



# Leimberg's Think About It

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October 2007

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## SECOND NATIONAL CHARITABLE PLANNING WITH LIFE INSURANCE TEST!

Think you know charitable planning and its tax rules and how they apply to life insurance?

Here's your opportunity to test yourself in a safe environment. The answers are at the end. Give yourself an "A" if you get 12 to 15 answers correct. You need to hit the books if you only get 10 or fewer correct.

When you look at the latest and greatest life insurance charitable planning technique, remember my smell test: "A gift is not a deal – and a deal is not a gift. Charity is about giving – not taking!"

Schemes such as CHOLI, highly complex and speculative arrangements in which investors "borrow" the insurable interests of charities to enable them to do something that state insurable interest law does not allow them to do directly (i.e., to purchase insurance coverage on the lives of the organization's older, wealthy, charitable-minded, and generous donors) are great ways to endanger both the charity and your own reputation.

CHOLI seeks to enable strangers to engage in what amounts to statistical gaming, gambling on the rate of deaths of a group of elderly insureds, and would fast-forward us ahead to the past – to a super-sized, modernized, and ostensibly sanitized version of the long outlawed "dead-pool." In most of these so-called "dead pool" arrangements, there is a certainty that third-party groups of institutional investors (primarily investment banks, insurance companies, and hedge funds) will receive their share of the "return on investment" sooner – in an obscenely greater amount – than the charity for which the arrangement is ostensibly (but not really) designed. Prudential agrees that the types of arrangements described above are not in the interest of the general public and violate the basic tenants of life insurance. Prudential will not support these types of arrangements.

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IFS-A141114 ED. 01/08 EXP. 01/10



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HERE IS YOUR 2007 NATIONAL INSURANCE AND CHARITY TEST:

1. Ed Brown is a corporate executive who is covered with a large amount of group term life insurance. You explain that the following is (are) advantages of naming a charity revocable beneficiary of his group term life insurance coverage:
  - A. He receives a current income tax deduction.
  - B. He does not have to report Table I Costs.
  - C. He receives a Section 101 credit.
  - D. P.S. 58 costs are waived.
  
2. A charity borrows from life insurance it owns and uses the loan proceeds to purchase income-producing investments. From the charity's perspective, the problem is?
  - A. The IRS will treat any income produced by the new investment as UBTI.
  - B. The income produced is not useable by the charity except to repay the loan.
  - C. The IRS will consider the transaction as a jeopardy investment.
  - D. Debt financing by charities is considered a per se breach of fiduciary duty.
  
3. All of the following are correct, EXCEPT
  - A. Life insurance is a jeopardy investment if it endangers or significantly reduces the charity's ability to accomplish its exempt purposes.
  - B. Naming a charity as irrevocable beneficiary precludes a current income tax deduction.
  - C. If the death benefit in a life insurance policy will almost certainly exceed the sum of the net premiums payable, it will probably not be considered a jeopardy investment.
  - D. A charitable remainder trust does not have to make any specific provisions regarding jeopardy investments.
  
4. Which of the following regarding current charitable split dollar rules is correct?
  - A. A personal benefit contract is one where only the donor receives a benefit from the purchase of a life insurance contract.
  - B. It is no longer possible to name two or more charitable beneficiaries of a life insurance contract.
  - C. No deduction for income or gift tax purposes is allowed for a transfer to a charity where the charity pays premiums on a personal benefit contract.
  - D. Only loans in excess of \$12,000 a year violate current rules.

5. If a client donates a fully paid-up or single premium contract to charity, her deduction is generally the lower of (a) the cost of a comparable single premium policy or
- A. The cost basis the charity carries over from the donor
  - B. The interpolated terminal reserve of the contract immediately prior to the gift
  - C. The Table I cost minus the contract's interpolated terminal reserve
  - D. The policy owner's net investment in the contract
6. A Directors' Amplified Gift (DAG) Type I allows a director who terminates his/her relationship with the sponsoring company to
- A. Assign the contract to a family member
  - B. Pledge the policy as collateral
  - C. Borrow directly from the contract
  - D. None of the above
7. A charity is often made beneficiary of all or a portion of a life insurance contract's death proceeds. In such a case, when the charity receives payment from the insurer, the payment is
- A. Estate tax deductible by the insured's estate
  - B. Subject to the alternative minimum tax
  - C. An item of IRD (Section 691 income)
  - D. Deductible as Section 691 income
8. If a client donates a policy subject to a loan to a charity, all of the following tax results will follow, EXCEPT
- A. Deductions will be disallowed
  - B. The donor may realize income on any gain
  - C. The transaction would be treated as part sale and part charitable contribution
  - D. Future premiums paid on the policy would be nondeductible
9. Charitable split dollar rules
- A. Impose an excise tax on a charity in the amount of premiums it pays on a policy for which a deduction is denied under the personal benefit contract rules
  - B. Require a charity to report each year premiums paid that are subject to excise taxes
  - C. Do not impose an excise tax if all direct and indirect beneficiaries of a policy are charities
  - D. All the above

10. Life insurance owned by and payable to charity, and even life insurance merely payable to charity but not owed by charity, is generally
- A. Free from the claims of creditors
  - B. Not reduced by typical estate settlement costs
  - C. Not subject to contest
  - D. All the above
11. The surrender of a life insurance policy owned by a charity results in which of the following:
- A. The charity will be taxed on any gain
  - B. The charity will be taxed but only on any UBTI.
  - C. The charity is entitled to exclude the first \$50,000 of gain
  - D. The charity will pay no tax because of its exemption
12. Life insurance, when used as a way to replace the net wealth that children would have received had no charitable gift been made, provides all the following advantages, EXCEPT
- A. The donor can receive a current income tax deduction for the immediate gift of property to charity.
  - B. The life insurance owned by the children passes to them income and gift tax free.
  - C. The charity does not have to wait until the donor's death to receive the property.
  - D. The donor's children will always be better off using the wealth replacement concept.
13. All of the following are correct statements, EXCEPT
- A. A charity can enhance its endowment fund by agreeing to match premiums a donor makes on a policy he/she has contributed to the charity.
  - B. Naming a charity as revocable beneficiary results in an immediate income tax deduction.
  - C. Life insurance can be owned by and payable to a charitable remainder trust.
  - D. Life insurance can be used by a charity to provide key donor life insurance protection.
14. A donor contributes a just-purchased life insurance policy to a charity. The value of the deduction for income tax purposes is
- A. The face amount of the contract
  - B. The present value of an annuity due
  - C. The gross amount of the premium paid at the time of application
  - D. The net premiums paid by the end of the 15<sup>th</sup> policy year

15. When a life insurance policy is contributed to charity, the charity must provide the donor with a receipt. That receipt must provide all of the following information, EXCEPT
- A. A statement that the donor received no goods or services in return for the gift
  - B. The name of the insurance agent who sold the policy
  - C. The amount of premiums paid by the charity
  - D. The name of each beneficiary

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## CHARITABLE PLANNING TEST ANSWERS

1. B

If Ed names a charity as the sole revocable beneficiary of group-term life insurance in excess of \$50,000 for the entire tax year, no income will be reportable for any of the coverage. The Table I cost of the first \$50,000 of group term life insurance coverage is not reportable as income normally. The cost of any excess coverage is also excludible from income as long as the charity remains the only beneficiary for the entire tax year. (IRC Sec. 79(b)(2)(B)). The donor can name more than one qualified public charity and split the proceeds in any way he/she wishes.

Of course, if and when the donor changes his/her mind and names a noncharitable beneficiary for amounts of coverage over \$50,000, he or she must then report income from that point on.

2. A

If a charity cashes in or sells a policy and realizes a gain, usually no tax will be payable because of the charity's tax-exempt status. Likewise, if a charity borrows on a life insurance policy for an emergency or opportunity — for example, to pay salaries or to purchase land or a building it will use — the charity will typically incur no income tax — as long as the borrowing is to accomplish a purpose inherent to the performance of the charity's exempt purpose.

But if a charity, CRT, or private foundation uses policy cash values — or uses the policy as collateral — to finance and purchase a new income-producing investment (e.g., a bond or stock investment or mutual fund), the income produced by that debt financing will be considered UBTI (unrelated business taxable income).

The net income (income less directly related deductions) produced by the new investment is taxable to the charity, generally at corporate rates. PLR 8040036 and TAM 8042012. Siskin Memorial Foundation, Inc. 790 F.2<sup>d</sup> 480 (CA-6, 1986).

### 3. D

A charity (including its officers and directors) has a fiduciary responsibility to invest assets wisely. A life insurance policy (or any other investment) that jeopardizes the charity's ability to accomplish its exempt purposes is considered a "jeopardy investment." This means the officers and directors must exercise (at least) ordinary business care and prudence in investing on behalf of a charity and must consider its current and long-term goals and needs as well as its entire portfolio and how the new purchase or acquisition fits in.

A CRT must specifically prohibit an investment that reduces the trust's ability to protect the interests of the remainder charity. IRC Sec. 508(e). A trust that requires the purchase (or maintenance) of life insurance would violate the rule that the trustee must be free to invest without restriction of discretion. (In my opinion, even a public charity should follow this rule. That is, it should never be required by the terms of the gift to purchase or maintain life insurance — or any other asset.)

Usually, as long as the death benefit significantly exceeds (or can reasonably be expected to exceed) the total net premiums payable over a reasonable period of time, life insurance should not be considered a jeopardy investment. However, the charity or trust must also give both initial and continuing attention to the soundness of the insurer and the appropriateness of the coverage for the charitable purpose.

### 4. C

Charitable split-dollar (and its twin charitable reverse split-dollar) were schemes by which promoters convinced their clients to take a deduction for checks written to charity even though the money was quickly channeled back to them through the black-box of life insurance to trusts set up for the "donor's" children and grandchildren. By overcharging the charity for the term portion it was getting, this scam effectively undercharged the children's trust and thereby shifted cash from the "donor" through the charity and on to the children's trust.

The IRS stated that the charity itself might be penalized for its participation in a charitable split-dollar arrangement on the grounds that it creates a private benefit or private inurement; it creates a taxable excess benefit; it is self-dealing with a disqualified person; and, if entered into by a private foundation, it might be a taxable expenditure. Charities that provide written substantiation of such contributions might be subjected to penalties for aiding and abetting the understatement of the "donor's" tax liability.

Currently, no income, gift, or estate tax deduction is allowed for a transfer to, or for the use of, a charitable organization if the charity pays — directly or indirectly — premiums on any personal benefit contract with respect to the transfer.

The term “personal benefit contract” is broadly defined and includes not only benefits to the “donor” but also a life, annuity, or endowment contract that benefits any member of the transferor’s family or any other person (other than a qualified charity) designated by the transferor.

If one or more charities are named as the only owners AND beneficiaries of a life insurance policy, then the deduction denial rule will not apply.

**Beware:** An outstanding loan of ANY size at the time a life insurance policy is given to charity will prevent any deduction regardless of how much net value there is in the contract. See Code Section 101(f)(10).

**Note:** Special exemptions are allowed for charitable gift annuities.

5. D

An outright contribution of a paid-up or single premium (or very short pay) policy through the absolute assignment of all rights is the simplest, most effective, and typically the most appreciated way to use life insurance to benefit a charity.

Generally, the gift of such a policy results in a current income tax deduction equal to the net premiums paid (i.e. the donor’s basis). IRC Sec. 170(e)(1)(A) and Reg. Sec. 25.2512-6(a), Example 3.

6. D

A DAG, Director’s Amplified Gift, is an arrangement under which one or more members of a company’s board of directors is given the right to suggest one or more charities as the recipient of the death proceeds of a policy purchased by, owned by, and payable to, the company on whose board they are serving. A specified amount is payable to the director-specified charity upon the director’s death while serving on the company’s board.

To fulfill its promise, the corporation generally purchases a limited payment life insurance contract on the director’s life. The cash values are available to the corporate owner for an emergency or opportunity.

At the director’s death, the corporation receives the proceeds income tax free except for any AMT (alternative minimum tax).

After the corporation receives the proceeds, it pays the promised amount (perhaps increased by the income tax savings the corporation will realize) to the board member-specified charity(ies). In some cases, to maximize its 10% of adjusted taxable income deduction limit, the corporation spreads out payments to charity over several years.

The insured directors are never taxed on any income nor are the proceeds included in their estates. Directors have no rights to the insurance contracts.

7. A

A client can name a charity as the beneficiary of all or a portion (by amount or percentage) of a life insurance contract. Although this action alone will provide no current income tax deduction, if, upon the insured's death, payment is in fact made to charity, the amount payable is deductible for federal and state death tax purposes.

**Note:** Because of the inclusion of the proceeds in the insured's estate, even though there is a deduction allowed for that same amount in computing the decedent's federal estate tax, qualification for Code Section 303 stock redemption or satisfaction of Code Section 6166 rules on installment payments of estate tax may be jeopardized since these two code sections require that the family business exceed 35 percent of the adjusted gross estate. The problem is that inclusion of the proceeds swells the adjusted gross estate making it harder to meet the "more than 35% of A.G.E" test. For this reason, I generally suggest that if it is important to qualify for either or both of these provisions, the charity should be made owner and beneficiary of the insurance. On the other hand, if flexibility and control are important, then the client should retain the power to change the beneficiary.

8. D

The contribution of a life insurance policy subject to a loan of any size will result in a tax disaster:

- No matter how small the loan is or even if the donor pays off the loan shortly after the contribution, the donor's deduction for the value of the policy will be lost permanently – regardless of how much the policy is worth when it is contributed. (If the donor merely writes an undirected and unrestricted check to the charity each year approximating the premium, the IRS will probably allow a deduction)
- If the loan is substantial compared to the premiums paid, the transfer will be treated as part sale and part gift as if the donor pocketed the loan amount and donated the balance. So the amount of the loan portion, less the donor's adjusted basis for that portion, would be gain taxable as ordinary income.
- There is a possible issue of prohibited self-dealing if the gift is made to a private foundation or charitable remainder trust and the donor is considered a disqualified person.

9. D

All the answers are correct. An excise tax is imposed on a charity in the amount of the premiums it pays on any life insurance, annuity, or endowment contract if the payment of

the premiums is in connection with a transfer for which a deduction is not allowable under the Charitable Split Dollar deduction denial rule of Code Section 170(f)(10). Payments are treated as if made by the charity if they are, in fact, made by any other person under an understanding or expectation of payment. However, the excise tax does not apply if all the direct and indirect beneficiaries under the contract (including any related side agreement) are qualified charities.

The charity must report each year the amount of premiums it has paid that are subject to the excise tax and note the name and taxpayer I.D. of each beneficiary, including beneficiaries under a side agreement.

10. D

There are many advantages to the use of life insurance in charitable planning:

- Almost anyone, regardless of economic station, can assure a meaningful and significant gift to charity and, in most cases, that gift will be far larger than if other tools or techniques were used.
- Such a gift is cost-efficient and provides “100 cent dollars” (i.e., there is no “slippage” due to administration or estate settlement costs as there almost always is with other types of property).
- A gift of life insurance to charity involves none of the costs, delays, or uncertainty of probate.
- There is a negligible risk of contest by heirs since life insurance passes by contract outside the probate estate.
- Life insurance, especially if owned by and payable to charity, is generally accorded a greater level of protection against creditors than most other assets.

11. D

Upon the surrender of a life insurance contract owned by a charity, the charity will realize the gain income tax free because of its tax-exempt status.

12. D

Life insurance is often used as a wealth replacement vehicle. This technique, often called an “inheritance alternative,” can be impressively effective, particularly when compared with doing nothing. If the donor makes a gift of stock or real estate or some other valuable asset to charity currently, he or she will be allowed a current income tax deduction. If the donor then gifts the money to children, that otherwise would have been paid in taxes, and pays no gift tax because of the annual exclusion and/or unified credit, the children can use that money to purchase life insurance on

the parent's life. At the parent's death, the child or children will receive the policy proceeds income tax free, estate tax free, and probate free.

The concept illustrates the power of shifting wealth by contract without taxes and other "slippage." Of course, the numbers will not always work out so that the children actually receive more, or as much, as they would have received had the parent made no gift to charity. But quite often, it will. And, from the charity's perspective, the gift is a "right here, right now" type gift rather than a "maybe someday" gift.

13. B

Many individuals name a charity as revocable or contingent beneficiary of one or more life insurance policies. Charities often insure the lives of prominent and continual donors to provide an economic shock absorber in the event of such a donor's death.

The major advantage is flexibility. The designation can be changed at any time.

The downside is that no charitable deduction is allowed for the value of the policy itself or for subsequent premium payments — unless the charity is both owner and beneficiary of the policy as well as holder of all economic rights.

Many charities will accept full ownership of a policy or purchase a new policy on the donor's life and, without legal commitment to do so, match the donor's premium payment contributions so the charity can own a policy twice as big as would otherwise be possible.

The donor's contributions would be fully deductible and the "no strings attached" gift he/she makes each year would double the rate of return the charity would otherwise enjoy.

**Note:** There should be a charitable goal or objective for ownership of the policy and the economics of the transaction should be positive and in keeping with the charity's overall purposes. The amounts should be reasonable in the light of the donor-insured's past and reasonably anticipated future gifts to the charity.

The purchase of life insurance within a CRUT has been sanctioned both by ruling and by Code, assuming the CRUT is both owner and beneficiary of the policy and holds all economic rights. The donor would be allowed an income tax deduction based on the increase in value each year of the charity's remainder interest.

The policy owned by a CRUT should form a relatively small (preferably under 15-20 percent) portion of the trust's assets.

**Note:** It is essential to check to be sure state insurable interest laws have been met and the policy has been documented as a means of meeting charitable goals and objectives, as well as being a prudent investment.

14. C

The value of the deduction of a “new” policy (one within its first policy year) contributed to charity is the gross amount of the premium paid to the date of the gift.

15. B

Quid pro quo rules require that a charity must report to the donor the value of any gift upon the receipt of that gift. An official authorized to sign the charity’s federal tax forms should sign IRS Form 8283.

Failure to obtain a Form 8283 (which lists the charity’s name, address, description of the policy, how and when the policy was acquired, its fair market value, and other information) is likely to result in the disallowance of the charitable deduction.

**Note:** If the donated policy is worth \$5,000 or more, a formal independent appraisal is required and must be obtained from someone other than the insurer that issued, or the agent who sold, the policy. Reg. Sec. 1.170A-13 (c).

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Life insurance death benefits are generally received income tax free (IRC Section 101(a)).

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