Individual Pension Plan: A Rich Man's RRSP

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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. IPPs are a wealthy person's answer to registered retirement savings plans. They are sanctioned by the Canada Revenue Agency (CRA) 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.

The existing RRSP legislation was created in 1957, at which time inflation and indexing were not taken into account. As a result, RRSP contribution limits are woefully inadequate for Canada's high-income earners. In 1991, the federal government remedied the situation by enacting the IPP legislation (in the Income Tax Act of Canada, subsection 147.1) to compensate high-income earners disadvantaged by RRSP rules. This allowed incorporated businesses to create deluxe Defined Benefit Pension Plans for just one person with every bell and whistle one could imagine.

In a nutshell, the IPP is essentially an RRSP upgrade with three main differences: IPPs have significantly higher limits for contributions. For example, the first year contribution into an IPP for 2005 could be as high as $385,228, compared to the maximum allowable RRSP contribution of $16,500. IPPs have creditor proofing and they have restricted collapsibility options. IPPs cannot be fully collapsed unless the plan holder is critically ill, severely disabled or has fallen on financial hardships. In essence, IPPs effectively guarantee the holder an income for retirement.

All IPP contributions, set-up fees, and maintenance fees made by a corporation on behalf of the key person are fully tax deductible to the corporation and are treated as a non-taxable benefit to the employee. All investment management fees for the assets held in the IPP can also be made a tax-deductible expense for a business and a non-taxable benefit for the business owner/executive. Interest on funds borrowed to top up IPPs are also fully tax deductible by the contributing company.

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 a spouse, heirs or estate. Spousal pension benefits may be upgraded to 100% in the event that a plan member retires or passes away.

Many executives and owners want a tailor-made benefit package that best suits their individual needs. IPPs have a number of practical applications. For one, they are useful tools to upgrade already existing Defined Benefit Pension Plans (DBPP), Defined Contribution Pension Plans or group RRSPs.

An IPP can be used as part of a total executive benefit package. A company can attract people who are currently employed and are members of a DBPP. Traditionally such candidates may not have wanted to leave an employer or DBPP before retirement because tax rules prevented them from transferring the full value of their pension credits to a locked-in RRSP. Using this retirement solution, companies can avoid such obstacles by creating IPPs for such employees and transferring existing pension plans to the new IPP without tax implications.

IPP Combination Versus RRSP Alone

A 45-year-old owner/executive who has worked for the same company since 1991 and has averaged a T4 income of over $100,000 per year and plans to "max out" their 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, this individual would have a registered retirement yearly benefit at age 69 of $362,549, fully indexed to the Consumer Price Index (CPI).

In comparison, if this same owner/executive only utilizes his/her RRSP option from 45 to age 69, he/she would only accumulate $3,226,413 in registered retirement tax-sheltered assets (using the same 7.5% compounded interest rate). 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. This particular owner/executive who implements both the IPP and RRSP tax solutions (as part of their retirement plan) would have an additional $1,570,105 of tax-sheltered assets in their registered retirement plan and have an additional $118,678 in annual retirement income.

There are several ways that a company can finance an IPP. A company can use funds that have accumulated in retained earnings. It can use outstanding bonuses owed to key people by making the employee's contribution for him or her. Or employers can obtain financing from a financial institution specializing in funding IPPs. Whatever option you chose, all interest on loans to fund an IPP are a tax-deductible expense for employers and a non-taxable benefit for IPP members. RRSP loans do not have this benefit.

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Dale's note: Check also to learn of any withholding tax on a portion of the funds, if the IPP is collapsed at retirement and transferred to an RRSP.