Insuring the Future

In this Newsletter:

CFP

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***PROVIDING...* ESTATE PLANNING ♦ CHARITABLE GIFT PLANNING ♦ BUSINESS SUCCESSION PLANNING**

Charitable Planned Giving

Charitable Planned Giving

Under current income tax provisions affecting charitable giving, a taxpayer with philanthropic interests would only have to pay taxes in their estate if they had a desire to do so.

You can:

- ***Give your tax dollars to Canada Customs and Revenue Agency (CCRA)***
- ***CCRA will control the distribution***
- ***This is a maximum cost!***

OR

- ***Give your tax dollars to your favourite charity***
- ***You will control the distribution***
- ***This is a minimum cost!***

Legislative Changes

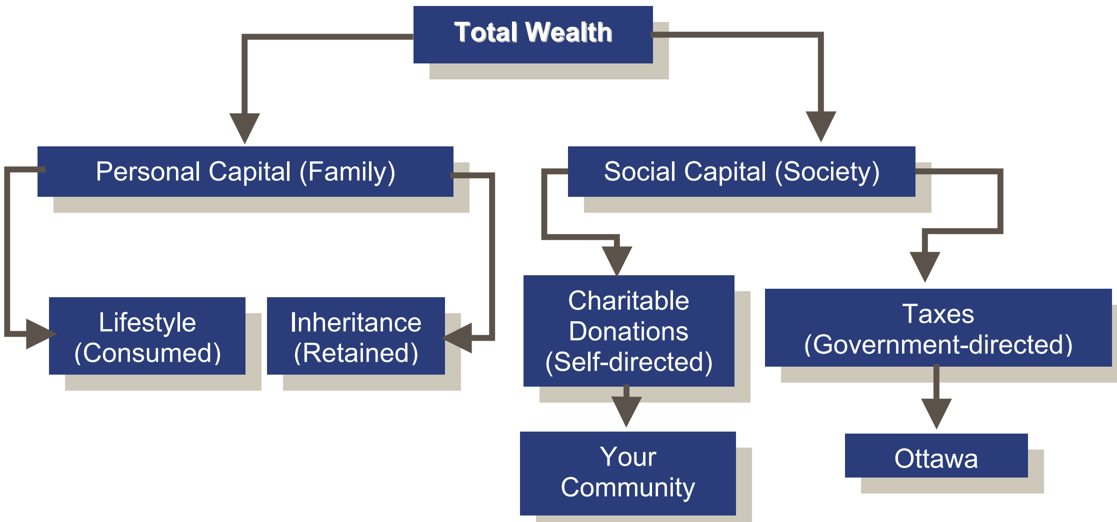
The substantial changes in the tax laws concerning charitable donations in the past five years seem to be due to the federal government's heightened desire to reduce the reliance of charities on public funding. These changes have facilitated and encouraged larger gifts by donors during their lifetime. For donors, a lifetime gift results in immediate tax savings and the added benefit of reducing probate fees at death. Testamentary charitable gifts also can be an effective way to reduce income taxes payable upon death.

Benefits

The making of larger gifts, both during a donor's lifetime and upon their death, benefits the charitable sector and also allows a donor's philanthropic desires to be satisfied. The new rules permit tax benefits to be enjoyed more fully, and sooner, than before by increasing the annual charitable giving limit and removing many of the pre-existing deterrents to the making of large donations.

In this newsletter, we will discuss various ways of charitable planned giving and the benefits for both you and the charity.

Transfer of Wealth



The chart above provides a way to put charitable planned giving into context. It illustrates how our total wealth is distributed. There is personal capital, which consists of what we consume on a day-to-day basis, and what we retain for private inheritance.

Then there is social capital, which is what we give back to society. There are two types of social capital – taxes, and charitable donations. Taxes are non-voluntary, out of our control. Unlike taxes, charitable donations provide a means to self-direct our contributions, to ensure they go the organizations we want to support. With planned giving, we hope to minimize the 'non-voluntary' contributions, and maximize the 'voluntary contributions'.

"Taxes are non-voluntary, out of our control. Unlike taxes, charitable donations provide a means to self-direct our contributions, to ensure they go the organizations we want to support."

Think of Social Capital as an opportunity to give something back to your community, to repay our debt to society by helping those that are less fortunate than us, and to be able to do this in your own community.

Benefits

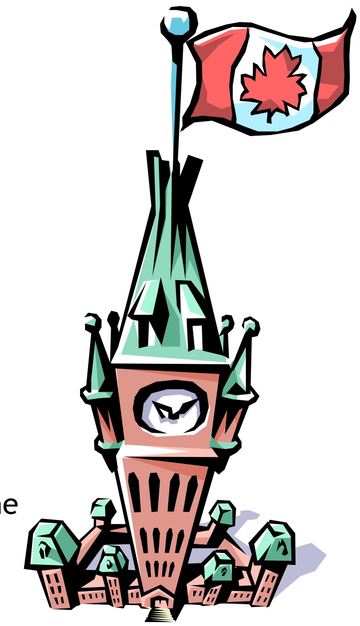
For individuals, the charitable giving tax benefit exists in the form of tax credits. In the case of corporations, a charitable gift is a deduction from net income for tax purposes. The comments in this paper discuss gifts by individuals. Most comments, however, are equally applicable to corporations and for this reason, corporations will not be discussed separately.

Tax incentives for charitable giving take the form of a two-tiered tax credit. At present, the first $200 of eligible donations in a given year receives a federal tax credit of 17%. Where total donations for the year exceed $200, that excess enjoys a federal tax credit of 29%. The actual tax credit will vary depending on which province the donor resides in since the applicable provincial rate must be factored in. As a general rule, donations in excess of $200 produce a credit equal to the highest marginal tax rate, which for the purposes of the illustrations contained herein we will assume to be 46%. For example, a donation of $10,000 could produce a tax credit of approximately $4,600.

Tax Credits

A tax credit is available for donations to:

- Registered charities (including Canadian universities and colleges);
- Registered Canadian amateur athletic associations; certain non-profit corporations;
- The United Nations and related agencies;
- Canadian or provincial governments, crown foundations, or municipalities and;
- Certain foreign universities.



At present, the Income Tax Act sets an upper limit on the credit that can be claimed annually by an individual on donations made in a particular year while he or she is alive. For regular donations, that is to say donations that are not made to the Crown or are not cultural or ecological property, this annual claim limit has been set at 75% of net income (from all sources). For example, if a donor's net income in 2001 was $50,000, donations of up to $37,500 could be claimed for tax credit purposes in that year. Donations not claimed in a given year may be carried forward for a five-year period, subject to the 75% of net income limitation in each such year. It is advisable to report all donations made in a given year on the tax return for that year, even if the total donations exceed the annual claim limit. Doing so aids in tracking the donor's carry-forward limits and solves the problem of lost or misplaced receipts.

With regard to donations made in the taxpayer's year of death and the year prior, the annual donation limit for donations was increased in 1996 to 100% of net income. This was a great improvement over the prior limit of 20% of net income. In the past, the 20% limit often meant that an estate could not fully utilize the credit generated by gifts to charities made by the deceased in his or her Will.

Gifts of Capital Property

Gifts of publicly listed shares and mutual funds may be more beneficial to a donor than selling the asset first and then donating the sale proceeds to charity due to the preferential tax treatment given on capital property donations.

In 1997, the government cut the normal inclusion rate in half for deemed gains arising from qualifying gifts to charities of publicly listed shares and mutual funds. Then in the October, 2000 federal Budget, the general capital gains inclusion rate for capital gains was reduced to 50% of the gain. The end result of combining these two provisions is that the inclusion rate is reduced to 25% on any capital gain that is realized when such shares or mutual funds are donated to a charity. This results in a top marginal tax on this type of donation of approximately 11.5%. This 1997 provision, however, contains a deadline for the making of such gifts of January 1, 2002 in order to benefit from the extra reduction in the capital gains rate. There has yet to be any mention made of any extension to this deadline.

When the gift is made, a donation receipt will be issued for an amount equal to the fair market value of the property donated. Caution must be taken to ensure that an appropriate fair market value has been determined, for example, through a professional valuation.

In order for the reduced rate to apply, the actual securities must be donated to the charity. If the securities are sold first and cash is then gifted, the reduced rate will not apply. As well, the charity cannot be a private foundation.

The reduction in the capital gains rate applies to donations of:

- Shares, bonds, warrants, and options, if listed on a prescribed exchange (Toronto, Montreal & Winnipeg exchanges, the Canadian Venture Exchange, NYSE, Nasdaq, and most other major exchanges);
- Mutual fund shares/units and segregated fund units; and
- Prescribed debt obligations.

Capital Replacement

"Where a donor wishes to make a donation of capital property, it is possible to use the savings in taxes to purchase a universal life insurance contract to provide his or her estate with the cash necessary to replace the value of the donated property."

Where a donor wishes to make a donation of capital property, it is possible to use the savings in taxes to purchase a universal life insurance contract to provide his or her estate with the cash necessary to replace the value of the donated property. In this way, the donor's heirs are not deprived of their inheritance. Consider the following example:

Donation of Publicly Traded Shares

Let's assume the donor has publicly traded shares with a current fair market value of $1,000,000, an adjusted cost basis of $200,000 and a resulting capital gain of $800,000. Assume additional income of $200,000 and a top marginal tax rate of 46%.

We will look at the amount of tax that would be paid if the shares were donated now and the resulting savings used to purchase a Universal Life Insurance policy and compare it to the alternative of the shares being disposed of at death with capital gains being paid at that time and no donation being made - ever. Assume the death (with no donation) happens soon, before the shares have increased in value.

The results are as follows:

	No Donation	*With Donation*
Other Income	$200,000	$200,000
Taxable capital gain ($800,000 x 25%)[1]		$200,000
Total income	$200,000	$400,000
Tax that would be payable:	$92,000	$184,000
Donation limit:		
75% of income ($400,000)	N/A	($300,000)
Plus 25% of taxable capital gain on gift ($200,000)[2]	N/A	($50,000)
Total donation claimed:	nil	($350,000)[3]
Resulting charitable tax credit on total donation claimed: ($350,000 x 46%)		$161,000
Net Tax		$ 23,000

Summary of Tax Savings

Savings in year of donation:		
Tax without donation ($200,000 x 46%)		$ 92,000
Tax with donation		$ 23,000
Savings:		$ 69,000
Plus tax savings on future credits from remaining $650,000		$299,000
Sub-Total of Savings		***$368,000***
Savings at death…		
Tax without donation ($800,000 x 50%) x 46%		$184,000
Tax with donation		Nil
Sub-total of Savings		$184,000
Total Savings ($368,000+$184,000)	=	***$552,000***

[1] The 1997 budget reduction of the capital gains inclusion rate by one-half on this type of donation, combined with the 2000 budget reduction of the general capital gains inclusion rate to 50%, results in an effective inclusion rate of 25%.
[2] Pursuant to earlier legislative changes, the donation limit can be increased by 25% of the taxable capital gain.
[3] As the donor is restricted to a $350,000 limit in the year of donation, and the Fair Market Value of the gift is actually $1,000,000, there is still $650,000 worth of donation to be carried forward over the next several years. This will result in future tax savings of approximately $299,000.

The donor could use a portion of the $552,000 tax savings to purchase a universal life insurance policy with a $1,000,000 face amount. Assume a joint last-to-die, increasing death benefit Universal Life Insurance policy is purchased for a male and female (non-smokers) aged 65. The costs could be paid from the tax savings of $552,000 over a five-year period with annual premiums of $70,000, for a total cost of $350,000. The policy could pay out $1.8 million at age 85 or $2.1 million at age 90 (assuming a 7% rate of return inside the policy).

On donations of other types of appreciated capital property, the resulting tax savings can also be used to purchase insurance to replace the value of the asset donated.

Using Life Insurance as a Charitable Planned Gift…

"Depending on how the contract is structured, life insurance can have numerous advantages when used as a charitable gift …"

Given the existing tax-environment in Canada, more and more clients are looking for opportunities to minimize the final tax they are going to pay at death. A number of estate planning strategies use charitable giving as a means to reduce the terminal tax bill. As well, planned giving provides a tool by which clients of modest means can leave their favourite charity a sizeable bequest with minimal impact on their beneficiaries. Life insurance is a vehicle that is often used to provide the best solution. To be effective, firstly, the policy must be permanent in nature - it must continue to be in effect until the client dies. There are many types of policies that can be used.

Depending on how the contract is structured, life insurance can have numerous advantages when used as a charitable gift:

- The client can create a large donation on death for a relatively small premium;
- The client can leave their entire estate intact for the estate's beneficiaries;
- A life insurance policy can generate a larger gift than an investment in a taxable vehicle would;
- The life insurance policy can be paid directly to a charity thus avoiding probate fees;
- Should the charity require money before the client's death, the charity may be able to borrow against the policy, or cash it in - provided the charity is the owner of the policy;
- The life insurance policy can generate an immediate tax credit for the estate to offset capital gains tax payable on death; and
- The client can remain anonymous if so desired.

…Using Life Insurance as a Charitable Planned Gift

Life insurance in a charitable giving environment can be structured in a number of ways:

- If the client makes the charity both the owner and the beneficiary of the policy, then the premiums the client pays each year will generate a tax credit each year. The proceeds payable on death will go directly to the charity.
- The client could own the policy personally and make the charity the beneficiary directly. Caution must be exercised to ensure that the proper name of the charity is used. While it will not generate an annual tax credit for the client, it will allow the entire proceeds of the policy to be claimed against deemed income in the year of death. It is in that year that most clients will be faced with the highest tax bill. Tax must be paid on all accrued capital gains, all money remaining in the client's RRSP or RRIF and all recaptured depreciation. The tax credit on the charitable bequest could be used to offset the tax otherwise payable by the client's estate.

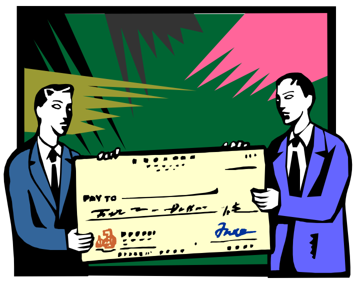
Direct Designation of Charity as Beneficiary

Prior to the February 2000 Budget, direct beneficiary designations of charities on life insurance policies, RRSP's and RRIF's did not entitle the donor to a charitable tax credit on their death for the amount of the proceeds. To be entitled to the credit the donation had to be made in the donor's will. The changes will now allow for tax credits where direct beneficiary designations are made on these products provided the donor died after 1998 and the policyholder or RRSP/RRIF annuitant is the same person as the donor.

Various Donation Options

Owner	Beneficiary Designation	Revocable	Subject to Probate	Tax Credit
Donor	Estate (with legacy to Charity in Will)	Yes, by changing your will	Yes	Yes - credit is based on amount left to charity in Will on insured's death - credit is claimed on final tax return
Donor	Charity	Yes, by changing the beneficiary	No	Feb29/00 Budget (now law) - allows a tax credit retroactive to Jan 1/99 for deaths after 1998 - prior to Jan 1/99 no tax credit was available
Charity (from outset)	Charity	No	No	Yes - as each premium is paid, based on annual premium
Donor	Absolute assignment to charity	No	No	Yes - as each premium is paid, plus credit on the value of policy at date of assignment

RRIF or RRSP Insurance



If a client dies with RRIF or RRSP holdings and the client does not have a spouse or financially dependent child or grandchild to whom the assets can be rolled over, then the full amount of that RRIF or RRSP will be taxable income in the year of death.

Often, if the client wished to pass that money on to his or her heirs, the client would purchase life insurance in an amount equal to the potential taxes payable. The insurance would be used to pay the tax and the assets would pass in whole to the intended heirs. The government would get its tax revenues and the heirs would get the asset.

Under the new charitable giving rules this application of life insurance can be taken one step further. A client could buy life insurance coverage equal to the value of the RRIF or RRSP and leave that insurance benefit to a favourite charity via the client's will or a direct designation. The end result is that the tax credit available as a result of the charitable donation will offset the tax payable on the RRIF or the RRSP due to the deemed disposition at death. The client avoids the payment of taxes on the RRIF or RRSP at death, and will have made sure that the heirs take the full amount of the asset, while the charity receives a sizeable donation.

"The end result is that the tax credit available as a result of the charitable donation will offset the tax payable on the RRIF or the RRSP due to the deemed disposition at death."

Case Study...

Mike and Anita Langford, both aged 65, are concerned with the amount of tax that will be payable to CCRA (formerly Revenue Canada) in their estate. They would like to preserve as much as possible for their family, but wonder how they can leave money for both their family and a planned gift to the university they both attended. They have designated in their will to leave $60,000 (which is set aside in T-Bills) to the university. They hold about $350,000 in registered assets split between them, which has a potential tax liability of approximately $161,000.

After exploring various scenarios with their professional advisors, they decided to use the $60,000 to purchase a Universal Life insurance policy for $300,000, which instantly magnifies their gift 5 times. They will designate the university as the beneficiary of the insurance plan, which will have an estimated death benefit of $355,784 (assuming 7% return on the investment account in the plan) in 20 years.

To keep our example simple, we will assume that the second death of Mike and Anita occurs in 20 years and they still have $350,000 in their RRIF.

The gift to the university upon both deaths will offset the tax owing on their RRIF. The result, their family keeps the estate mostly intact with no tax on the $350,000 RRIF, the university will receive the total insurance benefit (estimated at $355,784) tax-free, and CCRA will receive nothing. Mike and Anita must update their Will to reflect their current wishes.

…Case Study

Assuming a 46% marginal tax rate, an interest bearing investment would have to achieve an 18.16% annual rate of return before tax to equal the insurance death benefit in 20 years.

	Bequest through Will	**Gift of Life Insurance**
Gift after 1st Year (in the event of both deaths)	$60,000	$316,471
Gift at age 85 (in the event of both deaths)	$60,000	$355,784
Annual Tax Payable on Interest Earned	Yes	No
Tax receipt in estate	$60,000	$355,784

	Amount left to Family	**Amount left to Charity**	**Amount of Tax Paid**
Estate Before...	$215,400	$60,000	$134,600 (after charitable gift)
Estate After....	$350,000	$355,784	$0
Difference	**$134,600**	**$295,784**	**($134,600)**

Summary…

With the legislative changes, the structure of charitable giving can be just as important as the amount that is given, both to the charity and to the client. The options to the client are much broader than simply signing a cheque or leaving a sum of money to a charity in a Will.

In many cases, a client needs professional advice to assist in assessing the options. Many clients are unaware of the giving alternatives. For professionals providing estate planning advice - whether it is Will or Power of Attorney preparation, tax planning, assessing insurance needs, or investment planning - it is becoming incumbent upon such advisors to include a discussion of charitable giving.

Planned gifts can take many forms including cash gifts and bequests, gifts of property, gifts of publicly traded securities and life insurance, charitable annuities, charitable remainder trusts and gifts of remainder interests in property. Professional advisors will often need to work together with the charity to structure a gift that provides maximum tax savings to the individual while providing effective assistance to the charity.

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...Summary

The 100% of net income donation limit in the year of death and in the preceding year may create a bias toward estate gifts. However, this will depend on the size of the gift and the client's net income for the relevant years.

The annual limit of 75% of net income provides opportunities to increase lifetime gifts. Each client's situation must be analyzed to determine which is more beneficial: giving now or deferring the gift to the estate.

Whether it is by the donation of publicly traded shares, appreciated capital property, stock options, the proceeds of an insurance policy or the assignment of a policy itself, there are numerous tax advantages available to donors. Charitable donations should never be purely tax motivated but the tax savings that can be achieved both in life and at death go a long way to encouraging philanthropy and rewarding those who explore the numerous opportunities available to them.

For more information...

If you need to have any specific information in relation to these articles or any other insurance related matters, call or email me and I'll provide you with the information needed to help solve these and other estate and business planning needs.

Regards,
John Jordan CFP