Individual Pension Plans

A powerful tool for retirement saving

By Mark T. Fitzgerald, CFA, and Stephen Cheng, FCIA

The Age Advantage

We all know the key to RRSP investing is to let time work in one's favour: contribute early in life and let long-term compound returns do their magic. But what can you do when retirement is on the horizon and RRSP assets are not enough, or when there is no unused contribution room and time is running out to grow the RRSP? The answer could be an Individual Pension Plan (IPP), where age and not time is the advantage – the older you are, the more tax-deductible contributions you can make.

An IPP is a defined benefit pension plan established for an individual and sponsored by an employer whereby a specific pension is promised based on years of service and employment income, and sufficient tax-deductible contributions can be made according to actuarial assumptions approved by the Canada Revenue Agency (CRA). Because the amount of pension benefits earned in an IPP affects the required present value of the pension liability, the older a plan member is the greater the IPP contribution required. This same time value of money effectively works in the opposite direction in an RRSP, where the older the person is, the lower the retirement benefit that will arise from the fixed contribution. Based on certain assumptions, once a person is older than 40, the allowed contributions to an IPP will exceed those allowed to an RRSP.

An IPP is therefore a very powerful and tax-effective tool for certain individuals to provide for retirement benefits. It works best for business owners, incorporated professionals and executives who are older than 40, earning the maximum income that can be covered for pension plan purposes ($125,000 in 2010 dollars) and who have several years of service with the sponsoring company. As an example, the annual contribution to an IPP for a 55-year-old on January 1, 2010 who earned over $125,000 in 2010 is $31,100, while it's $37,600 for a 65-year-old. Both amounts are much greater than the 2010 RRSP contribution limit of $22,000.

The Contribution Advantage

However, the real advantage of an IPP over an RRSP is the ability to make tax-deductible past service contributions for employment years existing prior to setting up the IPP. The CRA allows past service to be recognized, on a voluntary basis, as far back as January 1, 1991 and sometimes earlier. This past service contribution is calculated in two parts. One amount recognizes the member's Past Service Pension Adjustment and is satisfied by a tax-free transfer from the member's RRSP and/or by a reduction in the member's unused RRSP contribution room. The other is an actuarially calculated amount based on CRA Funding Restrictions. This second amount highlights the real benefit of an IPP as it can add up to several thousand dollars of tax-deductible contributions for each year of past service recognized.

To qualify for the maximum post-1990 past service contributions, the plan member must have sufficient personal RRSP assets or unused RRSP room. If these are insufficient, the number of past service years that can be recognized may have to be reduced, with a corresponding reduction in the allowable past service contribution. To be able to recognize all years of past service from 1991 to 2009, the plan member currently needs to have $375,950 in RRSP assets/unused contribution room.

Looking again at our 55-year-old plan member mentioned above with sufficient RRSP assets and employment service going back to 1991, an IPP tax-deductible past service contribution of approximately $195,000 could be made in 2010. This amount, combined with the current annual contribution of $31,100, equates to a first-year contribution advantage over an RRSP by as much as $226,100. The equivalent

amount for a 65-year-old is $350,100. Past service contributions can be made either by the company (employer) or by the member (employee).

The At Retirement Advantage

The advantage of an IPP does not stop here, as further tax-deductible contributions can be made on retirement. During the asset accumulation period of a plan, the CRA has a number of "Maximum Funding Restrictions" based on assumptions about normal retirement age, inflation rates, age of spouse, level of interest rates and other relevant factors. However, on retirement, the CRA allows the assumptions governing funding to be relaxed in order to enhance retirement benefits. This could result in an increased actuarial liability of tens of thousands of dollars, thus allowing considerably more terminal funding contribution room.

As IPPs become better understood, their use is increasing given that the tax advantages for certain qualified individuals are so great. While IPPs can be complex, especially concerning the issues surrounding terminal funding, a qualified actuary has all the expertise required for set-up and ongoing maintenance, and actuarial service fees are very reasonable and tax-deductible to the company. There are also many qualified investment managers who have the expertise to manage IPP funds. IPPs must adhere to rules surrounding pension legislation, and, since the funds are to be used to meet a specific and expected pension, they should be managed conservatively and in a fiduciary way rather than in a more speculative manner.

An IPP is Flexible

Although IPPs are complex, they should not be considered inflexible. While the funds can only be used for retirement, they can be transferred to a locked-in RRSP or a locked-in RRIF, subject to maximum transfer amounts, thus remaining in the member's control. A member can also elect to receive an ongoing pension payment from the plan or commute the amount to an annuity. Generally, all funds belong to the member. On death, a pension will continue to the spouse, and, on the spouse's death, all funds will flow to the designated beneficiaries.

Some may shy away from an IPP because once it is established, minimum contributions must be made to fund the plan if the plan is not exempt from registration with the federal or provincial pension regulator. However, in B.C. (and some other provinces), IPPs for over 10% shareholder employees and related persons or highly compensated employees are, in fact, exempt from registration. In these cases, businesses that have fluctuating income can maximize their tax benefits by adjusting the timing of past service contributions accordingly.

Pension income splitting with a spouse and asset creditor proof are further benefits of an IPP. In addition, as strange as it may sound, a business owner who established an IPP to transfer large amounts of funds out of the business may have been happy with the huge declines in the stock market in 2008. That's because an IPP allows additional contributions to make up for poor returns, providing even more tax-deductible contributions to be made. Of course, the stock market eventually needs to recover – but it always does. ▢

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