FINANCIAL PLANNING

IPPs: Growing in popularity

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By PETER MERRICK

Incorporated businesses looking to add a benefit for their owners and top executives might want to consider a tax minimization structure that in recent years has gained in popularity. It is called the individual pension plan.

An IPP is a sound business decision for all business owners and top executives who have historically maximized their RRSP and have the income to support a more aggressive tax deferral arrangement.

IPPs are a business owner/ executive answer to traditional registered retirement savings plans. They are sanctioned by the Canada Revenue Agency and offer the best tax and retirement savings solution for individuals 40 years old and older who have a T4 income of more than $100,000 and have historically maximized their RRSPs and pension contributions.

Implementing the IPP solutions will allow both an employer and its key people to receive maximum tax deferral.

Before 1991, owners and key executives of small businesses were disadvantaged by pension rules that prevented them from creating and participating in defined benefit pension plans because there was no structure available in this country for providing a pension for just one person.

So in 1991 the federal government remedied this situation by enacting IPP legislation (in the *Income Tax Act* of Canada, subsection 147.1) to compensate high-income earners disadvantaged by pension and RRSP rules, allowing for a DBPP to be created for just one person in the form of an IPP.

Similar to the adoption rate of RRSPs that where first introduced in 1957, which did not become popularized in Canadian culture until the late 1970s, IPPs are predicted by industry experts to become as common place for Canada's top earners in the next 15 years as RRSPs are today, as Canada's highest income earners trade in their RRSPs for the much more tax and retirement efficient IPP structure.

It is estimated that the number of registered IPPs in Canada will grow from 6,000 plans in 2005 to over 300,000 plans by 2020. When this predicted growth manifests, assets held within IPPs will climb from $1 billion in 2005 to over $200 billion by 2020.

How good are IPPs ?

Imagine you have a 55-year-old executive, David Smith, who has owned an incorporated business since 1991 with a T4 income of more than $100,000 and a marginal tax rate in Ontario of 46.41 per cent. This owner is serious about saving for retirement and in the next 10 years, when he reaches 65 he plans to retire.

By creating an IPP for himself this year, this business owner will be able to defer $114,743 immediately from taxes from his company and his personal income.

This money will then compound tax-free within the IPP. The next year Smith will be able to contribute an additional $24,122 into his IPP tax deferred and his contribution room will increase by 7.5 per cent annually until he retires (the investment mix chosen for this illustration bond portfolio, earning seven per cent annual).

When Smith reaches 65, he will have accumulated $632,384 in his IPP.

If this business owner decides not to create an IPP for himself and instead chooses to take this same amount of money out of his business, after having paid the personal marginal tax rate of 46.41 per cent, for the purpose of saving for retirement, then his financial situation becomes much different.

The first year after taxes, Smith will be left with $61,490 to invest.

The following year, after taxes, he will make a $12,927 contribution to his non-IPP; and his contribution level will grow at 7.5 per cent. The asset mix is the same, earning seven per cent annually. At age 65, he will have an accumulated value in his non- IPP of $276,435.

Based on the stated assumptions, this particular business owner who has chosen the IPP solution will have saved $355,949 more than opting to take the non-IPP option.

Other IPP advantages

Tax deductibility

All contributions, interest and expenses are tax deductible to the incorporated business and are a non-taxable benefit to the person the IPP is set up for as long as the money is kept in IPP.

Creditor proof

Assets held in the IPP cannot be seized by creditors of the business on condition that the pension plan was set up in good faith—not just because of a looming bankruptcy.

Ownership of plan assets

At retirement, the business owner/ executive owns any actuarial surplus. The surplus may be used to upgrade pension benefits or pass the surplus tax-free to his or her spouse, to his heirs or to an estate.

Guaranteed lifetime income to members and their spouses

The pension plan offers a predictable retirement income. An actuary determines the current annual costs of the future retirement income.

Eligible spouses receive 66.66 per cent of pension in the event of death of the plan member. Spousal pension benefits may be upgraded to 100 per cent at the time the member retires.

Past service funding

For business owners and executives, the individual pension plan funding formula is more generous than RRSP limits.

The pension plan allows business owner to make contributions for years of service prior to the set-up of the plan. No other plan or individual investment can offer this benefit. First year contributions with past service funding can be as high as $369,000.

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 pension plan can be amended to provide the most generous terms possible. Some of these include: full consumer price indexing, early retirement pension with no reduction as well as bridge benefits.

Individual pension plans may be the best deferred income plan to provide for both business owners and executives but don't expect a regular financial adviser or benefit consultant to be well-versed in all the intricacies of IPPs.

There are many pension, tax, legal and investment rules involved with the implementation and maintenance of these DBPPs.

To my knowledge there are only a half dozen firms cross Canada who specialize in the creation, implementation, maintenance and wind-up of IPPs.

And it is well worth time and money to find the right person or people to work with when contemplating the IPP tax and retirement solution.

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PENSION FUNDING: Planning to avoid predicaments

By LOUIS MARTEL and NICHOLAS MORISSETTE

The chief financial officer is wondering why his company's pension plan has a solvency deficit and its solvency ratio is 90 per cent. Obviously, there have been modest investment returns over the past few years, coupled with a decline in long-term interest rates. However, he cannot understand how the situation could have deteriorated so much when the solvency ratio was over 120 per cent just three years ago.

He is reminded that the company took significant contribution holidays during that period. But was that the right thing to do? Would it have been wiser to retain a buffer? Nevertheless, the company did enjoy a contribution holiday for three years, so the strategy may have been appropriate at the time.

What should the company do in the future? What funding strategy would best meet its objectives and those of the pension plan?

The existence of a funding policy would have enabled decision-makers to understand the situation and, consequently, avoid this predicament. The decision to take a contribution holiday would have taken management's long-term principles into account and not been driven solely by a desire to optimize short-term results. The principles would have been carefully analyzed to ensure that the plan's financial results were in line with those of the plan members, the employer and the plan administrator who all assume the risk.

What is a funding policy?

A funding policy provides guidelines for decisions with respect to the plan's funding, for both going concern and solvency purposes. It is a document in which are specified:

- the objectives of the parties to the plan; and
- the parameters to be respected when financing decisions are made that will optimize the probability of achieving the objectives.

The policy may be drawn up by the plan sponsor, usually the employer, or the plan administrator, which in some cases would be a pension committee, depending on the party that is responsible for the plan's financial management.

Content of funding policy

The content of the policy depends on the complexity, terms and characteristics of the pension plan. The policy typically covers the following items:

Objectives

The policy must state the funding objectives that link the plan's financial management to the overall objectives of the party that established the objectives. This party is generally the plan sponsor or administrator.

The objectives are usually related to the following aspects:

- security of the promised benefits;
- stability of contributions over time;
- minimization of contributions over a given horizon;
- fairness of funding among the generations (*e.g.*,

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