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CHARITABLE GIFT PLANNING WITH LIFE INSURANCE

Life insurance can be integral to a variety of charitable gift planning strategies. Some individuals purchase life insurance because it allows them to make a charitable bequest without depleting an estate's assets. Others utilize life insurance to magnify the size of their charitable gift.

Gift of a Life Insurance Policy

A common charitable strategy is to gift a new or existing life insurance policy to a charity, whereby the charity becomes the owner and beneficiary of the policy. The charity can generally issue a charitable receipt for the fair market value of the policy at the time of transfer and for any premiums paid by the donor on behalf of the charity. For a newly-issued policy, one approach would be to consider the fair market value to be equal to the portion of the premiums paid by the owner that represents the carrying cost of the coverage following the completion of the transfer.

Determining the fair market value of an existing policy can be complex and typically should be established by a qualified professional who will consider information specific to the policy. This would include the life insured's current underwriting status and the replacement cost of new coverage. As well, there is a reasonably new anti-avoidance province in the Income Tax Act that could deem the fair market value to be the taxpayer's cost in certain circumstances.

Consider the example of Katie who plans to purchase a life insurance policy in anticipation of donating it to her favourite charity. Katie could apply for insurance by completing the application and name herself as the applicant. She could then accept delivery of the policy as the new owner and pay the first monthly premium to settle the policy. Within the first month after receipt of the policy, Katie could assign ownership of the policy to the charity. The charity can issue charitable receipts for the value of all premiums paid by Katie subsequent to the transfer. If the policy goes on premium offset, Katie is not entitled to a charitable receipt because she has not made any premium payments during the offset period as the offset is covered by the policy's internal cash value.

There are alternatives to establishing Katie as the original owner and subsequently assigning the policy. One strategy would be for Katie to request that the carrier issue the policy in the name of the charity once all underwriting decisions have been made. Or, Katie could opt to name the charity, with their permission, as the original applicant. Assuming Katie pays the premiums, these two approaches would allow Katie to receive a charitable receipt for the initial premium paid on delivery of the policy as well as future premium payments.

The charitable receipt is tied to the payment of premiums subsequent to the charity's assumption of ownership. There is no charitable receipt issued upon the death of the life insured under the strategies discussed above. Individuals generally use these types of strategies when they prefer the income tax relief today or the strategy fits with their overall charitable objectives.

Gift of the Life Insurance Benefit

Another charitable strategy using life insurance involves an individual retaining ownership of the insurance policy while naming a charity as the beneficiary for all or a portion of the proceeds of the policy. The charity can issue a charitable receipt for the value of the proceeds received upon the death of the life insured under the policy.

Consider the example of Matthew who currently owns a life insurance policy on his own life that he would like to use for the benefit of his favourite charity. Matthew could name the charity as beneficiary of the policy, while retaining ownership. Given that he retains ownership, Matthew is not entitled to any charitable receipts during his life-time. However, on his passing, the charity will receive the death benefit and Matthew's estate will receive a charitable receipt equal to the death benefit.

Provided the life claim is settled during the existence of Matthew's general rate estate (GRE), the estate's representative will have the option to claim the charitable gift on:

- Matthew's terminal (final) tax return;

- Matthew's income tax return in respect of the year prior to death;
- the GRE's current and prior tax returns, with the opportunity to carry forward excess charitable amounts for utilization in the subsequent five years; or,
- any combination of the above three options.

The decision as to which return and when to claim the donation credit will reflect income limitations (75% & 100%) that are integral to the tax credit.

Under this approach, the policy owner is not entitled to a charitable receipt during the life insured's lifetime; instead, the receipt arises only after the insurance proceeds are paid to the charity subsequent to the individual's passing. In addition to addressing an individual's charitable objectives, this strategy can be useful when individuals anticipate a large tax liability upon death and choose to make a charitable gift to offset some or all of their income tax liability.

Replacement of a Significant Gift

Life insurance can be used to replace value within an estate allowing a donor to fulfill a charitable contribution without impairing the estate value earmarked for other personal bequests. In this scenario, the charitable receipt does not arise in respect of the life insurance but rather from the donation made with the individuals' personal assets while the person is alive. Life insurance is used to replace the assets that were gifted to the charity.

Consider the example of Pat and Chris who plan to complete a sizable gift to their favourite charity before the end of this year. While the gift will not affect their current lifestyle, they are concerned that the gift will significantly reduce the amount of wealth available to pass on to their next generation. To address the gap that would otherwise arise in the family's estate, Pat and Chris could acquire insurance on their lives with a face amount equal to the value of the gift or possibly more to account for the time value of money. The new insurance could be funded with the tax savings realized on their charitable gift. Upon their passing, the insurance policy will replace the value of the charitable gift allowing the couple to achieve their personal bequests involving the transfer of family wealth.

The three strategies discussed above highlight common uses of life insurance to support charitable gifts. The goal in any plan is to find the most appropriate strategy that allows individuals to best meet their personal objectives.

A LOOK AT THE CHARITABLE TAX CREDIT RATES

The Canadian federal and provincial governments provide significant assistance to charities through tax incentives that encourage Canadians to donate to registered charities. The impact of the charitable tax credit is to lower the after-tax cost of a charitable gift for individual Canadians.

In general terms, the charitable tax credit is a two-step calculation. The first $200 of qualifying donations is eligible for a tax credit based on the lowest tax bracket, federally and in the individual's province of residence. Qualifying donations above $200 are eligible for a higher tax credit. In some provinces the credit is based on the top tax bracket; however, this standard rule of thumb no longer applies in respect of New Brunswick, Quebec, Ontario, Alberta and the federal government.

The following table sets out the 2016 tax credits for charitable gifts. The provincial rates are added to the federal rate to derive the total available tax credit.

2016 Charitable Tax Credit

	Tax credit on gifts up to $200	Tax credit on gifts over $200	Top marginal tax bracket
Federal	15.00%	29.00%(1)	33.00%
Newfoundland and Labrador	8.20%	16.80%	16.80%
Nova Scotia	8.79%	21.00%	21.00%
Prince Edward Island	9.80%	16.70%	16.70%
New Brunswick	9.68%	17.95%	20.30%
Quebec	20.00%	24.00%	25.75%
Ontario(2)	5.05%	11.16%	13.16%
Manitoba	10.80%	17.40%	17.40%

	Tax credit on gifts up to $200	Tax credit on gifts over $200	Top marginal tax bracket
Saskatchewan	11.00%	15.00%	15.00%
Alberta	10.00%	21.00%	15.00%
British Columbia	5.06%	14.70%	14.70%

Notes

1) The federal tax credit on gifts over $200 is 29% for individuals with taxable income up to $200,000. When an individual's taxable income is greater than $200,000, the federal tax credit becomes 33% on the lesser of taxable income in excess of $200,000 (2016 amount) and the amount of the gift in excess of $200. This will be shown in the example below.

2) The Ontario tax rates shown are before the Ontario surtaxes of 20% of Ontario taxes in excess of $4,484 and 36% of Ontario taxes in excess of $5,739.

The table highlights:

- There are significant variations between provinces. For example, Ontario offers the lowest credit at 11.16% while Quebec provides the highest credit at 24%.
- The traditional rule of thumb that gifts over $200 receive credit at the top tax bracket no longer applies unconditionally. While a number of provinces continue to offer the tax credit at their top tax bracket, the federal and a number of provincial governments no longer utilize the top tax bracket in the formula when calculating the applicable credit for the majority of taxpayers. For example, the federal credit for donations over $200 is capped at 29% for all taxpayers whose taxable income is less than $200,000. The top federal bracket of 33% is utilized only for credits in respect of individuals whose taxable income exceeds the 33% threshold and is applied as a unique formula.
- Of particular interest is Alberta where the tax credit of 21% is substantially greater than the province's top tax bracket of 15%.

Example One:

Margaret, who lives in Alberta, makes charitable donations that total $1,000 in 2016. Her 2016 taxable income is $100,000.

- Margaret's federal tax credit is **$262** [$30 + 232, derived as ($200 x 15%) + (($1,000 - $200) x 29%)].
- Her Alberta tax credit is **$188** [$20 + $168, derived as ($200 x 10%) + ($1,000 - $200) x 21%]
- *Margaret's total tax credit is **$450** in respect of her charitable gifts that total $1,000.*

Example Two:

Tom, who lives in Ontario, makes charitable donations of $25,000 in 2016 and has taxable income of $210,000 that same year.

- Tom's federal tax credit is **$7,622** [$30 + 3,300 + $4,292, derived as ($200 x 15%) + ($10,000 x 33%, which is the lesser of taxable income in excess $200,000 and the amount of the charitable gift in excess of $200), plus ($14,800 x 29%, on the remainder of $14,800)].
- Tom's Ontario tax credit is $2,778, but has a total tax value of **$4,334** that results because of Ontario's surtaxes ($2,778 x 1.56). The $2,778 is derived as $10 + $2,768, calculated as ($200 x 5.05%) + (($25,000 - $200) x 11.16%).
- *Tom's total tax credit is **$11,956** in respect of his charitable gifts that total $25,000.*

Planning helps to ensure that a charitable gift is completed in an efficient manner and the maximum tax benefits are achieved.

RRSP BENEFICIARIES: PROCEED CAUTIOUSLY

An RRSP offers taxpayers the opportunity to utilize a tax-preferred approach for accumulating assets for retirement. Within pre-determined limits, RRSP contributions can be deducted against a taxpayer's total income lowering his or her overall income tax liability for that particular year. In addition, investment earnings within the plan grow tax deferred.

Effectively, the contributions and earnings are tax deferred until removed from the plan. As such, withdrawals from an RRSP during the annuitant's life time are subject to tax. In addition, the death of an RRSP annuitant creates an income inclusion for the deceased equal to the fair market value of the property held within the RRSP. This income amount is included in the annuitant's income for the year of death, adding to other tax liabilities that may arise in the final tax return.

There are some rollover situations that create exceptions to the general rule. For example, when the deceased's spouse or financially dependent children or grandchildren are named as beneficiaries, the flow of the funds can create an offsetting deduction for the deceased and eliminate the tax liability that would otherwise arise from the deemed disposition. Through these rollover exceptions, an amount equal to the RRSP "refund of premiums" (which is essentially the value of the plan at the date of the annuitant's death) offsets the deceased's income inclusion. Funds are then taxed in the hands of the beneficiaries when withdrawn from the plan.

A beneficiary designation on an RRSP directs the funds to the named beneficiary. When a beneficiary receives RRSP funds directly under the terms of the plan, and no rollover applies, he or she becomes jointly and severally liable together with the deceased for the amount of taxes owing in respect of the proceeds received.

The issue of joint and several liability arose in a July 2016 Tax Court of Canada case, Sylvia O'Callaghan v. The Queen. The facts of the case were quite simple.

- Siegfried Starzyk passed away on July 19, 2007.
- Sylvia O'Callaghan (Siegfried's sister) was the named beneficiary on his RRSPs and received $274,050.83 directly from the RRSP carrier.
- Sylvia paid $135,000 to Bruno Starzyk (Siegfried's brother) who, nine months later, became the executor of Siegfried's estate.
- The estate filed the deceased's final tax return that showed all taxes owing were in respect of the deemed disposition of the RRSP. The estate subsequently paid $38,980 toward the total income taxes owing, leaving an outstanding tax liability of $57,704.54.
- The CRA issued a reassessment against Sylvia because they had reason to believe that the estate did not have sufficient funds to pay the remaining taxes owed.

Justice Favreau concluded that Sylvia, as beneficiary of the RRSP, was jointly and severally liable with the estate in respect of the income taxes owed on the disposition of the RRSP at the time of Siegfried's death. It was Justice Favreau's position that the joint liability provision of the Income Tax Act "does not impose any obligation on the Minister to attempt to collect an amount from the estate or from the legal representative of the estate before issuing an assessment."

While Sylvia attempted to persuade the court that her payment of $135,000 to Bruno was in his capacity as the estate representative, Justice Favreau concluded this was not the case. He explained that the payment to Bruno was in his personal capacity, several months before being appointed the estate representative. In addition, he noted "payment of any tax amounts owing should be paid directly to the Receiver General."

The take away from this case is that named beneficiaries of an RRSP should consult appropriate professional advisors for guidance. Planning might involve setting aside a portion of the RRSP funds received and communicating with the CRA and estate representative to ensure all taxes have been paid.

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