The TaxLetter®

Vol. 33, No. 12 | Your Guide to Tax-Saving Strategies | Single Copy: $10.00 | December 2015

FINANCIALPLANNING

"Melt and cascade": An effective way to stream wealth tax-free

Thawing out

Mark Halpern, CFP, TEP

Melt and cascade describes what happens to a solid ice jam on a hot summer's day: a fixed form becomes a fluid, more dynamic element. The insurance industry borrowed this vivid imagery from nature to help Canadians "thaw out" the funds in registered and unregistered investments they are not using in their retirement and stream the money to children or other beneficiaries in the most tax-efficient method possible.

Unintended gifts

Unless they take steps to preserve their estates while alive, Canadians who die without a spouse or financially dependent child or grandchild unknowingly "bequeath" to the government up to 50 per cent of the value from their Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF) holdings. They also "bequeath" up to 25 per cent of the growth from their non-registered holdings such as business equity, real estate, bonds, etc. On top of that, they will likely have additional estate costs to pay—such as trust fees and estate administration (formerly probate) taxes, that can be 1.5 per cent in Ontario for example. This means a $1 million non-registered investment portfolio or a $1 million home will have $15,000 of probate costs.

Death, second marriages and the single tax payer

This issue is further exacerbated today as so many marriages end in divorce and there is often no spouse or common-law partner to "roll over" assets to on a tax-free basis. This results in harsh taxation on the death of a single tax-payer.

For those who get married a second time, most people would prefer to leave money to their children from their first marriage as opposed to leaving their money to a new spouse and potentially to the new spouse's children. Most people want to leave as little as possible to the Canada Revenue Agency.

Melt and cascade to charity

In addition, some parents or grandparents may also want a charity to inherit some of their wealth—and again, the melt and cascade method helps stream remaining RRSP and RRIF funds away from the government and into their favourite non-profit organizations.

Counterintuitive, but effective

Not surprisingly, some may find this method counterintuitive: you took pre-tax money and put it in an RRSP to grow tax-sheltered; and now you are being asked to either stop making RRSP contributions or collapse your RRSPs before you turn 71 when you will have to convert the RRSP to a RRIF. Truth is, it really does not matter when you start collapsing the RRSP (whether you are retired or not), as you will still have to pay the tax and many clients pay taxes at the top level before and after retirement.

Mark Halpern, Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) is the Founder and President of illnessPROTECTION.com. Mark is one of Canada's top life insurance advisors with special expertise for business owners, entrepreneurs, medical professionals and high-net worth individuals and families. He can be reached at 905-475-1313.

mark@illnessPROTECTION.com

How 'melt and cascade' works: Five examples

Here are five recent examples to illustrate the advantages of alternative investing and how the melt and cascade strategy was used to minimize or eliminate taxes on the registered assets (RRIFs and RRSPs) and non-registered assets of high-net-worth individuals.

1) Betty is a 71-year-old widow whose husband left her a large estate that included a $1-million RRIF from which she has to receive this year a minimum of $52,800 of income (and increases in subsequent years). She does not need this RRIF income to pay everyday bills, so she cascaded the after-tax RRIF income into the premiums of a $1-million life insurance policy on her life.

As with all life insurance with a designated beneficiary (ies), when she dies the $1 million will be paid out tax-free and probate-free to her beneficiary (ies). Compare that to leaving more money in the RRIF (only taking the minimum income) with a designated non-spouse beneficiary and reinvesting her after-tax minimum RRIF income. In that case, about half of the value remaining in her RRIF and one quarter of the appreciation in her other investments will go to Ottawa in the form of taxes.

2) Jack is 65, a divorced single man with a thriving law practice and two grown children. He has accumulated almost $2 million in his RRSP and wants to leave half of it to his children and the other half to charity. He starts withdrawing from his RRSP to provide the after-tax funding needed to buy a $2 million life insurance policy on his life.

When Jack dies, $1 million of death proceeds will be received by his children tax-free and probate-free. The remaining $1 million of insurance proceeds will go to the designated charity and generate a charitable receipt of $1 million, saving the estate approximately $500,000 of tax.

In the end, his children get a $1.5 million benefit ($500,000 more) versus just the $1 million, his favourite charity recognizes him while he is alive as a $1-million donor and he will be remembered for leaving a large charitable gift, instead of a large sum to the tax department, through this creative planning.

3) Alice and Steve, a married couple, own and operate a busy car dealership. They wanted to transfer money to the next generation without triggering any taxes. In this case, Steve used income from his non-registered investments to pay the premiums on three life insurance policies, one on each of their three children's lives. He is the owner of the policy, Alice is the contingent owner and the children are tertiary owners. The cash value of the policies continues to build and remains tax sheltered within the life insurance policy.

When a parent transfers a life insurance policy to their child, the cash value goes with it and so does the valuable risk protection. That insurance coverage on the children is especially important if, at some point in the future, they become uninsurable. With the child named as a contingent owner when the parents die, the policy will go directly to each child on a rollover basis and the child can use it for his/her own own estate planning. A life insurance policy purchased for one child can be transferred to a different child in the future for any reason. If the cash value in the policy is later accessed by the child there may be income tax associated with that accessing; however, any income tax will be at their own rates versus their parents.

4) This is a very common scenario. Ralph is a 53-year-old accountant in a second marriage. Ralph wants to provide for his second spouse, but also wants to preserve and pass some of his wealth to his children from his first marriage. Ralph took money out of his RRSP to fund a life insurance policy on his life. When he dies, the benefit from that policy will be paid into a testamentary trust for his second wife, who will receive all of the income during her lifetime and may receive some capital in the descretion of the trustees. The children from his first marriage will act as the trustees of this trust so when the second wife passes away, whatever capital remains in the trust will pass to those children, tax-free.

5) The melt and cascade strategy works especially well with charitable giving. Don, a 73-year-old retiree, was receiving about $120,000 a year in taxable income from his RRIF and losing half of it in taxes. Don also wished to leave a large legacy to charity. We worked with Don to re-allocate his $120,000 RRIF income to pay the premiums on

a new $2-million life insurance policy on his life. After Don received his new insurance policy, he transferred it to his favourite charity that is also the beneficiary. This way Don's annual premium payment of $120,000 is classified as a charitable donation. Having the policy owned by the charity helps Don offset the $120,000 of RRIF income effectively reducing his current tax liability for the RRIF income. The life insurance policy proceeds paid on death will generate a $2-million legacy for which he is recognized during his lifetime.

Melt and cascade—not limited to tax-sheltered funds

The melt and cascade strategy does not have to begin with tax-sheltered funds. In fact, many clients who have maxed out their RRSP and RRIF contributions use the proceeds from the disposition of bonds, stocks and GICs—even segregated funds—to pay the life insurance premiums. This is even more effective when done within a corporation or holding company as business owners can pay the insurance premiums with the corporate assets/income. Incorporating charitable gifting with either appreciated corporate securities or by the business owner with his/her shares and using corporate-owned life insurance can be very tax efficient because of the value associated with retaining the corporation's Capital Dividend Account for an estate or family heirs.

Cascading flows one way

You should also know that there is no reverse cascading—at least not without exacting taxes. So, for example, if a parent cascades a life insurance policy to an adult child and for some reason the child transfers ownership back to the parent, a policy gain may be triggered resulting in tax to the adult child.

Life insurance—an investment with many benefits

Life insurance is one of the best ways to ensure your family, loved ones or favourite charities quickly and easily receive your last gift. As you can see, there are many ways you can use the funds that you already have to help finance the premiums. The unmatched flexibility, tax-free benefits and ability to designate any beneficiary is what distinguishes life insurance from any other investment.

You have worked hard for your money and you love your family. Like most readers, you probably prefer to leave a larger estate to the people and charities you care about, with as little as possible for the tax department.

Ask for professional help

It makes sense to invest 60 minutes of your time with a professional planner to keep your money in the family.

Contact us to determine how this strategy can help you, or to get a second opinion on your current planning.

Don't do this yourself—seek professional help. The best way to achieve financial peace of mind is getting advice from an impartial and experienced Certified Financial Planner or Trust & Estate Practitioner. ❐

Mark Halpern is a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) and one of Canada's top life insurance advisors. He is CEO of WEALTHinsurance.com™ and illnessPROTECTION.com®, with special expertise for business owners, entrepreneurs, medical professionals and high-net worth individuals and their families. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 or mark@WEALTHinsurance.com.
Visit WEALTHinsurance.com
Get your FREE Estate Planning Toolkit at http://wealthinsurance.com/toolkits.html
The expanded toolkit now includes:
Estate Directory
Estate Planning Checklist
Executor Duties Checklist
Business Owners Planning Guide
Sign up for free updates at

© Copyright 2015 by MPL Communications Inc., Reproduced by permission of *The TaxLetter*, 133 Richmond St. W., Toronto, ON M5H 3M8