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INCOME STREAMING

Melt and cascade: Thawing out frozen funds

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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. In the insurance industry, the term applies to retirees "thawing out" the funds in registered and unregistered investments to stream that money to children or other beneficiaries with little to no taxes.

Canadians who do not have a will and die without a spouse, financially dependent child or grandchild "bequeath" to the government up to 54 per cent (in Ontario) 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 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.

Since so many marriages end in divorce today, 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 taxpayer.

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.

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.

It might seem 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 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 bracket before and after retirement.

How 'melt and cascade' works

These recent examples 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 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 designated beneficiaries, when she dies the $1 million will be paid out tax-free and probate-free to her beneficiaries.

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.

Transferring policies

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 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 or her personal 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.

Not limited to tax-sheltered funds

The melt and cascade strategy does not have to begin with tax-sheltered funds. 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 only

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.

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