

ADVANCING *Issues*

Summer 2003 • Published quarterly by Corporate Planning Associates • Vol. 10, No. 5

The Promise of Increased Retirement Savings Room

By David Vicic, Senior Vice President, Corporate Planning Associates

We have all heard the stories warning us that we are not saving enough for retirement and that the dream of retiring at age 55 simply will not happen for the vast majority of Canadians. Those involved in the retirement planning business have long espoused the benefits of increasing the tax-assisted savings maximums. More recently, both the House of Commons Standing Committee on Finance and the C.D. Howe Institute have put forward proposals to increase the retirement savings limits. The government finally listened to the experts and put forward proposals in the last Federal Budget, to raise certain limits that affect the amount that individuals can put away for retirement. In addition to the changes to the retirement savings limits, the government made an announcement concerning a savings vehicle [Tax-Prepaid Savings Plan (TPSP)] that is already in use in the United States and the United

Kingdom and that could be put into place in Canada.

While the government's proposed changes did not match what the experts had asked for (and what its own committee suggested), it was a step in the right direction given its past history with the RRSP limits. When the retirement savings system was overhauled by the Conservative government in the early 1990s, the RRSP contribution room maximum was scheduled to increase to

\$15,500 by 1995 and indexed thereafter. However, changes to the limits were proposed by the Liberal government in the 1995 and 1996 Budgets that froze the maximum contribution room at \$13,500 through to 2003, rising to \$14,500 in 2004, \$15,500 in 2005 and indexed to the increase in the Average Industrial Wage thereafter.

The Budget of 2003 has proposed to increase the registered pension plan and RRSP limits as follow:

Registered Retirement Savings Plan – Annual Contribution Limits		
Year	Current Level (\$)	Proposed Limit (\$)
2003	13,500	14,500
2004	14,500	15,500
2005	15,500	16,500
2006	**	18,000
2007	**	**

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**Defined Contribution Pension Plan –
Annual Contribution Limits**

Year	Current Level (\$)	Proposed Limit (\$)
2003	14,500	15,500
2004	15,500	16,500
2005	**	18,000
2006	**	**

**Defined Benefit Pension Plan –
Benefit per Year of Service**

Year	Current Level (\$)	Proposed Limit (\$)
2003	1,722	1,722
2004	1,722	1,833
2005	**	2,000
2006	**	**

Note: For those years denoted with **, the value is determined by increasing the previous years' maximum by the increase in the Average Industrial Wage.

It should be noted that the contribution rate for RRSPs is *still* 18% of earned income. It will take \$100,000 of earned income to generate the maximum of \$18,000 in 2006. For those who are members of a defined benefit pension plan that pays a benefit of 2% of pensionable earnings per year of service, the maximum annual benefit will be hit when pensionable earnings reach \$100,000.

Pension Benefits

A less publicized part of the Budget will affect those individuals who are members of a defined contribution pension plan. In a defined contribution plan, the funds that have been contributed over time, together with the investment income earned, are used at retirement to purchase an annuity, payable for the employee's

(and possibly the spouse's) life. The new Budget proposal will allow the pension plan to pay out pension benefits similar to what a RRIF does, without actually setting up a RRIF.

Although many people have said that the government did not go far enough with the increases in the RRSP limits, there may be a reason why. The government announced that it was studying the creation of Tax-Prepaid Savings Plans. The plan may be to link the RRSPs and TPSPs by setting a single overall maximum contribution that could be made to the plans in any given year. These plans would be similar to RRSPs, in that investment income earned in the plan would not be taxed. However, there are two differences that set TPSPs apart from RRSPs:

- Contributions to the TPSP *would not* be tax deductible and,
- Withdrawals from the TPSP *would not* be subject to tax.

While any increase in the retirement savings level is welcomed, it would appear that the government could have done more. Many industry experts were looking for an increase in the 18% contribution rate that would have benefited all Canadians as well as a substantial increase in the maximum allowable contribution. By only increasing the maximum RRSP contribution, only those earning in excess of \$75,000 will benefit from the increased savings room.

However, individuals earning more than \$100,000 will still be subject to a “reverse discrimination” – the higher the income, the lower the percentage of earnings that can be contributed or be replaced by pension benefits.

For example, an individual who is making \$100,000 can contribute \$18,000 or 18% of earned income. An individual who is making \$200,000 can still only contribute \$18,000 (since cap is set at \$100,000) or 9%.

The same is true for members of defined benefit pension plans. Let's assume that an employee has 35 years of service with average earnings of \$100,000 and a benefit of 2% per year of service. This individual would receive a lifetime benefit of \$70,000 or 70% of pre-retirement income.

Now let's assume that the average earnings are \$200,000. Due to the maximum benefit restrictions, this individual would receive a lifetime pension of \$70,000 or 35% of pre-retirement earnings.

For those who are members of defined benefit pension plans, holding off on retirement until 2005 could mean an increase in their pension of over 16% (\$2,000 vs. \$1,722). This, of course,

assumes that the individual is currently accruing the maximum allowable pension benefit. The change in the maximum allowable benefit could apply more pressure on defined benefit plans since increased benefits mean increased costs and many pension funds have been hit hard by the poor performance of the stock market in recent years.

Although the government has promised to *look* into the TPSP as a means of increasing savings, it will be some time before they are incorporated in Canada. Unfortunately, this delay does nothing to help Canadians save for their retirement now. For many Canadians, time is running out as is their dream of retiring early.

Pension anyone?

By: Jamie Purves, Senior Vice President, Corporate Planning Associates

High-income executives, owner/managers or professionals may be interested in an Individual Pension Plan (IPP) strategy. For the well paid executive, a group pension plan doesn't provide adequate funding for retirement. As discussed in David Vici's article, recent pension reform, while welcomed, falls short of being meaningful. An IPP can offer enhanced pension income under the right circumstances. Professionals and owner/managers face a delicate balancing act between the financial needs of their company and their personal need for income and an effective retirement plan. While RRSPs are a common saving vehicle, drawing a larger salary to fund it is a cost to the company. Many professionals and owner/managers forego setting up an RRSP choosing instead

to retain the earnings within their company. They hope for an exit strategy to finance retirement, which may not be prudent. What happens if the business fails? Will there be an interested buyer for the business? A soft economy could severely affect the value of the company just as the individual wants to retire. For these and other reasons, IPPs are getting a serious second look.

Qualifying for an IPP

An IPP is a registered defined benefit pension plan established to provide pension income to one individual, though an owner/manager may also add a spouse employed by the same or related company. To qualify for an IPP the member must have T4 income, be employed by an incorporated company taxable under the Income Tax Act and works best

for individuals age 40 and older. The company establishes the IPP for the individual. At set-up the employer can contribute a lump-sum amount based on prior years' service back to 1991. This amount can be substantial. As an example: a 55-year-old with T4 income of \$100,000 for each year since 1991 would have a past service contribution of \$284,178. If the individual contributed to an RRSP during that time, CCRA determines the amount of RRSP assets that must be transferred into the IPP. This 'Qualifying Transfer' offsets a portion of the past service contribution available to the company. On a go forward basis the company is obligated to contribute a pre-determined amount to the IPP each year. Using the example above the initial annual contribution amount for the IPP of a 55-year-old

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is \$23,682 versus an RRSP limit of \$14,500. What's more, these contributions and any expenses for the administration of the IPP are tax deductible to the sponsoring company.

The IPP can be a sound business decision for both entrepreneurs and executives looking for maximum tax relief and potentially higher pension income in retirement. I say potentially because a defined benefit plan establishes the future pension stream at inception. The amount of pension (defined benefit) to be received in retirement is determined by formula with contributions equal to the cost of providing the pension. In contrast, an RSP is a defined contribution plan, \$14,500 limit for this year, with the level of retirement income determined by the accumulated value of the plan at retirement. The IPP's assets may be invested under a life insurance contract, a trust company or under a trustee self-directed vehicle. Generally, any

investment that is RRSP eligible is acceptable for an IPP. Every three years an actuarial assessment ensures the IPP is adequately funded. Depending on investment returns it's possible to top-up the plan in the event of a shortfall or reduce future contributions if there's a surplus. At retirement or when the business is sold the IPP can be transferred to a locked-in retirement account (LIRA), an annuity, or in certain provinces to the Registered Pension Plan of a new employer. When transferred to a LIRA maximums apply with any surplus paid as a taxable lump sum to the plan member. In the LIRA funds can accumulate tax sheltered up to the end of the calendar year in which the individual turns 69.

Estate Planning with IPPs

From a planning perspective, an IPP satisfies on a number of fronts. First it formalizes the individual's retirement plan and clarifies future lifestyle options. In the event of

business failure an IPP is creditor-protected. For estate planning purposes, an IPP's assets are payable to a surviving spouse, or if there is no surviving spouse, to another beneficiary or the plan member's estate. Amounts payable to the spouse may be transferred to a LIRA on a tax-free basis up to prescribed maximums.

As with all strategies, careful consideration of your specific circumstances is the best first step to determine you might benefit from an IPP. Assessments are usually free of charge and require you to provide some basic financial data. Reviewing the results with your advisor in the context of your overall financial plan ensures the proper fit.



ADVANCING *Issues*

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Subscription price: \$100 per year

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