Individual Pension Plans for Incorporated Health Care Professionals

Saving for retirement in a tax-efficient manner

Health care professionals may not have the opportunity to benefit from a typical employer pension plan and, instead, are responsible for accumulating their own retirement savings. A common strategy employed by incorporated health care professionals involves the accumulation of wealth by retaining funds within their corporation. However, there have been recent changes to the taxation of passive investment income earned inside private corporations which may potentially reduce accessibility to the small business tax rate. Therefore, these changes have limited the amount that can be accumulated in a corporation at preferential tax rates. Incorporated health care professionals may wish to consider an Individual Pension Plan (IPP) — a retirement savings plan that can provide additional opportunities to minimize the overall tax liability.

An IPP is an employer-sponsored pension plan that it is typically created for one key employee, not a group of employees. There are two factors relevant in determining IPP contributions: age of the employee and the amount and method of compensation. Consequently, IPPs are most appealing when the combination of these factors allow for contributions that exceed the Registered Retirement Savings Plan (RRSP) contribution limit. An individual's RRSP contribution limit is generally 18% of the previous year's earned income, subject to an annual maximum. For 2020, the maximum is $27,230 which is 18% of $151,278. For individuals who have earned income equal to or greater than $151,278, they will be limited to the annual maximum RRSP contribution limit. Therefore, when the professional has a more mature practice (i.e. over age 40), and is limited by the annual maximum RRSP contribution limit, an IPP may be advantageous.

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IPPs are defined benefit (DB) pension plans regulated under provincial legislation and registered with Canada Revenue Agency. The corporation is both the IPP sponsor and administrator, and names a trustee who will manage the IPP's assets. When appointing a trustee, consideration should be given to their firm's understanding of pension legislation and the type of custodial arrangement that governs the IPP. To establish the proper funding level, an IPP must be assessed by an actuary every few years.

Accumulating Retirement Assets in an IPP versus your Corporation

The federal small business tax rate (9% in 2019) applies to the first $500,000 of active business income generated by a private corporation through which the health care professional runs their practice. In addition, depending on the province, there is a provincial small business tax rate that applies to income up to a business limit.

Traditionally, any excess after-tax corporate income is used to grow an investment portfolio held within the corporation. Income arising from the investment portfolio is treated as passive investment income. As a result of recent changes to the rules governing the taxation of passive investment income, the small business limit will be reduced in the following year for a corporation that earns passive investment income between $50,000 and $150,000 in the tax year. The federal small business limit of $500,000 is reduced by $5 for every $1 of passive investment income over $50,000. Some provinces have not adopted the same federal treatment.

For example, if a corporation's passive investment income is $70,000, its small business income limit will be reduced from $500,000 to $400,000. If passive investment income is $120,000 the limit will be reduced to $150,000.

Once a corporation's passive investment income reaches the top threshold of $150,000, access to the federal small business tax rate will not be available, all active business income will be taxed at the corporation's federal general corporate tax rate (15% in 2019), and therefore its tax liability will be increased. The provincial general corporate tax rate may also apply. The potential loss of access to the small business tax rate is likely to have an adverse impact on professionals with a large retained earnings balance inside their professional corporations. An IPP should be considered as a tool for retirement income accumulation that may help minimize the tax impact of the passive investment income rules on the corporation.

Considerations for IPPs

IPPs can offer several benefits that make it an attractive strategy to help accumulate retirement savings.

- As a DB pension plan, the retirement income from the IPP will be predictable over time.
- There is some flexibility in how an IPP is set up. An IPP may include features such as an additional voluntary contribution account held under the IPP umbrella that is separate from the required IPP contributions or a defined contribution component.

- Costs associated with setting up and maintaining an IPP may be higher than other registered plans. However, administrative costs including accounting, actuarial and investment management fees paid by the corporation to establish and maintain the plan, as well as contributions to the IPP, are tax-deductible to the corporation.
- IPP contributions are not taxable to the plan member at the time of contribution so there is the benefit of tax deferral.
- Depending on investment returns, contributions may need to be increased or decreased to fund the pension benefit. If the corporation needs to borrow to fund the IPP, the interest may be deductible. Certain provinces may allow flexibility in funding requirements. For professionals that retire before the age of 65, the plan could pay a bridge benefit.
- Income splitting with your spouse or common law partner is permitted when the IPP benefits are paid out.
- Income splitting can begin at age 55 rather than age 65 — generally the minimum age requirement in all provinces (with the exception of Quebec) for pension income splitting is 65.
- Once the IPP plan holder has retired, the actuary can determine if there is sufficient contribution room to pay for terminal funding. Terminal funding provides an opportunity to make additional contributions if there is contribution room based on various actuarial assumptions for the IPP plan holder.
- IPPs are protected from creditors.

Comparing an IPP with an RRSP

The key benefit of IPPs is that they permit higher annual contributions than traditional RRSPs. This typically occurs as the plan holder ages to ensure the plan is fully funded and can potentially enable greater tax-deferred accumulation within an IPP. A plan holder may accumulate significantly more in an IPP than in an RRSP because contributions are based on increasing age and income.

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Funds within an IPP are generally locked-in, which means they cannot be withdrawn until retirement. With an RRSP however, funds may be withdrawn at any time, and are subject to tax.

Contributions can be made for past years of service covered under an IPP based on the salary drawn from the corporation. It is also possible to roll over the health care professional's RRSP funds to an IPP, tax-deferred, to take full advantage of past service contribution room.

As with an employer-sponsored DB plan, IPP contributions will reduce the plan holder's RRSP contribution room in the following calendar year.

Retirement and Death

Upon retirement, the funds accumulated in an IPP may be used to provide ongoing retirement benefits, used to purchase an annuity or transferred to a Life Income Fund (LIF) or locked-in RRSP. (Where certain conditions are met, Quebec may allow a transfer to be made to a RRIF.)

If the plan holder passes away before reaching retirement but has a surviving spouse, they will have the option of purchasing a deferred annuity with the IPP funds or commuting them to a locked-in plan. These options may vary by province. If there is no surviving spouse upon the death of the plan holder, the IPP proceeds are distributed to the plan holder's estate or a named beneficiary and are subject to tax.

Considerations

The optimal strategy for accumulating retirement savings will vary with each individual health care professional. Due to the inherent complexity involved in establishing and maintaining an IPP, consult with your TD advisor and other IPP specialists when considering if this retirement plan is right for you.