

Tailor-Made Benefits Plans For Top Executives

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Incorporated businesses looking to add a benefit for their owners and top executives might want to consider a little known tax-avoidance structure called the individual pension plan (IPP). IPPs are a wealthy person's answer to 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. IPPs are Defined Benefit pension plans set up for an individual, a family, or a small group of key employees.

Many top executives and owners of businesses in this competitive employment environment want tailor-made benefit packages that best suit their individual needs. Fortunately, for these high-income earners employed by an incorporated or professional corporation, the federal government introduced in 1991 into the Income Tax Act the concept of IPPs to compensate those disadvantaged by RRSP rules.

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 As well, they are a nontaxable benefit for the plan beneficiaries until, as with an RRSP, money is withdrawn from the plan.

The IPP tax solution allows for hundreds of thousands of tax-deferred income dollars (from an incorporated business) to be invested into an IPP structure, enabling that executive to earn nontaxable interest which compounds until retirement.

IPP VERSUS RRSP

Imagine a 45-year-old executive who has worked for the same company since 1991 and has averaged a T4 income of more than \$100,000 a year. If they decide to 'max-out' their IPP contribution room and RRSP (using a yearly rate of return of 7.5 per cent), they will accumulate \$4.8 million in registered retirement assets. Opting for this tax solution, this individual would have a registered retirement yearly benefit at age 69 of \$362,549 fully indexed to the consumer price index.

In comparison, if this same executive only utilizes their RRSP option from 45 years old to age 69, they would only accumulate \$3.2 million in registered retirement tax sheltered assets. This amount of RRSP assets on an annual basis would generate \$243,871 of retirement income from age 69 and beyond.

The decision is clear. The executive who implements both the IPP and RRSP tax solutions as part of their retirement plan would have an additional \$1.6 million of tax-sheltered assets in their registered retirement plans and have an additional \$118,678 in annual retirement income.

MITIGATING EMPLOYER RISK AND FINANCIAL LIABILITY

Many employers involved in the IPP setup stage ask "how can their company mitigate the potential liability of being responsible for maintaining an employee IPP benefit for an unspecified period until the employee or his or her spouse die?"

Employers have several options available to them. The employer, as a condition of opening and maintaining the responsibility for an executive IPP for a key person, may negotiate to have the key employee guarantee to work for the employer for a stipulated period of years in advance of promising to allow them to keep the IPP at their company if they leave before they retire. For example, a company may promise to continue to keep the pension on the company's books provided this individual works another five years or promises not to retire before he or she turns 55 years old.

Alternatively, the employer can negotiate to have the employee do one of several things should he or she resign if the above conditions are not met. The executive can transfer the IPP to another company that will take responsibility for the pension benefit, convert the IPP into a locked-in RRSP, or buy an annuity.

What employers usually prefer for long-term employees is to convert their IPP to an annuity at retirement because the responsibility of funding the pension benefit is then shifted from the employer to an insurer. For employees who have a short term of service with the company, employers usually prefer that their former employees transfer their company IPPs to a locked-in plan. If the IPP is registered in Quebec, IPP monies can be transferred into a non-locked-in RRSP.

Many individuals 45 and older, who believe they have many more years to work, find the option to transfer their IPP appealing because they can continue to control how the assets are invested. In addition, employees who decide to transfer an IPP to their own company or another employer will continually see their contribution room increase compared to what they would receive if they had only a Defined Contribution pension plan or RRSP option to defer taxes from their income.

CAUTIONS

It must be remembered that IPPs are registered pension plans that must be set up and maintained properly. If it is determined that an IPP is not in compliance with the Income Tax Act/regulations and CRA's Registered Plans Directorate regulations, the registration of an IPP may be revoked at anytime. Recently, there have been a number of high profile tax cases that have resulted in the deregistration of IPPs for individuals who have transferred pension monies from other Registered Pension Plans based on these plans satisfying CRA's four criteria:

- **Criteria One** – The IPP must comply with all laws and regulations governing registered plans and all filings must be up to date
- **Criteria Two** – The IPP was established to create a pension plan prior to the plan being set up and/or the transferring of pension benefit assets from another DB plan from another employer to the IPP
- **Criteria Three** – There is a bona-fide relationship between the plan member and his/her company
- **Criteria Four** – If assets from another DB plan have been transferred to an IPP, members of the IPP can expect earnings similar to those earned as an employee

If an IPP's status is revoked, it immediately turns into a retirement compensation arrangement. The formerly registered IPP will forward 50 per cent of assets to CRA on behalf of the plan member. These funds will be refunded to the RCA plan member at a later date when money is withdrawn from the RCA. On withdrawal of funds from the RCA, taxes will be paid at the RCA beneficiary's marginal tax rate. In the worst case scenario, CRA may not permit the assets from the IPP to be rolled over into an RCA and taxes will be charged on all assets held in the former IPP.

Heavy interest charges may be levied by CRA for overdue taxes owed by both the IPP sponsor and member of the plan, plus there may be large fines charged for non-compliance. If an IPP is in violation of the Pension Benefits Standards Act, 1985, provincial acts, or the Income Tax Act, individuals can be guilty of an offence and can be fined up to \$100,000 or imprisoned for a term not exceeding 12 months, or both. In addition, a corporation/sponsor of an IPP that is convicted for violating these acts and regulations may be fined up to \$500,000.

WHERE IS THE IPP TIDAL WAVE COMING FROM?

Currently, there are more than 9,000 registered IPPs across Canada representing approximately \$1 billion of total assets invested.

In the year 2000, 22 million Canadians filed tax returns. Of those 598,700 (2.7 per cent 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.

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

In the 1990s, there was an explosion of self-employment in this country. Currently there are 2.3 million self-employed Canadians and 1.1 million active incorporated businesses in Canada. With 75 per cent of Canada's one million businesses employing fewer than five people, it means most of the IPPs in this country will be created

OTHER KEY IPP ADVANTAGES

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 and over, earning \$100,000 or more. IPP yearly contributions at 40 years old are \$21,700 and will increase at a compound rate of 7.5 per cent annually.

It is hypothesized that the IPP market will experience a growth similar to that of the mutual fund industry in Canada. The Investment Fund Institute of Canada says, in 1990, the mutual fund industry was \$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 prepare to enter retirement en masse beginning in 2010.

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
- wealth distribution

IPP specialists predict over the next 15 years, if half of 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 DB pension plans in place across Canada.

It is inevitable that the 20 per cent of affluent Canadians who own 72 per cent of the \$420 billion in RRSPs will opt to migrate much of their RRSP assets into IPPs.

CLOSING CONSIDERATIONS.

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 set-up and maintenance stages. Therefore, it is well 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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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 as 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 start of the new year.

CRA registration – CRA cannot 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 plan holder 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 per cent at the time the member retires or at the plan member's death.

Pension income spousal income splitting – Recent changes to the Income Tax Act (Canada) allow employees at age 55 who are drawing a pension from their IPP to allocate to their spouses up to one-half of their IPP pension income.

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 set-up of the plan going back to 1991. If the first year of the set-up of an IPP is 2007, the past service and current service funding contribution/corporate deduction could be as much as \$361,000. Remember, the maximum 2007 RRSP contribution is \$19,000.

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, the plan can be

amended at retirement to provide the most generous terms possible. Some of these include full consumer price indexing and early retirement pension with no reduction as well as 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. It is safe to project that their income will remain at \$100,000 annually adjusted to inflation until retirement. Assume that 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 the company to make a onetime \$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 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 non-taxable benefit for IPP members.

Luring key people to your organization – By using an IPP as part of a total executive benefit package, a company can attract people who are currently employed and are members of a Defined Benefit pension plan. Traditionally, such candidates may not have wanted to leave an employer or DB plan before retirement because tax rules prevent them from transferring the full value of their pension credits to a locked-in RRSP. Now a company can avoid such an obstacle by creating an IPP for these employees and transferring existing pension plans to the new IPP without tax implications.

