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Life Insurance Planning

Expert's Critical Analysis of Charitable Gifts of Life Insurance

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Q. What are the preferred methods for transferring life insurance for a charitable purpose?
See: The preferred method for transferring life insurance for a charitable purpose is to either transfer ownership of the policy outright to the charity or to a charitable remainder trust. If rather than transferring the policy, the charity is named as a beneficiary of the policy, then the client has no lifetime tax benefits; at death the life insurance proceeds are included in the client's estate but the proceeds qualify for a charitable deduction.

Q. What are the tax benefits of an outright gift of the policy to a charity?
See: Although the specific results should be determined by an accountant or tax attorney, the transferor is entitled to an immediate charitable deduction for the fair market value (FMV) of the life insurance policy. Generally, if the policy is not paid up, FMV is the interpolated terminal reserve, plus the unearned premium, less outstanding loans. If the policy is paid up, the FMV is the premium replacement cost of the policy, based on the single premium payment. Generally, the FMV will usually be slightly higher than the policy cash value.

Q. Are there any limitations on the amount of the charitable deduction?
See: Since life insurance is ordinary income property, the deduction may not exceed the insured's net cost. Ordinary income property means that if the policy is surrendered or sold, the proceeds in excess of the net premiums are ordinary income to the policy owner. If, for example, John's total premium payments were $10,000 and the FMV of the policy is $35,000 when he decides to transfer the policy to a charity, then the net cost of the policy and the charitable deduction is limited to $10,000. If the policy paid aggregate cash dividends of $4,000, then the deduction is $26,000. If the FMV of the policy is $24,000, that is the amount of the deduction.

Q. Is an appraisal required since the FMV of the gift is over $5,000?
See: If the FMV of the gift is over $5,000 a qualified appraisal is required. The appraisal may be prepared by an expert, such as an experienced agent, not affiliated with the carrier issuing the policy. At the time of the transfer, the insurance company will issue a statement showing all the pertinent information, including the FMV of the policy. The appraiser may rely on this statement when preparing the appraisal.

Q. What is the charitable deduction when a new policy is purchased which is transferred to the charity?
See: The FMV and charitable deduction for a new policy is the initial premium payment to the insurance company. Whether a new policy or an existing policy is given to the charity, the insured is entitled to a charitable deduction for the annual premium paid to continue the policy in effect.

Q. What limits apply to the charitable deduction for the initial contribution and the subsequent premium payments?
See: There are several different limits. On gifts to a public charity, a donor is entitled to a charitable deduction up to50 percent of his or her adjusted gross income (AGI). If the charity is a private foundation, the deduction is limited to 30 percent of AGI. Any excess may be carried forward for five years. If, however, the gift is "for the use of" the charity as distinguished from a gift "to" the charity, the deduction is limited to 30 percent of AGI.

Q. What is the distinction between a gift "for the use of" a charity and a gift "to" the charity?
See: Cash gifts "to" a charity should qualify for the 50 percent deduction. If the premium payments are made directly to the insurance company, the gift may be deemed to be "for the use of" the charity. There is no definitive answer as to how the payment will be treated. It is therefore recommended that the premium be paid to the charity, rather than to the insurance company.

Q. Are there any strategies for avoiding the percentage limitations?
See: One strategy often used is to divide the insurance policy into several different policies. The donor may then make annual gifts until all the policies have been transferred.

Q. Are there any tax traps if the policy is subject to a loan?
See: There are several tax traps when a policy transferred to a charity is subject to a loan. The transfer may be deemed to be a bargain sale and the donor will realize ordinary income on the gain. Another problem with a policy loan is that the charity may be deemed to have unrelated business taxable income.

Both problems may be avoided by paying the loan before the transfer to the charity.

Q. Are there any benefits when the donor contributes appreciated property to the charity to be used to pay premiums?
See: If appreciated property is given to the charity, the donor receives a charitable deduction for the FMV of the property and avoids payment of any capital gains tax. If for example, John contributes Greenacre, to a public charity, having a FMV of $1,100,000 and a basis of $100,000, John receives a charitable deduction of $1,100,000. If John had sold the property, he would have paid a capital gains tax of $280,000, leaving $820,000. Since they charity is tax exempt, it can sell the property and have the use of the entire proceeds. Although the charitable deduction John may take is limited to 30 percent of AGI for appreciated property, any excess may be carried forward by John for up to five years.

Q. How do you structure a charitable remainder trust funded with life insurance?
See: Generally, there are two planning strategies donors may want to use. The first is to name a charitable remainder trust as the beneficiary of the policy with the surviving spouse as the lifetime beneficiary of the trust. At the time of the insured's death, the proceeds are included in his or her estate, but the estate is entitled to a charitable deduction for the value of the remainder interest to the charity and it is also entitled to a marital deduction for the spouse's life interest. There will be no deduction, however, for premiums paid during the insured's lifetime.

Q. What is the second planning strategy?
See: The second method provides more tax benefits and planning flexibility. The insured can transfer an insurance policy to a charitable remainder unitrust (CRUT). The donor will receive a charitable deduction for the value of the charitable remainder interest based on the FMV of the policy and for a portion of future premium contributions. The CRUT may be in the form of an "income only" CRUT with the spouse as the beneficiary. With the income only CRUT, the spouse receives the lesser of the specified percentage or the income of the CRUT. Since the only asset of the CRUT will be the policy, it is unlikely that any income will be created during the donor's lifetime. Therefore, no payments will be made to the spouse until after the policy proceeds are collected by the CRUT at death.

Q. Can you give an example of the income only CRUT?
See: John creates an income only CRUT with Mary, his wife as beneficiary, and transfers a $500,000 life insurance policy to the CRUT with a FMV of $100,000. The payout is the lesser of 5 percent of the CRUT value or the CRUT income. Ten years later John dies and the death proceeds of $500,000 are invested at 8 percent producing income of $40,000. Mary receives $25,000 the first year. Thereafter, the annual payout increases each year during Mary's lifetime as the value of the fund increases each year since excess earnings are added to principal. The annual payout with the unitrust is based upon the value of the CRUT determined annually.

Q. Is it possible to structure the CRUT with a make-up provision?
See: If the CRUT is structured with a make-up provision (NIMCRUT), then the annual amount due to Mary prior to death accumulates and is paid when excess earnings are available. If, in our example, the CRUT is structured as a NIMCRUT, then the annual 5 percent payment to Mary accrues each year. Assuming the value of the trust remained at $100,000 then after 10 years the NIMCRUT owes Mary $50,000. If the insurance proceeds produce the same 8 percent return, then the first $25,000 is paid to Mary as the annual 5 percent payout, and the balance of the annual income of $15,000 is paid to Mary until the IOU is paid in full. As a practical matter, the value of the NIMCRUT should increase each year, thereby increasing the IOU and the amount that eventually is paid to Mary.

Q. Is it possible to use a Charitable Remainder Annuity Trust (CRAT) rather than a unitrust?
See: A CRAT cannot be used if the policy is not paid up because, unlike a CRUT, additional contributions to a CRAT are not allowed. Additionally, with a CRAT, the annuity payments must be made even if the trust has no income. This means that the policy cash value would have to be liquidated to pay the life estate.

Q. How do the grantor trust rules affect charitable remainder trusts?
See: The grantor trust rules provide that if income of the trust may be used to pay premiums on the grantor's life, then the trust is treated as a grantor trust. A grantor trust does not qualify as a charitable remainder trust. In such situations, the trust should provide that premiums are paid out of principal and that any dividends or withdrawals are treated as principal, so then the grantor trust rules do not apply. [IRS Letter Ruling 9227017.] Subsequent contributions to pay premiums are treated as principal.

Q. How do the insurable interest rules affect the gift to charity?
See: The laws of most states provide that a charity has an insurable interest in a donor's life. In the few states where that may be the rule, the gift will not qualify for any deduction, even if the policy is transferred to the charity by the insured.

Q. What if the donor dies within three years of transferring the policy to the charity?
See: Although the death proceeds are included in the insured's estate, the estate is also entitled to a charitable deduction for the transfer to the charity.