Intergenerational Wealth Transfers — The Waterfall Concept

Many permanent life insurance policies have unique features and tax attributes that make them ideal vehicles to facilitate the transfer of wealth between generations. The reason that this insurance transfer strategy is so popular is because the transfers can be done in a tax-efficient manner, without giving up control of the gift, and in most cases without the assistance and cost of lawyers.

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What is the Waterfall Concept?

The Waterfall Concept involves the tax-deferred accumulation of wealth inside a tax-exempt permanent insurance policy, followed by a rollover of the policy to a child or grandchild. The provisions in subsection 148(8) of the Income Tax Act (ITA) govern the rollover. There are many variations of the Waterfall Concept so it can be tailored to meet your client's objectives.

It is referred to as a Waterfall because the wealth transfers that qualify for this rollover must be to children or grandchildren. Like a waterfall, the transfers only flow one direction — downward. The definition of a child in the ITA includes your children, grandchildren, your son- or daughter-in-law, your spouses' children from a previous marriage, adopted children and children from a common law relationship. The term child is not restricted to a particular age. For the rollover to apply, the life insured on the policy must be a child and the policy must be transferred to a child. The life insured and future policyowner don't have to be the same child. In addition, the gift of the policy to the child must be made without consideration of any type.

Death of the policyowner: Whenever the policyowner is older than the life insured there is a real possibility that the policyowner will pass away before the life insured. If this were to happen, the policy would become part of the deceased's estate and the gains in the policy would become taxable to the deceased. Probate fees may also apply. The larger the age differential between the policyowner and the life insured, the greater the risk of this outcome.

Income attribution: A rollover prevents tax from arising as a result of the transfer, but has no impact on the taxation of transactions that occur after the transfer. As such, if funds were removed from the policy under a situation where the income attribution rules would apply, taxes payable would be attributed back to the transferor.

Loss of control over the policy: The legal age to be able to negotiate a contract is 16 in all provinces other than Quebec, where the age is 18. If the policy were transferred to someone under that age, there would be no one with the legal capacity to authorize transactions until the child reached the legal age to contract. A court application for the appointment of a trustee would be required if a transaction needed to be executed.

Control over the use of funds: One of the advantages of the Waterfall Concept is the retention of control over the asset being transferred. Once the policy is transferred to the child, they will have control of the contract unless the transfer is structured to retain a level of control.

How does it work?

The transferor would purchase a tax-exempt permanent life insurance policy on the life of a child and over fund it, typically over a three to five year time horizon. The policy would grow on a tax-deferred basis and eventually be transferred to a child of the transferor for no consideration. Because the provisions in subsection 148(8) of the ITA would apply in this situation, the child or grandchild becomes the new policyowner without any immediate tax consequences. Only when the child or grandchild withdraws the funds from the policy, will they be taxed, but at their tax rate — not the transferors. The benefit is that their tax rate will most likely be much lower than the transferors and the taxes are deferred until the withdrawal actually occurs.

What other issues are there to consider?

The Waterfall is a very simple concept that is becoming more popular given the aging population and the massive wealth transfers anticipated in the years ahead. However, there are a number of issues that should be considered when setting up the arrangement to ensure the client's objectives are realized.

How to deal with these issues?

Using the features available in many tax-exempt permanent life insurance policies, most of the issues raised can be dealt with.

First, we could name a child of the original policyowner as a contingent owner. This means that upon the original policyowner's death, the policy would transfer to the contingent owner outside of the estate. Because the transfer is to a child on a policy that has a child of the original owner as the life insured, the rollover provisions would apply. This strategy is particularly useful in cases when the gift is to skip a generation. In those cases, the grandparent would acquire a policy on the life of a grandchild with the child's parent as contingent owner. Upon the grandparent's death, the policy could rollover to the parent on a tax-free basis and the parent could then transfer the policy to the child at the appropriate time. This doesn't eliminate the risk of the policyowner dying before the life insured, but it reduces the likelihood of that happening. Given that these policies are usually transferred shortly after the child reaches age 18, there is a very good chance that the parent will be alive at this time.

Next, the transfer of the policy would be deferred until the child reached age 18. This avoids concerns about income attribution and loss of control.

Finally, to retain control over the use of the funds in the policy, an irrevocable beneficiary can be placed on the policy prior to the transfer to the child. The irrevocable beneficiary must consent to policy withdrawals of any type before the child can get access to the accumulated value in the contract. The irrevocable beneficiary acts like a trustee to ensure the original owner's wishes for the use of the funds are realized. The irrevocable beneficiary must be a trusted individual to ensure they allow the child to use the policy as originally intended.

What are the advantages of the Waterfall Concept?

- The transferor has provided a valuable gift and legacy for their child or grandchild.
- The transferor has stopped the annual taxation that would have arisen on the investment income generated on the gifted amount.
- Taxes are avoided when you transfer the funds to your child or grandchild. And when they withdraw from the policy, it's taxable at their tax rate not the transferor's if the transfer is properly structured.
- Probate fees have been avoided and the transferor's privacy has been respected by ensuring the transfer doesn't go through the estate.
- A trusted individual can control the use of the funds in your absence.

And, all this can be done through the life insurance contract without the need for legal intervention.

It's a gift your child or grandchild will never forget

As a result of passing on wealth by way of the Waterfall Concept, the transferor's child or grandchild can use the gift for university, a wedding, or any other important reason. They will be giving their child or grandchild the right start. They will also be helping them create a valuable insurance policy at very reasonable rates should the children decide to keep it for the future, avoiding possible insurability issues down the road.

For more information about Intergenerational Wealth Transfers — The Waterfall Concept, contact your RBC Insurance sales representative today.

This document is not an illustration or projection and is provided as an example based on specific assumptions that will not apply in other cases. The figures displayed are incomplete and must be accompanied by an RBC Insurance life insurance illustration.

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The Waterfall Concept

To help you further understand the Waterfall Concept, here's an example of how grandparents can help provide financial security throughout the life of their grandchild. Your RBC Insurance Sales Representative can help you customize this example for your client.

An 8 year old grandchild receives a unique and valuable gift from her grandparents on her birthday. It's the first in a series of contributions to a life insurance policy that can be transferred to her when she reaches age 18. Obviously the grandchild is too young to appreciate the value of this gift currently, but over her lifetime it will provide her with financial security and estate planning opportunities. It will also remind her of her grandparents and their thoughtfulness throughout her life.

For grandparents, the purchase of a tax-exempt permanent insurance policy makes it possible to transfer assets that are generating taxable income into a tax-deferred growth vehicle. Any tax that may be payable if the values in the policy are accessed prior to the death of the insured, will ultimately be payable by the grandchild at her effective tax rate.

How does it work?

The grandparents are owners of the policy on the life of the grandchild. They retain control of the policy until such time as it is transferred. When the grandchild reaches age 18, the policy can be transferred to the grandchild on a tax-deferred basis if properly structured. Control of the policy can remain in the hands of the grandparents, if desired, by putting an irrevocable beneficiary on the policy prior to the transfer.

For this grandchild, the gift could provide financial assistance throughout her lifetime:

- additional funds for university when the grandchild reaches age 18 ($20,000 over 4 years)
- after-tax funds to increase a down payment on a home ($10,000 at age 35)
- funds to supplement retirement income starting at age 65 ($8,161 for 15 years)
- a death benefit to provide for taxes, final expenses, and her estate (at expected mortality) ($271,370 at age 80)

How was this legacy created?

The grandparents invested $25,000 over 5 years into a tax-exempt permanent life insurance policy on the life of the grandchild. The growth in the policy is projected at 5.00%* and the original face amount is $454,083. The policy can be transferred without consideration to the grandchild at age 18 without any tax impact. Any withdrawals from the policy after this point would be taxed in the hands of the grandchild at her effective tax rate of 35.00%. When the grandchild begins university, she withdraws a total of $20,000 over 4 years to help fund her university education. The tax impact on those withdrawals will likely be negligible given the tax credits available to offset the costs of her post secondary education combined with the personal tax credits available to her. At age 35, she withdraws $10,000 after tax from the policy to increase a down payment on a home. At age 65, the available funds in the policy have now reached $186,916. This amount can be used as collateral to borrow funds to supplement a retirement income. Assuming a 7.00% loan rate, the grandchild could borrow $8,161 per year to age 80. The loan will ultimately be repaid through the death benefit. If in fact, the grandchild passed away at the end of the income period, the death benefit would be sufficient to settle this loan and leave $271,370 to deal with taxes and other expenses that arose upon her death.

The cost of this legacy: $5,000 per year for 5 years. Is your grandchild worth the investment?

*NOTE: The rate of return excludes the Preferred Client Bonus and the Wealth Accumulation Bonus.

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