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Life insurance and charitable giving – part II

This second part of the charitable giving article series looks at two estate replacement strategies using life insurance. In these strategies, the estate or heirs receive the insurance death benefit and the charity receives a significant donation from non-insurance assets. The objective is to preserve the estate's value using life insurance.

Part I of this article series looks at the basic rules concerning charitable giving and life insurance, including donating using a charity-owned life insurance policy and donating using a beneficiary designation of a personally owned policy.

The first strategy discussed in this article shows a client with significant registered investments which are donated on death to help offset taxes that would otherwise be owing by the estate. Life insurance is used to replenish the estate. The second strategy shows a client who donates marketable securities and uses the tax savings from the donation tax credit to fund a life insurance policy. Again, the life insurance proceeds will replenish the estate.

Estate replacement strategies using life insurance

Strategy #1 – Client expects to own registered investments at death

Clients who anticipate owning registered assets at death may have a significant tax liability that they can plan for using a charitable donation. Their estate may be replenished with life insurance proceeds.

The fair market value (FMV) of investments held within registered plans is included in an individual's income in the year of death, unless a rollover is available to a surviving spouse or eligible dependent.[i] This could create a significant tax liability for clients with sizable portfolios held within their registered retirement savings plan (RRSP) or registered retirement income fund (RRIF).

A planning strategy to address this potential source of taxation at death is for the individual to designate a charity as the beneficiary of their registered plan(s) and purchase a life insurance policy to replace the after-tax value of the registered portfolio that their heirs would have otherwise received. The donation of the registered investments to the charity would give rise to a donation tax credit which may offset the tax liability arising from the registered assets. Let's look at an example.

Example – Rekha owns a $1,000,000 registered portfolio

We'll look at Rekha's situation to see how this strategy can significantly benefit a charity while preserving her estate for her two sons. Rekha is 65, a non-smoker and standard risk. Her marginal tax rate at death is 50%.

Let's assume Rekha owns a significant registered portfolio which is projected to have $1,000,000 of assets at her life expectancy. She also owns a non-registered portfolio which is also projected to have $1,000,000 of assets at her life expectancy and is made up of mostly tax-paid assets (they won't have unrealized capital gains). Rekha's sons are the beneficiaries of both her registered plan and of her estate. Without planning, her anticipated tax bill at death is $500,000, leaving $1,500,000 to her sons.

Rekha has a philanthropic interest. Her advisor shows her how her favourite charity could receive the $1,000,000 in registered assets and her sons could still receive a comparable inheritance from her estate by purchasing life insurance. Her advisor recommends that Rekha purchase a Canada Life Universal life insurance policy with $500,000 of coverage

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and an annually increasing cost of insurance. The policy would be funded for ten years with a $22,869 annual premium and have a 10 year GIO interest option with a 0.5% interest rate.

Strategy #1 – results at death:

- With no planning, Rehka's esate has a $500,000 tax liability and her sons receive $1,500,000.
- With planned giving using insurance, her sons get slightly less from the estate to account for the insurance costs, but the charity receives a significant donation of $1,000,000.

Strategy #2 – Client donates public securities to a charity and uses tax savings to fund a policy

Typically, gifts of capital property made to a charity are deemed to be disposed of at FMV for tax purposes.[ii] Clients who own certain investments and want to see their favourite charity benefit during their lifetimes can, however, donate the securities in-kind and benefit from a zero-percent capital gains inclusion rate.[iii] These investments include:

- shares or debt obligations listed on designated stock exchanges
- shares of a mutual fund corporation
- units in a mutual fund trust, and
- an interest in a segregated fund

A zero-percent capital gains inclusion rate means none of the capital gain, if any, would be included in donor's income for tax purposes as a result of the gift. Typically, 50% of a capital gain is included in income. A donation strategy that takes advantage of the of the zero-percent capital gains inclusion rate with minimized impact to estate values involves the client:

1. Gifting securities in-kind to a charity
2. Using the tax savings from donation tax credit to fund a life insurance policy
3. The insurance proceeds will replenish the estate

Cash or other types of investments may be used in this strategy; however, if they have accrued capital gains they won't be eligible for the zero-percent capital gains inclusion rate.

Example – Andy owns marketable securities with significant accrued gains

We'll look at Andy's situation to see how this strategy can significantly benefit a charity while preserving his estate. Andy is a 55, non-smoker, standard risk. His marginal tax rate is 50%.

Andy's a buy and hold investor and owns publicly traded shares worth $250,000, which have doubled in value since he purchased them. He's involved in his church (a registered charity) and interested in donating $25,000 to it annually for the next ten years. Andy's advisor tells him that he can donate the securities as an in-kind gift and not pay capital gains taxes

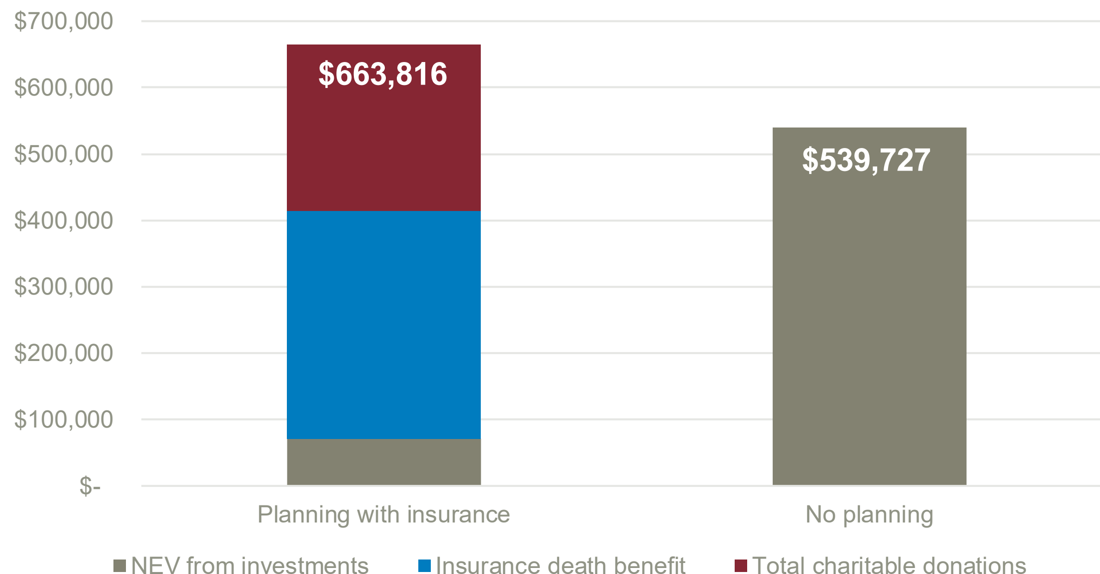
on the transfer. He would then use the tax savings from the donation tax credit to fund a policy that will replenish his estate.

The value of the tax savings Andy achieves through his annual charitable donation is $12,500 per year. Andy's advisor shows him how a delayed value participating life insurance policy with a $12,500 annual premium can replace the capital he donated from his estate and potentially provide for growth over that amount as well.[iv]

Let's compare the value of Andy's estate at age 85 where he didn't donate his publically traded shares and held them until death, compared to where he donates $25,000 worth those shares over a 10 year period and purchases the insurance policy using the tax savings to fund the premium payments. We'll assume the publically traded shares grow at a rate of 3.5% per year.

Strategy #2 – results at age 85:

- Using life insurance – the charity obtains $250,000 of donations over 10 years and Andy's estate is replenished with insurance proceeds of approximately $343,000 with an investment account balance of $70,796.
- With no life insurance – Andy's net estate value from the investments is $539,727.



Conclusion

Charitable giving with life insurance can involve strategies where a charity receives non insurance assets and the donor's estate receives insurance proceeds. The two estate replacement strategies shown in this article involve the charity receiving significant amounts from a donor and life insurance is used to replenish the estate for the donor's heirs. Donating non insurance assets, like publically traded shares, may allow the donor to access other tax benefits, in addition to the donation tax credit.

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[i] For example, see subparagraph 60(l)(v) of the *Income Tax Act* (Canada) (“ITA”).

[ii] Paragraph 69(1)(b) of the ITA.

[iii] Subsection 38(a.1) of the ITA.

[iv] The policy used in this example is Canada Life’s *Estate Max20*, $145,993 total coverge and schedules additional deposit option of $6,393.03, full premium offset starting in policy year 11, paid-up addition dividend option and 2021 dividend scale.

The example provided is not complete without the Canada Life illustration, including the cover page, reduced example and product features pages all having the same date. Read each page carefully as they contain important information about the policy.