

INDIVIDUAL PENSION PLANS

If an individual's circumstances are appropriate, he or she may be able to save for retirement through an individual pension plan ("IPP"). With an IPP, rather than the individual making annual contributions to a registered retirement savings plan ("RRSP"), the individual's employer would make annual contributions to the IPP. On retirement, the IPP would then pay a pension to the plan member.

As the name indicates, an IPP is simply a registered pension plan ("RPP") for an individual or an individual and his or her family members. This is different from the more common form of an RPP, which is a plan for a group of employees that would not be related. IPPs became popular when the federal government introduced its major pension reform legislation in 1990.

The major advantage of an IPP is the additional tax-sheltered savings that can be created when compared to RRSPs. The additional contribution room is available due to the fact that an IPP is usually established as a *defined benefit* plan as opposed to as a *defined contribution* plan (also known as a *money purchase* plan). This is discussed further below.

AN IPP AND YOU

As indicated above, an IPP can, under certain circumstances, provide you with the capacity to make greater tax-deductible contributions to fund your retirement income than would be available with traditional RRSP contributions. The description of the ideal candidate should help you determine if an IPP would be applicable to you. Also, set forth below is an example of the additional contribution room that can be created.

The ideal candidate for an IPP is an individual who

- ❖ is at least 45 years old,
- ❖ is an employee of a corporation (could be an owner/manager or an executive); proprietorships and partnerships are not eligible (e.g. professional who cannot incorporate),
- ❖ has historically had employment income of at least \$100,000 per year since 1990,

Janaury 2008

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- ❖ has a reliable future employment income stream in excess of \$100,000 per year, and
- ❖ has no foreseeable need to access the funds set aside for retirement (i.e. your retirement funds will not be needed for an emergency); the reason for this is that the funds inside an IPP are locked in, as opposed to RRSP funds, which can be liquidated.

Example of Post-1990 Current Service Contributions

Assumptions:

- ❖ individual age 60;
- ❖ annual salary of \$120,000; and
- ❖ return of 7.5% on funds inside IPP.

Comparison of Current Service Contributions

Year	IPP	RRSP	Additional Contribution Room - IPP
2008	\$30,100	\$20,000	\$10,100
2009	\$32,400	\$21,000	\$11,400
2010	\$34,800	\$22,000	\$12,800

Defined Benefit Plans

As indicated above, the greater contribution room for an IPP over an RRSP results from the fact that the IPP is a defined benefit plan.

Some examples of defined benefit plans are

- ❖ Flat Benefit Plans, which pay a fixed dollar based on years of service (this is most common in a union environment);
- ❖ Career Average Earnings Plans, which base your benefit entitlement on your earnings throughout plan membership;
- ❖ Final Average Earnings Plans, which base your pension on, say, the last five years of earnings; and
- ❖ Best Average Earnings Plans, which base your entitlement on your best five years of earnings throughout your employment.

Basically, a *defined benefit* plan can allow greater tax-sheltered savings due to the fact that the *level of income at retirement* drives the annual contributions (as

opposed to the *level of contribution* with a *defined contribution* plan). As the level of income is defined, the annual contributions to the plan are based on certain assumptions regarding:

- ❖ future investment performance;
- ❖ future inflation rates;
- ❖ life expectancy;
- ❖ years of employment; and
- ❖ an individual's projected retirement age.

Contributions to an IPP

Amounts that can be contributed to an IPP are restricted by the Canada Revenue Agency ("CRA") maximum funding formula. The formula uses numerous assumptions and the funding rules are quite complex. The individual will require the assistance of an actuary to deal with the compliance issues.

In general, assumptions can be either optimistic or conservative. As the assumptions prescribed by the CRA tend to be conservative in nature, the result is that under certain circumstances, an individual can contribute more on an annual basis to an IPP than to an RRSP.

The CRA prescribes the maximum annual pension accrued/earned to be as follows:

- ❖ For 2008, the lesser of 3% of annual earnings and \$2,333 per year of employment.

The maximum benefits will be increased to \$2,444 in 2009, with full indexing thereafter.

As a result of this formula and the assumptions made in the maximum funding formula, larger contributions to an IPP will be required as the individual gets older (since the expected time to retirement is shorter).

In addition to the above restrictions on contribution limits, most IPPs are classified as *designated plans*, which have other restrictions on the contributions and benefits that can be provided under the plans.

A "*designated plan*" is a pension plan that, in addition to meeting other requirements, is established for *specified individuals*.

"*Specified individuals*" are individuals who are *connected to an employer (as defined in the Income Tax Act)* or who *earn more than 2½ times the year's*

maximum pensionable earnings (“YMPE”) (for 2008, YMPE = \$44,900) from the employer or an employer who does not deal at arm’s length with a participating employer.

Payments from an IPP

As a defined benefit plan, payments from an IPP are pre-determined. The plan text would establish the payment structure, which could be, for example, based on the employee’s five best years of earnings (see page 2 above for other examples). Payments would typically begin on the employee’s retirement. The plan text would also deal with what would happen on the employee’s death. If there are other family members in the plan, surplus funds would typically remain in the plan.

ADVANTAGES OF AN IPP

Contributions in Excess of Normal RRSP Limits

The major advantage of an IPP is the ability to make current service contributions in excess of normal RRSP contribution limits. The actual calculation is based on an individual’s age, earnings and a formula prescribed by the CRA. Due to these factors, larger contributions to an IPP will be required as the individual gets older, since the expected time to retirement is shorter.

Potential Ability to make Lump Sum Past Service Contributions

Depending on the circumstances, it may be possible to make a lump sum pre-1991 past service contribution to an IPP. Depending on the length of service and the individual’s age, the past service contributions can be quite significant. However, it should be noted that these past service contributions are not allowed in cases where similar retirement benefits are not extended to non-connected persons.

Creditor Protection

RRSP assets are generally not protected from personal creditors (unless they are part of an insurance contract). Assets held inside an IPP/RPP are protected from creditors of both the employee and the employer, under federal and provincial pension benefits standards legislation.

Terminal Funding Payments

If it is properly structured, an IPP can provide for terminal funding benefits in the year of retirement. Often, the retirement date of an owner/manager with the date the business is sold and therefore the payment of the terminal funding benefit can have the effect of reducing the sale proceeds for the business (thus deferring the tax).

Bridge Funding Payments

If it is properly structured, an IPP can provide bridging benefits for an individual who retires before the normal retirement age of 65. Bridge benefits supplement an individual's retirement income until the individual starts to receive Canada Pension Plan ("CPP") and Old Age Security ("OAS") benefits. The inclusion of this benefit enhances the amount of current contributions that can be made to a plan.

Interest Deductibility of Payments to IPP

Interest on funds used to make an RRSP contribution are not deductible; however, interest payments are deductible in respect of funds borrowed by a corporate employer to make deductible contributions to an RPP.

Executive owns the Surplus

An executive will usually own any surplus that accumulates in an IPP. This becomes relevant in an arm's length situation and is preferable to having to share the surplus with other plan members under a group RPP.

Possible Inter-Generational Transfer of Pension Assets

If other family members are included in a plan, it may be possible to use the funds remaining in the pension plan after the death of the first generation to provide retirement benefits for younger family members. This effectively allows for the tax-deferred inter-generational transfer of registered assets beyond the death of the last spouse.

Investment Risk lies with Employer

Due to the fact that the IPP is providing a pension based on a formula, the executive is not concerned with the underlying performance of the investments in the pension plan. Thus, the investment risk lies with the employer.

Additional Contributions Allowed if Plan Deficit Occurs

If the investment performance of the assets held inside a pension plan is poor and a plan deficit occurs, the employer can (and will be required to) make additional tax-deductible contributions to the plan. Thus, you have the ability to top up your pension if your portfolio performance after both investment and actuarial fees are deducted is less than 7.5% per annum. This benefit is not available with RRSPs.

Locked-In Feature Prevents Access to Funds until Retirement

The funds inside an IPP are locked-in. This will prevent an individual from accessing the funds prior to retirement, and after retirement, access is limited to the amount prescribed by the CRA and the applicable provincial pension regulations. Thus, protection is provided for spendthrift plan members.

DISADVANTAGES OF AN IPP

Costs

IPPs are considerably more costly to establish and administer than RRSPs. IPPs have set-up, annual filing and tri-ennial valuation fees, as discussed below.

Complexity

An IPP has annual filing requirements with the CRA and places fiduciary responsibilities on the trustees (who could be family members). In addition, IPPs face a high level of government regulation, under both income tax and pension legislation. In comparison, an RRSP is relatively simple and easy to understand.

Liquidity Restrictions on Funds

IPPs have restrictions on withdrawals and therefore they are not as liquid as RRSPs. Funds held inside an IPP are locked-in funds and as such cannot be used to fund emergencies.

No Spousal Contributions

If an IPP is created, the individual no longer has the ability to make spousal RRSP contributions due to the pension adjustment. Thus, the ability to split income using your retirement assets is not available with an IPP. However, if the spouse's circumstances are appropriate, he or she could have his or her own IPP.

Funding Requirements for an Employer

Depending on how it is structured, an IPP can place annual funding requirements on an employer. This could be a financial burden if the company experiences hard times. This concern can be alleviated somewhat if the plan provides for flexible funding options.

Surplus Position will limit Current Contributions

If a plan is in a surplus position, the employer will be restricted from making current contributions. Thus, a situation could arise which would restrict the contributions to below what would have been available if the individual simply

contributed to an RRSP. This can occur if the portfolio performance is above average or if the government adjusts the annual contribution limits.

ADMINISTRATIVE ISSUES RELATING TO AN IPP

There are several administrative requirements involved in establishing and maintaining an IPP.

Registration with the CRA

In order for any contributions to an IPP to be deductible for tax purposes, the IPP must be registered with the CRA.

Registration Procedure

In order to register the IPP with the CRA, an application must be submitted by registered mail in the prescribed form, containing the prescribed information required by the CRA. Some of the documents that must be submitted along with the application form include certified copies of the following: the plan text, the trust deed, insurance contracts, all documents relating to the funding of benefits, all agreements relating to the plan, and all resolutions and by-laws that relate to the plan. An individual would want to consult his or her professional advisors for assistance in preparing the application and the accompanying material.

For straightforward applications (meaning those that are in respect of plans dealing with post-1990 current service only), the CRA has taken over a year to process the application.

Investment Restrictions

A further administrative issue is the restriction regarding which investments an IPP can hold and the penalties for non-qualified investments. Care must be taken in the operation and administration of the IPP to ensure that its registered status is not put in jeopardy by holding non-qualified investments.

Annual Filings

The administrators of an IPP have to file information returns with the CRA every year on or before March 30.

Tri-ennial Actuarial Valuation

An actuarial valuation has to be done in respect of the plan every three years.

Deductibility of Contributions

To be deductible, contributions must be made to the IPP within 120 days of the corporate year-end.

Public Disclosure

Certain information relating to registered pensions is available to the public, including any information required to be provided to the provincial pension board in the application for registration.

Winding-Up

How and when the IPP would be wound up is left to the discretion of the administrators or trustees. The governing documents of the IPP must provide for any remaining funds to be distributed on winding up to the plan members.

COSTS OF AN IPP

As indicated above, there are costs involved in establishing and administering an IPP. An indication of the type and purpose of the costs is set forth below.

Establishment of IPP

There will generally be one-time legal, accounting and actuarial costs related to the creation, organization, and registration of an IPP. Our experience has seen these costs range from \$3,000 to \$7,500.

Annual Maintenance

The annual costs relating to the maintenance of an IPP, including the monitoring of the funding surplus or deficit and the filing of information returns required under the Income Tax Act, may be in the range of \$500 to \$1,500.

Tri-ennial Actuarial Valuation

An actuarial valuation has to be done in respect of the plan every three years. An actuarial firm is required to perform this valuation. The costs of this valuation have been in the range of \$1,500 to \$3,000.

SUMMARY

An IPP can have significant tax benefits if an individual's circumstances are right. In most cases, the costs to establish and administer an IPP are not a deterrent if other circumstances indicate that the IPP would be beneficial.