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Creditor Protection for Your Investments

For the clients and friends of
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This article is written to a specific financial requirement, but it is only one piece in a much wider financial plan that includes tax planning, retirement income, insurance, business succession, and estate planning. While many people associate the designation "wealth advisor" with stocks, bonds and GICs, the financial planning component is equally important to ensure an individual's finances actually serve their purposes in the most tax-efficient manner.

Many people who work for themselves are exposed to some litigation risk that can potentially lead to severe financial consequences. I spoke to a tradesman recently who says he worries about his liability every day. This article was written to address those concerns in a general way and give a jumping off point for discussion.

Liability Insurance

The easiest and simplest protection is to carry adequate insurance. When I was a veterinarian, prior to becoming a Wealth Advisor, I carried significant liability insurance to protect myself against both real or imagined negligence on my part. It was easy to purchase and relatively inexpensive. Many of my farming and horse clients had multi-million dollar operations and I felt a real desire for them to be protected with recourse against me in case I was ever negligent. I always strived to do my best in the work and in my communications with clients. This is the first line of "defence".

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Interestingly, communication failure is the most frequent cause of complaints in my former profession and may also be true in yours. In many cases, insurance is either not available, or it if just too expensive to justify.

Spousal Transfer

Married couples with one spouse outside of the business can have much of the family assets in his or her name. This is a common technique, but can be unwound by a court if an asset change of ownership is deemed to be an attempt to prevent recovery of damages. It may also trigger taxes as well as be a problem should the relationship break down.

Holding Corporations

Many people split their limited companies into an operating company (opco) and a holding company (holdco). Excess cash from the opco is moved into the holdco. This provides a layer of creditor protection since the holdco is a separate entity. It also adds paperwork, time, government, legal and accounting fees. It also used to be that there were tax advantages associated with holdcos. These have largely disappeared, though dividends from Canadian corporations can still be passed through the holdco to you in a tax-advantaged way. To set up a holdco, you will need to speak to both your accountant and lawyer.

The Segregated Fund

The segregated fund (seg fund) is a simple, common method for anyone to use and can be held inside an RSP/TFSA/personal account. It is actually an insurance product wrapped around a mutual fund. It is the insurance component that provides the creditor protection. Like other protection techniques it can't be used with a specific impending threat in mind as a way to dodge legitimate creditor claims. If for example, a lender was intending through normal channels to seize assets, the owner could not protect the value by selling them and using the proceeds to buy seg funds.

When a seg fund is purchased, the proceeds buy notional units in a mutual fund that goes up or down in value similarly to a regular fund. As an added bonus, there are guarantees of 75 to 100% on the principal after 10 years. For example, if you put $100,000 into a seg fund family you would be able to specify the per cent guarantee in the contract. This principal guarantee makes the management fees higher than an ordinary fund. I would only use them for creditor protection because the higher fees eat into returns. Additionally, while the guarantee sounds great, most quality funds have a very low chance indeed of ever triggering the guarantee. Still, like all financial tools, for very conservative or older investors, or those who like high-risk sectors, it has its place. Like all insurance products, you have to apply and be accepted. Application for seg funds is not usually a problem for most people.

The Individual Pension Plan

The individual pension plan (IPP) is another method of saving for retirement at about twice the contribution rate of an RSP for people over 40 and earning more than $111,000 in T4 income. It provides creditor protection for the principal and a pension style investment intended to grow at about 7.5% per year. As above, you need to have a limited company and again there are costs. It can also be used to reduce taxes on the sale of a business as well. In the case where the business is being passed on to a son or daughter an IPP can be made intergenerational.

The Retirement Compensation Arrangement (RCA)

This inter-vivos trust (living trust) is sometimes called the super-sized pension plan because there are no set limits on the tax-deductible contributions as there are with RSPs (lowest) and the IPP (medium). Revenue Canada says that the contribution size must be reasonable in respect to the beneficiary's income, but there is no limit. There are also no limits on the type of investments used and can include insurance unlike the IPP or RSP. For high-income incorporated business owners, this can be a powerful tool to maintain a high income into retirement.

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