



Use of life insurance to minimize taxation at death

Many individuals with sizeable estates are faced with the prospect of the tax timebomb where certain assets accumulated while alive, such as small business shares and RRSPs/RRIFs, are subject to a significant tax liability at time of death. In some cases, the income tax liability is so large that the estate has to liquidate assets in order to pay the tax.

This is often both impractical and undesirable for shares in private corporations such as farming and ranching operations. The major exception to the deemed disposition rules at death is if the property is bequeathed to a spouse, either directly or through a qualifying spousal trust. If assets are transferred to a spouse or spousal trust, the capital gain arising on death is effectively deferred until the surviving spouse dies.

Once the income tax liability has been quantified, steps can be taken to fund the liability. In many cases, there are insufficient liquid assets to either fully cover the income tax liability or leave the estate with enough net assets to distribute funds to the beneficiaries in sufficient quantity to satisfy the wishes of the deceased. In most of these cases, the use of life insurance to fund the income tax liability should be considered -- especially those where the estate is comprised mostly of non-liquid assets which are to be bequeathed, in their current form, to the beneficiaries. This is especially the case with farming and ranching families. Most assets are non-liquid and having to sell the assets can result in a very undesirable situation. Consider current market conditions. If you were forced to sell your cattle during a market such as the present, this would result in a significantly lower value than planned.

When utilizing the spousal rollover to defer the income tax liability until the death of the surviving spouse, one cost-effective method to plan for the funding of the income tax liability is to use joint-and-last-to-die life insurance. This type of policy pays amounts to the beneficiaries when the last of two people dies, which coincides perfectly with the timing of the need. Compared with policies that insure only one life, joint-and-last-to-die policies are often very cost effective. This is because the risk is spread across two lives and thus the insurance companies are able to offer lower prices to reflect this decreased risk. Also, because the benefit is paid out upon the second spouse's death, there is a longer time frame, also contributing to the lower risk.

If there is no spousal rollover, and the desire is to leave, for example, private company shares directly to the children of the deceased, life insurance on the parent can be used to cover off the tax owed by the estate. When utilizing life insurance to fund the expected income tax liability arising on death, the beneficiary of the policy should generally be the estate to ensure funds are readily available to the personal representative to fund the liability.

Charitable donations to reduce tax

Until 1996, charitable donations weren't a major consideration as a means of reducing taxes in the year of death because the amount eligible for the donation tax credit was limited to a maximum of 20 per cent of the individual's net income for the year, with a one-year carryback.

Effective for 1996 and subsequent taxation years, the rules have been amended to allow charitable donations of up to 100 per cent of net income to qualify for the tax credit in a taxpayer's year of death with excess donations still eligible for the one-year carryback. The 2000 Federal budget allowed donors to name charities as beneficiaries and as such be entitled to a full tax credit when the death benefit is finally paid to the charity. These changes made planned giving using life insurance very attractive to potential donors. These tax changes give rise to a potentially major estate planning opportunity.

Every effort has been made to ensure accuracy, but errors and omissions are possible.



An example

Assumptions:

- A father who owns a family farm wishes to gift the shares to his children through a provision in his will.
- He would like to eliminate the capital gains taxes payable at his death in respect of the shares.
- When he passes away, the taxable capital gains reportable on the deemed disposition of shares on death is \$500,000 and tax owing on this amount is \$250,000 (assuming a 50-per-cent marginal tax rate).

Solution:

- A life insurance policy for \$500,000 payable to a selected charity
- A clause directing his personal representative(s) to make any election under the Income Tax Act to reduce taxes.

Result:

At death, the life insurance proceed will be paid directly to the charity and will be considered a donation by father in the year of death. The tax receipt issued for the donation by the charity will qualify for a tax credit that can be used in the deceased's tax return. This tax credit has completely eliminated the tax liability on the shares at death and the value of the estate is preserved. The premiums for the life insurance are paid with a relatively small percentage of the funds that would otherwise have been used to pay the taxes owing.

It should be emphasized that it would require less life insurance coverage to simply pay the taxes owing at death as compared to using the life insurance proceeds for charitable donations to eliminate the tax liability.

However, by naming the charity as the beneficiary of the life insurance policy owned by the donor, the proceeds are not exposed to probate fees as prescribed under the applicable provincial rules and creditors of the donor have no right to the funds payable under the policy if the donor dies indebted.

The use of life insurance in the context of charitable giving at death will appeal to those individuals who want to reduce or eliminate taxes at death and/or who have a strong desire to make a bequest to one or more charities. This opportunity should be considered in the bigger context of planned giving options that are available to the prospective donor both during his or her lifetime and at death.

The following chart shows three different options:

Option 1: For those who don't wish to make a donation, nor purchase insurance.

Option 2: Purchasing enough life insurance to pay the tax liability.

Option 3: Purchasing life insurance equal to the taxable gain, and naming the charity as beneficiary of the death proceeds.



The results are that with option 3, the individual is able to retain most of the estate, significantly reduce the tax liability, and make a significant donation a favorite charity.

	1 No donation No insurance	2 Buy insurance to pay tax liability	3 Donation equal to full taxable gain (charity is named beneficiary)
Taxable income	\$500,000	\$500,000	\$500,000
Tax liability (50%) before donation	\$250,000	\$250,000	\$250,000
Tax credit	\$0	\$0	\$250,000
Taxes owing	\$250,000	\$250,000	\$0
Remaining estate value	\$250,000	\$500,000	\$500,000
Donation to charity	\$0	\$0	\$500,000

Excludes opportunity cost of life insurance premiums and value of any other assets in the estate.

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The above should not be taken as providing legal, accounting or tax advice. You should obtain your own independent professional advice from your lawyer and/or accountant to take into account your particular circumstances.