

ADVANCED MARKETS

Many Things To Consider With Life Settlement Gifts To Charity

BY BENJAMIN T. WEINBERG

PICTURE THIS COUPLE: retired empty nesters Claude and Carmine Cash-cow, who no longer need Claude's \$3 million universal life insurance policy and have no desire to continue paying premiums. They've discussed making a significant gift to their alma mater, but this would adversely impact their quality of life. Orthodox advice would be to gift the policy to the school, but a prior life settlement may allow a higher deduction. Should they give two in the bush (gift the policy), or one in the hand (sell the policy and give the proceeds)?

Assume that the economics of the life settlement are better than keeping the policy until the insured's death. Assume also that the charity is classified as a public charity and not a private foundation, that the life settlement value (LSV) is equal to fair market value (FMV) when the policy is gifted (valuation is critical in charitable giving), and that basis is equal to premiums paid. (Note: Whether gifting the policy or the proceeds, there is a 5-year carryover of excess contributions, and substantiation and appraisal rules apply.)

► **Gift Of Policy**

As a general rule, policyholders should first pay off existing loans (to not violate the draconian charitable split-dollar rules). And to avoid an assignment of the income tax problem, there should be no prior agreement to sell the policy.

When life insurance is gifted to a public charity, the donor's deduction is reduced by an amount equal to ordinary income had the policy been sold, but some ambiguity in the rules leads to uncertainty in

calculating the deduction. (The following case study shows multiple methods of taxation.)

If the gain is all ordinary income, then the deduction equals basis; and if it is all long-term capital gain, then the deduction is the fair market value of the policy. (However, if the "step-down" election has been made, then it equals basis). If the gain is part ordinary income and part capital gain,

AGI limitation is based on a 50/30% split, or whether it is purely 30%. If there is a loss, then there is again a question as to whether the limit is 50% or 30%.

► **Gift Of After-Tax Proceeds**

When gifting after-tax proceeds of a life settlement to charity, any charitable deduction equals the net sales proceeds (after-tax), the AGI deduction limitation is 50%,

CHART 1: THE CASE FACTS

VARIABLES AND ASSUMPTIONS

► Policy Data	► Tax Data	► Tax Assumptions
Cumulative Premiums Paid (Assumed Basis) \$500,000.00	Blended Federal and State Ordinary Income Marginal Rate 41%	Federal Ordinary Income Marginal Rate 35%
Policy Cash Surrender Value (CSV) \$625,000.00	Blended Federal and State Capital Gains Marginal Rate 21%	Federal Capital Gains Marginal Rate 15%
Life Settlement Offer \$1,000,000.00		State Ordinary Income Marginal Rate 9.3%
		State Capital Gains Marginal Rate 9.3%

Source: The Weinberg Group, Inc.

CHART 2: GIFT OR SELL?

CALCULATIONS

Scenarios	DONOR				DONEE (5) Received by Charity
	(1) Net Sales Proceeds (After-Tax)	(2) Tax Deduction	(3) Tax Savings (Col.2 * 0.41)	(4) Net After-Tax Cost to Donor (LS Offer - Col. 3)	
Gift of Policy					
All Ordinary Income	N/A	\$500,000.00	\$205,000.00	\$795,000.00	\$1,000,000.00
Eligible to Capital Gains	N/A	875,000.00	358,750.00	641,250.00	1,000,000.00
Gift of Net Sales Proceeds (A/T)					
All Ordinary Income	\$795,000.00	795,000.00	325,950.00	674,050.00	795,000.00
Capital Gains	870,000.00	870,000.00	356,700.00	643,300.00	870,000.00

Source: The Weinberg Group, Inc.

the deduction equals basis plus capital gain. If there is a loss, then the deduction equals fair market value.

The donor also has adjusted gross income (AGI) deduction limitations. If the gain is all ordinary income, the limit is 50% of AGI. If it is all capital gain, the limit is 30% (however, if a "step-down" election is made, the limit is 50%). If the gain is part ordinary income and part capital gain, there is some question as to whether the

and losses are not deductible. One question is whether an LSV gain in excess of the cash surrender value (CSV) is eligible for capital gains, and the following case study shows both scenarios.

► **The Cashcows**

Refer to our earlier example involving a \$3 million death benefit for a universal life insurance policy issued years ago to Claude

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S CORPORATION PLANNING

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The unique pass-through nature of an S corporation allows the tax-exempt life insurance death benefit to increase the basis of the surviving shareholders on a pro-rata basis. Unfortunately, when life insurance proceeds are received in the *same* tax year as redemption, a portion of this basis increase is allocated to the estate of the deceased owner. Since this shareholder *already* receives a step-up in basis to fair market value under existing rules, this portion of the proceeds is arguably wasted for tax purposes. A solution lies just below the surface.

The buy-sell agreement can be structured so the basis increase from the insurance proceeds *fully* accrues only to the surviving shareholders. The entire deceased shareholder's stock is redeemed through a promissory note *prior* to filing the insurance claim and receiving the insurance proceeds. The remaining shareholders can elect to close the corporation's books using a short-year election.

According to the Internal Revenue Code, if any shareholder terminates an

owner's interest during the tax year, the taxable year will be deemed to consist of 2 taxable years, the first of which ends on the date of termination. The insurance claim can then be filed and the S corporation can collect the proceeds. All the basis increase is allocated to the surviving shareholders by virtue of the termination of the deceased interest prior to filing the insurance claim.

Ascertaining the ideal arrangement for a buy-sell agreement requires a careful balancing between tax and practical issues. Life insurance can be an effective tool to leverage a step-up in basis. A strategically timed short-year election may enable the owners to further reduce their future tax exposure while retaining the traditional advantages of an entity buy-sell agreement.

The sheer number of S corporations demands innovative and valuable strategies for business owners seeking to preserve and protect their business. Fortunately, estate and business transfer opportunities with S corporations are readily available for those seeking solutions. Just take a look beneath the surface. ■

THINGS TO CONSIDER

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Cashcow, who is now age 81. Chart 1 shows the case facts:

Using the gain characterization rules described previously, a life settlement offer of \$1,000,000 on a policy with a \$500,000 basis (cumulative premiums paid) results in an estimated gain of \$500,000. The CSV in excess of basis (\$625,000 - \$500,000) results in \$125,000 of gain characterized as ordinary income, or 25% of the entire \$500,000 gain. The remaining 75%, or \$375,000, could be classified as ordinary income or capital gain, depending on the opinion of the client's professional advisers.

The most important column in Chart 2 from the donor's point of view is Col. 4, "Net After-Tax Cost to Donor." If a major portion of the donor's gain is eligible for capital gains treatment, then leaving 2 in the bush (i.e., gifting the policy) is slightly more advantageous, whereas if the gain is characterized as all ordinary income, then it is better to have one in the hand (i.e., sell the policy and donate the proceeds). As far as the charity is concerned, it is always better off with a gift of the policy followed by its making the sale.

► Other Scenarios

Our case example illustrates only one scenario. There are infinite potential fact patterns and each one must be analyzed to determine whether it is more advantageous for a donor to give a policy or its proceeds to the charity.

There are many issues that go into determining a proper course of action when considering a life insurance gift to charity. Once all questions as to both the financial and the non-financial elements have been answered in such a way that a life settlement is still a solution, and a life settlement offer has been received or estimated, it is time to determine what is in the donor's best interests, to give the charity "two in the bush" or "one in the hand." ■

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