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Life insurance and charitable giving – Part I

Life insurance proceeds can help support a charity's ongoing activities, advance its capital intensive projects and create a legacy for you and your family. Planned giving with life insurance may also create tax benefits to reduce your tax bill during your life or on death. This article will help you maximize the benefit of your donation by discussing two common methods of charitable giving with life insurance.

Advantages

There are many advantages to donating with life insurance.

- You can make a significant gift even if you have limited resources.
- You can make a relatively large donation on death in comparison to the insurance costs.
- You'll have a non-refundable donation tax credit that can be used either during your lifetime or by you and your estate on death, depending on your gifting arrangement.
- From a charity's perspective, receiving a donation as the beneficiary of a life insurance policy is easier and more certain than from an estate with potential liquidity issues, creditors' claims or litigation.

Ways to donate with life insurance

Charitable giving with life insurance generally happens in two ways.

1. You can donate the insurance proceeds through your will or by naming the charity as beneficiary of the policy.

2. You can pay the premiums on a life insurance policy that's owned by the charity.

Let's discuss the tax and non-tax considerations involved with each option.

1. Gifting insurance proceeds

You can donate your policy's proceeds directly by naming a charity as beneficiary, or indirectly through your will. This method has two main advantages over a charity-owned policy. First, you maintain control over the policy, so you can direct the funds to another charity if your priorities or objectives change. Second, the donation tax credit is based on the amount of proceeds, which can help address any income tax liabilities that arise on death.

There are differences between gifting an insurance payout to a charity through your will and by direct beneficiary designation.

A. Gifting insurance proceeds through your will

You can designate your estate as the beneficiary of your life insurance policy, and have your executor make a gift to a charity based on the direction in your will.

With this option, you should consider the following.

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- Since the proceeds are received by the estate, it may be subject to executor fees and estate administration taxes (i.e. probate fees).
- A probated will is a public document, so the donation may not be confidential.
- If the proceeds are first received by the estate, it can be subject to the claims of the estate's creditors.
- The distribution of an estate can be prolonged, particularly if it is subject to litigation.

Another point to consider is what happens if the charity stops operating or its registration is revoked by the Canada Revenue Agency (CRA). Your will should include instructions to address these circumstances.

B. Gifting insurance procceds by beneficiary designation

To eliminate some of the concerns mentioned above, you can name a charity as the beneficiary of your policy. This ensures it receives the proceeds directly and it won't become part of your estate – so it won't be subject to fees, taxes or creditors' claims, and be less susceptible to estate litigation.

If the charity is designated as an irrevocable beneficiary, you'd no longer have full control over the policy since policy changes (including policy beneficiary changes) cannot be made without the consent of the irrevocable beneficiary.

C. Income tax considerations

A charitable donation made through your will, by your estate,[i] or by beneficiary designation through your life insurance policy[ii] is considered to be made either by your estate or your "graduated rate estate" (GRE),[iii] as the case may be.

This means your estate or your GRE will obtain the donation tax credit. The allocation of the donation tax credit resulting from the gift depends on whether your estate is designated as a GRE – discussed below.

Another tax rule states that if you donate by beneficiary designation, then immediately before death you must have a level of control over your policy so that changing the policy's beneficiary would require your consent.[iv] This rule is typically satisfied by virtue of your ownership of the policy. It has caused some uncertainty as to whether the donation tax credit would be available where the charity is an irrevocable beneficiary (which means the charity must consent to any policy changes). Fortunately, the CRA confirmed that you can still obtain a tax credit if the charity is an irrevocable beneficiary.[v]

I. Your estate is a GRE

A GRE has more flexibility for using the donation tax credit to maximize the benefit of the gift. The donation tax credit may be allocated to:

- The deceased – for the year of death and the preceding year (i.e., last two taxation years).
- The GRE – for the year in which the donation is made and its previous taxation years, if any.

Any unused balance can be carried forward by the GRE to offset income tax payable in its next five taxation years, up to 75% of its net income.

Generally, your ability to claim a donation tax credit is limited to 75 per cent of your net income for the year. For donations made by will or by beneficiary designation, this annual limit is increased to 100 % of net income in the year of death and the preceding year.

This flexible allocation of the donation tax credit is available to a GRE, or a former GRE, if the donation is made within 60 months of death. GREs exist for 36 months after death. A former GRE is an estate that stopped being an individual's GRE because it existed for more than 36 months after death, but meets the other requirements of the definition of a GRE.

II. Your estate is not a GRE

If your estate is not a GRE, it may use the donation in the year it's received by the charity to offset its income taxes payable in that year, up to 75% of its net income. Any unused balance of the donation credit may be carried forward by your estate in its next five taxation years.

D. Example – gifting life insurance proceeds

In this example, assume Dave and Dawn, both aged 65, nonsmokers, standard risk, have an estimated $1 million tax liability on death which they want to eliminate by gifting sufficient assets to a charity they're closely involved with.

Their advisor suggested they could offset their estimated tax liability by donating approximately $2 million to the charity. Their advisor also explained how life insurance is both a cost effective and tax efficient method of donating.

After assessing their needs, Dave and Dawn decide to purchase a joint last-to-die Canada Life universal life insurance policy with a 10 Pay cost of insurance option. The table below highlights how this insurance option will achieve Dave and Dawn's estate planning objectives.

Dave and Dawn, both age 65, Joint last-to-die, Canada Life universal life insurance, $2,000,000 coverage, 10 Pay, 1.5% GIO, minimum funded, charity designated as beneficiary[vi]	
Annual life insurance premium for 10 years	$85,061
Death benefit at year 25	$2,007,690
Donation	$2,007,690
Donation tax benefit on death benefit (approximate)	$1,000,000
Internal rate of return on death benefit at year 25	4.2%
Interest rate required on a traditional investment to equal death benefit at year 25 (assume a 52% marginal tax rate)	8.8%

Looked at another way, for Dawn and Dave to achieve the same result without using life insurance, their GRE would have to gift approximately $2 million to the charity. In contrast, with life insurance they still gifted over $2 million to the charity, but were only out-of-pocket $850,610 over a ten year period.

E. Points to consider when donating insurance proceeds by will or beneficiary designation

For policies owned by individuals:

- If you don't need the donation tax credit on death and you're sure which charity you want to benefit, consider the charity-owned policy option discussed below.
- The tax credit from your donation may be substantial. If sufficient taxable income isn't available in either your GRE or your final two taxation years, some or all of the tax credit may go unused and your spouse or common-law partner will not be able to claim the unused tax credit.[vii]

For policies owned by corporations:

- A GRE can still donate insurance proceeds and obtain a donation tax credit if the policy is corporate-owned. The corporation would receive insurance proceeds as beneficiary. Generally, the amount of the proceeds less the policy's adjusted cost basis (ACB) would credit its capital dividend account (CDA) which allows it to pay tax-free capital dividends to its Canadian resident shareholders. As a result, the insurance proceeds may be distributed by the corporation to the estate or GRE as a dividend (capital dividend or taxable dividend, or both), and then donated to the charity. The estate or GRE may also donate shares of the corporation to the charity to be later redeemed by the corporation using the life insurance proceeds.

- A corporate policyowner shouldn't designate a charity as beneficiary of its policy. Instead, it should continue to be the policy beneficiary. Upon receipt of the insurance proceeds, it may either make a donation to the charity or pay it out to the shareholder (which may be your estate or GRE) who can make the donation. Considering that corporate tax rates are usually lower than the donation tax credit rate for the shareholder, it's generally more tax efficient for the shareholder to make the donation.

2. Gifting when the charity owns the policy

The second common method of donating to a charity using life insurance is to pay for the cost of a policy that's owned by the charity. Many charities prefer this option for the following reasons:

- It gives the charity greater assurance that it will receive the insurance proceeds. This is unlike the previous method where beneficiary designations may change, or the proceeds could pass through the estate and be exposed to other costs or used to satisfy other obligations.

- As an owner, the charity can ensure the policy is kept inforce. If you stop making premium payments, the charity may choose to make the payments or cancel the policy and obtain any remaining cash value.

- The charity may access the policy's cash value, if any, through a policy loan, cash withdrawal or by using the policy as collateral for a loan.

- Since charities aren't taxable, they're not concerned with the tax implications of certain policy transactions.

Charities can apply for insurance on a donor's life if they obtain the donor's consent and demonstrate an insurable interest in the donor's life. They can do this by showing a connection to the donor, for example, by demonstrating a pattern of prior donations.

You can also transfer ownership of an existing policy to charity and continue to pay the premiums (if required), or make cash donations to the charity so the charity can pay the premiums.

A. Income tax considerations

When a charity owns a policy on your life, you'll receive a donation tax credit based on the premium payments you make in respect of the policy. You and your estate won't receive a donation tax credit from the insurance proceeds . You may also receive a donation tax credit if you transfer a policy to a charity. As a result, there are two main tax considerations that can arise when a charity owns a life insurance policy on your life.

I. Will the premium payments be recognized as a chartiable gift for tax purposes?

The premiums you pay on a policy that's owned by a charity can be eligible for a donation tax credit when you either give cash to a charity to pay the insurance premiums, or pay the insurance premiums on behalf of a charity (even though funds aren't directly received by the charity).

Premiums paid before a policy is transferred to a charity aren't considered a donation. Also, you can't receive a charitable tax credit for premiums paid by policy dividends or the policy's internal cash values.The tax implications from a charitable

donation are slightly different for individuals and corporations. The table below describes the tax benefits received by individuals and corporations when paying the premiums on a policy owned by a charity.

	Donation by an individual	Donation by a corporation
Tax benefit	Receives a non-refundable tax credit	Receives a tax deduction
Result	Income taxes are generally reduced by up to 50% or more of the amount of the donation (depending on province, amount donated, and the donor's marginal tax rate)	Reduces its taxable income by the full amount of the donation
Limits	Can use the charitable donation credit up to 75 % of net income in the year	Can use charitable deduction up to 75% of its taxable income in the year
Carry-forwards	Unused charitable donation credits can be carried forward for up to five years, subject to the 75% limit	Unused charitable deductions can be carried forward for up to five years, subject to the 75% limit

II. What are the tax consequences if you own a life insurance policy and transfer it to a charity?

If you transfer an existing policy to a charity you could realize a taxable policy gain, but you may also be entitled to a donation tax credit, depending on the circumstances.

- Policy gain on a transfer

The tax consequences of gifting a life insurance policy are governed by subsection 148(7) of the *Income Tax Act* (Canada) (the "Act")[viii]. In the context of a donation where a charity doesn't pay for the policy, the transfer price for tax purposes is the greater of the policy's cash surrender value (CSV) and it's ACB. If the transfer price for tax purposes is greater than the ACB, the difference is considered a taxable policy gain – taxed as regular income for an individual and passive income for a corporation.

- Value of the donation on a transfer

Generally, when you transfer a life insurance policy to a charity, it's considered a gift in an amount equal to the fair market value (FMV) of the policy, subject to the following deeming rule in the Act. The amount of the donation will be deemed to be the lesser of the policy's FMV and the policy's ACB if it is transferred within:

  - Three years of acquiring the policy, or
  - 10 years of acquiring the policy and it's reasonable to conclude that the policy was acquired with the intention to make a gift.

You should obtain an actuarial valuation of the policy if the donation tax credit is based on the policy's FMV. Life insurance carriers do not provide policy valuations. The FMV of a policy is a question of fact. According to the CRA, various factors should be considered; such as, the CSV, policy loan value, face value, age - health - and life expectancy of the insured, replacement value, conversion privileges and other terms of the policy.[ix]

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B. Example – charity owns the policy

In this example, assume Sheila, 50, nonsmoker, standard risk, is a regular donor to her favourite charity and wants to make a significant donation to help with funding the charity's future capital intensive projects. Sheila's marginal tax rate is 50%.

Her advisor suggested she could make a significant donation using life insurance. Sheila's interested in paying an annual premium of $10,000 for 15 years. After reviewing several types of policies, Sheila decides to purchase a Canada Life participating life insurance policy. The table below highlights how this insurance option will help Sheila achieve her estate planning objectives.

Sheila, age 50, Canada Life participating life insurance policy, $ 297,729 basic coverage, $10,000 premium, offset at year 16, paid-up addition dividend option, charity is the policyowner[x]	
Life insurance premium for 15 years	$10,000
Tax benefit of premiums (approximate)	$5,000
Net cost annually	$5,000
Death benefit at year 35	$436,920
Internal rate of return on net cost to death benefit at year 35	6.8%

C. Points to consider when the charity owns the policy

If you will have a tax liability at death (for example, from owning investments, shares of a private corporation or registered assets), consider owning the policy personally or, if applicable, by your corporation. As discussed above, this will allow the insurance proceeds to create donation tax credits for your final tax return and your estate.

If you require more tax credits in a specific year than what you'd receive by paying an annual premium, consider making a larger cash donation to the charity in that year for the purpose of making premium payments in future years.

Summary

Donating with life insurance is a great way to support charities. Whether you own the policy to achieve tax benefits on death, or have a charity-owned policy to achieve tax benefits while living. Either way, life insurance allows charities to maximize the amount they receive to advance their efforts and benefit our communities.

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[i] There's no difference from a tax perspective between donations made through either your will or your estate.
[ii] Including an RRSP, RRIF or TFSA, per subsection 118.1(5.2) of the Income Tax Act (Canada) (the "Act").
[iii] The graduated rate estate of an individual means the estate that arose on and as a consequence of the individual's death if (a) that time is no more than 36 months after the death, (b) the estate is at that time a testamentary trust, (c) the individual's Social Insurance Number is provided in the estate's tax return for the taxation year that includes that time and for each of its earlier taxation years that ended after 2015, (d) the estate designates itself as the graduated rate estate of the individual in its tax return for its first taxation year that ends after 2015, and (e) no other estate designates itself as the graduated rate estate of the individual in a tax return for a taxation year that ends after 2015.
[iv] Subsection 118.1(5.2) of the Act.

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[v] CRA Technical Interpretation 2004-0065451C6, May 4, 2004.
[vi] The example provided is not complete without the corresponding life insurance illustration, including the cover page, reduced example and product feature pages all having the same date. Read each page carefully as they contain important information about the policy.
[vii] CRA Technical Interpretation 2014-055551E5, January 27, 2015.
[viii] Specifically, the transfer price of a gifted life insurance policy for tax purposes, per subsection 148(7), is:

- For policy transfers before March 22, 2016: the policy's CSV.
- For policy transfers after March 21, 2016: the greatest of: i) the policy's CSV ii) the FMV of the consideration given; and iii) the policy's ACB.

[ix]CRA Information Circular IC89-3 "Policy Statement on Business Equity Valuations", August 25, 1989.
[x] The example provided is not complete without the corresponding life insurance illustration, including the cover page, reduced example and product feature pages all having the same date. Read each page carefully as they contain important information about the policy.

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