# 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. This insurance transfer strategy is popular 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.

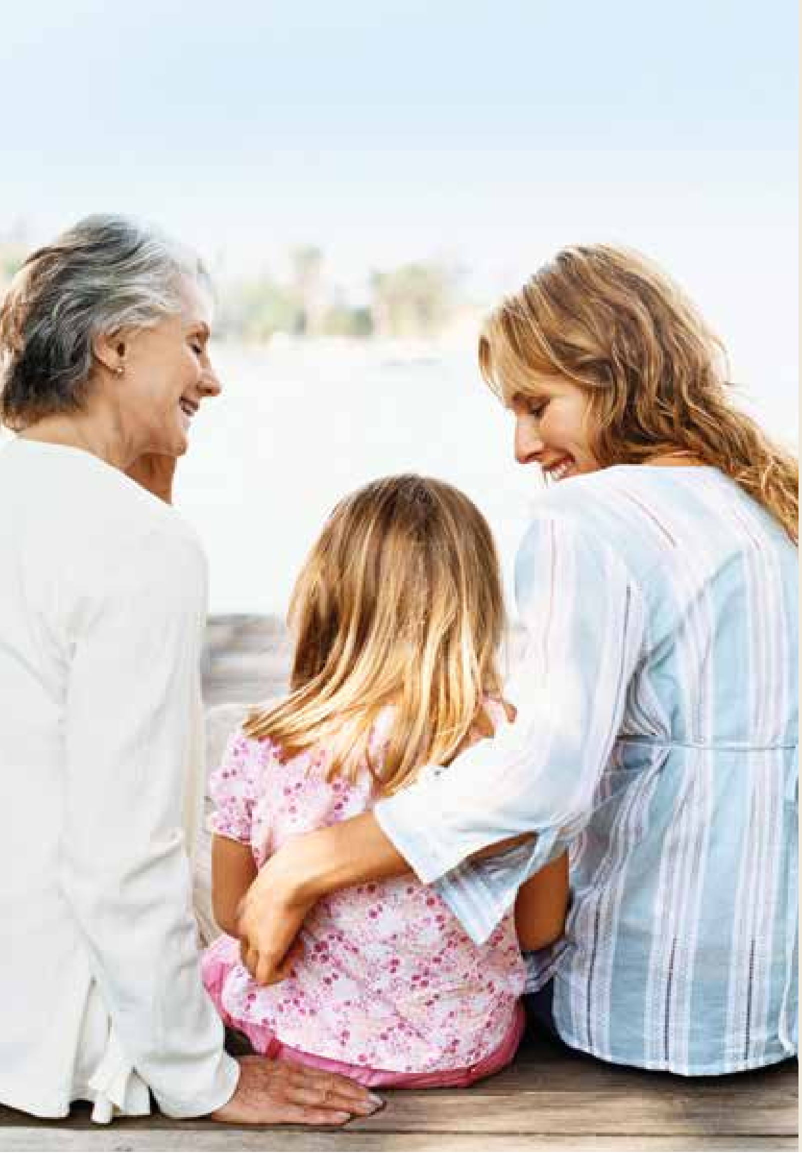
### What is the Waterfall Concept?

The Waterfall Concept is a strategy where a parent or grandparent uses a tax-exempt permanent life insurance policy to accumulate wealth tax-deferred, then transfers it to their child or grandchild as a gift without tax consequences to use throughout their lifetime.

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, like a waterfall, the transfer can flow downward only — i.e. for the gift not to be taxable, the life insured on the policy must be a child's, and the policy must be transferred to a child.

The provisions in subsection 148(8) of the Income Tax Act (ITA) govern the rollover. Under this subsection, a child is defined as the transferor's child or grandchild, their son- or daughter-in-law, their spouse's child from a previous marriage, their adopted child or their child from a common-law relationship. The term "child" is not restricted to a particular age, and 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.

RBC Insurance



**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 happens, the policy will become part of the deceased's estate, and the gains in the policy will be taxable to the deceased. Probate fees may also apply. The larger the age difference between the policyowner and life insured, the greater the risk of this outcome.

**Income attribution:** For the gift to be non-taxable, we rely on a rollover provision in the ITA. 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 are removed from the policy in a situation where the income attribution rules apply, any taxes payable will 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 except Quebec, where the age is 18. If the policy is transferred to a child under the legal age, the child does not have legal authority to deal with the policy until the child reaches the legal age to negotiate; thus, a court application for the appointment of a trustee will be required if a transaction needs to be executed.

**Control over the use of funds:** If structured right, the transferor can retain some control over the policy after it has been transferred to the child. Otherwise, the child gains control upon transfer.

## How does it work?

The transferor purchases a tax-exempt permanent life insurance policy on the life of a child and contributes to it, typically for three to five years. The policy grows on a tax-deferred basis and is eventually transferred to the child of the transferor for no consideration. According to the provisions in subsection 148(8) of the ITA, the child becomes the new policyowner without any immediate tax consequences. However, any time the child withdraws funds from the policy, the funds are taxed in their hands — not the transferor's — at their effective tax rate. The benefits of this strategy are that the child's tax rate will most likely be much lower than the transferor's, and taxes are deferred until the withdrawal actually occurs.

## Dealing with potential issues

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

Most of these issues can be dealt with by utilizing the features available in the insurance policy:

**The policyowner can name a child as the contingent owner:** If a contingent owner is named, then upon the original policyowner's death, the policy will be transferred to the contingent owner outside of the estate. Because the transfer is to a child and the life insured is also a child of the original owner, the rollover provisions apply.

This strategy is particularly useful in cases where the transferor wants the gift to skip a generation. For example, if a grandparent acquires a policy on the life of a grandchild and names the child's parent as the contingent owner, upon the grandparent's death, the policy will roll over to the parent on a tax-free basis, and the parent can 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 it. 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.

**The policy's transfer can be deferred until the child reaches age 18:** This avoids concerns about income attribution and loss of control.

**An irrevocable beneficiary can be placed on the policy prior to transferring it to the child:** The irrevocable beneficiary must consent to policy withdrawals of any type before the child can access 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 can provide a valuable gift and legacy for their child or grandchild.
- The transferor avoids annual taxation on the investment income generated on the gifted amount.
- They also avoid taxes when they transfer the funds to their child or grandchild. And when the child withdraws funds from the policy, as long as the transfer has been properly structured, the funds are taxable to the child, not the transferor, at the child's tax rate.
- Probate fees can be avoided and the transferor's privacy respected by ensuring the transfer doesn't go through the estate.
- A trusted individual can control the use of the funds in the transferor's absence.
- And, all this can be done through the life insurance contract, without the need for legal intervention.

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

Passing on wealth using the Waterfall Concept enables grandparents or parents to give funds to a child to use for university, a wedding or any other important reason. They can give the child the right start and help them create a valuable insurance policy, at very reasonable rates. The child may also keep the policy in force if they want, avoiding possible insurability issues down the road.

**For more information about intergenerational wealth transfers and The Waterfall Concept, contact your RBC Insurance® sales representative today.**

RBC Insurance

# Intergenerational Wealth Transfers

## 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.**

Juliette, a four-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 an insurance policy that can be transferred to her when she reaches age 18. Obviously Juliette 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 universal life insurance policy makes it possible to transfer assets that are generating taxable income to 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 Juliette at her effective tax rate.

### How does it work?

The grandparents are the 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 Juliette, the gift could provide financial assistance throughout her lifetime. Here are a few examples of the potential outcomes that could be derived:

| | |
|---|---|
| Additional funds for university when Juliette reaches age 18 | $20,000 over 4 years |
| Funds to supplement retirement income starting at age 65 | $21,580 per year for 21 years |
| A death benefit, net of loan, for taxes, final expenses and her estate | $429,063 at age 85 |

### How was this legacy created?

The grandparents invested $25,000 over five years in a universal life insurance policy on the life of the grandchild. The growth in the policy was projected to be 5%*, and the original face amount was $512,972. The policy was eligible to be transferred without consideration to the grandchild at age 18 without any tax impact. Any withdrawals from the policy after this transfer were taxed in the hands of the grandchild at her effective tax rate.

When the grandchild began university, she withdrew a total of $20,000 over four years to help fund her university education. The tax impact of those withdrawals was negligible given the tax credits available to offset the costs of her post-secondary education combined with the personal tax credits available to her. By age 65, the available funds in the policy had reached $649,362, which she was able to use as collateral to borrow funds to supplement her retirement income.

The cost of this legacy: $5,000 per year for five years.

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

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. For more information, please contact your RBC Insurance representative.

RBC Insurance

Underwritten by RBC Life Insurance Company.


83902 (09/2013)

VPS84766