An introduction to:

The Individual Pension Plan

An opportunity to have your cake and eat it too!

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**What is an Individual Pension Plan?**

An Individual Pension Plan (IPP) has been called a ‘supercharged RRSP.’ More formally, it is a registered, defined-benefit pension plan for an individual or group of individuals. Its existence enables a business owner or executive to have a personal pension plan that will pay a predetermined pension income based upon his or her years of service and income earned similar to pensions of government employees and teachers.

The plan must be sponsored and funded by an incorporated employer; though the plan member may assist in funding the plan. They may be set up for one person or for a group of employees within the same company.

**Who is a potential IPP candidate?**

These plans are commonly set up for owners of private corporations. They may also be set up for key executives of a corporation or by professionals, such as doctors and dentists, who have professional corporations from which they draw a salary. IPPs may also be set up for the spouses of business owners if the spouse is an income-earning employee of the corporation.

A proprietor or partner of a non-incorporated firm is not eligible to participate in an IPP but an employee of a proprietorship or partnership can participate provided the proprietor/partners sponsor the plan.

While there is no age or income limit, it is not economically feasible to set up an IPP unless the individual is over 40 years of age and has had income that has allowed them to contribute the maximum amount into their RRSP. A rule of thumb is an income of at least $100,000.

**How it Works**

An IPP allows an incorporated company to establish a registered pension plan in the name of a single employee and to make annual pension contributions (including retroactive contributions) that far exceed annual RRSP contribution limits. These contributions can be made by the company or jointly by the employer and employee.

Upon retirement, the holder of the IPP will have a retirement benefit which is generally much greater than through an RRSP. At that time, the plan holder has several pension choices available to them.

To qualify as a plan holder, you must receive remuneration from your employer in the form that is reported on a T4, T4A or T4PS slip. This typically represents income in the form of salary, wages, bonuses, taxable benefits and allowances, and distributions from employee profit sharing plans.

Dividends are not eligible and thus, if you are the plan member and you own the business, you will want to ensure that enough salary is paid to you in order to generate the maximum contribution room.
So what are the advantages of an IPP?

There are many advantages of the Individual Pension Plan over the traditional RRSP which itself is an excellent retirement savings vehicle. The most obvious advantage is that as a member, you will receive a pension amount that is known in advance and is generous in the amount it will pay out. If the rate of return in the portfolio falls short of the targeted 7.5% required return then the company is able to contribute more funds to top up the plan.

All amounts paid into the IPP by the company are tax-deductible to the company. The company can deduct the amount that is contributed into the IPP and this amount is greater than RRSP limits. Contributions into an IPP increase with your age unlike RRSPs which remain a predetermined maximum with no regard for age. RRSP contributions must be made within 60 days of the calendar year to qualify for a current year write-off but contributions to an IPP are deductible if they are made within 120 days of the fiscal year end.

It is important to note that the IPP may be established after the corporate year-end but it must be submitted for registration before the calendar year-end to qualify.

All other fees associated with the IPP (such as actuarial costs, set up fees, and portfolio management fees) are also deductible to the company. If the company borrows to contribute into the IPP, the interest costs are deductible whereas the interest on an RRSP loan is not deductible.

In the event that the holders or sponsor of an IPP run into financial trouble, the holders have the comfort of knowing that the assets in their plan are generally protected from creditors, as long as it was set up in good faith. Currently, most RRSPs do not offer this protection, which can be of great importance to a business owner.

The IPP can recognize past service since 1991 (and in a few cases pre-1991) and the past service contributions can be paid and deducted immediately or amortized up to 15 years.

IPPs can be implemented to age 69. At the discretion of the company and depending on the retirement payout option chosen, terminal funding may be provided to allow early retirement with full pension, bridge benefits for CPP and OAS and full inflation protection.

The IPP is professionally managed and subject to stricter investment disciplines than RRSPs.

How about the disadvantages?

There are a few disadvantages to Individual Pension Plans.

There is no spousal IPP so income splitting as per a spousal RRSP is not possible. However, if a spouse is an employee of the same company, he or she may also be included in the pension plan.
An IPP is not as flexible or liquid as an RRSP. You can always deregister part of an RRSP if you find yourself desperately short of cash. However, you have no access to the funds inside an IPP while you are employed; and once you are retired, the employer portion of the IPP is locked-in, so you are restricted as to how much you can access each year.

There is more legislation governing IPPs and hence there are higher expenses involved. It must be set up by an actuary and registered with the Canada Revenue Agency (CRA). Funds are held in a trust which must be audited by an actuarial firm every three years. The good news is that all expenses associated with the administration of the IPP are fully deductible from current corporate income.

If the portfolio earns an excess return, it may reduce future contributions. This may not be a significant negative because some people appreciate the reduced cash flow requirement that would leave more money in their company after-tax. IPPs are more conservatively invested which mitigates some of this risk.

**How are IPP contributions calculated?**

Eligible IPP contributions are calculated by an actuary using assumptions that are mandated by the Income Tax Act. The actuary will calculate the current service costs as well as any past service costs which may be contributed.

The actuary will also calculate any terminal benefits, if desired, and will usually assist in filing the proper ongoing documents required by the CRA in order to keep the pension plan operational.

**What happens when I’m ready to retire?**

As the pension plan member, you can elect to commence pension payments anytime from the age of 50. You may be subject to a reduced pension but, as previously mentioned, there may be terminal benefits available which, if you choose to fund them, will enable you to receive a maximum pension payout and CPP/OAS bridging benefits, if desired.

If you prefer to retire later in life, you can continue to participate in the IPP as long as you continue to receive T4 income up to the end of the year that you turn 69.

In order to provide an annual pension income you can choose one or a combination of the following:

**Life Annuity:** A life annuity is an annuity that will pay you for as long as you live. Should you pass away, the annuity policy can be set up to continue 2/3 of your payout to your surviving spouse. You can elect to have a minimum guarantee payment to your estate should you and your spouse pass away within a given period of time. The normal guarantee is for five years if you have a spouse and 15 years if you do not. The annuity can be indexed to inflation through a CPI-1% formula.
If you opt for no guaranteed minimum payment then any funds remaining in the IPP upon you and your spouse’s death are retained by the insurer.

Choosing the annuity option allows you to fund terminal benefits, including the bridging benefits, full CPI indexing and an unreduced early retirement pension. If the IPP is overfunded, you do not have to take the surplus out of the plan and if underfunded you can either top up the plan or amend the plan so that the benefits correlate to the amount in the plan.

**Payment from the IPP:** You can elect to receive an immediate or deferred pension payment from the plan itself. Deciding on taking payments at a later time may be advantageous in some circumstances.

In the event of death (of you and your spouse), the assets in the plan will go to your designated beneficiary, subject to taxation, but there is still an estate value.

This option also allows you to fund terminal benefits and surplus assets can remain in the plan.

If returns of 7.5% are not earned in the plan, then the sponsoring company may have to top up the pension and this might not be possible or desirable to the company if you are no longer involved with it. As well, if you choose this option, you will also have to continue to pay ongoing actuarial and administration fees. Very few people choose this option.

**Transfer the assets to a LIRA, LIF or LRIF:** These are simply locked-in versions of RRSPs and RRIFs. A LIRA is a locked-in RRSP that can not be collapsed and must eventually be rolled into a LIF, LRIF or annuity.

A LIRA is ideally used when you are not yet prepared to take monies out of the IPP. Otherwise, depending on the pension legislation followed, the assets would be transferred to a Life Income Fund (LIF) or a locked-in Retirement Income Fund (LRIF) and a pension would be dispersed based within the minimum and maximums allowed by the legislation. Most IPPs would follow under provincial legislation and thus would have both LIF and LRIF options available. Since current legislation has eliminated the need for LIFs to be converted to life annuities at age 80, these will likely become the more popular choice.

Most people choose this option since it grants the most amount of flexibility and the assets go to your spouse or beneficiary upon your death.

A big negative is that this option does not allow for terminal funding opportunities and if the plan is overfunded, the excess amount is paid to the annuitant in a lump sum that is subject to tax. There is some flexibility in that many members will transfer the plan assets to a LIRA thereby foregoing any current year income and will use the excess assets as current year income.
What happens if I die before I retire?

If you should die while a holder of an IPP (i.e. before retirement), all the assets within the plan are available for transfer to your spouse, another beneficiary or to your estate. Transferring the assets to your spouse can be done so on a tax-free, rollover basis (subject to an allowable funding maximum). If a spouse is living at the time of your death, then the spouse must be the beneficiary.

These rules are no different than those available to employees of defined benefit pension plans.

How will the assets be invested?

IPPs have more strict rules than regular RRSPs and are usually professionally managed so that you are relieved of the burden and stress of managing your money and to ensure that the regulated investment standards are followed.

In general, if investments are allowed inside an RRSP, they are also allowed inside an IPP. There are no foreign property restrictions.

Prudent Man standards apply to each investment to ensure appropriate quality and diversification. If the sponsoring company is a publicly traded corporation, there is no investing in the securities of the sponsoring company.

Example of an IPP in action

Victoria Client is 50 years of age and owns a brewing company from which she has earned a salary of $150,000 since 1990. Her RRSP is worth $253,000 and she has no contribution room currently available.

If Victoria was to establish an IPP for herself through her company, she would have to transfer $214,200 from her RRSP into her IPP (this is known as a qualifying transfer) and her company can contribute an additional $86,212 as a lump sum or through amortized payments over a set period of time (the time frame determined by Victoria). If Victoria’s company borrows to make any of her contributions the interest will be tax deductible.

At age 65, using a 7.5% return assumption and based on maximum contributions being made, the combined value of Victoria’s remaining RRSP and IPP will be worth almost $1,866,000 whereas if Victoria only continued to maintain and contribute to her RRSP the value of the RRSP would be worth about $1,314,000. The difference of $552,000 is an increase of 42% over the RRSP and provides substantially higher retirement income.

If the IPP fails to earn 7.5%, then Victoria can increase her contributions to make up the shortfall whereas if the RRSP fails to earn 7.5%, oh well.

If Victoria chooses to retire as early as age 55, her company can fund terminal benefits in order to maximize the amount of pension Victoria is to receive.
Summary

While not for everyone, an IPP creates a personal pension plan that provides tax-free growth well beyond the contribution limits of an individual RRSP and reduces taxes for the corporate employer of business professionals. The IPP allows for higher contributions, creditor-proofing, greater tax deductibility and higher investment standards. It does so at greater cost to the corporate sponsor.

IPPs are important vehicles for owners of cash-rich companies to provide themselves with a comfortable retirement.

Please call me to see if an IPP makes sense for you as a pension option.

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