# Segregation From Your Money

Eileen Reppenhagen

About 17 years ago, I attended a CGA, BC-sponsored retirement planning seminar. Alternative methods of employing your money to earn an income in retirement were presented, including something hereafter called "seg funds". Last month, out of about 120 CGAs (Certified General Accountants) in Vancouver, it was interesting to note that very few had any idea what a seg fund was, just like 17 years ago.

Seg funds are insurance products. I do have clients that own these products. Clients are usually unhappy because the MER (Management Expense Ratio) on the seg funds is much higher than "regular" funds. They complain that they really don't understand what they own. I distrust this product also because there is little to account for, i.e. you can't balance the T3 slip to the change in the investment.

Seg funds are basically mutual funds held inside a life insurance product to maximize gains and minimize risk. Seg funds are also known as guaranteed investment funds or GIFs. Sometimes you will find seg or GIF in the name of the investment and sometimes you will not.

The seg funds' real value is in their ability to creditor proof your holdings, but creditor proofing comes at a cost. Seg funds have higher than usual MERs, which means great commissions for the salesperson. Google "seg funds" to learn more about how they might fit into your planning. For some people, they are the perfect product.

Seg funds offer features that for the right reasons, investors might find attractive, but for the wrong reasons, combined with funds that are not doing so well, could be a disaster.

Here are the major seg fund features:

- Maturity guarantees on the return of the original capital (that varies widely);
- Death benefit guarantees that the capital less any withdrawals of units at fair market value will be returned to the estate/beneficiary at death;
- Guarantees can vary between 75% to 100% on the original capital;
- Creditor protection (for this insurance product);
- Probate avoidance by naming a beneficiary (for this insurance product);
- Freeze or reset options may allow the gain to be locked in without triggering capital gains;
- Ability for younger family members to purchase seg funds where the term is linked to the life/demise of a senior family member, which triggers a death benefit guarantee;
- No vote. Seg fund owners have no rights as shareholders to vote or be notified of annual general meetings for their underlying investments. Segregation takes on a new meaning when you are segregated from having a voice.
- The T3 slip from a seg fund includes the capital gain or loss on disposition of the units of the seg fund. You don't own these funds directly in your own name. On disposition of an insurance product, you don't account for the funds as you would your other investments!

## How Does Withdrawal During Your Lifetime Work?

Seg funds are only guaranteed at the end of the life of the insured person.

Should withdrawal be initiated from a seg fund, those funds will be withdrawn based on the fair market value of the underlying funds at the time of the withdrawal.

One of my clients was very disgruntled when she learned how this works. Do not expect to get all of the total invested.

Let's say you bought in at $5.00 per fund unit for 20,000 units within the seg fund ($100,000).

At the time you wish to make a withdrawal, the fair market value of the funds held by the seg fund is $3.00. You want to withdraw $50,000. What would happen?

In order to obtain $50,000, you would sell 16,666.67 units to generate the $50,000 (83% of the total units held).

The remainder available for withdrawal is now 3333.33 units. At $3.00 x 3333.33 units, fair market value is $9,999.99. Of course, if you had a maturity guarantee of 100%, you would be able to collect 3333.33 units x $5.00 or $16,666.65, but only at maturity.

The $33,333.35 capital loss ($100,000 - $50,000 - $16,666.65) plus income or losses allocated to the funds would be reflected on your T3 slip for the year.

## Who Regulates the Sale of Seg Funds?

In March 2005, the Insurance Council of B.C. adopted, and has since amended several times, a Code of Conduct: http://www.insurancecouncilofbc.com/PublicWeb/PUB_CodeofConduct.html.

It is interesting what they consider as examples of misconduct relating to seg funds. See page 3.2 – "3.4.6 - Signed and submitted segregated fund applications solicited and completed by another agent to help the other agent circumvent the insurer's internal policy that prohibited life agents from selling segregated funds unless they were also licensed to sell mutual funds..."

Another example of misconduct that is interesting has to do with competence. See page 5.2 – "5.4.1 - Sold an insurance policy that was inappropriate given the client's stated objectives and circumstances and that a prudent and competent agent would not have recommended..."

## Risk Assessment Documentation

Exactly who has to be competent? The insurance agent or the client?

Insurance sales persons should be required by the insurance regulators in their province/territory to assess the ability of their clients to withstand the loss of their capital. For a list of who those regulators are go to: http://www.insurancecouncilofbc.com/PublicWeb/DisplayLinks2.aspx?CategoryCode=PRORE.

When seniors approach or are approached by sales persons selling seg funds, one would hope they are cautioned that this product may not necessarily meet their needs, and why not. If they don't need creditor proofing or protection for the downside on their investment losses, seg funds may not be the best product for their circumstances, particularly for someone who wants to use their money to travel in the next few years.

All of us should be very wary of any insurance or investment sales person who concludes we are sophisticated and willing to take high risks and attempt to get us to sign away our right to complain if the investments are risky.

Assessment as "sophisticated" may appear to be very flattering, but it is fraught with peril. There is no protection from the insurance sales person placing your investment funds in high-risk mutual funds. Remember that some mutual funds are at risk for total loss of capital. Look at it this way. There is no insurance in this insurance product until you are dead. While you are alive, if your investment value deteriorates, the agent won't care because at the end of the day the value will be in the guarantee.

Is it appropriate for a senior, for example one I know, whose only income is CPP, OAS and GIS, may or may not own their own home or apartment and a vehicle, with little or no investments or cash other than about $30,000, be considered an appropriate candidate for this type of investment? What if their stated purpose for investing is to take out $5,000 a year for 6 years while they are still healthy to fund their travel bug? If the senior signs that they are "sophisticated" and accept "high risk", their money might be invested in funds that do not allow for their withdrawals.

If a client has received a settlement for an accident, especially a head injury or has impairment in mental functions, should there not be some way to require more than just their signature that they are willing to risk their entire capital?

Currently, insurance sales persons are required to assess risk, but they are not required to obtain any third party verification of their private conversations with clients.

If the client signs that they are willing to assume a high-risk portfolio in spite of the facts, there is no recourse. No matter what the facts, a signature and a check mark that they are willing to risk it all will absolve the insurance agent of responsibility for the complete loss of the investment.

If the senior is less than fully competent to understand the risk, it becomes the client's signature against the client. The insurance commission is not prepared to act to protect the consumer from themselves. They will tell you to go to civil court.

## Tax Reporting

T3 slips for seg funds include capital gains and losses, as well as other income allocations.

Owning a seg fund is completely different from owning mutual funds. If the investment is a seg fund, you don't have to include the proceeds on a Schedule 3 when you dispose of the units of the fund. The T3 slip already includes those capital gain or loss calculations.

Accountants do not always see the purchase documents nor understand what a seg fund is. If you don't call a spade a spade and explain what it is, they may not treat your investment appropriately.

## Time for a Review

During the "risk assessment" process by a sales agent, a process should be initiated to ascertain that competence and the understanding of risk has been properly assessed for all clients over the age of 65.

Ensure a proper risk assessment has been conducted. If, in spite of the facts, someone insists that they are willing to roll the dice, an independent professional should be required to explain the risks and assess competence. We are required to obtain independent legal advice when signing for a mortgage, why not when investing in an insurance product?

## Product Naming

Everyone should be accorded the courtesy of names that reflect the nature of the investment. Names given to seg funds or GIFs by the insurance industry do not always reflect their true nature. Lack of appropriate naming can be misleading and confusing for taxpayers and tax preparers.

*Eileen Reppenhagen, CGA, Tsawwassen, BC (604) 943-7414, eileen@taxdetective.ca, www.taxdetective.ca*