PROFESSIONAL Tax & Estate Planning NOTES

The New York Community Trust

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3 CHARITABLE GIFTS USING LIFE INSURANCE

When people think about the assets they have available to contribute to charity, life insurance is rarely on the list. But many people who have put their children through college and paid off their mortgages may have more life insurance than they need. Your charitable clients may be pleasantly surprised to learn that they can afford to make larger gifts than they thought. And, if they donate the policy to a public charity such as The New York Community Trust, they'll also receive an income tax deduction.

VALUING THE GIFT

For a donor with more life insurance than he or she needs, naming charity as the sole beneficiary, without assigning all rights in the policy, can be a cost-free way to provide for charity, and it is a revocable decision.

Alternatively, the irrevocable gift of an insurance policy to charity entitles the donor to an income tax deduction, the amount of which depends upon the type of policy contributed. For example, a gift of a fully paid up policy will result in a deduction equal to the policy's replacement cost, up to the cost basis of the policy (premiums paid less dividends received). The deduction for a gift of a policy on which premiums are still due is approximately the cash surrender value of the policy, again limited to the donor's basis.

In order to effect the transfer of a life insurance policy, the donor must irrevocably designate The New York Community Trust or other charity as beneficiary and assign to it all incidents of ownership. The insurance proceeds are excluded from the donor's estate provided the transfer was made more than three years before the donor's death. If the gift was made within three years of death, the proceeds are includable in the gross estate, and the estate will receive an offsetting charitable deduction.

When a donor retains some rights under the policy, the transfer is treated as a gift of a partial interest in property. No income tax deduction is permitted and the gift may be subject to gift tax.

In some states, a charity is not considered to have an insurable interest in a donor's life. At one time, the Internal Revenue Service advised that this was the case in New York. As a result, New York State insurance law was amended to clearly permit a New York resident to purchase and assign a policy to charity. As a general rule, the donor's domicile will determine the applicable state law.

Although the income tax deduction for a gift of an insurance policy will not exceed cost, the appraisal rules under Code Section 170[1] apparently apply because an insurance policy

[1] All "Code Section" references are to Sections of the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." references are to the Treasury Regulations promulgated thereunder.

is not money or a publicly traded security. A qualified appraisal must be made by an independent appraiser, presumably an independent agent or insurer.

PREMIUMS

Donors who contribute insurance policies that are not fully paid up have two options regarding future premiums. Typically, the donor makes annual gifts to the charity, which may use the contributions to pay the premiums. Alternatively, the donor may pay the premiums directly to the insurance company. The IRS may take the position that this is a gift "for the use of" the charity; the income tax deduction for such a gift is limited to 30 percent of the donor's "contribution base" (adjusted gross income or "AGI," computed without regard to any net operating loss carryback), while a gift "to" charity is subject to a higher, 50 percent limitation.

GROUP TERM INSURANCE

A gift of a policy that is provided by an employer through group insurance can also be advantageous to your clients. The cost of such a policy with coverage in excess of $50,000 generally must be included in the employee's income. Naming The New York Community Trust as beneficiary will result in the exclusion of the cost from the employee's income, although it will not give rise to an income tax deduction. A gift of only the coverage in excess of $50,000 may constitute a partial interest on which gift tax may be payable. However, it is likely that the $10,000 annual gift tax exclusion would cover the value of the gift in most instances.

INSURANCE AND TRUSTS

A charitably minded person may put an insurance policy to work to benefit charity through a charitable remainder trust, including a "wealth replacement" arrangement.

A charitable remainder trust provides for payments to income beneficiaries for a period of time, with the remainder payable to charity. Funding a charitable remainder trust with life insurance avoids making an initial commitment of fairly sizable assets. A charitable remainder unitrust, which allows the donor to make future contributions, is commonly used; the trustee may then use the additions to pay premiums. The donor is entitled to an income tax deduction (calculated using IRS tables) for the initial contribution and for the additions. An annuity trust does not permit such additions.

When the donor wishes to provide for a spouse or children and then charity, a "net income with make up" unitrust may be considered. Such a trust would make payments to the income beneficiary out of income only, avoiding the need to invade principal to make payments in early years when there is no income. The trust would distribute excess income in later years (after the policy matures and the proceeds are paid to the trust) to make up for payments that were not made earlier. The remainder, of course, goes to charity.

It is important to keep in mind that the trust instrument may not restrict the trustee from earning a reasonable rate of return on investments. Accordingly, the trustee must have the authority to dispose of the policy if he concludes that the return from the policy is not adequate.

Generally, a policy should not be contributed to a charitable remainder trust if the donor has borrowed against it. Unless the gift is the initial gift to the trust, the IRS may treat the policy loan as an act of self-dealing. In addition, the trustee generally should not borrow against the policy as the borrowing will be treated as "acquisition indebtedness." As a result, if the borrowed proceeds are invested, the income produced will be considered to be "debt-financed income," causing all income of the trust to be taxable at the trust level.

Life insurance also may be used to replace the value of an asset given to charity. For example, a charitable remainder trust may be funded with highly appreciated securities or other assets, and the donor may use income paid to him by the trust (or the value of the charitable deduction) to pay premiums on a life insurance policy for the amount placed into the trust.

Or a donor might name a charity as the beneficiary of certain retirement plan assets, such as an IRA, which otherwise would be subject to income tax in his or her estate. Life insurance might be purchased to replace the value of those assets for his or her heirs. (See March 1995 *Professional Notes* for a discussion of estate planning using retirement plan assets.)

Life insurance can be purchased and maintained to keep the proceeds out of the donor's estate and, therefore, fully available to heirs without any gift or estate tax consequences. For example, the children could apply for and retain all the incidents of ownership of the policy; they could use gifts of cash from their parents to pay for the premiums (without gift tax consequences if each parent tranfers less than $10,000 per year to each child), provided the gifts are not *required* to be used for the payment of premiums. Alternatively, the donor could place the policy in an irrevocable insurance trust, naming his or her children as trustees, with the assets of the trust payable to the children on the death of the donor or spouse.

Under these types of arrangements, the donor guarantees the amount left to the children, makes a commitment to charity, and receives either an income tax deduction which, in the case of the charitable remainder trust, will be the present value of the remainder interest left to charity or, in the case of the IRA, an estate tax charitable deduction. And the children may receive as much as they would have had the property been left to them, even though the amount of the insurance policy is less than the value of the property in the charitable remainder trust, because the insurance proceeds (unlike the property bequest) will not be subject to estate taxes.

SPLIT-DOLLAR LIFE INSURANCE: A GIFT THAT FAILS

A gift that was heavily promoted by some in the insurance industry and a handful of charities involved a cash contribution to a charity which used the gift to buy split-dollar life insurance on the donor. At the donor's death, a small portion of the insurance proceeds went to the charity and the bulk of the proceeds went to the donor's family or an irrevocable trust benefiting the family. Although the donor or the trust may have paid a portion of the premiums, such payments were not proportional to the amount of the insurance proceeds ultimately payable to the donor's family. These arrangements were questionable because of the private inurement issue inherent in the use of charitable assets to benefit the donor and his family and because of the apparent lack of donative intent.

The IRS went after these arrangements on the theory that in substance, the donor had bought the policy, contributed part of the interest in the policy to charity, and under the partial interest rules of Code Section 170(c)(3), no deduction is permitted. In 1999, Congress codified the IRS position that no charitable income tax deduction would be permitted for a transfer to (or for the use of) charity if charity pays a premium on the "personal benefit contract," as defined in Code Section 170(f)(10)(B), if any direct or indirect beneficiary under the contract is the donor, a member of his family, or a person other than a charity designated by the donor.

Moreover, an excise tax equal to the premiums paid will be charged to the charity. To make these rules easily enforceable, charities are required to inform the IRS of any premiums paid with respect to split-dollar insurance policies.

Fortunately, Code Section 170(f)(10)(E) expressly provides that where a charitable remainder trust owns all incidents of ownership of an insurance policy, income beneficiaries are not treated as indirect beneficiaries of the insurance contract for these purposes. As a result, the ability of a charitable remainder trust to be funded with insurance is not affected.

CONCLUSION

Even sophisticated clients who are committed to making charity part of their financial and estate planning may overlook life insurance as a potential gift. But this "surprise" asset, when it is no longer essential, can effectively increase your client's ability to provide for charity.

For more information, call:
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For further reference:

IRS Notice 99-36, 1999-26 IRB 3.
Code Sec. 170(b)(2)(B): Gift of group term life insurance to charity.
Code Sec. 170(b)(1)(A) and (B): Contributions "to" and "for the use of" charity.
Code Sec. 170(f)(3): Gifts of partial interests in property.
Code Sec. 170(f)(10): Split-dollar life insurance.
Treas. Reg. Sec. 1.79-2(c)(3): Gifts of group term insurance life insurance.
Treas. Reg. Sec. 1.170A-13(c): Appraisal rules.
Treas. Reg. Sec. 53-4941(d)(1): Self-dealing rules.

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About The Trust

For 76 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds — which now number more than 1,400— meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust develops strategies to meet emerging issues and works collaboratively with other funders.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. In 1999, The Trust made grants of $130 million and administered $2 billion in assets.

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