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Demystifying Individual Pension Plans

Getting serious about accumulating retirement assets

BY MARK LESNIEWSKI

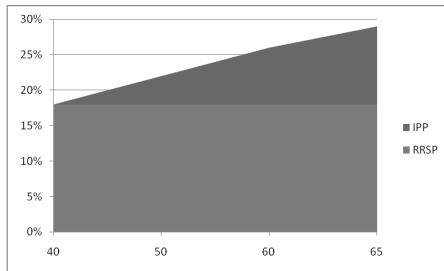
According to a recent RBC poll, 75% of Canadians believe that the “retirement of their dreams” is out of reach. Existing programs such as RRSPs are incapable of accumulating the gap in required assets in a relatively short time frame. For business owners, incorporated professionals and executives, the Individual Pension Plan, or IPP, represents a superior vehicle for accumulating retirement assets. Despite their numerous advantages, IPPs remain relatively unknown. This article will attempt to reduce the IPP to its essential elements.

Plan Implementation Considerations

An IPP is a registered defined benefit pension plan designed to provide the maximum pension benefit permitted under the Income Tax Act. A corporation sponsors the IPP and through tax-deductible contributions provides benefits to the IPP member in relation to T-4 earnings.

The amount of tax-deductible contributions is determined primarily through three variables: age, length of service with the corporation, and T-4 earnings.

Age



Age	40	50	60	65
Contribution (%/earnings)				
IPP	18	22	26	29
RRSP	18	18	18	18

Of the three variables, age is the most important determining factor to maximize contributions. The accompanying table shows the percentage of T4 earnings for ages 40 through 65 that can be contributed to an IPP versus an RRSP.

Once business owners or executives reach age 40, the amount that can be contributed to an RRSP or IPP is about equal. The IPP allows for more generous contributions, especially at ages 50 and above.

As is the case with RRSPs, there is a specified maximum earnings level upon which contributions are based. This maximum has increased steadily from \$86,111 in 1991 to \$124,722 for 2010. Future increases are projected in line with average wage increases.

Length of Service

An IPP can provide for benefits prior to the IPP implementation date and is referred to as Past Service¹. Contributions in respect to Past Service can be made even if all eligible RRSP contributions have been made. To eliminate any doubling of benefits over this same period, a specific amount has to be transferred from the RRSP (referred to as a Qualifying Transfer) or alternatively, unused RRSP room is reduced (for individuals who have elected not to make full RRSP contributions).

Past Service benefits can be recognized for service going back to 1991. In specialized cases, service prior to 1991 can be recognized. The table below highlights the IPP Advantage for a 60 year old IPP member who has average historical T4 earnings of \$124,722, with various periods of service:

IPP Member, Age 60			
Average Earnings from 1991 to present			
	5 Years	12 Years	19 Years ²
Total Value Past Service Benefits	\$164,900	\$395,800	\$626,700
Less: Qualifying Transfer	101,000	254,200	368,000
Equals: Net Past Service Contribution	\$63,700	\$141,600	\$258,700
Plus: Current Service Contribution	33,000	33,000	33,000
Equals: Total IPP Contribution	\$96,600	\$174,600	\$291,700
Contrast: RRSP Contribution	\$22,000	\$22,000	\$22,000

¹ In contrast, Current Service refers to benefits for service on and after the IPP setup date.

² Period from January 1, 1991 to December 31, 2009.

As can be seen from the preceding table, contributions on behalf of Past Service can be substantial. The financial case for IPPs is the substantial difference between the RRSP contribution and the Total IPP Contribution in the first year after the setup of an IPP.

It is important to note however, that although the Net Past Service Contribution can be made in a lump sum, it is possible to amortize this amount over a period of up to 15 years. This will still result in IPP contributions that will be more than double compared to the RRSP.

HIGHER T-4 EARNINGS WILL RESULT IN LARGER PAST SERVICE BENEFITS. HOWEVER, EVEN RELATIVELY MODEST T-4 EARNINGS CAN RESULT IN MEANINGFUL CONTRIBUTIONS.

T-4 Earnings

The third variable for determining tax deductible contributions to an IPP is the level of T-4 earnings paid to the IPP member. It is important to note that because IPP benefits are paid in relation to T-4 earnings, dividends and other forms of income do not qualify. Obviously, higher T-4 earnings will result in larger Past Service benefits. However, even relatively modest T-4 earnings can result in meaningful contributions. This is shown in the table below which is based on a member who is age 60, with 19 years of Past Service, over varying T-4 earnings levels:

IPP Member, Age 60 Average Earnings from 1991 to present			
	\$50,000	\$75,000	\$124,722
Total Value Past Service Benefits	\$314,800	\$467,800	\$626,700
Less: Qualifying Transfer	<u>149,200</u>	<u>232,700</u>	<u>368,000</u>
Equals: Net Past Service Contribution	\$165,600	\$235,100	\$258,700
Plus: Current Service Contribution	<u>13,200</u>	<u>19,800</u>	<u>33,000</u>
Equals: Net IPP Contribution	\$178,800	\$254,900	\$291,700
Contrast: RRSP Contribution	\$8,000	\$13,500	\$22,000

Ideal IPP Candidates

Reviewing the preceding table, we note that for an older individual, an IPP makes sense even if they have little service with the sponsoring corporation and/or their earnings are low. Service and earnings become more important for younger IPP members. However, even for a younger IPP member, an IPP can still make sense if they have a long employment history with the sponsoring corporation and their earnings levels are significant.

Thus, the ideal prospect for an IPP emerges with the following characteristics:

- Business owner, incorporated professional or executive;
- Age 40 or older;
- Ten or more years with the corporation;
- Average T-4 earnings of \$75,000 or greater.

The IPP in Operation

Upon establishing an IPP, the IPP behaves quite similar to an RRSP. Once the contribution amounts are calculated by an actuary, they are contributed to a trust and invested in a similar manner to an RRSP. Like an RRSP, the investment returns accumulate tax-free while in the IPP which allows for greater compounding of assets.

The table below shows asset accumulation at age 65 (from age 55) in an IPP versus an RRSP, assuming the same investments are chosen:

Accumulated Assets at Retirement Average and Initial Earnings at Age 55			
	\$50,000	\$85,000	\$120,000
IPP Accumulation	\$838,700	\$1,386,400	\$1,757,700
RRSP Accumulation	\$464,500	\$804,200	\$1,108,900
IPP Advantage	\$374,200	\$582,200	\$648,800

Table Assumptions

- Accumulation from age 55 to 65, for given initial earnings at age 55
- Future earnings assumed to increase at 5.5% per annum
- Investment earnings 7.5% per annum

The importance of the tax shield should not be underestimated. An IPP will result in significantly greater accumulation of assets using a vehicle that is similar in risk profile to an RRSP.

Investments

Generally stated, any investment that is available to an RRSP is permitted in an IPP. There are two notable exceptions. First, investment in one's own corporate stock, mortgages or debt is not permitted. Second, assets have to be invested in a diversified portfolio which generally limits investments to no more than 10% of the portfolio book value in any single security.

THE IMPORTANCE OF THE TAX SHIELD SHOULD NOT BE UNDERESTIMATED. AN IPP WILL RESULT IN SIGNIFICANTLY GREATER ACCUMULATION OF ASSETS.

AN ADDITIONAL LUMP SUM CONTRIBUTION CAN BE MADE UPON RETIREMENT THAT WILL ENHANCE THE MEMBER'S ACCRUED PENSION BENEFIT.

IPP Plan Wind-Up

While the IPP is in operation, no assets can be withdrawn. However, assets can be obtained from the IPP in one of three ways.

The least popular option is to transfer the IPP assets to an insurance company to purchase an annuity that will provide income for as long as you live (and which may include survivorship benefits to the spouse). The IPP member must be of pensionable age³ to take advantage of this option. This option is currently unpopular due to low interest rates, but does represent an interesting strategy to insure against outliving your assets.

The most popular option is to wind-up the plan and transfer the assets to a prescribed RRSP⁴. Such assets can continue to accumulate tax-free until the end of the year the former IPP member turns age 71. At that time, the assets must be used to provide on-going pension-type income to the member which will either be an LRIF/RRIF product (depending on the locking in requirements of the jurisdiction) or annuity purchase. A plan wind-up can occur at any age subsequent to the set-up of an IPP⁵.

The third option is to continue the IPP and pay an accrued pension from the IPP trust. The underlying corporation must continue to sponsor the IPP. One advantage to this approach is that an additional lump sum contribution can be made upon retirement that will enhance the member's accrued pension benefit. Depending on the age at retirement, this additional amount can be worth several hundred thousand dollars.

Summary

For business owners, incorporated professionals and executives who are serious about accumulating retirement assets, an IPP represents the best vehicle under the Income Tax Act to accomplish this objective. More strongly, any business owner, incorporate professional or executive who uses an RRSP to accumulate retirement assets should have an IPP.

³ Varies by provincial jurisdiction and is generally age 55, except for Alberta which is age 50.

⁴ The typical vehicle is a locked-in RRSP that requires the assets to be used to provide annuity type income. Jurisdictions such as Quebec and Prince Edward Island do not require a locked-in RRSP. A trend in jurisdictions that require a locked-in RRSP allow for partial un-locking of assets (i.e., similar status to an RRSP) at the time of income disbursement.

⁵ However, the primary purpose of an IPP must be a pension plan, meaning there has to be at least one or more years of Current Service.

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IPP inc. is a firm of actuaries and retirement plan specialists. Although the firm provides a full spectrum of actuarial and retirement plan services, it specializes in the implementation and administration of Individual Pension Plans across Canada. IPP Inc. has witnessed rapid growth and is one of the largest independent actuarial consulting firms in the IPP marketplace, where it services its clients from Calgary and Toronto office locations.

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