The Role of Life Insurance in Enabling Large, Low Cost Charitable Gifts

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Executive Summary

- The combination of tax breaks and additional cash flow from charitable remainder trusts (CRT's), coupled with life insurance replacing the value of assets donated to the CRT, offers an extremely low-cost way to make very substantial gifts to charity.

- Three different types of charitable remainder trusts provide a means to avoid capital gains taxes when highly appreciated assets are sold, to increase substantially the effective stream of lifetime income from the donated assets, and to make gifts to family members.
  - The CRT option that allows income distributions to be deferred until the trust actually earns income enables a CRT invested in certain kinds of assets to serve as an effective means of supplemental retirement savings.

- CRT's have a number of non-tax benefits equally as great as their tax and estate planning advantages:
  - Increased cash flow for retirement income and as a source for gifting;
  - Diversification of overly concentrated investments without incurring capital gains taxes; and
  - Creditor protection for investments inside the CRT.
  - The donor can, in most cases, manage the CRT investments and retain the right to alter the shares of the charitable interests going to specific charities.

- Charitable lead trusts, which provide an income interest to charity for a fixed period of years with the remainder going to family, reduce the estate and generation-skipping tax exposure on the property staying within the family.
  - A combination of a charitable remainder trust and life insurance wealth replacement trust, when used with a charitable lead trust, can help to minimize or avoid the remaining transfer tax burden without reducing current cash flow.

- Private family foundations are an increasingly popular means of maintaining family control over assets that produce on-going support for charities while perpetuating family involvement in the charitable and civic life of the community.

- Charitable capital and endowment gifts through life insurance policies owned by charities are another tax-advantaged means of charitable giving. The donors can pay the equivalent of premiums to the charity with appreciated assets without incurring capital gains taxes.
  - The charity-owned life insurance policy can guarantee that a capital gift or endowment pledge of a promised amount will be made.

- Charitable giving strategies involving life insurance depend on the use of policies and premium structures that reduce commissions and other policy costs and that maximize the risk-adjusted returns from the life insurance investment.

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by
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Life insurance holds the key to unlocking a largely untapped market for large charitable gifts. Its central role lies in its unique ability to replace the value otherwise lost to the donor's family of major capital gifts to charity and, because of the tax advantages of both charitable giving and life insurance, to do so at relatively little cost to the donor.

This article is intended to help potential charitable donors and organizations see more clearly how very substantial charitable gifts can be made at the least cost and with the most flexibility by taking advantage of the tax and cash flow advantages of certain charitable giving techniques and by using life insurance to replace the assets given away. Life insurance thus becomes the indispensable ally both of those soliciting large capital gifts for charity and those who might consider making them if they can do so without shortchanging their families.

The more technical aspects of this discussion will not be new to those experienced with charitable planned giving. What may be different is the notion that very substantial gifts can be made at very little net cost if the donors are encouraged to think about replacing, with life insurance, the value of what they are giving away. In short, we will see how inexpensive major charitable donations can be and how life insurance makes it possible on a very large scale to benefit charities and family at the same time.

"Split Interest" Gifts: The most common and effective way to accomplish these objectives is through one of several types of partial or "split interest" charitable gifts. These are so named because they all consist of both an income stream for a period of time followed by a lump sum distribution of the amount remaining. The annual income interest can last for the longer of either one life or one or more lives -- for example, as long as husband or wife shall live -- or for a period of up to 20 years.

By far the most prevalent such gift-giving vehicle is the charitable remainder trust (CRT). Family (donor, donor and spouse, or children) receives the income stream for a period of years, and charity gets the remaining lump sum at the end of the income period. Because the charitable remainder trust is by far the most common "split interest" charitable gift and because it offers the most potential for donors seeking to replace the value of their donations to charity, we will concentrate on this especially beneficial gift-giving device.

Less common, because only the very wealthy with excess income can consider it, is the charitable lead trust (CLT). Charity receives income for a period of years with the remainder generally passing to children or grandchildren. This technique is suited to those seeking to reduce their income and estate tax burdens who can also afford to forgo the income from the assets donated to the CLT. This alternative is discussed on page 9.

Charitable Remainder Trusts: The charitable remainder trust (CRT) can take one of three different forms: (1) a **"charitable remainder annuity trust (CRAT)"**, which pays a constant amount and fixed percentage of the trust's initial value each year to the donors or other income beneficiaries for their lives or a period of up to 20 years; (2) a **"charitable remainder unitrust (CRUT)",** which pays a fixed percentage of the trust's value each year based on its value in that year, rather than a fixed percentage of the trust's initial value, as with the CRAT; or (3) a **"pooled income fund,"** which is similar to the CRUT in that it pays out a percentage of the pool each year based on the changing value of a pool of fund assets managed by the charity itself and the pro-rated share of the pool contributed by the donor.

Common Tax Advantages: The three CRTs are similar in that they each offer the significant tax advantages of (1) a means of avoiding capital gains taxes, when the donated assets are sold, on the difference between their current value and the donors' cost basis in them and (2) an upfront tax deduction at the time of the initial transfer to the CRT for the value, as determined by IRS tables, of the trust's remainder value that will pass to charity when the income interest ends.

The deemed (or "present") value of the remainder interest eventually passing to charity must be at least 10 percent of the value of the donated assets. There is also an annual limit on the charitable deduction allowed for charitable contributions – 50% of adjusted gross income for cash gifts and 30%, in most cases, for a donation of appreciated property. However, if the deductible amount exceeds this percentage of income, it can be taken, if necessary, up to the same percentage of adjusted gross income, over the next five years.

Allowable Percentages of Income Distributions: For each type of CRT, the percentage of annual income distributed back to the donors or other income beneficiaries each year must be at least five percent. The maximum depends on the age of the donors at the time the trust is created and the interest rate then in effect, which is used to calculate the value of the charitable remainder. This interest rate, sometimes referred to as the discount rate, is 120 percent of the Federal mid-term rate, and is subject to monthly fluctuations. The rate of either the month in which the trust is funded or either of the two prior months may be used. A relatively higher interest rate at the time the CRT is created allows for the income payout rate to be higher without having the present value of the charity's interest fall below the minimum 10 percent of the trust's initial value. Charitable giving software will readily compute the maximum permissible payout rate.

Appreciated Property Donated to CRTs: Because one of the main tax advantages of CRTs is the avoidance of capital gains taxes on the sale of highly appreciated property by the trustee of the CRT, it is most often this type of property which is used to fund them. Stock, business property, and debt-free real estate are therefore most often the donated assets.

Restrictions on CRT Donations of S Corporation Stock: Donors and charities should be aware that S corporation stock may not, in general, be used to fund a CRT, even though it might seem the most likely candidate because it has a low capital gains tax basis in comparison with its current value. That is because of the limitations on the type of permissible owners of S corporation stock and the fact that only certain types of trusts, not including CRTs, can hold it.

Choosing Between Types of Charitable Remainder Trusts: With an understanding of the common characteristics of the three types of charitable remainder trusts, what are the reasons to choose one form over another?

Pooled Income Funds: In general, the pooled income fund is most appropriate for the myriad of small contributions to individual charities for which a separate trust would be an uneconomic proposition. Charities tend to favor this option because of the certainty that they will receive the remainder (donors can reserve the right to alter the charitable recipients of the other CRTs) and because, with professional money management techniques, charities might hope to achieve a rate of appreciation in the fund that exceeds the payout rates to income beneficiaries, thereby increasing the ultimate remainder value for themselves.

Charitable Remainder Annuity Trusts (CRATs): These are most suitable for those looking for a payout of a constant and predictable value which will not fluctuate with the value of the trust. In this respect, they function like a fixed annuity or as a substitute for, or supplement to, a defined benefit pension payment. CRATs can only be funded with one-time contributions, although multiple trusts can be established at different times with similar provisions.

Charitable Remainder Unitrusts (CRUTs): These tend to be the most popular for two reasons. First, they can receive more than one contribution -- for example, a donation in year one and then another one three years later. Second, the payouts have a chance of keeping pace with or exceeding the rate of inflation. Because the payout is a percentage of the trust as it is revalued each year, it will increase if the trust assets appreciate. This will more likely occur if the payout rate is set somewhat below the expected rate of appreciation of the trust, after annual administrative and investment management costs are subtracted.

Added Flexibility with NIMCRUTs and FLIP CRUTs: A popular variation of CRUTs operates like a deferred savings vehicle. Known as a NIMCRUT ("net income with make-up charitable remainder unitrust"), it allows payouts or a portion of them to be effectively postponed by setting the annual payout amount as the lesser of the specified percentage of trust assets or the annual income of the trust. This permits lower payouts in early years, when, depending on the nature of the assets, there be little or no income to distribute, and greater payouts in later years to make up for years in which income falls below the specified payout percentage.

The most aggressive use of the NIMCRUT, the "spigot" CRUT involves total control over the timing of income through a deferred annuity as the trust investment. Initially, there is no trust income because it is all deferred within the annuity. Income is later taken from the annuity and paid out from the trust to make up for past distributions below the stipulated percentage of trust assets.

Because the IRS has attempted to discourage the use of "spigot" trusts, more conservative planners suggest the use of a FLIP CRUT. These start out as NIMCRUTs, with income distributions effectively deferred for several years. They are later converted ("flipped") to a regular CRUT, after which distributions equal the specified percentage of trust assets. Minimizing the income from the trust investment in the early years allows subsequent distributions to be larger once the trust has been converted.

NIMCRUT may be of greatest interest to many potential donors who are younger and who might view the NIMCRUT as an effective retirement savings vehicle for assets which have or are likely to appreciate significantly and which produce little or no income.

Choosing between a CRAT and a CRUT: It is fair to offer the following general recommendations for those who like the idea of a charitable remainder trust but are undecided as between a CRAT and a CRUT:

CRATs are preferable for older donors and those who want a predictable and consistent income stream. The older donor or other individual with a shorter period over which to take distributions will be less affected by a payout that does not increase with inflation.

CRUTs are the only option for those who want to make more than one contribution to a CRT that they can control. They also offer the only possibility for distributions to keep pace with inflation. In addition, those who contribute assets that will produce little or no near-term income or who like the idea of a deferred savings mechanism will need to choose a NIMCRUT. They made need or want to have the trust drafted in a way that it will later convert (flip) to a regular CRUT when they are looking for larger distributions from it.

Reasons for Charitable Remainder Trusts: With an understanding of how CRTs work and why one might choose one type over another, let's look further at their benefits and the cost attached to creating them. Although CRTs are most known for the tax and estate planning benefits that enable substantial charitable gifts to be made for relatively cost, there are several non-tax benefits that may be equally compelling reasons for creating a CRT. We will look at them first before seeing how the value of a CRT donation can be replaced with life insurance.

The Non-Tax Advantages of Charitable Remainder Trusts: As if the tax and estate planning advantages of charitable remainder gifts of highly appreciated property are not enough of an enticement for those with even the slightest charitable inclination, the non-tax advantages may be equally compelling.

Investment Diversification: The most fundamental principle of investment management is portfolio diversification. No matter how successful an investment has been or even how marketable it may be, an excessive concentration in it is simply unsound. While diversification is important in general, it is imperative for those approaching or in retirement who remain too heavily dependent on the performance of one investment. The CRT offers a way to diversify an excessive concentration in one or a few investments with a low tax basis without paying capital gains taxes.

Increased Cash Flow: The highly appreciated assets which are the best candidates to fund CRTs typically produce little or no income. CRTs offer a way to increase cash flow as a percentage of an investment from the 0 to 3 percent range before the CRT is created to anywhere from 5 to 9 percent afterwards. Even if some of the extra income is used for gifting purposes, the net cash flow may be much greater than before.

Cash Flow for Retirement Income: Using the NIMCRUT with a deferred annuity or with a FLIP CRT - to postpone CRT income distributions in the early years and defer them until retirement - can provide even more substantial cash yields as a percentage of principal in the high distribution years. Though the additional retirement income is deliberately deferred, there is some immediate increase in cash flow from the upfront income tax deduction.

Ability of Donor to Control CRT Investments: In most cases, the donor can control the CRT investments and can even serve as the CRT trustee. The only exception is that a co-trustee is required to arrange an objective appraisal of hard-to-value real estate, closely held business or similar investment property.

Asset Protection: Property in a charitable remainder trust does not belong to the donors even though they may have an income interest in it. Such assets have been irrevocably given away and are therefore beyond the reach of creditors. While creditors could attach the income from a CRT once paid out to the debtor, a NIMCRUT may provide an effective shield.

The Flexibility to Modify the Shares of the Trust which Charities Will Receive: In most cases, the CRT donor can retain the right to alter the interests which the charities will receive from a CRT or to eliminate their interests altogether. The alma mater which declines to admit a brilliant grandchild or offends by its adherence to political correctness can be forced to pay the consequences. The only condition is that one or more qualified charities eventually receive the trust's remainder value; there is no requirement that they remain the same as those originally named or that they take in the same proportion as may have been initially specified.

The Low-Cost Charitable Gift Using Charitable Remainder Trusts and Life Insurance: The main thesis of this article is that the combination of charitable remainder trusts and life insurance offers an extremely low-cost method of making substantial charitable gifts. Indeed, the tax advantages of charitable remainder trusts -- the ability to avoid immediate capital gains taxes while receiving an upfront income tax deduction for the value of the charitable remainder -- are so great that it can be demonstrated, using reasonable assumptions and various examples, that such gifts can be made for very little cost.

Assume that the current plan is to sell a non-diversified appreciated investment, triggering significant capital gains taxes, with the investment of the balance at a certain after-tax rate of return through life expectancy. In the alternative, assume that the non-diversified investment is donated to a CRT, that immediate capital gains taxes are thereby avoided, and that life insurance is purchased with some or all of the extra income that is generated by the charitable remainder trust. Then, compare the eventual amount of income tax-free insurance proceeds that can be purchased with the CRT distributions as opposed to the after-tax investment from the current asset after it is sold and taxes are paid. With a competitive insurance policy, the insurance alternative may not lag far behind the future value from investing the current asset. When you add the eventual contribution to charity at the end of the CRT, it should come out well ahead.

If, in addition, one assumes that the after-tax balance from the current investment will remain subject to estate taxes while the insurance policy will be owned by an irrevocable trust to avoid them, then the insurance plus charity gift strategy should reap rewards more than twice as great as the current plan. This general technique of replacing current assets subject to estate taxes with insurance proceeds that will escape them is known as "wealth replacement."

What follows below is just one example, in round figures, where all of the CRT distributions are used to buy life insurance held outside of the donor's taxable estate.

Current Strategy	**Status Quo**	**CRT + Life Insurance**
Current Assets	**$2 million**	**$2 million**
Eventual Value of Taxable Estate	**$6 million**	**$0**
Life Insurance	**$0**	**$6 million**
Amount for Family	**$3 million**	**$6 million**
Amount for Government	**$3 million**	**$0**
Amount for Charity	**$0**	**$2 million**

Summary of CRT + Life Insurance Advantages

Double Net Estate for Family
Make Large Charitable Contribution
Eliminate Estate Tax

The Best Property to Give to CRTs -- Appreciated Assets and Retirement Plan Funds: Quite clearly, the best assets to give away to charity in general are those with the greatest exposure to taxes if left in the hands of the donors.

Assets with Large, Unrecognized Capital Gains: Traditionally, the logical property to give to CRTs has been that which would incur the most capital gains taxes if sold outright. This includes closely held business assets, publicly held stock, and real estate, including residences that will not have the benefit of a capital gains exemption.

Retirement Plan Balances at Death: Increasingly, it has been recognized that the heavy erosion of retirement balances from estate and income taxes makes these funds a logical source of charitable gifts. Many professionals, executives, and small business owners have a high percentage of their savings stashed inside of retirement plans, including Individual Retirement Accounts. These assets in the hands of the wealthy are the biggest targets of all for the IRS, potentially falling prey to federal and state estate taxes and federal and state income taxes. The portion of retirement plan balances going to family rather than the government can be as little as 25 percent. It is no wonder that financial planners often refer to these funds as "junk money." If not spent or distributed and gifted or transferred to charity, these assets are relatively worthless.

If retirement plan funds are not put to a better purpose, including as a funding source for charitable remainder trusts, here is the combined impact these taxes could have on a $1 million plan balance at death fully subject to estate taxes. Because of the large amount subject to income taxes, a 40 percent combined Federal and state income tax is assumed.

Turning Dollars Into Pesos:
The Fate of Retirement Plan Balances at Death

Plan Balance:	**$1 Million**
State Estate Tax:	**100,000**
Federal Estate Tax:	**400,000**
Income Taxes:	**240,000**
Total Tax Bite:	**740,000**
Percent for Government:	**74 %**
Percent for Family	**26 %**

Income and Estate Tax Avoidance for Charitable Gifts of Plan Assets: Because of the heavy erosion of plan assets at death from income and estate taxes, retirement plan funds, or portions of them, are ideally suited for charitable gifting for those willing to share their wealth with charitable organizations as well as family. Retirement plan balances going directly to a charity at death avoid both income and estate taxes. Therefore, a bequest from these funds, which would yield only 25 cents on the dollar if directed to family, delivers 100 percent to charity. The difference is that the tax laws are so favorable to charity that the government's 75 percent share of a transfer to family is permitted to go to charity instead.

Charitable Remainder Trust Gifting with Retirement Plan Funds: Those seeking increased cash flow as well as a lower tax bite on their retirement plan assets should consider designating a CRT as a beneficiary of their retirement plans either at the death of the first spouse and plan participant or at the death of the surviving spouse.

Naming the CRT as the initial plan beneficiary with spouse and perhaps children as the income recipients will make the most sense where retirement plan assets are needed to fully fund the "credit shelter trust" that takes advantage of the estate tax exemption. In fact, the value of distributions to family members from a CRUT that can last beyond the surviving spouse's life expectancy may be greater than the accumulation from payouts that might otherwise have to occur before the spouse's death under the minimum distribution rules.

For "marital deduction" planning, the surviving spouse will need at least the full income interest from retirement plan assets if they are to avoid estate taxes at the first death. Any CRT beneficiary designation would normally follow the spouse's income interest from a

"QTIP" (income only) marital deduction trust. The CRT is only funded at the death of the surviving spouse, with an income stream from the CRT provided for children for a period of years.

Replacing Wealth that Goes to Charity or the Government with Life Insurance: In either of the ways described above, the CRT is an effective means of avoiding much of the large tax exposure of retirement plan assets with contributions to charities. To the extent the charitable contributions are viewed as shortchanging family, the amounts going to charity or being consumed by taxation can be replaced by gifts to children. To make such gifts in cash, the participant, or participant and spouse, might take additional distributions from the retirement plan. To assure the wealth replacement for family of the contributions eventually going to charity, these gifts might take the form of premiums on a life insurance policy on the participant and spouse that is held in a trust outside of their taxable estates, as shown in the example on page 7.

The Advantages of CRTs with Life Insurance Trusts vs. Charitable Bequests at Death: Most large charitable gifts have traditionally taken the form of bequests at death made as part of the donor's will. It should be emphasized that these are not nearly as cost-effective for the donor as lifetime gifts through a charitable remainder trust where a portion of the income is used to replace the value of the donation to the trust. Nor do bequests deliver any of the non-tax CRT benefits, such as lifetime investment diversification.

When made at death, charitable donations simply qualify for a charitable deduction for estate tax purposes. However, when made during life through a CRT, there is, as mentioned, an immediate income tax deduction available for the value of the charitable remainder, avoidance of capital gains taxes when the highly appreciated property is sold by the CRT, investment diversification, and, perhaps most importantly, additional income from these assets to be enjoyed during life. Some of that extra income can then be used to fund life insurance that replaces the value of the charitable donation with assets that avoid estate taxation. Any additional extra income is the equivalent of found money, providing the donors with cash flow that does not exist if the charitable donation takes the form of a bequest.

Thus, the multiple advantages of charitable gifting during life by means of the CRT and life insurance approach instead of waiting until death to make a bequest are (1) investment diversification during life without incurring capital gains taxes, (2) a substantial upfront income tax deduction for the value of the charitable remainder, (3) the ready ability, using some of the extra income for life insurance, to replace the value of the charitable gift outside of the taxable estate, and (4) even after paying for the life insurance and income taxes on the additional income, a significant increase in net cash flow.

Charitable Lead Trusts: CLTs are the reverse of CRTs. They grant the temporary income interest to charity, instead of to the donor or donor's family, and the remainder value of the trust to family instead of to charity. They are much less common than CRTs because only the very wealthy are generally willing to forgo current or potential income from the donated property. If the donor is not quite in this net worth bracket, the CRT option, with its ability to turn illiquid, highly appreciated assets into a greater, regular cash flow -- with an upfront income tax deduction and without capital gains taxes when the donated assets are sold -- will likely have more appeal.

Different Tax Treatment for CLTs than for CRTs: CLTs receive tax treatment and advantages different than those accorded CRTs. They offer, in most cases, no upfront deduction for a donation of appreciated assets, and the trust must pay taxes on its income, including capital gains from the sale of the contributed property or otherwise. On the other hand, each annual distribution to the charity from the CLT qualifies for a deduction, which tends to offset the trust's taxable income.

The CLT's real tax advantage and utility as a gift-giving mechanism for the rich is in substantially reducing the value of the trust's remainder that eventually goes to family and is therefore subject to gift, estate, and generation-skipping taxes. If the property is passed immediately to family by gift, its gift and generation-skipping tax value would be 100 percent of the property's worth. By giving one or more charities an income interest in the property for a period of years, the transfer tax value is significantly discounted.

It should be noted again that creating a CLT is especially advantageous when interest rates are low, as a lower rate will result in a lower transfer tax value for the remainder portion of the CLT that eventually passes to other family members. On the other hand, lower interest rates also result in a lower remainder value (and lower tax deduction) for the charitable remainder part of a charitable remainder trust. Relatively speaking then, lower interest rates are better for the creation of CLTs, and higher rates are better for CRTs.

For those sufficiently well-heeled to consider the CLT, it is an ideal way to pass several million dollars in trust to grandchildren while potentially limiting the GST valuation below the exemption amount that two grandparents can currently give free from the 55 percent GST. Jackie Onassis' well-publicized estate planning involved just such a transfer for similar reasons. By this means, her reported transfer of $100 million to a CLT, providing charities with a 24-year income interest at 8 percent annually with the remainder for grandchildren, was reduced for estate valuation purposes to around $3 million -- a 97 percent discount. The GST will ultimately depend on the value of the trust when the charities' interests end. With any CLT, the unitrust, which increases the charities' payout amount as the value of the trust grows, will help to limit the future amount exposed to the GST when the charitable lead income interest expires and the assets pass to family.

Combining a CRT for Children, a CLT for Grandchildren, and an Insurance-funded Wealth Replacement Trust: Consider a creative way for a family to use both types of charitable trusts to benefit children and grandchildren as well as charity. The CLT, as just described, allows a discounted valuation on an eventual transfer to grandchildren. On the other hand, by diverting the income to charity for an initial period of years, the CLT deprives the donors and their children of the cash flow from these assets. To make up for this loss of income, a substantial CRT is created that generates extra income for the donors and their children. Some of this extra income from the CRT, if used to pay for life insurance, can replace the value of the trust remainder that the CRT will eventually leave to charity rather than family. If replacing wealth for children, the insurance should be on the lives of the donors. If replacing it for grandchildren, the insurance could be on the children who are parents of the grandchildren. This is socially useful and relatively inexpensive form of multi-generational wealth transfer planning and charitable giving for those in a position to consider it.

Charitable Gifts of Life Insurance Premiums or Policies: In a number of situations, life insurance premiums or policies make an attractive charitable giving alternative. They are an especially effective tool for charities engaged in a major capital campaign.

Note, however, that the purchase of a new policy for a charity is much more advantageous for the donor than giving away an old one. If an existing policy is transferred, the income tax deduction for the gift is limited to the lesser of the cash value of the policy or the premiums paid. An insurance policy is not treated as a capital asset and, therefore, is not valued for income tax deduction purposes at its fair market value. For that reason, donors who wish to maximize the deductible value of their charitable gifts should contribute highly appreciated capital investments before they give away an existing life insurance policy.

Purchasing New Policies Provides a Double Tax Benefit: Where new policies are acquired for charities, however, donors can obtain a double tax break -- a charitable deduction and possible capital gains tax avoidance. This second potential benefit has received very little attention.

The premium payment itself is a charitable donation where the charity owns the policy or is named as the irrevocable beneficiary. In addition, if the charity owns the policy, the donor can make annual gifts, equal to or greater than the premium, in the form of highly appreciated liquid assets, such as publicly traded stock. The donor receives a tax deduction for the full fair market value of the donated asset and need not pay the premium in cash. The charity then sells the assets, or otherwise comes up with the cash to pay the premium, without any capital gains tax owed by the donor.

If the donor pays the premium and the appreciated property must first be sold to realize the necessary cash, fewer dollars will remain, after capital gains taxes, to buy life insurance for the charity. The charity-owned policy thus enables capital gains tax avoidance on the in-kind asset donated to pay the premium and a larger ultimate benefit for the charity.

Using Life Insurance to Guarantee a Bequest or Pledge of a Promised Amount: Life insurance also assures that a charitable gift of a certain size will be made no matter when the donor/insured dies. If made in a will, the donation might be limited to a certain percentage of the estate, leaving no way to determine in advance what the size of the estate, and the bequest, might be. Even that percentage amount, depending on the wording of the estate tax apportionment provisions of the will, could be further reduced by a tax allocation made at the expense of the charitable bequest.

The charity's and donor's interest in knowing that a sum certain will be donated, no matter when the donor might die or what the other provisions in a will, are particularly great if the bequest is designed to fulfill a major capital pledge. This is especially true if the expected gift is the means of financing a major capital project or of repaying a loan taken out in anticipation of ultimately receiving the pledge. In this case, the life insurance policy is really insuring more than the donor's life. It is guaranteeing the financial future of the charity.

Choosing a Life Insurance Company and Product: The rationale for charitable giving strategies that involve life insurance is much more compelling where a conscious effort is made to seek the highest risk-adjusted return from the life insurance investment. Even sophisticated consumers and almost all professional advisors do not understand the extent to which the return from life insurance policies of the same type will vary considerably.

All insurance companies are not alike. Both in their financial strength and rate-of-return performance, they are very different. Companies' solvency ratings and historic rates of return are readily measurable and capable of comparison. It is critical to focus on these factors in selecting a company and to avoid the inherently confusing and misleading exercise of comparing insurance companies' illustrations of non-guaranteed future returns, which, as often as not, bear no relation to past or present performance.

The advantage of the life insurance investment alternative, however, depends on, or is at least considerably enhanced by, the right kind of life insurance policy from the right company. Rates of return on life insurance policies vary considerably - by 2 percent (200 basis points) or more - even when the underlying investments of the policy are identical. That is because differences in the pure insurance costs of an insurance policy (the "mortality and expense" charges) for the same individual can account for variations of at least 100 basis points. In addition, the savings from a policy with a low commission versus a standard commission premium structure can reduce commissions by 80 percent or more and can also enhance the investment return by 100 basis points.

To put these differences in perspective, imagine an investment in insurance premiums of $25,000 annually for 30 years with one such investment producing an internal rate of return at the insured's death of 6% and the other 8%. These returns are, of course, after-tax rates, since life insurance death benefits are (in almost all cases) not subject to income taxation. The first such investment produces $1,976,454, and the second yields $2,832,080 – a difference of $855,626 or 43%.

Understanding the differences in rates of return from life insurance investments of seemingly similar kinds holds important advantages both to donors using life insurance to replace the value of their charitable contributions and to charities seeking to assure the promised benefits from the insurance policies they own. In addition, both donors and charities should monitor the status and performance of the insurance they already own. In many cases, the policies are falling well short of delivering on their earlier projections and bear a substantial risk of falling apart before the deaths of the insureds.

Other articles from Life Insurance Advisors, Inc. provide further insight into the ways to secure the best results and the advice required to obtain them. (See, among others, "How to Make Permanent Life Insurance a Good Investment" and "How to Avoid the Premature Death of an Existing 'Permanent' Insurance Policy").

Conclusion

Charities and their largest donors, recognizing the ability to make very substantial capital gifts at greatly discounted costs, should significantly raise their planned giving goals. For charities, instead of simply encouraging a potential contributor to make an outright donation of a relatively small amount of appreciated securities, they should demonstrate that, for the same cost, using a CRT or CRT with life insurance, a gift of many times that amount can be made. For charitable donors, the revelation may be two-fold. First, they can have a dramatic and lasting impact on their favorite charities for a price not exceeding the cost of the much smaller, but less tax-effective, donations they might already be making. Second, larger donors who may have been planning to make substantial bequests at death should now recognize the tax, cash flow, and wealth preservation advantages of gifts during life through the combination of the CRT and life insurance wealth replacement trust.

Indeed, all of this is possible because of very favorable tax provisions that offer ways to make substantial gifts to charities substantially at the expense of the government and therefore without sacrificing the future interests of the donor's family. These parts of the tax code take some of the sting out of the other, punitive wealth transfer levies and make it possible to do good and do well at the same time. Those who take advantage of these opportunities will most likely realize their dreams -- for their families and for the causes that are dearest to them -- that will last beyond their own lifetimes.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.