Individual Pension Plans (IPPs)

Introduction

An Individual Pension Plan (IPP) enables an owner-manager or a corporate executive to save for retirement by making tax deductible contributions from the company that may be larger than those allowed for a registered retirement savings plan (RSP). An added bonus is that funds within an IPP are generally protected from creditors.

What is an IPP?

An IPP is a defined benefit (DB) registered pension plan with the benefits designed to suit the needs of the individual employee.

IPPs have been around for many years; however, their popularity has increased recently because of a number of factors:

- The maximums that can be contributed to a pension have increased in the past few years allowing larger tax deferrals and larger pensions.
- The fees to set up and maintain the plans have decreased.
- The “boomer” bulge: boomers are now in the age range where tax deductible contributions to an IPP are significantly higher than those allowed into an RSP.

How Does an IPP Work?

A DB pension plan provides a retirement benefit based on factors such as years of service with the company and salary level. Under a DB plan, the company is responsible for funding the pension such that it will be able to pay out a pension defined by a pre-set formula. For instance, a commonly used formula to define the annual pension is 2% times the average salary for the 5 years before retirement times the number of years of enrolment in the pension plan. For someone whose average earnings is $110,000 and has been a member of the pension plan for 20 years, the annual pension will be 2% × $110,000 × 20 years = $44,000. There are, however, limitations on the benefits that need to be taken into account when investigating the IPP option. One such limitation is the maximum salary amount on which the pension can be based. For 2012, that amount is $132,333.

Under a DB plan, what is known now are the future pension payments that will be paid out during retirement; what is not known are the contributions needed to fund the pension between now and when the pension payments commence. This contrasts with a defined contribution (DC) pension plan or an RSP, under which the annual contributions are known but the eventual payouts depend on the funds accumulated within the DC plan or RSP account.

An IPP is relatively easy to set up, but it does require the involvement of several different parties:

- The trustees (3 individuals or 1 corporate trustee) oversee the running of the pension plan and are appointed by the pension plan administrator, which is usually the owner-manager’s or executive’s corporation.

- An actuary is engaged to determine the contribution amounts and must perform a review every three years to ensure the plan is adequately funded. Often the actuary or a consultant will assist in the setting up and maintaining of the pension plan including drafting the initial registration documentation and annual filings for the Canada Revenue Agency (CRA) and provincial or federal pension authorities.

- TD Waterhouse will act as custodian for the investments and assist the trustees to manage the funds within the plan.

Making Contributions

Contributions to an IPP can be made by the employer or the employee, but in most cases the employer is the sole contributor for the annual funding requirements. The annual contributions are determined by the actuary. The company needs to make the contribution within 120 days of the corporation's fiscal year-end in order to be able to deduct them as an expense in the year.

When the IPP is being set up, there is the ability to take into account previous years that the employee has worked for the corporation (going back to 1991). This "past service pension adjustment" (PSPA) allows the pension formula to include the past years when calculating the future benefit, i.e. the years of service factor is increased by the past years of employment or 'service'. The funding for the PSPA generally comes from a combination of a "qualifying transfer" from the employee's RSP to the IPP and from employer's contributions. The employee's RSP is used first so that the employee doesn't get both an RSP contribution and an IPP pension plan contribution for the same time periods. After the RSP transfer amount is determined, a calculation is made to determine the employer's portion of the past service funding requirement.

For IPPs established after March 22, 2011, past service deductions are only permitted to the extent that the value of the past service benefits to be granted exceed the maximum of a prorated portion of RSP assets that can be transferred into the IPP, or a stipulated calculated amount; or after all unused RSP contribution room has been applied. The proration factor is the number of years of past service / (lesser of 35, age – 18). The reflection of a prorated portion of RSP assets was a new addition introduced into the legislation as of March 22, 2011 (and subsequently passed), and this may reduce the size of the IPP past service deduction. However, it may only impact those who have RSPs that have performed very well during the person's lifetime, otherwise this adjustment in many cases will have little or no effect.

An actuarial valuation of the pension plan is usually required every three years. At that time, it is determined whether the plan has sufficient monies to fund the projected pension. Depending upon whether there is a funding shortfall or surplus, new employer contribution amounts are then recommended in order to ensure the plan can meet its future obligations. The Income Tax Act (Canada) specifies the parameters to be used in the benefit projection. If the actual results differ, for instance the portfolio return is less than the specified 7.5%, then top-up contributions may be made during the lifetime of the plan or when the employee is ready to retire. Most provinces require any underfunding to be made up over a period of years, e.g. over a 15-year period or until age 65, but BC, Alberta, Manitoba and PEI do not require the underfunding to be made up. If the corporation does need to borrow in order to meet its funding obligation, the borrowing costs are tax-deductible; note however, that the IPP cannot be used as collateral for the loan.

It is interesting to note that, whereas poor investment returns and capital losses in an RSP cannot be made up with additional contributions, in an IPP they potentially can. If the funds within the pension plan are not sufficient to fund the projected pension payments, additional contributions can be made to bring the plan up to the required level, effectively making up for the losses or the poor investment returns.

At Retirement

At retirement (or by age 71 at the latest), the pension plan member has a number of options to access the pension funds.

1. Making periodic pension payments from the pension plan. The trustees are responsible for ensuring the appropriate withholding taxes are remitted to CRA for each payment.

2. Winding up the plan and transferring the commuted value to a locked-in registered plan such as a locked-in RSP, LIRA, LRIF or LIF. (Some exceptions exist, such as Quebec where the funds are not locked-in for specific types of IPPs). If the plan is overfunded at that time per an Income Tax Act (Canada) formula, the excess is paid out to the plan member as a fully taxable payment.

3. Purchasing a life annuity.

At retirement, there may be an opportunity to make a final 'terminal funding' contribution which will top up the plan for the then existing conditions such as actual retirement age. This may be a good way to remove excess funds from the company as a tax deductible expense and yet defer including the funds in the employee's immediate income.

Example – Pat Rite

Pat Rite turns 52 in 2012 and has been running his small public relations firm, PR Inc., since 1991. His salary in 2012 is $132,333 (maximum earnings utilized by the plan) in addition to dividends issued to him as sole shareholder. Both he and his spouse were able to save a significant portion of their combined incomes. He has made RSP contributions in the past and now has a personal RSP worth $406,120. Pat is interested in saving taxes and making sure his retirement is funded adequately.

Pat fits the criteria for an IPP. He is over age 40, has high salary income from an incorporated company and has good cash flow capability.

Let's compare the contributions that can be made to the IPP versus the allowable contributions to an RSP (based on the rules as of January 2012). For instance, the table shows that when Pat is age 60 the IPP contribution can be $53,800 versus only $34,700 to an RSP. Note that the IPP contributions exceed the RSP contributions by an increasingly greater amount as age rises.

Year	Age	IPP Contribution		RSP Contribution
2012	52	$30,200		$22,970
2013	53	$32,400		$23,820
2014	54	$34,900	*	$25,100
2015	55	$37,500	*	$26,500
2016	56	$40,300	*	$28,000
2017	57	$43,300	*	$29,500
2018	58	$46,600	*	$31,100
2019	59	$50,000	*	$32,800
2020	60	$53,800	*	$34,700
2021	61	$57,800	*	$36,600
2022	62	$62,200	*	$38,600
2023	63	$66,800	*	$40,700
2024	64	$71,900	*	$42,900
2025	65	$77,200	*	$45,300

** Years 2013 to 2024 are estimates only*

Since Pat has been employed by his corporation since 1991, he can have 1991 to 2011 taken into account when calculating his years of service. The funding required to add the extra 21 years of service is calculated by the actuary and takes into account Pat's RSP account balance and potential contributions by PR Inc. His RSP of $442,940 can be rolled into the IPP as a qualifying transfer to fund part of the PSPA. The employer's contribution of $191,260 can be made by the company in the current year or over a period of years. If the company makes both of its 2012 contribution of $30,200 and the past service in 2012, the total tax deductible contribution expense for the company will be $221,460 during 2012.

At retirement, there is an opportunity for Pat to use the excess cash that was built up in the company to fund extra pension benefits. The table shows how the pension increases if the company tops up the plan when Pat retires. For instance if Pat retires at age 60, the company can make a one-time terminal funding contribution of $630,604 and thus boost Pat's annual pension from $100,123 to $132,143.

At Age	Terminal Funding	Annual Pension Income	
		No Terminal Funding	With Terminal Funding
55	$467,340	$52,211	$72,487
60	$630,604	$100,123	$132.143
64	$310,161	$161,070	$186,281

Let's now compare the two scenarios where Pat contributes to both an IPP and an RSP versus him contributing to an RSP and a non-registered account. The table shows how the funds will accumulate under the two scenarios.

Year	Pat's Age	Scenario 1 IPP + RSP	Scenario 2 RSP	Non-Registered
RSP Qualifying Transfer		$442,900	$442,900	
Past Service Contribution		$191,260*		$129,101
2012	52	$713,055	$499,949	$140,640
2013	53	$800,149	$562,158	$153,698
2014	54	$896,369	$630,361	$168,261
2015	55	$1,002,502	$705,132	$184,393
2016	56	$1,119,501	$787,067	$202,240
2017	57	$1,248,388	$876,703	$222,029
2018	58	$1,390,364	$974,722	$243,997
2019	59	$1,546,517	$1,081,857	$268,253
2020	60	$1,718,323	$1,198,997	$295,052
2021	61	$1,907,165	$1,326,894	$324,662
2022	62	$2,114,734	$1,466,459	$357,431
2023	63	$2,342,645	$1,618,670	$393,589
2024	64	$2,592,939	$1,784,579	$433,585
2025	65	$2,867,505	$1,965,421	$477,613
	Values assume a growth rate of 7.5% p.a. and a corporate tax rate of 32.5% p.a. ** Assumes no offsetting qualifying RSP assets are available for transfer and no unused RSP contribution room exists*			

1) The IPP + RSP column assumes that contributions are made to an IPP and RSP. The annual RSP contribution room available to Pat is $600.

2) The RSP column shows the accumulation of funds within the RSP only assuming an IPP is not used.

To make it a fair comparison, the amount in excess of the IPP contribution level over the RSP contribution room is invested into a non-registered account on an after-tax basis.

In the first scenario, Pat will have accumulated $2,867,505 when he turns 65. In the second scenario, he will have accumulated $1,965,421 in the RSP and $477.613 in the non-registered account. Considering these amounts on an after-tax basis, the first scenario will still result in a larger balance to fund Pat's retirement when he uses an IPP.

Please note that if the past service contribution of $191,260 can be offset through the transfer of other RSP assets (pro-rated as specified earlier) or by the application of unused RSP contribution room (for IPPs established after March 22, 2011) then the differential will be reduced. In the worst case for Pat (i.e. where the past service contribution is completely offset), this would result in $2,449,521 being accumulated in the RSP and $219,864 in a non-registered account (calculations not shown), which is still not as attractive as an IPP approach.

Benefits

Key benefits from the use of an IPP include:

- IPPs have larger contribution levels than RSPs after about age 40.
- Funds in an IPP are creditor-proof.
- Investment management fees are tax deductible by the company.
- Contributions can be made for past years back to 1991. The amount that can be deducted for past service is reduced by the amount of any additional RSP assets available for transfer (due to the introduction of the proration formula) or by unused RSP contribution room for IPPs established on or after March 22nd, 2011). Pre-1991 contributions are possible in certain circumstances.
- Tax-deductible contributions may be made in the future to make up for poor investment returns or capital losses.
- Use of an IPP for inter-generational income splitting may be possible when the owner-manager's children are involved in the business.

Disadvantages/Caveats

When setting up an IPP, it is important to be aware of the following:

- IPP pension payments are relatively fixed when started, whereas RSPs allow for more flexibility of retirement income payments. Starting in 2012, the minimum IPP pension payable after age 71 will be subject to the minimum payment payable as if the IPP assets were held within a Retirement Income Fund (RIF).
- The income-splitting strategy of using a spousal RSP is lost. However with the new pension income splitting rules introduced in the 2007 Federal Budget, income splitting will still be possible. An

alternative is that if the spouse or common law partner is an employee of the company and receives a salary, he or she can be included in the IPP.

- An IPP is best suited for companies with relatively stable levels of income and cash flow in order to make the required annual contributions. If the company cannot afford to make a contribution in future years, it can borrow to make the contribution or simply wind down the plan.
- An IPP is not flexible in terms of withdrawing funds before retirement, as contributed monies must remain in the plan until the member retires or the plan is wound up. RSP withdrawal programs such as the Home Buyers' Plan or the Lifelong Learning Plan are not available through an IPP.
- The fees to administer an IPP are higher than that of an RSP.

Conclusion

An IPP can be a great way for owner-managers to save for retirement by way of higher tax-deductible contributions. It is also a great way of ensuring the funds are available in the future even if something happens to the company, because the funds inside an IPP are creditor-proof. If the individual meets the criteria of being over the age of 40, with high employment income via their own company or one that is looking for more creative ways of compensating their executives, the IPP option should be considered.

Due to the complex nature of IPPs, it is best to consult your tax advisor to properly investigate the feasibility of an IPP and to determine the most suitable funding method for your particular situation.

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