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Life Insurance as a Charitable Planning Tool: Part 1

'A gift is not a deal—and a deal is not a gift. Charity is about giving—not taking!'

We are entering a time when providing financial support to charitable organizations is more important—and yet, because of the economic condition of our country, a more difficult task—than ever. As estate planners, we need to consider the highly useful and significant role that life insurance can play in providing charitable support through the funding of major gifts, the building of endowment funds, and the replacement of wealth otherwise lost to heirs. Life insurance, if used properly, can provide unique leverage for accomplishing the dreams of the charitably-minded client and the mission of the charity.[1] This first part of a two-part column explores advantages and disadvantages of using life insurance, valuation and tax ramifications, and traditional as well as new, creative planning strategies.

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The challenges

Using life insurance both creatively and ethically in charitable planning is not nearly as easy or simple as it sounds. The combination of the life insurance product, its taxation, and the tax implications of using life insurance in a charitable context create considerable complexity at a level seldom encountered and not always appreciated by life insurance or other professionals.

State, as well as federal, law must be taken into account. Issues of conflicts of interest and abuse of the special tax treatment afforded to charities and their donors constantly arise.[2] The IRS and the various states' Attorneys General are ultra-sensitive to all dealings with charities where there is—or may be—a motive other than detached, disinterested generosity, and/or where the donor receives a benefit from the transfer that is more than incidental and insubstantial. And the officials are rightfully watching everyone involved. The consequences to both charity and donor—as well as to promoters, advisors, agents or brokers or even insurers—can be quite severe if the planning, the implementation, or the review process is flawed.[3] Great care must therefore be taken both to use life insurance to its fullest potential as well as to avoid misuse or abuse.

Advantages of using life insurance

There are many reasons why life insurance could be considered the "Ultimate Endowing Tool":

1. A life insurance policy provides a guaranteed death benefit. So, assuming premiums are paid, the charity's receipt of a given amount is certain. Compare this with a gift of real estate or marketable securities that may be subject to wide fluctuations in value.

2. If the insurance policy is owned by a charity, assuming premiums are paid, the gift can't be revoked by the donor. So rather than a "maybe someday" gift that might never be made, charity-owned life insurance is a "right here, right now" gift.

3. Life insurance provides an "amplified" gift. Incredible leverage is possible. A relatively small amount of premiums can translate into a large and meaningful gift. The leverage ratio of death benefit to premiums paid is extremely favorable, usually many times

more than the charity would otherwise receive through a non-life insurance gift.

4. Life insurance can legitimately be considered a way to obtain "immortality on the installment plan": Almost anyone, regardless of economic station, can assure a meaningful and significant gift, a larger gift to charity through life insurance than by other methods.

5. A life insurance gift is cost-efficient and provides "100 cent" dollars. There is no "slippage" due to federal estate or state death taxes, state or federal income taxes, administration or estate settlement costs, or any other fees or charges.

6. Life insurance involves none of the cost, delay, or uncertainty of probate.

7. The use of life insurance involves a negligible risk of contest. Because of the contractual nature of life insurance and the fact that it passes outside a person's probate estate, there is only a scintilla of a chance the payment of life insurance owned by and payable to a charity could be successfully contested by disgruntled heirs. Nor can a surviving spouse intercept the policy proceeds payable to a charity. A spouse may elect against the decedent's will without affecting a charity's claim to policy proceeds because the insurance money passes by contract to the charity outside the probate estate.

8. There is no statutory limitation on charitable gifts of life insurance. Under so-called mortmain statutes, in some states, gifts to charity made by will within a relatively short period prior to death can be disallowed. But life insurance proceeds are typically not subject to such restrictions or risk.

9. Life insurance is generally accorded a greater level of protection against creditors than are other assets under most states' creditor laws.[4]

10. The policyowner has the right to borrow or use policy cash values as collateral as soon as they develop. If the charity is the owner of the policy, it can use policy values for any reason whatever at any time. These cash values are obtainable almost instantly once they accrue in the policy. If the donor is the owner of the policy, he or she can use policy values for any reason at any time.

11. Life insurance can be publicity-free or can provide "leveraged" honor. The size and even the existence of a life insurance gift can be completely confidential because of the contractual nature of life insurance. On the other hand, amplified recognition is possible if publicity is desired. For example, a "millionaire's club" can be formed to announce each purchase of a policy with a "face value" (initial death benefit) of $1 million or more.[5]

12. Unlike other installment-type gifts, the gift of life insurance can be "self-completing." So, regardless of how few premiums the donor paid prior to death, the amount the donor intended the charity to receive (i.e., the policy's death benefit) is paid to the charity. Compare this to annual gifts made by a "best intentions" donor who dies after one or two years. Furthermore, if the insured becomes disabled, assuming a "waiver of premium" feature was attached to the policy and the disability meets the terms and conditions of the waiver of premium provision, the insurer will keep the contract in force and pay all premiums on behalf of the policyowner. Thus, such a charitable gift is, in essence, "self-completing" in the event of the insured's disability. The charity can choose to continue the policy—either out of income or capital or by using the policy's own cash values and nonforfeiture options—if the donor starts to pay premiums but for some reason is unwilling or unable to continue.

13. A life insurance gift to charity is relatively "painless." From a cash flow perspective, the gift of personally owned life insurance to charity is not typically perceived as the loss of "a needed asset" because no income-producing asset is being given away. From wealth transfer perspective, a gift of life insurance to charity doesn't affect the family business, home, or investmen't portfolio that the heirs expect to receive.

14. The transfer itself is simple and cost-efficient. Any size or type (e.g., term insurance, ordinary, variable, universal, or combination) of policy can be used, and absolute assignment forms are cost-free.

15. Upon making the gift, the donor typically pays no ordinary

1 For detailed commentary, see *Tools and Techniques of Charitable Planning* (National Underwriter, 800-543-0874); *Tax Planning With Life Insurance* (800-950-3055); and *The Tax Economics of Charitable Giving* (13th Edition, Arthur Andersen, 800-775-5730).

2 See Bonannon and Huston, "Should Charities Accept Gifts of Life Insurance?," 3 J. Gift Planning 26 (1st Quarter, 1999).

3 For instance, it is essential that the payment of premiums by the charity is a "prudent" course of action and that charity has "insurable interest," as defined under state law.

4 See Gideon Rothschild's article: http://www.mosessinger.com/resources/creditprotec.shtml, and Peter Spero, "Using Life Insurance and Annuities for Asset Protection," 28 ETPL 12 (Jan. 2001).

5 It is important from the charity's perspective that lifetime recognition of the donor be commensurate with the ultimate gift. This means that the charity should keep in contact with the donor and "make a big fuss not only upon the donation of the policy but each year as premiums are paid."

income tax on any gain in the policy, no matter how large the gain.[6]

16. From the charity's perspective, there is much less administrative responsibility for an insurance policy than for real estate or other similar assets. Usually, there are no complex or expensive valuation procedures nor is there concern about environmental problems. If the value of the gift is $5,000 or less, the insurer—typically at no charge—provides all the necessary information. (See below for further discussion of valuation and documentation for tax purposes.) Compare the cost, the degree of time and effort, and the complexity of a gift of life insurance to the valuation of charitable gifts of closely held stock, real estate, or interests in an FLP (family limited partnership) or LLC (limited liability company).

17. Annual premium statements (request duplicate premium notices), coupled with annual "thank you" notes, give the charity a continuing contact—and opportunity to enhance its relationship—with the donor. It is very important that each annual premium be considered by the charity as an opportunity to renew and deepen the relationship and bond between the donor and the charity, and recognize again the generosity of the donor. Whenever possible, those directly affected by the gift (e.g., scholarship recipients or department heads) should be introduced to the donor—perhaps giving the donor a "progress report" and a further chance to see what each annual premium is helping accomplish and sustain.

Downsides and costs

No tool or technique is without cost or risk. Certainly, life insurance in a charitable context is no exception to that general rule. A life insurance policy should be only one of many types of assets in a charity's investment portfolio and in the planner's tool kit. Therefore, like any other asset, its appropriateness must not only be considered initially, but also be reviewed annually. The charity must monitor premium payments, cash values, and dividends as well as the financial health of the insurer. Gifts of life insurance should not be sought by a charity in place of the solicitation of outright gifts or an endowment program, but should complement these. We shouldn't be asking, "What is the cost of waiting for the insurance benefits versus having dollars given currently to an endowment and compounded over time," but rather, "How can we maximize both types of gifts?" Most of the problems with respect to life insurance occur not because of the product itself, but rather because it is misunderstood or improperly used.

Traditional ways to use life insurance

Contribution of paid-up or single pay policy. The oldest, simplest, and most appreciated way to use life insurance to benefit a charity is through an outright contribution (absolute assignment) of all rights to an existing "paid-up" or single premium policy.[7] However, the donor's retention of any meaningful economic right in the policy or a loan against the policy at the time of the gift—no matter how small—will bar a charitable deduction.[8] Generally, the gift of an existing paid-up or single premium insurance policy results in a current deduction to the donor equal to the net premiums the donor has paid.[9]

The gift of a policy should have substantially greater value if the insured is terminally ill. Reg. 25.2512-6(a) provides that "[i]f...because of the unusual nature of the contract such approximation is not reasonably close to the full value, this [interpolated terminal reserve plus unearned premium] method may not be used." A client who is very ill—or even one who is paying a significant rating or has unusual limitations on the policy—may be able to claim the gift of that policy to charity is worth more than it would be under normal circumstances. This is the same argument the IRS would make upon the gift of a policy by such an insured to a non-charitable donee.

Contribution of 'premium-paying policy.' A premium-paying policy is one for which premiums remain payable. Typically, a charity is made the absolute owner and beneficiary, and holds all ownership rights. The charitable organization must have an insurable interest in the donor. Otherwise, all deductions may be lost. State law must be checked. If the charity has an

6 Beware of contributions of policies with loans, particularly where the owner has borrowed against the policy to pay premiums. This issue is discussed in more detail in Part 2.

7 This assumes the existing insurance is no longer needed or has served its purpose.

8 Policy loans may also subject the policy to the bargain sale rules. Reg. 1.1011-2(a)(3); Rev. Rul. 80-132, 1980-1 CB 255. As a result, the donor would have some reportable gain but, because of the rules enacted to bar charitable split-dollar, no deduction—no matter how seemingly insignificant the loan against the contract at the date it is donated.

9 Technically, the deduction is generally limited to the lower of (1) "replacement cost" (cost of comparable single premium policy), or (2) the policyowner's basis (net premiums paid to date of gift). Reg. 25.2512-6(a), Example 3, and Section 170(e)(1)(A). See Ryerson, 312 U.S. 260, 25 AFTR 1164 (S.Ct., 1941). Replacement cost is defined as the single sum an insurer would charge to issue a policy on a person the same age and sex as the insured. Comparability requires that the hypothetical policy have the same economic value; i.e., a merely equivalent death benefit is not sufficient. Rev. Rul. 78-137, 1978-1 CB 280.

insurable interest, the charity can be the original owner and beneficiary. Otherwise, the donor (or preferably donor's spouse) can purchase the policy and make an immediate absolute assignment once the policy is issued. (If the insured's spouse purchases the policy, the insured never acquires incidents of ownership and consequently, there is never a question of estate tax inclusion.) The deduction for a policy in premium-paying status is usually the policyowner's basis—that is, the net premiums paid.[10]

As noted above, the gift should have much greater value if the insured is terminally ill.[11] Even a client who is paying a significant rating or has accepted unusual limitations on the policy may be able to prove that the gift of that policy to charity is worth more than it would be under normal circumstances.

From the donor's perspective, the drawback of an absolute gift of either a paid-up or premium-paying policy is that the transfer is irrevocable. The donor can't change his or her mind after making the absolute assignment. The charity has no absolute assurance the donor will continue to make contributions, and the policy may—or may not—be an appropriate investment for the charity to accept or continue to hold.

Deduction for gift of 'new' policy. For income tax deduction purposes, the value of a charitable gift of a policy within its first year is the gross amount of the premium paid at the time of application.[12] If the policy has been in force "for a while," the donor generally will be limited to a deduction of his or her basis.[13]

Deduction for gift of term insurance. Term insurance is an unlikely and probably (for the reasons discussed below) an inappropriate gift to charity in most cases. Although the Regulations do not specify, in most cases the value of term insurance for purposes of computing a deduction will probably be the unearned premium as of the date that ownership of the contract is transferred to the charity.

Premium payments deductible. Premium payments made by the donor after the gift of a policy or on a policy originally purchased and owned by a charity can result in annual income tax deductions.[14] Although it is best if the donor promises to support a policy he or she has given to charity, in most cases the donor is under no legal obligation to continue premium payments. If the donor discontinues payments, the charity has a number of options: It can (1) continue premiums until the insured's death, (2) place the policy on "paid-up" status at a lower "face amount" (death benefit) with no further premiums payable, (3) surrender the policy for its cash value, or (4) sell the policy to a "high net worth settlement company" or viatical settlement company (assuming certain conditions are met).

Premiums should be paid directly to the charity, and the charity should then write its check to the insurer rather than the donor paying the insurer directly. The reason for the donor to make contributions to the charity rather than to pay premiums to the insurer is this: The donor potentially obtains a higher current deduction for "gifts directly to the charity" rather than for "gifts for use of a charity."[15] For instance, suppose your client has $100,000 of adjusted gross income ("AGI"). If she pays a $50,000 premium directly to the insurer, the IRS may limit her current income tax deduction to $30,000 (i.e., 30% of $100,000) rather than 50% of her AGI. If she wrote her check to the charity and the charity in turn wrote its check to the insurer, her current deduction limitation would be 50% of AGI (i.e., $50,000), a $20,000 difference.[16]

As a practical matter, it is generally suggested that the donor "round up" the amount of each donation so that the charity can have the excess to defray the costs of administering the program or add some money each year to its current operating budget. And instead of paying cash each year, a more tax-smart technique would be for the client to donate appreciated securities sufficient in amount for the charity to sell and net enough money to pay premi-

10 Technically, the deduction is generally the lower of (1) the interpolated terminal reserve plus unearned premium (less outstanding loans) at the date of the gift, or (2) the policyowner's basis. Reg. 25.2512-6(a) and Section 170 (e)(1)(A). In the early years of a policy, its value is typically lower than the policyowner's cost, and so value is used. After the "cross-over" point when cost is less than value, the taxpayer is forced to use cost as the deductible limit. The gift will qualify for the 50%-of-adjusted-gross-income ("AGI") ceiling if the gift is to a public charity. A five-year carryover is allowed for any excess.

11 Reg. 25.2512-6(a) provides that "[i]f...because of the unusual nature of the contract such approximation is not reasonably close to the full value, this [interpolated terminal reserve plus unearned premium] method may not be used."

12 Powers, 312 U.S. 259, 25 AFTR 1168 (S.Ct., 1941).

13 Technically, the value of the gift is the sum of the interpolated terminal reserve plus the unearned premium less policy loans. The unearned premium is that portion of the premium that carries the coverage beyond the date of the gift. Reg. 25. 2512-6(a). But if the donor's basis in the policy is lower, the deduction is limited to basis. Hence, in most cases, the deduction is the donor's basis in the policy.

14 Awrey, *25 TC 643 (1955)*.

15 Gifts "to" the charity are deductible up to 50% of the donor's contribution base (essentially AGI) while gifts "for the use of" charity are currently deductible only up to 30% of the donor's contribution base. Sections 170(b)(1)(B) and 170(b)(1)(A).

ums and have a little extra for administrative expenses.

Requirement of absolute assignment of all rights. To obtain either a gift or income tax deduction, the donor must assign all incidents of ownership in the policy. If the donor assigns the policy cash value to charity but retains the right to change the beneficiary or borrow the cash value, or retains any other personally[17] beneficial economic right,[18] no charitable gift or income tax deduction will be allowed.[19]

Stated another way, if the gift is of a "partial interest," a charitable gift tax deduction will be denied and the transfer of the policy becomes a taxable gift. A donor must give all[20] of his interest—or an undivided portion of each and every substantial interest—in the property to obtain a deduction.[21] For example, suppose Jo-Ann assigns the cash surrender value of a policy on her life to United Cerebral Palsy. At the time of her gift, the cash value in the policy is worth $10,000. The stipulation of her gift is that UCP will receive an amount equal to the greater of $10,000 or the policy cash value on the day before her death. The balance is to pass to Jo-Ann's son, John. Because she gave to charity less than her entire interest in the policy, her income tax charitable deduction will be denied. Furthermore, because this is a gift of a partial interest, no gift tax charitable deduction will be allowed. That means Jo-Ann has made a taxable gift.

If incidents of ownership in the policy are retained, the policy proceeds will be included in the donor's estate. Although there may be a corresponding estate tax deduction for the amount actually received by charity, the inclusion could possibly cause the estate to fail to qualify for benefits under Section 303 (partial stock redemption), 6166 (installment payment of estate tax), or 2057 (deduction for qualified family-owned business interest ("QFOBI")). Finally, if the partial interest rule applies, the surviving spouse may argue that he or she has a right to elect to receive a share of the policy proceeds on the ground that the proceeds are part of the "augmented estate"[22] for purposes of the spouse's elective share. It may therefore generally be more advantageous to borrow cash from a policy and make a gift to charity of the cash than to make a partial interest gift of the policy itself.

Name charity as contingent beneficiary. Some clients have few relatives and should consider naming a charity as a contingent beneficiary of a policy. For example, the beneficiary designation might read, "To my wife if living, otherwise to my children in equal shares or their issue, but if no children survive, to The Boy Scouts of America, Troop 74, North Wildwood, New Jersey." This is simple. To the extent money is actually paid to the charity, the proceeds are estate tax deductible.

Name charity beneficiary of all or a portion of insurance proceeds. This is a very simple procedure and will avoid probate. The donor retains flexibility and total control over the policy and its cash values, and can remove the charity and name a family member, friend, or trust at any time. Under this technique, the donor's estate can deduct the amount of proceeds that actually pass to charity. The proceeds will be included in the donor's gross estate because the donor has incidents of ownership under Section 2042, but this inclusion is offset by an estate tax charitable deduction allowed under Section 2055(a). Because the estate tax charitable deduction is unlimited, there is no estate tax—no matter how large the death benefit.

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16 See Slavutin, "Life Insurance and Charitable Giving—Important Tax Rules," ALI-ABA Course of Study, *Uses of Insurance in Estate and Tax Planning*, which suggests that premium payments made to insurance companies will be considered gifts "for the use of" charity rather than "to" charity. See also Schlesinger, "Charitable Giving: Using Life Insurance in Charitable Planning," 25 ETPL 387 (Oct. 1998). No five-year carryover is available for any contributions "for the use of" charity in a given year in excess of this limit. Reg. 1.170A-10(a)(1). See Kirschten and Neeley, *Charitable Contributions: Income Tax Aspects*, 521 Tax Mgm't (BNA), p. A-92. Conversely, if the donor makes a cash contribution "to" charity, the donor's current income tax deduction is subject to a limit of 50% of AGI; any excess of the gift over the current year's deduction limit can be carried forward for up to five years. Rockefeller, 76 TC 178; (1981), *aff'd* 676 F.2d 35, 49 AFTR2d 82-1140 (CA-2, 1982), and Rev. Rul. 84-61, 1984-1 CB 39, seem to imply that the donor's payments directly to an insurer would be considered a gift "to" rather than "for the use of" charity. However, neither the IRS nor the courts have ruled on this specific issue. See also Kirschten and Neeley, *Charitable Contributions; Income Tax Aspects*, 281-3rd T.M. (BNA), p. A-10, n. 102, and Zaritsky and Leimberg, *Tax Planning With Life Insurance* (RIA, 800-950-3055). A 30%-of-AGI limitation applies to gifts to private foundations regardless of whether the check is made directly to the charity or directly to the insurer. C corporations may deduct up to 10% of net income contributed to charity. See Section 170(b)(2). S corporations are not subject to this limit. See Groves and Osteen, *Charitable Contributions by Corporations*, 290-2nd Tax Mgm't (BNA), p. 1-19.

17 The prohibition is against the retention of a right that does or might benefit the donor. However, it is permissible for the donor to retain the right, exercisable in conjunction with the charity, to change and add new charitable beneficiaries. Ltr. Rul. 8030043.

18 Nor can the donor expect a current income tax deduction if he buys an annuity that is coupled with an option to purchase term insurance at special rates if he gives the annuity to charity but keeps the rights to buy term insurance at special rates. See Rev. Rul. 76-1, 1976-1 CB 57.

19 Rev. Rul. 76-143, 1976-1 CB 63.

20 For example, a donor can't obtain a current income tax deduction by giving charity the cash value portion of a policy but keeping policy proceeds in excess of cash values. See Rev. Rul. 76-143, *supra* note 19; Rev. Rul. 76-200, 1976-1 CB 308.

21 Sections 170(f)(3)(A) and 170(f)(3)(B)(ii).

22 See Uniform Probate Code (UPC) section 2-202.

Value and Form of Gift	Deduction Disallowed Unless
$250 or Greater	Charity provides Donor with contemporaneous written acknowledgment of contribution stating amount of cash or noncash property received and value of any consideration provided by Charity to Donor in return for gift.
More Than $500 but Less Than $5,000	Same as above, plus Donor must complete IRS Form 8283 which provides Charity's name, address, description of property, how and when Donor acquired property, basis, FMV, and method by which property was valued.
$5,000 or More	A "Qualified Appraisal" is obtained. Reg. 1.170A-13(c) provides that neither the Donor nor the insurance agent (or insurer who issued the policy) can perform this appraisal.

No income tax deduction is allowed for merely naming a charity as beneficiary. But if that retained interest is later assigned to a charity, the insured donor will be allowed an income tax (and gift tax) deduction at that time. Similarly, the insured receives no income tax deduction for future premium payments until and unless the charity is the policy's beneficiary and also owner of every economic benefit represented under the policy.[23] The problem with this arrangement is that it is difficult for the charity to plan on the ultimate benefit since the donor can change his or her mind. And of course, there is no current benefit for the charity.

Name charity as beneficiary of policy rider. A "rider," as its name implies, is term insurance "riding on top" of the basic policy. For instance, a client purchasing a $1 million permanent policy for her family might at the same time buy an additional $200,000 term rider and name a charity (say, Villanova Law School) as the beneficiary. Designating a charity as the beneficiary of a specified amount or percentage of the basic policy's death benefit or of an additional term insurance rider is simple and cost-effective. This strategy keeps the insured donor's family's security intact and also provides a significant gift to charity. The client continues to own and control the ownership of the policy and its cash values—as well as the right to change or even eliminate the charitable beneficiary.

No current income tax charitable deduction is allowed because the insured has not made a complete current and absolute gift of his or her entire interest to charity. An estate tax charitable deduction will be permitted for 100% of the amount actually received by the charity. So if a charity receives $100,000 out of a $300,000 policy or if charity receives a $200,000 rider, the insured's estate is allowed a corresponding estate tax deduction, effectively eliminating the tax on that amount.

Valuation substantiation

Documentation is important. All gifts of policies to charity must be documented and records retained. IRS Form 8283 should be used and signed by an official authorized to sign the charity's tax return.[24] Failure to include the Form 8283 could result in a disallowance of the charitable deduction.

If the donated policy has a value of $5,000 or more, it is necessary to obtain a formal appraisal from someone other than the insurer or the agent that sold the policy.[25] Probably, an agent other than the one that sold the policy would be accepted. The appraisal should be performed not earlier than two months before the date of the gift of the contract, and must be attached to the donor's return and filed before the return's due date (including extensions). Exhibit 1 summarizes these requirements.

Estate tax implications

If a policy is donated to a charity that becomes the owner and beneficiary, the proceeds are removed from the donor's estate. However, Section 2035 must be considered. If the policy is transferred from the insured to the charity within three years of the donor-insured's death, the policy proceeds will be included in the donor's gross estate. Section 2055 will, in most cases, provide an unlimited deduction for insurance proceeds passing directly to charity (or to a charitable remainder trust), and will generally eliminate any estate tax. Although the deduction appears to

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[23] Rev. Rul. 76-143, *supra* note 19.

[24] See Ross, "Gift Taxation of Life Insurance After TAMRA," ¶ 5503, *Successful Estate Planning Ideas and Methods* (Prentice Hall Law and Business).

[25] See Reg. 25.2512-6 and Rev. Rul. 59-195, 1959-1 CB 18, for gift tax valuation procedures. The charity should provide the donor with a receipt for the policy. That receipt should spell out the donor's name, date of the gift, description of the policy including face amount, name of the insurer, serial number, and "quid pro quo" statement that the donor received no goods or services in return (i.e., received only an intangible charitable benefit).

"wash" the inclusion, it may not be a precise match: As noted above, planners should compute the impact of the inclusion of life insurance upon the estate's ability to qualify for the benefits of Sections 303 (partial stock redemptions), 6166 (installment payment of federal estate tax), and 2057 (QFOBI deduction) prior to its scheduled phase-out.[26]

Creative thinking within the law

There are a number of ways planners can help clients help charities through life insurance that are both creative and within the spirit, as well as the letter, of the law. As explained in more detail below, the use of these ideas must also fall within the scope of an ethical and appropriate investment—not just for charities in general but for the specific charity and donor in question. These creative ideas may include the following.

Second-to-die amplified gift. The death benefit otherwise payable is greatly enlarged by the use of a second-to-die (survivorship) insurance policy. The charity purchases a policy on the donor's life or the donor contributes the policy to charity. Leverage is enhanced through use of a survivorship type of contract. For example, a couple can purchase a $1 million policy on their lives payable at the death of the survivor of the two. The same premium purchases a larger death benefit than ordinarily because no payment must be made by the insurer until the later death and more premiums (i.e., for a longer time) must typically be paid by the owners(s). Alternatively, the donor's outlay may be reduced. So the same death benefit could be purchased using a lower premium, because the cost of providing a death benefit is lower if no payment needs to be made by the insurer until the death of the survivor of two individuals.

Matching dollars. The client names the charity absolute owner and beneficiary of a policy on his or her life. The charity's endowment fund pays one-half the premiums. The donor commits to paying the other half. The donor's fully deductible, no-strings-attached gift in essence doubles the rate of return the charity would otherwise enjoy. This greatly enhances the endowment fund.

The 'mass participation perpetual gift.' Also known as the "forever endowment" technique, it works like this: The charity writes a letter to its supporters. The letter invites them to purchase and then contribute to—say, Dickinson Law School—a policy on their lives (or give the charity cash and the charity buys the policy, if eligible to do so). The donors name the charity (e.g., Dickinson Law School) as owner and beneficiary. Each donor "targets" a goal. Accordingly, each donor purchases a policy that will develop a target amount of cash value (e.g., $5,000, $10,000, $50,000, $100,000 of cash value) in a specified number of years (e.g., five or ten years).

Contributors obtain a current income tax charitable deduction for their contributions. The proceeds are not included in the donor's estate because the policy is owned by the charity. The gift is perpetual because it is assumed that the charity agrees to invest the proceeds at an insured-owner's death and use only the interest on the death proceeds. This arrangement works best where the charity establishes and maintains a close relationship with the donor(s) and where the policies are structured so that the payment process is completed in a relatively short time (e.g., ten years). Thus, a ten-pay life contract might be ideal. Once the policy is paid up, the charity is then assured it will remain in force until the insured's death.

Charity as revocable beneficiary of group-term life insurance. A client could name a charity the revocable beneficiary of group-term life insurance on his or her life in excess of $50,000.[27] The advantage of this technique is that it eliminates the need for the client to report Table I income tax cost of the term insurance coverage in excess of $50,000, as long as the charity remains the beneficiary. No matter how much group-term insurance is involved, the donor no longer has to report as income the excess coverage over $50,000.[28] Nevertheless, if and when the donor changes the beneficiary designation and names a non-charitable beneficiary for amounts of coverage over $50,000, he or she must then again report income. The insured receives no income tax deduction by naming a charity as the beneficiary of the group-term insurance, but income tax is avoided on the value of "premiums" required to provide protection in excess of $50,000. To obtain this benefit, the charity must be the sole beneficiary of amounts over $50,000 for the entire tax year.

Any question about this being a partial interest gift can be avoid-

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[26] See *Tools and Techniques of Estate Planning* (12th Edition, 800-543-0874).

[27] Usually, the cost of up to $50,000 of group term life insurance coverage is not reportable as income but the cost of coverage in excess of $50,000 of coverage is taxable to the employee under so-called Table I rates. (Note TD 8821, 6/3/99, revising group-term rates downward.)

[28] Section 79(b)(2)(B).

		Example	Actual
Input:	Coverage in Excess of $50,000	$450,000	$______
Input:	Age of Donor: End of Calendar Year	55	______
Input:	Cost per Month per Thousand Dollars	.43	______
Compute:	Excess Coverage/1,000	$450	______
Compute:	*Reportable Income From Excess Coverage* (Units of Excess Coverage × Cost per Month)	$193.50	______
Compute:	Reportable Income From One Year's Coverage (Monthly Reportable Income × 12)	$2,322	______
Input:	Donor's Income Tax Bracket	28%	______
Compute:	Income Tax Savings for Naming Charity *(Tax Bracket × Reportable Income)*	*$650.16*	______

ed by naming the charity the beneficiary of the entire proceeds rather than merely the excess coverage over $50,000. The more aggressive position is that the excess coverage is probably a permissible fractional interest in the insurance, so that the partial interest rule should not apply. But prudence suggests the conservative course of action. The existence of an insurable interest should not be a problem in most states, but should be checked.

Example. Assume that a 55-year-old employee in a 28% income tax bracket is covered with group insurance equal to his salary of $500,000. Exhibit 2 shows how to compute the income tax savings of naming a charity as beneficiary of the "excess" coverage.

Insurance as a wealth replacement/enhancement vehicle. Also called an "inheritance alternative," this technique can be impressively effective. Assume, for example, that a client wishes to make a current gift to charity but feels her children or grandchildren may want or need the financial security represented by the asset she wants to contribute to charity. If she does nothing, her beneficiaries will lose a percentage of her wealth (30% to 50% due to federal and state death taxes and estate settlement slippage) and, if nothing is done, the charity receives nothing.

Instead, suppose the donor makes a current gift of stock or real estate to a charity or to a charitable remainder trust[29] ("CRT"), and obtains an immediate income tax charitable deduction for a current gift of "other property" to a charity or to a CRT. The donor then gives all or portion of her current income tax savings from the deduction to her children, using the gift tax annual exclusion, gift splitting, and/or the unified credit. The children directly—or through a policy-owning entity such as a trust—purchase and pay premiums on insurance on the life of the donor and/or donor's spouse (often using a second-to-die type contract). The children eventually receive the policy proceeds free of income tax, estate tax, and probate. If the amount of insurance matches what they would have received, net after all taxes and "slippage" had their mother made no lifetime charitable gift, the wealth has been replaced. In many cases, the children receive as much as—if not more (net after estate taxes and other estate transfer "slippage") than—they would have received if the donor had made no charitable gift. If the children actually receive more than they otherwise would have received, their wealth has been enhanced.

From the charity's perspective, this is a "right here, right now" rather than a "maybe someday" type of gift. This technique can be leveraged using second-to-die coverage. The major advantage of this technique is that a good bit—if not all—of the wealth the family would have received had no gift been made, is replaced and in some cases perhaps even enhanced. The technique can work by making an immediate gift of appreciated property directly to charity or by giving appreciated property to a CRT.

[29] See Section 664.

Purchase of life insurance inside a CRT. A charitable remainder unitrust[30] ("CRUT") is tax-exempt.[31] It may be directly funded with a life insurance policy.[32] The IRS has ruled that the purchase and maintenance of life insurance by a CRT is not, per se, a "jeopardy investment" that risks the charitable objectives of the trust.[33] The CRUT can be named owner and beneficiary of an existing insurance contract, or the trust can use its assets to purchase a new policy. The donor's income tax charitable deduction would be based on the present value of the remainder interest (i.e., the charity's portion) of each premium payment.[34] In essence, the donor-insured obtains a current income tax deduction for the increase each year in the value of the charity's remainder interest, even if premiums are paid directly to the insurer.[35] For example, assume that Bob contributes to a CRUT $100,000 of stock and an insurance policy on his life with a $100,000 death benefit. The trust provides for a 6% annual distribution (valued annually) to his grandson Able, for life. Bob also will contribute $10,000 per year to the CRUT to pay the life insurance premium and to enhance the value of the trust even more.

Bob will receive a charitable deduction measured by the present (discounted) value of the policy (using his basis as a starting point and ascertaining the discount from the Section 7520 rate tables and using his age and the appropriate Section 7520 rate). Each time he makes a premium payment, he'll also receive a deduction (again, discounted to take into consideration how long the charity must wait to receive its remainder interest).

In this example, the annuity stream preceding the charity's interest produces a gift to the life annuitant, his grandson Able. The younger the annuity beneficiary is, the greater the gift Bob is making. His grandson's right to the annuity stream is immediate and certain, which makes Bob's gift a present interest gift that qualifies for the annual exclusion. The big advantage is that upon Bob's death, the corpus of the trust is increased significantly by the life insurance proceeds. Because the payment to the annuity beneficiary is based on the annually measured value of the trust, the annuity increases after the grantor's death—as does the amount eventually payable to charity.

A loan by the CRT against the policy's cash values, if used to finance another investment, would result in the income from that other investment being treated as debt-financed income, which would be treated as unrelated business taxable income ("UBTI") and will result in the tainting of all the CRT's income for the year.[36] The exemption of a CRT from income tax applies only if—during the year—the trust has no UBTI for that year.

Part 2 of this column, which will appear in the next issue of ESTATE PLANNING, will suggest additional planning strategies, will examine the effect of state law, and will explain how to handle troublesome transactions. ■

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30 A charitable remainder annuity trust ("CRAT") can't be used because only one contribution can be made to a CRAT.

31 Section 664

32 Ltr. Rul. 7928014.

33 The CRUT's receipt of life insurance might be considered a jeopardy investment if the proceeds of the policy are allocated by the trust document, or by default pass, to the annuity beneficiaries.

34 See Millard, "Using Life Insurance to Fund a Donor's Charitable Gifts," 22 ETPL 297 (Sept./Oct. 1995), and Schlesinger, *supra* note 16.

35 Ltr. Rul. 8745013.

36 Ltr. Rul. 8745013 and Reg. 1.664-1(c). See also Leila G. Newhall Unitrust, 105 F.3d 482, 79 AFTR2d 97-547 (CA-9, 1997).