STRENGTH BEYOND NUMBERS •
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Hazel de Burgh is used to dealing with overtly hostile people. She is, after all, a forensic accountant who has to expose frauds. But auditing the LAPD was another story

Watching THE Detectives

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DEFINING TERMS • Sweet success • Business risks • It's an art, not a science
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Catch the IPP wave

THE INDIVIDUAL PENSION PLAN INDUSTRY IS ON THE VERGE OF AN EXPLOSION, WHICH COULD PROVE PROFITABLE FOR CAs

SUSANNA DENTI

Traditionally the big four accounting firms prepared financial statements for corporations offering large defined-benefit pension plans. The emergence of the individual pension plan (IPP) benefits smaller CA firms and sole practitioners. It will find CAs billing accounting services to smaller corporate clients that have created IPPs for their owners/executives.

This new service will be a profitable endeavour for CAs, generating more billable hours. On a micro level, the average CA will bill six to eight additional hours upon setup of an IPP followed by an annual billing of three to four hours per IPP filing.

The best place for a CA to gather information on IPP accounting is the Accounting Section 3461, Employee Future Benefits, in the *CICA Handbook*. In general, all of Section 3461 relates to small business employee benefit plans, which applies to the accounting of IPPs in particular.

According to Section 3461, the components of the pension expense of an IPP recognized in a plan sponsor's financial statement are the following: the current service cost of the IPP, plus interest cost on the accrued benefit obligation, minus the expected return on plan assets, plus the amortization of any past service costs arising from a plan initiation or amendment, minus the amortization of any net actuarial gain or loss, plus any amount immediately recognized as a result of a temporary deviation from the plan, plus any increase or decrease in a valuation allowance, plus a gain or loss on a plan settlement or curtailment.

Incorporated business owners/executives who dutifully make maximum RRSP contributions now think their personal RRSP limit will not lead to a comfortable retirement income.

Fortunately for high-income earners employed by an incorporated or professional corporation, in 1991 the federal government introduced the concept of IPPs into the Income Tax Act (subsection 147.1) to compensate high-income earners disadvantaged by RRSP rules.

IPPs are presented as an RRSP upgrade, with annual contributions fully deductible by the corporation/IPP sponsors and are a nontaxable benefit for the plan beneficiaries until money is withdrawn from the plan.

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The IPP tax solution allows for thousands of tax-deferred income dollars (from an incorporated business) to be invested into an IPP structure, allowing that owner/executive nontaxable interest, compounding until retirement.

Imagine a 45-year-old owner/executive with the company since 1991 has averaged a T4 income of more than $100,000 a year and who plans to max-out his or her IPP contribution room and RRSP (using a yearly rate of return of 7.5%) will accumulate $4,796,518 in registered retirement assets. Opting for this tax solution, the individual would have a registered retirement yearly benefit at age 69 of $362,549 fully indexed to the consumer price index.

In comparison, if the same owner/executive only utilizes his or her RRSP option from ages 45 to 69, he or she would only accumulate $3,226,413 in registered retirement tax-sheltered assets. This amount of RRSP assets on an annual basis would generate from age 69 and beyond $243,871 of retirement income.

The decision is clear; the owner/executive who implements both the IPP and RRSP tax solutions as part of his or her retirement plan would have an additional $1,570,105 of tax-sheltered assets in his or her registered retirement plan and have an additional $118,678 in annual retirement income.

Other advantages include:

- *Creditor proofing*: Assets held in the IPP cannot be seized by creditors of the plan or the incorporated business.
- *Extended contribution period*: A company has 120 days after its year-end to make an IPP contribution, which will be considered an expense for the company in the previous business year. Contributions into a RRSP that can be applied back to the previous calendar year need to be made within the first 60 days after the new year.
- *CRA registration*: CRA can not de-register an IPP on condition that the plan was set up in good faith by an active corporation.
- *Ownership of plan assets*: At retirement, the IPP member owns any actuarial surplus. It may be used to upgrade pension benefits or the planholder may pass it on to his or her spouse, heirs or estate.
- *Guaranteed lifetime income to IPP members and their spouses*: This pension plan offers a predictable retirement income. An actuary determines the current annual cost of the future retirement income. Spousal pension benefits may be upgraded to 100% when the member retires or dies.
- *Past service funding*: For owners/executives, the IPP funding formula is more generous than the RRSP limits. The plan allows companies to contribute for the pension plan member for years of service prior to the setup of the plan going back to 1991.

If the first year of the setup of an IPP is 2005, the past service and current service funding contribution/corporate deduction could be as much as $361,000, while the maximum 2005 RRSP contribution is $16,500.

- *Terminal funding*: One of the most attractive features of the IPP is the possibility of terminal funding. While CRA restricts the benefits that can be pre-funded at retirement, the plan can be amended to provide the most generous terms possible. These include: full consumer price indexing, early retirement pension with no reduction, and bridge benefits.

Imagine an IPP has been created for a 49-year-old owner/manager. As of January 1, 2005, this owner/manager has T4 earnings of $100,000 and has maintained this level of income since 1991, and it is safe to project that his or her income will remain at $100,000 annually adjusted to inflation until retirement. Assume this IPP member will retire at 60 on January 1, 2016 with 25 years of pensionable service (1991 to 2015). Before the retirement benefit begins to be paid out of the IPP, there is a window of opportunity for his or her company to make a one-time $251,000 terminal funding contribution to the IPP, in addition to regular IPP government prescribed funding contribution and annual growth calculations.

- *Flexible funding options*: Money can be used to fund the IPP that has accumulated in retained earnings of a company. Funding can come from outstanding bonuses owed to owners/executives by making the employee's contributions for him or her into the IPP. Another option would be for the employer to obtain financing/loans from a financial institution. All interest on loans to fund IPPs is a tax-deductible expense for employers and a nontaxable benefits for IPP members.

Currently, there are 3,200 registered IPPs across Canada representing approximately $800 million of total assets invested. According to the Canadian Taxpayers Federation, CRA, Statistics Canada, the Canadian Federation of Independent Businesses and the Canadian Centre for Policy Alternatives in 2000, 22 million Canadians filed tax returns; of those 598,700 (2.7% of tax filers) earned more than $100,000 in T4 income. Potentially an additional 600,000 business owners and executives have the ability to pay themselves T4 incomes of more than $100,000 if there is a tax incentive, such as the IPP, for them to do so.

In 1999, 72% of the $420 billion in RRSPs was owned by the top 20% affluent families, who also owned 94% of the $92 billion invested in stocks outside RRSPs

The richest 10% of Canadian families have an average net worth of $980,903, accounting for 53% of national wealth in 1999. At that time, 72% of the $420 billion in RRSPs was owned by the top 20% affluent families. This 20% also owned 94% of the $92 billion invested in stocks outside RRSPs, and 81% of the $80 billion invested in mutual and investment funds outside RRSPs.

In the 1990s there was an explosion of self-employment. Currently there are 2.3 million self-employed Canadians and 1.1 million active incorporated businesses. With 75% of Canada's one million businesses employing fewer than five people most of the IPPs will be created by owners of Canadian-controlled private corporations looking for a strategy to take money out of their corporations in a tax-effective way.

In 2001, the average Canadian worker was 39 years old. The creation of an IPP only makes sense for individuals aged 40-plus, earning $100,000 or more. IPP yearly contributions at 40 years old are $18,200 and will increase at a compound rate of 7.5% annually. The maximum 2005 RRSP contribution has been set at the inadequate contribution level of $16,500.

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It is hypothesized that the IPP market will experience a growth similar to that of the mutual fund industry in Canada. According to the Investment Fund Institute of Canada, in 1990 the mutual fund industry was worth $24 billion; at the end of 2000 it had grown to $430 billion. The IPP market is on the verge of the same kind of explosion as more Canadians earn $100,000 and enter retirement en masse beginning in 2010, as baby boomers start to retire.

Boomers are looking for both tax and investment solutions that will provide them with wealth preservation; CRA sanctioned tax avoidance solutions; creditor protection; wealth accumulation and wealth distribution.

IPP specialists predict that over the next 15 years, if half the people who currently earn $100,000-plus choose to upgrade their RRSPs to an IPP, there will be more than 300,000 of these defined-benefit pension plans in place across Canada.

It is inevitable that affluent Canadians will opt to migrate much of their RRSP assets into IPPs.

If the average plan accumulates $500,000, there will be more than $150 billion sitting in IPP assets. Given an average asset management fee of 2% a year, the assets held in IPPs will create more than $3 billion in recurring investment fees paid annually.

In addition, to remain registered each IPP will require actuarial and trustee administration, billing about $1,500 a year, generating about $450 million annually.

In real terms, an IPP will need to be accounted for on a company's corporate financial statement. The average cost for the total IPP new accounting services nationally will generate 2.4 million billable hours (IPP setup) and create 1.2 million in (ongoing) annual billable hours.

Lastly, the emerging IPP industry will create about $4.5 billion in new annual revenue for Canada's 68,000 CAs, 35,000 CMAs, 60,000 CGAs, 100,000-plus financial advisers and 2,572 actuaries, which is not calculated in Canada's current gross domestic product formula.

Obviously, IPPs require a specialty in areas such as accounting, actuary evaluation, investment management, pension legislation, employment law and employee benefit plan construction. Many employers and their accounting professionals will need to seek educational services to aid them in the IPP setup and maintenance stages. Therefore, it is worth the time and money to hire an IPP consultant to assist in the design, implementation and maintenance of an IPP solution.

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