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Tax Letter

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PHILANTHROPIC NEW YEAR'S RESOLUTIONS

Reaching for your chequebook or credit card to make charitable donations is the least tax cost-effective strategy.

We've identified more than 20 ways to be even more charitable – all of them more tax and cost-effective – encouraging you to look around at your loved ones and consider how you can build a more enduring philanthropic legacy. The most important 10 are described below.

Make a new year's resolution to do better and give yourself the gift of even more tax savings.

1. Set Up a Donor Advised Fund (DAF)

DAFs are probably the greatest hidden treasure for philanthropy in Canada. You can establish a DAF as a public foundation – personally, corporately, or both – which will allow you to donate to one entity, receive one tax receipt and subsequently distribute money to any registered charities in Canada. The nice part is that you don't have to decide right away. A DAF is the "light" version of a private foundation, involving far less paperwork, disclosure, and administration, enabling you to donate now (and get a tax receipt now) and then strategically determine where to direct your money. It can be a good complement to many of the donation maximizing strategies below.

2. Donate Appreciated Securities

When you sell stocks, exchange-traded funds, mutual funds or segregated funds at a higher price than you bought them, half of the capital gain is included in your income for tax purposes and thus is taxable. While it's great that a publicly traded security's price went up, these investments are essentially a future tax liability. Fortunately, you can get around this if you donate those stocks "in

kind" to a registered charity or your DAF. In that case, you get a tax receipt for the current fair market value of the donated securities, *and* you pay no tax on any capital gain.

If you have appreciated securities that you want to sell, donating them makes much more sense than selling them, paying the capital gains tax, and donating the cash that's leftover. So, anytime you're thinking about donating, consider whether you have appreciated stocks you can give the charity instead of writing a cheque or charging your gift to a credit card. And if you love the securities so much, you can always buy them back again at the current market value.

3. Donate Savings from Tax-Loss Selling

It's been a challenging year for many investors, unaccustomed to high levels of market volatility. Your portfolio may contain investments in a loss position, and you may have decided to sell some because you don't think they'll recover. Selling at less than your adjusted cost base results in a capital loss that you can apply against capital gains in the prior three years or in any future year. If you save taxes through tax-loss selling, consider donating all or some of the money you save as a moral victory from market challenges.

4. Donate Existing Permanent Life Insurance

If you have a permanent Life Insurance policy that you no longer need, consider gifting it to charity. You have the option of simply changing the beneficiary designation on the policy to the charity, in which case there is no immediate tax benefit, but your estate will receive a donation receipt for the death benefit after you pass away. You can also donate the policy itself to the charity. In that case, you'll get a donation receipt for the fair market value of the policy that you can apply against income tax due on your next tax return. Any premiums you continue to pay on the policy will also receive donation receipts. One note of caution: beware of the "3 year" and "10 year" rules explained below to ensure you get a tax receipt for the fair market value of the policy, not just its cost.

Where a currently owned policy is gifted, the donor must make an absolute assignment (transfer of ownership) of the policy to the registered charity and name the charity as beneficiary in order to obtain a donation tax credit. When a policy is assigned to a charity, any consents required by provincial laws to change a beneficiary must be signed before there is a valid charitable gift. If the donor wants to retain the ability to change the charitable organization that will benefit from the gift, the life insurance policy gift may be made to a community foundation (similar to using a Donor Advised Fund as per #1 above).

In general, where an absolute assignment of a policy is made to a charity, the donor is considered to have made a gift equal to the fair market value of the policy (less any advantage to the donor). Fair market value is a question of fact. The Canadian Revenue Agency (**CRA**) has provided guidance relating to the factors that should be considered in valuing a life insurance policy, in Information Circular 89-3. Such factors include cash surrender value, policy loan value, face value, state of health and life expectancy of the life insured, conversion privileges, other policy terms such as riders, double indemnity provisions and replacement value.

If a gift of a life insurance policy is made immediately after issue or within certain

periods of time, subsection 248(35) of the Income Tax Act (**ITA**) will deem the fair market value of the gift to be less than it otherwise would be. For gifts made within 3 years of purchase – or within 10 years of purchase, if it's reasonable to assume the property was acquired with the intention to make a gift –, subsection 248(35) deems the donation to be the lesser of the fair market value otherwise determined and the cost of the policy. For this purpose, "cost" is defined as the adjusted cost basis of the policy. If a policy is transferred to a private corporation by a shareholder and then given to charity by the corporation within the 3-year or 10-year period, subsection 248(36) deems the lowest amount that is the cost to the shareholder or corporation to be the cost for purposes of determining the amount of the gift. The CRA has stated that this subsection will apply in conjunction with 248(35) on a gift made by the corporation (interpretation #2017-0692361C6).

Fair market value is a question of fact. Consulting a valuation professional for assistance in establishing the fair market value of a life insurance policy is recommended.

The CRA has also confirmed that, in determining the tax consequences of the transfer of a life insurance policy to a charity, ITA subsection 148(7) governs. Under this subsection, the policy transferred by way of gift is deemed to occur at the greatest of:

- the policy's "value" defined in ITA subsection 148(9) as the policy's cash surrender value (**CSV**), or nil;
- the fair market value of consideration, if any, given for the policy (no consideration is given in the charitable context as a receipt is not consideration); and
- the adjusted cost base (**ACB**) of the policy immediately before the transfer

A taxable policy gain and thus an income inclusion would only arise where the operative element is CSV in excess of ACB.

5. Donate Existing Term Insurance

Term insurance provides Life Insurance protection for a specific term, and most people wrongly assume that it has no residual value at the end of that term. However, before a term policy expires you have the option to convert some or all of it to permanent insurance with no medical evidence required. If you don't need the Life Insurance protection for yourself, you can donate the insurance policy to a charity. As with #4 above, you'll get a donation receipt for the fair market value to save you taxes, and any future premiums are tax-deductible charitable donations. The best prospects for this are older people with health challenges. This will provide the best fair market value donation receipt.

6. Donate A New Life Insurance Policy

You can also buy and donate a new Life Insurance policy to your favourite charity. Again, the premiums you pay are charitable donations. And when a charity owns permanent insurance – and this applies to #4 and #5 above as well – it doesn't have to wait for the insured individual to die in order to benefit financially. Instead of reinvesting dividends in additional insurance coverage (which keeps the dividends from being taxed when held outside a charity), the charity can receive the cash dividends every year with no tax consequences. It can also access the cash surrender value (CSV) of the policy with no tax consequences. Either approach

allows the charity to put your legacy gift to work while you are alive to see it.

7. Donate Flow-Through Shares

Flow-through shares are issued by certain resource companies in the mining, oil and gas, renewable energy and energy conservation sectors. They flow through to investors the exploration and development expenses that junior resource corporations can't benefit from claiming, making them a very tax-effective investment. They're also an extremely cost-effective donation vehicle. For example, if an Ontario resident taxed at the highest marginal rate of 53.5% donates cash, the after-tax cost is 49.6%. If that same person donates flow-through shares, the after-tax cost could be as low a 5%-15% based on the availability and jurisdiction. Some examples of flow through share companies are PearTree Canada, Oberon Capital Corporation, Ber Tov Capital, WCPD and more.

8. CPP Philanthropy

If you are "financially fortunate", you probably don't need your Canada Pension Plan (CPP) (or Quebec Pension Plan) benefits to fund your expenses in retirement. That money just gets taxed, invested and taxed again. We call it "The Tax Grind". And it ends when you die.

Instead, you can use only this government-supplied "never spend money" to pay the premiums on a Life Insurance policy. A married couple receiving about $26,000 of CPP benefits annually can purchase approximately $1.4 million in permanent Life Insurance using those funds and now pay no taxes on their CPP income.

9. GPS – Gift Pension Strategy

Create an exceptional charitable gift that combines favourable elements of an Annuity, Life Insurance, Philanthropy and Tax to achieve guaranteed income, maximize legacy gifts, create annual gifts, and save taxes. There are 4 ways to implement the GPS – Gift Pension Strategy. Using a $1 million gift as an example, you can receive guaranteed annual income of more than 9%, donate from $1.63 million to $2.7 million to charity, or leave an additional $1.7 million for your family **plus** a $1 million legacy gift to your favourite charity or DAF.

10. RRSP/RRIF Tax Converter

Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) are great savings vehicles that defer taxes on investment growth, for as long as the money remains within the plans. Eventually, the accumulated money has to come out. And that's when the problem arises – because all the withdrawals are taxed as regular income. In Ontario, high earning taxpayers lose 53.35% of those savings to the CRA. A $2 million RRSP/RRIF is worth only $920,000 to your heirs, though it can be transferred to your spouse's plan, or your children in certain cases.

Consider using the RRSP/RRIF Tax Converter strategy to donate all or part of your RRSP or RRIF to your own charitable fund (Private Foundation or Donor Advised Fund) or favourite charities, leaving nothing to the CRA. Your gift can be amplified further by using some of the transferred money to purchase a Life Insurance policy owned by the charity, your personal foundation or DAF.

THE HIDDEN BENEFITS OF LIFE INSURANCE

Everyone knows what Life Insurance *is*, but very few people know what Life Insurance really *does*.

They mistakenly believe that Life Insurance is only there to replace income, pay off a mortgage, keep food on the table for their families, and protect their kids' ability to get a good education. At the start of their careers, it was a necessity, much like car insurance or property insurance – but now that they've made it, they say it isn't important.

What most people don't know is that Life Insurance is an extremely flexible tool that complements all the other financial planning strategies they have in place. It has myriad applications, especially for people who have wealth to protect and are interested in creating a legacy for their families and the charitable causes they support.
This article illustrates just a few of the many ways that Life Insurance can be leveraged to support two key goals shared by many high-net-worth individuals – to pay less tax and leave a bigger legacy. We'll use a typical client example, but keep in mind that each of these strategies can be customized and targeted to achieve very specific objectives.

From success to significance

Bob and Cindy built a thriving business from the ground up. They are 63 and 60, with four children and eight grandchildren. They are pillars of their community and support their local hospital and various other charitable causes.

Their net worth of more than $120 million consists of real estate investments and corporate assets. Their current planning includes a very generous (and unintentional) tax liability of $25 million, due after the second spouse dies. That bill can be funded in several ways. Three of the most common are:

- Using cash on hand – though this would require $41.2 million in pre-tax cash from the corporation, assuming the eligible dividend tax rate of 39.34 percent.
- Borrowing – but an estate may struggle to access that much credit, and high interest rates may take a big bite out of inheritances. As well, the interest is not deductible and the loan must be paid back.
- Selling assets - most people don't want to risk a "fire sale" that doesn't provide fair market value, as well as the fact that there are many additional tax consequences when assets are sold.

Fortunately, there is a fourth and better option. Dedicating a Life Insurance policy to the task of paying estate taxes, which is usually much less expensive and more tax effective. Life Insurance, when corporately owned, can be paid for with cheaper after-tax corporate dollars. It also provides a mechanism for getting money out of your corporation tax-free through the capital dividend account (CDA).

Five ways Bob and Cindy can use Life Insurance to pay estate taxes – and more

1. Cover the tax bill

Purchasing a $25 million Life Insurance policy will take care of the taxes for a lot less than doing nothing. Funding options include an annual premium of $334,592 payable for life, an annual premium of $372,935 payable to age 85, or an annual

premium of $675,000 payable for 10 years only. The highest amount this couple could pay after 10 years is $6.75 million – vastly less expensive than $41.2 million.

2. Cover the tax bill with financing

It's also possible to acquire a $25 million Life Insurance policy in a manner that's cash-flow neutral, using the Immediate Financing Arrangement (IFA) strategy. A policy's cash surrender value (CSV) is welcomed as security by all Canadian chartered banks. If Bob and Cindy are comfortable with financing, they can pay the premiums and immediately borrow back up to 100 % of the premiums paid, and invest the loan proceeds.

Because the money gets invested, they can deduct the interest expense. This arrangement can be structured in a cash-flow neutral manner, and their estate still receives the full $25 million to take care of the estate taxes. If the insurance policy is corporately owned, their corporation receives an additional Capital Dividend Account (CDA) credit of $24.8 million, allowing a future tax-free withdrawal of $24.8 million for the next generation.

3. Cover the tax bill and maximize charitable giving

We are dealing with a very community-minded couple who want to leave a significant charitable legacy. They can leave a big gift, at the same time eliminating estate taxes. By buying a $50 million Life Insurance policy at a cost of $1.3 million annually, the total cost will only be $13 million, payable over 10 years. At death, the estate will receive the money and donate it to the couple's charitable foundation – generating a $50 million tax credit that mitigates the estate taxes and turns it into charity instead.

4. Cover the tax bill and maximize charitable, with financing

This strategy can also be made cash-flow neutral. Just as in strategy #2 above, Bob and Cindy can pay the premiums and immediately borrow back the policy's CSV, invest that money, and deduct the interest expense. In this case, the charity receives the full $50 million, entirely offsetting the estate taxes. Again, assuming this is a corporately owned policy, the corporation gets an additional CDA credit of $49.7 million.

5. Generate cash flow for a charity with the GiftMAXIMIZER strategy

People think that Life Insurance only provides a benefit when the insured dies. But there are actually two ways to benefit from Life Insurance for charity while the insured is alive! We call this the GiftMAXIMIZER strategy.

Our generous couple can donate, for example, $500,000 annually to their foundation, Donor Advised Fund or directly to a charity for 10 years. Their total net cost after the annual charitable donation tax credits amounts to $2.5 million. The foundation can use the funds to pay premiums on a joint last-to-die Life Insurance. Dividends paid out from permanent Life Insurance are usually used to buy Paid up Additions, which increase the death benefit and CSV. But the dividends can be taken out as cash dividends and given to charity every year tax-free.

Starting as early as the first year of the policy, the charity can begin to receive annual tax-free cash dividends. But waiting

until year 10 means that those dividends won't reduce the legacy gift on death. At that point, the charity can begin to receive annual tax-free cash dividends that start at $162,000 and increase annually until the second spouse dies.

In the end, in exchange for a net investment of $2.5 million over 10 years, the charity could receive $5 million from annual dividends and a substantial legacy gift on death of $7.7 million in insurance proceeds. That's $12.7 millions of charity at a cost of $2.5 million.

Get Professional Help

Don't go it alone. Get the benefit of experience and knowledge from insurance professionals who can assess your needs and suggest appropriate strategies. Simply getting insurance in place isn't enough. Get the right types of insurance in the right amounts, with the help of professionals who will be there to advocate for you in the event a claim is made.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.