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TAXSTRATEGY

For business owners & incorporated professionals: Individual Pension Plan

IPP vs RRSP

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As a financial advisor to business owners and professionals, there are generally three questions I am asked:

1. When will I be able to stop working if I don't want to work anymore?
2. Will my family be looked after financially if I get sick or hurt?
3. Will my family be looked after financially when I die?

The last two questions are usually answered by a customized form of insurance, tailored to your specific needs.

When will I be able to stop working?

The first question confounds most Canadians. Most published reports indicate that baby boomers are not prepared for retirement, with many mired in debt. Not having enough money for retirement is a top financial concern.

A myriad of reasons may explain their nervousness. To list just some of the most obvious factors: the decline of employer-sponsored defined benefit plans; the 2008 stock market crash and the recession that followed; and, as part of the "sandwich generation," many baby boomers are now caring for both elderly parents and adult children who are unable to find work.

Moveover, with advances in healthcare allowing Canadians to live healthier and longer, people need even more money to provide for themselves as they age. Living longer in a prolonged era of historically low interest rates adds to financial discomfort and uncertainty as savings are spent.

Two ways to gain confidence in your retirement readiness

Yet, there are two steps most everyone can take to gain greater confidence about their retirement readiness.

Step 1: Develop a robust financial plan

The first is to develop a robust financial plan.

I have learned that many people believe their financial advisor has provided them with a financial plan for retirement when, in truth, the person they are dealing with is often more interested in providing investments.

A true retirement plan can only be assembled once you sit down with a professional advisor and talk about what you (and your spouse/partner) want to do, when you want to retire, where you want to live and how much you think it will cost monthly, after tax, in today's dollars to accomplish this.

Step 2: Take advantage of retirement savings vehicles

The second step you can take to gain greater confidence about your retirement readiness is to take advantage of retirement savings vehicles to your maximum ability. On this point, business owners and incorporated individuals have more choices than the average Canadian.

The basic retirement savings vehicle: the RRSP

For one, there is the basic retirement savings vehicle, the

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Registered Retirement Savings Plan (or "RRSP"). This was introduced by the federal government more than thirty years ago to help people save for the years they will need to pay for once they've retired. It is also the most popular, with over 59 per cent of Canadians saying they have contributed to an RRSP according to a recent poll by Royal Bank of Canada.

IPPs: Customized, high-performance vehicles

A lesser known but highly-attractive vehicle for business owners and incorporated professionals is an Individual Pension Plan (or "IPP"), which allows you to save significantly more than you would under current RRSP rules, while saving taxes and enjoying an increased level of creditor protection.

What is an Individual Pension Plan?

Essentially, an IPP serves two roles. It is a defined benefit pension plan that allows greater tax-deferred contributions than an RRSP and, upon retirement, an annual pension income that takes into account your years of employment and level of T4 income.

A defined benefit pension plan provides security in that you'll know how much you'll receive in pension benefits each year—an important characteristic given the vagaries of the capital markets. RRSPs, on the other hand, do not provide the certainty of a fixed income at retirement.

IPPs are designed to be a sort of miniature version of one of the large-scale public sector pension plans—such as the Canada Pension Plan Board, which looks after our Canada Pension Plan benefits.

IPP objectives and benefits

Two key objectives of IPPs are to lower risk and achieve a steady return of 7.5 per cent per year.

Another major benefit with IPPs is that they have a safety cushion mechanism built into them. Should investment returns fail to deliver a 7.5 per cent return (averaged over three years), additional tax-deductible "top up" contributions are made to bring the plan into line.

Designed for high-income business owners and professionals

The IPP was designed specifically for high-income business owners and incorporated professionals such as doctors, dentists, lawyers, accountants, pharmacists and other professionals who draw T4 income.

Using Canada Revenue Agency rules, you can decide each year whether your IPP pension benefit will be accrued using a defined benefit plan method or the more traditional defined contribution plan method. (In contrast to defined benefit plans, defined contribution plans do not provide a fixed amount of funds at retirement; with defined contribution plans, what's "defined" is the amount of money you put into them.)

Does your cash flow vary year to year? IPPs provide flexibility

The option of having your IPP pension benefit accrue using either a defined benefit or defined contribution method gives you flexibility. It allows you to switch every year between the two kinds of plans depending on the cash flow needs of your business. Less cash flow means you can switch to the less expensive defined contribution option.

IPPs offer higher contribution limits than RRSPs

Using the IPP, you can increase the size of your nest egg by making higher contributions every year—as much as 65 per cent higher than those allowed under RRSPs, depending on your T4 income and years of service.

That can translate into a major difference in the ability to save for the future versus an RRSP. Here's an example of a client, who is a 55-year old business owner and has been incorporated for 10 years.

Let's assume she has saved $285,714 in RRSPs and makes the maximum contributions each year until age 65. As you can see in the accompanying chart, if this business owner stays in RRSPs, a total of $1,570,905 will have accumulated at age 65. However, if she invests instead in an IPP—and makes the higher annual contributions—she will have $2,272,001 at age 65. That's a difference of $701,096, or 45 per cent more than if she had used RRSPs to save for retirement.

IPPs offer creditor protection and other benefits

An IPP also offers a number of tax deductions to your corporation, including on all investment and administrative fees.

Moreover, unlike RRSPs, IPP assets enjoy creditor protection by provincial legislation.

As well, by using an IPP, you have greater access to investment vehicles. You can choose options other than those allowable for an RRSP, including shares of private businesses and real estate.

By contrast, RRSPs are not creditor proof in Ontario unless you have declared bankruptcy. Even then, any RRSP contributions made in the 12 months prior to declaring bankruptcy are not protected. Some RRSPs can be creditor protected if issued by a life insurance company.

Benefits of transferring assets to an IPP from an RRSP

Another attraction of IPPs is that they have a special subaccount, known as the Additional Voluntary Contribution account. Using this, you can transfer any remaining RRSP assets into the IPP, and obtain the tax deduction of fees and the creditor protection of plan assets available under a pension plan.

IPPs allow wealth transfer tax-free

Here is a special feature of the IPP unavailable in your RRSP. Most Canadian don't realize their RRSP will be fully taxed on the death of the second spouse. An RRSP can only be rolled over on a tax-deferred basis to a spouse or disabled child. Where there is no spouse, the RRSP gets fully taxed in the year of death. If your spouse or children are employed in your business and earning T4 income, they are eligible to become members of the IPP. In this way, the IPP assets can pass to the next generation without incurring tax or probate fees.

Taking responsibility for your personal retirement needs

Governments continue to remind us, implicitly or otherwise, to rely less on the public purse and start taking personal responsibility when it comes to retirement and needs like assisted living and special care workers. These costs are necessary, and can be expensive over time.

If you've worked hard as a professional or business owner, you owe it to yourself and your family to ensure you've done all you can to save for your future. Contact us to determine whether the IPP is a viable retirement savings vehicle for you. The best way to achieve financial peace of mind is getting advice from an impartial and experienced Certified Financial Planner. ❒

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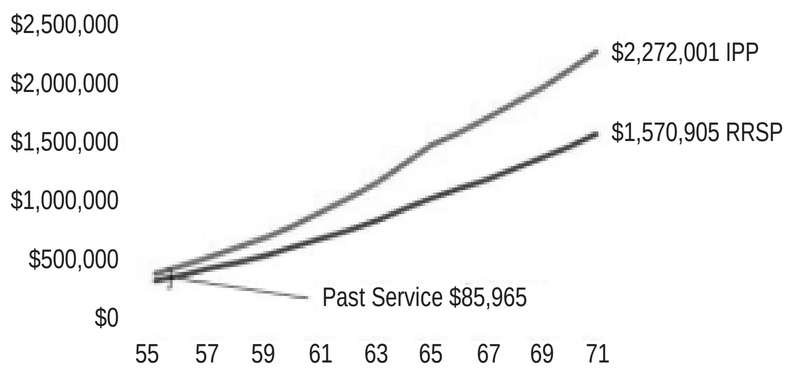

Assumptions:
- 55 yr-old business owner
- Incorporated 10 yrs.
- RRSP of $285,714 rolled into IPP (max. allowed)
- Contributions to age 65
- 7.5% ROI