LIFE INSURANCE

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Potentially More Attractive to Donors

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The donation of a life insurance policy or the proceeds of life insurance offers a donor an opportunity to leave a significant legacy to a favourite charity for a relatively small payment. Recent policy changes by the Canada Revenue Agency ("CRA") have made the donation of a life insurance policy even more attractive.

Background: Split-receipting rules

The "split-receipting" rules that were introduced in 2002 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.

Under the new rules, 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. 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.

Donations of life insurance policies

The new split-receipting rules have had a significant impact on donations of life insurance products. For example, "split dollar" or "shared ownership" insurance arrangements are now receiptable. These are arrangements whereby the donor gifts his or her ownership interest in the death benefit portion of a universal or whole life insurance policy to a charity while maintaining the investment portion for himself or herself. The donor pays the entire premium, and, under the split-receipting rules, obtains a receipt from the charity for the portion of the premium attributable to the death benefit. A valuation of the portion of the premium that relates to the gift to the charity is required in order to determine the amount of the receipt.

Over the years, the CRA has been asked about determining the division of the premium between the death benefit and the investment portion and has always declined to provide guidance because it is a valuation issue. CRA has always maintained that questions of value are questions of fact on which it will not rule. When a donor and charity enter into a split dollar arrangement an actuary should be consulted to determine the amount that can be receipted.

Valuation of insurance policies for donation purposes

Another significant change, which is arguably a result of these rules, relates to the CRA policy shift on valuing a life insurance policy for donation purposes. In 2007, the Canada Revenue Agency announced a significant shift in its policy on determining the value of an existing life insurance policy donated to a charity.

Until the change in policy, when a donor transferred an in-force policy to a charity, the charity would issue a receipt equal to the cash surrender value (less any outstanding policy loan) at the time of the gift; subsequent payments of premiums by the donor would also qualify as a charitable gift. If the policy had no cash surrender value at the time of the gift, such as would be the case with a term-to-100 policy, no receipt would be issued for the donation of the policy, though receipts would be issued for premiums paid by the donor after the transfer to the charity.

In late 2007, the CRA announced at the Roundtable of l'Association de planification fiscale et financière (APFF), and reiterated at the Conference of Advanced Life Underwriters Roundtable (CALU) in May, 2008, 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 paragraphs 40 and 41 of CRA's Information Circular 89-3: "Policy Statement on Business Valuation."

The factors set out in these paragraphs include, in addition to the cash surrender value:

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

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 transfer of the policy by the donor to the charity will generally be a taxable event. 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. The CRA confirmed in its response at the CALU Roundtable that for purposes of determining the proceeds of disposition of the policy to the donor for these purposes, the "value" of the policy is its cash surrender value, as provided in the Income Tax Act (the "Act"), 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.

A valuator or actuary must be consulted in order to determine the fair market value of the donated policy. The receipt would 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.

In 2003 the Ministry of Finance attempted to limit the tax benefits from "buy-low, donate-high" charitable donations made under tax shelter and other arrangements. This included recent amendments to the Act that could be relevant to the issue of what is the appropriate receipt amount for donations of life insurance.

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 Canadian Life and Health Insuance Association (CLHIA) Roundtable that 248(35) of the Act would apply to gifts of life insurance donated to a charity.

Despite the potential application of proposed subsection 248(35) in certain situations, the new CRA position on the valuation of in-force life insurance policies can make gifts of life insurance potentially more attractive to donors from a tax perspective, especially older donors who may be in poor health. Charities should ensure they have policies and procedures in place to accept and receipt in-force life insurance policies, as it is ultimately the responsibility of the charity to issue the receipt for the correct amount.

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