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Charitable Legacy Planning Part 1

Examining the Uses of Life Insurance in Funding Your Clients' Legacy

BY BILL BUSLEE, STEVE KROEGER AND JACK ELDER

This first of two parts deals with charitable applications of pre-existing life insurance policies. Part 2 will deal with new life insurance policies.

Life insurance is a critical component of personal, business and estate financial planning. What we sometimes overlook is that life insurance also can serve an important role in charitable planning.

This article will examine four ways in which a life insurance policy can be used to fund a significant charitable gift. We'll review naming a charity as beneficiary of a policy, transferring ownership of an existing policy to a charity and having the charity purchase a life insurance policy on a benefactor. Finally, we will look at a unique case in which funds lent

from an IRA were used by a church to purchase a life insurance policy on the IRA participant/church member.

Roger and Shirley Smith are a successful couple. Roger is a longtime member of the local hospital's board of directors. Shirley just finished serving two terms as the president of the local library. They have worked with their financial advisor and attorney to create what they feel is a comprehensive estate plan. During the planning process, they located two small paid-up permanent life policies and a term policy that were not incorporated into the plan — they weren't needed. Two of the policies are on Roger's life and total \$125,000: a \$25,000 whole life contract with a cash value of \$12,000 and a \$100,000 term life policy with a possible three more years of coverage.

The third policy is a \$25,000 whole life policy with a \$10,800 cash value on Shirley's life. Additionally, Roger has more than \$1 million in IRA funds.

Naming a charity as beneficiary of a policy

Naming a charity as beneficiary of a life insurance policy can allow an individual to leave a significant charitable legacy without losing control of the policy and its cash value during his or her lifetime. Insureds remain as the policy owners during their lives and reserve the right to change the beneficiary designation and maintain access to the policy cash value. Although the insurance proceeds will be included in the taxable estate of the insureds, the insureds' estate should receive an offsetting estate tax charitable

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deduction of an equal amount.

The disadvantage of this approach is that the insureds do not receive an income tax charitable deduction because they still own and control the policies. In addition, because the insureds retained control over the policies, charities may not give the insureds lifetime "recognition" for the gift; the acknowledgment generally comes once the charities receive the policies' proceeds — after the insureds' death.

It is important to make sure that a charity has an insurable interest in an individual, according to applicable state law. There typically is an insurable interest when the owner and the insured have a family or business relationship. The insurable interest rule dates back several centuries and is intended to prohibit speculation on life expectancies (and the resultant risks associated with such speculation). Individuals should work with the charity to ensure that they meet these requirements.

Outright gift of a policy to charity

The Smiths may decide to assign Roger's paid-up policy to the hospital and Shirley's paid-up policy to the library.

The hospital and the library favor this strategy because each is assured of receiving the proceeds, and while Roger and Shirley are alive, each charity has access to the policy's cash values and dividends. Roger and Shirley may prefer this strategy because it could lead to a sizable charitable income tax deduction and the non-pecuniary benefits of making a substantial gift during their lifetimes. However, those donors who are averse to giving up access to the policy cash values or control over the policy or those who need an estate tax deduction, will not favor an outright gift.

Donating a life insurance policy to charity is not without its pitfalls. Policy valuation, state insurable interest laws and encumbered policies each pose potential traps for the unwary that should be navigated with the assistance of an experienced insurance professional.

If a donor makes an outright gift of

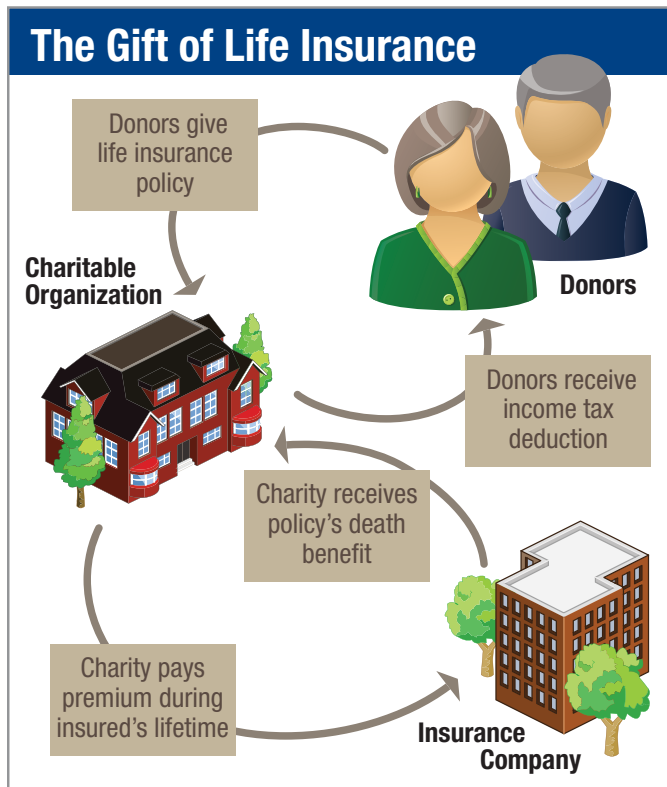
a policy to charity, the amount of the contribution is deemed to be the lesser of either the value of the policy or the donor's basis in the policy. The value of a whole life policy is the interpolated terminal reserve at the date of the gift, plus that part of the last gross premium paid before the gift that extends to some premium anniversary date after the gift, plus dividends accrued to the date of the gift, minus any outstanding indebtedness against the policy. [See Treas. Reg. §25.2512-6(a).] Contributions of property other than money and publicly traded securities in excess of \$5,000 require a qualified appraisal under Treas. Reg. §1.170A-13(c). Bear in mind that insurance companies will provide valuation information on IRS Form 712 upon request.

In the case at issue, the value of each of Roger's and Shirley's policies is equal to the interpolated terminal-reserve value on the date the policy is donated, subject to certain adjustments.

State insurable interest statutes prohibit ownership of an insurance policy on the life of an individual in which the policy owner has no insurable interest. However, depending on the state, charitable organizations may qualify as an exemption to the insurable-interest rule. In our case, the hospital and library may have an insurable interest in the lives of their benefactors based on Roger and Shirley's history of contributions. Regardless, the effect of a state's insurable-interest statute should be examined in each case before a life insurance policy is transferred to a charity.

Neither of the Smiths' policies is subject to loans. An existing policy with outstanding loans is not recommended as a gift to charity because the transfer of the policy will be treated as part sale, part gift transaction.

In sum, the Smiths will receive a tax deduction for the outright gifts of the pol-



icies and for any future contributions that could ultimately be utilized for premium payments. But because they no longer own the policies, they will not have access to the cash values nor will they receive an estate tax charitable deduction. [INN](#)

Next month: Part 2 of this article will address these issues with new life insurance policies.

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Charitable Gifts of Life Insurance – Part 2

By Bill Buslee, Jack Elder and Steve Kroeger

This second of two parts deals with charitable opportunities that involve new life insurance policies. Charitable applications of pre-existing life insurance policies were addressed in the previous installment.

You may remember that Roger and Shirley Smith are a successful couple. Roger is a long-time member of the local hospital's board of directors. Shirley just finished serving two terms as the president of the local library. They have worked with their financial advisor and attorney to create what they feel is a comprehensive estate plan. The third policy is a \$25,000 whole life policy with a \$10,800 cash value on Shirley's life. Additionally, Roger has more than \$1,000,000 in IRA funds.

Charity Owned Life Insurance (“CHOLI”)

Provided the charities have insurable interests and assuming that the Smiths have met their financial planning needs and have additional insurable capacity, Roger and Shirley may make a substantial gift to the charity by consenting to CHOLI. The Hospital and Library can each apply for and own a policy on Roger and/or Shirley naming itself as beneficiary. In the CHOLI scenario, the donor makes annual contributions to the charity in an amount equal to or greater than the premium. The charity, in turn, pays the premium, and, at maturity, collects the death benefit.

The charitable income tax deduction is equal to the amount of the annual contributions.³ Because no “incidents of ownership” exist, the policy proceeds are not included in the Smiths respective estates; however, the charitable estate tax deduction is not available under this approach.

The policy is owned by the charity. As such, disgruntled family members may not target the policy proceeds and the Smiths should be made aware that the charity may access the cash values or surrender or sell the policy at any time (even over the objections of the insured).

Charitable Uses of IRAs with Life Insurance

A case on which the Internal Revenue Service issued a Private Letter Ruling (PLR)⁴ in 2007 offers a fourth potential opportunity to benefit a charity through life insurance. An individual who had established a self-directed IRA invested a portion of his funds in the form of a loan to his church. The church then used part of the loan proceeds to

³ Subject to a maximum of 50% (30% for Private Foundations) AGI limits, the Smiths may either make annual payments to cover the premium or make a substantial lump sum payment for future premiums. Charitable contributions that are not deductible in the current year because they exceed AGI limits may be carried-over for 5 years.

⁴ PLR 200741016

purchase life insurance on the IRA owner/church member with the policy serving as collateral. The loan stipulated a 5% annual interest payment which was utilized by the IRA to help satisfy its Required Minimum Distributions. Funds not used to purchase the life insurance were placed in an account to service the loan and put to work on other church projects. In the PLR, the IRS ruled that this was neither a prohibited transaction nor a prohibited investment in life insurance. Consequently, the IRA will continue to enjoy its normal tax-favored treatment under Section 408 of the Internal Revenue Code.

Since Roger currently has \$1,000,000 in his IRA that he won't need in retirement, he could do a tax-free conversion of his account into a self-directed IRA and have the custodian lend \$750,000 of it to his favorite charity.⁵ If \$400,000 funded the life insurance contract⁶, the remaining \$350,000 would be available to support the loan agreement. Invested prudently, earning 5% in a tax-free environment, allows for annual interest payments at 4.38%⁷ to continue 15 years before exhausting the principal assuming no other money is donated to maintain the arrangement. At Roger's death, the principal would be returned to the IRA for distribution to the beneficiary with the net proceeds going to the charity.

The advantages of this transaction combine the most positive aspects associated with the three previous methods of charitable giving with life insurance. First of all, it allows current recognition of the donor's philanthropy while at the same time maintaining access to policy values. If retrieval of the cash in the contract is ever desired for whatever reason, the IRA custodian simply calls all or part of the loan. Further, the charity has ownership of a valuable life insurance policy which eventually leverages the donor's charitable inclinations far beyond what can be done through the \$100,000 Qualified Charitable Rollover.⁸ In addition, while neither the loan nor the direct contribution provides a tax deduction, at least the loan will ultimately be returned to the IRA participant's heirs. Finally, it must remember that a PLR only applies to the taxpayer requesting it; however, a similar structure within similar circumstances should produce similar results.

Conclusion

Along with items mentioned in Part One, we have seen that life insurance can play an important role in an individual's or a couple's financial planning process and play an important role in the life of a charity as well. Individuals or couples can name a charity as a beneficiary of current life insurance policies. It is possible to transfer ownership of

⁵ The PLR specifically stated "Church B is a tax-exempt religious organization as described in Code section 501(c)(3)." It is assumed that other tax-exempt concerns so organized would also qualify.

⁶ Care should be taken to avoid a Modified Endowment Contract (MEC). IRC §72(e)(4)(A)(ii) requires that any gain occurring in a MEC which is assigned, be reported as income. Potentially this could create unrelated business taxable income (UBTI) for the charity.

⁷ Rev Rul 2009-29 - Annual Long Term AFR as of September, 2009

⁸ IRC §408(d)(8), as amended by TEAMTRA 2008

an existing policy to a charity, and under certain circumstances a charity can purchase a life insurance policy on a benefactor. Whichever direction Roger and Shirley decide to take, it's evident that their charities will benefit from their generosity well beyond their lifetimes.