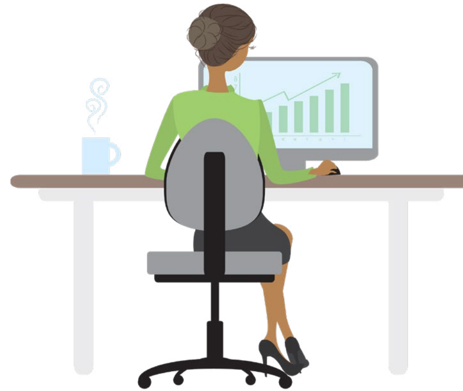
Why entrepreneurs should consider using this lesser-known retirement account

Individual Pension Plans are ideal for business owners who are at least 40 years old and earn more than $100,000 a year.



Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs) get all the attention when it comes to retirement planning, but for business owners, there is another option. The lesser-known Individual Pension Plan (IPP) is designed especially for high-income entrepreneurs who are looking to save more.

IPPs can be complicated, so it's a good idea to talk to a financial professional before setting one up, but here's what you need to know about them, including who's eligible, how they work, and why they might be helpful with your retirement planning.

What's an Individual Pension Plan?

An IPP is a type of defined benefit workplace pension that incorporated business owners can set up for themselves. Like other corporate DB pensions, the company (the plan sponsor) contributes to the plan and invests those contributions on your (the plan member's) behalf. At retirement, you get a set monthly pension income based on a formula that's related to your age and years of service.

How does an IPP work?

An actuary calculates the amount that the business should contribute annually to your IPP based on the pension benefit formula. Those contributions are invested and are left to grow tax free. While the money can be used to purchase a variety of securities, investments must also follow strict guidelines outlined in the Income Tax Act (so, again, talk to a professional). As with an RRSP, you don't pay any tax on the funds until they are distributed in retirement.

You can't technically withdraw money from an IPP like you can from an RRSP. Rather, when you retire—as early as age 50 or as late as after the year in which you turn 71—you will start to receive monthly payments based on that predetermined formula. It's important to make sure you are comfortable with those funds being less accessible as you contribute. You could also transfer the funds into a Locked-in Retirement Account (LIRA) or use the money to buy an annuity, thereby collapsing the IPP and any related accounting or administration costs to the business.

Who is eligible to open an IPP?

If you own an incorporated business with active income (i.e., not a holding company), live in Canada, pay Canadian income taxes, and draw T4 income from the business, you can create an IPP. Experts have different opinions on how much income you should earn before setting one up, but if you are around 40 years old and make more than $100,000 a year it could make more sense to use an IPP than an RRSP.

What are some of the benefits of an IPP?

It has to do with how much you're allowed to contribute to an IPP versus an RRSP. With an RRSP, allowable contributions are based on 18% of your annual earnings, up to a maximum income of about $151,275. If you earn above that amount, you can only contribute a maximum of $27,230 (for 2020). However, contribution room in an IPP increases with age and surpasses the RRSP maximum once you hit 40. At that same income, for example, the annual IPP contribution

allotment for a 40-year-old is about $28,500—it's roughly $45,000 for a 64-year-old. There's even a "catch-up" option that allows lump sum contributions for prior years worked, even if the IPP was just created.

What are some of the other differences between an IPP and an RRSP?

There are a few. Here are some of the more notable ones.

Greater financial security

Because an IPP is a defined benefit pension, you may have a better sense of what your cash flow will be in retirement. An RRSP, on the other hand, is more like a defined contribution pension, in that the payout at retirement depends on how well your investments perform.

You'll pay less business taxes

Since it's the business paying into the account, you won't get a tax deduction on your personal income tax like you would with an RRSP. However, the contributions your company makes to the IPP are tax-deductible expenses. Administration and investment management fees are also tax deductible to the corporation.

Creditor protection

Assets held in an IPP cannot be seized by creditors seeking payment.

Forced savings

This could be an advantage or a disadvantage depending on your company's cash flows. Once an IPP is set up, there is an obligation, in several provinces, to make contributions. If your business' cash flows are volatile, then an IPP may not be suitable. If they're not, then those forced savings will come in handy in the future.

Are there any drawbacks to an IPP?

Unfortunately, no plan is perfect, so, yes, there are some.

Setup and administration costs

According to some estimates made by website Advisor.ca it costs about $2,500 to set up a plan and a few thousand dollars annually to maintain it. Costs will vary depending on the complexity of the plan.

No new RRSP contribution room

When your company contributes to an RRSP on your behalf, your RRSP contribution room declines—often to nothing. That may be OK since you are saving money anyway through the business, and if you do have personal money to invest, you can tap into a TFSA or a non-registered account.

You need to draw a salary

For an IPP to work, you need to pay yourself a salary, as the pension formula is based on income. Many business owners pay themselves dividends because they're taxed at a lower rate than salary, so the way you pay yourself may need to change. Talk to a tax professional to figure out how best to proceed.

Potential account top-ups

Because of the DB-like structure, your business must pay out a certain amount per month upon your retirement. If the market declines significantly and if the plan is underfunded, then you may need to put more into the account to make up the difference. On the other hand, if you've earned a lot more in the account than expected, you may need to stop paying into it until the funds are again in line with the proper pension payments.

Lack of flexibility

As mentioned above, you can't take money out of an IPP like you can an RRSP as IPPs are subject to pension legislation, unlike RRSPs. While this could be a positive in that you won't be tempted to remove money early, the lack of flexibility may also be a drawback. Be absolutely sure that you're OK with the withdrawal rules before you set one up.

An IPP is more complicated than an RRSP or TFSA, so it's certainly not for everyone. But for some entrepreneurs, it could offer better retirement savings opportunities as well as a tax break for the business. As always, consult your advisor to discuss what's best for your circumstances.

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