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Backdoor Tax Changes: Life Insurance and Cross-border Donations

Tax changes come in two ways: loud and obvious, often through inclusion in a Federal or Provincial budget, or quietly through the backdoor. Two recent changes of the backdoor variety have implications for donors and the charitable sector. They are: 1) Canada Revenue Agency's recent policy change on valuation of gifts of established life insurance policies; 2) the rules governing cross-border charitable bequests between Canada and the U.S.

1. Valuation of Donations of Existing Life Insurance Policies

Canada Revenue Agency's (CRA) long-standing policy on the valuation of gifts of existing life insurance policies is outlined in IT-244R3, paragraph 3. When an individual owns a life insurance policy that has accumulated capital it is possible to donate the policy to charity. A receipt may be issued for cash surrender value (CSV) and subsequent premium payments, if any, may also be receipted once the charity owns the policy. In addition, the donor would need to recognize as income the amount between the adjusted cost base and the cash surrender value of the policy.

This policy position was thrown on its head in October 2007 when CRA Rulings responded to a question posed by PPI Financial Group at the L'Association de planification fiscale et financiere (APFF) annual convention in Montreal. The question argued that to be consistent with the valuation of life insurance in IC 89-3, the value of an existing policy donated to charity should be fair market value, not cash surrender value. CRA agreed. Now, like most other types of the property, the receipted value of the gift is fair market value.

While the new position changes the valuation of the gift, it does not change the tax treatment of policy at disposition if the policy has equity. As with the previous rules, the donor will need to pay tax based on the difference between the adjusted cost base and cash surrender value, not the fair market value. This treatment is consistent with subsections 148(7) and 148(9) of the Income Tax Act. If the cash surrender value exceeds the donor's adjusted cost base, the excess will be taxed to the donor as ordinary income.

On the face of it, this change is welcome and logical. A policy's fair market value, valued by an actuary, will typically be greater than the cash surrender value – although its not

entirely clear how value is determined. Older policies that have outlived their original intent of family protection can now be quite valuable if donated to charity. CRA's position in IT-244R3 was, however, effectively restricted to insurance policies with an equity component, for example, whole life and universal life policies. With the new position, donations of term life insurance policies are possible. Term policies have no equity – no cash-surrender value that a charity can access – but when they are mature they may have a significant fair market value. But this value is only maintained if the donor or the charity continues paying the premiums.

All of a sudden donations of existing policies, which are fairly unusual, are now quite compelling to potential donors. This will be a blessing, or in the absence of strong charitable intent, a curse. Charities should review their gift acceptance policies in light of CRA's new position. Determining fair market value for existing policies will be new to most charities. The ability to secure a large receipt for a term policy will heighten the risk of dumping in the form of a gift. Fewer than 4% of term policies pay a death benefit and typically premiums increase as the insured ages. The temptation will be great for individual to secure high valuations, donate the policy and then walk away from future premium payments. Once lapsed, the policy is worthless. Most charities don't have the cash to continue paying the premiums. While the valuation process should factor in this scenario and impair the receipt, there will be marketplace pressure to inflate values. Charities should also be mindful that under the intermediate sanction rules issuing false receipt can result in "sanction" or fine of 125% of the value of the receipt.

With that warning out of the way, it is worthwhile looking at a positive scenario for both donor and charity.

Example:

John Pilgrim, 73, has a whole life policy with a face value \$100,000, a cash surrender value of \$48,000, and an adjusted cost base of \$10,000. The policy has been in place for 27 years, is now paid up, and has outlived its original purpose of providing for family. John's life insurance agent arranges for the policy to be valued by an actuary for donation purposes. The actuary values the policy at \$80,000, and John donates it to his favourite charity. The following is the tax treatment of this simple scenario.

Donation receipt (FMV)	\$80,000
Tax credit @ 45%	36,000
Taxable income (\$48,000 – \$10,000)	38,000
Tax on income (assuming a 45% tax rate)	17,100
Net tax savings (\$36,000 – \$17,100)	\$18,900

In this scenario, the charity could surrender the policy for \$48,000 cash, which is more than the receipt. Or they could retain the policy until John dies and then collect the death benefit of \$100,000. Many policies have death benefits that grow with time, so the benefit could be even greater if John lives beyond his life expectancy.

Consistent with backdoor policy changes, the communication process has been spotty. While you can find supporting documents on the internet provided by insurance industry entities, CRA has not issued a written ruling or stated that IT-244 will be reissued. You will not currently find anything about the change on the CRA Charities Directorate

website. In fact, it was only in March that the Charities Directorate was informed by a third party about the position shift.

2. Canada-U.S. Tax Treaty

The second recent backdoor change to the tax treatment of gifts came with the release in September 2007 of the Fifth Protocol to the Canada-U.S. Tax Convention, which is commonly known as the Canada-U.S. Tax Treaty. The new protocol withdrew Article XXIX B (1), which governed cross-border gifts at death and replaced it with Section 26 (1.1). Canadian donors to US charities have lost something in the process.

Introduced in 1995, Article XXIX B (1) harmonized the tax treatment of bequests by a resident of their country to a charity in the other country. As a result, for charitable bequests it did not matter which side of the border the recipient charity or donor were located. Since taxation at death is different in Canada and the U.S., the tax benefits of donations were as well. In Canada, donors receive a tax credit that may be claimed on the final two lifetime returns (T1). In the U.S., bequest donors get relief from estate tax, but no income deduction. The new protocol tries to ensure equal tax treatment on both sides of the border, but that has resulted diminished tax savings for Canadian donors to U.S. charities.

With Section 26 (1.1), Canadians who make a bequest to a U.S. charity will not receive a Canadian receipt and tax credit that can be claimed on the final two T1s. Instead, the donation will be treated as if the individual received the proceeds equal to an elected amount between fair market value and adjusted cost base. The tax owing on this particular asset can be eliminated by electing the adjusted cost base, but the gift does not qualify for a tax receipt or resulting tax credit that can be claimed against other income. In other words, the Canadian deemed disposition is treated as if it was the U.S. estate tax.

For Canadian bequest donors to U.S. charities, this means that they should donate appreciated assets; the higher the appreciation the better the tax result. A bequest of cash to a U.S. charity will result in no tax relief.

The loss of Article XXIX B (1) does not affect American bequest donors to Canadian charities. Americans can still leave a bequest to any Canadian charity, and the tax consequences will be the same as from a bequest to an American charity. They will get an estate tax charitable deduction for testamentary gifts. Unless they have Canadian source income, U.S. donors to a Canadian charity that is not a university and does not have a supporting organization in the United States will not receive an income tax charitable deduction for lifetime gifts, but they do receive relief from gift tax. In essence, the Canadian charity is deemed to be a U.S. charity. This treatment is consistent with the Code and unchanged.

Finally, Section 26 (1.1) has implications for Canadians who own U.S. property, such as snow-birds, and for Canadians who are domiciled in the U.S. Previously, Canadians with U.S. property that they wished to bequeath to a Canadian charity would receive a U.S. estate tax charitable deduction for the gift. Now that offset is gone. If a Canadian bequeaths U.S. property to a Canadian charity they may only get relief from the deemed

disposition in Canada. The Treaty is now consistent with the Internal Revenue Code, which it typically supplements and overrides. Under this new rule, Canadian can no longer offset U.S. estate tax by donating a U.S. property to a Canadian charity. Comfort can be taken in the knowledge that U.S. estate tax only applies to worldwide assets over \$3.5 million (2009 level).

By contrast, if a Canadian leaves U.S. property to a U.S. charity, the estate receives an estate tax deduction for the full amount of the bequest, an outcome which is not affected by the 5th Protocol of the Tax Convention.

The good news is the 5th Protocol does not affect the special tax treatment of donations that alumni and families of Canadian and U.S. universities enjoy under the Treaty. These donors can still make donations to their *alma mater* and claim them as if they were giving to a domestic charity, both during life and at death.

While the 5th Protocol will not affect most Canadian charities, it represents another example of how Canadians are discouraged from supporting international charities. At a time when Canada is becoming more international and expansive in its outlook, the tax system in support of charitable giving is becoming more restrictive.