



The Financial Planner

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Budget 2005: Tax and Retirement Highlights

On Wednesday, February 23, Finance Minister Ralph Goodale announced some significant changes to the Canadian tax and retirement planning regime, including:

- An increase in the basic personal amount;
- Higher RRSP and RPP limits;
- An end to the 30 per cent foreign content restrictions;
- The addition of investment-grade gold and silver bullion to the list of qualifying RRSP property;
- Lengthening the amount of time an RESP program may remain in existence;
- A commitment to review the way RRSPs are held for financial dependents in the event of the annuitant's death;
- The elimination of the rule forcing LIF owners to purchase annuities at age 80;
- An increase to the GIS;

Inside . . .

Budget 2005	2
Summary of Salient Details	2
Seeking Views	5
The ABCs of Individual Pension Plans	5
IPP Contributions Versus RRSP Contributions	6
Other IPP Features and Benefits	6
Who are the Ideal Clients for an IPP? ...	6



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- Higher limits for CDIC deposit insurance; and
- Lower corporate tax rates.

The budget document also included a call for comments on several other issues of interest to financial advisors, including:

- The removal of the statutory restriction on residential mortgages exceeding 75 per cent of the value of the property;
- The maximum period during which a bank could reasonably hold a cheque;
- The entry of foreign banks into the Canadian marketplace; and
- How to improve the federal legislative and regulatory environment as it applies to credit unions and caisses populaires.

Please see the following article for a more detailed summary of the measures proposed in Budget 2005.

Budget 2005

Summary of Salient Details

The following article summarizes some of the proposed Budget 2005 changes that may be of particular interest to financial advisors.

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Basic Personal Amount

The income tax system currently includes personal credits to allow individuals to receive a basic amount of income on a tax-free basis. The basic personal amount eliminates income tax on taxable income of up to \$8,012 for 2004. The budget proposes that, by 2009, the amount of income that any Canadian will be able to receive tax-free will grow to at least \$10,000 as a result of progressive increases in the basic personal amount. Specifically, the basic personal amount will be increased:

- For 2006, by \$100.
- For 2007, by \$100.
- For 2008, by \$400.
- For 2009, by the greater of \$600 and the amount required to bring the basic personal amount to \$10,000.

The income tax system also includes personal credits in respect of a spouse or common-law partner or a wholly dependent relative. These credits eliminate tax on up to \$6,803 of additional taxable income for 2004. The amounts on which these credits are based will also be increased:

- For 2006, by \$85.
- For 2007, by \$85.
- For 2008, by \$340.
- For 2009, by the greater of \$510 and the amount required to bring the amounts on which these credits are based to \$8,500.

These increases to the amounts will be in addition to increases that take effect due to indexation of the tax system.

The amount upon which the spouse or common-law partner amount (including the equivalent amount that a single individual can claim for a wholly dependent relative) is based, is reduced on a dollar-for-dollar basis by the dependant's net income over a threshold. This threshold is intended to ensure that small amounts of a dependant's income will not affect the calculation of these credits. This threshold will be adjusted to reflect the increases described above.

RRSP and RPP Limits

The budget proposes the following increases in RRSP and RPP limits:

- The contribution limit for RRSPs will be increased to \$16,500 for 2005, \$18,000 in 2006, \$19,000 in 2007, \$20,000 in 2008, \$21,000 in 2009, and \$22,000 in 2010.
- The money purchase RPP annual contribution limit will be increased to \$19,000 for 2006, \$20,000 for 2007, \$21,000 for 2008, and \$22,000 for 2009. Corresponding increases will be made to the maximum pension limit for defined benefit RPPs. Because RPP limits are based on current year earnings, while RRSP limits are based on prior year earnings, the RRSP limits are lagged one year behind the corresponding RPP limits. The DPSP limit will remain at one-half of the money purchase RPP limit.
- The proposed limits will be indexed to average wage growth, starting in 2010 for RPPs and DPSPs, and in 2011 for RRSPs.

Foreign Property Rule

The Foreign Property Rule (FPR), which set a limit on the amount of foreign property that could be held inside registered savings plans, was introduced in 1971 to ensure that a substantial proportion of tax-deferred retirement savings flowed to Canadian companies and to support the development of Canada's capital markets. The federal government has proposed that the FPR be scrapped, effective as of 2005.

The move caught many advisors by surprise, and may result in the wind-up of the so-called "clone" derivative funds that were structured to circumvent the rule. The move may also cause many investors to question the need for Self-Directed Registered Retirement Savings Plans, since one of the primary benefits was the ability to combine holdings under one plan in order to maximize foreign content. One wonders how many smaller investors will bother paying \$100 annually in SDRRSP fees when they can now open up as many accounts as they like without having to worry about staying under the FPR maximum.

Qualified RRSP Investments

The rules governing Registered Retirement Savings Plans and certain other tax-deferred income plans provide that these plans must invest only in "qualified investments" prescribed by the Income Tax Regulations. The budget proposes to add to the list of qualified investments, investment-grade gold and silver bullion coins and bars, and certificates on such investments.

Investment-grade gold must have a purity of at least 99.5 per cent, while investment-grade silver must have a purity of at least 99.9 per cent. Legal tender bullion coins

will qualify if they are produced by the Royal Canadian Mint and all or substantially all of their fair market value is attributable to their precious metal content. Bullion bars will qualify if they are produced by a metal refinery accredited by the London Bullion Market Association, as evidenced by a hallmark identifying the refiner, purity, and weight. Certificates will qualify if they are issued by a federally or provincially regulated financial institution and represent a claim on precious metal holdings of the issuing institution. For all such investments – that is, coins, bars and certificates – the investment must be acquired either from the producer of the investment or from a regulated financial institution.

These changes will be effective for investments made on or after February 23, 2005.

Registered Education Savings Plans

Contributions to an RESP are not deductible for income tax purposes and are not taxed upon withdrawal. Investment income accruing in the plan is taxable only on withdrawal. For each beneficiary of an RESP, there is an annual contribution limit of \$4,000 and a lifetime contribution limit of \$42,000. Contributions to an RESP can only be made for 21 years following the year in which the plan is entered into. An RESP must be terminated by the end of the year that includes the 25th anniversary of the opening of the plan.

The government's Technical Advisory Committee noted that students with disabilities often have special needs that must be accommodated in order to pursue post-secondary education, in particular with regard to the time required to begin or complete a post-secondary education program. The Committee recommended that the time limits during which an RESP can remain in existence, and during which a subscriber can make contributions, be extended to take into account the needs of students with disabilities.

In response, the budget proposes that, if an RESP beneficiary qualifies for the disability tax credit in the 21st year following the year in which the plan was entered into:

- The maximum period for making contributions to the RESP be extended to 25 years following the year in which the plan was entered into.
- The termination date of the RESP be extended to 30 years following the year in which the plan was entered into.

While this change applies only to single beneficiary RESPs, if an individual who qualifies for the disability tax credit is a beneficiary under a family plan, that individual's

share of the family plan can be transferred into a single beneficiary RESP in order to ensure access to these extended limits.

These extended limits will apply for the 2005 and subsequent taxation years. In addition, the government has indicated that the list of post-secondary educational institutions – in which enrolment generates entitlement to qualifying withdrawals under the RESP rules – will be reviewed over the coming months.

Registered Plans and Financial Dependents

Currently, financially-dependent children with mental or physical infirmities are eligible to receive, on a tax-deferred basis, a deceased parent's (or in the case of a child that is financially dependent on a grandparent, the deceased grandparent's) proceeds from a registered retirement savings plan (RRSP) or a registered retirement income fund (RRIF) if the funds are transferred to the child's RRSP or are used to purchase a life annuity. The Committee recommended that the Government review these rules in order to allow more flexibility in respect of a deceased's RRSP or RRIF proceeds left to a financially-dependent child or grandchild with a disability and, in particular, that the use of a discretionary trust be permitted in these circumstances. The Government will review the tax rules in this area with a view to providing more flexibility where appropriate.

Life Income Funds

The growing ability of seniors to choose from a wide range of options regarding their voluntary and leisure activities and their participation in the labour force also means they will be looking for increased flexibility as to when and how they can use their retirement savings to provide income during their retirement years.

To that end, Budget 2005 proposes to increase the financial flexibility enjoyed by individuals who transfer funds from their federally regulated locked-in RRSPs into life income funds (LIFs) by eliminating a rule that currently requires holders of LIFs to convert them into annuities on reaching age 80.

Locked-in RRSPs are typically generated when individuals who change employment opt to take the vested pension benefits they have acquired under a registered pension plan (RPP) in the form of a locked-in RRSP, rather than in the form of a deferred annuity or transfer of credits into the RPP of a subsequent employer. To provide income during an individual's retirement years, a locked-in RRSP

may be used to acquire a life annuity or converted into a LIF.

At present, regulations made under the federal *Pension Benefits Standards Act, 1985* (PBSA) stipulate that the terms of LIF contracts (under which locked-in RRSPs are converted into LIFs) must require their beneficiaries to use any remaining LIF funds to purchase a life annuity at age 80. Budget 2005 proposes to eliminate this requirement. As a result, future beneficiaries who transfer their locked-in RRSPs into LIFs will be able to retain the option of continuing to withdraw funds from their LIFs in accordance with existing withdrawal rules even after they reach age 80.

Guaranteed Income Supplement

Budget 2005 proposes to increase maximum monthly GIS benefits by \$36 for single seniors and \$58 for couples. Half of this increase will take effect on January 1, 2006, and the remaining instalment will take effect on January 1, 2007. Corresponding increases will also be extended to recipients of both the Allowance and the Allowance for the Survivor benefits.

OSFI and CDIC

The Government is taking steps to clarify the roles and responsibilities of the Canadian Deposit Insurance Corporation (CDIC) and the Office of the Superintendent of Financial Institutions (OSFI) to eliminate unnecessary overlap and duplication. The two agencies will present a plan to the Minister of Finance for streamlining administrative functions by June 30, 2005. OSFI will become the sole organization responsible for reviewing new entrants into the financial sector and for developing prudential rules and guidelines. Budget 2005 also announced that the CDIC deposit insurance coverage limit will increase to \$100,000 from \$60,000, effective immediately.

Corporate Taxation

The budget proposes to reduce the general corporate income tax rate to 19 per cent from 21 per cent by 2010. The general corporate income tax rate will be reduced to 20.5 per cent effective January 1, 2008, to 20 per cent effective January 1, 2009, and to 19 per cent effective January 1, 2010 (all prorated for taxation years that include those dates). It also proposes to eliminate the corporate surtax on January 1, 2008, prorated for taxation years that include that date.

Seeking Views

In the 2005 Budget Plan documents, the government indicated it is seeking views on the following issues:

Residential Mortgages Exceeding 75 Per Cent of the Property Value

For more than 30 years, federal financial institutions legislation has prohibited the provision of residential mortgages exceeding 75 per cent of the value of the property. This statutory restriction on residential lending was intended to protect financial institutions from the risk of fluctuating property values. However, the requirement to have insurance in every case when a mortgage exceeds 75 per cent of the value of the property may have increased the cost of home ownership to some Canadians.

The Government is seeking views on providing more flexibility to residential mortgage lenders and homebuyers by removing the statutory restriction on residential mortgages exceeding 75 per cent of the value of the property.

Cheque Hold Periods

Currently, the Government requires banks to disclose in a written statement their policies with regard to the holding of cheques when a personal deposit account is opened, and to notify existing account holders of any changes to the cheque holding policy. However, consumers and other groups are of the view that many individuals face long hold periods for cheques that they deposit with banks, even when those cheques are drawn on another Canadian financial institution. It has been argued that these long hold periods force many individuals, and particularly lower-income individuals, to turn to alternative financial service providers (where they face higher interest costs and fees) to gain more rapid access to their funds to meet their daily needs.

The Government is seeking views on establishing a maximum period during which a bank could reasonably hold a cheque.

Foreign Bank Entry

Recent legislative reforms relating to foreign banks in Canada have sought to encourage entry into Canada as a means of fostering competition in the financial sector.

Yet, in an effort to facilitate entry through various structures, the legislative framework has evolved into a complex set of rules that are broad in scope. The scope and com-

plexity of the framework may impose an unintended regulatory burden on foreign banks seeking entry and has implications for the resources required to administer it.

The Government is seeking views on the scope of the foreign bank entry framework, its core principles and how to simplify its mechanics.

Credit Unions and Caisses Populaires

Credit unions and caisses populaires continue to face the challenge of building on their advantage as locally rooted financial institutions. Bill C-8 provided additional structural flexibility to the financial cooperative sector, allowing them to organize their operations to fit their business needs. However, there may be room for further improvement in the federal statutes in areas such as membership requirements for associations.

The Government is seeking views on measures to improve the federal legislative and regulatory environment as it applies to credit unions and caisses populaires.

The ABCs of Individual Pension Plans

By: Peter Merrick

Have you heard about Individual Pension Plans (IPPs)? The IPP is what many in the financial industry are calling a "RRSP Upgrade". The IPP is a Defined Benefit Pension Plan (DBPP) set up for one person.

The concept of the IPP was introduced in section 147.1 of the *Income Tax Act* in 1991, but has rarely been used until very recently. There are four important differences between IPPs and RRSPs:

- IPPs have significantly larger contribution limits;
- all contributions made into an IPP are a tax deductible expense for the company sponsoring the plan;
- IPPs offer creditor protection; and
- collapsibility options are limited, in that IPPs cannot be fully collapsed unless the plan holder is critically ill, severely disabled, or has fallen on financial hardship.

Forward thinking accountants, investment advisors, actuaries, and insurance agents across Canada are placing bets that a large portion of Canada's 2.3 million self-

employed individuals, and the owners/executives of the 1.1 million active incorporated businesses, will adopt the IPP solution over the traditional RRSP for themselves.

If their hunch is right, the financial industry will see the transfer of tens of billions of dollars out of RRSPs into IPPs. The last time the Canadian financial industry had this type of migration of assets from one type of financial product into another was in the early 1990s, when, overnight, hundreds of billions of dollars moved from GICs into mutual funds. According to the Investment Funds Institute of Canada (IFIC), in 1990 there were only \$24 billion invested in mutual funds. At the beginning of 2000, the total asset value of all mutual funds in Canada was \$430 billion.

IPP Contributions Versus RRSP Contributions

The IPP is a sound business decision for almost all business owners and executives who are over 40 years of age, have historically maximized their RRSP contributions, and have the income to support a more aggressive tax-deferral arrangement.

For example, a 53-year-old owner/executive who has worked for the same company since 1991, has averaged a T4 income of over \$100,000 per year, and who plans to “max-out” her IPP contribution room (using a yearly rate of return of 7.5%) will accumulate \$2,270,943 in registered retirement assets. Opting for this tax solution, this individual would have a registered retirement yearly benefit at age 69 of \$171,651 fully indexed to the Consumer Price Index (CPI).

In comparison, an owner/executive who only utilizes his/her RRSP option from age 53 to age 69, would only accumulate \$1,450,044 in registered retirement tax sheltered assets (using the same 7.5% compounded interest rate). This amount of RRSP assets would generate \$109,603 in retirement income, from age 69 on.

This particular client/owner/executive who implements both the IPP and RRSP tax solutions (as part of their retirement plan) would have an additional \$820,899 of tax-sheltered assets in their registered retirement plan and have an additional \$62,048 in annual retirement income.

Other IPP Features and Benefits

All interest on funds borrowed to top up IPPs are 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 an estate. Spousal pension benefits may be upgraded to 100% in the event that a plan member retires or dies.

An IPP may be used as part of a total executive benefit package, and may help a company 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. By adopting the IPP strategy, companies can avoid such an obstacle by creating an IPP, and transferring existing pension plans without any tax implications.

One of the most attractive features of the IPP is the possibility of terminal funding. The CRA restricts the benefits that can be pre-funded before retirement. However, at retirement, an IPP can be amended to provide the most generous terms possible. This means that, before an individual declares his or her retirement and starts collecting a pension benefit, his or her company can make a considerable contribution into the plan that is both deductible for the company, and a non-taxable benefit for the individual. Some of the features that can be added are full consumer price indexing, early retirement pension with no reduction, and bridge benefits.

An IPP member has several options upon termination of employment, or retirement. In either case, pension plan funds may be transferred to or invested in the following financial instruments:

- an annuity – single or joint and last survivor;
- a locked-in RRSP (LIRA);
- a Life Income Fund (LIF); or
- a locked-in RRIF (L-RIF), where applicable.

Funds can also be transferred to a new employer, if the new employer is willing to offer an IPP.

Who are the Ideal Clients for an IPP?

To qualify for an IPP, a plan member should:

- have T4 income;
- be an owner/executive of an incorporated company which is taxable under the *Income Tax Act*; and
- have an influence on the decision-making processes of his or her company.

Generally speaking, IPPs are best suited for key executives or owner-managers over 40 years old, earning a base salary of more than \$100,000. *Note:* The tax advantages are higher for older owners/executives.

Before a financial advisor starts promoting IPPs to his or her clients, it is very important to acquire knowledge in areas as diverse as pension legislation, accounting, actuarial evaluation, investment management, employment law, and employee benefit plan construction. Financial professionals wanting to enter the IPP market 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 who will assist in the design, implementation, and maintenance of an IPP solution for your clients.

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