GIFTS OF LIFE INSURANCE

PG CALC WEBINAR

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Presented by:

Alison O'Carroll, Senior Consultant
PG Calc Incorporated
115 NE 100th Street, Suite 300
Seattle, WA 98125
Tel: 206-329-8144
E-mail address: aocarroll@pgcalc.com
http://www.pgcalc.com

Introduction

In 2009, there were 291 million group and individual life insurance policies in force, and the face amount of those policies totaled approximately $18 trillion. The face amount of individually-owned policies totaled about $10.3 trillion. To give some context to these numbers consider that in that same year the Gross Domestic Product (GDP) for the U.S. was approximately $14.3 trillion. In 2012, life insurers paid $63 billion in death benefits to beneficiaries.

Although the average policy size has increased, the total number of individual policies in force and the number of individual policies purchased each year have both been declining. For example, in 1990, 14,199,000 individual policies were sold, but in 2009 that number had dropped to 10,139,000. In 2013, only 44 percent of United States households owned individual policies. However, during this same period there has been an increase in the amount of group life insurance policies.

Thus, it can be concluded that the majority of people have some form of life insurance for family protection, loan security, estate liquidity, or to assure business continuance. Many of these individuals have made charitable gifts of life insurance in one form or other. A survey of charitable organizations in 2009 revealed that just 122 charities stood to receive almost $500 million in death benefits from life insurance policies they owned and 129 organizations expected to receive over $100 million as named beneficiaries of policies.

Gift planners tend to be ambivalent about life insurance gifts. On the one hand, they recognize the appeal of being able to finance a large future gift on the installment basis, and they have likely received insurance proceeds for their charitable work. On the other hand, they are wary of insurance agents and promoters who regularly approach them about the latest plan that can generate millions of dollars for the organization.

The purpose of this paper is to help gift planners better understand the opportunities and problems associated with life insurance gifts and to better manage the policies owned by a charity. To provide a background for this discussion, the paper begins with a primer on types of life insurance. Then it discusses the common ways of giving life insurance, in each instance dealing with the tax implications and marketing opportunities. Finally, the paper poses and answers a number of practical questions about accepting, crediting, and managing life insurance policies and also a related product, the deferred variable annuity.

I. Primer on Types of Life Insurance

A. Terminology

1. Owner

   The individual or entity that owns the contract. The owner is responsible for paying premiums, may name the beneficiary, and may access cash value through a policy loan.

2. Insured

   The individual on whose life the policy is based. Policy proceeds are paid upon the death of the insured. (The owner and the insured are often the same person, but they need not be the same.)

3. Beneficiary

   The individual or entity that receives the policy proceeds upon the death of the insured.

4. Insurable interest

   To prevent speculation on the death of individuals, and possibly mischief, a policy can be purchased only by those who would suffer some kind of loss if the insured dies. They are said to have an "insurable interest." In most states, it is permissible for a charity to own life insurance on its donors. However, it is important to consult with legal counsel to determine the rules of your state.

5. Insurability

   The ability to purchase insurance on the life of a given individual. In determining whether to issue a policy and the amount of premium to charge, an insurance company takes into consideration the health and financial situation of the insured, and also the amount of life insurance already in force on the life of that person.

6. Viatical Settlement

   A **viatical settlement** is the purchase of a life insurance policy from a terminally ill person, who is expected to die within two years, for an amount substantially below the face value of the policy. Viatical settlements were more common in the early 1990s when many AIDS patients, desperately in need of money, sold their policies to get cash. The purchasers expected to collect death proceeds in the not too distant future that would represent a very good return on their investment. (The word "viatical" comes from the Latin "viaticum" referring to the Sacrament given to a dying person. The root meaning was provision for a journey.)

7. Life Settlement

   A **life settlement** is the purchase of a life insurance policy from a person who is not terminally ill but likely has some health condition resulting in the fair market value of the policy being worth more than the cash value. There is a life settlement market consisting of investors who appraise and purchase policies. Sometimes, they approach charities that are holding donated life insurance policies and advise the charities that they may be able to sell certain policies for two or three times the cash value. Indeed, the value of a policy may be greater than the cash value, depending on the age and health of the donor and other factors. For this reason, a charity might want to have its portfolio of policies evaluated. On the other hand, a charity may consider it unseemly to do business with investors who speculate on the death of individuals.

B. Types of Life Insurance

1. Temporary (Term)

Temporary (Term) insurance is written for a specific period and pays the death benefit if the insured dies within that period. Ordinarily, no cash value is built up, and the policy owner pays only for the cost of protection against death.* The death benefit may remain level while the policy is in force, or it may change. An example of the latter would be decreasing-term insurance to provide proceeds roughly equal to a mortgage balance. There are both group term policies that cover employees of a company or members of an association and individually-owned term policies. The cost of term insurance increases over time, and for most policies premiums increase annually, every five years, or every 10 years. Because premium costs escalate and needs change, only about six percent of term policies remain in force until death.

* There is a product called universal term life insurance that does contain a cash value component.

2. Permanent

Permanent life insurance remains in force until the policy matures, is terminated by the owner, or lapses because of non-payment of premiums. There are three basic types: whole life, universal life, and variable life.

a. Whole Life Insurance

A whole life policy provides a guaranteed death benefit, guaranteed cash values, and fixed annual premiums. In the event the policy pays dividends, they can be applied to premiums, received in cash, or used to purchase paid-up additional insurance. The latter would increase the death benefit.

It is possible to purchase whole life policies with graded or modified premiums. If the premiums are graded, they increase incrementally for a certain number of years and thereafter remain level. If the premiums are modified, they remain fixed at a relatively low level for a certain number of years, and then they increase substantially in a single year to the level where they remain. Both of these options are designed for young people who anticipate greater future earning power.

A special kind of whole life insurance is an endowment policy. It pays the face amount of the policy in the event of death or on a specified date – age 65, for example – even though the insured is still alive. At the specified age, the cash value inside the policy equals the death benefit. As with other whole life policies, premiums remain the same, and cash value accumulates according to a guaranteed schedule. Endowment policies are not very common.

b. Universal Life Insurance

Universal life insurance is a combination of term insurance and a tax-deferred investment account. Unlike whole life insurance, the cash value, death benefit and premium payments are not fixed and guaranteed. In some universal life policies the amount credited to the cash account is based on prevailing interest rates, though the policy might provide for a guaranteed minimum rate.

A universal life insurance policy, unlike a whole life insurance policy, allows the policy owner to use interest from accumulated savings to pay the premiums. The death benefit, savings element, and premiums can be reviewed and altered as the policy holder's circumstances change.

Many universal life policies were marketed with the promise that the owner need pay premiums for only a limited number of years. After that, enough cash value would be accumulated to sustain the policy. In other words, the policy from that point would be "self-paying." However, many of the projected returns were not realized with the consequence that the cash value was depleted, and either the policy lapsed or the owner had to pay more premiums to sustain it.

c. Variable Life Insurance

This type of insurance allows the policy owner to allocate a portion of premium dollars to a separate account and choose investment options made available by the company. These could include stocks, bonds, equity funds, bond funds, and money market funds. Variable life policies are considered to be securities contracts and must be sold with a prospectus. The major advantage is that one can participate in various investment options without being taxed on earnings. These policies are the most expensive because of investment management costs, and they carry risks. If investments perform poorly, the policy holder may have to pay more to keep the policy in force. Also, the cash value and death benefit may decline, though the death benefit would not decline below a defined level.

C. Variations of the Types of Life Insurance

As might be expected, there are many variations of these basic types. One is the **second-to-die** policy which covers two insureds, and pays the death benefit when the survivor of them dies. Because their joint life expectancy is longer than the life expectancy of either alone, premiums are lower. This type of policy is sometimes purchased by a husband and wife when funds will not be needed until both of them have died.

Another variation is a **first-to-die** policy, which can cover several insureds and pays when the first insured dies. Premiums are understandably higher because of the greater probability of an early death. This beneficiary arrangement is often selected by partners of a business so that, when a partner dies, money will be available to purchase the deceased partner's share from his or her estate.

Instead of paying premiums over a long period of time, a policy owner might decide to make a large lump-sum payment up front – perhaps as much as is necessary for the policy to be fully paid-up (in the case of whole life insurance), or what is deemed necessary to sustain the policy (in the case of universal life insurance). This arrangement is called a **single premium** policy.

II. Common Ways to Give Life Insurance

The following ways of giving life insurance are listed in order of their value to the charity. In each instance, the tax benefits and the likely prospects for that type of insurance gift are noted.

A. Transfer Ownership of Paid-Up Policy

<u>Value to the charity</u>. A gift of a paid-up policy is equivalent to an outright gift of cash, for the charity can, if it chooses, immediately surrender the policy for cash. More likely, it will retain the policy until the insured individual dies and then collect the death benefit. Meanwhile, the cash surrender value will likely continue to grow.

<u>Tax benefits</u>. The donor is entitled to an income tax charitable deduction for the *lesser* of (1) the replacement value (the current single premium cost of purchasing a policy with equivalent coverage given the insured's current age and state of health) and (2) the adjusted cost basis of the policy.

The <u>adjusted cost basis</u> of a life insurance policy is:

Total premiums paid,
Less withdrawals,
Less dividends distributed
Less any outstanding policy loans, and
Less mortality charges. (This is the cumulative cost of insuring each year what the company has at risk, namely the death benefit less the policy's cash value. In other words, essentially the cost of the 'term' insurance benefit to the insured.)

The insurance company can provide the adjusted cost basis.

The <u>replacement value</u> of a life insurance policy could be more or less than the cash surrender value. In the event that the insured's health has deteriorated, it could cost more than the cash value to purchase an equivalent policy. On the other hand, if life expectancies and/or interest rates have increased, it might be possible to purchase an equivalent policy for less than the cash value. However, an appraiser should be able to argue successfully that a policy should not be worth less than the amount of cash the charity would realize from surrender of the policy.

The deduction is generally limited to the lesser of the replacement value of the policy and the adjusted cost basis because the internal gain in the policy is treated as ordinary income, not capital gain, and per IRC Sec. 170(e)(1)(A) no deduction is allowed for the portion of a contributed asset that would be ordinary income.

If the policy owner surrenders the policy for cash, and the amount received by the owner (inclusive of any loan balance) is greater than the cost basis, the owner will recognize ordinary income in the amount of the difference. (See Reg. 1-72-11(d)) This is true whatever the actual replacement value might be because the surrender of the policy is not deemed to be a sale or exchange.

However, if the policy is sold or contributed to a third party, the amount of gain in excess of the internal gain (cash value minus adjusted cost basis) due to earnings on the policy capital may qualify for capital gains treatment. In the case of a charitable gift, this would mean that the deduction could exceed the adjusted cost basis. The following two examples demonstrate the different results.

<u>Example 1</u>: Mr. K gives a charity a paid-up policy that has a face value of $100,000, an adjusted cost basis of $25,000, and a cash value of $48,000. Mr. K's health has not materially changed, and the replacement value, as determined by an appraiser is essentially the same as the cash value (hence, also $48,000).

Income tax charitable deduction	$25,000
Tax on gain	--0--
Value to charity (replacement value*)	$48,000

* This is what the charity would have to pay to be in the same position as receiving the gift from the donor.

If he had surrendered the policy and given the proceeds, he would have been entitled to a charitable deduction of $48,000, but he would have been taxed on $23,000 of ordinary gain. Assuming he could have used the entire deduction in both cases, the tax consequences would have been the same.

<u>Example 2</u>: Mr. K's health has deteriorated, and based on a premium quotation from the insurance company considering current conditions, the appraiser determines the replacement value to be $58,000.

Income tax charitable deduction $25,000 (basis) + $10,000 (capital gain resulting from appreciation in value)	$35,000
Tax on gain	--0--
Value to charity	$58,000

For support of the conclusion reached in Example 2, see Revenue Rulings 2009-13 and 2009-14. The first of these rulings indicates that gain realized upon surrender of an insurance contract will be taxed as ordinary income, but that gain in excess of the inside build-up under the contract may qualify as capital gain.

The most conservative approach for Mr. K in Example 2 is to claim a deduction for only $25,000, but there is support for claiming the larger deduction.

Prospects. Some individuals purchased policies years ago to provide family protection when their children were small, or to back a loan taken out to start a new business. Now the children are grown or the loan has been repaid, and they have achieved financial security. The policy, meanwhile, has been paid up and is essentially an idle asset. Such persons are good prospects for a charitable gift of a paid-up policy.

B. Transfer Ownership of an Existing Policy on Which Premiums are Still Owing

Value to the charity. If the policy is a form of permanent life insurance and has been in force for two or more years, it will likely have some cash value which is accessible to the charity. Assuming the donor continues to pay the premiums, the cash value will increase each year, and the charity will eventually collect the death benefit if it retains the policy.

Tax benefits. The donor is entitled to an income tax charitable deduction for the *lesser* of the (1) “interpolated terminal reserve value”, and (2) the adjusted cost basis. (If the policy has been owned for a number of years, the interpolated terminal reserve value could be greater than the adjusted cost basis.) However, if there has been deterioration in the health of the insured, it is possible that the appraised value of the policy would be higher than the interpolated terminal reserve value. In that case, following the same reasoning as for a paid-up policy, the deduction is arguably the adjusted cost basis plus the excess of the appraised value over the interpolated terminal reserve value.

The interpolated terminal reserve value is the sum of the:

- cash reserves, prorated between anniversary dates (the cash build-up),
- prorated prepaid premiums, and
- the prorated portion of any dividends expected to be paid during the year the policy is transferred.

It is **approximately the cash surrender value**, and it can be obtained from the insurance company by requesting IRS Form 712 for the policy. See **Appendix A** for a sample statement of value and Form 712 from an insurance company.

The donor is entitled to a deduction for each premium payment regardless of whether the donor makes a contribution to the charity, which uses it to pay the premium, or the donor pays the premium directly to the insurance company. If the first option is selected, the donor could contribute long-term appreciated securities instead of cash, thereby getting the double benefit of a charitable deduction plus avoidance of tax on the capital gain.

Example: Ms. P gives a charity a policy she has owned for six years. It has a face value of $100,000, an interpolated terminal reserve value of $5,400, and an adjusted cost basis of $7,500. Each year she makes a contribution to the charity equal to the $2,500 annual premium. She receives an initial charitable deduction for $5,400 plus a deduction of $2,500 each year for the contributions used to cover the premium. (In this case the appraised value of the policy is the interpolated terminal reserve value. That will usually be the case.)

Prospects. Individuals who conclude that their other investments are sufficient to meet family and business needs may be willing to give an existing policy. It may, in fact, be the best way for them to make a charitable gift without impairing other assets intended for family members. Some individuals may not wish to give the entire policy to charity, particularly if it is large. When a donor has a larger policy ($500,000, for example), the life insurance company may allow the owner to split the policy into two policies (say one $400,000 and one $100,000 policy). The donor can then give one policy to the charity and keep the other policy to meet family needs.

C. Purchase a New Policy, Initially Naming the Charity as Owner

Value to the charity. Although the policy has no initial cash value, permanent life policies will accumulate cash value, and all policies will pay a death benefit if the insured dies while the policy is in force.

Tax benefits. The donor is entitled to an income tax charitable deduction for premiums paid to the insurance company after ownership has been transferred to the charity and, of course, for any contributions made to the charity to cover the premiums. The donor should either name the charity as owner on the application or pay the minimum premium required before transferring ownership. If the donor is the initial owner, pays an entire year's premium, and then transfers ownership, the initial charitable deduction will be limited to the interpolated terminal reserve value, which will be less than the premium paid. A charitable deduction is allowed for the full amount of the premium paid but only after the charity is named as owner. (Note: Be sure that the charity would have an insurable interest under applicable state law before the purchase of a life insurance policy on the life of a donor where the charity is the owner.)

Example: Mr. B, age 40, would like to contribute $100,000 to his charity's endowment, but he has no substantial capital assets other than the equity in his home and his 401(k) retirement fund. He purchases a universal life insurance policy with a face value of $100,000, naming the charity as owner, and pays premiums of $2,500 per year for 10 years, after which the policy is expected to be paid up.

Total premiums paid	$25,000
Total charitable deduction	25,000
Tax savings (28% tax rate)	7,000
After-tax cost of policy	$18,000

The amount of death benefit the charity receives depends on the investment return on the premium deposits. If the return exceeds expectations, the death benefit received by the charity could exceed $100,000. If the return is below expectations, some additional premium payments could be necessary to sustain the policy at its $100,000-death-benefit level.

Prospects. Individuals who want to assure a major future gift, but cannot afford a large outlay of capital, may be willing to purchase a new policy and make the charity owner. They can pay for their gift on the installment basis, and each installment will be a tiny fraction of the eventual gift. This gift arrangement appeals particularly to individuals who are in their thirties and forties, and possibly fifties, who do not have a lot of available capital but do have some discretionary income.

D. Name the Charity as Primary Beneficiary of a Policy

Value to the charity. Provided the owner keeps the policy in force and does not change the beneficiary, the charity will eventually receive the death benefit. Beneficiary designations, like bequests, can be changed, and the charity will receive nothing if the owner substitutes another beneficiary. A charity could be named as beneficiary of either an individual term policy or of the death benefit under a group term contract.

Tax benefit. Life insurance proceeds payable upon death are included in the policy owner's gross estate, but an estate tax charitable deduction is allowed for the entire amount paid to a charity. Consequently, no estate tax will be payable on the proceeds received by a charity. If an individual were named as beneficiary, the proceeds would be subject to estate tax at the applicable rate. In certain states, proceeds paid to an individual would also be subject to state estate tax.

Prospects. The best prospects for this arrangement are individuals who either have no heirs or have otherwise provided for their heirs, but who want to retain access to the cash value if they should need it, and to retain the right to name a different beneficiary should family circumstances change. They could name the charity as beneficiary of any type of policy. Where group life insurance is provided by an employer, and it is not an essential part of the employee's estate plan, the employee may be willing to make a charity the beneficiary if this option is brought to his or her attention.

E. Name the Charity as a Co-Beneficiary to Share the Death Benefit With Others. (The other beneficiaries could be either individuals or charities.)

Value to the charity. The potential for the charity is less than if it were named sole beneficiary, but the charity may still receive a significant amount if it remains a beneficiary and the policy continues in force.

Tax benefit. The estate of the policy owner/insured is entitled to an estate tax charitable deduction. This will be reduced if the charity receives only a fraction of the death proceeds, and individual heirs receive the rest.

Prospects. Individuals who name the charity as a co-beneficiary, rather than sole beneficiary, may have other charitable commitments or family responsibilities for which a portion of the death benefits is needed.

F. Name the Charity as a Contingent Beneficiary to Receive the Death Benefits Only if the Primary Beneficiary(ies) is(are) Not Living

Value to the charity. When there is a primary beneficiary who is much younger than the insured, the charity has a remote chance of receiving anything. Still, there are instances when the primary beneficiaries do predecease the insured, and the charity does receive a significant amount.

Tax benefit. The estate of the policy owner/insured is entitled to an estate tax charitable deduction in the event that the charity receives the death proceeds.

Prospects. Some individuals, at their present stage of life, feel that all of their assets, including life insurance policies, are required to provide financial security for family members. However, they are willing for the charity to be the default beneficiary in the unlikely event that all family members predecease them or the entire family is “wiped out” in a disaster. Even though the charity would prefer to be a primary beneficiary, it should gratefully acknowledge a contingent beneficiary designation. A donor who feels appreciated for such a designation may take steps to assure a charitable gift as family responsibilities diminish and the estate grows.

G. Purchase a Charitable Giving Rider

Holders of larger life insurance policies – usually a death benefit of $1 million or more – can attach a charitable giving rider to their policy. When the policy pays its death benefit, the insurance company will pay an additional 1-2% of the face value to a qualified charity of the policyholder’s choice. These riders usually come at no additional cost. (AXA Equitable will pay 10% at no extra cost.)

Value to the charity. Provided the owner keeps the policy in force and does not change the beneficiary, the charity will eventually receive the amount specified in the rider. For a $1 million dollar policy that might be $10,000 to $20,000, and perhaps more.

Tax benefit. The estate of the policy owner/insured is entitled to an estate tax charitable deduction in the event that the charity receives the proceeds from the rider.

Prospects. The best prospects for this arrangement are individuals who have large life insurance policies but who want to leave the bulk of the insurance benefit to their heirs.

H. Give Policy Dividends

Under certain types of permanent insurance, regular dividends are paid. Quite often these dividends are reinvested to purchase additional life insurance. However, a donor could choose to receive the dividends paid to their life insurance policies in cash and donate them to charity. The dividends would be deductible as with any other cash gift but this strategy does not require any additional cash outlay form the donor.

Value to the charity. While the amounts may be modest, this can be a source of cash gifts.

Tax benefit. The donor would receive an income tax charitable deduction equal to the value of the dividends given.

Prospects. The best prospects for this arrangement are individuals who have dividend paying life insurance and who are looking for a creative way to increase their support of charity.

I. Name the Charity as a Beneficiary of a Commercial Annuity

Strictly speaking, an annuity is not life insurance. However annuities, both fixed and variable, are sold by life insurance companies, and the owner can name a beneficiary, which could be a charity.

Many people have purchased deferred variable annuities in order to defer taxation on the cash accumulation. They will name an individual as beneficiary to receive the cash value when they die. All of the gain will be taxed as ordinary income to the beneficiary. By contrast, death proceeds from a life insurance policy are not subject to income tax.

If a charity is named as beneficiary, the tax is avoided because the charity is tax-exempt. Thus, naming a charity as beneficiary of a commercial deferred variable annuity is a tax-efficient way to make a gift.

An individual who annuitizes a deferred variable annuity or purchases an immediate annuity from an insurance company often will arrange for payments to be made for the longer of his or her life or for a period of years – 10 years, for example – and name a beneficiary. If the individual dies prior to the expiration of the guarantee period, the beneficiary will receive the payments for the balance of the guarantee period or, alternatively, the commuted value of the payments paid in a lump sum. Some persons may be willing to name a charity as the beneficiary. Again, whatever is passed to the charity will not be taxed.

III. Practical Questions for the Gift Planner

A. What are the key questions to ask when offered a gift of life insurance?

As seen from the preceding descriptions, there are many different ways for a donor to make a gift of life insurance to their favorite charity. The value of the gift to the charity varies greatly depending on the type of gift and the type and size of the policy. Hence the answer to the question "is this a good gift for us" is that it depends.

- What type of gift is being contemplated? Beneficiary designation or a transfer of ownership.

- What kind of policy is it? Term versus a permanent form of life insurance. Be careful as often the donors themselves do not really know what kind of policy they have or how it works. Ask to see a copy of the policy.

- If it is term insurance,
    - amount of the death benefit
    - length of the term
    - amount of the premiums
    - whether the donor intends to continue making the premium payments
    - insured's age and general state of his health

  If the donor does not intend to continue making the premium payments, most charities will not be interested in accepting the policy. There is no immediate cash value and they are reluctant to spend general operating dollars on a gift that may never be realized. Even if they are willing to pay the current premium for a few years, when the term ends the jump in premium cost can be prohibitive. However, one exception where it might be worthwhile for the donor or the charity to make a premium payment is when the donor is in his early 70's and has health issues. The policy is then a candidate to be sold on the secondary market for immediate cash. If this is a possibility a charity wants to explore, they should discuss it with the donor and get their full agreement before proceeding. Some donors will be happy to know the policy can be converted to cash; others will want to take the chance that the full death value will be received and/or will be uncomfortable with a third party owning a policy on their life.

- If it is permanent insurance,
    - whether it is paid-up or if premiums are still owed

    - length of time the donor has owned the policy

      Generally the donor needs to have owned the policy for a few years for it to have accumulated any cash value. If it is paid up and there is cash value there is no reason not to accept the policy. The charity should discuss with the donor as to whether the policy will be cashed out or held.

    - age of the donor

    - general health of the donor

These last two pieces of information will help you to determine if it is better to cash out or to hold the policy. If the decision is to cash out the policy, the secondary market can be explored. While it depends on the amount of cash value that has accumulated, the donor's health may have to be very poor in order to realize more on the secondary market.

- ask to see a copy of the policy

- if premiums are owed, whether the donor intends to continue making the premium payments.

  If the answer is no and it would be up to the charity to continue the premium payments, a financial analysis should be done to determine whether it is in the best interest to pay and keep the policy or to cash out. Once again, a charity may be very reluctant to dip into general funds for the premium payments and it can be time consuming to keep track of the insured. See discussion above about this decision.

This list of questions is not exhaustive but will get you started. Depending on the specific type of policy it is and the answers you receive to the questions you ask, other questions may need to be asked. You don't need to be an expert in life insurance; find a partner (consultant, insurance agent) to help you to evaluate the policy. Oftentimes the donor's insurance broker will be very helpful in providing sufficient information and explanation to make an informed decision.

B. Why is it necessary to have a life insurance policy appraised when the replacement value or interpolated terminal reserve value can be obtained from the insurance company?

Many people have raised that question, and some contend that an appraisal should be unnecessary if the policy is valued no higher than the number provided by the insurance company, for that number is no more subjective than the daily quotations for listed securities. They would concede, however, that an appraisal would be required if the policy is believed to be worth more than the insurance company numbers because of impaired health of the insured or some other factor.

Even though hiring an appraiser to provide a number that can be obtained from the insurance company seems ridiculous, an insurance policy does constitute property other than money or publicly-traded securities (the only exceptions to the appraisal requirements). (See Reg. Sec. 1.170A-13(c).) Thus, if a person transfers ownership of a policy where the deduction will exceed $5,000, it is prudent to secure an appraisal from a qualified, independent appraiser. The appraiser should not be the charity or the agent who sold the policy. An appraiser, knowledgeable about the many types of life insurance on the market today, is probably better able than the donor and the charity to understand all of the provisions of the contract and ask the right questions of the insurance company. In most cases, the appraisal should be straightforward and relatively inexpensive.

As with gifts of real estate and tangible personal property that are worth more than $5,000, the donor must file Form 8283 with the tax return on which the deduction is claimed. If the charity disposes of the policy within three years, it must file Form 8282.

C. If premiums on a donated policy are still owing, is it better for the donor to make premium payments directly to the insurance company, or to make contributions to the charity with the understanding that the charity, though not required to do so, intends to use those contributions to make premium payments?

The donor's charitable deduction would be the same with either alternative, but there are three advantages to the donor's making contributions directly to the charity.

1. The donor could contribute appreciated securities, thereby getting the added benefit of avoiding tax on the capital gain.

2. If cash is contributed to the charity, the contribution limit will be 50 percent of adjusted gross income. If the donor pays the premium directly to the insurance company, the gift will be "for the use of" the charity and the contribution limit will be 30 percent of adjusted gross income. Depending on the total amount of the donor's contributions, the differential may or may not be important.

3. The charity can more easily monitor whether premiums have been paid in a timely manner.

The advantage of paying the premiums directly to the insurance company is that the charity is relieved of this administrative responsibility. Also, a donor who receives a bill directly from the insurance company may be more diligent about paying it than making a voluntary charitable contribution.

D. What are the consequences if a policy subject to a loan is contributed to a charity?

Sometimes a donor wants to transfer ownership of a policy subject to a loan. This is treated as a **bargain sale**, and the donor would realize, and need to report, a certain amount of income.

<u>Example</u>: Marjorie transfers ownership of a policy that has an interpolated terminal reserve value of $20,000, an adjusted cost basis of $15,000, and is subject to a $6,000 loan.

1. Cost basis allocated to the loan is:

$$\frac{\$6{,}000}{20{,}000} \times 15{,}000 = \$4{,}500$$

Ordinary income attributed to the loan is:

$6,000 – 4,500 = $1,500

Marjorie will be taxed on the $1,500.

2. Cost basis allocated to the gift (or equity):

$$\frac{\$14{,}000}{20{,}000} \times 15{,}000 = \$10{,}500$$

Marjorie's charitable deduction is $10,500.

Unless the charity wants to retain this policy, it would have been preferable for Marjorie to surrender the policy for $14,000 and then give that amount of cash to the charity. Also, the charity would avoid incurring a debt and possibly having debt-financed income.

E. Should a charity accept gifts of life insurance, and, if so, what acceptance guidelines should apply?

Every charity should accept transfers of ownership of life insurance policies and welcome beneficiary designations. No guidelines are necessary regarding being named as beneficiary. They couldn't be enforced anyhow because a charity is often unaware that it is beneficiary of a policy, just as it may not know that it has been named in a will.

Guidelines regarding transfers of ownership can be relatively brief. There would be no minimum policy size. However, the charity might require a minimum age for the insured. Tracking owners and insureds over a long period as they move about the country is difficult, and a minimum insured age can shorten that period. In the acceptance guidelines, it should be clear that the charity, as owner, may exercise all rights of ownership – keeping the policy in force, borrow part of the cash value, surrender the policy for cash, or elect a paid-up policy with a reduced face value. The charity should not commit to continuing to pay premiums, though it probably would pay them so long as the donor makes contributions for this purpose.

See **Appendix B** for a sample gift acceptance policy for life insurance gifts. The sample comes from the Planned Giving Design Center as a part of *White Paper: Everything Charities Need to Know About Life Insurance Gifts*, by Richard Weber and Randy Fox. This paper is a good source of additional information and includes a survey of charities conducted by the Partnership for Philanthropic Planning. (266 charities answered questions about their approach to gifts of life insurance; while somewhat dated it is still very informative.)

F. Should a charity encourage gifts of life insurance?

Every charity in its planned giving literature should list life insurance among the options available to donors, describe particular ways of making such gifts, and encourage consideration of them. Less clear is whether a charity should embark on a campaign to persuade its donors to purchase new policies in which the charity is named as owner and beneficiary.

Some insurance companies have created products specifically for the charitable market. They generally contain some or all of the following features:

- The application process is very simple. Donors do not have to undergo a medical examination, and they are required to answer very few questions on the application. Some insurance programs guarantee a policy to every applicant, though they often limit the death benefit to premiums paid if death occurs within two years.

- The policies are often universal life, and the premium level is such that, if projected earning assumptions are met, premium payments would be necessary only for a limited number of years. If a whole life policy were used, premium payments, though lower, would be for an indefinite period. Charities have found that donors are reluctant to make a commitment to pay premiums for their entire lives.

- The charity may receive some cash contributions from the insurance company prior to the death of the insured. This is accomplished by collecting larger premiums than necessary to sustain the policy and then returning the excess to charity.

- The charity is expected to solicit a significant segment of its constituency with the objective of completing a minimum number of policies. This prevents adverse selection of people who might have difficulty qualifying for a policy because of pre-existing medical conditions.

These charity life insurance programs may be appealing because life insurance is a highly-leveraged gift. Individuals can think of themselves as major donors, even though their current outlay is modest. The charity will benefit through the accumulation of cash value in the policies and distributions of death proceeds over time.

These advantages must be weighed against the following disadvantages:

- Money that would otherwise be given to the annual fund may be used for the premiums, thereby converting present dollars to future dollars. Although donors are asked to make premium contributions in addition to their normal annual gifts, premium contributions, in fact, sometimes replace their annual gifts. Even when donors do not discontinue annual gifts, they may be unable to increase them because of the added obligation.

- Participants in life insurance programs tend to be younger than donors of other planned gifts, resulting in a long deferral period for the charity.

- Because of the long deferral period, the present value may be only a small fraction of the face value.

- Some donors seek recognition based on the face value of their policy which, if granted, could result in a disincentive to make major outright gifts.

- Donors may not continue premium payments until the policy is paid-up or self-sustaining. If the program uses universal life policies, return projections may not be realized, necessitating more premium payments to keep the policy from lapsing. More than 85 percent of term life insurance policies lapse and nearly 88 percent of universal life policies lapse for non-payment of premiums. Within the first three years, almost 25 percent of permanent insurance policy holders lapse. More than 70 percent of policies sold to seniors at age 65 never pay a claim.

- The premium for a mass-marketed policy is considerably higher than the premium a healthy donor would pay for a policy with the same coverage but requiring normal medical qualifications.

- The charity must invest time monitoring premiums due, collecting payments and tracking insureds.

- If the charity does business with a particular insurance company or agent, it may alienate other agents within its constituency.

G. How should life insurance gifts be credited?

If the charity has a legacy society that extends membership to any person who has arranged a future gift, then either transferring ownership of a policy to the charity or naming the charity as a beneficiary might qualify one for membership, whatever the size of the policy.

Additionally, when ownership of a permanent life insurance policy is transferred, the charity may wish to credit the current value of the policy (normally either the replacement value or the interpolated terminal reserve value) plus all contributions for premiums toward membership in current gift clubs. For example, if the interpolated terminal reserve value were $8,500, the donor would be recognized in the same way as a person who made any outright gift in the amount of $8,500. However, the charity must be careful not to credit the face value of a policy the same as an outright gift. The following chart indicates how different gifts might be credited.

Type of Gift	Current Value[1]	Future Value[2]	Amount Credited for Current Giving Club	Qualifications for Legacy Society
Ownership of policy that has been in existence for a number of years	$15,000[1]	$100,000	$15,000	Yes
Ownership of new policy	---0---	100,000	---0---	Yes
Beneficiary designation	---0---	100,000[3]	---0---	Yes[3]
Outright gift (of non-insurance asset)	100,000	100,000 plus earnings	100,000	No

(1) The current value normally would be the interpolated terminal reserve value (where premiums are owed) or the replacement value (where the policy is paid up). In some cases, such as where health has deteriorated, the current value could be larger than the interpolated terminal reserve value or the replacement value if a person the insured's age was in normal health.

(2) This would normally be the face value of the policy, which is the amount the charity would receive at the death of the insured if the charity is not removed as beneficiary.

(3) The charity could limit membership in the Legacy Society to those who have named it as beneficiary of an individual policy. In that case, merely naming the charity as beneficiary of a group policy would not qualify one for membership.

There are many options for counting life insurance gifts in a capital campaign. Presumably, the charity will have made a decision whether to have:

1. A single goal that encompasses both current and deferred gifts,

2. Two goals, one for current gifts and one for deferred gifts, or

3. Three goals, one for current gifts, one for irrevocable deferred gifts, and one for revocable deferred gifts.

If the charity chooses one goal, the most conservative approach is to count only the current value of policies owned by the charity per the above chart. However, some charities credit the discounted present value of the face value of the policy, or even the entire face value if the insured is over a certain age.

If the charity chooses two goals, it probably would credit all life insurance gifts towards the deferred-gift goal. In the case of policies owned by the charity, it could adopt the counting guidelines described above with reference to a single campaign goal. If the charity is beneficiary but not owner, it could either not count the gift at all, or count a deeply-discounted present value to take into consideration the possibility of a beneficiary change.

If the charity elects three goals, only policies it owns would count towards the second goal, again per the guidelines described above regarding a single campaign goal. Policies, where the charity is beneficiary but not owner, would count towards the third goal, either at face value or at a discounted face value.

H. What should a charity do if a person donates a policy and then stops paying premiums or making contributions to cover them?

Some donors, having transferred ownership of a policy to a charity, continue making premium payments directly to the insurance company. Others make outright contributions to the charity with the understanding that the charity will use them to pay the premiums. In either case, the donor may stop covering the premiums for various reasons such as a change in financial circumstances, moving away, or simply losing interest in the charity.

Obviously, the charity has a number of options: it can pay premiums with its general funds, surrender the policy for cash, or, if cash value is sufficient, elect a paid-up policy with a smaller death benefit. The choice between them entails both business and donor-relation considerations. If the donor is unable to pay the premiums because of deteriorating health, the charity probably should pay them, both to fulfill the donor’s dreams for the gift and also simply because it makes good business sense. On the other hand, if the donor has distanced him or herself from the charity or moved away, the best decision might be to convert the policy to cash and eliminate the need to continue tracking the insured’s whereabouts.

I. Should a charity conduct a periodic review of its life insurance policies?

For FASB reporting, a charity must determine annually the cash values of policies it owns. This can be provided by the insurance company. Periodically (every three to four years), it should go beyond an update of cash values and conduct a thorough review of the policies it owns. Based on this review, it can make informed decisions about the right course of action for the policies it owns. In the event it decides to cash-out a policy, it would be a good idea to determine whether the policy might be worth more on the life-settlement market than the cash proceeds the insurance would pay. An insurance professional not actively engaged in marketing insurance products to the charitable market is probably best equipped to do the review. The cost to pay an expert for the review will be fairly minimal and could result in substantial benefits to the charity.

Sometimes someone associated with a life settlement company will contact a charity and offer a free review. Subsequent to review, that person might offer to purchase selected policies for more than their cash surrender value. The offer is tempting to the charity, for it would realize more than it supposed the policies were worth, and it would have current dollars for pressing needs.

There could be instances when selling policies on the life settlement market makes sense for a charity. However, the charity must remember that it is not being paid more than the policy is worth. The purchaser has determined that it can pay a certain price, based on current interest rates and the insured's age and state of health, and in all probability realize a profit. Prior to selling a policy, the charity should discuss the matter with the donor. If the charity proceeds without prior knowledge of a donor, who was counting on the charity's future gift being the face value, the charity will have a major donor-relations problem on its hands.

J. Should a charity commit to establish a named endowed fund with the proceeds paid on an insurance policy?

Suppose that the current minimum for a named endowed scholarship at a college is $50,000. A 45-year-old donor transfers ownership of a new, whole-life policy with a $50,000 face value to the college, stipulating that at his death the proceeds are to be used to establish a scholarship named for himself. If the college raises the required minimum for a scholarship endowment at the historical rate of inflation (approximately 3.5%), the minimum required for such an endowment at the time of the donor's death would be about $200,000. Thus, available funds would be well below the minimum at the time.

The college might commit to creating the scholarship, if the total amount received from the policy plus any other gifts equals the required scholarship minimum in effect at the death of the donor. However, the donor would have no certainty that a scholarship in his name would ever be established, and would be left emotionally unsatisfied. A better alternative is to require that the present value of the proceeds expected to be received by the charity at the end of the donor's life, using a discount rate equal to the historical inflation rate, would be no less than the current minimum for a named endowed scholarship fund. The scholarship agreement would also address eventualities such as the policy's not being kept in force until the end of the insured's life.

K. Should a charity participate in life insurance programs that are promoted from time to time, often through a board member?

Sometimes a charity will be approached regarding a program that contemplates gifts of life insurance on a larger scale. In those cases, multiple donors are actively recruited to participate in a broad-based sale of life insurance rather than the more usual one-on-one gift conversations. Whether or not these programs make sense for both the charity and its donors can be difficult to determine. A charity should approach these plans carefully and analyze them thoroughly (using third party experts), taking the same steps you would normally take before making a major investment.

It is beyond the scope of this paper to analyze the programs in great detail but some observations and thoughts are given for two common types of plans. An additional resource is a white paper offered by the Partnership for Philanthropic Planning, *Charitable Life Insurance Evaluation Guidelines.* This paper is designed to help charitable gift planners in the analysis and evaluation of charitable life insurance proposals; attached as **Appendix C** is its "Quick Start Questions".

1. Premium-Financed Life Insurance Plan

Such a plan can be very appealing to a financially-strapped charity because it is promised money at no cost to itself or its donors. The charity identifies a large number of members and friends of the organization who agree to be the insured under policies purchased by the charity. These members and friends are merely asked to "lend their lives," that is to give up some of their insurability. They are not asked to contribute any money. The charity then purchases life insurance policies on each of their lives, and it is the owner and beneficiary. To pay the premiums on the policies, the charity borrows money each year from a financial institution. The lender will have been identified by the promoter of the program and is part of the package. Negotiable securities may be pledged to collateralize the loan by the charity. In a reverse amortization, the interest will be added to the loan amount. According to the promoters of the plan, the death benefits collected will be enough to retire the loan and have a healthy balance for the charity.

Any plan that seems too good to be true probably is. There are both legal and economic questions regarding these premium-financed life insurance plans, as well as donor considerations.

<u>Legal Questions</u>

To maintain its exempt status under IRC Sec. 501(c)(3), a charity must be operated exclusively for one or more exempt purposes, none of its net earnings may inure to the private benefit of people affiliated with the charity, it may not be organized and operated for private interests, and any trade or business in which it engages must further the organization's exempt purposes.

The promoters of some of these programs have obtained legal opinions that participation in such a program would not jeopardize a charity's exempt status.

<u>Economic Questions</u>

Even if a charity is not at legal risk, it could be at economic risk. One concern is that distributions will not flow as expected, which will require greater borrowing. Another concern is that the interest rate on the loans, if not locked in, could rise. Consequently, the net outlay of the charity could exceed the proceeds it receives. The charity also will reduce its borrowing capacity if it needs a loan for its tax-exempt purposes. Finally, it also bears a public relations risk, for it will have been perceived as participating in a scheme that generates huge commissions for the promoters with uncertain benefits for itself.

Donor Considerations

Because of the many variables and risks in this type of program, charities can be put into a bad position and damage their donor relationships at the same time. In the end, the realized gift to the charity may be just a fraction of what was projected. In addition, the donor has given up some of his “insurance capacity”. If more insurance is needed later for family or business reasons, your donor may be foreclosed from that option. Careful communication with potential participants is crucial.

2. An Arbitrage Arrangement

An arbitrage arrangement involves simultaneously purchasing an annuity and a life insurance policy. For the arbitrage to work, the annuity payments must be large enough to cover the cost of the life insurance premiums, income tax on the annuity payments (if any), and the interest on the capital used to purchase the annuity. This is occasionally possible due to the different mortality tables used for purposes of underwriting life insurance and issuing annuities, and perhaps differences between various companies’ pricing models.

The participation of charities is sought for two reasons: The first is to cause the annuity payments to be tax-exempt. If they were taxable, the arrangement probably would be impractical because there would be insufficient after-tax dollars to pay the premiums on the life insurance policy and the interest on the capital used to purchase the annuity. The second reason is to identify individuals in the right age range who have not already purchased life insurance to the extent of their insurability.

The amount of life insurance that an insurance company will allow an individual to purchase is dependent on various factors, including net worth and the amount of life insurance already in force on the person’s life.

- Variation One – Charity Advances Money from its Endowment to Purchase the Annuity

  The promoter will promise the charity a guaranteed return that is higher than it is currently receiving on the fixed-income investments in its endowment. In response, the charity might withdraw $1 million from its endowment and use it to purchase, through the promoter, a single premium immediate annuity (SPIA) on one of its donors in the 75-80 age range. The annuity might pay $100,000 annually to the charity, and since the charity is tax-exempt, no tax would be payable on the annuity payment. The charity, again working through the promoter, then purchases on the life of its donor, a life insurance policy with a face value of $1,000,000 and pays a premium of $40,000 per year. The $60,000 spread between the annuity payment and the insurance premium is larger than the $40,000 - $50,000 (4-5 percent) the charity is currently earning on the bond portion of its portfolio.

Even if the charity gains more cash flow temporarily, it forecloses the possibility of investing the $1,000,000 differently if interest rates rise, for it cannot recover the $1,000,000 until the donor dies. This is a lost opportunity cost.

The donor reduces the amount of insurance he or she would be able to purchase in the future. This could be a concern if circumstances change and more life insurance is needed. The donor might also regard having donated his or her insurability as doing his or her duty for the charity and not make any large donations in the future.

- Variation Two – Anonymous Investors Provide the Money to Purchase the Annuity

  Although the particular plans vary, investors usually purchase bonds or other securities issued by a bank, and the money from the purchasers goes into a trust established by the participating charity. The trustee of this trust then buys SPIAs on the lives of wealthy individuals provided by the charity, and who have agreed to be insured. Life insurance policies are purchased on the lives of the same individuals. The annuities supposedly produce enough cash to pay the premiums on the life insurance and interest (at a fixed rate) to the investors. At the death of each annuitant/insured, the death proceeds are paid to the investors, enabling them to recover their investment. If any excess death benefit remains, it is paid to the charity. Typically, a charity is promised that it may expect five percent or more of the proceeds at absolutely no cost to itself.

  Following are some of the concerns about these plans:

  1. The insurable interest rules are circumvented. Essentially, strangers (the investors) are speculating on the lives of the charity's donors. They could not purchase insurance on the lives of these individuals directly because they have no insurable interest, so the charity is, in effect, loaning them its insurable interest in its donors.

  2. In spite of the term "legacy" in some of these plans, they were not developed primarily to promote philanthropy. The potential commissions paid to promoters on sales of annuities and life insurance are enormous. Investors are motivated to buy the security because it is relatively safe and offers an attractive interest rate. The promoters involve charities in order to exempt annuity payments from taxation and to secure assistance in finding high-net-worth individuals. The ultimate benefit to those charities is only a fraction of the profit realized by the promoters. This means that the tax-exempt status of charities is being used primarily to benefit others.

3. It is possible that a participating charity will incur unrelated business income tax because the investments in the annuities and in the life insurance are debt financed.
4. A charity is better advised to nurture the philanthropic impulse of its donors and develop relationships with them. It may suffer in the long-run if it departs from its historical mission and tries to get something for nothing, especially if it is perceived as speculating on the lives of its donors while enriching investors.

5. Arbitrage schemes have been under attack in Congress and may go the way of charitable split-dollar life insurance.

L. Can a life insurance policy be contributed for a gift annuity?

Some individuals have life insurance policies that are either paid up or, at least, have been owned long enough to have accumulated considerable cash value. In some cases, the policy is no longer needed for family protection or liquidity to cover estate expenses, and it is just sitting in the safe deposit box. To derive some current benefit from the policy, the owner might be willing to transfer ownership to a charity for a gift annuity.

In many cases, the current value of the policy will exceed the policy holder's adjusted cost basis. The gain, if the policy were surrendered, would be taxed as ordinary income, not as capital gain. If the policy is contributed for a gift annuity, the income tax charitable deduction must be reduced by the amount of gain allocated to the gift value. The reduction is computed the same way as when "unrelated use" tangible personal property is contributed for a gift annuity.

<u>Example</u>**:** Mr. W, age 74, owns a paid-up life insurance policy which he would like to contribute for a gift annuity. The face value is $100,000; the replacement value, which is approximately the same as the cash value, is $40,000; and the adjusted cost basis is $22,000.

He could either (1) transfer ownership of the policy (in which case the charity would immediately surrender it for the cash value) or (2) surrender the policy and then contribute the cash proceeds. In both cases, his annual payments for the rest of his life will be $2,280 (5.7% x $40,000). However, the tax consequences will be different, depending on whether he transfers the policy or gives the proceeds.

If he transfers the policy:

Income tax deduction	$9,733
Taxation of payments during life expectancy:	
Ordinary income (including taxable gain reported ratably)	$1,343
Tax-free	$937

If he surrenders the policy and contributes the proceeds:

Income tax deduction	$17,697
Taxation of payments during life expectancy:	
Ordinary income	$577
Tax-free	$1,703
Taxable ordinary gain in year of gift	$18,000

(Assuming a gift date of June 1, 2014 and using May CMFR of 2.4 percent)

The advantage of transferring ownership of the policy is that none of the gain in the policy will be taxed in the year of transfer. However, a smaller portion of each payment will be tax-free. Surrendering the policy and then contributing the proceeds causes the gain to be taxed in the year the policy is surrendered. However, the charitable deduction will offset most of the taxable gain, resulting in little tax.

The advantage of this second alternative is that more of the payments will be tax-free. In deciding which alternative is preferable, the donor must weigh the larger up-front savings from transferring the policy against the more favorable taxation of payments from giving the proceeds following the policy surrender. Another consideration is the need for an appraisal should the donor contribute the policy rather than the cash proceeds.

M. Are the tax consequences of transferring ownership of commercial deferred variable annuity and transferring ownership of a life insurance policy the same?

The consequences are different. As noted above, if a person transfers ownership of a life insurance policy the deduction may be limited to the adjusted cost basis. However, the donor will not be taxed on any gain in the policy.

A person who transfers a commercial deferred variable annuity will be treated as receiving an amount of income equal to the cash surrender value and will be taxed on the amount by which the cash surrender value exceeds the cost basis. For annuities acquired on or before April 22, 1987, the donor is taxed on the gain when the donee surrenders the contract. For annuities acquired after April 22, 1987, the donor is taxed on the gain when the contract is transferred, no matter when the donee surrenders it. The gain is taxable as ordinary income.

The charitable deduction will be for the cash surrender value because the donor will already have been taxed on the gain. From a tax standpoint, it makes no difference whether the donor transfers ownership of the annuity contract to the charity, or whether the donor cashes the annuity and contributes the proceeds. If the usable deduction equals or exceeds the gain, the donor will have no out-of-pocket cost.

Example: George purchased a commercial deferred variable annuity in 1993 for $25,000. It now has a cash value of $60,000. George transfers ownership of the contract to a charity.

Cash value	$60,0000
Adjusted cost basis	$25,000
Gain taxed as ordinary income	$35,000
Charitable deduction	$60,000
Deduction remaining after offsetting gain	$25,000
Tax savings (35% rate)	$8,250
Value to the charity	$60,000

The tax savings would be exactly the same if he had surrendered the contract and given the proceeds.

N. What is wealth-replacement life insurance, and should a charity ever suggest it to a donor?

a. Wealth Replacement Life Insurance with an Outright Gift

Example: George would like to give a parcel of real estate to a charity, but he hesitates to diminish the legacy intended for his children. He contributes the property, appraised at $250,000, to a charity and saves $87,500 in income taxes over the next several years during which he uses the deduction. He purchases a $250,000 life insurance policy on his life and makes his children owners and beneficiaries. Each year he gives the income tax savings to them and they use these dollars to pay premiums on the policy. At his death the children will receive $250,000. (Note: the father in this case must live three years for the death proceeds not to be included in his estate. If an irrevocable life insurance trust (ILIT) were the owner and beneficiary of the policy, the proceeds would not be included in George's estate even if he dies within three years. He would make annual gifts to the trust and the trustee would pay the premiums. To avoid or minimize taxable transfers, the ILIT could contain a "Crummey power."* At his death, the proceeds would be paid to the trust, whereupon trust assets would be distributed to the children, free of estate tax, and the trust would terminate.)

b. Wealth Replacement Life Insurance with a Charitable Remainder Trust

Example: Steve and Sharon own certain securities with a value of $2,000,000 and a cost basis of $500,000. They would like to make a substantial gift to charity, receive life income for themselves, and not diminish their children's legacy. They accomplish these objectives by transferring the securities to a charitable remainder unitrust and establishing an ILIT, again with a "Crummey power,"* naming the children as beneficiaries of the life insurance trust. Each year Steve and Sharon use some of the after-tax income from the unitrust to make gifts to the life insurance trust to cover policy premiums.

* The "Crummy power" is a provision that permits the beneficiaries of the ILIT to withdraw, during a limited period of time, gifts Steve and Sharon made to the trust. This allows those gifts to qualify for the gift tax annual exclusion. (currently $14,000, but indexed for inflation.)

Conclusion

Unfortunately, the way charitable gifts of life insurance are promoted has sometimes caused gift planners to shy away from such gifts. Indeed, there is good cause for caution, especially when a proposed plan purports to be virtually cost-free to everyone. However, many life insurance gifts can be extremely beneficial to charities. The only practical way that some individuals can even make a major gift is by naming a charity an owner or beneficiary of a policy. Thus, life insurance should always be on the menu of gift options discussed in planned giving literature, at seminars, and on websites.

Appendix A – IRS Form 712 Example

TRANSAMERICA
LIFE INSURANCE COMPANY

Transamerica Life Insurance Company
4333 Edgewood Road NE
Cedar Rapids, IA 52499

May 24, 2013

Policy Number:
Insured(s):

Dear Policy Owner:

Enclosed is the requested Form 712. Please note that Line 58(a) in Part II of Form 712 refers to the interpolated terminal reserve (ITR) in reaching the net total value of the policy in Line 58(f). ITR is generally considered to be the amount that is required to be held in reserves to cover the future liabilities of each policy. Currently, we believe there is no general agreement as to whether a universal life insurance policy has an ITR. However, we have included an ITR value in the form which best reflects our analysis of an ITR for such a policy.

The IRS issued guidance on the valuation of life insurance policies in Rev. Proc. 2005-25, issued on April 8, 2005. Under this guidance, the fair market value of a life contract generally is the greater of the Interpolated Terminal Reserve ("ITR") or a formula amount involving Premiums that have been paid plus policy Earnings, minus Reasonable Charges ("PERC"). Please note that the PERC amount is not currently called for on IRS Form 712. Rev. Proc. 2005-25 came out after the creation of Form 712, and the form has not been updated to include PERC.

We understand that the fair market value of a life insurance policy for federal tax purposes is a question of tax law for the individual taxpayer. Transamerica cannot provide legal or tax advice and cannot determine the value of this policy for federal income tax purposes for you. You must seek out and rely on the advice of your own qualified tax and legal advisors.

To assist you in determining the fair market value of the policy, we are providing you certain information:

- The policy's reserve value
- A PERC Amount
- The policy's accumulation value and cash surrender value (accumulation value less surrender charges), as of the date of this letter.

Policy's Reserve Value	\$254,444.00 as of 5/17/2013
PERC amount	\$254,691.17 as of 5/17/2013
Policy's Accumulation Value	\$255,312.66 as of 5/24/2013
Policy's Cash Surrender Value	\$254,910.85 as of 5/24/2013

We have calculated the PERC amount under our interpretation of the formula set forth in Rev. Proc. 2005-25. Transamerica does not represent or guarantee its interpretation of the manner in which a PERC amount or Average Surrender Factor is determined will be accepted by the Internal Revenue Service.

We appreciate your business and this opportunity to be of service to you. If you have any questions or need additional assistance, please contact the Customer Service Department at 1-800-852-4678.

Thank you for choosing Transamerica!

Customer Service Department
Fax 1-866-622-5051
tii.customerservice@transamerica.com

Innovative Solutions Insurancesrvcs Llc 10516

Enclosure(s): IRS Form 712 - Life Insurance Statement

Appendix A – IRS Form 712 Example

Form 712 (Rev. 4-2006) Page 2

Part II **Living Insured**

(File with Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. May also be filed with Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, or Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States, where decedent owned insurance on life of another.)

SECTION A—General Information

36 First name and middle initial of donor (or decedent)	37 Last name	38 Social security number

39 Date of gift for which valuation data submitted	▶	
40 Date of decedent's death for which valuation data submitted	▶	

SECTION B—Policy Information

41 Name of insured	42 Sex	43 Date of birth

44 Name and address of insurance company
Transamerica Life Insurance Company 4333 Edgewood Rd NE, Cedar Rapids IA 52499

45 Type of policy	46 Policy number	47 Face amount	48 Issue date
Universal		$2,000,000.00	8/28/1991

49 Gross premium	50 Frequency of payment
Flexible	

51 Assignee's name	52 Date assigned

53 If irrevocable designation of beneficiary made, name of beneficiary	54 Sex	55 Date of birth, if known	56 Date designated

57 If other than simple designation, quote in full. Attach additional sheets if necessary.

58 If policy is not paid up:				
a Interpolated terminal reserve on date of death, assignment, or irrevocable designation of beneficiary	**58a**	$254,444.00		
b Add proportion of gross premium paid beyond date of death, assignment, or irrevocable designation of beneficiary	**58b**			
c Add adjustment on account of dividends to credit of policy	**58c**			
d **Total.** Add lines 58a, b, and c			**58d**	$254,444.00
e Outstanding indebtedness against policy			**58e**	
f Net total value of the policy (for gift or estate tax purposes). Subtract line 58e from line 58d			**58f**	$254,444.00
59 If policy is either paid up or a single premium:				
59a Total cost, on date of death, assignment, or irrevocable designation of beneficiary, of a single-premium policy on life of insured at attained age, for original face amount plus any additional paid-up insurance (additional face amount $____)	**59a**			
(If a single-premium policy for the total face amount would not have been issued on the life of the insured as of the date specified, nevertheless, assume that such a policy could then have been purchased by the insured and state the cost thereof, using for such purpose the same formula and basis employed, on the date specified, by the company in calculating single premiums.)				
b Adjustment on account of dividends to credit of policy	**59b**			
c **Total.** Add lines 59a and 59b			**59c**	
d Outstanding indebtedness against policy			**59d**	
e Net total value of policy (for gift or estate tax purposes). Subtract line 59d from line 59c			**59e**	

The undersigned officer of the above-named insurance company (or appropriate federal agency or retirement system official) hereby certifies that this statement sets forth true and correct information.

Signature ▶ Title▶ Vice President Date of Certification ▶ 5/24/2013

Appendix B (from PGDC white paper)

SAMPLE - GIFT ACCEPTANCE POLICY FOR XYZ CHARITY

XYZ Charity agrees to accept gifts of life insurance policies under the following terms and guidelines:

Ownership-Donor will irrevocably transfer 100% of any transferred policy to XYZ Charity.

Beneficiary-XYZ Charity must be named as an irrevocable beneficiary of no less than____% of any transferred policy. Donor may name up to ____ additional 501(c)(3) organizations to receive the balance of the death benefit (Total must equal 100%).

Additional premiums, if any, will be paid directly to XYZ Charity by Donor and XYZ Charity agrees to handle all administrative functions of said donated policy including but not limited to the following:

- -Remittance of Premiums
- -Delivery of Gift Receipt to Donor
- -Ordering of in force policy illustrations as needed
- -Portfolio rebalancing
- -Policy monitoring and review
- -Settlements

XYZ Charity will accept policies from life insurance carriers that carry a Best's rating of ____or higher or an equivalent rating from another recognized ratings company.

XYZ Charity agrees to consider gifts of the following types of life insurance from donors:

___Term insurance
___Whole Life Insurance
___Universal Life Insurance
___Guaranteed Universal Life Insurance
___Indexed Life Insurance
___Variable Life Insurance

For gifts of Life Insurance in excess of $________, XYZ Charity agrees to place the name of the Donor, or such appropriate person as he/she selects, in a place of prominence at the site of XYZ Charity. Further, for gifts in excess of $______________, XYZ Charity, will discuss with Donor, their preference for allocation of the proceeds from said gift.

Source: *White Paper: Everything Charities Need to Know About Life Insurance Gifts*, by Richard M. Weber and Randy A. Fox. Hosted on the Planned Giving Design Center website.

Appendix C (from PPP paper)

Appendix 4:
Quick Start Questions

The following questions may be useful as a "quick start" guide to help the gift planner ascertain whether or not there is reason to consider the proposed program.

OUTCOMES
- What is the projected financial benefit to your organization?
- What is the projected financial benefit to the investors?
- What are the assumptions used in the projections?
- What actuarial assumptions are being used?

COMPENSATION
- How are commissions applied?
- Will any death benefit be paid to the heirs of the insured?
- On what will the death benefit be based?

LOANS
- What will be the interest rate on the loan?
- Is the interest rate fixed or adjustable?
- Is collateral or other pledges required from your organization?
- To what extent is the charitable organization liable to the lender in case of a default on the loan?

INVESTOR INFORMATION
- What is the financial strength of the participating insurance companies?
- Are there issues that may affect this rating in the future?
- Do the investors have a vested relationship with each other?
- Do the investors maintain the right to sell their interests to another party?
- If yes, under what conditions?
- Will the charity be notified in advance of such a sale?
- Will the charity have veto power?
- How will the charity be able to track who has invested in the policies and who owns them at any time?

REGULATORY ISSUES
- Will a trust established for purposes of the plan be subject to regulation under securities laws?
- Will payments issued by the investors to the charity be treated as UBIT?

Source: *Charitable Life Insurance Evaluation Guidelines,* National Committee on Planned Giving (now Partnership for Philanthropic Planning), 2005.