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Report

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IPPs versus RRSPs: The AIW Index Argument

*by Ian E. Baker, FCIA, FSA**
Westcoast Actuaries Inc.

One of the highest-rated workshops at the CALU 2005 Annual Meeting, *IPPs Revisited*, challenged members to review the subject of Individual Pension Plans (IPPs) in the context of retirement planning. In doing so, it advanced the argument that:

a) the future indexing of the maximum pension limits are linked to the increases in the Average Industrial Wage (AIW) Index;

b) the AIW Index is likely to be less than 5.5% in future years; then,

c) the contribution advantage of IPPs over Registered Retirement Savings Plans (RRSPs) is decreased or eliminated when the AIW index is 2.5% or less per year.

This article rejoins the exchange of views as to the appropriate application of IPPs and argues for a more favourable consideration of their place vis-à-vis RRSPs.

Background Information

To understand this argument requires a basic understanding of RRSPs and IPPs.

Money purchase (MP) pension plans are defined under the Income Tax Act[1] and the Income Tax Regulations. An MP plan defines the contribution to be made by the employer (and perhaps, the member) via a formula. In MP plans, the known factor is the amount of contribution, and the unknown factor is the amount of pension at retirement age that those contributions and their accrued investment earnings will generate.

RRSPs are a type of MP plan. The maximum contribution to an RRSP is 18% of the member's previous year's earned income up to a specific dollar limit. Note that the RRSP dollar limit for the current year equals the previous year's MP dollar limit.

The MP dollar limit is defined in 147.1(1) of the Act.

Defined benefit (DB) pension plans are also defined under the Act and the Regulations. A DB plan defines the

** Ian Baker is Principal & Consulting Actuary with Westcoast Actuaries, Inc. in Vancouver. He may be reached by e-mail at ian.baker@westcoast-actuaries.com or by phone at (604) 570-0083.*

pension a member is to receive upon retirement via a formula. An actuary is required to calculate and certify the contributions needed to properly fund this pension promise. Therefore, in DB plans, the known factor is the amount of pension at retirement, and the unknown factor is the amount of funding required. The actuary is required to update his or her calculations at least every three years. Note that for any particular calendar year, the maximum pension dollar limit per year of credited service is defined as exactly 1/9 of the MP dollar limit for that year (see Regulation 8500(1)). Also, note that for private-employed Canadian citizens, the maximum accrual per year of credited service in a DB plan is 2.0%.

IPPs are a type of defined benefit plan. IPPs are designed to provide maximum pension at retirement and thus maximum contributions. Most IPPs are designed for owner-employees and highly paid executives of Canadian corporations.

The Magic Factor of 9

The relationship cited above between the MP dollar limit and the DB dollar limit has been termed "the magic factor of 9." This relationship equates a $9.00 contribution in an MP plan to $1.00 of annual pension at age 65 in a DB plan, regardless of the member's current age.

Obviously, this equation is a generalization. Assume that at age 65, the lump sum needed to provide an annual pension of $1.00 per year (non-indexed[2]) is $13.93[3] using an interest rate of 5% per year.

Now, consider the power of compound interest. A member age 25 would need only $1.97 today in order to amass $13.93 over the next 40 years at 5.0% per year. Whereas a member age 60 would need $10.91 today to amass $13.93 over the next five years.

The age 25 member would not give up $9.00 of contribution to obtain a pension which today has a value of only $1.97. Similarly, the age 60 member would gladly give up the opportunity to contribute $9.00 in order to receive a pension that has a value today of $10.91.

With this equality built into the Canadian tax system, the reasonable conclusion is that RRSPs are appropriate for younger members while IPPs are appropriate only for older members. We believe that IPPs are appropriate, in the right circumstances,[4] for members who are at least age 40.

Actuarial Assumptions

Regulation 8515(7) describes the assumptions and methods to be used by the actuary to determine maximum funding contributions under IPPs as follows:

a) projected accrued benefit method used to determine actuarial liabilities and current service costs;
b) a valuation interest rate of 7.5% per year;
c) a salary increase rate of 5.5% per year;
d) a rate of increase in the Consumer Price Index of 4.0% per year;
e) retirement at age 65;
f) assumed continuous employment until retirement;
g) at retirement, member is assumed to be married to a person who is the same age;
h) no pre-retirement mortality;
i) post-retirement mortality is based upon the 1983 Group Annuity Mortality Table using 80% of the average of male and female rates; and
j) plan assets are valued at their fair market value.

Therefore, contributions to be made under IPPs are defined by the assumptions and methods above as well as the DB limit in the year the member is expected to turn age 65.

Dollar Limits

For many years, the DB limit was frozen at $1,715.00 per year of credited service (modified to $1,722.22). In recent years, the Federal Government has decided to increase the dollar limits.

The February 2003 Federal Budget set new dollar limits, as shown in Table 1 below.

Maximum RRSP and IPP Current Service Contributions

Consider a connected person[5] who is exactly age 50 on Jan. 1, 2005. Furthermore, assume this person had 2004 T4-income of $100,000, and is expected to have $100,000 of T4-income in 2005.

This person's 2005 maximum RRSP contribution is $16,500 (the lesser of 18% of $100,000, and $16,500).

Under an IPP, this member is expected to retire at age 65 on Jan. 1, 2020. The defined benefit dollar limit in 2020 is expected to be $4,405.11

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TABLE 1

Year	Money Purchase Dollar Limit $	Defined Benefit Dollar Limit $	Increase %
2003	15,500	1,722.22	
2004	16,500	1,833.33	6.45
2005	18,000	2,000.00	9.09
2006 +	Indexed to AIW	Indexed to AIW	

The February 2005 Federal Budget set new dollar limits as shown in Table 2.

TABLE 2

Year	Money Purchase Dollar Limit $	Defined Benefit Dollar Limit $	Increase %
2005	18,000	2,000.00	
2006	19,000	2,111.11	5.55
2007	20,000	2,222.22	5.26
2008	21,000	2,333.33	5.00
2009	22,000	2,444.44	4.76
2010 +	Indexed to AIW	Indexed to AIW	

[$2,444.44 multiplied by 1.055 raised to the power (2020 minus 2009)].

The IPP member's current service cost for 2005 is $22,423 [$4,405.11 times 14.5263[6] multiplied by 1.075 raised to the ½ power[7] divided by 1.075 raised to the power (2020 minus 2005)].

For this person, the contribution excess of the IPP over the RRSP is $5,923 ($22,423 minus $16,500).

Note that the MP dollar limit and the DB dollar limit have been increasing by around 5.5% since 2003.

The AIW Index Argument

Now let us assume that the AIW increases by 2.5% per year after 2009 rather than by 5.5% per year.

As per the example above, the defined benefit dollar limit in 2020 is expected to be $3,207.32 [$2,444.44 multiplied by 1.025 raised to the power (2020 minus 2009)]. Therefore, the IPP member's current service cost for 2005 is $16,325 instead of $22,423. Thus, the IPP current service contribution is, in fact, less than the maximum RRSP contribution for 2005.

Now, you would naturally conclude that IPPs are not as powerful as you have been led to believe.

However, this conclusion is *incorrect* for the following reasons:

a) The actual AIW Index has never been used to determine the DB dollar limit even though this Index has been far less than 5.5% per year since 1991.[8]

b) In the mid-1990s, the Federal Government changed the DB dollar limit from $1,715 (which had been unchanged for over a decade) to $1,722. The next change occurred in the February 2003 Federal Budget which was scheduled to use the AIW Index to project the DB dollar limit commencing in 2006 (see Table 1 on the previous page). However, the Federal Government overrode this scenario in the February 2005 Budget (see Table 2 on the previous page). I have every reason to expect that on or prior to 2010, the Federal Government will again override the current scenario in order to revise the specific DB dollar limits. Therefore, I don't foresee a time when the AIW Index will be used to determine DB dollar limits.

c) Corporations can make IPP contributions in respect of the unfunded liability generated by granting the member past service credits provided certain conditions are met.[9] RRSPs do not offer this feature.

d) RRSP dollar limits are controlled by the MP dollar limits. If the AIW Index is used to determine the MP dollar limits then the RRSP dollar limits will also be reduced accordingly.

Conclusion

The AIW Index has not been a factor in determining the Money Purchase and Defined Benefit dollar limits. Recent Federal Budgets have emphasized this point.

IPPs offer the highest dollar contributions and deductions for high earners. However, above a certain salary level (e.g., $100,000 in 2005), the dollar limits do not affect IPP contributions. For example, consider two members who will attain age 65 in the same calendar year: they will have the same IPP current service contributions even though one member earns $300,000 while the other member earns $400,000.

When determining whether an IPP is appropriate for your client, the focus should be on the advantages/

restrictions of an IPP versus an RRSP. In comparing these two products, IPP advantages are:

a) higher contributions for older members;

b) ability to make a past-service contribution;

c) more creditor-proof;[10]

d) ability to make further tax-deductible contributions if the IPP has a deficit;

e) terminal funding opportunities at retirement;

f) contributions can be deducted if made within the fiscal year or within 120 days after the fiscal year end; and

g) interest on funds borrowed for contributions is tax deductible.

In comparing these two products, IPP restrictions are:

a) lacks income-splitting like a spousal RRSP;

b) no access to funds while employed;

c) higher expenses;

d) excess surplus reduces ability for the employer to make ongoing contributions;

e) no cash lump sum available — assets are to be used to provide a pension;

f) investments must follow pension guidelines; and

g) mandatory minimum contributions (except for British Columbia, Manitoba, Prince Edward Island and Quebec).

Certainly, IPPs are more complicated than RRSPs but so is just about any insurance product. However, I believe that the IPP can be an effective retirement planning product for the right person in the right circumstances.

Endnotes

[1] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

[2] Non-indexed means a pension that remains constant. Indexed means a pension that increases each year, usually as a result of an increase in the Consumer Price Index (CPI).

[3] Assumes a joint-and-survivor annuity (with the member age 65 and the survivor age 62) which pays the survivor $0.667 per year after the member’s death, and which is guaranteed for a period of five years.

[4] The right circumstances, at a minimum, mean: a) a bona-fide employer-employee relationship exists between the member and the sponsoring employer; b) the member earns T4-income (partnership and dividend income do not count); c) the sponsoring employer is profitable; and d) the sponsoring employer can use the deductions.

[5] A person who owns directly or indirectly 10% or more of any class of shares of a company or not dealing at arm’s length with such a person.

[6] The annuity factor for a joint-and-survivor annuity (with the member age 65 and the survivor age 62) which pays the survivor $0.667 per year after the member’s death, and which is guaranteed for a period of five years.

[7] Our practice is to assume that IPP current service contributions are to occur during the middle of a calendar year.

[8] The AIW Index has increased since 1990 as per the table below.

Year	Aggregate AIW Index 12 months ending each June 30th	Increase %
1990	6,206.66	
1991	6,507.68	4.85
1992	6,751.07	3.74
1993	6,954.92	3.02
1994	7,051.57	1.39
1995	7,155.60	1.48
1996	7,239.76	1.18
1997	7,439.67	2.76
1998	7,541.09	1.36
1999	7,627.22	1.14
2000	7,775.85	1.95
2001	7,936.78	2.07
2002	8,089.33	1.92
2003	8,227.81	1.71
2004	8,353.47	1.53

[9] The conditions required are that the member had performed past service with the sponsoring corporation and member has sufficient RRSP assets to transfer into the IPP.

[10] Bill C-55, which received first reading in the House of Commons on June 3, 2005, proposes to extend creditor protection federally to RRSPs and RRIFs. (See discussion in *INFOexchange*, 2005, Vol. 3. See also the discussion of *Amherst Crane Rentals v. Arlene Clare Perring* in *INFOexchange*, 2005, Vol. 1.)