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Individual Pension Plans

Financial Advisory Support

In order to enhance the retirement income of a business owner, professional or key employee and receive greater corporate tax deductions, some employers will set up an Individual Pension Plan (IPP) for the employee. An IPP is a defined benefit pension plan that usually has one individual member. However, a spouse who is an employee of the same sponsoring corporation can also be included as a plan member. As a pension plan, an IPP must adhere to Canadian pension plan rules and regulations. This article identifies and discusses the key advantages and considerations associated with IPPs.

WHAT IS AN IPP?

An IPP can be thought of as a replacement for your retirement savings plan (RSP) if you are a business owner, a professional, or a key employee. Contributions grow in the IPP on a tax-deferred basis, just like an RSP. With an IPP, rather than you making annual contributions to an RSP, your business or employer makes annual contributions to the IPP. Note that once an IPP is established, you will not be able to make future RSP contributions other than about $600 per year.

As a defined benefit pension plan, the amount of retirement benefit that you are intended to receive from the IPP is generally “defined” or predetermined to be a fixed amount per year. The IPP provides you with the opportunity to achieve the maximum retirement benefits permitted by Canada Revenue Agency (CRA) from a registered plan.

RULES FOR ESTABLISHING AND MAINTAINING AN IPP

As IPPs are recognized as registered pension plans by CRA, they must be created and administered according to CRA rules and federal or provincial pension legislation.

WHO IS ELIGIBLE

A business owner, professional, or key employee who receives pension-eligible income (usually T4 employment income) from their business/employer may be a candidate for an IPP. It is important to note that dividend income, self-employment income received from an unincorporated company, and income allocated to a partner from a partnership are all examples of income that are not pension eligible. In addition, you must be a resident of Canada and must pay income tax in Canada at the time the IPP is established.

Although you are not required to have a certain level of income, or be a particular minimum age, most experts agree that you should earn T4 income in excess of $100,000 and should be age 40 or older to benefit from establishing an IPP.

CONTRIBUTION LIMITS

IPP contributions must be calculated by an actuary, and are based on a defined benefit formula using your age, years of service and your T4 earnings history. The actuary must use a set of assumptions that is set from time to time by CRA. For example, one of the prescribed assumptions is that the expected actuarial interest rate is 7.5% per year. Also, the maximum benefit that you can receive in retirement from a defined benefit plan is limited to $2,444.44 per year of service (for 2009, indexed thereafter). For 2009, the maximum pension benefit is achieved once you have $122,222 of T4 income.

Annual contributions to the IPP typically increase as retirement nears since there are fewer years available to fund the predetermined retirement benefit.

ADVANTAGES OF AN IPP

Some of the main **advantages** of the IPP compared to the RSP as a retirement savings vehicle are as follows:

CONTRIBUTIONS ARE GENERALLY HIGHER THAN TO AN RSP

At certain ages (typically forties and older), the maximum annual tax-deductible contribution into an IPP by your business/employer is greater than the maximum annual RSP dollar limit (i.e. $21,000 for 2009) based on various actuarial assumptions.

EMPLOYER CORPORATE TAX DEDUCTIONS

The IPP allows past service to be captured as if you were a member of the IPP as far back as 1991 (or before, if certain conditions are met). Past service contributions are in two parts: first, a transfer from your RSP into the IPP, and second, a deductible past service contribution from your business/employer.

In addition, your business/employer may potentially make a significant deductible lump-sum contribution at the time you retire. This contribution may provide for enhanced retirement benefits such as full indexing, improved early retirement or bridging benefits.

CREDITOR PROTECTION

In the event that you or your business/employer run into financial trouble, the assets in the IPP are generally protected from creditors, as long as it was set up in good faith (meaning that the you / the business were not in financial difficulty, or anticipating that you soon would be, when the IPP was established). Currently, RSPs are creditor protected only in the event of personal bankruptcy.

THE ABILITY TO MAKE UP FOR POOR INVESTMENT RETURNS

If the investment earnings within the IPP are less than the 7.5% expected actuarial interest rate, additional contributions must be made to make up for asset deficiencies (depending on the jurisdiction – in some provinces there is no requirement to fund deficiencies, assuming proper plan design). Furthermore, if funds are borrowed by your business/employer to make IPP contributions, the resulting interest expenses are tax-deductible to the company. RSPs do not provide the ability to make up for investment losses, and the interest payable on RSP loans is not tax-deductible.

PENSION INCOME SPLITTING

If you receive certain types of qualifying retirement income, you may be permitted to income-split up to one-half of the amount paid out with your spouse. The types of retirement income that qualify to be split depend on the age of the person who is the primary recipient of the income. If you are 65 and older you may income split amounts paid out of your retirement income fund (RIF) as well as certain other eligible retirement income. If you receive periodic payments from a defined benefit pension plan (such as an IPP), the payments can be income-split with a spouse as early as age 50. As a result, IPPs allow pension income splitting much earlier than under a RIF.

CONSIDERATIONS FOR AN IPP

Some of the main **considerations** of the IPP compared to the RSP as a retirement savings vehicle are as follows:

FUNDS ARE LOCKED-IN

Since the IPP is a registered pension plan, the funds in the plan are locked-in both during your working years and in retirement under provincial legislation (with exceptions in certain provinces). This means that there is less flexibility compared to an RSP when it comes to withdrawals from the IPP. To allow for additional pension income flexibility, some of the provinces such as Ontario and Alberta, and also federally legislated plans offer partial unlocking of locked-in plans at certain minimum ages.

ADMINISTRATION COSTS

As a registered pension plan, the IPP is required to file annual federal and provincial reporting. In addition, an actuarial valuation is required every three or four years (depending on the provincial jurisdiction). Therefore, annual professional fees averaging a minimum of $850 per year (although higher fees in the initial year) would be incurred to maintain the IPP. However, the fees are tax-deductible when paid by your business/employer.

MANDATORY CONTRIBUTIONS

Pension legislation in certain provinces requires minimum funding for the IPP. If you are employed in a province that has such a requirement, and if the assets in the IPP fall in value, your business/ employer may be required to make mandatory contributions to make up for any deficiencies. While the ability to make up for investment losses may be a positive, it may also be a disadvantage. For example, if the investments in an IPP drop in value by a considerable amount, substantial contributions may be required by the company. If you are a business owner or incorporated professional, your own business is responsible for the required contributions. This may place a financial burden on you and your business.

Alternatively, if an IPP's investments produce better-than-average returns and the IPP becomes over-funded, the actuary may reduce the amount of required future contributions. At the same time, your business/employer's ability to reduce taxes through tax-deductible contributions is lessened. RSPs have greater flexibility with respect to the frequency of contributions – they can be maximized or altogether avoided at your discretion.