

# Changing Perspectives on IPPs

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Noah Clarke, MA  
Investment Counsellor

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# FOCUS ON INTENT

IPPs are just familiar enough to be broadly marketed by financial professionals but also complicated enough to be precarious if left in the wrong hands.

In most cases, following a preliminary review to determine that a client can generate sufficient contribution room via an IPP, most clients are delivered a registered pension product along with administrative services. The nuances of funding and long-term tax optimization are seldom reviewed prior to the client's retirement date. **This is a problem.**

We know that the main benefit of the Individual Pension Plan (IPP) is the possibility to make greater tax-deductible contributions than are permitted for a RRSP. This value proposition is the hook that prompts most (if not all) preliminary discussions on setting up an IPP. And why not? If IPPs did not offer the tax advantages that they do, there would be little reason to discuss them further. As shown in the table below, in the first year, IPPs could open up a significant amount of tax-deductible contribution room for a client, depending on their age.

Age	Maximum Annual Current Cost Estimate	Maximum Past Service Estimate <sup>1</sup>	Maximum RRSP Contribution
45	\$33,576	\$117,781	\$29,210
50	\$36,881	\$275,100	\$29,210
55	\$40,512	\$380,160	\$29,210
60	\$44,501	\$495,540	\$29,210
65	\$46,924	\$622,320	\$29,210
70	\$41,438	\$960,365	\$29,210 <sup>2</sup>

But we have some concerns about focusing too much on the size of tax-deductible contributions at setup if it means kicking other planning items down the road.

There are several client-specific factors (including long-term intentions) which should be incorporated from the outset to properly determine how much value an IPP can provide in comparison to

<sup>1</sup> Estimate does not include amount required to be transferred from RRSP in fulfillment of qualifying transfer.

<sup>2</sup> These estimates assume the individual has reached age 18 before receiving T4 employment income in excess of \$162,278 from the potential IPP sponsor from 1991 to 2021.

RRSPs. Contrary to much of what is written on IPPs, these factors have less to do with the age or salary history of the client and more to do with how they hope to access the funds in retirement. Failure to account for these factors could lead to some significant headaches later.

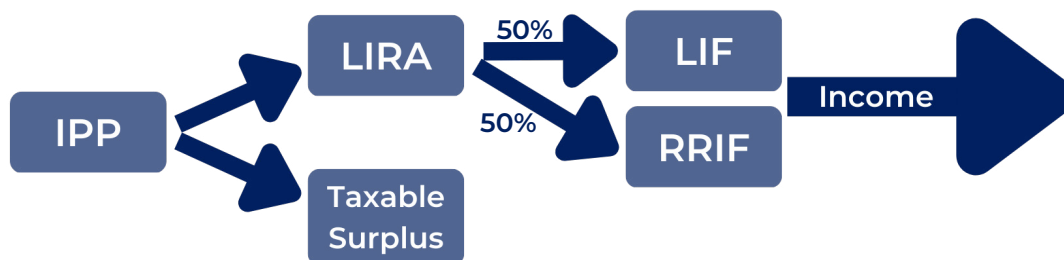
### **Starting from The End** ---

In all cases, to access funds from the IPP, plan members must choose between either winding up the plan (transferring the commuted value to a LIRA—that is, a locked-in retirement account) or electing to take pension payments directly from the plan. This decision can be postponed up until age 71 but no later. As the optimal funding amount for an IPP will be contingent on this decision, it should be part of the plan from the beginning. The following sections provide an overview of these two options, their advantages and weaknesses, and the different planning considerations required for each.

# WINDUP

## Option A: Disperse the Trust

Historically, Qube has promoted the idea that the best course of action would be to “cash out” at retirement by winding up the trust and taking the commuted value. Our rationale was that this route provides additional flexibility in choosing when and how much to withdraw each year. It also terminates the need for ongoing actuarial services.



However, this planning has been challenged by complications arising from the Maximum Transfer Value rules<sup>3</sup>. The MTV reduces the benefits of an IPP in which the plan member intends to eventually wind up the plan.

### The Maximum Transfer Value

The MTV is a relatively straightforward calculation. It is equal to the Normal Form Pension multiplied by an age-specific present value factor.

### Normal Form Pension

The Normal Form Pension, also referred to as the IPP pension accrual, is set at 2% of annual earnings multiplied by the number of years of service. The only adjustment made to pensionable earnings received throughout the plan member’s working career is indexation to the YMPE (Yearly Maximum Pensionable Earnings). Therefore, if an IPP member’s pensionable income was—in real terms—lower in early years and increasing up to retirement, no direct means to catch up is provided by the plan (such as a 5-year highest average salary calculation).

Calculating the accrued pension benefit is a relatively straightforward calculation. No adjustments are made to average a member’s income, and all previously earned pensionable income is known. Additionally, we have information on historical DB (Direct Benefit) limits; all these conditions allow us to **calculate the accrued pension benefit** in today’s dollars at the time of setup.

<sup>3</sup> Maximum Transfer Value (MTV) is the amount allowed to transfer tax-free from the IPP Trust to the plan members LIRA account.

For example, a prospective 60-year-old plan member who had drawn salary at or above the maximum pensionable earnings cap in all years since 1991 would have an accrued pension benefit of \$97,389 in 2021. This means that our plan member has accrued, in today's dollars, a Normal Form Pension equal to \$97,389 thanks to their many years of credited service.

### Present Value Factor

The present value factor is a static CRA-prescribed number based on age which increases up until age 65 (standard retirement) and drops off after that<sup>4</sup>.

Age	PV Factor	Age	PV Factor	Age	PV Factor
49	9	57	10.8	65	12.4
50	9.7	58	11	66	12
51	9.6	59	11.3	67	11.7
52	9.8	60	11.5	68	11.3
53	10	61	11.7	69	11
54	10.2	62	12	70	10.6
55	10.4	63	12.2	71	10.3
56	10.6	64	12.4		

For instance, the present value factor for our hypothetical 60-year-old would be 11.5. If they pursued a windup in that year, their MTV would then be equal to \$1,119,973 (11.5 multiplied by \$97,389). Any amounts in the IPP exceeding \$1,119,973 would be kicked out as taxable income in the year of windup. This overage—often referred to as plan surplus—can make pursuing a windup very unappealing; the associated tax bill can be quite large.

<sup>4</sup> Between the ages of 49 and 64, these factors are to be interpolated based on the member's exact age (i.e., expressed in years, including any fraction of a year).

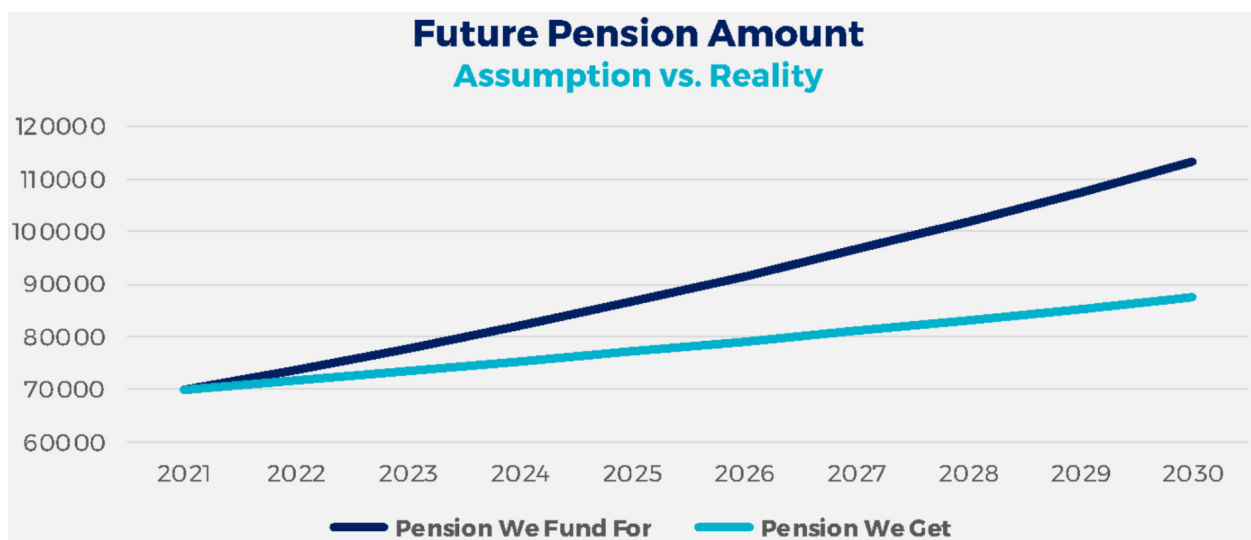
# SURPLUS

## Why would there be a surplus?

It cannot simply be the case that all IPP plan members have been earning above-expected returns, can it? As it turns out, no. The issue has more to do with the Maximum Funding assumptions—with one specific assumption having an outsized impact on the amount members are allowed to contribute to the plan and as a corollary the surplus position of the IPP at windup. That is, the assumption that the maximum annual pension accrual unit (2% of earnings up to an annual maximum) increases at a rate of 5.5% per year.

When determining how much can or should be put into the plan, a plan actuary will first look at how much pension income they expect the plan member will be owed at retirement. If they must assume that maximum pensionable earnings will increase 5.5% year-over-year up until retirement, \$1 of accrued pension today will be much more expensive to support 10 years out when it is inflated annually by 5.5%.

As an example, if your total accrued pension today is \$70,000 and your assumed retirement date is 10 years down the line, the actuary must assume that the future value of your current pension accrual at retirement will be \$113,336. From there, the actuary then applies other mandatory funding assumptions to calculate how much needs to be in the plan to endow this annual pension amount.



At issue is the fact that maximum pensionable earnings have **increased by far less** than actuaries are forced to assume—only 2.5% on average over the last 10 years. In our previous example, this would mean that the future value (at retirement) of the current accrued pension would only be \$87,420 at windup. The difference of \$25,916 is important; when the plan is wound up, the number used in the MTV calculation is the actual realized Normal Form Pension amount, rather than its projected value. Without considering any other factors such as higher-than-expected real investment returns, this scenario could result in 23% of the IPP value becoming taxable income at windup.

Effectively, the disconnect between assumed rates and realized rates can allow plan members to fund their IPPs on an ongoing basis at much higher rates than would be permitted in an RRSP, but if they choose to wind up the plan, some of this extra room will be forfeited.

### **How to Plan for the Surplus**

The likelihood of a surplus under maximum funding assumptions does not necessarily have to be viewed as a negative. Instead, it brings up very interesting questions:

1. How valuable is the IPP deferral if you max fund the plan and pursue a windup?
2. Would the IPP outperform an RRSP if you underfunded the plan (funded to the MTV)?
3. Is there an opportune age to set up and wind up the plan?

To answer these questions, let's once again examine our 60-year-old IPP candidate.

#### *1. Maximum Funding the Plan*

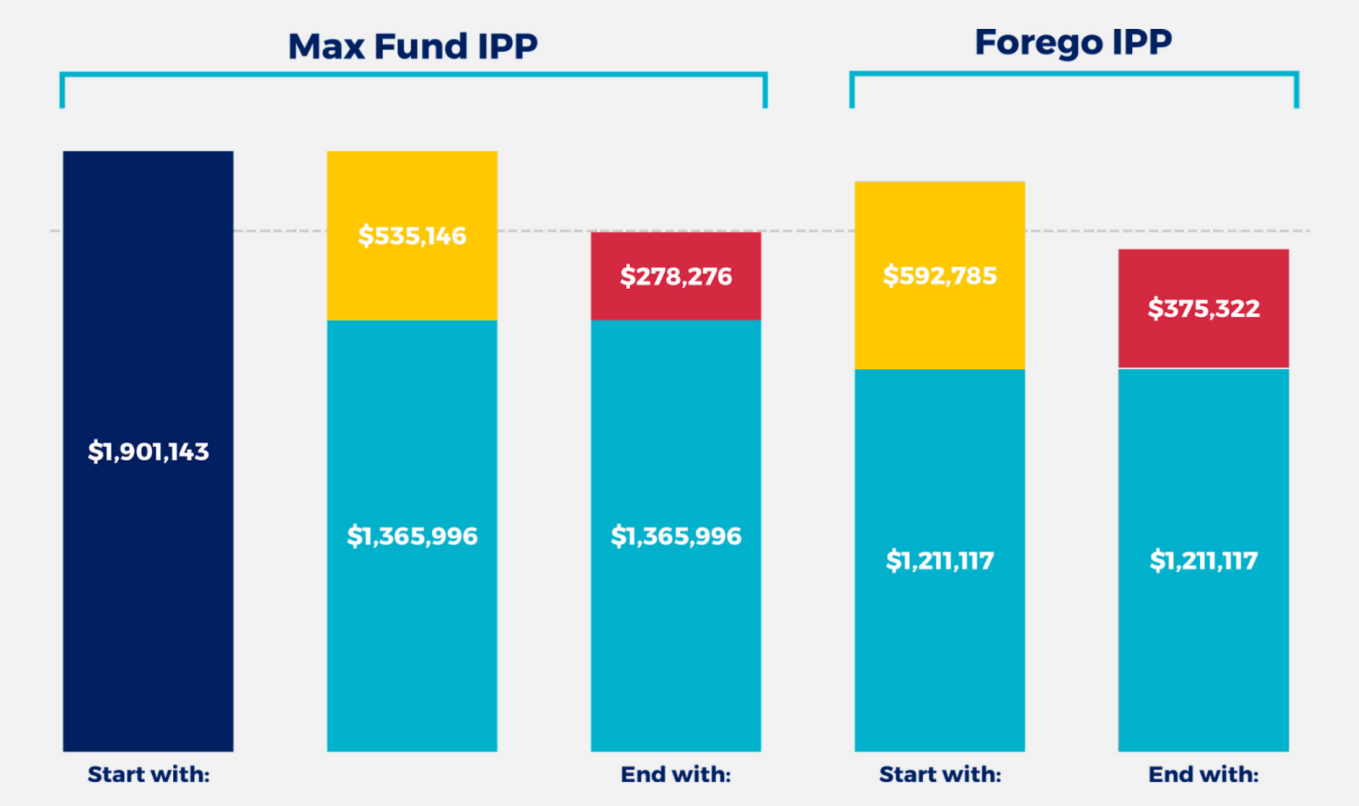
At setup, we determined that their accrued Normal Form Pension was \$97,388.80 and their first-year contribution room was \$538,460 (past service plus current service). To secure the full past service contribution amount, they would need to make a qualifying transfer from their RRSP equal to \$792,060. Over the next 5 years, they will then be able to make annual contributions of \$45,344; \$46,204; \$47,080; \$47,972; and \$46,924 (assuming maximum pensionable earnings).

If they fully fund the pension and their investments return by 5%, at the end of the year in which they turn age 65, they will have an IPP with a fair market value of \$1,901,143.

If maximum pensionable earnings increase by 2.5% annually up until their retirement, their normal form pension will be \$110,161 and their MTV will be \$1,365,996. After windup and applying a top marginal tax rate of 48%, they will have after-tax cash of \$278,276.44 and a LIRA with a fair market value of \$1,365,996.

Our IPP candidate may have decided to forgo the IPP and instead continue to maximum fund their RRSPs annually while keeping an excess retained earnings in their corporation. In this case,

at age 65, they would have an RRSP with a fair market value of \$1,211,117 along with a corporate investment account worth a fair market value of \$592,785 (estimated \$375,322 after-tax on-hand value to the plan member)<sup>5</sup>.



Looking at the results, we can conclude that our IPP candidate would be slightly better off having gone the IPP route rather than sticking with RRSPs. However, given that the difference is relatively small, the benefit **may not be valuable enough** to offset the extra costs and complexity associated with running an IPP. The client certainly is not harmed by the IPP, but they are also not seeing a game-changing difference in their accumulated retirement savings.

If this scenario was reviewed prior to implementation, the client may or may not choose to go the IPP route. Either way, they would have a better understanding of their purchase, which is a positive for everyone involved. The bottom line is that if the intent and implications of an IPP have not been reviewed with your client before or since the initial setup, a checkup is required.

**2. Underfunding the Plan (Funding to the MTV)**

An alternative method for getting around the MTV concern would be to fund only up to the MTV.

<sup>5</sup> Assumes SBR environment, 60% equity / 40% fixed income portfolio, 20% annual turnover, 6.35% return on equities, 3% return on fixed income.



In practice, given a relatively reliable estimate of future increases to the maximum pensionable earning unit and future investment returns, this would not be difficult to accomplish. For our 60-year-old candidate, the goal would be to maximize contribution amounts without causing the market value of the account to surpass \$1,365,996 at the end of year 5. In our case, this could be accomplished through a \$216,926 reduction of the company's initial past service contribution and elimination of all future current service contribution amounts. Setting up the IPP would then create a lump sum corporate deduction of \$314,494 at the expense of forgoing total combined RRSP contributions of \$143,284 over the next 5 years.

Building on this minimization strategy, we could aim to fund up to the MTV plus one year of regular income, which would open slightly more funding. In this way, the taxable surplus in the year of windup would need to be offset by reducing all other regular sources of income. Typically, even for a client aged 71, the taxable surplus is triggered one year before regular minimum payments begin, so it would just be a question of whether they could halt all other sources of income in the year of windup.

Again, looking at the results of this alternative, we would suggest that there are still slight benefits provided by the IPP, but a question remains as to whether it is worth the hassle.

### *3. Choosing an Opportune Setup Age*

There are a lot of moving parts to consider in relation to this point. It is not as simple as waiting until age 40 and then calling an actuary. The opportune age will differ from client to client and period to period. All that can be said is, as a rule of thumb, the closer one is to their retirement (windup) date, the less impact the 5.5% AIW (Average Industrial Wage) annual increase will have. Therefore, in a scenario in which the plan member intends to fully fund the plan, the taxable surplus at windup will be smaller the closer they are to age 65 (all things held constant).

We suggest that clients begin looking at their possible entry and exit points early but hold off on implementation until the opportune moment. These entry points will need to be regularly updated based on the client's objectives, financial position, and investment experiences. Doing so will ensure that when they eventually set up the plan, they get the biggest bang for their buck.

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Referring to IPPs as a "super-charged" RRSP is a misnomer. If the client plans to wind up their IPP in the future, a more accurate description would be that IPPs are a "somewhat better" alternative to an RRSP. To ensure that this holds true, and that there are no surprises at retirement, careful planning is needed throughout the client's earning years.

## *Option B: The IPP Becomes a Pension*

The IPP is usually pitched as a method for creating a large tax-deductible expense to the corporation, but the value really comes from the tax deferral within the plan. As reviewed, going the windup route makes it challenging, if not impossible, to maximize both benefits. Either you fully fund the plan and then lose a substantial portion of the deferral, or you under fund the plan to keep all the deferral but lose out on extra corporate deductions. A fair number of business owners would not be in the position to fund an IPP in the first place if they were content to settle for this type of either/or scenario.

There is, however, a third option, which is to **use the IPP as intended**. Although there will be other implicit costs associated with going this route, electing to take a pension from the plan allows one to maximize both the corporate deductions and the deferral.

Over the last couple of years, Qube has started to promote this option more frequently to clients. The factors that made us previously balk at this option are still present: less freedom to withdraw from the investment accounts (set annual withdrawal amounts), ongoing filing requirements, and ongoing actuarial costs. But when the client understands and accepts these drawbacks, the benefits can outweigh the costs.

By electing to take a pension from the plan, the MTV is no longer a concern. Therefore, although all previous discussion regarding enhancement of past and current service contributions are still relevant, there is no other shoe waiting to drop. The plan member can fund the plan as they desire—up to the set limits.

### **Taking a Pension**

At retirement, to commence no later than the end of the year in which a plan member turns 71, all future service accruals will be terminated. The annual pension amount will be based on all service accrued up to that point in time. For clients age 66 and over, this amount will be adjusted to account for the delayed retirement (comparable to delaying CPP or OAS payments).

Since an IPP is a defined benefit pension plan, it must provide members with a lifetime pension when they become annuitants. The IPP carries a basic 66.67% survivor benefit with a five-year

guarantee. In other words, if the plan member dies, 100% of the pension payments will continue to be paid out for a period of 5 years from the date of the annuitant's retirement and, thereafter, annual pension payments will be reduced by one third.

Fortunately, we can make custom enhancements to the plan by adding on optional pension benefits. These options will be stipulated in the terms of the plan prior to commencing payments and will change the final pension amount<sup>6</sup>. The usual customizations include:

- Changing the length of the guarantee period
- Changing the survivor benefit percentage (no lower than 66.67%)
- Fully indexing pension payments to CPI

These adjustments are separate from the terminal funding enhancements which can open considerable extra funding room at pension commencement. Unlike the terminal funding enhancement, these customizations **do not change the funding limits**. Instead, they will only alter the amount that must be paid out annually to the plan member.

### **Planning to the Pension**

Since the taxable surplus is no longer a concern, one may presume that there is no reason not to fully fund the pension plan. Should it be obvious for the plan member to max out all regular funding opportunities and then top the plan off by making terminal enhancements?

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A word of caution is required here. Since the pension payments will not be affected by past or present contributions, maximum funding could lead to a situation where the plan member's estate benefits more from the marginal contributions than the plan member.

Unless estate maximization is an ancillary goal of the IPP, we would suggest that there is goldilocks zone for plan funding. The question in this case becomes not: "How much can I put into the plan?" But rather: "How much should I put into the plan if my goal is to sustain regular pension payments for a reasonable period without locking up excess funds?"

Commencement of the pension does not change how plan assets are invested. To determine the optimal amount required in the plan, we can use a [Monte Carlo simulation](#) on future expected returns or withdrawals.

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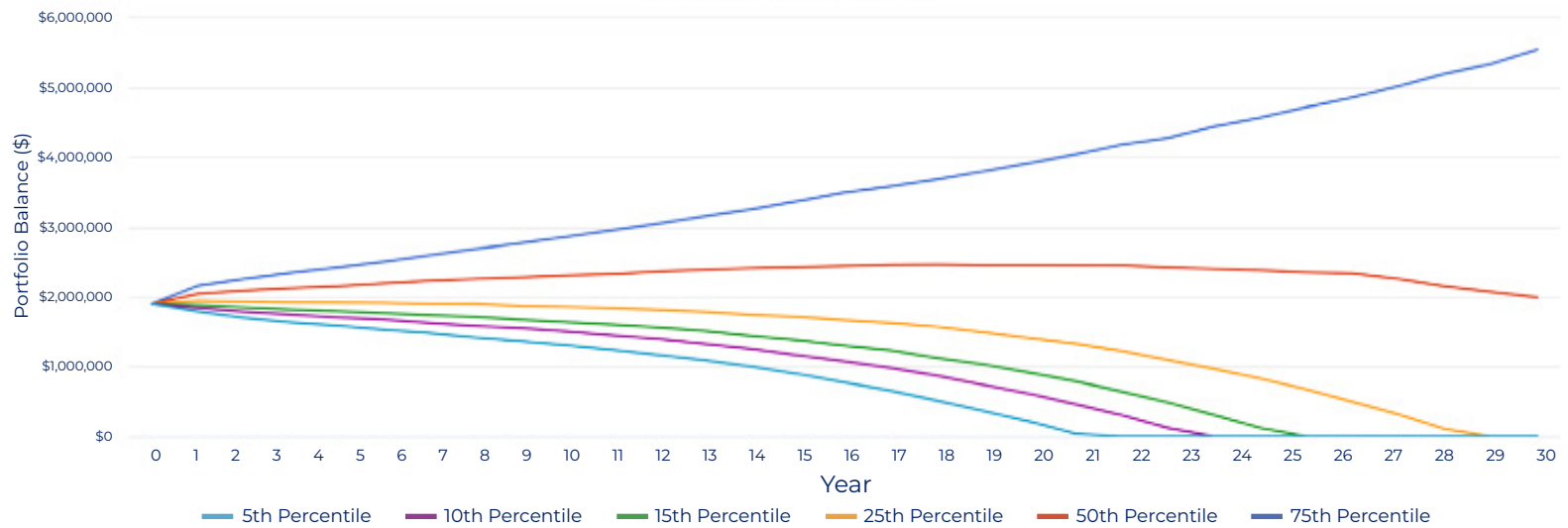
<sup>6</sup> Increases to the guarantee period or survivor benefit must be done on actuarial equivalent basis, which means that the member must forgo a portion of their lifetime retirement benefits to get the increased guarantee.

## No Estate Maximization Objectives

For our 60-year-old, we know that they will have an accrued pension benefit of \$110,161 at age 65. We also know that, if they had fully funded their plan and achieved a 5% annualized return on the investment, the fair market value of their IPP would be \$1,901,143 at retirement.

To determine whether this would be enough capital invested to sustain an annual inflation adjusted withdrawal of \$110,161 up until the plan member's age 90, we ran their 70% equity/30% fixed income portfolio through a Monte Carlo simulation.

### Simulated Portfolio Balances



In 84% of the scenarios run, the initial capital investment of \$1,901,143 would sustain annual inflation adjusted withdrawals of \$110,161 for at least 25 years<sup>7</sup>. Depending on the client's objectives and preferences, this may represent too high of a probability that they will not be able to spend all that they had saved for retirement. In which case, we would want to reduce a portion of the contributions made to their IPP.

Note here that unlike a standard retirement analysis, depleting the IPP assets will not expressly result in ruin for the client. Typically, IPP plan members will have additional retirement savings held outside of the IPP, in which case, we can be slightly more aggressive with our confidence bands for this analysis.

In a scenario where the client is satisfied with a 50% chance that their IPP assets would sustain

<sup>7</sup> Monte Carlo simulation results for 5,000 portfolios with \$1,901,143 initial portfolio balance using available statistical model data from January 1988 to December 2020. Returns were modeled as correlated random samples using a stochastic volatility model. The historical pre-tax return for the selected portfolio for this period was 9.10% mean return (8.64% CAGR) with 8.33% standard deviation of annual returns. The simulated inflation model used historical inflation with 2.50% mean and 1.12% standard deviation based on the Consumer Price Index (CPI-U) data from January 1988 to December 2020. The generated inflation samples were correlated with simulated asset returns based on historical correlations. Our 60-year-old's portfolio is made up of 15% MSCI ACWI Market Gross Index (\$CAD), 45% SP 500 Gross Index (\$CAD), 10% S&P TSX Gross Return Index (\$CAD), and 30% DEX Canadian Bond Universe Index (\$CAD).

annual inflation adjusted withdrawals past age 90, accumulated pension funds at age 65 would need to be reduced to approximately \$1,550,000. This would require a reduction of approximately \$375,00 in prior funding.

### **Maximizing Income and Estate Value**

Alternatively, if the client has an estate maximization goal, the IPP could be beneficial. First, the tax deferral on invested funds is quite valuable. Second, all investment management fees charged to the IPP remain tax deductible to the company throughout the life of the plan (a benefit not available through other tax-deferred accounts).

Lastly, any funds left in the IPP after the client and their spouse pass away would belong to the **last surviving spouse's estate** rather than the sponsoring company. The funds would be distributed in accordance with the beneficiary designations or the will. Designated beneficiaries would each receive their allocated share **pre-tax** and would include the amount received as income on their tax return. This differs from the treatment of RSPs and RIFs, where the estate first pays the taxes and then distributes the after-tax funds to the designated beneficiaries. In the case that splitting the IPP's market value across multiple beneficiaries would reduce overall taxes, this is a compelling planning point worthy of review.

One caveat is that if terminal funding is pursued and fully funded, the expectation is that plan member(s) will continue receiving a pension from the plan for the remainder of their lives (and to do so, the plan must remain in existence for the duration). An IPP must have a plan sponsor to remain in existence.

Note that terminal funding amounts are voluntary and can be amortized over several years. In a sense, this additional feature allows one to keep benefitting from annual tax-deductible contributions to their IPP while simultaneously drawing annual income from the IPP.

If the client later decided to wind up their corporation (whether through the sale of the company or simply a closure), they would need to change the sponsor of the plan to another eligible company. If no alternative sponsor was available, the

plan would have to be wound up, in which case having taken advantage of the terminal funding option would create a higher taxable lump sum payment.

Electing to take a pension from the IPP allows one to fund the plan without concern for a looming tax bill. In this situation, an IPP provides a much larger long-term tax deferral than allowed through an RRSP. The only drawback pertains to liquidity concerns. Unlike with an RRSP, the client's annual income from the IPP will be limited by prescribed maximums. Therefore, care must be taken to ensure the client has sufficient external sources of income to support additional spending needs. As well, funding may still need to be pulled back slightly where the client's intent is to draw all plan assets down to \$0 by the end of their expected lifetime.

# CONCLUDING REMARKS

Until retirement, little thought is usually given to what happens to the IPP and its assets at that point in time. Plan members often expect that the IPP will be wound up and the money will be transferred to a LIRA so that they can have the flexibility to draw and defer income as part of an overall financial plan. Unfortunately, the end to an IPP is not always so straightforward.

As such, we believe the planning focus for IPPs needs to shift from how much contribution room is opened to how much of the tax deferral can be kept. This level of planning will require much more expertise on the part of trusted advisors.

Having spent a considerable amount of time researching the many nuances of IPPs (some covered in this paper and others still left out for the sake of brevity), our perspectives on how best to optimize the benefits of an IPP have changed. Though there continue to be advantages provided when a client elects to wind up their IPP, they may be more moderate than presented. The focus should be less on marketing the short-term benefits of an IPP and more on the benefits of the plan within the context of the client's long-term objectives.

Should you or your clients have any questions related to a prospective or existing IPP, we welcome the opportunity to weigh in on the best course of action going forward.



**Qube Investment Management Inc.**

Kendall Building  
9414-91 Street  
Edmonton, AB T6C 3P4

Phone (780) 463-2688  
Fax 780-450-6582  
Email [info@qubeinvest.ca](mailto:info@qubeinvest.ca)  
[www.qubeinvest.ca](http://www.qubeinvest.ca)