What To Do With That Life Insurance Policy Where Premiums Are Still Owed?

PG Calc Featured Article, September 2014
http://www.pgcalc.com/about/1410-featured-article.html

What should your organization do with a life insurance policy on which premiums are still owed? This is a dilemma encountered by many non-profits from time to time. It arises in two instances:

1) When the non-profit is first offered a gift of a life insurance policy, and
2) When the non-profit is already the owner of a life insurance policy and for some reason finds itself paying the premiums.

This article will help you understand what to look for and what questions to ask if you find yourself in either situation.

<u>Scenario One</u>: A donor offers to give you a life insurance policy on which premiums are still owed

First, determine the type of policy being offered. There are two basic types of life insurance: temporary (term) and permanent (whole life, universal life, variable life). 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. In contrast, with a permanent insurance policy there is the opportunity for a build-up of cash value over time. A word of caution: sometimes donors don't really know what kind of policy they have or understand how it works. Request a copy of the policy and permission to speak with their insurance broker and/or insurance company.

If it is term insurance, determine:

- 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 health

If the donor does not intend to continue making the premium payments, most non-profits 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.

In a poll conducted during a recent PG Calc webinar on gifts of life insurance, almost half of participating non-profits indicated that they had never paid any part of the premiums on donated life insurance policies. (Another 15% said they didn't know and 7% said they had never been faced with the situation.)

However, there is an instance where it might be worthwhile for the non-profit to make a payment or two. This is when the donor is in her 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 non-profit wants to explore, it should discuss the idea with the donor and get the donor's full agreement before proceeding. Some donors will be happy to know the policy can be converted to cash; others will be uncomfortable with a third party owning a policy on their life.

If it is permanent insurance, determine:

- accumulated cash value (this is what the non-profit would receive if it decided to surrender the policy for immediate cash)
- age and general health of the donor
- whether the donor intends to continue making the premium payments

Even if a donor indicates she is willing to continue making the premium payments, a non-profit may ultimately decide its needs are served better by cashing in the policy. It may not have faith that the donor will continue the payments (it might help to have her execute a pledge agreement). Perhaps it doesn't want the administrative chore of monitoring the policy and subsequent payments. Or maybe the non-profit has a strong need for immediate funds.

If it would be up to the non-profit to continue the premium payments, a financial analysis should be done to determine whether it is in its best interest to pay and keep the policy or to cash out. To get started on this analysis, request an "in force illustration" from the insurance company. The illustration will show you the accumulated cash value and the number of years this value will cover premium payments without additional funds contributed. Depending on the policy, there might be two sets of columns – one that shows the number of years covered based on interest rates and insurance charges guaranteed under the insurance contract and another that shows the number of years covered based on non-guaranteed projected values.

In doing the analysis, take into account the age and health of the donor, i.e., how many years of premium payments might be left?; look to see if the cash value is projected to increase in the near term even without additional payments; and, assuming the donor does not have known health issues, how the total amount of premium payments to be made over the donor's life expectancy compares to the death benefit that would eventually be realized.

The exact financial analysis that is appropriate will vary for different policies. As you start to wade into these waters, don't be afraid to enlist the aid of those with greater expertise. The insurance agent may be willing to help you evaluate your options, your finance office should be able to offer some guidance, or you may have a board member or other volunteer who is knowledgeable about insurance and is willing to help.

One client I work with was offered a life insurance policy by a donor as part of a blended gift. The death benefit was quite high and it was important the non-profit have a high degree of certainty that it would eventually be received, as the donor was being given permanent recognition for the gift while living. The donor thought the policy was paid up; upon review it was discovered that while the accumulated cash value was projected to cover premium costs through age 93 there was an unprotected gap should the donor live particularly long. The donor ultimately agreed to give a cash gift sufficient to close that gap. The non-profit will pay additional premium payments over the next 30 years, and the fund should be sufficient to cover these payments, assuming the non-profit earns a certain rate of return on the funds. There is still some risk to the non-profit of the gift not being ultimately realized (remember to look at the financial strength of the insurance company) but it is at a much lower, and acceptable, level.

<u>Scenario Two</u>: The non-profit finds itself inadvertently paying premiums

I was recently asked about a life insurance policy of which a non-profit was the owner and sole beneficiary. It had recently been discovered that the non-profit also was the premium payer. The cash value was approximately $50,000. Dividends were currently sufficient to pay the premium amount and add to the cash value by $300 a year. The planned giving director wondered if this was a usual situation and what she should do with the policy.

This is a more common situation than many of us would like to think. In the webinar poll mentioned above, 14% of the respondents said that they had paid premiums by default and not by choice (a separate 8.5% said they had paid premiums but expected upfront to do so). Often the situation is uncovered when a consultant is hired and prompts the non-profit to “clean house” with regard to their existing gifts. Or a new planned giving officer comes on board and looks at existing gifts (or stacks of unidentified envelopes or files) with a more inquisitive eye.

On its face, it seems it would be beneficial to the non-profit to keep the policy described above. There is a chance they might receive the death benefit (presumably significantly more than the cash value), in the meantime the cash value is increasing each year, and for now the policy is continued at no cost to the non-profit. It will want to monitor the policy annually and make sure this remains the case. An in-force illustration will help the non-profit determine ahead of time if and when a shift might occur and premium payments be required from general funds. At that time a more thorough analysis as to whether to “keep and pay” or cash in the policy should be conducted, along the lines discussed earlier.

For example, consider Karen, a donor to a local non-profit. She is 75 years of age and has a universal life insurance policy, one of the “permanent” forms of insurance. She had purchased this policy long ago to provide for her children, but has since accumulated other assets to leave to them. Karen would like to give her life insurance policy to the non-profit for an unrestricted gift. Currently she is paying an annual premium, but she would like to stop making these payments once the policy is given to the non-profit. The death benefit is $1.25 million and the cash value is $200,000.

The planned giving officer meets with Karen to discuss the gift. She finds out that while Karen would prefer that the non-profit hold the policy and eventually receive the much larger death benefit, she understands if it were to decide to cash the policy in now. The PGO brings up the timeline of the gift as one of the factors that would influence the decision. Karen shares that while she feels fine now, she has lived with adult onset diabetes for many years. The gift officer obtains Karen’s permission to contact the insurance broker and request an In-Force Illustration.

The In-Force Illustration shows that the accumulated cash value is sufficient, given certain reasonable assumptions, to cover the premium payments for twelve years. Karen is pleasantly surprised to further learn from the illustration that under this scenario the cash value actually increases for a few years before it starts to diminish. The non-profit decides to retain the policy and have premiums paid from cash value for at least a few years: 1) Karen’s life expectancy of 11-15 years is probably shorter than it would otherwise be due to the diabetes, 2) with no cash outlay of its own, the accumulated cash value will most likely grow for a few years, and 3) the difference between the cash value and the death benefit is substantial. All of these business reasons dovetail with the donor’s preference that the policy be retained, which is also important to the non-profit.

The PGO gratefully accepts the life insurance policy and tells Karen that they plan to hold it for the foreseeable future. The PGO tells Karen that the non-profit’s policies are evaluated every few years to ensure they remain effective and that the decision to hold or cash-in might change in future years. Karen is happy with this outcome and very pleased to have used a previously idle asset to make a substantial gift to her favorite cause.

Of course, all of this assumes that the donor has declined to make further premium payments. Always be in contact with the donor first to apprise them of the situation and see if she will once again pick up the payments. One client I worked with did this on an older policy and not only was the donor willing to start covering payments again, he also agreed to cover back premium payments made by the non-profit! Then again, a different client had a policy donor that had ended her involvement with the non-profit and wouldn’t answer her letters or phone messages, let alone make any more payments.

Some Concluding Thoughts

The discussion thus far has focused largely on deciding what to do from a financial standpoint. There may be other factors to consider, not the least of which is your donor’s preference. Depending on the situation, it may tilt your decision towards covering premium payments for at least a few years.

The world of life insurance is a complex one. This article provides a starting point and some basic considerations to help you think through your options. I leave you with the rule of thumb that it is better in most instances for a non-profit to not make premium payments out of its general funds. However, every policy should be evaluated individually and regularly. The good news is that you don’t need to become a life insurance expert to do so - find a partner (consultant, insurance agent) to help you and then get started!