Donations of Life Insurance – an Overview

A flexible tax-smart way to make charitable gifts.

Individuals who are interested in leaving a significant future gift to charity should consider the leverage and tax benefits of life insurance. Or perhaps, if you own an existing life insurance policy that has outlived its original purpose consider donating it to charity. Since 2007, donations of existing life insurance policies to registered charities may be receipted at fair market value. Previously, the receipt value was limited to the cash surrender value or the equity built up in the policy. This Canada Revenue Agency (CRA) rule can lead to significant tax savings and a valuable gift to charity.

There are two common ways to structure a donation of a new life insurance policy:

1) Name charity owner ***and*** beneficiary of the policy.
2) Name charity beneficiary of the policy, but not the owner

Although both plans should result in a valuable future gift to charity, they offer different tax and charitable planning benefits. The choice of the structure that is right for you will depend upon your goals.

Option 1: Name of charity owner and beneficiary of the policy

This option is best suited for donors who want to make a future gift and receive immediate tax relief.

The donor takes out a new policy on his or her life (or two lives), and names the charity beneficiary. Then ownership of the policy is transferred into the name of the charity. This would also apply in the case of an existing policy that no longer serves its original purpose. By naming the charity the owner of the life insurance policy, the policy itself is the donation. Each subsequent premium payment made by the donor is eligible for a tax receipt from the charity, which provides annual tax savings to the donor. When the donor dies, the insurer will pay the face amount or death benefit to the charity. Since the policy was donated at inception, the donor's estate will not receive any further tax benefits for the gift.

Typically, a donor will pay the annual premium to the life insurance company. The life insurance company will then confirm receipt to the charity. Some charities prefer to receive the annual premium payment directly as a gift, which they then use to pay the insurance company.

The advantage of this latter method is the immediate tax savings and the pleasure/recognition of interacting with the charity as a donor. The donor can increase the tax savings of the annual gift for the premiums if the premium payments are paid directly to the charity is paid with appreciated public securities, not cash. Gifts of public securities do not trigger any capital gain, which provides a second tax saving in addition to the tax credit.

The disadvantage of this charitable plan is reduced flexibility for the donor. Once the policy is donated it is irrevocable and the donor cannot change the ownership or the beneficiary, although the donor may choose to stop paying premiums. When donors stop paying premiums, charities will occasionally continue paying to keep the policy active.

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Example:

Daisy Loh, age 48, would like to contribute $500,000 to her university to establish a scholarship in honour of her parents. She has high taxable income. She purchases a universal life insurance policy with a face value of $500,000, naming the charity as owner and beneficiary, and pays annual premiums of $3,900.

Annual premium/tax receipt $3,900 Annual tax credit @ 46% + $1,794 After-tax cost $2,106
+ highest combined federal and Ontario individual tax rate
The amount of death benefit the charity receives depends on the investment return on the premium deposits. For example, a higher than projected return could result in a death benefit in excess of the policy's face value of $500,000. Assuming Daisy died at age 78 after paying premiums for 30 years. She would have made a future gift of at least $500,000 for an after-tax cost of $63,180.

Option 2: Name charity beneficiary of the policy, but not owner

Naming one or more charities the beneficiary of a life insurance policy, but not the owner, provides a future gift, future tax savings, and planning flexibility.
The donor simply names one or more charity as the beneficiary on a policy he or she owns. The policy may already be in existence and has outlived its original purpose, or it may be new. Since the donor retains ownership, when the death benefit is paid, the full amount is eligible for a tax receipt that can be claimed on the final two lifetime returns. This gift is a "direct designation" of insurance proceeds, which means the death benefit produces the same tax savings as a gift by will, but the amount is exempt from provincial "probate" fees.

The advantage of this method is flexibility and privacy. Charitable beneficiaries can be changed easily, and, like a bequest by will, there is no obligation to inform selected charities that they are beneficiaries, which ensures privacy in planning. In addition, continued personal ownership of the policy can mean you still have access to cash in the policy, should you need to withdraw it. The final advantage is a receipt for the full death benefit amount. The tax credit can be claimed against tax liabilities in the rest of the estate.

Example:
Don and Kay Johannsen, age 64 and 62, are business owners who are charitable. They expect to have a significant tax bill at death when they pass their Muskoka cottage to their children. They purchase a joint, last-to-die universal life policy with face value of $1 million with annual premiums of $12,440 per annum. It names three charities as beneficiaries. Don and Kay are cautious and want the flexibility to change their mind about beneficiaries
– reserving the right to name a child, for example -- and to borrow from the policy.

Gift at Death of Second Spouse $1,000,000 Tax credit @ 46% on Final T1 $460,000
+ highest combined federal and Ontario individual tax rate

Assuming the second spouse dies in 25 years, the couple would have paid $373,200 in premiums to make a gift of $1 million to their favourite charities. In addition, the tax credit of $460,000 on the final lifetime tax return would offset all of the tax owing on the cottage.