Benefits CANADA

Building wealth with IPPs

Al Emid | July 26, 2011

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An individual pension plan (IPP) can be an effective vehicle for funding a business owner's retirement and minimizing their personal taxes. It can also play a part in corporate tax planning. And yet it remains something of a rarity in Canada.

Recent growth has been steady but not stellar. According to the Canada Revenue Agency, there are 12,128 registered plans (as of on March 31, 2011), of which 10,497 are active. The remaining 1,631 are deemed "in cessation" due to lack of service. That compares with 11,745 registered in 2009, with 10,076 active.

In the current business environment, there is great potential for IPP sales, according to Rona Birenbaum, co-founder of Toronto-based Caring for Clients Inc.

"I come across many situations where an IPP would be a good tool for wealth building for the owners of companies and the subject has not been raised either by their accountants or by their financial advisor," she says.

The ongoing shift from defined benefits (DB) pension plans to defined contribution (DC) plans represents a sales opportunity for advisors, especially in companies trying to limit financial obligations.

An IPP can provide a more generous retirement savings program for senior executives than a DC plan and represents a retention tool for companies offering senior executives a premium retirement program.

Birenbaum suggests that one factor holding down sales may be that some advisors do not see IPPs as a positive cost-benefit equation. "That being said, if you are the type of advisor that understands that the way you serve a client best, have loyalty, generate referrals is by actually doing what's right for the client even if it's not particularly profitable for you, then I think there would be more IPPs in place."

IPPs become cost-effective for an individual 40 years of age and older and earning at least $127,611 in T4 income. An IPP can hold most of the same assets as an RRSP, with some restrictions, such as a limit of 10% concentration in a single stock and limits on mortgage holdings.

The 2011 federal budget included several tweaks to the IPP

- Where the employee is eligible for a deposit based on past service, he or she must first transfer existing RRSP assets.
- The company can make up the shortfall between the eligible past service amount and value of these RRSP assets.
- The IPP must pay out each year after the individual turns 71 an amount equal to the greater of the regular pension payable or minimum required if the assets were held in a RRIF.

Other features resemble those of an RRSP, such as the ability to hold a range of investment options, tax-sheltered growth, creditor protection, and the ability to roll over proceeds on a tax-deferred basis to a spouse upon the plan holder's death.

Disadvantages include the regulatory requirement to ensure a minimum annual growth rate of 7.5%. When the plan's assets fail to hit that threshold, the IPP may be deemed underfunded, eventually leading to problems with the CRA.

For the advisor, it is crucial to ask company owners where they are in the typical market cycle. Drawing up worst case financial scenarios over the coming five to seven years will help ascertain whether the company has the flexibility to fund its IPP obligations. If not, the company must at least have sufficient borrowing capacity. The company has five years to catch up on these pension liabilities if the required tri-annual actuarial analysis demonstrates a liability.

If the entrepreneur-plan holder's children also work for the company, they may also qualify to receive proceeds on a tax-deferred basis.

But the IPP has advantages over the RRSP. The requirement to maintain the 7.5% threshold—which means that contributions may exceed those allowable for RRSP's, and where assets have eroded, the company must make up the difference, a factor not present with RRSP's. If the eroded assets eventually regain their value, the plan holder gets an expected additional benefit.

The benefits of an IPP are not exclusive to the plan holder alone. The plan can save help reduce the company's tax burden as well. If profits are below $500,000, the applicable tax rate is just 15%. IPP contributions can be used to reduce company profits to that level, benefiting both the plan beneficiary and the sponsor company

Costs can become a drawback and do not vary tremendously between insurers and other institutions. MRS Trust, for example, charges $3,750 to set up an IPP for a first and second plan holder. Tack on $800 in annual maintenance fees, $1,875 for the triennial report for both plan holders, $250 for annual reports and some provincial filing fees.

An IPP can become a source of conflict between shareholders, who may disagree on how to deploy company finances. One shareholder may want to set up an IPP, while another may have more pressing financial obligations, and prefer present-day cashflow in the form of dividends.

Payments to the IPP reduce the amount available for shareholder dividends, so the servicing advisor must find a solution satisfactory to all shareholders.

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