Manulife

Charities and Life Insurance

Introduction

In this Tax Topic, we look at the basic rules relating to charitable giving through life insurance and in particular, the methods of gifting life insurance.

There are three main methods by which a donor can gift life insurance to a charity. First, the donor can make a bequest of the proceeds of a life insurance policy through his or her Will. Second, the charity may be named as beneficiary under a policy owned by the donor. Third, the donor can donate a newly acquired policy or an existing policy during his or her lifetime. The first two of these methods involve a charitable donation at death. The following section outlines the tax treatment of such donations.

Tax Treatment of Charitable Donations at Death

For deaths on or after January 1, 2016, where a gift is made by a Will, by a direct designation (under a life insurance policy, RRSP, RRIF or TFSA) or by the estate, the gift is deemed to be made by the estate (and no other taxpayer) at the time the property is transferred to the charity (and at no other time). This establishes for all estates (whether the estate is the graduated rate estate ("GRE") or not) who is seen to have given the gift and the timing of that gift. For a more detailed discussion on GREs, please see the Tax Topic entitled, "Trusts as a Planning Tool".

Flexible rules for claiming estate gifts are contained in modifications to the definitions of "total charitable gifts" and similar definitions for "total cultural gifts" and "total ecological gifts". Basically, the executor of a GRE will have the flexibility to allocate the donation among any of:

- the taxation year of the estate in which the donation is made;
- an earlier taxation year of the estate; or
- the last two taxation years of the deceased individual against 100% of net income.

Also, the flexibility expands beyond the GRE and the individual to allow the normal estate rule (claim permitted in year of gift by the estate with a five year carry forward to also be used.

Gifts made by Will, direct designation or in the estate within 60 months of death will be permitted flexible use of the charitable donation tax credits so long as the gift is made by the individual's GRE or an estate that would otherwise qualify as the GRE but for the 36 month period required in the definition of the term GRE. Gifts made by direct designation are generally speedy and would likely not have difficultly satisfying these time limitations. It is for this reason that gifts of life insurance may become a preferred method of making charitable donations at death.

There is no distinction between a gift by Will and an estate gift. Both would be deemed to have been made by the estate at the time of the gift and permitted a claim in the year and the five (or in respect of ecological gifts, ten) following taxation years of the estate. However, a non-GRE cannot access the flexibility discussed above.

Bequest of policy proceeds

An individual can make a donation of life insurance proceeds through his or her Will. The individual owns the policy during his or her lifetime and the individual's estate will be the beneficiary of the policy. The individual's Will would indicate that a gift of an amount equal to the life insurance proceeds will be paid to a charity named in the Will. The charity will receive a gift of the lump sum amount equal to the insurance proceeds on the death of the insured.

The donor will not receive a tax credit for the premiums paid during his or her lifetime. If the estate is the GRE, flexible use of the donation tax credit will be available as described above.

Where a gift of proceeds is made under an individual's Will, the insurance proceeds pass through the estate of the individual. Accordingly, the funds may be subject to probate fees and creditor claims as well as estate litigation. Donor confidentiality may not be protected. However, the donor does retain absolute control of the policy throughout his or her life.

With this type of charitable gift, the charity is at risk since the Will can be changed to eliminate the charity as a recipient of the gift. Claims against the donor's estate can reduce the funds which were originally intended for the charity.

Donor owned policy – Charity as beneficiary

If a donor owns a policy and names a charity as the beneficiary he/she will not qualify for a charitable donation tax credit for premiums paid. However, a charitable donation tax credit will arise on death and flexible use of the tax credit may be made provided the requirements of subsection 118.1(5.2) of the Income Tax Act (the "Act") are met. This subsection requires that:

- the transfer is made in consequence of death by an insurer to a charity because of obligations under a policy;
- the charity, immediately before death was not the owner nor an assignee of the individual's interest under the policy;
- the policy is on the donor individual's life; and
- the individual's consent would have been required to change the recipient of the transfer.

It is important to note that subsection 118.1(5.2) does not apply to gifts made by direct designation under a policy owned by a corporation. In this case, it is the CRA's view that the payment of the death benefit to a charity is made by virtue of "an obligation on the part of the insurer and cannot be considered as a gift on the part of the person who bore the cost of the premiums" (Canada Revenue Agency (CRA) #2000-0054467 dated December 19, 2000 (unofficial translation to English). Designating a charity as beneficiary of a corporate-owned policy would result in no capital dividend account credit for the death benefit since the corporation is not the beneficiary, and, no charitable deduction under subsection 110.1(1). By naming the corporation as beneficiary, the corporation could make a gift of proceeds of life insurance and receive both the CDA credit and the charitable deduction, avoiding these pit falls.

Subsection 118.1(5.2) of the Act requires that the individual's consent is required to change the recipient of the death benefit immediately before the individual's death. At the 2003 CALU Tax Policy Round Table (#2003-0004315), CRA commented on irrevocable beneficiary designations in favour of a charity where the donor continues to own the policy. They stated that, in their view, where a policyholder makes an irrevocable designation of a qualified donee as the beneficiary of a life insurance policy, the premiums paid by the donor would not qualify as a charitable gift. In other words, an irrevocable beneficiary designation cannot be used as an alternative to actually donating the policy by transferring ownership of it to the charity. In addition, CRA indicated that if an irrevocable beneficiary designation is made in favour of a charity, the death benefit received by the donee will not be deemed to be a charitable gift for purposes of the charitable tax credit under subsection 118.1 of the Act. The reason given was that immediately before the individual's death, the individual's consent would not have been required to change the recipient of the death benefit; in fact, the charity would be required to consent to a change of beneficiary as it was named irrevocably.

Since 2003, the CRA has reversed their position on the point above (#2004-0065451C6). It is now CRA's view that an irrevocable beneficiary designation in favour of a charity would not disqualify the charitable donation tax credit in the year of death.

In summary, this method allows flexibility if the donor changes his/her mind as to the charitable organization that will benefit from the gift. As the gift is made directly by designation, it will not pass through the estate of the donor and will not be subject to probate fees or estate creditors. However, since the donor can change the beneficiary (unless irrevocably made), the charity risks not ultimately receiving the gift.

Charity owned policy

A charity can acquire a life insurance policy under which the donor is the life insured and the charity is the beneficiary. Since the charity does not have an insurable interest in the donor, the charity must obtain the donor's consent when applying for the policy; generally, where a donor is interested in making a gift of life insurance, this is a minor formality. Alternatively, the charity can become the owner and beneficiary of a policy that is recently acquired or already owned by the donor under which the donor is the life insured.

Where a donor donates a life insurance policy to a charity or a charity takes out a policy on the donor's life, the premiums paid by the donor will be considered a charitable donation eligible for a charitable tax credit (for individuals) or deduction (for corporations). Note that CRA has confirmed in a technical interpretation (#2002–0172875, dated December 24, 2002) that the beneficiary designation need not be irrevocable in order to obtain this treatment. The donor may also get a credit or deduction for the value of the policy (see the discussion below, re: *Value of policy*) if an existing policy is donated. However, upon death, no further tax benefits accrue to the donor or his/her estate.

One point of caution: generally, premiums paid prior to the transfer of a policy will not qualify as charitable donations; only those paid after the transfer will be receipted. Although, for a newly issued policy, the fair market value of the donated policy may well be the amount of premiums paid to the point of transfer (see the discussion below, re: *Value of policy* for more detail on this point).

Under each of the alternatives (whether issued to a charity or transferred to a charity after issue), the donor will continue to make the premium payments on behalf of the charity owner and will be entitled to a donation tax credit (or deduction for corporations) for the amount of the premiums. Either the donor can pay the premiums to the charity who will forward the funds to the insurance company or the donor can pay the premiums directly to the insurance company. The CRA has indicated in Archived Interpretation Bulletin IT-244R3, "*Gifts by Individuals of Life Insurance Policies as Charitable Donations*", dated September 6, 1991, that the fact that a donor makes a cash contribution to a charity and specifies that it be used to pay the premium on a life insurance policy does not influence the determination of whether or not the donation qualifies as a gift under subsection 118.1(1) of the Act. Likewise, if the premiums are paid directly to the insurance company, the premiums will be considered a constructive payment of a donation to a charity and will therefore be considered a charitable gift.

If the donor ceases paying premiums, the policy may lapse or the charity, as owner, may continue to pay premiums or surrender the policy for its cash value, if any. It is for this reason that many charities will not accept gifts of life insurance policies unless they are fully paid-up. At death, the charity will receive the death benefit directly, as beneficiary of the policy. The policy proceeds will not pass through the donor's estate.

Assignment of policy

Where a currently owned policy is gifted, the donor must make an absolute assignment (transfer of ownership) of the policy to the registered charity and name the charity as beneficiary in order to obtain a donation tax credit. When a policy is assigned to a qualified donee, any consents required by provincial regulations to change a beneficiary must be signed before there is a valid charitable gift. Where the donor wants to retain the ability to change the charitable organization that will benefit from the gift, the life insurance policy gift may be made to a community foundation.

Value of policy

It is the current position of the CRA (as set out in response to Q1 at the Association de Planification Fiscale et Financiere ("APFF") conference on October 5, 2007) that where an absolute assignment of a policy is made to a charity, the donor is considered to have made a gift equal to the fair market value of the policy (less any advantage to the donor). Fair market value is a question of fact. The CRA has provided guidance relating to the factors that should be considered in valuing a life insurance policy generally, in Information Circular IC-89-3. Such factors include cash surrender value, policy loan value, face value, state of health and life expectancy of the life insured, conversion privileges, other policy terms such as riders, double indemnity provisions and replacement value. (For more information relating to valuation of a life insurance policy, see the Tax Topic entitled, "Transfer of an Insurance Policy

Involving Corporations and a Shareholder or Employee").

The CRA's current position reverses the CRA's previous long-standing position as set out in Archived IT-244R3 (and in other numerous technical interpretations). Previously CRA indicated that where an absolute assignment of a policy was made to a qualified donee, the value of the policy is the amount by which the cash surrender value at the time of assignment exceeds any policy loan outstanding, plus any accrued dividends and interest that are also assigned.

Where a gift of a life insurance policy is made immediately after issue or within certain periods of time, subsection 248(35) of the Act would apply (2008 APFF CRA Roundtable, Q2, dated October 10, 2008). For gifts made within 3 years of purchase or within 10 years of purchase, if it's reasonable to assume the property was acquired with the intention to make a gift, subsection 248(35) deems the donation to be the lesser of the fair market value otherwise determined and the cost of the policy.

For these purposes, subsection 248(35) of the Act defines "cost" as the adjusted cost basis of the policy. Prior to this version of the legislation, there were several technical interpretations requesting the CRA's point of view regarding what it considered the "cost" of a life insurance policy in this context. Previously, the cost of a life insurance policy was viewed as being a question of fact. Initially, the CRA stated, (2009 CLHIA Roundtable, Q7, #2009-0316701C6), "while premiums paid to acquire and maintain a life insurance policy may reflect the cost, this may not always be the case."

At the Conference for Advanced Life Underwriters ("CALU") Roundtable in May 2010 (#2010-0359391C6), the CRA stated:

> It is our view that the adjusted cost basis of an interest in a life insurance policy as defined in subsection 148(9) would generally be a reasonable proxy for the 'cost' of an interest in a life insurance policy for purposes of the deemed fair market value of an interest in a policy under proposed subsection 248(35) of the Act.

At the 2010 STEP Conference Roundtable, in the context of a transfer to a corporation and subsequent charitable donation made by the corporation, the "cost" was seen as the deemed cost under subsection 148(7) of the Act. Subsection 148(7) of the Act deemed the cost to the transferee (the corporation in this context) as the cash surrender value or nil if the policy has no cash surrender value.

With the amendment to subsection 248(35), the debate surrounding the meaning of the term "cost" has been resolved. However, fair market value remains a question of fact. Consulting a valuation professional for assistance in establishing the fair market value of a life insurance policy is recommended.

Tax consequences of transfer

The CRA has also confirmed that, in determining the tax consequences of the transfer of a life insurance policy to a charity, subsection 148(7) of the Act governs. For transfers before March 22, 2016, subsection 148(7) provides that a policy transferred by way of gift is deemed to occur at the policy's "value". Value is defined in subsection 148(9) of the Act as the policy's cash surrender value; if there is no cash surrender value, the value is nil. Where the cash surrender value exceeds the adjusted cost basis of the policy, there will be a policy gain and an income inclusion for the donor as a result of the gift pursuant to subsection 148(1). Since an insurance policy is not a capital property, a gift of a policy is subject to the 75% income limitation, without the extra 25% limit that is available for gifts of capital property. For transfers on or after March 22, 2016, the policy transferred by way of gift is deemed to occur at the greatest of: "value" (i.e. CSV or nil); the fair market value of consideration, if any, given for the policy: (No consideration is given in the charitable context as a receipt is not consideration.) and, the ACB of the policy immediately before the transfer. A taxable policy gain and thus an income inclusion would only arise where the operative element is CSV in excess of ACB as described above.

Disbursement quota and life insurance policy gifts

Bill C-47, which received Royal Assent on December 15, 2010, repealed he 80% disbursement quota and the concept of "enduring property". The purpose of the 80% rule was to ensure that charities expended a certain percentage of total gifts each year on charitable activities or gifts to other charities. Gifts of enduring property were excluded from this rule. Enduring property included gifts by bequest or inheritance, including gifts made by direct beneficiary designation in an RRSP, RRIF, TFSA or life insurance policy, as well as gifts made subject to a 10-year direction.

Prior to the elimination of the 80% rule, it was common to make a gift of a life insurance policy and any subsequent premiums under the policy, subject to a 10-year direction. Generally, the direction required the charity to hold the policy, any proceeds or any property substituted for the policy or proceeds for a period of not less than 10 years after receipt of the last premium payment. The CRA provided detailed comments and administrative practices relating to 10-year gifts in Archived IT244R3 and in certain technical interpretations.

With the elimination of the 80% disbursement quota, carving out exclusions by way of 10-year directions will no longer be required, making gifts of life insurance policies simpler. However, charities holding existing life insurance policies that were donated subject to a 10-year direction still have to hold the policies in accordance with those directions. Charities would have accepted these gifts subject to those conditions at the time the gift was made.

Charities are still required to disburse 3.5 percent of the value of assets not used in charitable activities or administration if those assets exceed certain thresholds ($100,000 for charitable organizations and $25,000 for charitable foundations).

Regulation 3702(1)(b)(vi) of the Act provides that the value of an unmatured life insurance policy that is not an annuity contract is nil for purposes of the 3.5% disbursement quota rule.

The elimination of the 80% disbursement quota removes a large administrative burden from charities. It also allows for a much simpler process when making gifts of life insurance policies and subsequent premiums to charity.

Split-dollar life insurance and charitable gifts

In the charity owned policy context, there may be circumstances where "split-dollar" or co-owned life insurance may be used. For a more detailed discussion of these circumstances, see the Tax Topic entitled, "Split Dollar Life Insurance – Applications".

In a charity owned insurance situation involving a split between the charity and the donor, the main question relates to the amount of any advantage to the donor. In #2011-0398461C6, the CRA stated:

> Where an advantage is provided in respect of a gift, the donee must be able to support the basis for the determination of the amount of the advantage provided….
> If the value of the advantage cannot be reasonably ascertained, no charitable tax deduction or credit will be allowed…. It is the responsibility of the qualified donee to identify the advantage, and the amount thereof, on a receipt provided to a donor in respect of a gift.

The context of this technical interpretation involved a universal life insurance policy with a return of premium feature that added an amount of death benefit coverage each year in the amount of premiums paid in the year. A separate identifiable premium was charged for this layer of additional coverage. The donor paid all the premiums (i.e., for the base face amount and the additional coverage) and the charity owned the policy. The charity was only designated as beneficiary for the base amount of insurance. The amount of insurance added each year relating to premiums paid was designated to the donor's estate. It seems logical that the portion of the premium that paid for the additional coverage would represent the value of the advantage and should therefore reduce the amount receipted by the charity. This logic was confirmed in an earlier technical interpretation (#2009-031202 dated November 19, 2009).

However, where the split is not easily identifiable, establishing the value of any advantage to the donor and thus the remaining charitable gift can be more difficult. For example, a whole life policy that provides death benefits and accumulates cash values would not have an identifiable cost of insurance charge as is the case with a universal life policy. Where a specific amount of death benefit is to be received by the charity and the cash value received by the donor, it may be more difficult to establish what portion of the premium paid is in respect of a specific amount of death benefit (and thus what portion would relate to the cash value).

It is the donee's responsibility to properly calculate the amount of the gift and any advantage received by the donor. As matters of valuation are questions of fact, it is wise to seek guidance from valuation professionals in establishing these amounts. Charities may choose not to accept gifts of this nature due to the additional complexities or require, as a condition of accepting such gifts, that a professional valuation be undertaken.

Conclusion

In this Tax Topic, we have reviewed the basic issues relating to charities and insurance policies. It is important to understand these rules to ensure the appropriate benefit is derived from life insurance gifts.

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