RETIREMENT PLANNING

Individual Pension Plan: a retirement option for those with an entrepreneurial bent

As pension plans continue to decline, leaving workers who aren't ready to retire searching for options, this one-person plan could fit the bill

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'In the right circumstances, and for the right person, a commuted-value Individual Pension Plan (IPP) provides an unmatchable set of benefits,' says lawyer Trevor Parry, president of the TRP Strategy Group.

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If you're contemplating an exit from a job with a defined-benefit pension plan, but you're not ready to stop working just yet, you may be wondering what the options are.

What if your pension was just as mobile as you are – and could travel with you to your next engagement?

A pension-plan member with an entrepreneurial bent who leaves a job with a defined-benefit pension may have the option for a "mobile pension:" If they establish a new venture or join an existing company, they may be able to transfer the commuted value of their defined-benefit pension to an Individual Pension Plan (IPP).

An IPP is a one-person defined-benefit (DB) plan established by a corporation with the incorporated owner as the employee and plan member. If this option is on the table, the pension termination statement for the plan member will usually state that the commuted value may be transferred to another DB plan, so long as that plan will accept the transfer. The IPP could be that plan.

"In the right circumstances, and for the right person, a commuted-value IPP provides an unmatchable set of benefits," says lawyer Trevor Parry, tax and estate specialist at Raymond James and former national sales director of a boutique actuarial firm specializing in IPPs. Mr. Parry is also president of the TRP Strategy Group.

"With a commuted-value IPP, entrepreneurs can design and grow their own pension benefit, using assets they control, and retaining estate value that would otherwise 'disappear into the ether' at the plan member's or their survivor's death. And because the benefit moves over from the initial plan with no tax implications, the plan member avoids the substantial tax hit they would ordinarily face in commuting the plan."

Understanding IPP basics

To establish an IPP, an incorporated, active company must act as the plan sponsor, and the plan member must be an employee of the corporation earning T4 employment income from the corporation. Then, once the plan is in place, the plan text contains a formula defining the amount of benefit to be earned by the plan member. (Typically, the plan will provide for the maximum accrual that the tax rules allow.)

While the plan member is employed and accumulating pension benefits, IPP contribution amounts are calculated by an actuary based on the pension benefit formula, the member's age and T4 earnings history, and a set of actuarial assumptions. Plan investments must also follow strict guidelines as set out in the Income Tax Act. The member will typically forego making RRSP contributions, because the pension adjustment for the IPP will reduce RRSP room.

Meeting the 'primary purpose' test

In order to benefit from this strategy, however, the conditions need to be just right. Principal among these is the so-called “primary purpose” test, which is contained in the tax legislation, and is intended to ensure the commuted value IPP is not largely designed as a tax-avoidance mechanism.

Under the primary purpose rules, the pension must be primarily designed to provide a lifetime benefit in retirement, corresponding to pensionable employment income. In practice, this means the entrepreneur must have “bona fide” employment in the new scenario which is generating reasonable and pensionable employment income.

If this condition is not met, the risk is that CRA may disallow the transfer or de-register the plan, requiring the plan member to include the entire amount of the commuted value as taxable income in the year of commutation.

Seeking professional advice

“CRA is quite diligent in reviewing these plans,” Mr. Parry says, “and thus it is imperative that appropriate professional advice be sought and that the circumstances line up exactly. Prospective candidates for a commuted-value IPP need to understand the possible pitfalls associated with the strategy, and not just the potential benefits outlined by an optimistic sales person.”

“That said, an appropriate commuted-value IPP can provide two significant ancillary benefits: avoiding the significant inclusion in taxable income at commutation, and potentially enhancing the estate value.”

Lea Koiv, a professional accountant and retirement strategist, has encountered a number of cases where the commuted-value IPP strategy is suitable. “Not all plan members terminating their employment or retiring are able to commute their pensions. If, however, they are able to, both the copycat annuity and the IPP warrant review.”

Ms. Koiv adds that “solutions cannot be ‘cookie cut,’ as each case needs to be assessed on its own merits. In some circumstances, remaining in the plan may be the most appropriate choice for a pension-plan member.”

“One case that I worked on involved an executive from a publicly listed company,” Ms. Koiv says. “This individual acquired a stake in an existing small business, joined the management team – then drew a salary allowing for a maximum pension accrual.”

“In a case like this, it is clear that the ‘primary purpose’ requirement will be met: there is a legitimate employer-employee relationship and the plan member continues to accrue a pension. In another case, a plan member left a public-sector employer and became employed in a family business. Again, the ‘primary purpose’ test will be met.”

Steering the course

The IPP market in Canada is expected to grow as the number of broadly based defined-benefit pension plans continues to decline, leaving workers who aren’t yet ready to retire searching for options. For those workers, finding appropriate, expert advice will be key, whether from actuarial firms or experienced IPP advisory support.

A pension-plan member with an entrepreneurial bent who leaves a job with a defined-benefit pension may be able to transfer the commuted value of their defined-benefit pension to an Individual Pension Plan (IPP). 'Because the benefit moves over from the initial plan with no tax implications, the plan member avoids the substantial tax hit,' says lawyer Trevor Parry.

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