STEPUP
Sales Tax Estate Planning Underwriting & Product Newsletter

Segregated funds and mutual funds

What is the Difference

As you well know, Empire Life has been selling segregated funds for many years now and as of January 2012, launched a portfolio of mutual funds. Both are pools of financial assets managed by investment professionals and they cover different asset categories designed to fit a wide variety of investment objectives. The purpose of this article is to outline some of the general differences between segregated and mutual funds, including taxation differences on non-registered funds. It is of a general nature and not specific to any particular investment product. Both segregated and mutual funds may either be registered (RRSP, RRIF, etc...) under the Income Tax Act (Canada) or be non-registered.

Segregated Funds

Segregated funds are offered through life insurance companies and are regulated by Provincial Life Insurance Acts and are considered to be an inter vivo trust for tax purposes (para 138.1(1)(a) of the Income Tax Act Canada). They are a variable insurance contract or deferred annuity contract between an insurance company and a policy owner. In either case, it is a contract where the liabilities of the insurance company vary in amount depending on the market value of the assets in the fund. The policy owner makes premium deposits through the segregated fund contract and the insurance company invests the money in securities such as stocks, bonds and money market investments. Segregated funds are considered an asset of the insurance company, held in trust for the investor. The segregated nature protects the investor against the insolvency of the insurance company.

In order that the contract is considered a life insurance contract, the insurance company must guarantee at least 75% of the premium paid into the contract, upon its maturity or on death of the Life insured. Some segregated fund contracts offer a 100% guarantee. The guarantees at maturity or death may be the same or different. Clients have the ability to reset the maturity guarantee (resets the death benefit guarantee as well) at a chosen higher market value of the investment. Reset terms vary by company and product.

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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He annually provides 100's of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As a Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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Segregated funds and mutual funds

A segregated fund will allocate all taxable income and realized capital gains to investors, avoiding income being taxed inside the fund at the top marginal rate. The fund acts as a flow through, i.e. income and capital gains or losses retain their characteristics to the investor and appear on a T3 slip (Relevé 16 for Quebec and NR4 for non-residents) in the same way they are realized in the fund (para 138.1(1)(f); ss 138.1(3) and s 104 of the Income Tax Act Canada). Capital gains and losses are reported separately on a T3 slip.

The 2017 Federal Budget proposed that segregated funds be able to carryforward non-capital losses incurred in 2018 onwards into future years, subject to the limitations for carrying forward and back non-capital losses.

Capital gains and/or losses by the fund are first allocated to investors who redeem units. The income allocated by a segregated fund to an investor is reinvested and the fund increases in value.

As segregated funds are insurance (annuity) contracts, a beneficiary can be named to receive any proceeds upon the death of the annuitant. Proceeds are paid directly to the beneficiary, bypass the estate and can avoid probate fees (where applicable) and other legal and accounting fees. Creditor protection may also be available where the named beneficiary is a member of the family class, with certain restrictions. In addition, for non-registered investments, unit holders may only be taxed on the income they receive. Taxation may either be based on how long you own the segregated fund units within the income period (prorated for the time held) or like mutual funds, all unit holders holding the unit of the segregated fund are taxed on income earned in the fund for the entire calendar year. Please check your segregated fund contract to see which one may apply to you.

Mutual Funds

Mutual funds are offered through life insurance companies and other financial institutions, are regulated by Securities Legislation and are an inter vivo trust for tax purposes (not considering mutual fund corporations). A mutual fund is a pool of investments made on behalf of a large group of individual investors. Each fund makes different kinds of investments depending upon its investment objectives and strategies. You receive units in the fund in exchange for your investment and your money is invested together with that of other people who wish to make similar investments (stocks, bonds, money market investments, etc...). All unit holders share in the profit or losses of the fund.

Professional portfolio managers who have the skills to make decisions about which investment to buy, hold or sell manage mutual funds. The fund typically owns many different types of investments and those that go up in value can compensate for those that go down, increasing diversification. Since your money is not locked in for a fixed period, you can generally redeem your investments and get the current market value back from the mutual fund at any time. Mutual fund management companies make it easier to keep track of your investments. Sophisticated systems send you regular financial statements, reports and tax slips.

Unlike bank accounts or guaranteed investment certificates (GICs), the Canada Deposit Insurance Corporation or any other government deposit insurer does not cover mutual fund units. Unlike segregated funds, there is no guarantee that when you redeem your units of a mutual fund you will make a profit or get back the full amount of capital you originally invested.

Mutual funds must distribute both taxable income and realized capital gains relating to fund activity on a T3 slip (Relevé 16 for Quebec and NR4 for non-residents) to the unit holder. Capital losses are not distributed to unit holders. Losses are netted against capital gains in the fund. Any net capital loss is carried forward to offset gains in the fund in future years. Unlike a segregated fund, the losses are not allocated to unit holders. In addition, unit holders could be taxed on income they never received if they purchased the units at the end of the income period. If units are bought at the end of the year, unit holders will be taxed for all income earned in the mutual fund in that year, even though they did not benefit from that income, that is, the income is not prorated as may be the case with certain segregated funds. If the unit holders redeem any of their units, they must calculate the gain or loss on their tax return. Unit holders may choose to receive distributions in cash or reinvest them by buying additional units.

On the death of the unit holder, proceeds are an asset of the estate (unless they are registered funds) and are subject to probate fees, the estate administration process and legal fees. Mutual funds have no protection against the claims of creditors, except in certain circumstances.

Many other differences exist between mutual and segregated funds, as well as different features between the products. If an investor is either approaching retirement or likes the security of guarantees and wants creditor protection, (s)he may want to purchase segregated funds. On the other hand, if an investor wants a wide variety of specialized fund choices in their investments and is willing to give up guarantees for potential increased returns, (s)he may want to purchase mutual funds.

Investors would be well advised to consult their investment advisor to determine what type of fund is best suited to their needs. The advisor in turn can contact our tax and estate planning team who can help answer technical questions.

Empire Life Investments