THE INDIVIDUAL PENSION PLAN (IPP) – A JUMBO RRSP

Column
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Individual pension plans have been around for years but they have recently started to gain popularity with business owners who are in a high tax bracket. According to Canada Revenue Agency there are only about 10,000 individual pension plans in Canada. However, as of late, individual pension plans have also come on the radar screen of high income earning doctors and dentists who have only been able to incorporate since January 2006.

As the name implies, this is a pension plan and like other pension plans it is creditor-proof.

Simply put, an individual pension plan or IPP is a defined benefit pension plan for one person (and sometimes the spouse). Think of it as a jumbo RRSP for professionals, business owners and executives in high income tax brackets. If you are a member of this group, by establishing an IPP, you can sock away substantially more money than the RRSP contribution limit would allow you to.

The amount you can contribute to an IPP is based on an actuarial calculation of salary and years of service that will be performed every three years and can allow contributions based on past service that go as far back as 1991. This catch-up can easily be over $100,000 if you drew income above $75,000 for the last 10 years. The company can even deduct interest if it borrows to fund the pension. By contributing to the IPP the company gets a very good deduction and the owner gets a top-up to his or her pension. The company will also be able to contribute substantially more into the pension annually than it could, by using an RRSP.

As the name implies, this is a pension plan and like other pension plans it is creditor-proof. Also, from an actuarial standpoint, the assumption is that it will grow at an average annual rate of return of 7.5%. So every three years, when the actuarial valuation of the plan is done, if the growth rate has been less than this, then the plan needs to be topped up and additional contributions need to be made to make up the shortfall. Therefore, if you want to maximize contributions to your IPP, you may want to invest very conservatively so that the rate of return on your investments falls short of 7.5% and that way the corporation can take money out of the retained earnings and make additional contributions to your IPP. Contributions to an IPP have to be made within 120 days from the fiscal year-end of the business.

On the other hand, if your business is cyclical and economically-sensitive, you may have trouble topping up your IPP if a stock market decline coincides with a slowdown in your business and falling revenues.

If you are a business owner who has been in business for a long time but have not contributed much to your RRSP, an IPP will provide you with a great opportunity to make a substantial lump sum tax-deductible contribution to your RRSP.

The older you are, the more sense IPPs would make for you. In 2010, if you earn $128,000 you can contribute $22,000 to an RRSP. A 60-year old earning the same amount would be able to contribute $34,500 to an IPP but a 40-year old would be able to contribute only $23,700. Generally speaking, if you are under 40, an RRSP would make more sense for you.

Ideally you should earn over $75,000 in T-4 income, have substantial years of service and be over 40 to get the most benefit from an IPP. From an income perspective, you will get the maximum benefit if your income is over $122,000.

Unlike RRSPs, you cannot set up spousal IPPs so income splitting before retirement is not possible with IPPs. However, the income received from an IPP is considered pension income so it would be eligible for pension income splitting before age 65. This is in contrast to RRIF income where pension income splitting cannot be done before age 65.

If you already have an RRSP in place, some of your RRSP funds can be transferred to your IPP as a tax-free roll over and you can keep the rest of the funds in your RRSP. However, once you set up an IPP your RRSP deduction limit will drop to $600 per year so the bulk of your contributions will have to be made to your IPP.

If you plan to retire early, you could make a lump sum contribution to your IPP to fund the defined benefit pension you need upon early retirement. This allows you to move money from the retained earnings in the corporation on a tax-deferred basis into your IPP.

If you retire in Canada, the IPP assets will be subject to locking-in provisions like any other pension plan and an income must begin to be paid at age 71. However, if you plan to retire outside of Canada, most provinces allow you to wind up the IPP and withdraw the whole amount. In this case federal tax treaties will apply and the IPP assets would be subject to tax in the jurisdiction that you move to.

The set up fee for an IPP is higher than for an RRSP and will differ depending on the type of plan and trustee arrangement. There will also be ongoing fees for the tri-annual actuarial valuations and tax filings. If you are a business owner or professional in a high income tax bracket, you should discuss IPPs with your financial advisor to find out if this would be a suitable strategy for you.

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