Give Me Shelter

IPPs can be effective retirement savings vehicles, particularly for your highly paid employees.

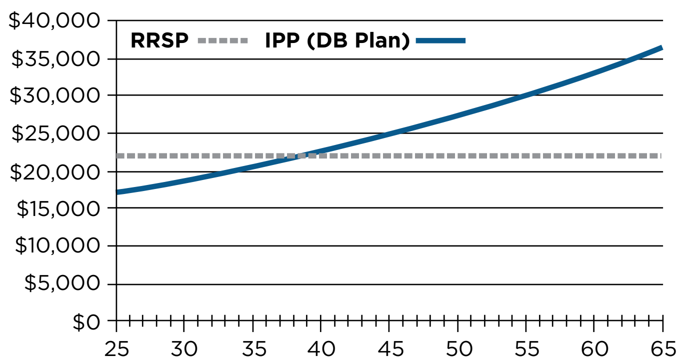
BY JEAN-ROBERT ÉLIE AND JOHN RICHARDS

In recent years, a number of defined benefit (DB) pension plan sponsors have been forced to terminate or suspend their plans due to, among other things, excessively low interest rates affecting their solvency and the volatility of the financial markets. In addition, there are very few new group DB plans being set up.

But one segment of the DB plan market that has seen significant growth recently is single-beneficiary plans. In Canada, several thousand individual pension plans (IPPs) have been created in the last few years.

IPPs are DB plans set up for the benefit of a single individual or an individual and his or her spouse. IPPs are particularly suited for highly paid employees, whether or not they are significant shareholders of a corporation.

Figure 1:
Comparison of the contributions according to age (2010)



Source: Avalon Actuarial

The DB rules under the *Income Tax Act* (ITA) allow individuals to accrue a prescribed lifetime retirement pension promise. But, according to calculations, more retirement capital is required to fund the pension promise than what is expected to be accumulated under RRSP rules. As a result, IPPs allow participants access to this additional tax-sheltered value.

Consequently, higher contributions are permitted under the IPP, and more income tax is deferred during the members' professional lives than what is permitted for RRSPs or defined contribution (DC) plans. These contributions are treated as business expenses and do not represent taxable benefits for the participants. To optimize the fiscal effectiveness of an IPP, it is usually financed entirely by employer contributions.

The IPP must be registered with the Canada Revenue Agency (CRA) and may have to be registered in the province where the participant resides. For example, in Quebec, IPPs are not required to be registered if the participant is a significant shareholder of the corporation. Ontario, however, requires registration with the Financial Services Commission of Ontario.

Figure 1 compares the maximum eligible contributions to RRSPs and to IPPs in 2010, in respect of one year of service according to the age of the participant.

Generally, once participants reach the age of 40, eligible IPP contributions exceed eligible RRSP contributions. Participants, therefore, can optimize the differences between the RRSP and the IPP to their advantage by making contributions to RRSPs early in their careers and implementing IPPs after age 40.

Past Service Benefits

One of the main advantages of an IPP is recognition of past years of service. Employees with many years of service in

a corporation can have their earlier years credited under the IPP.

Since the retirement pension payable to participants is directly connected to the number of years of service credited in the plan, participants who buy back the years of service they worked prior to the implementation of their IPPs will collect higher retirement pensions, and higher contributions are permitted.

When a participant buys back past years of service, an actuary calculates the contribution required to finance the additional pension provided by the buyback. The cost is usually shared by the participant and the corporation.

Participants who do not have any unused RRSP contribution room finance their portions of the buyback through a qualifying transfer from their current RRSPs. Their portion is calculated according to parameters set out in the ITA and is generally not equal to the accumulated value of the participants' RRSPs.

In Table 1, an IPP is implemented on Jan. 1, 2010, for an employee who is age 55 at that time and who has worked for 20 years with the corporation and has always earned a salary greater than the limits needed to earn a maximum accrual (currently $125,000). On Dec. 31, 2009, the participant's RRSP is at $315,000, and he has no unused RRSP room.

The participant must transfer $313,100 from his RRSP to the IPP to finance part of the cost of the buyback of his past service. The company, for its part, can make an immediate contribution of $254,800 for past service. Moreover, the current service contribution of $29,900 compares advantageously to the eligible RRSP contribution of $22,000. Therefore, the corporation can make a contribution of $284,700 ($254,800 + $29,900) during the year of the IPP's implementation.

Table 2 illustrates the accumulated value of the IPP at age 65 in comparison with the accumulated value of the RRSP only. The rate of accumulation used is 7.5%, the interest rate assumption prescribed for this type of plan. Thus, at age 65, the value of the IPP is greater than the RRSP by $756,400, which is quite significant. Of course, the 7.5% interest rate used here can be contested as being too high. It should be noted, however, that any performance loss in the IPP can then be covered by additional contributions in future years, something that cannot be done with RRSPs. The IPP represents a viable tax-efficient vehicle that can optimize additional retirement savings and can guarantee a certain level of retirement income.

Table 1: Implementing the IPP

	RRSP		IPP	
Current situation	**Accumulated value**	**Eligible contributions**	**Accumulated value**	**Eligible contributions**
	$315,000	$22,000	N/A	N/A
After implementation				
Current service contributions	N/A	($22,000)	N/A	$29,900
Transfer from RRSP	($313,100)	N/A	$313,100	N/A
Additional contributions	N/A	$0	$254,800	N/A
Total	$1,900	$0	$567,900	$29,900
Impact of IPP			+ $254,800	+ $7,900

Table 2: The accumulated value of the IPP and the RRSP at age 65

Value at age 65	IPP	RRSP with IPP	RRSP only	Advantage
Accumulation at 7.5%	$1,802,600	$13,700	$1,059,900	**$756,400**
Projected lifetime pension	$123,900	N/A	N/A	N/A

Source: Avalon Actuarial

Pension Adjustment

The past service pension adjustment (PSPA) calculation takes into account a buyback of years of service performed before the implementation of the IPP. It reduces RRSP room by the amount of the PSPA, which corresponds to the amount of the PA that would have been declared if the participant had had the IPP during each of the years bought back. This is why a transfer from the RRSP to the IPP must be done for buybacks of past service.

Actuarial Valuations

Upon registration and at least every three years thereafter, an actuarial valuation of the IPP must be performed to determine the amount of allowable contributions for the next three-year period. If a surplus develops under the plan, it may be:

- used to reduce future company contributions;
- used to improve benefits under the plan; or
- left in the plan, subject to prescribed limitations, until used.

On the other hand, if a funding deficit is created under the plan, additional tax-deductible contributions are required to finance this deficit in a lump sum or amortized over a period not exceeding 15 years. Depending on the provincial registration, the deficit arising upon plan termination may have to be contributed by the company in a lump sum or over a period not exceeding five years.

Pensionable Earnings

Employment income and bonuses paid by the corporation to the employee constitute the basis for the pension payable at retirement. Dividends, rental income and professional income are excluded from the calculation. Newly incorporated professionals can now participate in IPPs.

Termination of an IPP

The corporation can terminate an IPP at any time. At such time, the pension fund can be used to purchase a retirement pension from an insurer or transferred to the participant's locked-in retirement account, subject to the maximum amount prescribed in the ITA. The excess amount is paid to the participant in cash and is taxable. The purchase of the annuity might cost more than the assets of the fund and an additional contribution can be made, or, in some circumstances, the pension can be reduced to the level that the fund would support. For plans that are not subject to provincial registration, a transfer to the participant's RRSP without locking in is permitted.

Advantages & Disadvantages

Some of the advantages of IPPs have already been mentioned:

- higher maximum annual contributions;
- buyback of past years of service;
- additional contributions when the retirement fund performance is inferior to the actuarial valuation assumption;
- retention of key management employees; and
- corporate tax reduction.

In addition, IPPs allow corporations to reduce excess liquidity. They stabilize retirement income, making it easier to plan for the entire amount of income available at retirement. They can also be used to transition value between generations of owners.

Spouses may be added as IPP participants if they work for the same corporation, thus increasing benefits without doubling the costs of implementation and administration.

However, there are some apparent shortcomings to IPPs. Because they are more complex, their implementation and administration costs are higher than those of RRSPs. And, when their investment performance is significantly superior to actuarial assumptions, corporations could be required to take a temporary contribution holiday. Participants cannot contribute to their RRSPs during this period because a PA must still be declared.

IPPs offer considerable advantages as retirement savings vehicles: they permit tax-sheltered accumulation of significantly greater assets than what is possible with RRSPs or DC plans. Furthermore, because IPPs are DB retirement plans, they make it easier to finance a predetermined retirement pension, thereby securing a more stable retirement income. **BC**

Jean-Robert Élie is an actuary with Avalon Actuarial in Montreal, and John Richards is an actuary with Avalon Actuarial in Toronto. jeanrobert.elie@avalon.ca; john.richards@avalon.ca