By **Vernon W. Holleman III**

Private Family Foundations and Life Insurance

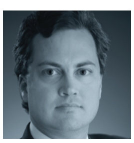
Enhance the impact of giving via an oft-ignored tool

Life insurance has tax advantages. Private family foundations (PFFs) have tax advantages. As an old television commercial used to say, "Peanut butter and chocolate taste great on their own … but when combined … these two great tastes, taste great together!" That formula, I'd venture to say, worked great for the H.B. Reese Candy Company. So, I now ask all those Reese's Peanut Butter Cup lovers out there: Can life insurance and PFFs work together to share a similar outcome?

Understandably, having a sweet tooth alone doesn't qualify you to answer the question posed. Some advisors may view the use of life insurance, in terms of PFFs, as creating redundancy, given that a PFF's assets grow, by and large, tax-deferred. But, there are a number of ways that life insurance can potentially enhance the impact of charitable giving on a family with a PFF.

When exploring the application of life insurance to charitable giving and PFFs, advisors and clients shouldn't limit their thinking solely to the scenario of a PFF owning insurance on a primary donor's life. For philanthropically minded families, there are other options to consider when using life insurance to capitalize on the leverage and tax benefits an insurance product offers. Let's look at using life insurance in charitable planning around PFFs in today's marketplace and explore how life insurance as an asset class is an enhancement tool for a PFF and charitably motivated clients.

Vernon W. Holleman III is president of The Holleman Companies in Chevy Chase, Md., which focuses on wealth transfer and charitable planning, business succession, benefit liability planning, executive benefits and disability



Charities Outside of Core Focus

Like effective businesses, those PFFs that stick most to their mission often have the highest degree of success. However, many successful families harbor interests beyond the scope of their PFF. Enter life insurance: It's a financial tool that can allow an individual donor to benefit one, or many, charities that fall beyond the scope of the PFF or to benefit charities to which a donor wants to provide a notable gift at death.

The first important component in using life insurance in this manner is the establishment of an "insurable interest." This means that there must be a relationship history between the charity and the donor, including a financial track record. For example, if a donor has given annually for a number of years to a charitable organization, is known to and involved with that particular charity and the charity counts on the donor's financial support, that relationship would likely be considered an insurable interest. This is because the charity would suffer a financial loss on the donor's death. Although each state has its own insurable interest laws, once established and approved by the insurance carrier, the charitable organization can then apply for the insurance and own the policy on the donor's life. The donor then makes gifts, which are deductible (assuming eligibility), to the charity, and the donor's gifts are used to pay the policy premium to the insurance carrier. Ultimately, the death benefit of the policy is received by the charity on the donor's death. The most obvious advantage of this use of life insurance is that it amplifies the donor's gifting: He's donated more in terms of dollars and, thus, provided more of an impact.

There's also a tax benefit to gifting in this manner. Gifts to charity are limited to 30 percent of adjusted gross income (AGI); however, assuming the charity is public, gifts are eligible for a deduction of up to 50 percent of AGI. This may not be the driving force

behind a donor's gifting, but it's significant, especially in a broadly thought-through giving program.

Community Foundations

In the above scenario, we looked at benefiting one charitable organization. However, many donors want to benefit several charities. An effective way to donate to more than one charity through a planned gift is by using the donor's local community foundation (CF). In this scenario, the CF would apply for, and own, life insurance on the donor, or on a donor-couple (a second-to-die or survivorship policy). The donor would advise the CF on which charities to make gifts to on the donor's

The need for flexibility has tended to make PFFs use some form of UL.

death and would also benefit from the interaction of the community-focused and involved professionals at the CF. Given its public nature, a CF allows for the maximum potential deduction amount (50 percent of AGI).

Life Insurance Inside the PFF

The primary reasons that a PFF or donor would own life insurance inside the PFF are to provide risk mitigation and diversification. Donors can think of life insurance as its own asset class; using a small percentage of PFF assets to acquire life insurance can help diversify the investment portfolio of the PFF. Life insurance provides a safety net, or loss replacement, for PFF investment losses if a donor dies while the market is down. That is, there's always a constant dollar amount provided by life insurance at the donor's death. Whether it turns out the insurance simply bolsters the funds available for charity (when investment returns are robust) or is a true saving grace (if returns are at a very negative point)—exploring and using life insurance as an asset class can be a real benefit to PFFs.

Types of Life Insurance

Today's life insurance marketplace is as diverse in its offerings as at any time in history, with new product introductions a constant. Understanding the breadth of options and the mechanical differences is important for a PFF exploring its use, as such insight maximizes both effectiveness and return. Each situation is unique and calls for thoroughness when planning with life insurance.

Term insurance, which is pure death benefit coverage for a premium, likely has little, if any, role in a PFF or related planning, given its long-term nature. But permanent insurance, which builds equity in the form of cash value, has two core chassis options, whole life and universal life (UL), both of which build cash value (that is, policy equity). At its core, UL has a flexible premium with varying degrees of guarantees and comes in four main varieties—traditional, variable, no-lapse and index. Whole life offers guarantees on the cash value in the policy, generally with a fixed premium that's long-term.

The need for flexibility has tended to make PFFs use some form of UL. UL varieties include "traditional," which provides a base-crediting rate paid on the overall insurance carrier performance. An example would be 4.5 percent variable, in which mutual fund sub-accounts provide specific asset class investments (for example, growth or international funds). Index UL provides the policy owner the option of hedging in various index accounts, such as the S&P, and offers both a return floor and ceiling (for example, a 3 percent floor and a 13 percent ceiling), thus mitigating risk, but providing some higher upside returns. A no-lapse guarantee UL is like long-term term insurance with absolute guarantees and, ultimately, returns.

Each of these types can be used for various options. The planning team, including a life insurance specialist, can help the donor and PFF understand the product options and work to explore the use of the life insurance in the total asset allocation picture and how its use will affect total return, through financial modeling. This worthwhile exercise will help a family with a PFF to understand both the life insurance product universe itself and determine if its use can play a role in the PFF.

Planning Considerations

There are a number of important considerations in properly preparing for a PFF to own life insurance, most importantly, to ensure that the PFF's tax status isn't jeopardized. Be cautious in the transfer of

existing life insurance or other complicated transactions, in which the perception, or reality, of self-dealing (prohibited by Internal Revenue Code Section 4941) or jeopardizing investments (prohibited by IRC Section 4944) can occur.

The Internal Revenue Service's prohibition against self-dealing restricts most transactions, or any act, between "disqualified persons" and the PFF. Transactions considered self-dealing come with onerous tax penalties. Disqualified persons are just about anyone (and their families) involved in the PFF (trustees, directors, officers, managers or notable contributors). IRC Section 4941 applies to life insurance; if the life insurance transaction is deemed to be self-dealing, then the asset jeopardizes the tax-exempt status of the PFF. There are, of course, exceptions to Section 4941, but those exceptions are beyond the scope of this article. The purpose of noting the self-dealing and jeopardizing investment rules is to make sure that advisors suggesting the use of life insurance in PFFs are aware of those rules and research them accordingly.

Advisors should be aware of the guidance the IRS provided in Private Letter Ruling 200232036 (released May 17, 2002). In PLR 200232036, the founder of a family foundation transferred to the foundation a term policy owned by an irrevocable trust that the founder had created for the benefit of himself, two stepchildren of his ex-wife and his brother. The founder agreed to two key points: 1) he would pay the premiums ongoing when due (via gifts to the foundation), and 2) he gave a board member, who was an attorney and was independent of the founder (that is, the attorney was a non-employee), the authority to make any and all decisions regarding the life insurance policy. All parties involved signed a binding agreement that included contingencies, such as the departure of the board member. The IRS deemed this transfer acceptable, given the circumstances and the disclosure planning involved.

A key point in the PLR is that the policy had no loan on it, as it involved term insurance. This case, and its circumstances, highlights the importance of the issue of self-dealing as a concern when exploring life insurance ownership and transfers in, or around, a PFF. A policy loan, regardless of how taken or used, makes the donation of a life insurance policy subject to being considered an act of self-dealing under Revenue Ruling 80-132, as discussed in both this particular PLR and in other cases. Therefore, I suggest advisors follow my general rule: Stay away from transferring policies into a PFF with a loan or using the type of policy that can create a loan on its own (for example, whole life). Whole life policies can be set up to trigger a loan to pay a premium; therefore, whole life should be the last type of life insurance a PFF ought to use. Better to be safe than sorry.

Control is another important aspect of using life insurance in a PFF. The donor must give the PFF complete control of the donated, or created (if new), policy. Advisors must explain at the onset of planning discussions the importance of giving up all incidents of ownership. Moreover, the plan for a policy owned in a PFF should be for the PFF to be the sole and unconditional beneficiary of the policy's death benefit. Memorialize this in writing in the PFF's minutes, and include how the policy proceeds will be used to continue the PFF's work (that is, its exempt purpose). This will help avoid any concerns addressed in IRC Section 4945, which requires all amounts paid out of a PFF to be used to enhance and promote the PFF's charitable intent (mission). If a portion of the policy is paid to a charity promoting other needs, even if for exempt purposes, the PFF could be in violation of Section 4945. If a donor wants to maintain control, and many do, or have multiple beneficiaries, he can acquire life insurance outside the PFF, and the PFF can be designated as the beneficiary of the entire policy, or a portion thereof.

The plan for a policy owned in a PFF should be for the PFF to be the sole and unconditional beneficiary of the policy's death benefit.

What the IRS wants to avoid is the intent to

benefit anyone other than the PFF. For example, in PLR 200232036, the donor gave up all control of the gift, despite obligating himself to make future premium payments. The foundation was able (control) to determine if those contributions (premium payments) would be used for keeping the policy in force or for another use.

Targeted Inheritance

An alternative for a family to consider is to target a specific dollar amount to be left to a donor's children and use life insurance to deliver that amount. Typically, the insurance would be owned by a trust, outside of the donor's estate, and the remainder of the estate would be left to the PFF. Determining the appropriate amount to leave to heirs is often a challenge. However, donors who have a clear idea of the amount they want to leave can acquire that amount of insurance in an irrevocable life insurance trust (ILIT), using the annual exclusion or lifetime exemption gifts (or a combination of the two), and it remains outside the donor's estate. This insurance funding strategy, of course, depends on the donor's age and health, the age of his spouse, as well as other considerations. An ILIT provides for the donor's heirs, and the remaining estate assets can be left, in their entirety, to the PFF and other charities, thus eliminating taxation entirely. This strategy allows a donor to provide for both a charitable legacy and his children, with great tax efficiency.

> Annuities are also a place to find opportunities for a forgotten asset to play a role in charitable planning.

Donor Ownership

There are times when a donor isn't driven by a tax deduction. In this case, simply owning life insurance or an annuity to benefit a PFF or other charitable organization can have some appeal. The driving force is maintaining control, with a secondary benefit being tax-deferred growth of the asset. This is particularly easy if a policy is already owned, yet no longer important to personal planning. An insured can simply change the beneficiary of the policy, making a PFF, CF or other charities the beneficiaries of all or a portion of the policy proceeds. A donor may also acquire insurance on his own life and change conditions as he sees fit. Note that a policy left to a qualified charity will qualify for the federal estate tax charitable deduction under IRC Section 2055(a).

The Forgotten Asset

Life insurance is an oft-forgotten asset. Policies that were once the center of a family's financial plan and are no longer crucial can be a great asset for charitable giving to the PFF.

Understanding where such a policy stands with regard to future performance is the starting point. In other words, answering certain questions such as: "Does it require further premiums?" and "Is there a loan?" are important before a transfer is considered. It's also important to know how long the insurance contract has been in place and the policy gain information. Assuming the policy makes sense to gift, a transfer of ownership form from the insurance carrier is the primary service work required to make such a gift transfer. The value of the contract must be carefully understood and documented for the tax deduction, but such planning is common and the life insurance a welcomed asset, assuming it doesn't have (or won't have) a loan or other issues, as discussed above. The insurance carrier, or in some cases an outside valuation firm, can help determine the market value of the policy, which isn't simply the cash value.

It's important to know that the gift of an existing life insurance policy to a PFF or other charity will revert back to the insured's estate if the insured's death occurs within three years of the gift being made (the "three-year rule").

It's also worth exploring existing policies (assuming whole life) if the dividends of the policy might be a resource for giving. Dividends can be assigned to a charity, instead of being taken in cash. This removes the out-of-pocket gift and still allows for a tax deduction when the dividend is paid. Also, consider whether such dividends could be a capital resource for acquiring new life insurance on a donor.

Annuities are also a place to find opportunity for a forgotten asset to play a role in charitable planning.

Like dividend payments, the annuity payments may be directed to the PFF, or left to the PFF, thus turning a tax-deferred asset into a tax-free asset.

Group term insurance also falls into the forgotten-about asset camp. Rarely is group term insurance a core, or important, insurance asset for a PFF. In the event of an insured's premature death, the group term insurance, usually set up at an individual's place of employment, is thought of, if at all, as final expense cost coverage. For families with, or considering, a PFF, group term insurance is a vehicle to leave more money to the PFF or another charity. Naming a PFF the beneficiary of a donor's group term coverage above $50,000 will not only help the PFF, but also, depending on how the group insurance of the employer is set up, help the donor avoid any income tax on the "economic benefit" cost (the IRS rates per $1,000 of group term life insurance provided policies) of that group insurance. The first $50,000 can also be given directly by gift, but won't have an income tax deduction associated with it.

PPVAs

Private placement variable annuities (PPVAs) are one of the few annuity types that families with PFFs should consider. The primary reasons include: fee transparency, simple mechanics, sophisticated investment options and choices and tax-deferred growth of assets.

For individuals or families owning liquid assets that they aren't ready to give away or want to maintain current control over, but who think they may want to give away in the future to their PFF or other charity, a PPVA can provide tax-deferred growth as long as it's maintained. Then, too, the beneficiary may be changed (from the PFF), prior to death, to a charity of the owner's choosing. In this example, the tax system can be avoided altogether, as the planned gift would qualify under the charitable estate tax deduction.

In such a case, the family has more efficiently grown the asset while avoiding estate tax. That said, a PPVA will require cash distributions at some point, including income tax on the gain portion of the distribution.

Investors need to be accredited and be qualified purchasers to invest in a PPVA. That's because PPVAs are unregistered investment products with alternative investments, such as hedge fund options, along with other traditional security investments, such as growth and balanced funds, or sub-accounts. (For more information on PPVAs, see "Private Placement Variable Annuities," by Edward J. Finley II and Michael Liebeskind, in this issue, p. 21.)

The economics have to make sense for life insurance if it's to be used by a family with a PFF.

What About Cost?

Like most buying decisions, economics are a key, if not the key, driver. The economics have to make sense for life insurance if it's to be used by a family with a PFF. Options for designing and structuring life insurance are beyond the scope of this article, but it's helpful even so to provide some rough numbers on price. To that end, a 75-year-old male and 70-year-old female, both in good health, willing to pay premiums annually on an ongoing basis, which creates the most amount of leverage on a joint and survivorship (second-to-die) life insurance policy, would have an annual premium of roughly, in one carrier product example, $19,500 per $1 million policy. At both their life expectancies (age 86 for the female), the projected internal rate of return (IRR) is 8.22 percent. At the male insured's age 99 (when the female insured is 94), the IRR on the death benefit is projected at 5.33 percent net. That's an attractive enough return for both donors and PFF to examine the use of life insurance as a valuable tool for creating diversification, flexibility, liquidity and steady return into the asset allocation.

Bottom Line

There are a number of ways and good reasons for PFFs, their creators and those who advise them to explore the use of life insurance to help promote and protect the important charitable work they're doing. Life insurance is a financial tool that, when properly used, can be a match that not only further fuels the passions and vision of PFF donors, but also helps enhance their legacy.