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Can an Individual Pension Plan help you reach your retirement goals?

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If you're looking for alternative to a Registered Retirement Savings Plan **("RRSP")**, an Individual Pension Plan **("IPP")** may be an option.

What is an Individual Pension Plan and am I eligible to establish one?

An IPP is a registered retirement vehicle that is established by a corporation (known as the Sponsoring Corporation) for an individual (or more if the participants are family members) - a shareholder or executive who hold (directly or indirectly) no less than 10 per cent of the shares in the corporation and receive a salary from the corporation.

Like an RRSP, an IPP serves as an investment account used to accumulate assets over time for your retirement on a tax-deferred basis. It also acts like a "traditional" pension plan with the monthly income at retirement being defined under an IPP.

If an IPP functions like an RRSP, what are the advantages of the IPP?

IPPs can be a valuable option for retirement and tax savings for several reasons.

1. **Larger contributions**

   One of the major advantages to establishing an IPP is the increased tax-deductible contribution room from age 40 onwards. High income earners may struggle to build a large enough nest egg that will allow them to maintain their pre-retirement lifestyle due to the annual contribution limits imposed on their RRSP. IPP contributions are calculated by an actuary according to a formula that could consider (among other things) the historical salary withdrawn from the Sponsoring Corporation and the age of the plan member. Accordingly, larger contributions can be made to an IPP where the IPP funding rate exceeds that of an RRSP, allowing a plan member to save more money on a tax-deferred basis towards their retirement goals.

   In addition, in the first year of the plan a Sponsoring Corporation may be able to contribute a large, tax-deductible lump sum to an IPP which accounts for "past services contributions" that have accumulated within the business. Similarly, a Sponsoring Corporation can also make another lump-sum contribution known as "terminal funding" - essentially a top-up contribution to the IPP when the member retires.

2. **Tax deductions**

   The Sponsoring Corporation may deduct IPP contributions from its taxable income provided they are paid within 120 days after year-end. Additionally, interest on borrowed funds used to make these contributions, actuary fees and other administrative fees, all represent eligible deductions to the Sponsoring Corporation.

3. **Reduce passive assets and income in the corporation**

   Legislation implemented in the 2018 federal budget mandates the reduction of the Small Business Limit to Canadian Controlled Private Corporations **("CCPCs")** that alone (or as part of an associated group) earn passive income in excess of $50,000. The Small Business Limit is fully eliminated for federal tax purposes when a company earns $150,000 of passive income. So for taxation years beginning after 2018, corporations that have excess passive income receive a diminished benefit of tax deferral on income earned inside their corporation. Removing the passive assets from the corporation will: 1) preserve the $500,000 small business deduction on active business income and 2) assist in maintaining the corporation's status as a qualified small business corporation for purposes of the Lifetime Capital Gains Exemption on a future sale of the shares of the corporation.

4. **Tax-free wealth transfer**

   The RRSP of a taxpayer is fully taxed upon the death of the second spouse and can only be rolled over on a tax-deferred basis to a disabled child. However, in the case of an IPP, if the children are employed and earn employment income from the Sponsoring Corporation, they are eligible to become plan members and be named beneficiaries of the IPP. In the event of death, the assets owned inside the IPP can avoid immediate taxation and go towards funding the employed spouse (similar to an RRSP) but also to the children's retirement, only to be taxed at the time they receive the IPP benefits. If the spouse/children are in a lower-income tax bracket than the member of the IPP, a lower level of income tax may be paid on the IPP benefits.

What are some downsides to using an IPP?

Of course, an Individual Pension Plan also has a few disadvantages for both the participant and the Sponsoring Corporation.

1. **Administration costs**

   While the setup and administration costs are generally tax-deductible to the Sponsoring Corporation, establishing an IPP has administrative costs. Moreover, there are annual administrative costs as well as actuarial costs. Also, the costs of winding up the IPP should be considered as this process may be onerous. An RRSP does not have these similar administrative costs.

2. **Access to funds before retirement**

   Previously, funds contributed to the IPP could not be accessed and were locked in until retirement. While the legislation implemented in 2020 by the Ontario government allows taxpayers to access funds prior to their retirement, doing so before the age of 50 would require additional planning. To avoid possible unintended tax consequences on accessing funds before retirement, we recommend seeking advice from your advisors.

3. **Funding requirements**

   An IPP will require funding from the Sponsoring Corporation in order for the taxpayer to achieve the targeted defined benefit at retirement. In the past, this funding was required on an annual basis which is burdensome to the corporation if financial hardships arise. Legislation implemented in 2020 by the Ontario government, relieved the annual funding requirement for IPPs on connected employees. That being said, if a taxpayer wants to achieve a specific defined benefit at retirement, they will want to ensure they keep to the funding requirements outlined in the actuarial valuation. As it may be possible to provide for different funding alternatives to the IPP, we recommend seeking advice from your advisors who can help to alleviate this concern.

What are the different types of IPP contributions and how do they impact my RRSP?

1. **Current year service funding** reduces the RRSP contribution room available in the following year as a pension adjustment.

2. **Past service contributions** factor the employment income earned in past years and years of service prior to the establishment of the IPP itself in determining the contribution threshold. A portion of the past service contribution must come from your RRSP (if applicable). This is known as a **qualifying transfer**. The qualifying transfer is required to adjust one's RRSP contribution room to the correct amount; as if one had been contributing to their IPP for those past years.

3. **Terminal funding has no impact on RRSP contribution room** and allows the Sponsoring Corporation to make an additional contribution to the IPP at retirement. This is comprised of deficit funding, which allows the plan member to cover any shortfall in the plan and optional contribution, which is used to fund enhanced benefits such as:

    - Early retirement benefits
    - Fully CPI-indexed pension
    - Enhanced survivor benefits

IPP vs. RRSP

Knowing the difference between an IPP and an RRSP is crucial for any business owner planning for their eventual retirement.

	Individual Pension Plan (IPP)	**Registered Retirement Savings Plan (RRSP)**
Contribution limit	Three types of contributions: 1. Current service contributions 2. Past service contributions 3. Lump-sum contribution (upon retirement) known as terminal funding	Annual contribution calculated as the lower of 18 per cent of earned income, up-to a maximum of $27,830 for 2021.
Costs	Plan set-up costs, annual administrative costs, actuarial costs, investment management fees, and IPP windup costs.	Investment management fees
Tax deductions	Plan contributions, interest on funds borrowed to fund IPP contributions, actuarial costs and administrative fees represent an eligible corporate deduction.	Plan contributions
Wealth transfer	If a spouse or children are employed by the corporation and earn T4 income, they are eligible to become plan members of the IPP. With careful planning, the transfer of wealth could be done on a tax-deferred basis and bypass probate.	RRSPs are fully taxed upon the death of the second spouse
Accessing funds before retirement	Funds are more easily accessed at the age of 50 onwards. Prior to the age of 50, additional planning is required to access the funds and mitigate any potential additional taxation that may occur at that time.	Funds can be withdrawn as needed

Is an IPP right for me?

While an IPP may offer better retirement saving opportunities to eligible individuals, IPPs are complex and may not be appropriate for everyone. Our team of tax and advisory professionals are ready to help you determine if an IPP is a good retirement strategy for you and will provide strategically tailored advice so that you're confident in making the right choice for your specific situation.

Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Contact your Crowe Soberman advisor for more information.

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