USING SEGREGATED FUNDS IN AN ESTATE PLAN

Segregated (or seg) funds are an investment product offered by life insurance companies. Seg funds are individual insurance contracts that invest in one or more underlying assets, such as mutual funds. However, unlike mutual funds, seg funds provide a death and/or maturity guarantee protecting a portion of the capital invested. However, a client must hold the investment for a certain length of time (usually 10 years) to benefit from the guarantee. There may be a penalty if the investment is cashed before maturity.

From an estate perspective, seg funds are often seen as a useful vehicle to minimize the potential estate administration fee (probate). As a seg fund is an insurance product, where a beneficiary is named on the plan contract, the proceeds normally pass outside of the estate and probate is avoided. However, there are a few cautionary notes to consider.

CREDITOR PROTECTION

Although not necessarily an estate planning purpose, creditor protection is an additional benefit of a seg fund. However, creditor protection may be lost in some circumstances. For instance:

- If the seg fund was purchased at a time that the investor knew he or she was facing financial difficulties or already was experiencing financial difficulty, creditor protection may be challenged.
- Segregated funds may not provide creditor protection from the Canada Revenue Agency (CRA) if income tax liabilities are outstanding in a non-bankruptcy situation.
- Segregated funds may not provide protection from any claims arising under family law to provide for a dependent.
- Creditor protection is typically available only when a family class beneficiary (e.g. spouse, child, grandchild or parent) is named on the plan contract.

The above list is not exhaustive and the topic is complicated. Therefore, an advisor should be careful if a client's motivation in purchasing seg funds is creditor protection.

FEES

A seg fund usually has a higher management expense ratio (MER) than does a mutual fund due in part to the need to pay for the insurance features embedded in the fund.

Where a seg fund is being purchased solely as a probate minimization tool, careful consideration must be given as to whether the fund's annual additional cost is less than the probate savings that will eventually be realized. In Ontario, the probate fee associated with a $1 million estate is $14,500; in British Columbia, the fee is $13,250 and in Nova Scotia, the fee is about $14,186. This one-time fee is paid after an individual's death, as opposed the higher MER associated with a seg fund, which is paid during the investor's lifetime. For comparison purposes, a 1% difference in MER on the same $1 million would equate to an annual fee of $10,000. If the fund was held for 10 years, the increased MER would equate to a fee of $100,000.

ESTATE PLANNING

From a planning perspective, it is important for an advisor to caution someone before entering a will to be aware of standard beneficiary designation language in a will and to fully review any seg funds held by the individual. It is possible to inadvertently change the beneficiary designation in a will, or that which is stated on a segregated fund contract, and thus defeat the estate planning goals of the investor in a seg fund product.

For instance, in *Orpin v. Littlejohn*, Mr. Littlejohn, shortly before his death, designated his two sons beneficiaries of an insurance contract held within his RRSP. Even though the account was structured as an RRSP, the investment product held within the policy was a seg fund. Subsequent to the designation, Mr. Littlejohn entered into a new will, which contained the following clause:

> I HEREBY DESIGNATE my spouse, LOUISE CLARE ORPIN, as the sole beneficiary of all moneys that I may have at the date of my death in any registered retirement savings plan, registered retirement income fund, registered pension plan, registered investment fund or any other similar device. I DIRECT my Trustees to make all necessary arrangements to transfer such funds to my spouse as soon as is reasonably practicable following the date of my death.

The question was whether the seg fund passed to the sons as per the designation in the policy or to the widow as per the direction in the will. At first blush, it could be argued Mr. Littlejohn was only attempting to change the beneficiary designation in any registered plans he had but not on any insurance contracts (including the seg fund). After all, insurance is never mentioned in the clause and he had changed the beneficiary designation of the seg fund shortly before entering the will. Furthermore, although a beneficiary designation may be made or revoked by a "declaration," including in a will, in order to be effective, a declaration must "identify the contract" or "describe the insurance or insurance fund." There was no language doing so in Mr. Littlejohn's will.

The court held that while the will did not specifically refer to an "insurance policy," the words used were sufficient to constitute a declaration for purposes of the Insurance Act. In short, the court held that in using broad language, including the words "or any other similar device," Mr. Littlejohn had changed the designation through "an instrument in writing."

Seg funds can provide attractive benefits, including probate minimization, creditor protection, and a guarantee on a portion of the investment. However, when used as a planning tool, advisors and their clients must give careful consideration to issues such as the incremental fee associated with the fund and the need for proper documentation.

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