Supersize that RRSP with an IPP

Welcome product for portfolios of older investors

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In a sense, financial advisors are running what amount to pension plans for each of their clients. Usually, these are registered retirement savings plans and ultimately registered retirement income funds. To the extent those plans contain financial products, this is largely how advisors are compensated.

In like fashion, advisors who acquire a working knowledge of individual pension plans can gather still more assets.

An IPP is basically a one-person defined-benefit (DB) plan, typically offered to well-heeled business owners, incorporated professionals and senior executives.

IPPs allow business owners to save more than they can in an RRSP, which means the advisor's compensation will also be higher.

Contrary to the current perception, DB plans are still viable mechanisms for funding retirement income, says Stephen Cheng, principal and consulting actuary with Vancouver-based Westcoast Actuaries Inc. "I don't believe they're dying. They still work nicely in appropriate circumstances," he said in a recent interview in Toronto.

However, Cheng said there is a general lack of knowledge about IPPs among advisors and accountants, which is why Westcoast focuses on education. The firm has published a handy booklet that it bills as presenting the "minimum adequate knowledge" for IPPs.

Think of an IPP as a "supersized" RRSP. While the latter lets the saver put aside a maximum of 18% of the prior year's earned income (regardless of age), an IPP's upper limits are established by an actuarial valuation conducted once every three years. The older the IPP member, the higher the contribution amount, assuming comparable income levels.

IPPs can contain similar investments to RRSPs, such as

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mutual funds or pooled funds. However, tax legislation provides less incentive to generate super-charged rates of return. IPPs are designed to be invested conservatively. If an IPP doesn't produce an annual return target of 7%, the client can put in a higher tax-deductible contribution to make up for the shortfall.

No such comparable mechanism exists for RRSPs — if you lose money on RRSP investments, you've simply lost that amount of tax sheltering.

"There's no real actuarial magic in IPPs," Cheng said, "The government prescribes it all. It doesn't matter which actuarial firm you go to. It will be the same numbers, so we approach it as a product."

Maximum contribution limits for RRSPs or defined-contribution (DC) pensions provide sufficient tax-assisted retirement savings for younger workers. But for those closer to retirement — in their fifties, for example — a much shorter pre-retirement asset accumulation period does not provide enough time for compound interest to work its magic in RRSPs or DC pension plans. Their contribution limits are based strictly on income, not age.

DB plans, including IPPs, are attractive to older investors because they provide contribution amounts that rise with age. Cheng said the RRSP/IPP break-even point is age 38, after which the IPP becomes steadily more attractive in terms of relative contribution amounts.

You can calculate the IPP contribution advantage over an RRSP by getting a free IPP quote at www.westcoast-actuaries.com. Cheng noted that a 60-year-old able to contribute the maximum $32,371 in 2008 would see the yearly IPP contribution amount rise eventually to $57,773 at age 69 in the year 2016. In the same period, the person with maximum RRSP room would contribute $19,000 this year, $20,000 in 2008 and eventually $30,335 in 2016.

Assuming normal investment growth of 7.5% a year and full recognition of past service back to 1991, the IPP ends up with roughly $1.565-million, almost 70% more than the estimated $923,000 the RRSP would accumulate.

Other advantages of the IPP are the assets are creditor-proof, and expenses (including for investment management of the pension fund) are tax-deductible by the company.

While it may make sense for advisors to recommend IPPs for certain professional clients, what happens to the RRSP that is likely already in place? The two can co-exist. Ideally, some RRSP assets are transferred in a tax-free rollover to the IPP. If you earned income from your corporation in the years since incorporation, you can go back to 1991 to accrue for past service contributions. However, because Ontario professionals won the right to incorporate only a few years ago, they would only be able go back to their incorporation date.

"Those with professional corporations haven't built up a lot of eligible prior service, but as we move forward they will have more years of eligibility, which will make IPPs more attractive," Cheng said.

To be eligible for pension coverage by an IPP, a client must have a bona fide employment relationship with the corporation, even if he/she is the owner. Pension-eligible compensation must be reported on T4 or T4A slips. Note that self-employment income and dividend income are not pension-eligible.

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Apart from tax-free transfers, members may opt instead to tap into their unused RRSP contribution room. While an RRSP's contributions are deductible against personal income, IPP contributions made by the company are deductible against corporate income.

Investment rules governing IPPs are more stringent than for RRSPs. A diversification requirement limits an IPP fund to no more than 10% of in any one security. And under the Prudent Man Standard, the IPP fund must be invested the way a prudent person would invest in a trust fund.

While IPPs are an attractive tax shelter for affluent clients, Cheng suggested advisors view IPPs in the total context of a client's assets.

"Many people don't realize their primary residence is the other big pension plan they have," Cheng said. "The gain is always tax-free. I always encourage people to get the biggest house they can afford and enjoy."

Admittedly, there is a learning curve for advisors wishing to tap into IPPs. Westcoast aims to minimize this by preparing all necessary documentation for registration requirements. It also takes care of the annual administration and triennial actuarial valuations.

Annual fees range from $500 to $1,100 or more, depending on the province of registration require ments. There are no extra charges for plan implementation of triannual valuations.

Cheng estimated there are between 7,500 and 8,000 IPPs in place in Canada, 1,100 of which were set up by Westcoast.

Financial Post
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