year (\$3,657.52 per month) to the unreduced accrued pension amount of \$51,044.40 per year (\$4,253.70 per month) (Part I)	\$117,294
Provide a bridging benefit of \$5,781.48 per year (\$481.79 per month) from age 60 to age 65 (Part I)	\$29,861
Improve post-retirement indexing from CPI - 1% to full CPI (Part I)	\$110,960
Change actuarial basis to the solvency basis using assumed long-term real return bond yield of 1.50% per annum (Part II)	\$275,711
Total (Part I Total \$258,115 plus Part II Total \$275,711)	\$533,826

The amount of actual terminal funding available depends on many factors such as age of the member, years of pensionable service, amount of accrued pension, age of the spouse, unreduced retirement date, amount of accumulated IPP assets and the Government of Canada long-term real return bond yield at the time of terminal funding. The age with the maximum terminal funding amount is likely the age at which the IPP member qualifies for unreduced early retirement or shortly before.

In general, the younger the spouse is, the higher the terminal funding contribution room and vice versa. Similarly, the lower the Government of Canada long-term real return bond yield, the higher the terminal funding contribution room and vice versa. In the case study shown above, if the spouse were 20 years younger and not 5 years younger, the total terminal funding contribution room (Part I and Part II combined) would have been \$763,745 instead of \$533,826. If the long-term real return bond yield were 1.11% (the actual rate on December 31, 2010) and not the assumed 1.50% per annum, the total terminal funding contribution room would have been \$607,247 instead of \$533,826.

The plan amendment to trigger terminal funding as well as the terminal funding contribution amounts must be approved by the Registered Plans Directorate of Canada Revenue Agency and the applicable pension regulatory authority. The whole process including preparation, filing and approval may potentially take a few months. It is highly recommended that the IPP client and their advisors plan terminal funding well in advance of the anticipated contribution date to allow sufficient time to prepare the required documentation and to obtain the necessary approval from CRA and the applicable pension regulatory authority.

What Does Part II Terminal Funding Accomplish?

Part II terminal funding does not result in an immediate increase in the lifetime pension amount for the IPP member because the maximum pension permissible to be paid is calculated based on the member's employment income history and the years of pensionable service credits under the IPP at retirement. The allowable pension amount is not based on the amount of IPP assets. By doing Part II terminal funding and funding the IPP in such a conservative manner, the expectation is that plan surplus will develop over time through excess real return (i.e. nominal return in excess of price inflation). Plan surplus, when paid to the IPP member in taxable lump sums, are effectively "additional" pension payments.

A Few Tax Planning Tips

1. For corporations that can not realize a significant value in selling the business (e.g. an incorporated surgeon who only performs surgery at a hospital), there may not be much of taxable gains for the employer to deduct the significant terminal funding contributions against. The best way for the IPP member to achieve terminal funding is by doing the following a few years prior to the official "retirement date":
 - ◆ Continue to "provide service" to generate company income and revenue;
 - ◆ Cease to receive T4 employment income from the company and "retire";
 - ◆ Commence pension to trigger terminal funding and have most of the company income contributed to the IPP.

2. Pension is an employment-related benefit provided by an employer to an employee. The employer is the official pension plan sponsor under the tax legislation and the IPP must be somehow connected or linked to the employer or former employer. It is therefore critical to do tax planning well in advance of the anticipated sale of the business to ensure that there is a "permanent home" for the IPP after the sale. Generally speaking, an asset sale would be preferred to a share sale for purposes of IPP terminal funding as the tax entity for the pension plan sponsor (company or employer) remains. If there is going to be a share sale, special attention must be paid to the following issues:

- ◆ It is most likely that the potential future purchaser will not keep the IPP attached to the company. The client should consider moving the plan sponsorship from the current company (OLDCO - the business that is going to be sold) to a different company (NEWCO - the new employer and the entity that will remain for the extended long term after the sale) a few years prior to the sale. Bear in mind that the new pension plan sponsor (NEWCO) must satisfy the following conditions:
 - There is a bona fide employment relationship between the IPP member and NEWCO;
 - The IPP member will be receiving T4 employment income from NEWCO;

- ◆ As part of the corporate reorganization to create NEWCO, It is absolutely critical to ensure the following:
 - OLDCO satisfies the “Predecessor Employer” definition in Income Tax Regulation 8500 for pension plan purposes. Otherwise, NEWCO may not be able to make any IPP terminal funding contribution with respect to the OLDCO service.
 - There will be potential gains from the future sale of OLDCO at the NEWCO level that are in excess of the lifetime capital gain exemption limit for the IPP member so the significant amount of IPP terminal funding contributions can be deducted against such gains.

Do You Require Further Consultation & Help

The IPP terminal funding concept is complex and may require careful advanced tax planning. We will be pleased to assist you as well as your financial and tax advisors in designing a solid plan to optimize tax efficiency and effectiveness and to comply with the income tax and pension legislative requirements. Please contact us as follows:

By phone: (604) 730-1898

By fax: (604) 730-1886

By email: appt@wainc.ca (to book a consultation session with an actuary)
IPP-Seminar@wainc.ca (to register for our monthly IPP General Seminar or our quarterly IPP Terminal Funding Seminar)

This content is for general information only. As it is impossible to include all situations, circumstances and exceptions in a commentary such as this, a further review or feasibility study should be undertaken with respect to terminal funding of an IPP and its implications. Every effort has been made to ensure the accuracy of the information contained in this commentary. However, because of the nature of the subject, no person or firm involved in the preparation or distribution of this commentary accepts any liability for its contents or use.