



BECAUSE YOU ASKED

ADVANCED MARKETS

Charitable Planning with Life Insurance

It's better to give than to receive – It's even better to give *and* to receive

Q Does the donor of a life insurance policy receive an income tax deduction if the beneficiary designation is irrevocably made to a charity?

A No. A current income tax deduction is unavailable, even if the beneficiary designation is irrevocable. Furthermore, contract rights to change the beneficiary designation may be limited by the insurance carrier. In order to obtain a current income tax deduction, the charity must become the owner and beneficiary of the policy.

Q What is the value of the income tax deduction a donor receives by making a gift of a life insurance policy to charity?¹

- For a new policy (in the first year), the deduction is generally the initial premium.
- For an in-force policy (two years or more), the deduction is equal to the lesser of the donor's basis in the policy or fair market value.

Q Is an appraisal required when donating a life insurance policy to charity?

A It depends. If an income deduction is sought by the donor and the amount claimed or reported as a deduction with respect to donated property exceeds \$5,000, the taxpayer is required to substantiate such donation with a "qualified appraisal" as provided by Treas. Reg. sec 1.170A-13(c). If no income tax deduction is sought, a qualified appraisal on property donated to charity is not necessary.

Q Is a receipt required for charitable gifts to obtain an income tax deduction?

A For a gift to charity with a value of \$250 or more (whether the gift is a cash gift or gift of property), the IRS requires the donor to have a statement from the charity showing:

- (1) the amount of money contributed and a description (but not the value) of any property donated, and
- (2) whether the organization provided any goods or services in return for the donor's contribution. If goods or services were received, a description and estimate of the value must be included.

In determining whether the donor needs to obtain this receipt from the charity or not, separate donations should not be combined. For example, if the donor gave \$25 to his church each week for a total of \$1,300, donor could treat each \$25 donation as a separate gift for which a receipt would not be required.

If a receipt is required, donor must obtain the receipt from the charity by the date he files his return or his return is due, whichever is earlier. See IRC sec 170(f)(8). The date of the receipt is important as demonstrated by a recent tax court case (*Durden v. Comm'r*, TC Memo 2012-140), which denied taxpayer a deduction for charitable gifts of over \$250 because a proper receipt was not obtained from the charity within the time allotted.

Q When transferring the ownership of a life insurance policy with a loan to a charitable organization, what is the value of the charitable contribution for income tax purposes?

A Gifts of a policy with a loan will be deemed a part gift/part sale when made to a charity. Unlike gifts to non-charitable beneficiaries, the donor must allocate his/her basis between the gift portion and the sale portion. Thus, only the amount of the donor's adjusted basis, which is apportioned to the gift to charity, may be considered a deductible charitable contribution. For example, assume a 10 year old policy with a basis of \$500,000 and a fair market value of \$2,000,000, and a loan of \$1,500,000. The basis would be allocated as follows: 1) The gift portion would be \$125,000, 2) and the bargain sale portion would be \$375,000. In this case, the value of the charitable contribution reported on Schedule A of Form 1040 would be only \$125,000. Therefore, the donor of the policy will recognize ordinary income on the loan amount up to the gain on the policy, or \$1,125,000 in this example (\$1,500,000-\$375,000).²

Q Is life insurance a permissible funding source in a charitable remainder trust (CRT)?³

A Yes, both single life and second-to-die life insurance policies can be purchased in a charitable remainder trust. However, one of the most common and effective methods to buy a single life insurance policy in a CRT is to insure the life of the older spouse in a joint CRT. Upon death of the older spouse, the CRT may be able to pay the surviving spouse an increased income amount as a result of the receipt of death benefits. However, consideration must be given to the IRS position in PLR9227017, where the IRS stated that the death benefit must be allocable to the charitable remainder paid to the charity. This may mean that only a Net Income Charitable Remainder Unitrust (NICRUT) or a Net Income with Makeup Charitable Remainder Unitrust (NIMCRUT) is acceptable.

Q Is it unreasonable to use life insurance in an ILIT to replace wealth transferred through a Charitable Remainder Annuity Trust (CRAT) or a Charitable Remainder Unitrust (CRUT)?

A No, it is tax effective for a donor to transfer appreciated assets to a charitable remainder annuity or unitrust because the assets can be sold by the trust without a capital gains tax. The annual pay-out from the trust (minimum of 5%) can be used to purchase life insurance in a "wealth replacement trust" (WRT). The funds available from the wealth replacement trust can be used to replace the assets transferred to the CRAT/CRUT. Keep in mind that the economics of the transaction will only work if the donor is charitably inclined.

Q Can life insurance be used in a Charitable Lead Trust (CLT)?

A Yes, life insurance can be an attractive funding source for a CLT. However, a number of important considerations must be kept in mind. First, it is essential to have sufficient additional assets in the trust to be sure that enough assets will be available to pay the annual minimum of 5% income amount to charity. Secondly, it is important to make sure that no income is ever applied to pay the life insurance premiums.⁴ This may include tracing income that is accumulated and added to principal and never used to pay premium. Lastly, an attorney should review IRC section 170(f)(10) to determine its applicability to the ownership of life insurance by a CLT.

Q Does a charity have insurable interest over a donor's life?

A Generally, yes. State insurable interest rules permit the charity to own a policy on a donor's life in most states. Check local state statutes for any specific limitations.

Q For financial underwriting purposes is it sufficient for the insured to merely be a donor to a charity?

A Generally, no. In order for the insurer to insure a donor there must be a history of giving to the charity or a history of raising funds for the charity or the insured should be a key employee of the charity.

Q Can the insured lend money to the charity (known as private financing) to purchase a policy?

A No. The use of private financing is not permissible under the charitable split dollar rules of IRC 170(f)(10). In addition, doing private financing with a private foundation would be not permissible, as it would be considered self-dealing.

Q Can the charity use third-party premium financing to help it purchase life insurance on the insured's life?

A Assuming the charity has an insurable interest to purchase the policy under a State's insurable interest rules, the charity may borrow funds and use them to purchase a life insurance policy. However, Congress has been looking at this issue in the context of concerns over Investor Owned Life Insurance (IOLI). There does not appear to be any immediate issue with regard to unrelated business taxable income (UBTI) because the cash value in the policy grows on a tax-deferred basis. However, it is important to avoid creating Modified Endowment Contracts (MECs) in this type of transaction. Withdrawals and loans from a MEC in a gain position are accorded LIFO treatment vs. FIFO treatment under IRC Section 72. Therefore, UBTI will be generated immediately upon such withdrawals/loans.⁵

1. Please see Internal Revenue Code (IRC) Section 170 for specific rules regarding charitable deductions. If you donate property that has a fair market value less than your cost basis, your deduction is generally limited to the lower fair market value.
2. Because of self-dealing and/or jeopardizing investment rules that may apply, the charity should consider whether it is a prudent investment to continue the ongoing premium payments on the policy, if applicable, and for how long, or whether or not surrendering the policy may provide a higher benefit.
3. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
4. If income from a CLT is used to purchase life insurance, the CLT may be characterized as a grantor trust, in which case the trust principal (and any life insurance) may be includable in the grantor's taxable estate and trust income will be taxable to the grantor.
5. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2. Cash value available for loans and withdrawals may be more or less than originally invested.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

©2012 John Hancock. All rights reserved.

MLINY11271217761 11/12