# Giving Life Insurance for Advisors

## The Basic Tax Rules

**Fair market value:** The fair market value of a life insurance policy given to charity is not necessarily the amount the donor can claim as an income tax charitable deduction for the gift, but it is the starting point in determining the donor's deduction.

Internal Revenue Service regulations and court cases establish rules for determining the fair market value of an insurance policy.

In the case of a paid-up policy, the fair market value for federal gift tax purposes is the cost of replacing the policy. See Reg. section 25.2512-6(a), Example (3). One case holds that for federal income tax purposes, however, the fair market value of a paid-up policy given to charity is the policy's cash surrender value because that is the amount the charity can realize from cashing in the policy. See *Tuttle v. U.S.*, 436 F.2d 69 (2d Cir. 1970).

For a whole life policy on which premiums remain to be paid, the fair market value is the policy's interpolated terminal reserve plus the unexpired portion of the last premium paid. The fair market value is (1) increased by the amount, if any, of dividends accrued to the date of gift and (2) decreased by the amount of any outstanding loan against the policy. See Reg. section 25.2512-6(a).

For a term policy, the fair market value is simply the unexpired portion of the last premium paid. See Revenue Ruling 76-490, 1976-2 C.B. 300; Rev. Rul. 79-47, 1979-1 C.B. 312.

## The Donor's Income Tax Charitable Deduction

**"Ordinary income" rule:** The income tax charitable deduction for a donation of an insurance policy is limited to whichever is less: the fair market value of the policy or the donor's basis in the policy. The donor's basis is equal to the net premiums (gross premiums minus dividends paid back to the donor) paid on the policy.

In other words, the donor receives no income tax charitable deduction for any appreciation (or inside build-up) in the policy. The reason is that any appreciation represents unrealized ordinary income as opposed to capital gain. Under Internal Revenue Code section 170(e)(1)(A), no federal income tax charitable deduction is allowed with respect to appreciation that represents unrealized ordinary income (or short-term capital gain).

**Planning technique:** Because of this, in some situations the donor may find it advantageous to cash in the policy and then donate all or a portion of the cash received. Although cashing in the policy causes the donor to realize any inside build-up in the policy as ordinary income, it may be possible to offset this income completely with the charitable deduction for the cash donation. Whether the donor will obtain a complete offset depends on the percentage limitations applicable to the income tax charitable deduction discussed below.

The result to the donor (assuming a complete offset) will be a net charitable deduction equal to his or her basis in the policy—the same deduction as would be allowed if the policy itself were donated. Unlike contributing the policy, however, contributing cash will not bring into play the qualified appraisal rules discussed below.

**Percentage limitations on the federal income tax charitable deduction:** The federal income tax charitable deduction is subject to various percentage limitations.

The overall ceiling on the deduction is 60% of adjusted gross income (AGI). Gifts to "public" charities of cash and short-term capital gain property are deductible up to this 60% limit. See IRC section 170(b)(1)(A).

Gifts to public charities of certain types of appreciated property held long-term are generally deductible up to 30% of AGI. See IRC section 170(b)(1)(C).

If the charitable contribution for a gift of an appreciated life insurance policy is reduced to the donor's adjusted basis in the policy because of inside build-up, the donor's income tax charitable deduction for the gift is deductible up to 60% of AGI, as if it were a cash gift. See IRC section 170(b)(1)(A).

"Excess" charitable contributions may be carried forward for up to five years. See IRC section 170(b)(1)(B).

The interplay of the 60% and 30% limits and the carry-over rules establish a hierarchy for deducting various types of gifts. The hierarchy (insofar as gifts to public charities are concerned) is as follows:

1. Current gifts subject to the 60% limit are taken into account first.
2. Current gifts subject to the 30% limit are taken into account second.
3. Carried-over gifts subject to the 60% limit are taken into account third.
4. Carried-over gifts subject to the 30% limit are taken into account fourth. See IRC section 170(b)(1)(B).

# Qualified Appraisal Rules

Generally, a qualified appraisal (as that term is defined in Reg. section 1.170A-13(c)) is needed to sustain a claim of an income tax charitable deduction with respect to a donation of non-cash property other than publicly traded securities if the claimed value of the property (or the aggregate claimed value of all gifts of similar property made during the year) exceeds $5,000.

Is a life insurance policy “cash” or a “publicly traded security”? It is clear that a life insurance policy is not a publicly traded security. It is also fairly clear that a life insurance policy is not “cash” because, although it can be reduced to cash by being surrendered, the policy itself is a bundle of rights different from the rights constituting ownership of cash.

Therefore, to protect the tax position of the individual who donates a life insurance policy having a claimed value of more than $5,000, it is prudent to obtain a qualified appraisal for the policy.

The income tax regulations provide that a qualified appraisal cannot be prepared by a party to the transaction in which the donor acquired the item to be appraised. See Reg. section 1.170A-13(c)(6)(iv)(B). Neither the insurance agent who sold the policy to the donor nor the issuing company may prepare the appraisal.

The safest course of action in obtaining the appraisal is probably to have the appraisal prepared by someone competent by reason of training and experience to value an insurance policy and who had no connection with the issuance of the policy (e.g., a tax accountant). There is no prohibition, it is worth noting, against the appraiser using information provided by the issuing company to appraise the policy.

In addition to obtaining a qualified appraisal, the donor is required to file an appraisal summary—IRS Form 8283—with his or her federal income tax return on which the gift is first claimed or reported. See Reg. section 1.170A-13(c)(4). The appraisal summary must be acknowledged (signed) by the donee organization.

If the donee organization, within three years of the date of gift, sells or otherwise disposes of donated property as to which it has signed a Form 8283, it must report the sale to both the IRS and to the donor on IRS Form 8282. See IRC section 6050L.

Requirements for a qualified appraisal: A full discussion of the requirements an appraisal must meet to be a qualified appraisal is beyond the scope of this discussion.

Nonetheless, it is worth noting some of the items of information that, by definition, must be included in a qualified appraisal.

- The date or expected date of gift.
- The appraised fair market value on the date or expected date of gift.
- The appraiser’s tax ID number.
- A statement that the appraisal was prepared for federal income tax purposes.
- A description of the appraiser’s background, education, experience, and membership (if any) in professional appraisal associations.
- A description of the fee arrangement between the donor and the appraiser. See Reg. section 1.170A-13(c)(3)(ii).

In order for an appraisal to be a qualified appraisal, it must be obtained no earlier than 60 days before the date of gift and no later than the day before the due date of the income tax return on which the gift is first claimed or reported. Due date includes extensions of time to file the return. See Reg. section 1.170A-13(c)(3)(iv)(B).

# Gift of a Policy Subject to a Loan

In general, if an appreciated asset is given to a charitable organization, the donor does not “realize” the appreciation for federal income tax purposes. The reason is that generally gain is realized only if an appreciated asset is sold or exchanged, and a charitable contribution is merely a donative disposition.

If appreciated property subject to a mortgage or other indebtedness is given to charity, however, the transaction is treated as a bargain sale under Reg. section 1.1011-2, and the donor does realize a portion of the appreciation as a capital gain or as ordinary income, depending on the type of appreciation involved.

The IRS has taken the position that a donation of a life insurance policy subject to a policy loan is a bargain sale —just as is a donation of mortgaged real estate. In other words, the IRS views the policy loan the same way it views a mortgage. See Rev. Rul. 80-132, 1980-1 C.B. 255.

Bargain sale formula: The amount of gain realized when property subject to debt is given outright to a charitable organization can be determined using this formula:

Gain Realized = (FMV - B) x (D/FMV), where

- "FMV" is the fair market value of the donated property (determined without regard to the debt).
- "B" is the property's adjusted basis in the donor's hands.
- "D" is the amount of the mortgage debt or policy loan. See Reg. section 1.1011-2.

Thus, for example, it appears that if a life insurance policy with a fair market value of $10,000, with a $4,000 adjusted basis in the donor's hands and subject to a $2,000 loan, is given outright to a charitable organization, the donor realizes a gain of ($10,000 - $4,000) x ($2,000/$10,000), or $1,200.

The donor is also entitled to claim a charitable contribution equal to $8,000 - I, where $8,000 represents the donor's equity in the donated policy, and "I" is the amount of the policy's appreciation that is allocated to this equity.

The allocation is made on a proportionate basis. "I" is equal to $6,000 (total appreciation) x ($8,000/$10,000), or $4,800.

The donor's charitable contribution, therefore, is equal to $8,000 - $4,800, or $3,200. Under IRC section 170(e)(1)(A), this reduced contribution may be claimed in an amount up to 50% of the donor's AGI (with a five-year carry-over for any excess contribution), assuming the policy is given to a public charity.

## Gift of Group Term Coverage

Generally, an employee must report as income the cost of employer-paid group term life insurance on his or her life for coverage in excess of $50,000. See IRC section 79(a).

A special rule, however, excuses the cost of employer-paid group term coverage in excess of $50,000 for coverage payable irrevocably to a qualified charitable organization for the entire portion of the taxable year during which such coverage is provided to the employee. See IRC section 79(b)(2)(B).

This basically means that an employee can "tack on" some additional employer-paid group term coverage for the benefit of his or her favorite charity at no tax cost to the employee.

## Insurable Interest Issue

In many states, statutes expressly permit a charitable organization to take out an insurance policy on the life of an individual, subject to certain requirements. Be sure to check applicable state law for the state in which you live.

## Wealth Replacement

There are numerous charitable gift planning techniques involving life insurance. One example is the use of life insurance to "replace" assets that have been donated either on an outright basis or through other planning techniques.

The so-called wealth replacement plan comes in several varieties. The basic idea of the plan is to make a charitable gift (either outright or via a charitable remainder trust or other "life income" plan) and to use the tax or other financial benefits resulting from the gift to pay for life insurance.

The wealth replacement plan can be an excellent way for a charitably motivated person to make a gift while still providing for loved ones. It should be kept in mind, however, that the purchasing of insurance with the tax and other financial benefits of the charitable gift is simply an investment choice on the donor's part, and that the donor may wish to consider other investment alternatives.

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**For further reading, see also from the Planned Giving Design Center:**

Articles:

- Charitable Gifts of Life Insurance
- Innovative Strategies for Using Life Insurance in Charitable Giving
- Life Insurance as a Charitable Planning Tool: Part I
- Life Insurance as a Charitable Planning Tool: Part II

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