INDIVIDUAL PENSION PLANS

Benefit from the tax deferral advantages of a registered pension plan

What is an IPP?

An Individual Pension Plan ("IPP") is a pension plan established for a single individual who is interested in maximizing his or her tax-assisted retirement savings. An IPP may allow a small business owner, owner-manager or senior executive to benefit from the retirement savings and tax deferral advantages of a registered pension plan. A typical IPP provides what is called a defined benefit; the amount of pension is determined at retirement by reference to a formula. This is different from a Registered Retirement Savings Plan ("RRSP") or a defined contribution pension plan, where only the account balance itself is available to provide benefits at retirement.

Pension plans registered under the Income Tax Act permit the deferral of taxation on employee compensation. Employer contributions are tax deductible, and are not subject to employee withholding taxes. Employee contributions are also tax deductible. Investments earnings on these contributions grow tax-free until they are used to pay benefits under the plan.

What is the purpose of an IPP?

While flexible in terms of its settlement options, the basic purpose of an IPP is to provide a retirement pension to the plan participant. In the right circumstances, an IPP permits much larger tax deductible contributions than an RRSP. An IPP can also normally offer the plan member a greater degree of creditor protection than an RRSP. With an IPP, a member will no longer be able to contribute to an RRSP in future years.

Who is the ideal candidate?

The ideal candidate meets the following criteria:

- is over 45 years of age, but under 70 years of age,
- either owns a corporation and draws significant employment earnings each year, or is a high earning employee/executive,
- fully uses his/her RRSP room annually but would prefer to save higher amounts on a tax deferred basis, and
- is not a member of another registered pension plan.

The IPP participant must receive T4 earnings from the employer who sponsors the IPP. Corporate dividends do not count for this purpose.

IPP Structure

Registration: Tax and Pension Standards

Every pension plan, including IPPs, must be

registered for tax purposes with the Canada Customs and Revenue Agency ("CCRA"). An IPP must also be registered with the appropriate provincial or federal regulatory agency charged with overseeing pension standards.

Sponsor and Participant

An IPP must be sponsored by an employer, and the participant under the plan must be an officer or employee with Canadian employment earnings.

An IPP is designed to provide flexible retirement income

Plan Benefits

Retirement Benefit

An IPP is designed to provide a pension at retirement. Because the aim of the IPP is to maximize available tax savings, the benefit that is offered is the maximum pension allowable under tax rules. This benefit is based on 2% of the member's best average earnings for each year of service (earnings may be indexed). If the participant is "connected" to the employer (if he or she directly or indirectly owns 10% or more of the shares of the employer, or does not deal at arm's length), then earnings must be averaged over all years for which benefits accrue (earnings may be indexed).

The pension is further limited to a maximum of $1,722.22 for each year of service (with different limits applicable to pre-1991 service). This limit is scheduled to increase to $1,833.33 in 2004 and $2,000 in 2005. The limit is then scheduled to increase thereafter along with the Average Industrial Wage.

Termination of Employment

Upon termination of employment, the participant is entitled to transfer his or her pension benefit to any of the retirement savings vehicles permitted by applicable pension standards legislation. For instance, in Ontario, these vehicles include a Locked-In Retirement Income Account ("LIRA"), a Lifetime Income Fund ("LIF"), and a Locked-In Retirement Income Fund ("LRIF"). The LIRA is basically a locked-in RRSP. Both the LIF and LRIF are basically locked-in Registered Retirement Income Funds ("RRIF"s) that provide for minimum and maximum withdrawals.

It is important to recognize that there are maximum values imposed by the Income Tax Act on transfers between registered pension plans and the retirement vehicles noted above. Amounts in excess of these limits must be paid in cash and will be included in taxable income when paid.

Retirement

An IPP can be structured to provide a pension at retirement, payable from the pension fund established under the plan. It may also permit the participant to make a transfer out of the plan to one of the registered vehicles noted above (LIRAs, LIFs, and LRIFs). However, in some jurisdictions, pension standards legislation may require that, once the participant has retired, the plan must be wound up (because it no longer has any active members): in this case, the participant must either make a transfer to a registered vehicle, or the retirement benefit must be provided by way of an annuity purchased from a life insurance company. Any surplus remaining in the plan at wind up would have to be distributed in accordance with the plan (typically to the participant), and would be taxable as income in the year it was distributed. However, if the applicable legislation does not require a wind up, the tax sheltering of the funds not required to pay benefits can continue quite possibly until the death of the participant and his or her spouse.

Locking-In

While there is flexibility for the participant to determine how best to structure his or her income at retirement, it is important to understand that all of the benefits under an IPP are locked-in. This means that they cannot be taken out in a lump sum, but rather must be used to provide retirement income, either through a transfer to a registered vehicle, or by way of a pension paid from the plan.

Death Before Retirement

A participant can designate a beneficiary to receive

the death benefit under the plan, but if there is a spouse, then the spouse has priority and is entitled to the death benefit, provided that the participant and spouse are not living separate and apart.

Death After Retirement

In the event that the participant's pension had commenced prior to death, then any surviving spouse is entitled to a survivor pension that is equal to 60% of the amount of pension the participant was receiving.

Surplus

In the event that investment earnings exceed the plan's funding requirements, the plan can be drafted to provide for the distribution of surplus to the participant. Surplus paid to a participant is taxable upon distribution.

Funding

Contributions

Both the employer and the participant can make contributions to the IPP.

IPPs allow for significantly higher funding contributions than RRSPs. This is particularly true as the age and service of the IPP participant increase. The establishment of an IPP allows for the funding of benefits with respect to past service, normally requiring a transfer of assets from the member's RRSP and/or a loss of RRSP contribution room.

Originally, IPPs were set up to include many years of past service, as a way for owner-managers to “catch-up” for years in which they did not participate in a pension plan. However, current tax regulations impose what is known as a “proportionality condition” on periods of service prior to 1991. Basically, contributions to the plan for periods of service prior to 1991 are only permissible to the extent that they equal current service contributions. This means that this pre-1991 past service cannot be funded immediately, but must rather be funded as current service under the plan is accrued.

No such rule exists for post-1990 service. Benefits provided with respect to post-1990 service instead require a transfer of assets from the member's RRSP to the IPP and/or a loss of RRSP contribution room.

Additional IPP contribution room is normally created at retirement because the limits outlined in the Income Tax Act do not allow for full pre-funding of the benefits promised under the IPP. The shortfall can, however, be dealt with at retirement.

The plan can provide for the distribution of surplus to the participant

IPP Funding Example

The following example illustrates the potential funding of an IPP.

Participant Information

- 60 year old owner/manager of successful corporation
- member has been working for her company since January 1, 1991
- T4 earnings have exceeded $86,111 every year
- maximum RRSP contributions have been made each year

In 2003, approximately $142,400 can be contributed to the IPP. This compares very favourably with the RRSP alternative, which only allows $14,500 of contributions in 2003. The participant must also transfer $167,400 from her own RRSP to the newly established IPP due to the IPP's past service benefits and Income Tax Act rules.

Over the next 5 years, the participant could contribute the following to the IPP, assuming that she continues in active employment with T4 earnings as indicated above.

Year	Age	IPP Contribution
2004	61	$26,486
2005	62	$28,472
2006	63	$30,608
2007	64	$32,903
2008	65	$35,371

In addition to the above, additional contribution room may be available in the year of retirement.

Media

Trust or Insured

Pension standards and tax regulations require that an IPP be funded either through a trust or through an insurance contract.

Investment of the Fund

Pension standards require the establishment of investment policies and procedures for the plan. There are also some restrictions on the investments permitted under an IPP. Investment management in an IPP can be tailored to meet the requirements of the participant.

What are the advantages?

Funding of past service

Depending upon the participant's circumstances, it may be worthwhile to include periods of past service in the IPP. This allows for much higher tax deductible contributions than an RRSP.

Risk Shifting

While not necessarily relevant for owner-managers, an IPP does move the risk of funding retirement benefits away from the employee to the employer. In an RRSP, retirement income is derived from contributions plus investment earnings. Investment earnings in an RRSP may be inadequate to provide the target retirement benefit. However, in an IPP, the benefit is defined by a formula, and it is the employer's responsibility to ensure that this benefit is adequately funded.

Depending on the individual, it may be worthwhile to include periods of past service in the IPP

Poor investment earnings can be corrected

In an RRSP, poor investment performance in any given year cannot be corrected by further tax-sheltered contributions. In an IPP, on the other hand, poor investment performance must be corrected, requiring further tax deductible contributions to the plan.

What are the disadvantages?

Lacks income splitting

For individuals who have made contributions to a spousal RRSP in the past, the creation of an IPP means that there will no longer be RRSP room to continue to make such contributions. However, the tax efficiency gained through increased contributions to the IPP will likely more than offset the advantages of income splitting at retirement through a spousal RRSP.

Benefits are locked-in

In establishing an IPP, a registered pension plan is created. As mentioned above, registered pension plans must comply with pension plan legislation which mandates that the funds contributed must be used for the purposes of providing an eventual retirement income. These rules mandate that the funds cannot be withdrawn while the member is employed. As noted above, even upon termination of employment, the funds may be transferred out but only to a locked-in retirement savings vehicle, and left to accumulate until retirement age.

Future regulation changes

While no tax policy changes to IPPs have been announced by the Department of Finance, it is always possible that the rules could be changed in the future. Such changes could impact the continued viability of an IPP as a tax-savings vehicle, and the advantages described above.

Actuarial and administration fees

Fee Schedule for Services provided by DSW Actuarial Services Inc.

The following fee schedule applies for IPPs.

Initial set up fees amount to **$2,500** if the IPP has no past service benefits, or **$3,000** if post-1990 past service benefits are provided.

Annual fees amount to **$500** thereafter, with an actuarial valuation required every 3 years for a fee of an additional **$1,000**.

Additional fees apply if pre-1991 service benefits are provided, and in the year of a particular event such as termination, death or retirement.

These fees are subject to change at the discretion of DSW Actuarial Services Inc. The fees indicated are for the services provided by DSW Actuarial Services Inc. only. In addition to the above fees, investment management fees and potentially other fees such as trustee fees will also apply.

FAQ

Q. This sounds great. Why isn't this more common?

IPPs are actually more common than most people realize due to the significant benefits they provide in particular circumstances.

In the past, actuarial fees for IPPs have been prohibitive for small business owners. Now, with actuarial services provided by an independent actuarial firm, the fees are much more reasonable.

There is also an historical reason. In 1991, Canadian pension tax rules were reformed to permit IPPs. Prior to this reform, pension plans for significant shareholders were not permitted. There was, naturally, a great deal of interest in this new tax planning advantage, and many new plans were implemented. However, in the mid-90s, changes were introduced to the funding rules for IPPs that decreased their advantage for younger individuals, with the result that fewer plans were set up. Despite these funding rule changes, however, IPPs remain attractive tax planning vehicles for individuals with the right combination of age and income level.

Q. What is the employer taking on?

In sponsoring an IPP, the employer is assuming all applicable statutory and regulatory requirements and obligations governing pension plans. While these vary by jurisdiction, they include such things as:

With services provided by an independent actuarial firm, the fees are much more reasonable

- funding obligations,
- administrative duties, and
- ensuring compliance with pension standards and tax regulations.

Q. What happens if the employer cannot afford the IPP in the future?

Generally speaking, the employer is required to make the contribution recommended by the actuary in his or her triennial valuation. As noted above, the rules applicable to any given IPP depend upon the jurisdiction, but in Ontario, the employer could wind up the plan, and the participant may agree to reduce accrued benefits. This means that, for an owner-manager, the plan itself will not be a financial straightjacket. However, if the participant does not agree to such a reduction, the employer would remain liable for all accrued benefits under the plan.

About DSW Actuarial Services Inc.

DSW Actuarial Services Inc. provides actuarial services in two main areas. We provide pension consulting services to commercial and non-profit organizations, as well as individuals requiring actuarial expertise. We also provide actuarial evidence services for lawyers requiring a report from an independent actuary.

As an independent firm, DSW Actuarial Services Inc. is able to provide professional service at a reasonable cost.

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