CHARITABLE GIVING

Gifting New and In-force Insurance Policies to Charities – Issues That a Charity Must Take Into Consideration

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Introduction

There is increasing interest in gifting new and in-force insurance policies to charities. Articles that highlight the benefits of such gifts often do so from a donor perspective and consider how the use of insurance gifts can be a very attractive aspect of an estate plan. What is not often addressed are the issues that a charity must consider when it is approached to accept these kinds of gifts. Such issues relate to valuation of the gift, maintaining the policy, monitoring the policy, and the impact on the charity's disbursement quota, among others. The purpose of this article is to highlight these issues and what both donors and charities should consider when a gift of insurance is being contemplated. This article will also touch on the charitable gift annuity planning tool and various planning considerations.

Issues for Charities – Split-receipting

The "split-receipting" rules that were introduced in 2002[1] have provided opportunities for charities to receipt transfers of property that would not otherwise have been considered gifts.

Prior to the introduction of the split-receipting rules, a charity was unable to issue a tax receipt for a gift of property where the donor still retained an interest in or would otherwise benefit from the gift. This was because the definition of gift as set out repeatedly by the courts stated clearly that a gift was a voluntary transfer of property for no consideration. If the donor would benefit in any way from the gift, that test would not be met.

The split-receipting rules now provide that a charity can issue a tax receipt in circumstances where property is received, but the donor retains a benefit. The specific rule provides that a charity must issue the receipt for the "eligible amount" of the gift. Eligible amount is defined to be the fair market value of the property gifted less any "advantage" received by the donor.[2] Advantage is defined very broadly to be any benefit received in the past, currently or in the future, by the donor or someone dealing at non-arm's length with the donor as a result of the gift.[3]

Donations of insurance products have been significantly impacted by the split-receipting rules. For example, "split dollar" or "shared ownership" arrangements are now receiptable.[4] These are arrangements whereby the donor gifts his or her ownership interest in the death benefit portion of the policy to a charity while retaining an interest in the cash surrender value of the policy and the death benefit associated with it. The donor directly or indirectly pays the entire premium, and, under the split-receipting rules, would obtain a receipt from the charity for the portion of the premium attributable to the death benefit. With such gifts, the charity must be careful to determine how much of the premium can be receipted. It will require a valuation of what portion of the premium relates to the gift to the charity.

Over the years, the CRA has been asked about determining the division of the premium between the death benefit and cash value portion and has always declined to provide guidance because it is a valuation issue.

[1] Proposed amendments to the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act," to add ss. 248(30) to (41). Unless otherwise stated, statutory references in this article are to the Act.

[2] Proposed section 248(31).

[3] Proposed section 248(32).

[4] CRA *Document* 2003-0004115.

The CRA has always maintained that valuation issues are questions of fact on which it will not rule.

Valuation of Insurance Policies for Donation Purposes

Another significant change, which is arguably a result of the split-receipting rules, relates to the CRA policy change on valuing a life insurance policy for donation purposes. At the 2007 APFF Roundtable, the CRA announced a significant shift in its policy on determining the value of an "in-force" life insurance policy donated to a charity.[5]

Historically, donors and charities relied on *Interpretation Bulletin* IT-244R3[6] to determine the amount of the charitable receipt available at the time of the transfer of the policy to the charity.

Paragraph 3 of *Interpretation Bulletin* IT-244R3 states that where a donor makes an absolute assignment of an in-force policy to a qualified donee, the amount of the gift is "the amount by which the cash surrender value of the policy at the time of the absolute assignment exceeds any policy loan outstanding."

Normally, a charity would issue a receipt equal to the cash surrender value (less any outstanding policy loan) at the time of the gift. Subsequent premium payments by the donor would also qualify as a charitable gift. If the policy had no cash surrender value at the time of the making of the gift, such as a term-to-100 policy, no receipt would be issued for the donation of the policy, although receipts would be issued for premiums paid by the donor after the transfer to the charity.

Interpretation Bulletin IT-244R3 also reminds the donor that the transfer of the policy may be a taxable event.[7] The proceeds of disposition of the insurance policy by the donor will equal the value of the policy at the time of the transfer, and to the extent that the proceeds exceed the adjusted cost basis of the policy, the donor will have an income inclusion.[8]

The response to a question at the 2006 APFF Roundtable[9] indicated that the value of the charitable gift was still to be determined in accordance with paragraph 3 of *Interpretation Bulletin* IT-244R3.

However, in 2007, the CRA announced at the APFF Roundtable, and reiterated (in English) at the CALU Roundtable in May 2008,[10] that the charitable receipt to be provided by the recipient charity for the donation of an insurance policy should be calculated using the "fair market value" of the policy taking into account the factors listed in *Information Circular* IC89-3, "Policy Statement on Business Valuation."[11]

The factors to be considered, in addition to the cash surrender value, include the following:

1. the policy's loan value;
2. the face value of the policy;
3. the state of health of the insured and his or her life expectancy;
4. conversion privileges;
5. other policy terms such as term riders, double indemnity provisions; and
6. replacement value.

The Circular also indicates that where the death of the life insured is "imminent" and it is proper to consider this factor in valuing a policy, the value may be greater than the policy's cash surrender value. The CRA has indicated that it will be stating its new position in a future Income Tax Technical Newsletter. (As of the time of writing, this position has not been dealt with in a Technical Newsletter nor has *Interpretation Bulletin* IT-244R3 been revised.)

As noted above, the donation of the policy may be a taxable event to the donor. The CRA confirmed in its response at the

[5] CRA *Document* 2007-0241901C6, dated October 5, 2007.

[6] "Gifts by individuals of life insurance policies as charitable donations," dated September 6, 1991.

[7] Ibid. at paragraph 5.

[8] Subsection 148(1) of the Act. See, also, the definitions of "proceeds of disposition" and "adjusted cost basis" in subsection 148(9) of the Act.

[9] CRA *Document* 2006-097021C6.

[10] CRA *Document* 2008-0270391C6.

[11] See paragraphs 40 and 41.

CALU Roundtable that for purposes of determining the proceeds of disposition of the policy to the donor, the "value" of the policy is its cash surrender value (as provided in the Act[12]) and not the fair market value as determined for receipting purposes. The amount included in income by the donor as a result of the transfer would be the cash surrender value less the adjusted cost basis of the policy – and hence in the right circumstances, the value of the receipt could be significantly greater.[13]

In light of the new policy, the charity will likely require assistance from a valuator or actuary to determine the fair market value of the policy. A receipt should be issued for the "eligible amount" of the donation – i.e., the fair market value of the policy, less the amount of the "advantage" if any.

Other recent amendments to the Act that could be relevant to the issue of what is the amount of the receipt were introduced in 2003 as part of the Ministry of Finance's attempt to limit the tax benefits from "buy-low, donate-high" charitable donations made under tax shelter and other arrangements.

Proposed subsection 248(35) of the Act limits the fair market value of the gift for receipting purposes in certain circumstances – namely, (i) where the gifted property was acquired by the donor less than three years before the date of the gift; and (ii) where the property was acquired less that ten years before the date of the gift and "it is reasonable to conclude that, at the time the taxpayer acquired the gifted property, one of the main reasons for the acquisition was to make the gift."

Proposed subsection 248(37) lists several types of property that are excluded from the application of 248(35), including inventory, real property in Canada, cultural property and certain shares. Life insurance policies are not so excluded. The CRA confirmed at the 2009 CLHIA Roundtable that 248(35) of the Act would apply to gifts of life insurance donated to a charity.[14]

The new CRA position makes gifts of life insurance potentially more attractive to donors from a tax perspective, especially older donors who may be in poor health. However, charities should ensure they have policies and procedures in place to accept and receipt in-force life insurance policies. Charities should also be aware of their responsibilities for issuing the receipt for the correct amount and be careful to ensure that donors will continue to pay the premiums for a donated policy that is not otherwise "paid up."[15]

This new change in policy does bring with it added responsibility for charities. Knowing that the receipt could be issued for the cash surrender value was relatively straightforward. The insurance company would provide the charity with that amount and the charity would issue the receipt. Today, a valuation will be required which adds to costs and complexity.

The responsibility for the receipt is that of the charity, not the donor, so it is the charity that will have to contract to obtain the valuation. To obtain such a valuation, it will be necessary for the donor to provide some quite personal information to the valuator. Presumably, the donor will be willing to do so to obtain the receipt but this could be complicated from a donor relations perspective.

Charities should also be careful when accepting gifts of life insurance when the policy is not fully paid up and the donor is committing to pay the annual premiums.[16] The question that arises is what happens if the donor ceases to pay the premiums. This is not a simple question and will depend on the circumstances in each instance. The options available are for the charity to either surrender the policy for its cash surrender value, or to continue to pay the premiums. Neither option is desirable and charities should have a

[12] Subsection 148(7) and definition of "value" in subsection 148(9) of the Act.

[13] Supra note 8.

[14] CRA *Document* 2009-0316701C6.

[15] Or alternatively, that they can find other donors who may be prepared to fund the ongoing premium obligations.

[16] One option to consider is having the donor make an additional "lump sum" donation to the charity sufficient to fund an annuity on the donor's life that would ensure premiums would be paid until the donor's death. The tax savings from the combined receipt for the life insurance policy and annuity may more than offset the cost of the annuity.

carefully considered gift acceptance policy applicable to insurance gifts which they can rely on if they decide the gift offered is not one they want. It is always easier to say no to a donor if a general gift acceptance policy setting out the parameters of the gift clearly states the terms on which such gifts will be accepted.

Another issue which should be considered for the policy on acceptance of life insurance gifts relates to the difficulties that can be encountered with gifts of term life insurance policies. Charities do need to be alert that they do not become a "dumping ground" for people with life insurance policies they no longer require, particularly where the policies are term policies or are not paid up. An elderly or ill donor may be entitled to a significant receipt for a term policy and, once he or she has received the receipt, may discontinue payment of the premiums, especially if the premiums increase significantly at a certain age. If the donor does so, the charity will get nothing on the donor's death, notwithstanding the receipt issued.

Charities, therefore, might be prudent to specify they will only accept permanent insurance policies under their gift acceptance policy.

Disbursement Quota

Interpretation Bulletin IT-244R3 touches on the impact of the donation of a life insurance policy on the recipient charity's disbursement quota. The Bulletin notes that where the donation is made subject to a trust or a direction that the property is to be held for not less than 10 years, the value of the gifted policy (i.e., the cash surrender value) and the proceeds of the policy are excluded from the charity's disbursement quota. Any subsequent gifts of the premiums that are made by the donor must also be subject to a ten-year gift direction in order to keep the value of the premiums paid out of the charity's disbursement quota. The CRA suggested that the donor should "at the time the policy is given, ... require the charity to keep the policy, or property substituted for the policy, for at least 10 years after the last premium is paid by the donor."[17]

In this context, the proceeds received on death are considered to be property "substituted therefore." The charity must therefore remember that if the donor dies before the end of the 10-year period, the proceeds must be held as enduring property until the 10-year hold period expires. If a charity has disbursement excesses and is not required to treat these gifts as enduring property, no 10-year hold should be suggested (unless the donor requests it).[18]

Charitable Gift Annuities

Another insurance gift planning vehicle is a charitable gift annuity. A charitable gift annuity involves a gift by a donor in return for the charity agreeing to provide an annuity to the donor. A portion of the gift is used to buy the annuity, based on the income the donor requires. The balance of the gift is the amount for which the tax receipt can be issued. These gift planning instruments can be tricky as they involve some fairly complex regulatory issues and questions.

In the first instance, an annuity is usually defined under the laws relevant to insurance to be an insurance product – which requires the "issuer" to comply with the provincial insurance legislation – a very onerous task for a charity. Charitable gift annuities should be structured to minimize the risk that the charity will be considered the "issuer."

Another question is whether a charitable gift annuity is a security. If it falls into that category, the terms and rules of the applicable securities legislation will apply. Again, it is possible to structure a charitable gift annuity to minimize the risk of applicability of this legislation.

A third issue with gift annuities is whether the contract with the donor creates a debt obligation of the charity – that is, is the commitment to pay the donor the annuity payment reflected as a liability on the charity's books? If it is, charitable foundations, whether public or private, are not permitted to use this gift planning instrument because of the restrictions on the ability of a foundation to incur debt.[19] Private foundations cannot incur any debt.

[17] Paragraph 8 of *Interpretation Bulletin* IT-244R3.

[18] The 2010 Federal Budget (released on March 4, 2010) contains proposals that will significantly modify the charitable disbursement quota rules.

[19] Subsection 149.1(1) of the Act.

Public foundations are not permitted to incur debt unless the debt is to fund operating expenses.

The CRA has suggested that charitable gift annuities would not fall into the permitted debt category, notwithstanding that the CRA has become a bit more flexible and now does permit public foundations to incur debt for investment purposes. The CRA has still indicated it is not prepared to confirm that a gift annuity qualifies as such a debt.

Charitable gift annuities fall into two categories. The first are self-insured – meaning that the charity sets aside and invests the portion that will fund the donor's annuity – and pays the annuity payments directly to the donor on a monthly basis. The second are reinsured or contract annuities, which generally means the charity takes a portion of the funds provided by the donor and buys an annuity from a licensed insurance company to fund the annuity to be provided to the donor. Again, the receipt is issued for the net amount left after the annuity is purchased.

It is this latter structure that can be put in place with less risk of regulatory trouble, as the role of the charity is limited to purchasing the annuity on the donor's behalf from the insurance company. In this case, the donor receives the payments directly from the insurance company and the charity is simply the facilitator of the annuity rather than the provider.

Charitable Insured Annuities

Another variation of the gift annuity using life insurance is the charitable insured or "back-to-back" annuity. The insured annuity is structured such that the annuity will provide the annuitant with the desired income, plus an extra amount which is designed to fund the premiums for an insurance policy that will replace the capital used to purchase the annuity. This structure can be easily turned into a method to fund a charitable gift on death which can be quite attractive for both the charity and the donor.

Charitable insured annuities are modified insured annuities where the life insurance policy is owned by the charity; the donor receives a tax credit for each premium paid for the insurance policy. The annuity pays an annual income to the donor and any remaining capital plus the insurance proceeds are paid to the charity on the annuitant's death. In other words, this structure creates a "life income" gift similar in result to a charitable gift annuity (particularly those that are self-insured) or a charitable remainder trust.

The steps involved are as follows:

> The donor acquires an annuity from an insurance company and receives the annuity benefits. The donor arranges for a new life insurance policy which, after the payment of an initial premium amount, will be transferred to the charity and the charity will be made the beneficiary. The intention is that the donor will fund the premiums out of a portion of the annuity payments received under the annuity. Generally in today's economic environment, the after-tax annuity payments will be greater than the donor could otherwise earn from such funds if the donor invested his or her assets in a fixed income investment.[20] This consequence, together with the fact that the donor can receive a tax receipt for the insurance premium payments, results in the donor being able to arrange to leave a significant gift to his or her charity of choice on death plus to have a higher income during his or her lifetime. It is important to note that such an annuity should not be funded with public securities, as there is a tax disposition with no offsetting charitable tax credit.[21]

Conclusion

Donations of life insurance are welcome gifts and charities with donors interested in supporting their mission with a gift of insurance should welcome the generosity. That said, charities need to be wise about accepting such gifts, and must be aware of the potential risks and the responsibilities attaching to such gifts. In turn, donors of

[20] This is the result of several factors, including the preferential tax treatment for "prescribed annuities," longer term interest rates used to price life annuity products, and the fact that at older ages, there is a mortality factor built into annuity pricing.

[21] This is due to the fact that ownership of the annuity is retained by the donor.

insurance products need to understand the considerations of charities in accepting these gifts.

A clearly articulated gift acceptance policy applicable to gifts of insurance is a prudent measure for any organization and its board to consider. Unfortunately, in today's world, the rules do not get simpler – and that is particularly true when it comes to gifts involving insurance.