

Charitable annuities: Small benefit for charities, no benefit for clients

The good old days

Prior to Dec. 21, 2002, charitable gift annuities (where periodic payments are made to a donor in return for the donation) were a potentially lucrative strategy for clients to support a charity. If the donor was old enough and the donation large enough (so the value of the payments didn't out-weigh the donation), payments could be tax-free to the donor. Neither the charity nor life insurance company had to report taxable income to the donor or government for the periodic payments. Sometimes the donor also received a charitable donation receipt for some part of the amount given to the charity.

The government taketh away

The federal government changed this after Dec. 20, 2002 with changes to the Income Tax Act. Out-of-date publications may indicate this situation still exists (they reference the 1983 individual annuitant mortality table to calculate how much of the charitable gift annuity payment is tax-free).

Now, there are no financial benefits to a client donating to a charity in return for a charitable gift annuity because charities can only issue a tax receipt for the amount of the donation less the current market cost of an annuity. Also, all or part of the annuity payments are taxable when the charity or life insurance company makes them.

Annuity payments made by a charity or insurance company as part of a charitable gift annuity are taxable to either or both the charity and taxpayer. They could be taxed as a prescribed annuity contract (PAC), or not. It all depends on how the annuity is set up.

Four unique scenarios

In 2003, the Canada Revenue Agency (CRA) provided guidance on how charitable gift annuities purchased after Dec. 20, 2002 are taxed.

Consider a situation where a client donates \$100,000 to a charity with an annuity that will pay the client \$7,700 per year as long as the client is alive. The cost of a commercial annuity to make the annual \$7,700 payments is assumed to be \$52,300. The mortality table prescribed by income tax regulations produces an expectation of life of eight years for the client.

Prior to Dec. 21, 2002, the charity would have issued a donation tax receipt for \$38,400 [$100,000 - (7,700 \times 8)$] and the entire amount of the annuity payments would have been tax-free.

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Scenario one: The charity accepts the donation and makes the annuity payments

The charity issues the annuity and the client is owner and annuitant. The charity could issue a donation tax receipt to the donor for \$47,700 [\$100,000 - \$52,300]. If the annuity meets all the other requirements for a PAC then \$1,162.50 of each year's annuity payment will be taxable to the annuitant.

The charity will determine the taxable portion of each annuity payment, issue a T4A to the client for the taxable amount each year and file the same information with the CRA each year. If the client resides in Quebec, the charity will also issue the appropriate Quebec tax slip and send the same information to the Ministère du Revenu du Québec (MRQ).

Although a lot of work for charities, some, including larger hospital foundations and universities, still enter into these arrangements.

Scenario two: The charity accepts the donation, purchases an annuity from an insurance company and pays client annuity payments

For the charity to avoid the risk of the client living too long, there are two annuities, one between the charity and client and one between the charity and the life insurance company. The charity would use \$52,300 to purchase the annuity from the life insurance company and can issue a donation tax receipt for \$47,700. The annuity between the charity and the client would have the same tax consequences and reporting responsibilities for the charity as in scenario one. The annuity between the charity and the insurance company would be subject to accrual taxation. The insurance company would compute the amount of accrued income each year and issue a T5 to the charity and report the income to the CRA each year.

Note: The same responsibilities and tax reporting would exist if the charity purchased the annuity from an insurance company and directed the company to make the annuity payments directly to the client. Unless the charity can demonstrate it's acting as an agent for the client when purchasing the annuity, the CRA deems it to be the owner of the annuity issued by the insurance company, and the charity is deemed to be paying an annuity to the client.

An advisor should recommend charities not enter these arrangements so they can avoid having to compute and report the taxable amounts of annuity payments each year.

Scenario three: The charity acts as an agent for the client to acquire an annuity for the client from a life insurance company

The CRA stated the responsibilities and tax treatment of annuity payments would depend on the terms of the relationship between the charity and client. If there's a clear principal and agent relationship, it's possible the annuity could be viewed as the client having purchased the annuity directly (which would result in PAC treatment, provided all other conditions for PAC are met). In this case the taxation and responsibilities would be the same as in scenario four (below).

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Unfortunately, no guidance was provided on what would be required for the charity to demonstrate a clear principal and agent relationship. If the charity can't clearly demonstrate they're acting as an agent for the client, the arrangement would produce the same taxation and responsibilities as scenario two.

If the charity wishes to proceed with this approach an advisor should recommend a charity obtain legal and tax advice on what documentation it must obtain to meet the CRA requirement of a principal and agent relationship between the charity and client with respect to acquiring an annuity for the client.

Scenario four: The client purchases an annuity from a life insurance company and donates the balance to charity

The donor would purchase an annuity from the insurance company for \$52,300 and donate \$47,700 to charity. The charity would issue a donation tax receipt for \$47,700. If the annuity meets all other requirements for a PAC then \$1,162.50 of each year's annuity payments would be taxable to the annuitant and the insurance company would report to the client on a T4A and to the CRA. If the client resides in Quebec, the insurance company will also issue the appropriate Quebec tax slip and send the same information to the MRQ.

Advisors should recommend this structure if the charity doesn't want to take on the risk that the client will live too long, or compute the taxable income from the annuity payments and do the tax reporting each year.

When a charity purchases an annuity, two other considerations may create adverse financial consequences for the client.

Firstly, it may compromise the PAC treatment of the annuity because a required condition to qualify as a PAC is that the annuity owner must also be the annuitant. Involving the charity may cause CRA to deem the charity to be the owner and the client the annuitant. Not qualifying as a PAC means accrual taxation applies, resulting in a much higher income reported for tax purposes in the early years of an annuity.

Secondly, the draft legislation deems no gift to have been made if the value of the annuity is 80 per cent or more of the value of the donation. If the annuity's current market value was \$85,000 and the donated amount is \$100,000, there will be no receipt issued in a charitable gift annuity situation. In scenario four however, the client donates the \$15,000 difference and receives a receipt.

Summary

The only benefit of charitable gift annuities versus a client annuity purchase remaining after Dec. 20, 2002 is for charities. In scenarios one, two and three, the charity receives the total donation and pays out a small portion periodically and takes the longevity risk, or pays out the cost of annuity. The charity is certain it will keep the portion that remains. In scenario four, the charity isn't 100 per cent certain the difference will be donated to it.

Charitable annuities create additional work (computation of taxable income and tax reporting) for the charity, offer no financial benefits to the client and no difference in money available for use by the charity. Scenario four would be the most widely applicable.

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