SUCCESS WITH LIFE INSURANCE GIFTS

PG CALC WEBINAR
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I. INTRODUCTION

Life insurance is a powerful and flexible financial and estate planning tool. Often presented either as a panacea for a wide range of financial needs or a complex riddle wrapped in a mystery inside an enigma – and frequently both at the same time – it's not too surprising that life insurance has developed a reputation as the bane of fundraisers. That's too bad, because a well-planned contribution of life insurance can be beneficial for the organization and the donor.

A charitable contribution of life insurance is simply a gift of property; in this case the property is a contract. From the organization's perspective, the charitable value lies in receiving the "death benefit," which is the dollar amount paid upon the death of the insured. However, there can be significant advantages for the donor who names the charitable organization as the owner of a life insurance policy.

In the following pages we will review the basic structure and economics of life insurance, discuss the rules and steps involved in making a charitable contribution of a life insurance policy, review three possible gift scenarios, and suggest considerations for reviewing proposed contributions of life insurance.

II. THE LIFE INSURANCE CONTRACT

At its core, a life insurance policy is simply a contract that promises to pay a specific amount of money (the death benefit) if a specific event (the death of the insured) occurs within a specific time period. There are four parties to the life insurance contract, each with its own interests and obligations under the policy:

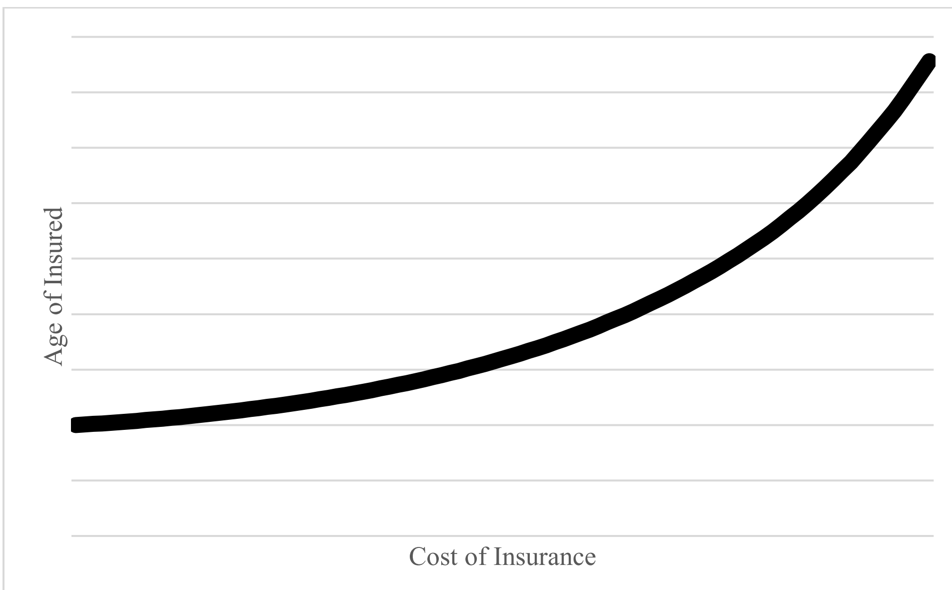
Owner	Insurer	Insured	Beneficiary
Buys and pays for the policy; has the right to change the beneficiary and to transfer ownership	Promises to pay an amount of money (the death benefit) upon the death of the insured	The individual upon whose death the insurer will pay the death benefit	The one to whom the death benefit will be paid

The contractual promise to pay the death benefit is usually good for one year and is renewable each year. The insurer charges a fee, the "cost of insurance" (sometimes referred to as the "mortality charge") in exchange for the promise to pay the death benefit. The older the insured the higher the fee since the likelihood of paying out the death benefit increases as the insured grows older.

To illustrate how the cost of insurance increases with age, consider a hypothetical insurer that intends to issue life insurance contracts covering a range of ages. The following table shows the "probability of death" at various ages and calculates the cost of insurance for each 1,000 insurance contracts.

1,000 insureds, with a $100,000 death benefit				
Age of Insured	Probability of Death in One Year	Number Dead in One Year	Total Death Benefit to be Paid in One Year	Cost of Insurance per Policy
30	0.001795	2	$200,000	$200
40	0.002580	3	$300,000	$300
50	0.004890	5	$500,000	$500
60	0.011452	11	$1,100,000	$1,100
70	0.022381	22	$2,200,000	$2,200

For the purposes of this illustration, we've used probability of death estimates provided by the Social Security Administration. In reality, insurance companied employ much more sophisticated and granular actuarial data when building their estimates. Adding in costs for administration and a profit margin, the insurance company will build a detailed schedule of premiums at various ages, illustrated in the following graph.



In exchange for payment of the premium, the insurance company issues a contract committing it to pay a specific death benefit amount provided that the insured dies within a specific period of time, usually one year. The contract can be renewed each year, but at a higher premium to cover the increased cost of insurance.

III. Financing the Cost of Insurance

Most modern policies are so-called "cash value" policies designed to allow the owner to pay either a fixed or variable premium each year which is projected to accumulate sufficient value to pay for the current and projected future costs of insurance each year. Accumulated premiums which have not yet been used to pay for the cost of insurance are invested and held to pay the cost of insurance in the future. These accumulated unspent premiums are what is commonly called the "cash value" of the policy. Cash value is, essentially, premiums that have been collected but not yet spent on insurance coverage.

The insurance industry has created an array of approaches to financing the cost of insurance. Following is a brief summary:

> **Term Life Insurance** – The policy pays a death benefit only if the insured dies within a certain period of time (usually one year). The amount of the premium increases each year because the likelihood of paying the death benefit during the coming year increases as the insured grows older. There are variations including: annual renewable term, where the insurance company promises to renew the death benefit coverage each year but at higher premium, and decreasing term, where the insurance company promises to renew the coverage each year for the same premium but with a smaller death benefit.
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> **Whole Life Insurance** – The premium stays the same and the death benefit coverage stays the same for the "whole life" of the insured. At the time of purchase the premium for a whole life policy is significantly higher than the premium for the same coverage under a term insurance policy. The extra money collected in the early years is accumulated and invested to provide a source of funds to pay the higher cost of insurance in later years when the insured is older. Under a whole life policy, the insurance company guarantees a specific death benefit value will be paid as long as premium payments are made on time regardless of actual investment performance, mortality experience, or other vagaries during the life of the insured.
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> **Universal or Variable Life Insurance** – Both the premium amount and the amount of the death benefit may be adjusted during the course of the policy. Similar to whole life policies, excess premiums are accumulated to be invested and used later to pay the cost of insurance. However, unlike whole life policies, many of the variables, including the cost of insurance, mortality assumptions, investment return and value of death benefit, are not guaranteed and can be adjusted from time to time. Depending upon the terms of the policy, the owner may be afforded the opportunity to select the investments owned by the policy.
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> **Limited Payment or "Vanishing Premium" Plans** – A limited number of annual premiums are projected, after which a sufficient policy value is expected to have accumulated in order to pay the cost of insurance for the lifetime of the insured. If the projections are accurate, then no further premiums will be required.
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> **Single Premium or "Paid Up" Life Insurance** – One very large premium is paid at the time of purchase, most of which is set up as an invested reserve to pay the cost of insurance for the lifetime of the insured.

The policy types differ in the way in which financial resources are accumulated to pay the future cost of insurance. Term insurance is the simplest: the premium increases each year as the cost of insurance rises. A whole life policy costs more than term insurance in the early years and retains the additional money to cover the increasing cost of insurance in later years. Variable or universal policies allow the annual premium to vary from year to year, but the objective is still to accumulate enough financial resources to pay for the cost of insurance over time.

Note that, if a cash value policy runs out of money before the death of the insured the contract will lapse without ever paying a death benefit. A lapsed policy costs the insurer nothing and, when developing their premiums, insurers count on a portion of their policies lapsing without paying a death benefit.

IV. CHARITABLE GIFTS OF LIFE INSURANCE

As noted above, the charity's primary interest is collecting the death benefit of the insurance policy. The easiest way to make a charitable gift of life insurance is for the donor to simply name the charity as the beneficiary of the policy. Like any other beneficiary designation, the donor can name the charity as beneficiary of all or a part of the death benefit and can change or eliminate the beneficiary designation if need be. For practical purposes, a beneficiary designation is much like a charitable bequest.

However, if the donor assigns ownership of the policy to charity, the donor will be able to take advantage of two tax benefits: a charitable deduction for the value of the policy at the time the gift is made and a charitable deduction in future years if the donor makes premium payments on the policy. Of course, contributing policy ownership to the charity also means the gift becomes irrevocable and, as owner of the policy, the charity will ensure that it is death benefit beneficiary.

The charitable deduction for a gift of ownership of a policy is for the "interpolated terminal reserve value" of the policy (basically the "cash value," subject to certain adjustments) or the total of premiums paid by the donor on the policy, whichever is less. If the donor claims a deduction greater than $5,000, a qualified appraisal is required to substantiate the value. The deduction for future premium payments is available even if the donor continues to pay the premiums directly to the insurance company.

Note that term insurance policies have no cash value. This does not preclude charitable contributions of term insurance policies; however, because the policy has no cash value the charitable deduction will be limited to the amount of premiums paid by the donor each year. A gift of term insurance is a beneficiary designation which could vanish if the donor lives longer than the period for which premiums have been paid. Donors can, and often do, contribute term insurance with a commitment to continue to pay the annual premiums in order to maintain the value of the death benefit for the charity.

After the charity has been named owner of the policy, the charity has unilateral control of the policy and may choose to maintain the policy and wait to collect the death benefit, cash in the policy ending the insurance protection and receiving the residual cash value now, or accept a guaranteed death benefit policy with no further premiums required.

Another option for the charity is selling the life insurance policy for cash. Certain commercial entities purchase life insurance policies and rely on the death benefit of the policy as the return on their investment. These financial intermediaries may be willing to pay more than the cash surrender value of the policy especially if the insured's life expectancy is shortened, for example in the case of a terminal illness. Sometimes called "viatical settlements," charities should consider the perceptions surrounding such transactions: the investors profit from the premature death of the insured.

It is critically important to ensure the donor understands that *the charity is under no obligation to make further premium payments on the policy*. Frequently, donors mistakenly assume either that no further premiums will ever be required or that the charity will pay future premiums.

Depending upon the financial health of the policy, it may be able to continue for many years without additional premiums. However, future events – overly optimistic projections, disappointing investment performance, higher than expected costs of insurance – can cause a policy to run out of money. In these cases, the policy will lapse, with no death benefit ever paid.

A life insurance policy owned by the charity is a valuable financial asset and should be reviewed periodically to evaluate its financial condition and the likelihood that it will remain financially viable and provide the expected death benefit. If the policy's financial condition deteriorates, the donor could be asked to make additional premium payments in order to preserve the death benefit or the charity could choose to surrender the policy and withdraw the remaining cash value or accept a paid-up policy with a lower death benefit.

While decisions about the policy are the charity's to make, good donor communication is key. The worst outcome is to ignore the policy until the charity, and probably the donor, receive notice from the insurance company that the policy has lapsed, at which point the promised death benefit has been lost.

V. THREE SCENARIOS: THE GOOD, THE NOT BAD, AND THE UGLY

The Good – Outright Gift of an Existing Policy

A donor owns a whole life insurance policy with a $100,000 death benefit that she purchased decades ago when her family was young and the death benefit provided financial security in case of her untimely death. Her children are now grown and she is comfortably retired. The economic fact is she no longer needs the financial protection provided by the policy, but she has continued to pay the $950 annual premium all these years.

If she contributes ownership of the policy to your charitable organization, she will receive an immediate income tax charitable deduction for the value of the policy. She believes the cash value is about $40,000 but understands that she will need a qualified appraisal to substantiate her deduction and cannot deduct more than the total of premiums she has paid over the years.

In addition, she is pleased to learn that she will receive an income tax deduction if she continues to pay the annual premiums and she understands that paying the premiums will allow your organization to maintain the policy.

Once named owner, your charitable organization will make certain that it is named as the death beneficiary and can choose to maintain the policy and wait to receive the death benefit. Maintaining the policy is especially viable in this case because the donor is willing to commit to making future premium payments on the policy. If that were not the case your organization could choose to terminate the policy and receive the cash value now or explore surrendering the policy to the insurance company in exchange for a paid-up policy with a lesser death benefit.

The Not Bad – A "Wealth Replacement" Policy

A donor, who had previously notified you of his plans to leave a generous $1 million charitable bequest to your organization is now considering a contribution of $1 million in assets to a charitable remainder unitrust paying 5% to the donor for life with the remainder to your charity. The assets are highly appreciated with a cost basis of $100,000. Using PGM Anywhere, you prepared the following Summary of Benefits Projection illustration for the donor projecting the lifetime benefits of the unitrust to selling the assets and reinvesting the proceeds himself.

Summary of Benefits Projection

ASSUMPTIONS:
Projection runs for 19 years. Measuring life age is 72.
Donor income tax bracket is 24% and 15% capital gains.

	Charitable Unitrust 5%	No Gift: Sold and Reinvested
Property Value	$ 1,000,000	$ 1,000,000
Cost Basis	$ 100,000	$ 100,000
Capital Gains Tax		$ 135,000
Reinvested Principal		$ 865,000
Charitable Deduction	$ 531,970	$ 0
Income Tax Savings	$ 127,673	$ 0
Investment Assumptions:		
Annual Income	3%	3%
Annual Appreciation	4%	4%
Sell Asset in First Year	Yes	Yes
Annual Amount to Spend	5.0%	5.0%
Total Benefit To Payment Recipient	$ 1,142,028	$ 987,854
Benefit to Remainder Beneficiary	**$ 1,456,811** (Charity)	**$ 1,260,142** (Donor)
Total Benefit	$ 2,365,865	$ 2,086,506

As you are reviewing the projection with the donor, he focuses on the "Remainder to Beneficiary" line which indicates that his heirs could receive $1,260,142 if he does not make the gift. In his mind, he had intended to make a $1 million charitable bequest to your organization and is interested in the charitable remainder unitrust as a way to accomplish that goal now. He observes that your projection suggests that his heirs might forego more than a quarter million dollars they could inherit if, instead of creating the charitable remainder unitrust, he kept, sold, and reinvested the asset and left a charitable bequest of $1 million as he had planned.

To address this objection, the donor could purchase a new $250,000 life insurance policy naming his heirs as the death benefit beneficiary. He could use some of the projected $127,673 in projected income tax savings from the charitable deduction to help pay for the new life insurance policy. And, if estate taxes are a concern, he could work with his financial advisors to name his heirs as owners of the policy which could reduce or eliminate the estate tax.

The Ugly – Policy Purchased for Contribution

A young donor, age 30, is motivated to make as large a contribution as possible and has been convinced that purchasing a new life insurance policy and then contributing it to your organization is a way to "leverage" his charitable contribution. According to the sales materials that have been presented to him, for "only" $950 per year he can purchase a policy with a $100,000 death benefit to give to your organization. He feels this is quite a bargain because, if he lives to his life expectancy of 62 years, he will have paid "only" $58,900 in premiums on the policy, which is $41,100 less than the $100,000 death benefit of the policy.

As an alternative to spending $950 per year (for the rest of his life) on an insurance policy, you might propose that the donor create a special fund to be invested and compounded in your endowment portfolio with no distributions until the end of the donor's lifetime. Assuming a modest average net total return of 5%, this fund would grow to about $411,000 over the donor's 62-year life expectancy. Indeed, this endowment fund would reach the insurance policy's death benefit amount of $100,000 by year 36, which is approximately 72% of the donor's life expectancy.

The following table compares purchasing a new $100,000 policy versus investing the premiums for various ages:

				If invested at 5%, compounded, instead			
	Life Expectancy						
Age Now	Years That Remain	Year	Assumed Annual Premium	Total at Life Expectancy	Year Value Reaches $100,000	Years before Life Expectancy	Percent of Life Expectancy
30	62	2087	$950	$411,000	2061	26	72%
40	52	2077	$1,400	$361,999	2056	21	77%
50	41	2066	$2,150	$305,000	2049	17	81%
60	31	2056	$3,550	$281,000	2042	14	85%
70	22	2047	$6,100	$247,000	2036	11	88%

By this analysis, the economic advantage of a newly purchased life insurance policy depends upon the donor dying very prematurely. Remember that life expectancies are averages. If your donor doesn't beat the average and dies before life expectancy, the life insurance policy death benefit is an advantage. (Of course, there's no magic at work here. The endowment gifts are simply not paying the cost of insurance which would be paid inside an insurance policy.)

VI. Evaluating Programs Promoting Charitable Gifts of Life Insurance

It seems there is a never-ending array of programs promoting life insurance in charitable giving. Often, these programs purport to offer new or especially creative approaches to charitable gifts of life insurance. Sometimes they promise vast new gifts with little effort on the part of your organization. Two common approaches are premium financing plans and suggestions that endowment funds be used to purchase a commercial annuity paired with a life insurance policy to arbitrage the premium differentials between insurers.

Premium financing plans often purport to raise substantial future funds for the charitable organization with little or no investment of time or money by the charity. Typically, these programs involve an outside investor who provides a loan to pay the premiums on individual insurance policies. The investor counts on the death benefit payments from the policies to repay the loan with interest leaving what is left for the charity. The charity's role in these plans is to recruit a large number of supporters who are willing to allow the purchase of life insurance on their own lives. Typically, the promotions for these programs suggest that, over time, the combined death benefits will be sufficient to repay the loans with interest and leave a substantial remainder for the charity. If the projections are off, the program will collapse. Before engaging in such a program, it is prudent for the charity to check ensure that it will not be responsible for the debt should the program fail.

Premium arbitrage plans involve the charity purchasing a commercial annuity to pay the premiums on a life insurance policy. These programs rely on pricing differences between a commercial annuity and a life insurance policy. In essence, a commercial annuity is the inverse of a life insurance policy: in return for a substantial lump sum payment to the insurer, a commercial annuity provides a fixed annual payment for the life of the insured, as opposed to a life insurance policy that provides a lump sum death benefit in return for a series of payments. The lump sum premium for a commercial annuity of a certain fixed amount will be less if the insured's life expectancy is shorter because the insurer expects to make fewer annuity payments. Each insurer has its own approach to underwriting, and there are legitimate reasons for differences in premiums from one insurer to the next. Premium arbitrage plans count on exploiting these pricing differences by purchasing the commercial annuity from an insurer that projects a shorter than usual life expectancy (and therefore is willing to charge less for the annuity) and purchasing the life insurance policy from an insurer who anticipates a longer life expectancy and therefore is willing to charge less for the policy

Before engaging in any program promoting life insurance, the charity should engage in a careful review of the proposal to ensure that there is real value for the charity. The National Association of Charitable Gift Planners has published "Charitable Life Insurance Evaluation Guidelines: A Tool for Charitable Gift Planners" to help assess charitable life insurance proposals. These guidelines are available from the Association's web site https://charitablegiftplanners.org/standards/charitable-life-insurance-evaluation-guidelines. The key elements of the recommended review are:

> **Complete Analysis** – Careful analysis of both the subjective and objective factors is key. Some aspects of charitable life insurance programs lend themselves to quantitative analysis, while other aspects are more qualitative in nature. A worthwhile charitable life insurance program will meet both subjective and objective criteria.
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> **Value and Values** – The analysis should guard both the value and the values of the charitable organization today and in the future. Even though a charitable life insurance program may be financially viable, it may still present unwarranted risk to reputation and/or consume unreasonable amounts of valuable staff time and resources.
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> **Nothing is Free** – Nothing of value comes without a price. All of the costs of the charitable life insurance program, including the costs of insurance, borrowing, commissions, and on-going administration, must be paid by someone at some point. The charity should have a clear understanding of all these costs and the sources of the funds to pay these expenses, as well as the ultimate source of the value the charitable organization expects to receive.
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> **Charitable Interest** – The charitable life insurance program must respect and serve the charitable interests of the donor.
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> **Obligations and Commitments** – Charitable organizations should fully understand the obligations involved in a proposed charitable life insurance program and the impact should the program not unfold as planned. Interest rates, mortality assumptions, and the cost of insurance are all variables that may increase or decrease the charity's out-of-pocket expenses over time.