18. LIFE INSURANCE

Many church members own life insurance at some point in their lives. Life insurance may provide peace of mind, risk protection, financial liquidity or investment diversification. For individuals who have not had time to build substantial net worth, life insurance can be used to create an estate for dependants at the death of the insured. To individuals who have been successful in creating wealth, life insurance can be an important vehicle in providing cost effective funds to pay wealth transfer taxes and other expenses or liabilities at death, thus preserving a legacy for heirs.

Insurance is often considered the perfect legacy asset:

- It matures automatically at death for the full face amount regardless of equity built or deposits made to date
- It passes immediately upon claim to named beneficiaries
- It passes free of the costs and delays of the probate process
- It passes in cash
- It passes free of income tax
- It passes free of estate tax where the insured has no incidents of ownership

Important Terms

There are a few basic terms that are important to understand. Life insurance is a contract under state law with the parties involved being described as:

- The insurer--the company issuing the policy,
- The insured--the individual whose life/lives are covered by the policy and at whose death a benefit is paid,
- The applicant--the individual or company who applies for the policy,
- The owner--the individual, company or organization who has legal rights to the policy such as the right to change beneficiary, and who owns the cash value,
- The beneficiary--the one to whom the death benefit is paid.
- The cash surrender value—the amount the policy owner would receive from the company if the policy is cashed in. the cash surrender value reflects the value of premiums paid plus investment growth less administration expenses.

Other important terms include:

- Premium-- the amount paid for a life insurance policy. The premium is reflective of (1.) the insured's age and the mortality costs associated with providing the death benefit, (2.) the insurer's expenses in issuing and maintaining the insurance contract, and (3.) the rate of return earned on the invested premiums.
- Participating contract--the policy owner receives or participates in unused premium, typically in the form of dividends, which results from savings in any of the above three factors.
- Non-participating--the policy owner does not receive any benefit from savings in company costs or investments.

- Dividend--a return of unused or excess premium and is not taxable income to the recipient. If the dividends are left on deposit with the company, the interest earned on the invested dividends is taxable to the insured. Therefore many policy owners elect to buy additional paid-up life insurance with their dividends, thereby reinvesting them in a way that does not generate taxable interest.
- Vanishing premiums--typically this terms is used to describe the time period (10 years, 15 years etc.) during which accumulated policy reserves, including cash values, cover all future premium charges. The reality is that the premiums do not really vanish, they remain due and payable, but by surrendering amounts of paid-up additions in conjunction with current payable dividends, the premium due is satisfied. However, if dividend performance is not as projected, the policy owner may be required to pay premiums to keep the policy in force.
- Incidents of ownership—these include the right to:
    1. Change the beneficiary;
    2. Surrender, pledge, or assign the policy;
    3. Change the contingent beneficiary;
    4. Select or revoke a settlement option;
    5. Receive policy dividends; and
    6. Reversionary interest in the policy.

  All incidents of ownership must be irrevocably assigned to the charity in order for an insurance gift to qualify for an income tax charitable deduction.
- Insurable Interest—the interest arising when a policy beneficiary has a reasonable expectation of benefiting from the continuance of the insured's life, or of suffering a loss at the insured's death. Policies obtained by persons lacking insurable interest are not enforceable.

Types of Life Insurance

Life insurance is designed to spread an individual's risk of loss among a large group of people. There are basically two kinds of life insurance: term insurance and permanent (cash value) insurance.

Generally, if the insured dies during a coverage period the company pays the policy face amount. Additional value might be added to the face amount for certain types of permanent insurance. Loans against a permanent life policy would be deducted from the death benefit.

Term Insurance

Term insurance is temporary insurance that provides coverage for a period of time. It is the least expensive form of insurance. It provides pure insurance coverage without any build up of cash value. As the insured's risk of death increases with age, the premiums increase at every renewal period. For estate planning purposes term insurance generally becomes prohibitively expensive to renew late in life. The more popular types of term insurance are:

- Annual Renewable Term: This contract provides fixed coverage for the present year and guarantees the right to renew for the following year at a specified rate.
- Level Term: This policy is written for a fixed period of years and total premiums for the entire period of coverage are divided into equal installments. Common types are five, ten or twenty year convertible and renewable term and term to age 65.
- Decreasing Term: Also known as declining balance term. Premiums remain constant over the period of coverage, but the amount of coverage decreases annually. These policies are generally used for mortgage protection.
- Modified Term: Usually designed to function as term insurance for five to ten years and then to automatically convert to whole life or permanent insurance.

Permanent Life Insurance

There are many varieties of permanent life insurance. Each provides unique features to assist the insured in reaching certain financial or risk protection goals. For example:

Whole Life Insurance: Whole life insurance features fixed premiums which typically are higher than term insurance premiums. To offset higher mortality and policy service costs at older ages, a portion of each premium paid goes into a reserve account. While the insured lives and the contract remains in force, part or all of this reserve is available to the policy owner as the policy's cash value. The cash value grows over time and approximates the policy's cash surrender value. Most policies are "participating" and pay out as dividends all earnings in excess of those required to maintain required reserves.

In time, the reserve and the equivalent guaranteed cash value grow to an amount equal to the face value of the policy. At that point the policy reaches its maturity value and is said to "endow" – that is, an amount is paid to the policy owner or designee and the contract terminates.

Joint Lives Life Insurance: Joint lives insurance provides "second-to-die" or "first-to-die" coverage. Second to die contracts are frequently used in irrevocable life insurance trusts and in conjunction with wealth replacement trusts. The policy is usually less expensive than two separate policies and is appropriate when looking for proceeds at the survivor's death. The policy premium can be paid up at the first death or continue until the second death.

Universal Life: Universal Life policies are a form of term life insurance in which the premiums are paid from the insured's earnings from a money market fund. They offer flexibility as long as enough money remains in the policy to cover mortality and annual expenses. The policy owner can raise or lower the death benefit, access the cash value via loans or withdrawals. Since a universal policy can be viewed as a term policy coupled with a side fund, it is the most sensitive of all whole life policies to changes in company profitability.

Variable Life Insurance: A form of life insurance in which the premiums are invested in securities and whose death benefits thus depend on the securities performance, though there may be a minimum guaranteed death benefit. The agent must have a variable annuity license and all illustrations should be accompanied by a current prospectus. The policy has fixed premiums, but neither the cash accumulation nor the death benefit is guaranteed. The death benefit may fluctuate, but not below a guaranteed minimum, based on the performance of the underlying investments.

Taxation of Life Insurance

There are income tax, gift tax, and estate tax consequences to life insurance. An in depth explanation of these issues exceeds the scope of this Manual.

Income Taxation: Generally, proceeds of life insurance are not subject to income tax (IRC §101(a)(1) with the following exceptions.

1. Transfer For Value Exception

   If the transferee of a life insurance policy acquired the policy for consideration, the proceeds are taxable income to the transferee. The transferee may deduct the consideration paid for the policy and all premiums or other payments made by the transferee after the transfer.

2. Exception to the Transfer for Value Exception.

   The transfer for value rule does not apply in the following situations:

   a. The purchaser acquired the policy directly from the insurance company as the original applicant and owner.

   b. The transferee acquired the policy by gift or through any transaction in which the transferee retains the income tax basis in the policy of the transferor.

   c. The transferee is the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.

      The transfer for value exception is often used when an insured who has established an irrevocable life insurance trust whose terms become inappropriate with the passage of time. With the consent of the trustee, the insured may use the transfer for value exception to acquire the policy from the insurance trust and transfer the policy to a new trust with acceptable terms. The three year period governing the exclusion of assets from the gross estate for estate tax purposes will begin to run with respect to the new transfer.

Gift Taxation: The transfer of all ownership rights in a life insurance policy is a taxable gift, the value of which is based on the interpolated terminal reserve at the time of the gift. Treas. Reg. §25.2512-6(A). The IPTR approximates the cash surrender value and can be calculated by the insurance company. In addition, the payment of premiums by someone other than the owner is a taxable gift. These events are subject to the annual gift tax exclusion and lifetime gift tax exclusion to the extent they are available.

Estate Taxation: Life insurance is includable in the insured's gross estate for estate tax purposes if the insured retains any incidents of ownership or if the proceeds are payable to or for the benefit of the decedent's estate. (IRC §2042) Incidents of ownership include any rights to economic benefits from the policy, including the power to change the beneficiaries, borrow against the policy, surrender or cancel the policy, assign or cancel the assignment of the policy. Treas. Reg. §20.2042-1(C)(2). Further, if any incident of ownership is actually transferred by the decedent without consideration within three years of death, proceeds are includable in the gross estate for estate tax purposes. Generally, the decedent's estate will be then be entitled to an unlimited estate tax deduction for insurance proceeds passing directly to charity.

Life Insurance as a Charitable Gift

A life insurance policy can be given to charity entitling the donor to claim an income tax charitable deduction. Life insurance policies are given to charity for primarily two reasons:

1. The coverage exceeds what the insured needs
2. The donor wants to leverage a relatively small amount of money (premium) into a larger charitable benefit by way of the death benefit.

Life insurance may be used as a charitable gift by:

1. Assigning the annual dividends to a charity. This method creates a deduction as dividends are paid.

2. Irrevocably transferring policy ownership and all incidents of ownership to charity.

   a. The charitable income tax deduction for the transfer of a **fully paid-up** policy is the lesser of
   (1) the donor's basis in the policy (premiums less dividends received) or
   (2) the policy replacement value.

   b. If the policy transferred to charity is **not fully paid-up**, the charitable gift is valued at the interpolated terminal reserve of the policy. This value is generally slightly more than the cash surrender value. It amounts to the value of premiums paid plus investment growth minus administrative costs. If the interpolated terminal reserve exceeds the donor's basis, the deduction is limited to basis. The insurance company can calculate the interpolated terminal reserve.

3. Purchasing a new policy for naming the charity as owner and beneficiary. Premiums paid by the donor for the gifted policy constitute charitable contributions. These contributions are easier to substantiate and procedurally simpler if the donor contributes the premium amount as a cash donation and the charity pays any premiums due. Premiums paid to the insurer are considered "for

the benefit of" the charity and are limited to 30% of adjusted gross income. Premium amounts donated in cash to the charity are gifts "to charity" and are consequently limited to 50% of AGI.

4. The policy owner can name a charity as the primary or contingent beneficiary of an existing or new policy. Although this does not qualify for an income tax charitable deduction, it will result in a federal estate tax deduction for the full amount of proceeds paid to charity, regardless of policy size.

Gifts of both fully paid-up and non paid-up insurance policies to a public charity qualify for the 50% of adjusted gross income limitation, with a five year carry forward.

Insurance Policies With Outstanding Loans

Charitable gifts of life insurance policies with outstanding loans can be problematic. When the outstanding loan exceeds the donor's basis in the policy, the donor must report and recognize the loan amount in excess of gain as an ordinary gain. Such gifts are typically treated as part gift and part sale, a bargain sale. If the charity accepts a life insurance policy and in turn borrows from the policy whether to pay premiums or reinvest may be subject to unrelated business income tax. Therefore, each situation must be reviewed by competent counsel prior to each transfer.

Gift Valuation and Substantiation

Gifts of life insurance policies are subject to substantiation rules applicable to contributions of non-cash assets. The following table summarizes the requirements:

Deductible Value	**Requirements to Qualify for Deduction**
$5000 or less	(1) Contemporaneous written acknowledgement describing the property received, (2) Donor completes Form 8283 Section A, Parts I, II, and III as applicable and attaches it to the tax return for the year during which the property was transferred to charity (including extensions).
Over $5,000	(1) Contemporaneous written acknowledgement describing the property received. (2) Donor obtains qualified appraisal from a qualified appraiser who is someone other than the donor, donee, agent that sold the policy or the insurance company or spouses of the donor or agent. (3) Donor completes Form 8283 Section B, Parts I, II, Appraiser completes Part III, and Charity completes and signs Part IV. Donor attaches 8283 to the tax return for the year during which the property was transferred to charity (including extensions).
Charity responsibility for gifts over $5,000	If property is disposed of within three years of the date of gift, charity files Form 8282 with the IRS and provides a copy to the donor.

Insurable Interest

States generally have insurable interest requirements for owners of policies. Many states, but not all, have statutes granting an insurable interest in the lives of donors to charity. Some require the donor to purchase the policy, others allow the charity to purchase the policy (with permission of the insured), and others are silent. Consequently, charities should be aware of the requirements in the states where their donors reside and donors should confirm whether or not his or her state grants an insurable interest to charity.

Additional Resources

Charitable Giving Tax Service. Marc Carmichael, editor. R & R Newkirk. Willow Springs, IL

Gift Law Pro. A module of CresPro Gift Planning software published by Crescendo Interactive. Also accessible on line at www.adra.org and www.iiw.org.

Planned Giving Management, *Marketing and Law*, *Second Edition*. Katelyn Quynn & Ron Jordan, John Wiley & Sons, Inc., 605 Third Avenue, New York NY. 2000.

Tax Economics of Charitable Giving, Joseph P. Toce, Jr., JD, CPA et al., Wealth and Tax Advisory Services, Inc. of RIA.