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Planning—Charitable Giving with Life Insurance

Given the increased transfer tax exemption equivalent of up to $10 million per person and a maximum rate of only 35 percent (2011-2012), some clients are no doubt wondering what to do with the life insurance they purchased in the past to cover currently reduced estate liquidity needs. As discussed in an earlier article, outright surrender of the insurance may seem like a good idea on the surface, but has several drawbacks including income tax consequences and potential loss of insurability should the need for addition life insurance coverage arise in the future.

However, for those clients who believe the increased exemption and low rates are here to stay, one option is to consider making a charitable gift of some of their "excess" life insurance. But before you recommend this option, be sure you know the rules.

Naming Charity the Beneficiary

If the insured owns a policy insuring his or her life, the simplest strategy for using the policy to benefit charity is to simply name a charity as a revocable policy beneficiary. Naming a charity as beneficiary of a life insurance policy allows an individual to leave a significant charitable legacy without losing control of the policy and its cash value during his or her lifetime. The insured can borrow against the policy, take cash withdrawals, and even surrender the policy outright. Furthermore, the insured as policy owner has the right to change the beneficiary and assign the policy at anytime, should there be a change of heart about the charitable gift.

From a tax perspective, although the insurance death benefit is includable in the insured's gross estate, the estate should receive an offsetting estate tax charitable deduction of an equal amount. On the other hand, the insured does not receive an income tax charitable deduction for premiums paid on the policy while he or she remains alive.

Furthermore, from a practical point of view, because the insured retains lifetime control over the policy, the charity may not recognize the gift until after the insured dies. Even more than the loss of the income tax deduction, this lack of lifetime recognition can be a deal-breaker for some clients.

Outright Gift to Charity

For those insureds for whom a current income tax deduction and lifetime recognition for charitable gifts are important, an outright gift of a life insurance policy to charity may be the right solution. The major downside to this approach is that the insured loses control of the policy and its cash value.

Following transfer of the policy, cash contributions by the insured to the charity to allow it to continue the policy in force are also deductible up to 50 percent of adjusted gross income. However, if the insured pays the premium directly to the insurance company, the gift is likely to be considered "for the use of" charity, rather than "to" charity, and the deduction will be limited to 30 percent of AGI.

Donating a life insurance policy to charity is not without its pitfalls. Policy valuation, state insurable interest laws and loan-encumbered policies each pose potential traps for the unwary.

As a general rule, the policy is deductible at the lesser of: (1) the basis or (2) the fair market value. The donor's basis in the contract is equal to the aggregate premiums paid minus dividends and withdrawals received. If the policy is paid-up, the fair market value is based on the cost of a replacement policy purchased with a lump sum (the "single premium" amount). Fair market value is determined by the amount it would cost for a comparable policy with an equal death benefit for an individual the same age as the insured. If the investment element (the "cash surrender value") of the contributed policy exceeds the policy's replacement cost, the donor could use the higher amount of the total benefit currently realizable from the policy (the "interpolated terminal reserve"). In the event the policy requires additional premiums, the fair market value is considered the policy's interpolated terminal reserve (on the date of transfer) and is adjusted for the proportionate value of premiums paid that cover the period extending beyond the date of the gift.

Note that contributions of property other than money and publicly traded securities in excess of $5,000 require a qualified appraisal under Treas. Reg. Section1.170A-13(c). Insurance companies will typically provide valuation information on IRS Form 712 upon request. 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.

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Another tax issue relates to policies with loans against them. First, the transfer will be treated as part gift and part sale, potentially triggering income for the donor. Second, policy loans may cause the charity having to have debt-financed income, which is considered Unrelated Business Taxable Income (UBTI), subject to a 100 percent penalty tax.

Another consideration is the insurable interest rule. Insurance companies (and the laws of most states) require an applicant for a new policy to demonstrate that a pecuniary loss would occur if the insured were to die. The insurable interest rule may prove an obstacle to having a charity acquire a new policy on an individual (especially where there has been no history of giving and/or pledge of future gifts). On the other hand, an individual always has an insurable interest in his or her own life, and in most states assignment of the ownership of an existing life insurance policy to charity will not run afoul of the insurable interest rule.

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Wealth Replacement Trust

Yet another use for life insurance is leveraging charitable gifts of other property through the use of a wealth replacement trust (WRT) in combination with a charitable remainder trust (CRT). In a common scenario, a donor transfers appreciated property to a CRT. The CRT, although under no obligation to sell the donated property, does so and reinvests the assets.

The benefits are significant:

- The donor receives a charitable income tax deduction for the value of the remainder interest in the year of the contribution (with a five-year carry-over).
- The charity pays no capital gains taxes on the asset sale and invests the entire sales' proceeds.
- The donor receives income from the charity (often significantly more income than the contributed asset was producing).
- The charity receives the remainder interest, satisfying the client's charitable inclinations.

A CRUT is typically used in order to maximize payouts to the donor and allow the payments to keep pace with inflation.

After creating the CRT, the donor creates a WRT. The trustee applies for, owns, and is beneficiary of a life insurance policy on the donor's life. The donor uses income from the CRT to make gifts to the trust equal to the premium payment, which is made by the trustee. The likely benefits of such an arrangement are as follows:

- The life insurance escapes estate taxation upon the donor's death, leaving the income tax free death proceeds available to replace the wealth transferred to charity in the CRT, and
- The donor's annual gifts should qualify for the annual gift tax exclusion, so long as the trust contains **withdrawal powers** for the beneficiaries.

Bottom Line

At a time when clients may be evaluating how to handle existing life insurance policies, using those policies to directly benefit charity or enhance charitable gifts of other property can make a lot of sense. Clients often receive current tax breaks while incurring little or no increased cost.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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