IG PRIVATE WEALTH MANAGEMENT

Individual Pension Plans - A retirement income opportunity for business owners

An Individual Pension Plan (IPP) is a defined benefit pension plan designed primarily to provide high-income-earning incorporated business owners or incorporated professionals, with the maximum amount of pension benefits allowed under the Income Tax Act (ITA). In doing so, an IPP will allow higher tax-deductible contribution amounts for individuals between the ages of 40 and 71 than a Registered Retirement Savings Plan (RRSP). IPPs are an excellent way for eligible individuals to accumulate retirement assets in a tax-deferred environment.

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In this article, we will cover the following:

1. Funding an IPP
2. Retirement income options
3. IPP advantages
4. Additional considerations
5. Roles and responsibilities

Funding an IPP

The annual retirement benefit of an IPP is determined using a pension formula based upon an individual's T4 income and eligible years of service with the employer. The employer is the IPP plan sponsor and is responsible for making the contributions to the IPP. Contributions made to the IPP by the employer are calculated based upon prescribed rules and actuarial assumptions and are tax-deductible. Actuarial valuations are performed periodically, usually every three years, to determine the contributions required for the IPP and the funding status of the plan to ensure that it can fulfill the retirement benefits the plan member is entitled to.

There are four types of contributions that can be made to an IPP:

Current service contributions

Current service contributions are made every year from the date the IPP is established until retirement or plan wind-up. The amount that is contributed depends upon the amount of T4 income the plan member is paid each year and their age. The amount that can be contributed to an IPP increases as the plan member ages.

Top-up funding opportunities

The actuary performs an actuarial valuation every three years to establish current service contributions for the next three years and to assess the funding status of the plan. Under the ITA the prescribed annual rate of return for an IPP is 7.5%. If the IPP is in a deficit position based upon this prescribed rate, additional contributions can be made to eliminate this deficit. Alternatively, if the IPP has a surplus that is in excess of 25% of the assets required to fund the pension liability, the plan sponsor would need to stop making contributions to the IPP until the surplus is below the threshold.

Past service contributions

When an IPP is established the plan member may have the opportunity to include prior years of service by making past service contributions for service from the later of January 1, 1991, or the date of incorporation. The amount of the past service contribution will depend upon the number of years of past service and the T4 income of the plan member in each of those years, but it can be a significant amount. In order to make a past service contribution the plan member will have to make a qualifying transfer of funds from their RRSP to the IPP to meet ITA rules regarding the past service pension adjustment. The difference between the total cost of the past service and the qualifying transfer would be funded by a tax-deductible past service contribution by the plan sponsor.

Terminal funding

An additional significant funding opportunity, referred to as terminal funding, is available upon the retirement of the plan member. While an individual is working and accruing service in the plan, the ITA has prescribed assumptions that must be used. However, upon retirement the IPP can be amended to provide bridging benefits until age 65, improved early retirement benefits, more conservative actuarial assumptions and full post-retirement indexing to the Consumer Price Index. These improvements could result in a large tax-deductible contribution to the IPP. Terminal funding is usually only advisable for plan members who intend to draw a pension or purchase an annuity in retirement.

Retirement income options

Pension

The plan member can choose to take a monthly/annual payment based upon the pension plan formula. Since a pension must have a plan sponsor, the corporation must continue its existence and there would be ongoing accounting and legal costs for the corporation. The actuary would also have to be maintained to provide administrative services for the pension and to complete Canada Revenue Agency (CRA) and provincial regulatory filings where required.

Transfer

The IPP could be transferred to a locked-in plan or RRSP depending upon the jurisdiction of the plan. The ITA establishes limits on the amount that can be transferred on a tax-deferred basis to a locked-in plan or RRSP, and a portion of the IPP would be immediately taxable.

Annuity

The IPP may also be used to purchase a life annuity contract which provides a monthly payment that mimics the monthly pension payment (amount of pension, survivor benefits, indexation, etc.) the plan member was entitled to.

IPP advantages

Increased savings

IPPs provide the opportunity for increased asset accumulation for the IPP plan member than they would be able to achieve through RRSP savings due to the increased contribution limits for individuals who are 40 years of age or older. IPPs are generally not advisable prior to the age of 40 because the amount an individual can contribute to an IPP only begins to exceed the amount they could contribute to an RRSP around age 40. At age 40 an individual can only contribute slightly more to an IPP than an RRSP, but by age 50 the annual contribution would be more than $10,000 higher and approximately $20,000 higher by age 65 for individuals with pensionable earnings high enough to maximize the IPP benefit.

Increased funding based upon investment performance

The ITA assumes that an IPP will have a net investment return of 7.5%. If the IPP does not achieve this rate of return, the plan sponsor can make additional top-up contributions to the IPP. These additional contributions are tax-deductible for the plan sponsor and increase the amount of tax-deferred assets held in the IPP.

Pension income credit and pension income splitting

If the plan member chooses either the pension or the annuity option, the federal pension income credit and pension income splitting are available at any age. Where the plan member chooses to commute to a locked-in account or RRSP, the federal pension income credit and pension income splitting on Life Income Funds (LIF) or Registered Retirement Income Funds (RRIF) are only available at age 65.

Corporate tax advantages

All contributions to the IPP are tax-deductible for the plan sponsor. Additionally, all other costs related to the administration of the IPP are also tax deductible, including actuarial fees, regulatory filing fees and investment fees.

The federal small business tax rate of 9% applies to the first $500,000 of active business income of a Canadian-controlled private corporation. If a corporation has passive investment income of $50,000 or more, the $500,000 federal small business limit is reduced in the following year. For every $1 of passive investment income earned in excess of $50,000, the small business limit for the following year will be reduced by $5, resulting in no small business limit once passive income exceeds $150,000. Implementing an IPP could help minimize the impact of the passive investment income rules, as funds invested in the corporation could be used to fund the IPP, thereby reducing the amount of passive income the corporation generates.

An IPP may also be able to assist with securing eligibility for the lifetime capital gains exemption that is available to residents of Canada who are selling the shares of a qualified small business corporation.

Creditor protection

The assets held within an IPP are protected from creditors.

Succession planning

An IPP provides the opportunity for multi-generational tax planning if the plan member's children are involved in the business. If the children are earning T4 income, they could be added as members of the IPP and accrue pension benefits. A greater potential impact is that, because the children are now plan members, the IPP would not have to be wound-up on the death of the parent or their spouse (the original IPP member(s)). This could create a significant tax deferral depending upon the IPP assets at the time of death.

Additional considerations

Complexity and cost

Establishing and maintaining an IPP is a more complex process than investing in an RRSP. Actuarial valuations will be required and filings with the CRA (and, in some jurisdictions provincial pension regulators) are also necessary. The costs of the actuarial services and the filings are tax-deductible.

Reduced RRSP room

Establishing an IPP will eliminate almost all of the plan member's RRSP contribution room while the IPP is in existence. In most cases the plan member will only generate $600 of RRSP room each year.

Roles and responsibilities

As a defined benefit pension, there are numerous roles that are involved in the establishment and administration of an IPP, including the plan sponsor, plan member, actuary, trustees and investment manager.

The **plan sponsor** is the employer/corporation that establishes the IPP. The plan sponsor is responsible for making all the contributions to the IPP.

The **plan member** is the individual who is accruing the retirement benefits. An IPP member can be a "connected" member, an individual who is related directly or indirectly (through a spouse or family member), or a "non-connected" member, such as a key employee of the plan sponsor. While most IPPs have only one member (the incorporated business owner or incorporated professional) it is possible to have more than one member (usually the spouse or common-law partner of the first member). IPPs are not very common for "non-connected" members because they create a significant liability for the plan sponsor as the funding commitment is irrevocable.

The **actuary** is responsible for the registration of the IPP with the CRA and, if required, the provincial pension regulatory authority. The actuary is also responsible for the design of the IPP and creating the plan text, trust agreement and statement of investment policies and procedures. Additionally, the actuary prepares periodic actuarial valuations, funding recommendations, tax filings and options upon the plan member's retirement or plan termination.

Trustees are appointed by the plan sponsor and hold the fiduciary responsibilities of the IPP. Trustees can be either individuals or a corporation, but if individual trustees are appointed, there must be at least three trustees, with at least one of the trustees being independent of the plan sponsor. Individual trustees must be Canadian residents. In many situations the three trustees are the plan member, their spouse/common-law partner and their accountant or lawyer.

The **investment manager**, typically the plan member, is responsible for making the decisions on the investments of the IPP. IG Wealth Management provides investment recommendations for the IPP.

Summary

Implementing an IPP could be an effective strategy for a high-income earning incorporated business owner or incorporated professional. An IPP will allow for greater capital accumulation which can then be used to generate a secure retirement income for the individual. Contact your IG Wealth Management Consultant for more information.

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Todd Sigurdson is Director, Tax and Estate Planning, at IG Wealth Management, where he specializes in retirement planning, pension inquiries, and tax and estate planning for high-net-worth clients. Todd is a Chartered Professional Accountant (CPA, CMA) and has earned the Certified Financial Planner (CFP), Registered Retirement Consultant (RRC) and Trust and Estate Practitioner (TEP) designations. Todd has over 20 years' experience with IG Wealth Management and 14 years with the Advanced Financial Planning department.