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DONATE LIFE INSURANCE TO CHARITY TO MAXIMIZE TAX SAVINGS AND PHILANTHROPIC IMPACT

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Donating a life insurance policy to a charity can be a great way of leveraging your resources and making a more impactful gift in support of the causes that are important to you.

There are usually two ways to donate life insurance to charity. The first one is owning the policy personally and naming the charity as beneficiary of the policy. In this case, you get no charitable donation receipts during your lifetime, but upon death your estate will receive a charitable donation tax receipt because the charity will receive the death benefit of the policy as a beneficiary.

The other method of making a gift of life insurance to a charity is to have the charity own the policy and be the beneficiary as well. In this case, CRA deems the policy donation to be done at fair market value (FMV) and this can be significantly higher than the cash value of the policy depending on several factors. By doing this, you will receive a charitable donation tax credit based on the fair market value of the policy. If you can continue to pay the policy premiums you will receive a charitable donation tax credit for the annual premium that you pay for the policy but upon your death, no charitable donation tax credit would be available to your estate.

The charity may agree to pay the premiums and relieve you of that burden or other donors of the charity may agree to pay the premiums for the policy you have donated and receive a charitable donation tax credit on that basis. If there is enough cash value in the policy, the cost of insurance can be deducted from the cash value of the policy too. The benefit of this strategy for the charity is that upon death of the donor they are likely to receive a significantly higher gift that is usually higher than the initial value of the gift and future premiums.

The following chart summarizes how the tax benefits of donation of a life insurance policy work:

POLICY OWNER	BENEFICIARY	PREMIUM PAYOR	TAX CREDIT ISSUED TO	TAX CREDIT BASED ON
Donor	Charity	Donor	Estate	Death Benefit
Charity	Charity	Donor	Donor	Policy Premium
Charity	Charity	Charity	Donor	FMV of Policy

What is the Process?

The first thing you need to do is to establish the fair market value of the policy. This can be done by an underwriter together with an actuary. The underwriter will establish your mortality risk and life expectancy based on your current age and state of health. The actuary will assess the features of the policy, such as cash surrender value, interest rate or dividend assumptions, guaranteed cash values, death benefit, cost of insurance, replacement cost, policy loans, conversion options, riders and other benefits.

In certain cases, where the life insured may be in poor health or may have become uninsurable, even a term life insurance policy that has no cash surrender value may have a fair market value worth hundreds of thousands of dollars depending on the age and life expectancy of the insured.

Once the fair market value of the policy has been established you need to talk to the charity you are planning to donate the policy to and obtain their agreement. The charity needs to agree with the valuation of the policy and if you do not wish to continue paying premiums on the policy they need to find a source of funding the premiums. This is not an overnight process and can take several weeks or months.

Charities are not interested in every life insurance policy. The policies that are most attractive for them are the ones where the insured is over 70 years of age and when the current state of health of the insured is not good and therefore there is a lower life expectancy. Interestingly these types of policies will have the highest fair market values and will provide the highest tax advantages for the donor.

Corporately owned policies, whether they are key person life insurance policies or policies obtained for funding of shareholder agreements on death that may not be needed any longer when the business is wound up, reorganized, sold or when the owners retire, can be good candidates for this strategy too.

Sometimes it may be possible to transfer the ownership of the policy to the insured in a tax effective manner but in many cases the tax consequences may be prohibitive, and companies decide to cancel the policies rather than transfer them to a shareholder, the insured, or to another entity. Donating these corporately owned life insurance policies to a charity can not only help a good cause but can provide tax relief at a time when the company may be facing a significant tax burden.

Tax Implications

When a life insurance policy is transferred to a non-arms length party, a disposition occurs for tax purposes. Under the new rules that took effect on March 21, 2016, the person who transfers the policy is deemed to receive proceeds equal to the higher of:

1 – The cash surrender value (CSV) of the policy
2 – The fair market value (FMV) of the consideration given for the policy or
3 – The adjusted cost base (ACB) of the policy at the time of transfer

If you donate a permanent life insurance policy with cash value to a charity, this could result in a taxable gain if the CSV exceeds the adjusted cost base (ACB) of the policy. The amount by which the CSV exceeds the policy's adjusted cost basis (ACB) is taxable to the policyholder. The life insurance company will issue a T5 for this amount to the policy holder and the gain will be 100% taxable like interest income.

However, provided the charity does not pay to purchase a policy from you and only issues a tax receipt based on fair market value of the policy, your taxable gain would be much lower if you donate a policy to charity than if you transfer the ownership of the same policy to your corporation or any other non-arm's length party, because tax rules are different when it comes to donation of life insurance policies to a charity.

If the charity does not pay for the policy and only issues a charitable donation receipt based on the fair market value of the policy, the proceeds of disposition of the policy for the donor will be based on the greater of the cash surrender value of the policy and the adjusted cost base of the policy. When it comes to donating a life insurance policy to a charity, the donation tax receipt which is based on the fair market value of the policy is not deemed to be consideration for the policy.

For example, let's assume that Joe transfers a life insurance that he owns personally to a corporation that he owns and controls and the company purchases the policy from Joe for $100,000. The policy has CSV of $50,000 and the ACB of the policy is $30,000. In this case, Joe is deemed to have disposed the policy for $100,000, which is higher than the $50,000 CSV or $30,000 ACB. He will be taxed on $70,000 (the $100,000 proceeds of disposition minus the ACB of $30,000).

However, if Joe donates the same policy to a charity, he will only have a taxable gain of $20,000 ($50,000 deemed proceeds of disposition – which in this case is the CSV as it is higher than the ACB – minus $30,000 ACB).

Donation of a life insurance policy to a charity can make a lot of sense both from a tax perspective and in terms of maximizing the impact of your philanthropy. However, you need to take the tax consequences into consideration. Therefore, make sure you consult an expert in philanthropic tax planning before you proceed, to ensure the best results.

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