GIVING THROUGH LIFE INSURANCE

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Making the most of life insurance

Many of us have one or more life insurance policies. Life insurance is traditionally purchased for a number of reasons—to provide security for a spouse, children or other loved ones, as a savings plan or as a way to provide funds for estate taxes and other estate settlement expenses.

Life insurance can also offer a convenient way to fund meaningful charitable gifts now and as part of your long-term estate and financial plans.

Considering life insurance's gift potential

Ask yourself the following questions to determine whether a gift of life insurance could play a role in your charitable giving plans:

- Do you have a policy on your life that was intended to protect a spouse who no longer needs it or children who are now financially independent?
- Do you have life insurance purchased to pay estate taxes? Recent changes in our nation's tax laws have resulted in the estate tax applying to fewer people. If estate taxes are now less of a concern for you, all or a portion of the proceeds from life insurance originally purchased for the payment of taxes may instead be devoted to charitable purposes.
- Do you have a policy purchased to complete payment of a mortgage or other debts that no longer exist?
- Do you have a policy you bought to help provide retirement income? Have you since accumulated adequate amounts in other retirement plans?

- Do you have life insurance you bought to help ensure that money would be available for your children's education? If you used other funds to pay for their education, is this insurance still needed?
- Do you have a policy to protect a business that no longer needs such protection?

You may find it beneficial to take the time to compare your life insurance policies with your present needs. Then consider how any unneeded policies may be used to help meet other goals.

Seven ways to give using life insurance

Each option for giving life insurance described here helps meet a different estate or financial planning goal. Consider whether any of these ways to give life insurance may be applicable to you.

1. Name a charitable recipient as beneficiary of a policy you own in one of the following ways:

- As primary beneficiary to receive part or all of the policy proceeds along with your spouse and/or other loved ones.
- As secondary beneficiary to receive part or all of the proceeds in case one or more primary beneficiary(ies) has predeceased you.
- As final beneficiary to receive part or all of the proceeds if all other beneficiaries have predeceased you.

2. Purchase a new policy. This can be a convenient way to make a substantial gift in

an affordable and tax-efficient manner. If the charitable beneficiary is the owner of the policy, you may deduct the amount of premiums paid on the policy when you itemize state and/or federal tax deductions. This annual deduction could help boost your total deductions to levels that allow you to itemize certain other expenses such as mortgage interest and state taxes.

3. Give a paid-up policy you already own by changing the owner and beneficiary. You can usually deduct an amount equal to the approximate cash value* up to 60% of your adjusted gross income (AGI). Any excess deductions can be used to reduce taxes in up to five additional years.

4. Give a policy on which you are still paying premiums. If a charitable recipient is named irrevocable owner and beneficiary, you may deduct future premium payments as charitable contributions as well as an amount equal to the approximate cash value* at the time the gift is made.

5. Make charitable gifts of other assets and purchase a policy benefiting your heirs to replace the money or other property given. This method merits serious consideration by those who want to make significant charitable gifts without necessarily reducing what their heirs will receive. The tax savings realized as a result of a gift of cash or other property may be used to help offset the cost of insurance purchased to replace the assets you donated.

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*For the exact amount you can deduct as a charitable gift, check with your tax advisor.

6. Purchase a policy whose proceeds will be used to pay estate taxes. In the event no taxes are owed, they will be paid to loved ones and/or charitable interests.

7. Assign policy dividends to charitable interests. This can be a convenient way to make a tax-deductible gift each year.

A gift with many benefits

As you can see, life insurance offers tremendous flexibility for those who wish to include charitable gifts as part of their long-range financial and estate planning.
To summarize the benefits:

- *A life insurance gift is immediate.* The proceeds are paid in cash shortly after the death of the insured person. Life insurance gifts generally are not subject to the costs and delays of the probate process.
- *A life insurance gift is convenient.* Changing the beneficiary of a life insurance policy may be simpler and more cost-effective than changing the terms of a will, creating a trust or arranging for other forms of giving.
- *A life insurance gift is private.* A life insurance policy is not a matter of public record, so you can maintain privacy regarding your plans.

- *A life insurance gift is economical.* Under certain circumstances, the size of a person's gift can actually be larger than the original cost. And when a qualified charity is the irrevocable owner and beneficiary, the premiums paid on the policy are tax deductible gifts. Check with your advisor to confirm tax deductibility in your case.

Summary of Tax Benefits	
If you . . .	you may deduct . . .
Give paid-up policy	Approximate cash surrender value
Give policy on which you are still paying premiums	Approximate cash value and future premiums paid
Purchase new policy for charity	Premiums (if charity is named owner and beneficiary)
Assign dividends to charity	Value of dividends
Buy policy to guarantee pledge to charity	Premiums (if charity is named owner and beneficiary)

Conclusion

Charitable giving and life insurance have gone hand-in-hand for many years. Today, as an asset owned by most American families, life insurance can offer a wonderful way to carry out your charitable intentions—especially in the case of an insurance policy purchased a number of years ago and no longer needed for its original intended purpose.

If you have any questions or would like additional information regarding charitable giving and life insurance, please do not hesitate to contact us.

State laws govern and regulate the issuance and operation of life insurance policies. These laws can affect the deductibility of gifts for federal income tax purposes. Check with your life insurance representative or other advisors for additional information. They may find the following section to be of particular interest.

Technical Advisory Section

The preceding pages discussed many of the benefits and methods of making charitable gifts of life insurance. The information and references in this section may be of particular interest to those who assist you in your estate and financial planning.

The basic tax rules

Fair market value: The fair market value of a life insurance policy given to charity is not necessarily the amount the donor can claim as an income tax charitable deduction for the gift, but it is the starting point in determining the donor's deduction.

Internal Revenue Service regulations and court cases establish rules for determining the fair market value of an insurance policy.

In the case of a paid-up policy, the fair market value for federal gift tax purposes is the cost of replacing the policy. See Regulation section 25.2512-6(a), Example (3). One case holds that for federal income tax purposes, however, the fair market value of a paid-up policy given to charity is the policy's cash surrender value because that is the amount the charity can realize from cashing in the policy. See Tuttle v. U.S., 436 F.2d 69 (2d Cir. 1970).

For a whole life policy on which premiums remain to be paid, the fair market value is the policy's interpolated terminal reserve value plus the unexpired portion of the last premium paid. The fair market value is (1) increased by the amount, if any, of dividends accrued to the date of gift and (2) decreased by the amount of any outstanding loan against the policy. See Reg. section 25.2512-6(a).

For a term policy, the fair market value is simply the unexpired portion of the last premium paid. See Revenue Ruling 76-490, 1976-2 C.B. 300; Rev. Rul. 79-47, 1979-1 C.B. 312.

The donor's income tax charitable deduction

Ordinary income rule: The income tax charitable deduction for a donation of an insurance policy is limited to whichever is less: the fair market value of the policy or the donor's basis in the policy. The donor's basis is equal to the net premiums (gross premiums minus dividends paid back to the donor) paid on the policy.

In other words, the donor receives no income tax charitable deduction for any appreciation (or inside build-up) in the policy. This is because any appreciation represents unrealized ordinary income as opposed to capital gain. Under Internal Revenue Code section 170(e)(1)(A), no federal income tax charitable deduction is allowed with respect to appreciation that represents unrealized ordinary income (or short-term capital gain).

Planning technique: As such, in some situations the donor may find it advantageous to cash in the policy and then donate all or a portion of the cash received. Although cashing in the policy causes the donor to realize any inside build-up in the policy as ordinary income, it may be possible to offset this income completely with the charitable deduction for the cash donation. Whether the donor will obtain a complete offset depends on the percentage limitations applicable to the income tax charitable deduction discussed below.

The result to the donor (assuming a complete offset) will be a net charitable deduction equal to his or her basis in the policy—the same deduction as would be allowed if the policy itself were donated. Unlike contributing the policy, however, contributing cash will not bring into play the qualified appraisal rules discussed on Page 11.

Percentage limitations on the federal income tax charitable deduction: The federal income tax charitable deduction is subject to various percentage limitations.

The overall ceiling on the deduction is 60% of AGI. Gifts to public charities of cash and short-term capital gain property are deductible up to this 60% limit. See IRC section 170(b)(1)(A).

Gifts to public charities of certain types of appreciated property held long term are generally deductible up to 30% of AGI. See IRC section 170(b)(1)(C).

If the charitable contribution for a gift of an appreciated life insurance policy is reduced to the donor's adjusted basis in the policy because of inside build-up, the donor's income tax charitable deduction

for the gift is deductible up to 60% of AGI, as if it were a cash gift. See IRC section 170(b)(1)(A).

Excess charitable contributions may be carried forward for up to five years. See IRC section 170(b)(1)(B).

Qualified appraisal rules

Generally, a *qualified appraisal* (as that term is defined in Reg. section 1.170A-13(c)) is needed to sustain a claim of an income tax charitable deduction with respect to a donation of non-cash property other than publicly traded securities if the claimed value of the property (or the aggregate claimed value of all gifts of similar property made during the year) exceeds $5,000.

Is a life insurance policy cash or a publicly traded security? It is clear that a life insurance policy is not a publicly traded security. It is also fairly clear that a life insurance policy is not cash because, although it can be reduced to cash by being surrendered, the policy itself is a bundle of rights different from the rights constituting ownership of cash.

Therefore, to protect the tax position of the individual who donates a life insurance policy having a claimed value of more than $5,000, it is prudent to obtain a qualified appraisal for the policy.

The income tax regulations provide that a qualified appraisal cannot be prepared by a party to the transaction in which the donor acquired the item to be appraised. See Reg. section 1.170A-13(c)(6)(iv)(B). Neither the insurance agent who sold the policy to the donor nor the issuing company may prepare the appraisal.

The safest course of action in obtaining the appraisal is to have the appraisal prepared by someone competent by reason of training and experience to value an insurance policy who had no connection with the issuance of the policy (e.g., a tax accountant). There is no prohibition, it is worth noting, against the appraiser using information provided by the issuing company to appraise the policy.

In addition to obtaining a qualified appraisal, the donor is required to file an appraisal summary—IRS Form 8283—with his or her federal income tax return

on which the gift is first claimed or reported. See Reg. section 1.170A-13(c)(4). The appraisal summary must be acknowledged (signed) by the donee organization.

If the donee organization, within three years of the date of gift, sells or otherwise disposes of donated property as to which it has signed a Form 8283, it must report the sale to both the IRS and to the donor on IRS Form 8282. See IRC section 6050L.

In order for an appraisal to be a qualified appraisal, it must be obtained no earlier than 60 days before the date of gift and no later than the day before the due date of the income tax return on which the gift is first claimed or reported. Due date includes extensions of time to file the return. See Reg. section 1.170A-13(c)(3)(iv)(B).

Gift of a policy subject to a loan

In general, if an appreciated asset is given to a charitable organization, the donor does not realize the appreciation for federal income tax purposes. The reason is that, generally, gain is realized only if an appreciated asset is sold or exchanged, and a charitable contribution is merely a donative disposition.

If appreciated property subject to a mortgage or other indebtedness is given to charity, however, the transaction is treated as a bargain sale under Reg. section 1.1011-2, and the donor does realize a portion of the appreciation as a capital gain or ordinary income, depending on the type of appreciation involved.

The IRS has taken the position that a donation of a life insurance policy subject to a policy loan is a *bargain sale*—just as is a donation of mortgaged real estate. In other words, the IRS views the policy loan the same way it views a mortgage. See Revenue Ruling 80-132, 1980-1 C.B. 255.

Bargain sale formula: The amount of gain realized when property subject to debt is given outright to a charitable organization can be determined using this formula:

$$\text{Gain Realized} = (\text{FMV} - \text{B}) \times (\text{D}/\text{FMV})$$

- "FMV" is the fair market value of the donated property (determined without regard to the debt).
- "B" is the property's adjusted basis in the donor's hands.
- "D" is the amount of the mortgage debt or policy loan. See Reg. section 1.1011-2 and Reg. section 1.1011-2(c), Example (4).

Thus, for example, it appears that if a life insurance policy with a fair market value of $10,000, with a $4,000 adjusted basis in the donor's hands and subject to a $2,000 loan, is given outright to a charitable organization, the donor realizes a gain of ($10,000 - $4,000) × ($2,000/$10,000), or $1,200.

The donor is also entitled to claim a charitable contribution equal to $8,000 - I, where $8,000 represents the donor's equity in the donated policy, and "I" is the amount of the policy's appreciation that is allocated to this equity.

The allocation is made on a proportionate basis. "I" is equal to $6,000 (total appreciation) × ($8,000/$10,000), or $4,800.

The donor's charitable contribution, therefore, is equal to $8,000 - $4,800, or $3,200. Under IRC section 170(e)(1)(A), this reduced contribution may be claimed in an amount up to 60% of the donor's AGI (with a five-year carryover for any excess contribution), assuming the policy is given to a public charity.

Gift of group term coverage

Generally, an employee must report as income the cost of employer-paid group term life insurance on his or her life for coverage in excess of $50,000. See IRC section 79(a).

A special rule, however, excuses the cost of employer-paid group term coverage in excess of $50,000 for coverage payable irrevocably to a qualified charitable organization for the entire portion of the taxable year during which such coverage is provided to the employee. See IRC section 79(b)(2)(B).

This basically means that an employee can tack on some additional employer-paid group term coverage for the benefit of his or her favorite charity at no tax cost to the employee.

Insurable interest issue

In many states, statutes expressly permit a charitable organization to take out an insurance policy on the life of an individual, subject to certain requirements. Be sure to check applicable law for the state in which you live.

Wealth replacement

There are numerous charitable gift planning techniques involving life insurance. One example is the use of life insurance to replace assets that have been donated either on an outright basis or through other planning techniques.

The so-called *wealth replacement plan* comes in several varieties. The basic idea of the plan is to make a charitable gift (either outright or via a charitable remainder trust or other life income plan) and use the tax or other financial benefits resulting from the gift to pay for life insurance.

The wealth replacement plan can be an excellent way for a charitably motivated person to make a gift while still providing for loved ones. Keep in mind, however, that purchasing insurance and using it for tax and other financial benefits when making charitable gifts is simply an investment choice on the donor's part, and that the donor may wish to consider other investment alternatives.

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