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March 2008

Focus on Philanthropy

A Guide to Charitable Giving for Professional Advisors

Focus on Philanthropy is a tri-annual Newsletter about charitable gift planning edited and produced by **The Calgary Foundation** (TCF). It is distributed to professional advisors in Calgary and surrounding area.

TCF's e-bulletin of February 13, 2008 released new information on the possibility of changes from Canada Revenue Agency (CRA) as to the valuation of a gift of an existing insurance policy.

The following articles present unique perspectives and case examples and a written opinion from CRA.

An Analysis of New CRA Position on Gifting of Life Insurance Policies

By Glenn R. Stephens
PPI Financial Group

CRA Makes Gifting of Existing Insurance Policies More Attractive To Donors

By DeWayne Osborn
Lawton Partners

CRA Opinion - Gift of a Life Insurance Policy

CRA responds to DeWayne Osborn's inquiry on the determinants of fair market value of life insurance policies.

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Calgary Stampede, Palomino Room

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Maximizing Use of
Retained Earnings Investments to
Benefit Clients, Families & Community

Derek Thompson, FSA, FCIA

Estate Planning Advisor
Raymond James Financial Planning



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New CRA Position on Gifting of Life Insurance Policies

BY GLENN R. STEPHENS, PPI FINANCIAL GROUP

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Introduction

IN REPLYING TO A QUESTION POSED AT A RECENT CONFERENCE in Quebec,¹ the Canada Revenue Agency (“CRA”) announced a change in administrative position regarding the gifting of life insurance policies to registered charities. As a result of this change, new opportunities for both donors and charities have arisen.

This article will discuss both of the key issues the CRA was asked to address. The implications of this new administrative practice will then be considered.

Key Issues Under Consideration

The CRA was asked to confirm its position on the following two issues:

1. What is the “value” of a life insurance policy that is gifted to a charity and how is that value determined?
2. Given that the donation of a policy is a disposition for tax purposes, what are the donor’s proceeds of disposition?

Value of Gift

For many years, the CRA’s administrative position on the value of a policy donated to charity has been outlined in Interpretation Bulletin IT-244R3 (the “Bulletin”). Paragraph 3 of that Bulletin states:

When a taxpayer has taken out a life insurance policy and later makes an absolute assignment of the policy to a qualified donee under subsection 118.1(1), the amount of the charitable gift is equal to the value of the policy (meaning, the amount by which the cash surrender value of the policy at the time of the absolute assignment exceeds any policy loan outstanding) and any accumulated dividends and interest which are also assigned at that time.

The above position fails to recognize that a life insurance policy’s “fair market value”, which should be the

benchmark for determining the amount of the charitable gift, could significantly exceed its cash surrender value. In fact, this position did not reflect the CRA’s own published position on the valuation of life insurance policies. As pointed out in the question posed to the CRA, a policy’s value can be determined by an actuarial analysis that considers a variety of factors already identified by the CRA in Information Circular 89-3.² This Circular was specifically drafted to address business equity valuations, but several comments in paragraphs 40 and 41 concerning the valuation of a life insurance policy should have general application.

Paragraph 40 of the Circular states that the factors to be considered in determining the value of a life insurance policy should include:

- (a) the policy’s cash surrender value;
- (b) the policy’s loan value;
- (c) the policy’s face value;
- (d) the state of health of the insured and his/her life expectancy;
- (e) the policy’s conversion privileges;
- (f) other policy terms, such as term riders, double indemnity provisions; and
- (g) the policy’s replacement value.

Paragraph 41 indicates that the imminence of death should be considered, along with the possibility that the insured will recover and not die.

Given that charities are required to provide a donation receipt equal to the fair market value of the donated property, the question posed to the CRA was as follows:

“Taking for granted that the fair market value of the policy is determined by a qualified actuary, in consideration of the factors outlined above, is the CRA of the opinion that the charitable organization can issue a receipt for an amount equal to such fair market value even if it is greater than the policy’s cash surrender value?”

In replying positively to this question, the CRA referred to the passage of Bill C-33 on June 15, 2006. It contains provisions stating that the eligible amount of a charitable gift is the amount by which the fair market value of the property that is the subject of the gift exceeds the amount of the advantage, if any, in respect of the gift.³ The CRA went on to say that paragraphs 41 and 42 of Information Circular IC89-3, referenced above, must be considered in determining the fair market value of a life insurance policy given to a qualified donee. The Department also stated that paragraph 3 of Interpretation Bulletin IT-244R3 must be read in light of this new administrative position.

As a result, where a charity receives a life insurance policy as a gift, it must provide a receipt reflecting the policy's fair market value at the time of the donation.

As the above discussion implies, the value of a given life insurance policy will be based upon its own unique characteristics, as well as the age, health and life expectancy of the insured. The cash surrender value should now therefore represent the minimum amount of the gift that can be receipted by the recipient charity.

Consider the example of a fifty year old male (standard risk) who purchases a Term to 100 policy for \$1 million with level, annual premiums of \$10,500. The policy has no cash surrender value. Under the CRA guidelines outlined in the Bulletin, a charity receiving this policy as a gift should not provide any gift receipt as the policy has no cash surrender value. But according to one actuarial analysis, assuming the policyholder continues to be in good health, this policy may be valued as follows:

	Estimated Value	Cumulative Premiums	Tax Savings From Donation@45%
Year 10 (age 60)	150,000	105,000	67,500
Year 20 (age 70)	350,000	210,000	157,500
Year 30 (age 80)	550,000	315,000	247,500

As this chart shows, even in the tenth year the policy's value exceeds premiums paid. The discrepancy increases, however, as the individual gets older. While tax savings from donating the policy never exceed premiums paid at any point in this example, it is not difficult to imagine situations where this would occur, especially in cases where the life insured/donor was in poor health at the time of the donation.⁴

Taxation on Transfer of Policy

The donation of a policy to charity constitutes a disposition for income tax purposes. The amount by which the proceeds of disposition exceed the policy's adjusted cost basis ("ACB") is taxable to the donor.⁵

Where a transfer arises as the result of a gift (and for the purposes of certain other transfers described in the Act), the proceeds of disposition reflect the "value" of the policy at that time. For these purposes, value is a term defined in the Act that essentially means cash surrender value (the value would be zero in the case of a policy without cash surrender value).⁶

Therefore, the value of the policy for the purpose of the determining the amount of the charitable receipt could be an amount that differs significantly from the proceeds of disposition. The CRA was asked to confirm this interpretation and replied affirmatively.

The result of this interpretation is that, where a policy is gifted to charity, the donor/transferor will be taxed only on the excess of the policy's cash surrender value over its ACB. This will be the case even where he or she has received a donation receipt reflecting the policy's fair market value, which could be a much higher amount than cash surrender value. In any event, the taxable income realized by the donor on the gift of the policy will be offset by the charitable donation credit.

Planning Implications

1. Greater Tax Savings to Donor

This new administrative position creates obvious opportunities for prospective donors who own insurance policies that may no longer be required for their original purpose. It confirms that even a policy without cash surrender value can have an intrinsic value that may be recognized when it is donated to charity. This type of planning should be considered in every case before a presumably redundant policy is surrendered or allowed to lapse.

2. More Legacy Funding for Charities

Charities should also welcome this new development, as donors now have much greater incentive to donate existing policies. These policies can provide significant medium and long term funding to support charitable activities.

However, charities will need to consider the implications of acquiring a life insurance policy. Two of these are as follows:

- In accepting a life insurance policy as a gift, charities may be assuming premium obligations. Generally, the future availability of the death benefit will justify payment of premiums by the charity. In some cases, the donor might agree to continue paying premiums and obtain an annual donation receipt for the payments. On the other hand, there will be situations where the gifted policy is fully paid up, which would be ideal for the charity.
- Charities are subject to disbursement quota rules.⁷ It is beyond the scope of this paper to review these rules in detail. The impact of a potentially large, non-cash gift on a charity's disbursement quota will vary depending upon the charity's own circumstances. In some cases, it may be necessary to make the policy subject to a "enduring property" rules in order to avoid negative impact on the disbursement quota.⁸

3. Planning Regarding New Policies

The above commentary is primarily of interest in considering the donation of policies that have been in existence for a number of years. However, it may have some relevance in situations where clients are purchasing new

insurance policies for their own personal or business needs.

For example, clients will frequently purchase term insurance on the assumption that coverage is only required for a limited period of time. If the policy is allowed to lapse or is not renewed, the client would not receive any current recognition for the premium payments.

But if the client did have charitable intentions, there may now be an additional benefit to purchasing a permanent insurance policy. If it was determined at a later date that the coverage was no longer required, the client would be free to donate that policy to charity and would receive a donation receipt equal to the current fair market value of the policy. In addition to making a charitable gift, the client could qualify for a tax benefit that would offset all or a portion of the premium costs incurred to date. As well, the purchase of a permanent insurance policy creates additional flexibility for estate and charitable giving strategies.

The new CRA policy on the gifting of life insurance policies has opened up interesting new planning opportunities for both donors and charities. As clients and their advisors become more familiar with this change, it is likely that many new strategies will be developed.

1 Conference Association de Planification Fiscale et Financière (APFF), October 3, 4 and 5, 2007.

2 Information Circular IC 89-3, *Policy Statement on Business Equity Valuations*. Referred to in this article as the "Circular".

3 See subsection 248(31) of the Income Tax Act, RSC, 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act". This provision was contained in Bill C-33 as part of the "split receipting" rules. Arguably, however, prior to the passage of Bill C-33, the CRA could have relied on subsection 118.1(1) of the Act to arrive at the same result. This is a longstanding provision that contains the definition of "total charitable gifts" and includes reference to the fair market value of donated property.

4 The author would like to thank Ashley Crozier of Crozier Consultants Inc. for providing this analysis. The figures provided are examples only and may change from situation to situation in accordance with many factors including policy features, interest rate assumptions and the health and insurability of the insured.

5 See subsection 148(1) of the Act.

6 See subsection 148(7) of the Act and the definition of "value" in subsection 148(9) of the Act.

7 "Disbursement quota" is defined in subsection 149.1(1) of the Act. Also see section 3701 of the Income Tax Regulations.

8 "Enduring property", which is defined in subsection 149.1(1) of the Act, is not included in a charity's disbursement quota. A life insurance policy can be an enduring property if it is made subject to a direction that it be held by the charity for a period of at least ten years. The ten year period runs from the date of the last payment. Proceeds paid within that time frame must be held (and presumably invested) by the charity for the duration of that period, after which time the funds may be expended for charitable purposes.

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CRA Makes Gifting of Existing Insurance Policies More Attractive to Donors

By DEWAYNE OSBORN CGA, CFP
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IN ORDER TO RECEIVE A TAX RECEIPT FOR THE GIFT of an existing policy, the donor must absolutely assign ownership of the policy to the charity. Working through an insurance agent and signing the appropriate forms completes this legal process. The charity would then assign itself as beneficiary of the death benefit. If premiums are still required, then all *future premiums paid by the donor* (not a premium offset situation) are eligible for a tax receipt.

Prior to October 5, 2007, if the policy did not have a cash value (e.g. term product), then no tax receipt was issued *until* the donor paid additional premiums. Furthermore, if it could be reasonable determined that the death benefit would be received in a certain period of time (e.g. very old donor, life is impaired by disease), IT 244R3 mandated the use of cash surrender value as the FMV of the gift.

When a life insurance policy is gifted, a taxable disposition occurs. If the cash surrender value of the policy is greater than its cost, ITA *Section 148* requires that the donor include in his or her income the amount of the difference (cash surrender value - adjusted cost base). The income is taxed as *normal income* and not as a capital gain, and the tax receipt will cover the amount of income inclusion. Once again, the insurance agent will know these values for tax purposes when the policy is assigned.

If the policy had a policy loan at the time it was gifted, the charity is now responsible for the loan repayment - not the donor. If the donor decided to *repay the loan* for the charity, THEN each loan re-payment made would qualify for a tax receipt.

CRA has changed its position on CSV being the determinant of fmV of life insurance policies as stated in the third paragraph of IT 244 R3. Now, CRA will allow life expectancy and other factors be used by an

actuary to determine the fmV for the purposes of determining the eligible amount of the gift. This position is more consistent with valuation of insurance in certain corporate situations as stated in CRA's Information Circular 89-3 paragraphs 41 and 42. PLEASE NOTE that CRA did not change its position on the disposition of policies under ITA 148(7). The income to the donor is still the difference between the CSV and the adjusted cost basis of the policy.

In discussions with CRA, they are not willing to change the wording of IT 244R3, but have provided an opinion in the attached letter ([view link](#)) dated February 25, 2008 detailing this new position.

While this ruling applies to any existing policy, consider this simple example using a term to 100 (T-100) product and an actuary's assessment:

A 70 year old man in good health purchases a T-100 policy. He will pay annual premiums of \$6,000. When Bob is 87 years of age, his financial advisor recommends that he sell off more of his growth equities and convert them to a more liquid investment.

Bob has always been charitably inclined. When his advisor heard of this new CRA position, he recommended that Bob cancel his bequest provision and gift over his life insurance policy. An actuary was hired and he determined the value of the policy to be \$139,475 *net of future premium payments*. The actuary assumed the following: **THAT the charity would guarantee that the premiums would be paid**, the life expectancy is from the Canada Life 2000-2002 Mortality Tables, and the assumed interest rate is 4.5%. Now Bob has a large tax receipt today when he needs it to complete his portfolio re-positioning. Without this new position, Bob would receive a tax receipt for \$4, which is equal to CSV as provided by the insurance agent from the insurance company.

Using another example provided to me by an advisor subscriber that demonstrates the tax effect of disposing of life policies under this new CRA position:

- Policy proceeds = \$400,000.
- Net CSV = \$60,000
- ACB = \$40,000
- FMV determined by an actuary to be \$250,000.
- The donor's marginal tax rate is 43.8%.

Upon gifting the policy to a charity, the donor will receive a \$250,000 tax receipt generating \$116,000 in tax savings in Manitoba ($\$250,000 \times 46.4\%$).

Taxable income from the disposition to the charity = $\$60,000 - \$40,000$ or $\$20,000$. The $\$20,000$ of income will attract tax of $\$8,760$ ($\$20,000 \times 43.8\%$). The donor's net tax savings is $\$107,240$ ($\$116,000 - \$8,760$).

Now, for the charitably inclined client with existing insurance policies, this enhanced method of gifting life insurance can result in a substantial gift to help better communities, provide the advisor with an easy way to eliminate taxation created by repositioning a client's highly appreciated portfolio, and/or significantly reduce the client's tax bill.

DeWayne Osborn is the General Manager, Compliance Officer, and in-house expert on charitable and planned giving at Winnipeg-based Lawton Partners.

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CRA OPINION – GIFT OF A LIFE INSURANCE POLICY

BY GHISLAIN MARTINEAU, MANAGER, FINANCIAL SECTOR AND EXEMPT ENTITIES SECTION
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FEBRUARY 25, 2008

Written confirmation of the tax implications inherent in particular transactions are given by this Directorate only where the transactions are proposed and are the subject of an advance income tax ruling request submitted in a manner set out in Information Circular 70-6R5. As stated in paragraph 22 of IC 70-6R5, written opinions are not advance tax rulings and, accordingly, are not binding on the Canada Revenue Agency (the “CRA”). Where the particular transactions are completed, the inquiry should be addressed to the relevant tax services office. However, we are prepared to provide the following comments.

Unless otherwise stated, all statutory references are to the *Income Tax Act*.

According to the legislative proposals contained in Bill C-10, which received Second Reading in the Senate on December 4, 2007, total charitable gifts depend on the eligible amount of a gift. Subsection 248(31), as proposed, sets out that the eligible amount of a gift is the amount by which the fair market value of the property that is subject of the gift exceeds the amount of the advantage, if any, in respect of the gift.

Paragraphs 41 and 42 of the Information Circular 89-3 list the factors to be considered in valuing a life insurance policy. As CRA stated at the 2008 annual conference of the *Association de planification fiscale et financière*, we are of the opinion that these paragraphs must be considered in establishing the fair market value (FMV) of a life insurance policy at the time of the gift to a qualified donee.

Paragraph 3 of the Interpretation Bulletin IT-244R3 *Gift by individuals of life insurance policies as charitable donations* must be read taking into account this new position.

Regarding the receipt, which may be issued under subparagraph 3501(1) of the *Income Tax Regulation*, the explanatory notes released with the November 9, 2006 draft technical Regulations amendments stated the following:

It is proposed that subsections 3501(1), (1.1) and (6) of the Regulations be amended to provide that every official receipt issued by a registered organisation in respect of a gift contain in addition to information already prescribed, a description and the amount of the advantage, if any, and the eligible amount of the gift.

We are of the opinion that for the purpose of calculating the eligible amount, the donee can take into account the FMV of the life insurance policy at the time of the gift determined as indicated above where the FMV exceeds the cash surrender value at that time.

Subsection 148(9) defines the term “value” for the purposes of section 148. Therefore, for purposes of subsection 148(7), we are of the opinion that the value of a life insurance policy corresponds to the amount determined according to subsection 148(9) and constitutes the proceeds of disposition for purposes of subsection 148(1).

We trust the foregoing comments are of assistance.

Ghislain Martineau

Excerpted from a letter sent by CRA to DeWayne Osborn in response to his inquiry on the determinants of fair market value of life insurance policies.

Derek Thompson FSA, FCIA

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DEREK IS AN ACTUARY, WITH A WIDE VARIETY OF EXPERIENCE IN THE insurance, investment, pension, and financial planning industry.

Formerly senior actuary for various insurance companies responsible for product development, valuation of liabilities and assets, marketing and bottom line management.

He has been in private consulting practice for the past 7 years dealing with insurance companies both onshore and offshore and with high net worth clients developing creative tax strategies, retirement and estate planning solutions for clients.

A high degree of expertise has been developed in the retirement, philanthropy and wealth management field working with various structures to save tax for corporate and high net worth clients.

In addition, Derek has developed very creative strategies to deal with corporate buyouts, created tax savings techniques around corporate retained earnings and methods to benefit corporations and individuals with tax effective solutions that also have provided significant benefits for philanthropic purposes.

Derek provides a valuable resource to the financial advisors of Raymond James who arrange for their high net worth clients to avail themselves of his services to enhance their financial situation.