GIFTS OF LIFE INSURANCE

PG CALC WEBINAR

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I. INTRODUCTION

Life insurance is a powerful and flexible financial and estate planning tool. For charitable giving purposes, the value for the charity lies in receiving the "death benefit" which is paid upon the death of the insured. However, policy loans, withdrawals, and other obligations can reduce the dollar amount coming to the charity.

Life Insurance Basics

At its core, a life insurance policy is simply a contract that promises to pay a specific amount of money (the death benefit) upon the occurrence of a specific event (the death of the insured during a specific time period). There are four parties to the life insurance contract, each with its own interests and rights under the policy:

Owner	Insurer	Insured	Beneficiary
• Buys and pays for the policy; has the right to change the beneficiary and to give away ownership	• Promises to pay an amount of money (the death benefit) upon the death of the insured	• The one upon whose death the insurer will pay the death benefit	• The one to whom the death benefit will be paid

The contractual promise to pay the death benefit is usually good for one year and is renewable each year. The insurer charges a fee, often referred to as the "mortality charge," in order to generate the funds needed to the death benefit. The older the insured the higher the mortality charge since the likelihood of paying out the death benefit increases as the insured grows older. The table below is a hypothetical illustration showing how the mortality charge changes as the expected mortality increases.

Assume 100,000 thousand insureds, all the same age, and a $50,000 death benefit.				
Age	**Probability of dying within one year**	**Projected number deceased**	**Total Death Benefit Paid**	**Mortality cost per policy**
30	0.001428	143	$7,140,000	$71.40
40	0.002323	232	$11,615,000	$116.15
50	0.005512	551	$27,560,000	$275.60
60	0.011407	1,141	$57,035,000	$570.35
70	0.025579	2,558	$127,895,000	$1,278.95
80	0.064457	6,446	$322,285,000	$3,222.85
90	0.174013	17,401	$870,065,000	$8,700.65

Most modern policies include provisions that allow the owner to pay either a fixed or variable amount each year (the premium) which is projected to accumulate sufficient value to pay for the

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cost of insurance each year. The accumulated payments which have not yet been used to pay for the cost of insurance are what creates value in the policy.

Before we discuss the practical aspects of life insurance as a charitable gift, following is a brief summary of the basic structure of life insurance policies:

- **Policy** – Life insurance is a legal contract (the "policy") promising to pay a certain amount (the "death benefit") upon the death of an individual (the "insured").
  - The insurance company seeks a large number of people to insure in order to spread the risk of having to pay the death benefit in any one year.
  - The company charges a fee (the "premium") for the policy and uses this money to pay death benefits to the beneficiaries of those insureds who die.
- **Term Life Insurance** – "all life insurance is term insurance"
  - The policy covers one life for a specified period of time (usually one year).
  - The amount of the premium increases each year as the likelihood of paying the death benefit during that year increases because the insured is older.
  - **Annual renewable term** – The insurance company promises to renew the coverage each year—but at higher premium for the same death benefit.
  - **Decreasing term** – The insurance company promises to renew the coverage each year for the same premium but with a smaller death benefit.
- **Whole Life Insurance** – The premium stays the same and the coverage stays the same for the life of the insured.
  - In the early years the premium for a whole life is significantly higher than for the same coverage under a term insurance policy.
  - The extra premiums collected in the early years are accumulated and invested to be used to pay the higher cost of insurance in later years when the insured is older.
  - The insurance company guarantees that a specific value in death benefit will be paid as long as premium payments are made on time, regardless of investment performance, mortality experience, or other vagaries during the life of the insured.
- **Universal or Variable Life Insurance** – Both the premium amount and the value of the death benefit may be adjusted during the course of the policy.
  - Similar to whole life policies, excess premiums are accumulated to be invested and used later to pay the cost of insurance.
  - Most of the variables, including the cost of insurance, mortality assumptions, investment return and value of death benefit, are not guaranteed and can be adjusted from time to time.
  - The policy owner may be provided some opportunity to select the investments owned by the policy.

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- **Limited Payment or "Vanishing Premium" Plans**
  - A limited number of annual premiums are projected, after which a sufficient policy value is expected to have accumulated in order to pay the cost of insurance for the lifetime of the insured.
- **Single Premium or "Paid Up" Life Insurance**
  - One very large premium is paid at the time of purchase, most of which is set up as an investment account to pay the cost of insurance for the lifetime of the insured.

Life Insurance Vocabulary

Life insurance employs a very specific and technical vocabulary. An understanding of several key terms will be helpful in the evaluation and comparison of charitable life insurance proposals:

Term	Definition
Account value	The sum of all premium payments adjusted by periodic charges, credits and partial withdrawals
Annuity	A contract issued by an insurer that promises to pay periodically an amount to a beneficiary (the amount of the annuity can be fixed or variable and continue for the lifetime of the insured or last for a shorter period depending upon the terms of the contract)
Beneficiary	The individual or entity to whom the death benefit or periodic annuity is to be paid
Cash surrender value	The cash value available upon surrender of the insurance contract
Death benefit	The amount paid upon the death of the insured (the amount of the death benefit can be guaranteed and fixed at the time the policy is issued or it can vary depending upon the terms of the contract, the net amount available may be reduced by loans or withdrawals made before the death of the insured)
Guaranteed value / guaranteed rate	Policy illustrations usually include certain minimum or guaranteed rates of investment return as well as assumed rates of investment return; guaranteed policy values are those projected based upon the guaranteed rates while values based upon the assumed rates are not guaranteed
Insured	The individual upon whose life a policy or annuity is issued
Insurer	The insurance company that issues the policy or annuity
Owner	The individual or entity that owns and controls the policy

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Policy	A contract issued by an insurer that promises to pay a death benefit to the beneficiary upon the death of the insured
Policy year	The "fiscal year" of the policy, generally beginning the first day the life insurance coverage is in place; premium payments and other outlays are usually assumed to be made at the beginning of the year while cash values are usually shown as of the end of the policy year
Premium	The amount paid to the insurer in exchange for the contractual promises of the policy (insurance policies usually require periodic payment of premiums during the lifetime of the insured, annuities usually require a single premium payment when the contract is issued)

Outright Contributions of Life Insurance

If a charity is named as the "beneficiary" of the policy, the charity will receive the death benefit amount when the insured dies.

If, instead, the donor assigns "ownership" of the policy to a charity (in addition to naming the charity as the beneficiary), the donor receives a current income tax deduction for "interpolated terminal reserve value" (basically the "cash value," subject to certain adjustments) of the policy. In addition, if the donor makes premium payments on the policy after it has been contributed to the charity, he or she can receive an income tax charitable deduction for those amounts, too.

Note: Policy loans, withdrawals, and other obligations may decrease, sometimes significantly, the value of the policy to the charity.

Donors may hold a variety of life insurance policies with different characteristics. What makes a good gift of life insurance? Here are some considerations:

1) Cash value – whole, variable, universal, or paid-up – polices make the best gifts because there is a current value associated with the contract which can provide for future payments and generate an income tax deduction for the donor.
2) Term or group policies are less desirable as charitable gifts because there is no value to the charity unless the insured dies during the period the policy is in force. In addition, there is generally no charitable deduction for the donor because there is no value in the policy other than the promise to pay the death benefit.
3) Policies with little or no outstanding loan balances make better gifts than policies with outstanding loans because the loan(s) will be repaid from the death benefit.

Example: Assume a donor, age 65, owns a whole life policy that he purchased when he was in his 30s. The policy will pay a death benefit of $100,000 upon his death. The premium is $800 per year. He has paid all premiums as scheduled over the years and has never taken any loans against

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this policy. The interpolated terminal reserve value of the policy is $18,000. The donor has committed to continue to pay the annual premium directly to the insurance company.

Following are the results of this contribution:

- $18,000 – current income tax deduction for the contribution of ownership of the policy (note that the donor may need a qualified appraisal to document the value of this deduction)
- $800 – annual income tax deduction for the value of the premium payment the donor makes to the insurance company each year after giving the policy to the charity
- $100,000 – death benefit paid to the charity upon the death of the insured

Administrative Considerations

Donors should be advised that the charity, as owner of the policy, has sole discretion to make decisions which will affect the value of the policy to the charity:

Further premium payments – the charity is *not* obligated to make any further premium payments on the policy

Policy loans – the charity can borrow the cash value from the policy

Paid-up insurance – the charity may elect to accept a smaller death benefit and eliminate the need for further premium payments

A contribution acknowledgement or receipt should be issued to the donor. This acknowledgement can be similar to the form used for gifts of securities. The issuing company, name of the insured, and the policy number should be included in the acknowledgement. Although the donor will be entitled to an income tax deduction for the appraised value of the policy, best practice for gift-in-kind receipts is to avoid assigning a specific dollar value for the contribution and to urge the donor to consult with his or her tax advisor. Be prepared that the donor is likely to need a Form 8283 ("Noncash Charitable Contributions") in order to claim the charitable deduction.

Life insurance policies owned by the charity are valuable assets and should be managed with the same care as any other investment or asset of the charity. Someone, either the business office or the development office, should be assigned responsibility for safekeeping and monitoring the value of life insurance policies. The financial performance of policies should be reviewed periodically to evaluate how they are performing compared to their financial projections. If a policy is failing to perform, the charity may wish to ask the donor to increase payments to the insurance company or consider cashing in the policy.

Counting life insurance gifts

Counting and reporting contributions of life insurance is a complex matter. Guidelines issued by The National Association of Charitable Gift Planners (CGP), CASE, and AFP all take a similar approach recognizing that the contribution of a life insurance policy can result in several different countable gifts. Following is a brief summary:

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- **Owner and beneficiary** – Most commonly the charity is named both owner and beneficiary of the policy. In this case a current contribution is counted for the cash value of the policy because that amount is the value of the asset (the policy) that has been contributed. In addition, depending upon the organization's counting policy, an expectancy gift (similar to a charitable bequest) can be counted for the face value or death benefit amount of the policy.
- **Beneficiary only** – In some cases the charity is named the beneficiary of a policy but is not assigned ownership. In these instances an expectancy gift can be recorded for the face amount or death benefit value of the policy. In these cases there is no current contribution to be counted because the donor has retained ownership of the asset.
- **Premium payments** – If the donor (or someone else) continues to make premium payments on a policy owned by the charity, these amounts should be counted as contributions each year.
- **Death benefit payments** – Payments of death benefits to the charity should be treated in the same way as charitable bequest receipts. The full value of the death benefit paid to the charity should be counted as a current gift but offset by the amount previously counted as an expectancy.

The "Guidelines for Reporting and Counting Charitable Gifts" published by the National Association of Charitable Gift Planners provide detailed explanations as well as guidance for special circumstances such as paid-up policies. The Guidelines are available on the CGP website: http://charitablegiftplanners.org

Finally, note that the *accounting* of gifts of life insurance for purposes of the organization's financial statements must follow the financial audit standards that apply to the organization In general, the accounting of a contribution of a life insurance policy is similar to the accounting for any other contribution of an asset.

"Wealth Replacement" Life Insurance

Since planned gifts often remove estate assets that would otherwise have gone to surviving heirs, life insurance naming the heirs as the beneficiary can provide a cost-efficient way to replace the assets given to charity.

Those donors who are concerned about estate taxes can work with their financial advisors to ensure that wealth replacement policies are owned by the heirs. Ownership by the heirs can avoid estate taxes on wealth passed to the next generation.

Evaluating Life Insurance Contributions

It seems there is a never-ending array of programs promoting creative applications for life insurance in charitable giving. Before engaging in any life insurance program, the charity should engage in a careful review of the proposal to ensure that there is real value for the charity.

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The National Association of Charitable Gift Planners has published guidelines for the evaluation of life insurance. These guidelines are available from the National Association of Charitable Gift Planners web site < https://charitablegiftplanners.org/ >. The key elements of the recommended review are:

Complete Analysis – Careful analysis of both the subjective and objective factors is key. Some aspects of charitable life insurance programs lend themselves to quantitative analysis, while other aspects are more qualitative in nature. A worthwhile charitable life insurance program will meet both subjective and objective criteria.

Value and Values – The analysis should guard both the value and the values of the charitable organization today and in the future. Even though a charitable life insurance program may be financially viable, it may still present unwarranted risk to reputation and/or consume unreasonable amounts of valuable staff time and resources.

Nothing is Free – Nothing of value comes without a price. All of the costs of the charitable life insurance program, including the costs of insurance, borrowing, commissions, and on-going administration, must be paid by someone at some point. The charity should have a clear understanding of all of these costs and the sources of the funds to pay these expenses, as well as the ultimate source of the value the charitable organization expects to receive.

Charitable Interest – The charitable life insurance program must respect and serve the charitable interests of the donor.

Obligations and Commitments – Charitable organizations should fully understand the obligations involved in a proposed charitable life insurance program and the impact should the program not unfold as planned. Interest rates, mortality assumptions, and the cost of insurance are all variables that may increase or decrease the charity's out-of-pocket expenses over time.

Conclusion

A life insurance policy is a complex financial instrument and a powerful financial planning tool. While the primary purpose of life insurance is to provide a lump-sum death benefit payment, policies also have the opportunity to allow cash value to grow on a tax deferred basis. This feature allows life insurance to become a valuable asset in some financial plans.

As a charitable contribution, life insurance policies should be viewed as any other contribution of an asset, recognizing that the charity's opportunity to make use of the contribution is likely not to come until some point in the future after the insured has died. From a fundraiser's point-of-view, the life insurance contribution is similar to a charitable bequest.

For the donor, life insurance policies can be a means to making significant contributions. It is incumbent on the fundraiser to ensure that the donor understands that the value of the life insurance contribution lies in the future death benefit. Those conversations can open the door for additional and more current contributions from the donor.

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