

## The Taxation of Charitable Annuities

Many Canadians have philanthropic goals. Canadians want to contribute to the well being of their communities, and one way of doing this is to make a donation to a charitable organization. We have seen significant changes to the tax rules relating to charitable giving in recent years. Tax considerations no doubt have some bearing on how taxpayers will structure their charitable giving. This edition of *Taxing Issues* focuses on the tax consequences relating to charitable annuities, as this is an area in which we have seen especially significant changes.

This document refers to “prescribed annuities” (PACs) and “non-prescribed annuities.” For detailed information on the tax rules applying to these types of annuities, we refer you to our separate *Taxing Issues* documents: *The Taxation of Personally Owned Non-Registered Prescribed Annuities* [PC 5998] and *The Taxation of Personally Owned Non-Registered Non-Prescribed Annuities* [PC 6000].

### I. Brief Overview of Charitable Annuities

Individuals wish to make charitable donations, but need to balance this desire with their need to have funds available for their personal and living expenses. Charitable annuities are a solution worth considering in these circumstances. An individual could make an irrevocable contribution of capital to a charitable organization. At the same time, the charitable organization would undertake to make guaranteed payments of a specified amount to the individual for some period, perhaps even the individual’s lifetime. In these circumstances, the charitable organization is essentially issuing an annuity to the individual. These arrangements are described as “charitable annuities”.

By way of background, there had been a number of court cases that called into question whether the traditional meaning of “gift” under common law was still the appropriate standard (i.e., that no advantage or benefit could be received by the donor). Also, there were issues in that with the traditional definition of “gift” there could not be any consideration, even partial consideration. Given the above, the government decided that it would be appropriate to review the tax rules relating to charitable giving.

Complicating the situation was the fact that Quebec has a different set of rules. Under the Civil Code of Quebec (Civil Code), an individual could sell property to a charity for less than its Fair Market Value (FMV), with the difference being considered a donation.<sup>1</sup> Thus, taxpayers in different parts of Canada were being treated inconsistently.

As a consequence of this review, on December 20, 2002, the Department of Finance (Finance) released proposed amendments to the ITA. When we look at the Technical Notes that accompanied the proposed amendments, Finance summed up the situation as follows:

“At common law, it is generally the view that a gift includes only a property transferred voluntarily, without any contractual obligation and with no advantage of a material character returned to the transferor ...

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<sup>1</sup> See section 1806 of the Quebec Civil Code.

At common law there is generally no ability to separate the rights of ownership of a single property in the course of making a gift. As such, at common law a contract to dispose of a property to a charity at a price below fair market value would not generally be considered to include a gift.

Nevertheless, there have been certain decisions made under the common law where it has been found that a transfer of property to a charity was made partly in consideration for services and partly as a gift.”<sup>2</sup>

The December 20, 2002 proposals are referred to as the “split-receipting” rules. The intent of the rules is to put individuals in the common law provinces on the same footing as those in Quebec. More importantly, the new rules allow the taxpayer to rebut the presumption that no gift was made when any form of consideration or benefit was received when the donation was made. (The new tax rules override the application of the common law principle to provide that a donation is still considered to be made in situations where the donor has received an “advantage”.) Finally, the intention is to provide clarity on the application of these rules.

On December 24, 2002, the Canada Revenue Agency (CRA) announced that the administrative position for charitable annuities was to be withdrawn for annuities issued after December 20, 2002. (The administrative position would, however, continue to apply to charitable annuities issued before December 20, 2002.<sup>3</sup>) CRA conceded that the administrative position had no basis in law. An administrative position would no longer be required, given that the “split-receipting” rules would address the taxation of charitable annuities.

When Finance released the proposed legislation in 2002, it announced a consultation period. Updated draft legislation was released in July 2005.<sup>4</sup> While the legislation has not been enacted, when we look at various technical interpretations that CRA has issued subsequent to the release of this legislation, we see that it is in fact applying this proposed legislation.

Take care when implementing charitable annuities. Review the constating documents of the charitable organization (letters patent, articles of incorporation, etc.) to ensure that the organization has the corporate powers to issue annuities. CRA has a long-standing position of not allowing charitable foundations to issue charitable annuities, since the foundation would be considered to incur a debt were it to issue an annuity. Thus, foundations risk revocation of their registered status. Registered charities that are not foundations are not, however, prohibited from issuing annuities.<sup>5</sup>

Note that there are essentially three types of charities – charitable organizations, public foundations and private foundations. The designation of a charity depends on its structure, its source of funding and its mode of operation. There are different tax rules relating to each. Charitable organizations primarily carry on their own charitable activities. Public foundations must give more than 50% of their income to other qualified donees, usually other registered charities. Private foundations may either carry on their own charitable foundations or may give funds to other qualified donees, usually other registered charities.<sup>6</sup>

It’s also important to review applicable federal and provincial legislation to ensure that there are no limitations that would prohibit the charity from getting involved in the annuity business.

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<sup>2</sup> See Draft Technical Amendments and Explanatory Notes to Amend the Income Tax Act, as issued by the Department of Finance on December 20, 2002. In particular, refer to the Explanatory Notes for subsections 248(30) to (38).

<sup>3</sup> See Income Tax Technical News 26 (ITTN-26), as issued December 24, 2002.

<sup>4</sup> See proposed subsection 248(30) to (41), as contained in the Revised Legislative Proposals Released Relating to the Taxation of Non-Resident Trusts and Foreign Investment Entities and Other Technical Amendments to the Income Tax Act, as released by Finance on July 18, 2005 (July 2005 Technical Amendments).

<sup>5</sup> See CRA document # April 1991-73, dated April 1991.

<sup>6</sup> See page 8 of CRA Guide - *Registering a Charity for Income Tax Purposes* (Form T4063).

## II. Annuities Issued Prior to December 21, 2002

CRA has long sanctioned the issuance of charitable annuities. The tax treatment was outlined in an interpretation bulletin first issued in 1973. The most recent version was issued on September 22, 1995. It spells out the rules for annuities issued up to and including December 20, 2002.<sup>7</sup>

Assuming that there are no prohibitions vis-à-vis the issuance of the annuity, the rules are relatively straightforward. We can look at the example from the interpretation bulletin. CRA assumed that \$60,000 was to be donated by a male who would be 81 years old at the end of the year in which the donation was made. The charitable organization undertook to pay him \$5,000 each year for as long as he lived.

This individual will be considered to have made a donation, with this being calculated as follows:

Total contribution to charitable organization:	\$60,000
Less: Annuity payments to be received over donor's expected life	
\$5,000 x 9 years	<u>(45,000)</u>
Amount for which donation receipt can be issued	<u>\$15,000</u>

In the above example, the life expectancy of 9 years has been determined by looking at the 1983 *Individual Mortality Table*, as issued by the Society of Actuaries. (Similar tables are available for joint life and survivorship annuities and annuities with guaranteed periods.)

When we look at how the \$5,000 annual annuity payment is to be taxed to the individual, CRA has stated that:

“No part of the annuity payment is required to be included in income even if the annuitant should live for more than 9 years, since the sum of the annuity payments the annuitant is expected to receive is less than the amount the annuitant paid to acquire the annuity.”<sup>8</sup>

CRA has based this position on the fact that if the term of the annuity is less than life expectancy or the annuity is for life, the annuity payments clearly represent a return of capital. Furthermore, if the annuity is for the life of the individual, it is expected that the annuity payments will be only a return of capital.<sup>9</sup>

We presume that since the person may live longer than the mortality tables suggest, CRA's view is that the only reasonable way to determine the amount of the donation for tax receipt purposes is by using the donor's life expectancy. No doubt some annuitants will enjoy many more years of tax-free income than is calculated at the outset. On the other hand, if our 81-year old male lived only 2 years and thus received only \$10,000 of tax-free annuity payments, his executors cannot go back to the charity and ask for a larger tax receipt!

Charitable organizations issuing such annuities need to determine what steps they will undertake to ensure that their own risks are managed. Some organizations will take the donated funds and invest them. This will be the source the charitable organization uses to make the annuity payments. The organization will obviously have to bear the risk of the donor (annuitant) living beyond the life expectancy per the CIA tables. (The charitable organization could avoid this risk by acquiring an annuity from an insurer. In this

<sup>7</sup> See Interpretation Bulletin 111R2 – Annuities Purchased from Charitable Organizations, dated September 22, 1995.

<sup>8</sup> See paragraph 6 of IT-111R2.

<sup>9</sup> See paragraph 3 of IT-111R2.

case, the annuity payments the organization receives are used to fund the annuity payments it has undertaken to make to the donor.)

It is interesting to note that CRA has confirmed that where a Canadian charitable organization made annuity payments in respect of a pre-December 21, 2002 charitable annuity to a non-resident of Canada, no non-resident withholding tax would be required in respect of these payments.<sup>10</sup>

### III. Annuities Issued After December 20, 2002

As stated above, the “split receipting” rules come into play for charitable annuities issued after December 20, 2002. Thus, the amount for which a tax receipt may be issued will be determined under the new rules. Furthermore, it will be necessary to determine how the annuity is characterized for tax purposes, and to then apply the appropriate tax rules to the taxation of the annuity payments. The annuity payments that the donor receives will generally have a taxable portion. (We note that where the charitable annuity qualifies as a prescribed annuity, and this annuity is issued at a higher age, the taxable portion may in fact be nil.)

#### (A) Determination of the Amount of the Donation

The new rules require that the amount “donated” to the charity be “split” into two. The “advantage” that the donor enjoys will have to be determined. A tax receipt can then be issued for the remainder. The proposed legislation provides that:

“The eligible amount of a gift or a monetary contribution is the amount by which the fair market value of the property that is the subject of the gift or monetary contribution exceeds the amount of the advantage, if any, in respect of the gift or monetary contribution.”<sup>11</sup>

It also provides that:

“The total amount of the advantage in respect of a gift or monetary contribution by a taxpayer is the total of

- (a) the total of all amounts, other than an amount referred to in paragraph (b), each of which is the value, at the time the gift or monetary contribution is made, of any property, service, compensation, use or other benefit that the taxpayer, or a person or partnership that does not deal at arms’ length with the taxpayer, has received, obtained or enjoyed, or is entitled, either immediately or in the future and either absolutely or contingently, to receive, obtain or enjoy
  - i. that is consideration for the gift or monetary contribution,
  - ii. that is in gratitude for the gift or monetary contribution, or
  - iii. that is in any other way related to the gift or monetary contribution,and
- (b) the limited-recourse debt ... in respect of the gift or monetary contribution at the time the gift or monetary contribution is made.”<sup>12</sup>

The “advantage” that the donor receives is the stream of annuity payments that the donor expects to receive from the charitable organization. Hence, a value will have to be assigned to this “annuity”. When CRA provided an overview of the new rules in December 2002, it indicated that the advantage would be “the amount that would be paid at that time to an arm’s length third party to acquire an annuity to fund the

<sup>10</sup> See Technical Interpretation # 2005-0145151E5, dated December 20, 2005.

<sup>11</sup> See proposed subsection 248(31) of the July 2005 Technical Amendments.

<sup>12</sup> See proposed subsection 248(32) of the July 2005 Technical Amendments.

guaranteed payments”.<sup>13</sup> Hence, we could look at how much would be paid to an insurer for such an annuity.

If we look at the current cost of a prescribed annuity paying \$5,000 per annum to our 81-year old, we arrive at an “advantage” of approximately \$37,700.<sup>14</sup> Hence, our taxpayer would receive a donation receipt for \$22,300 (for the \$60,000 donation, less the amount of the “advantage” of \$37,700).

In the above example, the \$37,700 represents the cost of an annuity stream guaranteed for life. CRA has confirmed that “from the donor’s perspective, it is the arrangement between the donor and the charity that will determine the tax implications to the donor”.<sup>15</sup> Thus, where the charity to guarantees to make annuity payments for only a finite period (say, the 9 years the donor is expected to live, per the 1983 tables), it would be cost of an annuity providing this payment stream that would be used in determining the “advantage”.

CRA has indicated that Finance will not be developing any regulations that will specify how the “advantage” is to be determined for charitable annuities. CRA suggests that the advantage could be determined by obtaining quotations from insurance brokers or insurance companies.<sup>16</sup>

There are situations in which it may not be possible to obtain a quote from an insurer, for example, for prescribed annuities to annuitants over the age of 90. Here, CRA has stated that it may be reasonable to use a quotation for a non-prescribed annuity, when calculating the advantage. Also, for smaller annuities, it would be appropriate to “scale down” the quote.<sup>17</sup>

#### (B) Taxation of the Annuity Payments to the Donor

Under the old rules, the donor would have received the annuity payments from the charity on a tax-free basis, as these were considered by CRA to be a return of capital. Under the new rules, the charitable annuity will have to be characterized for tax purposes (e.g., is it a “prescribed annuity contract” (PAC), non-prescribed annuity, etc.). The appropriate tax rules will then come into play.

Under the tax rules, only specific types of entities are permitted to issue “prescribed annuities”. Registered charities are amongst the permitted issuers.<sup>18</sup> Thus, where the annuity met all the terms and conditions required for prescribed annuity status, this is the basis on which the annuity payments will be taxed. (For additional information on prescribed annuities, please refer to our Taxing Issues on this item [PC 5998].) The annuity will be taxed on a proportional basis.<sup>19</sup> For the \$5,000 prescribed annuity payment to our 81-year old male, the actual taxable portion for a prescribed annuity with a 0 guaranteed period is nil. (Where the annuity is issued to a donor at a higher age, the taxable portion could well be 0 or some nominal amount.) CRA has indicated that where the charity issues the annuity, it is responsible for issuing a tax slip on which the taxable portion is reported.<sup>20</sup>

If the charitable annuity issued by the charitable organization itself is not a “prescribed annuity,” it will be taxed under the accrual rules provided at subsection 12.2(1).

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<sup>13</sup> See page 10 of ITTN-26, dated December 24, 2002.

<sup>14</sup> This amount is calculated as at April 24, 2006, and represents the cost of a prescribed annuity with 0 guaranteed period paying \$5,000 per annum, with the annual payments commencing in 12 months time. (If payments of \$416.67 per month were to be made, starting one month after acquisition, the cost of such a prescribed annuity would be \$39,500, again assuming 0 guaranteed period.)

<sup>15</sup> See Technical Interpretation # 2003-0000605, dated December 17, 2003.

<sup>16</sup> See Technical Interpretation # 2003-0008415, dated April 17, 2003.

<sup>17</sup> See Technical Interpretation # 2003-0009195, dated November 18, 2003.

<sup>18</sup> See Section 304 of the Income Tax Regulations.

<sup>19</sup> See Technical Interpretation # 2003-000605, dated December 17, 2003.

<sup>20</sup> See Technical Interpretation # 2003-0000605, dated February 17, 2003.

CRA does, however, contemplate situations where the charity takes some of the money from the donor and purchases an annuity from an insurer on behalf of the donor. Here, the charity is the donor's agent. The charity could instruct the issuer to make the annuity payments directly to the annuitant. Where this arrangement is properly structured, it is CRA's view that:

"If there is clearly a principal and agent relationship between the donor and the charity, the donor would be viewed as having purchased a commercial annuity directly from the commercial annuity provider. The annuity would be a PAC if it otherwise satisfies the conditions in subsection 304(1) of the Regulations ..."<sup>21</sup>

Thus in an agency situation it is clear that the annuity could be issued by a commercial issuer (e.g., insurer), and the taxation of the annuity payments would be determined based on how the annuity was characterized for tax purposes. Where the annuity is not a prescribed annuity, the taxation rules relating to non-prescribed annuities would come into play.<sup>22</sup>

#### (C) Charity Funds Annuity to Donor by Purchasing Another Annuity

Earlier in this document we indicated that the charitable organization has to make a decision as to whether it will accept the risk of issuing the annuity. In order to minimize the risk, the charitable organization may purchase an annuity from an insurer or some other issuer of annuities. This may be thought of as a type of back-to-back arrangement.

Thus, we have the "charitable annuity", where the charitable organization is making annuity payments to the donor. This "charitable annuity" is funded by payments from an annuity that the charitable organization has itself purchased. Under current tax rules, this second annuity would most likely be characterized as a non-prescribed annuity, with the accrual rules in subsection 12.2(1) coming into play. Since, however, the charitable organization is a non-taxable entity, payments received by it would not be subject to tax.

#### (D) Charity Purchases Annuity and Arranges for Payments to be Made to Donor

A charitable organization may purchase an annuity on its own behalf, say from an insurer, and may direct the insurer to make payments and report income directly to the donor. Here, the insurer would be making payments to the donor in satisfaction on the charity's obligations to the donor.

CRA, when asked about such an arrangement, stated that in determining the tax implications to the donor and the charity it would be necessary to look at three items:

- 1) the terms of the donor's arrangement with the charity;
- 2) the charity's arrangement with the annuity provider, and
- 3) perhaps even the donor's arrangement with the annuity provider.<sup>23</sup>

The specifics of the terms between all the parties would determine the tax implications to the charity and the donor, including tax reporting obligations.

#### (E) New "80% Rule" for Determining Whether a Charitable Donation has been Made

The proposed rules provide that the "advantage" that the donor receives should not represent more than 80% of the "donation".<sup>24</sup> Let's look at our 81-year acquiring the charitable annuity. He donated \$60,000 to the charity and we determined that the cost of acquiring a prescribed annuity would have been \$37,700,

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<sup>21</sup> See Technical Interpretation # 2003-0008195, dated October 27, 2003.

<sup>22</sup> See subsection 12.2(1) of the ITA.

<sup>23</sup> See Technical Interpretation # 2003-0008195, dated October 27, 2003.

<sup>24</sup> See proposed paragraph 248(30)(a) of the July 2005 Technical Amendments.

or 63% of the amount of the donation. Thus, our donor will be considered to have made a gift, and will receive a donation receipt for the \$23,300.

Where, however, in our example the cost of acquiring the prescribed annuity exceeded \$48,000, the “advantage” would exceed 80% of the donation. Hence, the donor will have to establish to the satisfaction of the Minister of National Revenue that the transfer was made with the intention of making a gift.<sup>25</sup> Thus, the donor would have to make an application to CRA in order to have any part of the “donation” accepted as a donation for which a tax receipt may be issued.

Finance has conceded that the tax savings arising from the charitable donation are not considered an “advantage” under the new rules.<sup>26</sup>

#### **IV. New Approaches in a post-December 20, 2002 Environment**

Donors considering acquiring charitable annuities after December 20, 2002 will have to assess how the new rules will apply to them. The charitable organization clearly would have to do the same.

The donor (and their advisor) will want to assess the tax consequences in the year of the donation, as well as in subsequent years. Our 81-year old would have received a tax receipt for \$23,300 in the year the donation was made. Also, he became an annuitant under a prescribed annuity for which the taxable portion was nil. Thus, no taxes would be payable on the annuity income stream.

One of our donor’s concerns may be whether he has sufficient income in the year of the donation in which to claim the non-refundable tax credits relating to the donation. For most gifts, the non-refundable credit may only be claimed in respect “total gifts” not exceeding 75% of net income. Of course, there is a 5-year carry-forward period for donations (in the year of death a 100% of net income limit applies).<sup>27</sup> (Donations made in the year of death are subject to the same 100% of net income limit, and may also be carried back one year, with a 100% of net income limit applying in that preceding year.<sup>28</sup>)

If the donor had concerns about being able to use the tax credits in the year (or within the carry-forward period), another approach he could take is to acquire the annuity directly and then each year donate an amount to the charity from his after-tax income. The charitable organization could, of course, be named the beneficiary under the policy, if the annuity has a guaranteed period or some form of death benefit.

Where the donor is contemplating an arrangement where the charity issues the charitable annuity, the permanence of the arrangement is a significant consideration. Where the donations are instead being made on an annual basis the donor could cease to make donations, should his financial situation change. The donor is also able to change the charity the donations are directed to.

Our donor (and the donor used in the CRA examples) is an 81-year old male. If we reduce the donor’s age by 5 years, the “advantage” increases from \$37,700 to \$45,700. Another 5-year reduction in age sees the “advantage” increase to \$54,000. Thus, our 76-year old “donating” \$60,000 to the charitable organization would receive a tax receipt for \$14,300. However, our 71-year old would receive a donation receipt for only \$6,000, assuming that he made successful application to the Minister of National Revenue to rebut the presumption that with an “advantage” in excess of 80% of the donation, a donation was indeed made. (Since \$54,000 is 90% of the \$60,000 “donation”, he would have failed the new 80% test).<sup>29</sup>

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<sup>25</sup> See proposed paragraph 248(30)(b) of the July 2005 Technical Amendments.

<sup>26</sup> See Explanatory Notes to Legislative Proposals Relating to Income Tax, as issued by the Department of Finance on July 18, 2005. In particular refer to Explanatory Notes for subsection 248(30).

<sup>27</sup> See “total gifts”, as defined in subsection 118.1(1) of the ITA.

<sup>28</sup> See subsection 118.1(4) of the ITA.

<sup>29</sup> This amount is calculated as at April 24, 2006, and represents the cost of a prescribed annuity with 0 guaranteed period paying \$5,000 per annum, with the annual payments commencing in 12 months time.

Of course, our 71-year old could simply purchase an annuity from an insurer for \$54,000, and donate the \$6,000 to the charity. By proceeding on this basis, he can avoid making an application to the Minister of National Revenue. (The ability to claim the non-refundable tax credits in respect of the donation would influence whether the \$6,000 is donated as a lump sum or over a number of years.)

Where our 81-year old male acquired a prescribed annuity receiving a \$5,000 annuity income stream each year, the taxable portion was nil. For our 76-year old, this increases to \$216. For our 71-year old, this increases to \$674.<sup>30</sup>

Clearly, where a charitable annuity is being considered, the tax consequences can only be accurately determined where the appropriate annuity quotations have been obtained. Age is critical to the tax consequences.

In addition to assessing the tax consequences relating to the donation, the donor would want to assess other financial aspects relating to the charitable annuity. Prime amongst these would be the financial stability of the charitable organization where the charity is itself issuing the annuity. Most donors would likely prefer a situation in which the charity, as agent, is acquiring a commercial annuity from an insurer or other issuer. Where this is done, liquidity concerns vis-à-vis the annuity income stream are also eliminated.

## **V. Summary**

No doubt many Canadian have philanthropic goals. At the same time, these individuals will want to ensure that they have adequate income (and or capital) for their needs.

Charitable annuities are worth considering, as both parties' needs may be assessed. Donors considering such annuities are advised to seek the appropriate professional advice so as to ensure that these are appropriately structured. Charitable annuities are not a "one size fits all" concept. With careful tax and other planning, the donors should be able to ensure meet their own needs and satisfy their philanthropic goals at the same time.

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<sup>30</sup> See above.