



## FINANCIAL PLANNING (2): PENSIONS

### UNDER-FUNDING THREATENS DEFINED PENSION PLANS

By Peter Merrick  
Toronto

Ageing has become a truly global challenge. Unsustainable benefits promises have become the principle source of retirement insecurity in most industrial countries.

The number of elderly — 65 and older — increased more than three-fold since 1950, from 130 million, or 4 per cent of world population, to 419 million, 7 per cent of world population in 2000.

Most of the world's elderly live in the industrialized west. When the baby boomers start to retire en masse beginning in 2010, Canada could see combined pension and health care cost exceed 25 per cent of total Gross Domestic Product. This may not be maintainable or sustainable!

We truly live in a connected world. Canadian companies and their employees have seen their pension assets plummet from \$614 billion at the end of 2000 to \$541.6 billion in mid-2003. According to Statistics Canada, two-thirds of pension plans in Canada are in the red.

This pension under-funding was sparked by the collapse of the dot-com bubble, the stock market decline and accounting fraud. During the last three years, stock markets have declined between \$5 to \$7 trillion.

And those investors losing money

are not just rich folks. Public and private pension funds are the largest institutional investors in the stock market.

Pension funds grew during the '90s stock market boom to the point where many become over-funded.

As an effect, many companies did not have to make large contributions to their plans and they could afford generous benefit increases to retirees at the same time.

**The stock market meltdown drastically changed the equation for many pension funds.**

The stock market meltdown drastically changed the equation for many pension funds. The under-funding occurred when investments in these plans failed to generate enough income to meet projected future obligations.

When that happens, companies must start making additional contributions to the funds, money that many of them do not have at the moment. The largest under-funded pension plans in Canada are at Nortel Networks Ltd., Alcan Inc., CIBC, and Bombardier Inc.

**What if there's not enough money to go around?**

Pensions, once thought as charity, are now thought as an essential part of the social responsibility of employers. In a Defined Benefit Pension Plan (DBPP) the employer has promised members of its plan a pension.

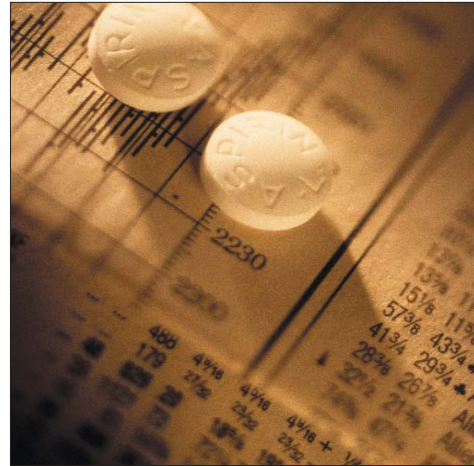
If a DBPP is under-funded and cannot meet its obligations to pay out its promised benefits, retirees will get first claim on the assets of the plan. Next to get paid are employees now eligible for pensions.

The remaining money is then divided among the rest. Yes, there is a risk a member of a DBPP might not get the benefits they were promised by their employers. However most members of a DBPP don't know this risk exists!

#### Limited Protection

Ontario is the only province that has created a fund called the Pension Benefits Guarantee Fund (PBGF). It offers limited protection for the over one million DBPP members within its borders. If DBPPs in Ontario have insufficient funds or are wound-up, the PBGF will only guarantee the first \$1,000 per month of pension benefit.

The PBGF was created in 1980, and the fund has an estimated \$200-million available to pay new claims.



PBGF assets are invested in fixed income products such as T-Bills and bonds.

The funds within the PBGF are raised by fees charged to registered pensions in Ontario, current revenue from its fees are \$30 million per year and payouts have been \$10 million. DBPP members should be concerned about situations like the Algoma

Steel pension that is under-funded by \$500 million.

It is entirely possible situations like Algoma Steel could claim the entire PBGF. This could be foreshadowing of events to come.

Louis Erlichman, a member of the Financial Services Commission of Ontario's Financial Services Tribunal, — See Funding on page 17 —

## TACKLING CHALLENGES OF BUSINESS SUCCESSION PLANNING

By Chris S. Reynolds  
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The entrepreneurial streak runs deep in this country. It is amazing how many people say they would love to run their own business, and this despite the raft of legislation and regulation this (and previous) governments heap on business.

Yet, every year, more and more people take on the challenge of running their own business. Why do they do it? Well, generating profits that are retained by the owners is one good reason but that is not enough.

It's more to do with autonomy. But as time moves on, how do you plan to pass on your efforts to someone else?

One of the most agonizing decisions faced by many businesses is

the moving on from one owner to the next. In a situation where the business is to be sold, the decision is easier. But what about passing the business on to other family members or even management?

Succession planning should be considered regularly. In traditional family-owned concerns, a succession plan should be in place by the time the founder reaches his or her mid-50s. But what sort of framework should be adopted for planning for this event?

Criteria should be developed for selecting a successor. And these criteria should be communicated to any family member involved in the running of the business as well as to management.

Research has demonstrated that there are seven stages to successor development.

The first stage is attitude preparation — important attitudes towards work and the family business are formed during persons 25 years of life. This stage includes: work, occasional business-related trips and outside work experience.

Next, is entry into the world of work — usually occurs when the successor is aged 20-30 and takes an existing necessary job in the business.

Important elements of this job include training, orientation and

developing relationships with other employees.

The next phase is business development and usually occurs between the ages of 25 and 35, when the successor should be cultivating necessary skills and abilities. After this follows leadership development.

**One of the most agonizing decisions faced by many businesses is the moving on from one owner to the next.**

This usually occurs between the ages of 30 and 40, when the successor's plans stretch beyond any one job to the time when he or she will be responsible for the entire business. Skills developed during this stage include team building and share decision-making.

If more than one successor candidate exists, this will be the period when a natural leader emerges and self-selection or conflict may occur.

If multiple candidates exist, the next stages selection would occur at this stage. Methods of making a choice include an early self-selection by the incumbent or selection by the outside board.

During this period, authority and responsibility are transferred to the

successor. This is a transitional phase — a time when the successor becomes involved in strategic decision-making and in developing his/her management team.

Finally comes the next round. Succession planning in a business should always be on the agenda and the new leaders of a business should begin talking about developing the next generation of leaders.

Running a business is tough. Passing it on can be even tougher, but with planning it can be made easier.

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## FINANCIAL PLANNING (2): PENSIONS



For some people, contributing to an Individual Pension Plan can be smarter than saving in an RRSP

### INDIVIDUAL PENSION PLAN HAS FLEXIBLE PROTECTION

Employed executives, owner-managers, and incorporated professionals with current salaried income in the \$100,000 range or more should assess the advantages, disadvantages and costs of an IPP. The main advantages are:

- The taxpayer can make substantially larger tax-deductible contributions over a number of years, than is the case with an RRSP.
- The assets of the IPP are creditor proof.

The possible disadvantages and costs of an IPP are outlined later in this article.

#### An IPP Defined

An IPP is a defined benefit plan whereby the annual contributions to the plan are actuarially based on the amount of the pension that is required to be paid upon the individual's retirement. Based on certain minimum salary levels over the years, the maximum pension benefit is currently \$1,722 for each year of service, but this increases to \$1,833 in 2004 and \$2,000 in 2005. (E.g.: 40 years of service X \$2,000 equals a maximum annual pension of \$80,000.)

Retirement can occur any time from age 50 to 69. This differs from an RRSP which is a defined contribution plan, where the ultimate pension is based on the contributions and earnings thereon over the years.

The IPP must be registered with the Canada Customs and Revenue Agency. Although an IPP is usually set up for one person only, it may be advantageous to add family members (i.e. spouse and possibly children) if they draw a salary from the corporation.

Contributions are made by the

corporation which employs the individual and deducted by it in computing income for tax purposes.

Note that the owner-manager must receive remuneration from the corporation in the form of salary and/or bonuses. Other remuneration such as dividends or management fees will not allow the corporation to make contributions to the IPP.

#### Contributions

There are three broad areas of contributions:

- initial contributions to fund years of past service
- annual contributions for current service
- additional contributions on retirement to enhance the benefits.

The initial past service contribution can be substantial, particularly where the individual has earned significant salaried income from the corporation in each year since 1991, when the IPP legislation was introduced.

For example, the employer of a 50-year-old owner-manager drawing a salary of \$90,000 for each year since 1991, could make a 2003 tax deductible past service contribution on setting up the plan of \$99,304. Under the legislation the individual would also be required to transfer \$159,400 from his RRSP into the IPP to further fund past service.

If the individual has unused RRSP contribution room, the transfer is reduced and the employer can contribute more. If the individual has made maximum RRSP contributions, but does not have \$159,400 in his RRSP (i.e. he has made spousal contributions) the past service amount

must be reduced. The current service contribution on behalf of the 50-year-old employee described above would be \$21,558.

Contrast this amount with the current RRSP maximum contribution of \$14,500.

Additional contributions can be made on retirement to provide full consumer price indexing of the pension and certain other special enhancements.

**The owner-manager must receive remuneration from the corporation in the form of salary and/or bonuses.**

In another IPP example, a husband and wife aged 45, each of whom has drawn a salary of \$90,000 since 1991, and who retire at age 60 can contribute \$885,824 more to their IPP than had they made the maximum RRSP contributions.

They will receive a substantial annual taxable pension each year, but the reducing balance of the funds remaining in the IPP will go on accumulating tax free income.

#### Actuarial Review

Every three years the plan must be actuarially valued to determine whether the earnings on the investments have resulted in an over or under funded capital base. If the plan is under funded, compulsory tax deductible contributions must be made either immediately or spread over a maximum period of 15 years. However, if the plan has a surplus, the

future annual contributions must be reduced.

#### IPPs Are Creditor Proof

The rising cost of liability insurance, the availability of appropriate insurance at any cost, and long-term protection of assets are of concern to many business people and professionals. Litigation concerning every conceivable form of loss is growing and we think this trend will likely continue in future years. Assets in an RRSP are generally not protected from creditors unless they are invested through an insurance contract. Assets in IPP, however, are entirely protected and the funds can only be used to pay out a pension. Incorporated professionals, anyone involved in high-risk corporate business activities, and others who may be exposed to litigation now or in the future, should consider an IPP.

#### The Drawbacks to an IPP

Several important potential disadvantages to an IPP need to be considered:

- In an IPP, the funds are locked in and can only be used to provide a retirement pension, whereas a individual can generally withdraw all or a portion of the funds in an RRSP at any time without restriction, but with some tax consequences.
- An IPP involves higher administrative costs. There is an initial set up fee, which might range between \$1,500 and \$3,000. The annual administration fee and actuarial valuation every three years might involve a combined annual cost of approximately \$800 or \$1,000. These amounts are deductible expenses for tax purposes.

• An IPP is a contractual arrangement requiring annual contributions based on actuarial projections regardless of the corporation's profitability. On the other hand, contributions to an RRSP are voluntary and can be made in any year up to amount of the unused cumulative RRSP limit.

#### Disposal on Death

On death, the benefit of the remaining funds can pass to a surviving spouse. If there is no surviving spouse the plan is normally wound up and the remaining funds will be taxable in the hands of a designated beneficiary or the estate. Where children are also employees of the corporation and members of the IPP, taxable distribution of the balance in the IPP can be deferred even longer.

#### Conclusion

IPPs are not for everyone, but anyone with concerns about protecting their assets from possible creditors now or in the long term, should consider an IPP in their retirement planning. Those owner-managers whose corporations are generating a secure stream of income and who have drawn salaries for the years since 1991, may also be interested because of the large amounts of money that can be put in over a relatively few years.

*This article first appeared in the fall 2003 issue of Statement, a newsletter for the clients of Collins Barrow Calgary.*

*\* Financial projections and estimates contained in this article were supplied by Algar, Virtue & Associates, Financial Planners, Calgary.*

## FUNDING CRUNCH COULD LEAVE PENSIONS IN LURCH

— continued from page 14 — and past chair of the Canada Pension Plan Advisory Board, has seen in many cases of smaller DBPPs where plans qualifying for PBGF protection.

"Most money from the PBGF ended up in the pockets of consultants, lawyers and bankruptcy trustees, rather than in the hands of plan members," Erlichman noted.

How can members of DBPPs make sure they receive their full retirement benefit? One under-utilized way is for individuals or corporations to create an Individual Pension Plan (IPP).

An IPP is an individual defined benefit pension plan for just one employee, as defined in subsection 147.1 of the *Income Tax Act*. It provides senior executives and business owners with the opportunity to achieve maximum tax relief combined with maximum retirement pension.

The IPP member owns any actuarial surplus. The surplus may be used to upgrade pension benefits, or the plan holder may pass the surplus on to their spouse, heirs, or estate. Spousal pension benefits may be upgraded to 100 per cent should the plan member retire or die.

Assets held in an IPP cannot be seized by creditors of the plan member nor plan sponsor on condition the pension plan was set up in good faith — not just because of a looming bankruptcy.

A plan member can opt for several choices with the pension plan when employment is terminated or when the plan member retires.

At termination and retirement, pension plan funds may be transferred or invested in the following financial instruments: annuity, single or joint and last survivor; Locked in RRSP (LIRA); Life Income Fund (LIF); Locked-in RRIF (L-RIF) where applicable.

The pension plan can be transferred to a new employer if the new employer is willing to offer an IPP.

#### Other Benefits of an IPP

By using an IPP as part of a total executive benefit package, Canadian companies can now attract top people who are currently employed and are members of a lucrative Defined Benefit Pension Plan.

Traditionally these candidates may not have wanted to leave their existing employer or Defined Benefit Pension Plan before retirement, because CCRA tax rules prevented them from transferring the full value of their pension credits to a locked-in RRSP.

A company can avoid this obstacle and attract these key people by creating an IPP for them, and then transfer their existing pension plan to the new IPP without tax implications.

Individuals leaving corporations to strike out on their own can also

transfer their DBPP to their new incorporated business' IPP.

It is important to note that if this pension transfer strategy is utilized and a Defined Benefit Pension Plan is transferred from one company to another in the form of an IPP, the member of the IPP needs continue to have an active T4 income from their new incorporated business.

Recently, individuals who have transferred their Defined Benefit Pension Plans to holding companies for the sole purpose of segregating their pension assets from their former employer's plan, who then immediately retire, risk CCRA deregistering their entire pension. Thus, all the assets held in the plan would be immediately subject to the marginal tax rate of the IPP member.

Note: Before implementing this strategy it is important to consult a pension and benefit expert who is aware of pension legislation and Individual Pension Plans in particular.

In light of the uncertainty of DBPP under funding, members of these plans must ask themselves if there will be enough money in their pension to pay the benefit they were promised by their employer for the rest of their life and their significant other?

By deciding to remain in a DBPP are these individuals playing pension musical chairs where the last person in the plan will not get a pension benefit seat at all?

Perhaps in the coming years we will see many DBPP members take their money out of these plans and run!

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