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Cascading life insurance – intergenerational wealth transfer

A tax exempt life insurance policy with cash value can provide permanent insurance protection on a child or grandchild while giving you a tax-efficient way to grow and transfer your wealth to the next generation.

When you transfer a life insurance policy to your child or grandchild whose life is insured under the policy, there's generally an automatic tax-deferred rollover. This is a unique feature of life insurance not available with marketable investments. For tax purposes, marketable investments are typically deemed to be disposed of at their fair market value when transferred to the next generation.

The cascading life insurance strategy is based on this tax-deferred rollover rule available for transfers to a policyowner's child or grandchild. Cascading life insurance may also provide a tax-efficient transfer of wealth to future generations while allowing continued control of the life insurance policy. The cash value growth within the policy (within prescribed limits) is also tax-advantaged compared to marketable investments, which may produce income and capital gains subject to tax.

How does cascading life insurance work?

1. Parents or grandparents[i] purchase a permanent life insurance policy on their child's or grandchild's life.

2. The parents or grandparents fund the policy with assets that they either intend to leave to the life insured (child or grandchild) as a legacy or assets that they want to transfer to the child for funding their schooling, a down payment on a house or other life events[ii].

3. The policyowner (parent or grandparent) names the life insured as the contingent policyowner to allow the tax-free ownership transfer of the life insurance policy to the child upon the death of the policyowner(s).

4. As another option, the policyowner may transfer the life insurance policy to the child (life insured) while they're alive so the child may access the policy's cash value[iii].

Intergenerational rollover

When a policyowner transfers their interest in a life insurance policy to a "child" as defined in the *Income Tax Act* (Canada) (the Act) during their lifetime or as contingent owner upon their death, and the "child" is the life insured under the policy, the transfer is deemed to occur at the policy's adjusted cost basis (ACB)[iv]. The result is a tax-deferred rollover of the policy to the child or grandchild.

As noted, the rule requires both the life insured and person receiving the policy to be a "child" of the policyowner. The definition of "child" includes[v]:

(i) the policyowner's child,
(ii) the policyowner's grandchild,
(iii) a person who, at any time before the person attained the age of 19 years, was wholly dependent on the policyowner for support and of whom the policyowner had, at that time, in law or in fact, the custody and control,
(iv) a person of whom the policyowner is the legal parent,
(v) a child of the policyowner's spouse or common-law partner, and
(vi) a spouse or common-law partner of a child of the policyowner, even after the child of the policyowner predeceases the son-in-law/daughter-in-law.

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The child who receives the policy doesn't have to be the same person as the life insured under the policy. For example, a grandparent may purchase a policy on the life of a grandchild and transfer ownership to their child (the parent of the life insured) on a tax-deferred rollover basis under the rule. The rollover is available as both the transferee and the life insured under the policy are a 'child' of the transferor. However, only one child may be the life insured at the time of the transfer to benefit from the tax-deferred rollover. If a policy insures the lives of two children, the rollover would be available provided there's only one life insured child at the time of the transfer[vi].

In situations where the proposed life insured doesn't meet the definition of "child" (such as a niece or nephew), a trust could be used to acquire the life insurance policy to achieve a similar tax-deferred rollover provided the trust is properly set up. Generally, the trust may transfer a life insurance policy to the life insured on a tax-deferred rollover basis[vii].

Ownership and beneficiary considerations

Child as contingent owner

In most cases where it makes sense, it's recommended that the child be named as contingent owner of the policy[viii]. The Canada Revenue Agency (CRA) confirmed that tax-free rollover treatment is available where a "child" is named as the contingent owner of the policy and, upon the death of the policyowner, becomes the new successor policyowner[ix]. If the child is a minor or is mentally incapable, a tax-deferred rollover is available where the life insurance policy is transferred to an individual who's appointed as the child's guardian of property in accordance with the relevant provincial legislation[x].

The rollover is unavailable in situations where the transfer is done through a will or a trust. The CRA states that a transfer of an interest in a life insurance policy to a child through a will results in two transfers – one from the deceased to their estate and one from the estate to the child. The first transfer is a disposition in proceeds deemed to be the greatest of the fair market value of the consideration given (in this case nil), the cash surrender value of the policy, and the policy's ACB. A policy gain may be realized if the deemed proceeds are greater than the ACB[xi]. The second transfer from the trust to the child may occur on a tax-deferred rollover basis[xii].

Jointly owned by parents

A spousal rollover is available for policies that are jointly owned. If a policy on the life of the child is jointly owned by both parents and one of the parents dies, the interest in the policy would transfer to the surviving spouse at its ACB[xiii]. If both parents die at the same time and the child is named as contingent owner, then a rollover is available under the intergenerational transfer rules described above.

Control of policy after transfer

If the parent(s) or grandparent(s) are concerned with a child accessing the cash surrender value of the life insurance policy after the transfer, they may name themselves as an irrevocable beneficiary of a portion of the policy's death benefit to ensure no policy changes happen without their consent.

Cascading life insurance benefits for each generation

The cascading life insurance strategy provides several benefits to both parents and future generations.

Parent

- The parent keeps control of the life insurance policy.
- The parent may reduce the amount of annual income tax they're paying on the income and growth of their investments by repositioning some of these assets into a tax-advantaged life insurance policy.
- While the parents own the policy, they can access the policy's cash value if necessary.

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Child or future generations

- When ownership of a life insurance policy is transferred to a child (life insured) either upon the parent's death or while the parent is living, the child gets permanent insurance for their family's protection.
- The child will have flexibility to access the policy's cash value to pay education costs, to help purchase a home or cottage, to add to retirement income, or to establish a financial legacy of their own to benefit future generations. Ways to access the policy's cash value include:

    - Policy loan – An advance secured against the policy's cash value. A policy loan is treated as a disposition of an interest in a life insurance policy and may result in taxable income if the policy loan amount exceeds the policy's ACB at that time.
    - Collateral loan – A loan or line of credit from a bank using the policy's cash value as collateral. Assigning a life insurance policy as collateral is not a disposition of an interest in a life insurance policy; and as such, is not subject to taxation.
    - Full or partial surrender of the policy – is a disposition of an interest in a life insurance policy and may be subject to taxation if the policy's cash value is greater than its ACB (proportionate ACB for a partial surrender).

- The policy's beneficiaries may also benefit from a tax-free death benefit. With a family member named as beneficiary, the death benefit bypasses the life insured's estate. This results in the death benefit generally not being subject to estate administration tax (probate fees) and exposure to the estate's creditors.

Conclusion

A life insurance policy on a child or grandchild provides both insurance protection and a tax-advantaged way to transfer wealth between generations.

Information for advisors. This material is not intended for use with clients.

The information provided is accurate to the best of our knowledge as of the date of publication, but rules and interpretations may change. This information is general in nature and is intended for informational purposes only. For specific situations you should consult the appropriate legal, accounting or tax advisor.

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[i] In the context of the tax-deferred rollover, any reference to parent will also include grandparent.
[ii] The availability of insurance coverage is subject to our underwriting requirements.
[iii] Unless an irrevocable designation is made, the successor policyowner may make changes to the policy; including, accessing its CSV, assigning the policy to a bank or changing the beneficiary designation. If you withdraw money from your policy, the policy's cash value and payout on death may be reduced and may result in taxable income being reported to you.
[iv] Subsection 148(8) of the Act.
[v] Subsections 70(10) and 252(1) of the Act.
[vi] Canada Revenue Agency technical interpretation 2005-0137151E5.
[vii] Subsections 75(2), 107(2), and 107(4.1) of the Act.
[viii] A subrogated owner in Quebec.
[ix] Canada Revenue Agency technical interpretation 9618075.
[x] Canada Revenue Agency technical interpretation 2008-0270431C6.
[xi] Canada Revenue Agency technical interpretation 9433865.
[xii] Subsection 107(2) of the Act.
[xiii] Subsection 148(8.2) of the Act.

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