APPENDIX 7 - GUARANTEES, WITHDRAWALS, AND OTHER SEGREGATED-FUND ISSUES

Topics in this section include:

1.0 Segregated Funds

1.1 Organization of the fund

The term "segregated funds" refers to a pool of assets held separately within the general assets of an insurer and used to cover the liabilities of the insurer under a group of individual variable insurance contracts (IVICs). Segregated funds are deemed to be *inter-vivos* trusts. The insurer is deemed to be the trustee of the segregated funds, and the policyholders are deemed to be the beneficiaries.

The income of the segregated fund is taxed in the hands of the policyholders as income from a trust in the same way that mutual fund unitholders are taxed on income from a mutual-fund trust. This treatment of annual taxation of income applies only to non-registered segregated funds. Where the fund qualifies as a registered plan, such as a Registered Retirement Savings Plan (RRSP), a Deferred Profit-Sharing Plan, or a Registered Pension Plan (RPP), the income was not subject to taxation until payments were made to the beneficiary.

To ensure that segregated-fund policyholders are taxed annually, the insurer allocates the income of the segregated fund to the policyholder in proportion to their share of the fund and income. This flow-through treatment ensures that the income of the segregated fund is taxed in the hands of the policyholder in the year the income is earned, in the same way that mutual-fund holders are taxed, the only difference being that the mutual-fund investor has the option of receiving the distributions of the fund in cash. A segregated-fund policyholder cannot receive the allocations of the fund in cash, as the policyholder has to wait until the contract matures (ten years) or until the annuitant's death prior to maturity. The taxed income in a mutual fund is referred to as "distributions," and taxed income in segregated funds is referred to as "allocations."

The insurer is required to report all allocations on a T-3 slip, and use the form to provide information on the source of earnings, since the income from a segregated fund would retain its character as interest, dividend, or capital gains in the hands of the policyholder, who would be taxed accordingly and could be eligible for a dividend tax credit, deductions on foreign taxes, an interest-income deduction (where applicable), and favourable capital-gains treatment. Another difference between distributions of a mutual fund and allocations of a segregated fund is that allocations may be made for capital losses, whereas the mutual fund does not distribute capital losses.

In a non-registered account, each allocation increases the adjusted cost basis (ACB) of the contract. Finally, when the contract is redeemed, the policy owner needs to pay a capital-gains tax, calculated as CG = proceeds of disposition — the latest ACB of the contract. The latest ACB of the contract is calculated as the ACB at the commencement of the contract, plus all allocations received to date.

Surrender of a contract prior to maturity may attract charges in the form of a market value adjustment and/or a penalty.

1.2 Guarantees of segregated funds

A segregated fund is a contract between an insurer and a policyholder. There could be third person named as the annuitant of the contract. The annuitant is the person named by the policyholder to receive the benefits of the policy if the annuitant is alive on maturity of the contract. Thus, an annuitant could be a different person than the policyholder. The annuitant is the person on whose life the death-benefit guarantee is given, and therefore on whose life the insurance charges apply. However, if the contract is held in a registered account, the policyholder and the annuitant have to be the same person.

A policyholder also names the beneficiary of the contract. The beneficiary is the person who will receive the proceeds of the contract on the death of the annuitant.

A segregated fund is required to offer a minimum guarantee of principal of 75%, but may offer higher guarantees, such as 85% or 100%.

For example, John deposits $100,000 into a segregated fund on January 15, 2010, naming himself as the annuitant and his daughter Jenny as the beneficiary. His contract maturity date is January 15, 2020. The fund offers a maturity guarantee of 75% and a death-benefit guarantee of 100%. This implies that, if the contract matures, the payout will be the higher of the account value at that point, or $75,000, the maturity guarantee.

Assume the fund value in the contract is $130,000 on maturity. John will receive $130,000 from the contract.
Assume that the contract value is $60,000 on maturity. John will receive $75,000 from the contract, made up of two components, the $60,000 fund value and $15,000 as a top-up guarantee from the insurer.

In other words, John is assured that he will receive a minimum of $75,000 on maturity.

If John decides to surrender the contract before the maturity date, there is no guarantee applicable. Assume that John wants to surrender his contract on October 15, 2015, and the account value on that date is $60,000, John will receive only $60,000 from the contract, which will be subject to early-surrender charges.

Assume that John dies on October 15, 2015, when the account value is $60,000; Jenny, the beneficiary of the contract, will receive $100,000 (100% death-benefit guarantee). This is made up of two components, $60,000 from the account and $40,000 death benefit from the death-benefit guarantee of the insurer.

1.3 Reset of guarantees

Many contracts permit a policyholder to reset the guarantees provided by the contract. For example, if the value on John's contract was $200,000 on October 15, 2015, and he decides to reset the contract on that day, his guarantees would be recalculated as follows:

Maturity guarantee: 75% x $200,000 = $150,000
Death-benefit guarantee: 100% x $200,000 – $$200,000

The downside is that the maturity date of the contract would be 10 years from the date of reset, or October 15, 2025.

1.4 Withdrawals from a segregated fund

If a partial withdrawal is made from the account value of a segregated fund, the guaranteed amount is recalculated.

Example:
Assume that John had a segregated fund with a 75% maturity and death-benefit guarantees, which he started with a deposit of $100,000 on January 15, 2010. The fund thus guarantees him $75,000 as maturity guarantee and death-benefit guarantee. On February 20, 2015, the account value was $150,000, and he wants to withdraw $30,000 from the account.

There are two methods used in the industry to recalculate the guarantees, namely the linear method and the proportional method.

Given Data

Guarantee before withdrawal:	$75,000
Withdrawal amount:	$30,000
Principal	$100,000
Fair market value	$150,000

Linear Method:

$$\text{Percentage withdrawn} = \frac{\text{Withdrawal Amount}}{\text{Principal}} = \frac{\$30,000}{\$100,000} = 30.00\%$$

Investment remaining = 100% – 30% = 70.0%

New Guarantee = 70% x Guarantee before withdrawal

70% x $75,000 = **$52,500.00**

Proportional Method:

$$\text{Percentage withdrawn} = \frac{\text{Withdrawal Amount}}{\text{Fair Market Value}} = \frac{\$30,000}{\$150,000} = 20.00\%$$

Investment remaining = 100% – 20% = 80.0%

New Guarantee = 80% x Guarantee before withdrawal

80% x $75,000 = **$60,000.00**

From the above, you will observe the following:

1. The linear method considers all withdrawal coming off the principal.
2. The proportional method considers the withdrawal as partly from principal and partly from growth.
3. The proportional method gives a better guarantee when the account value has increased, and the linear method gives a better guarantee when the account value has decreased.

4. The information folder tells the policyholder the method that will be used to recalculate guarantees when withdrawals are made from the contract.

Reset and withdrawal immediately thereafter:

Example:
Assume that John had a segregated fund with a 75% maturity and death-benefit guarantees, which he started with a deposit of $100,000 on January 15, 2010. The fund thus guarantees him $75,000 as maturity guarantee and death-benefit guarantee. On February 20, 2015, the account value is $150,000 when he resets the contract and withdraws $30,000 from the account immediately thereafter.

Withdrawal after Reset

Given Data

Guarantee before reset	$75,000
Guarantee after reset	$112,500
Principal after reset	$150,000
Withdrawal amount:	$30,000
Fair market value	$150,000

Linear Method:

$$\text{Percentage withdrawn} = \frac{\text{Withdrawal Amount}}{\text{Principal}} = \frac{\$30,000}{\$150,000} = 20.00\%$$

Investment remaining = 100% - 30% = 80.0%

New Guarantee = 80% x Guarantee before withdrawal

70% x $112,500 = **$90,000.00**

Proportional Method:

$$\text{Percentage withdrawn} = \frac{\text{Withdrawal Amount}}{\text{Fair Market Value}} = \frac{\$30,000}{\$150,000} = 20.00\%$$

Investment remaining = 100% - 20% = 80.0%

New Guarantee = 80% x Guarantee before withdrawal

80% x $112,500 = **$90,000.00**

You will observe that both the methods give the same guarantee after withdrawal, if the withdrawal is made after a reset. That can be understood if one realizes that, on reset, the entire fair market value (FMV) is converted to principal, and therefore there is no growth and the withdrawal comes off the principal in both the methods.