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INDIVIDUAL PENSION PLANS (IPP) AND RETIREMENT COMPENSATION ARRANGEMENTS (RCA)

Incorporated businesses looking to add a benefit for their owners and top executives might want to consider a couple of corporate tax-minimization structures – an Individual Pension Plan ("IPP") or a Retirement Compensation Arrangement ("RCA"). The reasons for either of these structures begins with a small business wanting to retain or reward top employees and business owners. The establishment of an IPP or RCA can result in a tax deduction for the corporation, while providing a pension plan that will defer the taxes of the participant until he or she begins to take pension payments out of the plan.

This article identifies and discusses the key features of both the IPP and RCA.

Individual Pension Plans (IPP)

Definition

IPPs have been available since 1991. They offer an alternative retirement savings solution for individuals 40 years of age and older and who have T4 or T4PS income from their company of more than $100,000. Ideally, candidates have also historically maximized their Registered Retirement Savings Plans (RRSPs) and pension contributions. In order to qualify, income must be employment income, not dividend or other investment income. This is because, as with all pensions, there must be an established employer-employee relationship.

IPPs are alternative retirement savings vehicles that allow for enhanced tax relief and increased pension benefits above and beyond those available through RRSPs and other retirement plans. They can be set up for one person or for a group of employees within the same company.

An IPP is sometimes referred to as an RRSP upgrade; but it is actually a Defined Benefit Pension Plan, and is typically designed to deliver the same legislated payout that a member of a defined pension plan can receive in retirement. This limit is about $2,000 per year of service. Finally a typical IPP will produce a maximum pension adjustment leaving minimal room for RRSP contributions.

Rules for setting up an IPP

IPPs can only be set up by corporations (active businesses and not holding companies). Contributions are made on behalf of the designated person(s) and are ideally suited to business owners and employees who are 40 years old or older and whose existing retirement savings alone are not expected to fully fund their desired retirement lifestyle. An IPP can also be a good option for self-employed individuals who have incorporated a company and earn a significant amount of income. When an IPP is established, the plan member must be resident in Canada and pay income tax in Canada.

Business owners who have well-established businesses that generate consistent profits annually are in the best position to fund an IPP. Types of executives and incorporated professionals who commonly establish IPPs include officers and directors of corporations, accountants, doctors, dentists and lawyers. There are no restrictions as to the level of annual income or the minimum age that is required to set up an IPP. However, ideally, individuals should earn an annual salary of at least $100,000 in order to benefit from establishing an IPP. That's because IPPs have high expenses and contribution limits that are dependent on the age and income of the plan member.

All contributions, set up fees and maintenance fees paid by a corporation on behalf of employees are fully tax deductible by the employer. As well, the contributions made to IPPs on behalf of their specified employees are excluded from the employee's income because the contribution is tax-deferred while the employee is in his or her peak earning years.

How to set up an IPP

Contribution limits

Since IPPs are defined benefit plans, they do not have predetermined contribution limits like RRSPs. The services of an actuary are needed to establish the amount the corporation can contribute so the plan is able to pay the promised retirement benefits. The benefits of membership in an IPP increase as a plan member ages. In general terms, the amount that must be contributed to fund the IPP is greater in later years (closer to retirement) than in the member's younger years. For example, the 2019 maximum current service contribution for a 55 year-old IPP member is $38,053 compared to $26,500 for an RRSP.

During an employee's younger years, larger contributions could be made to an RRSP. Therefore, in an ideal situation, an individual would make maximum contributions to an RRSP in early years, and subsequently switch to an IPP with maximum benefits in later years. The ideal year of the switch would depend on the start date of contributions and the contemplated age of retirement. Since an IPP is intended to reach a predetermined value at the time of the member's retirement, contributions will typically increase as retirement nears.

2019 Contributions – IPP vs RRSP

Age at Plan Entry in 2019	IPP** Strategy	RRSP Strategy	IPP Advantage
40	$123,571	$26,500	$97,071
45	$202,084	$26,500	$175,584
50	$288,209	$26,500	$261,709
55	$382,985	$26,500	$356,485
60	$487,066	$26,500	$460,566
62	$531,475	$26,500	$504,975

Based on annual earnings in 2018 of $151,278
SOURCE: LMC Group Actuarial & Retirement Plan Consulting
**Assumes earnings from Jan. 1, 1991 for past service.

There are three methods of contributing to an IPP:

- Initial contributions to fund years of past service (only as far back as 1991)
- Annual contributions for current service
- Additional contributions upon retirement to enhance benefits by using an extra "top-up" payment to bring pension payments up to a desired level.

The initial past service contribution can be substantial, especially if the individual has earned a significant amount of salary from the corporation in each year since 1991, when the IPP legislation was introduced. All contributions are tax-deductible to the corporation but tax-deferred to the member.

Investment choices in an IPP

The investments that are eligible for use in IPPs are the same as those that are eligible for any defined benefit pension plan, and may include mutual funds, stocks, bonds, GICs and other investments. The annual contributions must be invested in a way that will produce a 7.5% net annual rate of return as required by all pension plans. A valuation is required every three years to ensure the plan remains on track.

Options at retirement

At retirement, individuals who hold IPPs have several options available to them. These include:

- Continue the plan. The corporation maintains the plan and an annual pension is paid out. Pension payments are taxable income to the recipient.
- Purchase an annuity. The plan will transfer funds to purchase an annuity to a life insurance company. Annuities can be either single life or, if the member is married at the date of retirement, a joint survivor with payments reducing on the death of the member. The annuity will provide the retiree with a consistent annual stream of income throughout his or her lifetime. The purchase will continue to defer taxes, until annuity payments commence.
- Transfer plan assets to locked-in RRSP, LIF or other IPP. The retiree can transfer pension assets to a locked-in RRSP or Locked-in Retirement Account (LIRA).

Alternatively, some provinces also offer a locked-in RRIF (LRIF), a Prescribed RRIF (PRIF), a Life Income Fund (LIF) or another IPP. If the first option is chosen, there is a limit as to the value of assets that can be transferred into the locked-in RRSP on a tax-deferred basis, with any surplus being taxable as income in the year of the transfer. Depending on the province under which the IPP is governed, there are circumstances in which planning is more flexible because some or all of the IPP assets do not have to be locked-in (connected persons owning 10% or more of the corporation's shares in Quebec for example).

Advantages of IPPs over RRSPs.

- Tax deductible contribution limits are much higher than RRSP limits for those in their 40s or older. When an IPP is first established, the corporation is allowed to make an initial contribution to fund any past service that the employee may have given to his or her corporation (as they did not accrue pension benefits at this time). Past service contributions can be made for years of service as far back as 1991. Funding levels can be particularly high for an entrepreneur who has built a business over many years and thereby qualifies for a significant amount of past service credits.
- If an RRSP investment does not perform well, this can impact future retirement income. If the IPP investments don't perform to expectations, additional tax-deductible contributions are allowed so the promised benefits can be paid. Also, interest on funds borrowed to top-up or supplement IPPs are also fully tax deductible by the contributing company. If the average return on investments over a three-year period for an IPP is under 7.5%, a top-up may be required. Pension plan surpluses belong to the member.
- An IPP is a Registered Pension Plan and therefore gets the same creditor proofing as any other pension.
- A retirement age of 71 is used in most actuarial valuations of IPPs. However, holders of IPPs are permitted to retire early, in which case a terminal funding contribution can be made to top up the plan's assets and provide enhanced benefits for individuals who retire early. 'Terminal' funding will give the retiree the same pension benefits as originally required, but at an earlier age. This terminal funding contribution is also tax deductible to the corporation.
- Similar to an RRSP, but unlike other defined benefit pension plans, there are provisions for transferring the IPP assets to a spouse in the event of the death of the IPP participant. IPPs however offer more flexibility of choice to the surviving spouse, for example:
  - A surviving spouse can transfer the commuted value of the IPP to his or her RRSP if death of the plan participant occurs prior to retirement, and the spouse is not a member of the IPP.
  - If the spouse is a participant in the IPP, the full assets (death benefit) of the pre-retirement IPP will be rolled to the survivor with no deemed disposition of plan assets. This can provide a second pension benefit for the survivor.
  - If the participant dies and has been receiving pension benefits from the IPP, the surviving spouse can receive a spousal pension or take the commuted value as a lump-sum payment to a locked-in RRSP, or individual RRSP depending on the circumstances and province of residence.

Additional considerations regarding IPPs

- You can't create an IPP on your own. An employer must sponsor it – and that employer must be willing to make a substantial financial commitment, since the company is legally responsible for all of the benefits promised. Arguably this may work best for the self-employed who have incorporated their business – those for whom the concept originally targeted.

- Funds are locked in, in most provinces – the money and interest earned in an IPP cannot be withdrawn prior to retirement, even though the member may have contributed it. Also, because the assets within the IPP are locked-in under pension legislation, the settlement alternatives upon the death of the member are generally less flexible and attractive than those associated with RRSPs.
- An IPP faces the same complex federal and provincial regulation as any other defined benefit pension plan. That means fees for set-up and operation. In particular, the plan will need an actuarial valuation every three years (which can cost more than $1,500). Set up fees can exceed $5,000 and ongoing administration fees may run $1,000 to $2,000 yearly. These fees are tax deductible to the corporation.
- Income splitting options may not be as attractive. Contributions cannot be made to the account of an employee's spouse. Income spitting in the form of spousal IPPs is not available as there is with spousal RRSP contributions. Pension income from an IPP however may be split under the pension income splitting rules. Under these rules, pension income from the higher income earner can be allocated, for tax purposes, to the lower income earner to a maximum of 50% of the income. Pension income from an IPP; or lifetime annuity payments under a pension will qualify for the 50% income splitting regardless of the pension member's age in all provinces except Quebec (pensioner must be 65 to split eligible pension income). If the pension member elects the commuted value option, then income from a LIF or RRIF cannot be split until age 65 in all provinces.
- In most provinces, mandatory contributions are required to make up for deficiencies in the plan's assets, based on the performance of the plan's investments. If investments drop in value by a considerable amount, substantial contributions will be required by the contributor and, in the case of incorporated professionals; this can place a heavy financial burden on the company and its owner.

IPPs can be an extremely valuable retirement savings vehicle for certain individuals who seek enhanced retirement benefits. There are many rules to consider with IPPs and they are very complex. For those individuals who require greater flexibility or feel that the disadvantages of IPPs outweigh the advantages, an alternative is to maintain an RRSP account and establish another investment account (i.e. TFSA or non-registered account) that is earmarked for retirement. For individuals who may find an IPP restrictive, or for companies who do not want the ongoing commitment of an IPP, an RCA may be a good alternative.

Retirement Compensation Arrangement (RCA)

The Retirement Compensation Arrangement ("RCA") was introduced in 1986 to provide income to certain employees, senior executives and owner-managers who wish to supplement pension and registered retirement savings plans through tax-assisted contributions. The RCA is ideally designed for high-income earners (in excess of $150,000). They are supplemental retirement programs that compliment defined benefit pension plans, Individual Pension Plans or registered plans, all of which have regulated contribution limits. The flexibility of the RCA allows it to be adapted to a variety of tax and business strategies.

Definition

An RCA is a non-registered retirement plan, in the form of a trust, that can be established by a company to provide retirement funds to an employee of the company. These funds are contributed and tax-deductible by the employer or company and are payable on or after the employee's retirement, loss of office or employment (for example, an athlete retained as a scout after the end of a professional playing career).

An RCA is not a "registered" plan. Each dollar contributed, as well as any income or growth in value, is held in a formal trust for the employee. Half of the contribution is held in a non-interest bearing refundable tax account at Canada Revenue Agency ("CRA"), and half in an RCA trust account. Upon retirement, funds are paid out and taxed in the hands of the individual, at the post-retirement tax rate of the recipient.

Advantages of an RCA

There are a number of benefits to offering an RCA.

1) An RCA can be established for one or more individuals.

2) It can assist employers in attracting and retaining key employees.
3) Funds are held separately from company assets and are protected from creditors of the company.
4) An RCA also provides creditor protection for the employee.
5) Employee retirement funds are protected from unfriendly takeovers and changes in the Board of Directors or senior management.
6) Payments from an RCA to a non-resident are subject to a 25% withholding tax in Canada. Depending on the tax regime in the place of residence, the foreign tax credit may be claimed and so can be an extra benefit to the individual if he or she is in a lower-tax environment.

Example:
Anthony is the owner-manager of a small lumber company. Three years ago he set up an Individual Pension Plan for himself and his six employees. Anthony and his accountant have decided that although the IPP is worthwhile, Anthony's current retirement funding projection will not adequately meet his lifestyle.

To address this projected shortfall, the company establishes a Retirement Compensation Arrangement for Anthony in the amount of $100,000 annually over the next 10 years. Each year $50,000 is paid to CRA to the refundable tax account, and $50,000 is sent to the trustee for investment on Anthony's behalf. Upon retirement, Anthony receives payments from the trustee of the RCA consisting of the contributed principal and income earned in the trust. Anthony will claim the income at his personal retirement tax rate, and claim the tax deducted at source by the trustee.

The trustee will issue Anthony a T4A-RCA for Anthony's RCA payments and withholding tax for Anthony to use on his personal tax return. The trustee will also file an RCA tax return recording the payment plus tax to Anthony, CRA will then refund one-half of the amount to the trustee. In addition to this, Anthony will be able to receive pension payments from his IPP.

Refundable tax

Contributions made by the employer are prepaid tax at the rate of 50% of the amount of the contribution. This amount must be sent to CRA for the RCA trust. In addition, any income or capital gains earned in the RCA is also taxable at 50% of the amount of the income or capital gain. The trustee of the RCA must remit a T3-RCA tax return each year, even if there is no activity in the RCA in the year. When filing, the custodian must ensure that the correct amount of refundable tax has been sent to CRA or refunded to the trust. Tax is refunded at the rate of $1 for every $2 paid. Under these rules, a $20,000 payment to an individual would result in a $10,000 tax refund to the RCA.

Distributions

The trustee has to provide the beneficiary with a T4A-RCA slip detailing the distributions and the amount of income tax withheld at source. Distributions paid out of the RCA to the beneficiary are included in taxable income in the year received, and income tax calculated at the recipient's tax rate at that time.

How an RCA can be funded

An RCA can be funded in four ways:
1) With a lump-sum cash contribution upon set-up
2) With a periodic system of cash contributions over a period of time
3) With a letter of credit
4) With an eligible life insurance plan

Options 1 and 2 involve cash contributions which are deductible by the company. Although the employee does not personally report the income for tax purposes until payments commence from the RCA, any investment earnings are also taxed at 50% and refundable tax must be sent to CRA.

Under option 3 a letter of credit is a less expensive way for a company to fund an RCA. The employer provides cash for the trust to buy a letter of credit from a financial institution (usually a chartered bank). The issuer will have to pay the agreed-upon pension amount if the employer cannot do so. The cost of the premium for the letter of credit is based on the employer's financial standing, but usually is a percentage of the pension amount. Under this option, only the amount of the issuing fee is subject to the 50% refundable tax. The disadvantage to this option is that letters of credit are usually issued for only one year at a time, and although renewals are a routine procedure, there is no guarantee that a new letter will be issued if a company is experiencing serious financial hardship.

Using an exempt life insurance plan (Option 4) is another way to fund the RCA. The RCA owns the cash surrender value of the policy and pays the premiums with funds contributed by the employer. Under this option, the premium amount to purchase the insurance would be matched by the amount sent to CRA as refundable tax. There are estate planning uses for the life insurance proceeds and cash surrender value that must be discussed with a life insurance expert.

Eligible investments

RCA investment options are fairly flexible. When an RCA beneficiary is a "specified beneficiary" (owning 10% or more of the employer's shares) there are investment restrictions related to securities of the employer and life insurance that is used by the RCA to borrow funds that it in turn lends back to the employer. The investments should align with the retirement plan of the beneficiary, which means that professional financial advice is crucial. Advisors will work with the client, the trustee and the accountant. Generally speaking, investments allowing tax-deferral, such as Mackenzie Corporate Class Funds, or a Universal Life Insurance policy, can result in accelerated wealth building.

How to set up an RCA

The employer and employee will draw up a "Plan Document" to outline the benefits to which the RCA member will be entitled, including when retirement payments will commence and how the amount of benefits will be calculated. Following this, the employer and employee will meet with a legal advisor to draw up the "Trust Agreement", which outlines the terms under which the employer and the RCA trustee will work together. The agreement will detail the rights and responsibilities of the trustee for the administration of the RCA. In addition to these documents, the employer will need to obtain a "Corporate Resolution" from the Board of Directors of the company. This will authorize the employer to establish the RCA and agree to the method of funding. The Trustee must also apply to CRA to obtain an RCA tax number to establish the plan.

Summary

An RCA can be a valuable retirement option for high-income individuals. The RCA may be established in conjunction with an Individual Pension Plan, or as a separate plan. There are many rules to consider, and the administration and taxation can be complex. An RCA can be a beneficial addition to an Individual Pension Plan for a high-income individual. For RCAs that are funded under Options 1 or 2 the use of Mackenzie Corporate Class or Symmetry Portfolios can provide tax-deferred growth and simplified accounting.

Final note

Due to the complexity of IPPs and RCAs, it is important that financial, accounting and legal advice is obtained.

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