Charity-Owned Life Insurance:
An Objective Primer for Planned Giving Officers

Richard M. Weber, MBA, CLU, AEP®
President, The Ethical Edge, Inc.

Randy A. Fox, ChFC, CFP®
Founding Principal, InKnowVision, LLC

Value Statement: Life Insurance can be an important asset to charities because if it is structured, funded, and managed properly it is capable of providing a significant amount of liquid wealth that is not correlated to traditional investments or market results. These policies can, in turn, reduce portfolio risk while providing predictable amounts of funding over time. If implemented properly and owned broadly enough, cash flow from life insurance policies can be statistically determined by charities and foundations for which this asset class is appropriate.

Purpose of this paper: Life insurance is often proposed as an appropriate gifting vehicle for charity. Some of the time it is the gift of an existing policy or policies that are offered directly by a donor. At other times charities are ideal prospects for agents seeking to promote life insurance policies that may add value to a charity's or foundation's investment portfolio, and which may also provides substantial financial motivation to the agent. This paper seeks to describe the legitimate attributes of various types of life insurance as it pertains to charities so that Development and Planned Giving Officers can broaden their understanding and be clearer about the implications of accepting, owning, and managing life insurance as an additional asset class.

Introduction

Life insurance is generally purchased to protect the financial well being of those who are dependent on the insured (families and businesses) in the event of premature death – to replace income, protect assets, assure business continuity, create an estate, or to provide liquidity for an estate. Perhaps less obvious may be a benefactor's intention to leverage current cash flows into substantial endowments to favorite universities, museums, and other 501(c)(3) organizations at the death of the insured.

Life insurance can come to charities in several different ways: a donor may make an irrevocable gift of an existing policy that is fully paid for; or they may make the gift of a policy that requires additional annual premiums; or the charity may simply be named as a beneficiary of a policy that the donor continues to own and pay for. The charity may not even know that is a named beneficiary until the donor dies and the insurance proceeds are delivered, or the charity may choose to purchase a new life insurance policy on the life of one of its important donors or board members. Each of these different possibilities carries with it tremendous financial potential along with its own set of tax rules, risks and evaluation issues.

For these and other important reasons, life insurance may be considered a problematic asset for Development and Planned Giving Officers. Life insurance is understandably viewed as something that "pays off" only at the death of the insured and is therefore dismissed because a tangible present benefit cannot be perceived. Even though some policies may be cashed in or sold in the settlement market, cash or readily marketable securities are often the preferred gift. While many "permanent" life insurance policies have cash value (also referred to as "living benefits"), it has been unclear how a not-for-profit entity can enjoy those living benefits without undermining the future value of the death benefit. Often, even after charities receive a policy, the policy is placed in a file cabinet somewhere and forgotten about or ignored until the donor passes away. It is generally not considered or treated like the asset that it is, nor is it integrated into the charity's investment portfolio which is otherwise actively managed, regularly reviewed, and scrutinized with the fiduciary responsibility that accompanies such assets.

It is not only organizations who(?) may be reluctant to deal with the complexities of life insurance. Even individuals who have a more discernible need for life insurance may take no action, or may not completely insure their human life value due to the veil of confusion and complexity surrounding the many new and sophisticated product offerings of the last few years.

Not withstanding these possible barriers to accepting life insurance as a desired asset, by the end of 2008, more than $19.1 trillion of life insurance covered the lives of American policyholders.[1] To put the total volume of life insurance in perspective, the U. S. economy's gross domestic product for 2009 was approximately $14.3 trillion.[2] At the end of 2007, $580 billion of total life insurance policy benefits (including death benefits, dividends, and surrender values) were paid to beneficiaries and policy owners. According to survey respondents (Appendix A) - this group of charitable institutions alone is beneficiary to at least $590 million in policy death benefits. What?

The issues surrounding the viability of institutional ownership of life insurance on the lives of its benefactors is further confused by the manner in which such policies are proposed. It must be acknowledged that insurance commissions are extremely favorable to the selling agent in the year in which the policy is placed. While this is an understandable deterrent, Development and Planned Giving Officers may be unduly and negatively influenced by the compensation issue, and not explore further the relevance and value that such policies may still represent to the organization's overall investment portfolio.

In many ways, the subjective and often negative issues surrounding the acquisition of life insurance policies can be balanced by viewing life insurance in its more sophisticated form: an asset class for which living values not only coexist with the corpus of the foundation or institution's investment portfolio, but for which it can also be demonstrated to both moderate the volatility and somewhat increase the yield of an investment portfolio.

---

[1] American Council for Life Insurance Fact Book, 2009.

[2] Wikipedia: "Gross Domestic Product listed by the International Monetary Fund" at http://en.wikipedia.org/wiki/List_of_countries_by_GDP_%28nominal%29

While insuring the lives of benefactors may have an element of unseemliness, the timing of an individual death is unknown, both to the insurer, the institutional owner, and the insured. While we will all die, there is an amazing predictability to the distribution of deaths among a large population, allowing an institution to anticipate cash flows from death benefits back to the endowment.

Life insurance is both a formidable economic presence and one of the most complex financial tools Development and Planned Giving Officers may consider as they pursue the financial well being of their organizations. It is the intention of this paper to look at life insurance objectively from the standpoint of the benefactor and the institution, and to promote a clearer understanding of whether and when life insurance may prove suitable in a variety of circumstances. Ultimately, the use of life insurance will be best appreciated (and accepted by institution's trustees) when it can be discussed in the context and vocabulary for which institutions already manage their investment portfolios.

Survey

At the request of the authors of this white paper, PPP conducted what we believe to be the "first ever" comprehensive survey of not-for-profit/charitable institutions to better understand their considerations about – and investment in – life insurance. The survey reviewed the number of policies, the types of insurance, the premium funding levels, the existence of comprehensive gift acceptance policies and the consistency of normal review processes. These preliminary findings will enable us to establish meaningful industry benchmarks as various charities begin the process of formalizing their knowledge and capabilities in the area of life insurance ownership and gift acceptance.

The survey and survey results are in Appendix A

Chapter 1

Life Insurance "101" - What Development and Planned Giving officers need to know about life insurance

Term life insurance

The simplest form of life insurance has always been term insurance. As its name implies, it is purchased for a term of years generally extending from one-year (yearly renewable) term to 30-year term. The cost of the yearly renewable variety is most directly tied to the underlying probability of death this year and is perhaps the purest form of life insurance. Next year's price will be slightly higher, and the progression will continue until some advanced age when it is generally no longer renewable at the insured's option.

The modern term insurance policy purchased for a specified period of years is almost always priced with an initial premium that is guaranteed and level. That level premium is simply a mathematical "smoothing" of what this year might be $270 for a $1 million policy to what 20 years from now would be $3,230 for the risk of death for someone who is then 20 years older. It should be noted that once the initial premium period has passed, the policy can generally be renewed annually at the discretion of the policy owner without further medical evaluation – but at the premium demanded by the insurance company (subject to certain contractual guarantees). These post-guarantee renewal premiums will typically start out at a significant multiple of the original, level premium. Actual premium structures for a multi-year level guaranteed premium may follow the model as described in the previous section, or may heavily discount the premium for the initial period and make it almost immediately unaffordable for renewal once the initial guarantee period has expired.

Term life insurance is designed and priced for defined periods of time. Term insurance is an impractical solution for lifetime durations, since the cumulative, lifetime "price" will typically be 60 - 70% of the death benefit itself. Charitable institutions will almost always want to own policies that are designed for lifetime use.

Permanent styles of life insurance (see also Appendix B)

Just as the premium for a 20-year term policy can be understood on the basis of a mathematical leveling, a simple explanation for the "permanent" (or cash value) forms of life insurance is that the increasing risk cost is mathematically leveled out for an entire lifetime.

There are a number of life insurance products that have evolved to meet the various needs and considerations for long-term (typically lifelong) life insurance purchases.

Whole Life is the oldest form of lifetime, level-premium life insurance, dating back to at least 1759 with the formation of the first life insurance company in the United States called the "Corporation for Relief of Poor and Distressed Presbyterian Ministers." Whole life insurance is entirely guaranteed by the issuing carrier, and the payment of a death benefit is subject only to the policyholder's timely payment of a fixed and guaranteed premium and the solvency of the insurance company. Premiums are set, reserves are created, and death benefits are paid based on actuarially conservative expectations. Because of the guaranteed nature of the contracted death benefit obligation which may span decades, an insurer needs to carefully "price" its product to deliver a reasonable return to the company's shareholders, be competitive in the marketplace, and be fiscally sustainable through "boom and bust" economic cycles.

Participating Whole Life (PWL) is a variation on the whole life concept wherein the insurance company – typically beneficially owned by its policyholders rather than outside shareholders – hedges the pricing of a long-term commitment by charging (and guaranteeing) a somewhat higher premium, and returning to its policyholders their pro-rata share of gains through investment returns, mortality experience, and expenses that are more favorable than those incorporated in the pricing of the guaranteed premium. Historically, dividend-paying policies have generally provided greater long-term value than those policies that did not pay dividends.

Universal Life (UL) was first introduced in the late 1970's at a time when interest rates in the U.S. were approaching unprecedented high levels in the economy. The first insurers selling such policies were able to segregate new investment portfolios earning as much as 15% in federally guaranteed bonds, resulting in "current assumption" policies initially crediting as much as 14% to its cash value account (after deductions for insurance, expense charges and profits). In fact, a key feature of such policies was the "unbundling" or "transparency" of the various components of crediting rates, cost of insurance, and other expenses. Additional characteristics distinguishing UL policies from their whole life forbearers was there were no guaranteed premiums or benefits and the policy owner had only to pay enough into the policy to maintain a positive balance in the cash value account so that the policy could be sufficient for another 30 days until the next policy accounting. With 14% initial crediting rates and the ability to "calculate" a premium based on the current assumptions (which, in turn, were based on current market returns), projected premiums were often a fraction of the equivalent whole life policy. Not as transparent, at least initially, was that the universal life policy design transferred to the policy owner the risk that the policy – based on the requirement there be at all times a positive balance of paid premiums, credited interest, and debited expenses – would be in force when the insured died.

Current Assumption Whole Life is essentially a hybrid of whole life and universal life policy design. The modern non-participating whole life policy has fixed premiums and guaranteed cash values based on the policy's underlying structure of guarantees however death benefits, cash value, and/or premium payment periods can be improved when the carrier credits a rate higher than that guaranteed (and/or assesses a lower insurance charge than that guaranteed).

Adjustable Life insurance policies are essentially whole life policies that within limits have the premium and death benefit flexibilities of UL. Unlike UL, these policies are not "transparent" and contain non-forfeiture values. Policy premiums and death benefits can be adjusted along a continuum ranging from limited pay policies on a guaranteed basis to term insurance for limited durations. These policies have had a rather limited distribution, as they were only sold by a small

number of insurance companies.

Variable Life (VL and VUL) policies are a unique variation on whole life and universal life design in that the policy owner has the opportunity and responsibility to allocate and invest her premiums in designated sub-accounts for the support of the underlying policy and death benefit. Variable whole life policies still contain death benefit sufficiency guarantees, but the more popular variable universal life policies only guarantee certain expense elements and an upper limit to the scale of insurance charges that can be assessed against the policy from year to year. A variable universal life policy typically provides a variety of proprietary and non-proprietary mutual fund-like sub-accounts across a spectrum of fixed and equity accounts. The long-term viability of the policy becomes a function of the funding premiums paid and the market returns of the chosen sub-accounts.

Equity Indexed (EI) insurance policies are still another variation on universal life, the key difference being that the policy's crediting rate is not subject to the insurance company's own investment experience and the subsequent decisions of a Board of Directors. EI policies employ an elaborate formula and matrix of criteria to determine how much of the gains in a broad index of stocks (such as a S&P500™ index) will be credited to the cash value. Additionally, the typical Equity Indexed policy will never post a "negative" return as will occur from time to time in variable universal life. Equity Indexed products have a number of investment attributes, but under current regulation can be sold both by agents with and without securities licensing.

No-Lapse-Guarantee (NLG) universal life is a major subset of universal/variable universal life design in which – in exchange for the prompt payment of a stipulated (and guaranteed) premium – the policy will not lapse regardless of the fact that the cash value may decline to $0, a condition that would normally cause a universal life insurance policy to lapse. This is a significant departure from the principles of universal policy design and is the one type of universal-style policy that falls within the "guaranteed premium" category of term and whole life insurance products. There are, however, substantial restrictions on NLG Universal Life policies,

including limited cash value. Such policies are often considered "term to age 120" to reflect the reality of the lifetime guarantee but without the typical cash value that would accompany a lifetime policy. Because of the significant guarantee of sufficiency, owners should not anticipate accruing substantial cash values; in fact, the relatively nominal guaranteed cash value is all that should be expected. While the guarantees of NLG Universal Life are especially appealing in times of low credited interest rates, they could lose their appeal vis a vis non-guaranteed UL competitors when crediting rates in the marketplace exceed 5 or 6%.

Policy illustrations

The process of evaluating and making decisions about life insurance policies will almost always involve reviewing a *policy illustration*. Policy illustrations are generally used to numerically project guaranteed and non-guaranteed policy values over the lifespan of the insured. The *illustration*, however, is not the *policy*. While the policy is the legal contract between the insurance company and the policy owner, the illustration is an attempt to explain *how the policy works*. An illustration inherently projects the insurance company's current experience in death claims, general expenses, and investment return as those elements might affect the long-term financial outcome of a policy. The illustration suggests to the buyer a view of how the policy's values *might* look in the future through economic enhancements that exceed its guaranteed pricing elements. The illustration may also be used to demonstrate the policy's flexibility (i.e. the ability to suspend premium payments and/or withdraw cash values from the policy) in the event the insurance company continues to be able to enhance policy values in excess of the underlying guarantees contained in the policy. Policy illustrations, however, are merely projections far into the future of a current set of assumptions (and which assumptions will almost assuredly vary from those that are projected). By comparison, it would be as if an investor were considering the purchase of two different mutual funds, each of which takes the average return it achieved over the last twenty or thirty years and projects that rate of return – along with its current, changeable fund management fees – to suggest a specific outcome far into the future. In fact, such an "illustration" of

projected values for a mutual fund – or any related use of marketing material – is specifically prohibited by securities regulations; life insurance illustrations (even those representing policies that are deemed securities) are exempt from such regulation.

The use of policy illustrations

The use and flexibility of a policy illustration can be manifested in a number of ways. One method of utilizing the potential excess earning power of the policy is to let the enhancements take over the payment of premiums at some future time. The term "premium vanish," "disappearing premium," or "premium offset" is most often associated with this type of illustration. But the policy itself is not designed to "vanish" the premiums; the illustration simply calculates the current point in the future where non-guaranteed, projected enhancements give the policy owner the option of paying premiums out of excess policy values if those values in fact materialize due to favorable expense and investment experience.

In 1992 The Society of Actuaries published an extensive examination of illustrations and illustration practices associated with the purchase of life insurance. Its conclusion: " ... (when) illustrations are used to show the client how the policy works; (it is) a valid purpose of policy illustrations. Illustrations which are typically used, however, to portray the *numbers* based on certain fixed assumptions - and/or are likely to be used to compare one policy to another - are an *improper* use of the policy illustration.[3]" Furthermore, the Executive Summary of the Society's report concluded: " ... How credible are any non-guaranteed numbers projected twenty years in the future, even if constructed with integrity? How does the consumer evaluate the credibility of two illustrations if they are from different companies? Or even if they are from the same company how are different products with different guarantees being considered? *Most illustration problems arise because the illustrations create the illusion that the insurance company knows what will happen in the future and that*

[3] *Final Report of the Task Force for Research on Life Insurance Sales Illustrations under the Auspices of the Committee for Research on Social Concerns*, Society of Actuaries, 1992

this knowledge has been used to create the illustration.[4] (emphasis added)"

These cautionary words from the Society of Actuaries help to summarize the reasons policy illustrations cannot effectively facilitate a cost/benefit analysis or other comparisons within multiple policy possibilities. Illustrations are representations of assumptions made in policy design. These assumptions have to do with the building blocks of carrier expense and earnings: mortality costs, overhead expenses, investment income, the length of time a policy "persists" with the carrier, and the percentage of policyholders who drop out of the pool of insureds for reasons other than death. By regulation, the assumptions manifested in the policy illustration should reflect only the current and actual experience of the carrier. The dilemma, however, is that even though the policy illustration being reviewed has assumptions incorporating only those based on current experience, those assumptions are nonetheless being projected into an unknown future; the future will only reveal itself one year at a time.

---

[4] *Ibid.*

Chapter 2

Tax issues of life insurance gifts

One of the important considerations regarding the transfer of life insurance to charity is the tax consequences for both the donor and the non profit. By tax consequences, it is necessary to address income tax issues separately from estate and gift taxes. While these areas can be somewhat confusing and complex it is very important to have a basic understanding of the rules before accepting any policy as a gift.[5] The good news is that the transfer and acceptance of a life insurance policy itself is generally fairly simple to accomplish. Most necessary forms are available directly from the life insurance company of the transferring policy and are reasonably simple to complete.

There are two major qualifying factors regarding the income tax deductibility of the donation of a policy. First, the charity must have an "insurable interest" in the donor's life. While insurable interest rules vary from state to state, all are substantially the same. They define insurable interest as one in which the beneficiary (the charity in this case) would suffer loss if the event insured against occurs (in this case, the death of the donor). There have been instances when a deduction was denied because under the laws of the state involved, the charity had no insurable interest in the donor. It is important to note, however, that the insurable interest concerns only apply to new insurance policies that the charity may be applying for on the life of a donor. Existing policies that are being gifted to charities do not fall under this constraint.

One of the main reasons these laws exist is to prevent abusive practices. There have been instances where policies were taken out on misinformed insureds and the proceeds assigned to various not-for-profits. However these insureds really had no interest in the cause of the charity. These types of situations have caused the tightening of some of the insurable interest rules in some states.

---

[5] It is not the intention of the authors to provide tax advice, but rather broad concepts of income, gift, and estate taxation as it exists in 2011. In all circumstances, those concerned about the tax effect of a transaction involving a charity should seek specific tax counsel.

The second major factor that is necessary for a life insurance policy to be income tax deductible is that the donor must relinquish all incidents of ownership in the policy to be donated. That is, all financial and economic rewards must be given away. These benefits include ownership of the policy, the right to change the beneficiary, the right to borrow from a cash value policy, the right to surrender the policy for its cash value, the right to pledge the policy as collateral, and the right to select settlement options for the policy. Simply naming charity as irrevocable beneficiary is not enough because the policy owner still has access to ownership rights in the policy that could harm the charity's interests while continuing to benefit the owner.

Once the requirements for a completed transfer are met, it is important to understand the income tax consequences for the donor. Life insurance is considered ordinary income property. Therefore, a gift to a public charity will create an income tax charitable deduction up to 50% of the donor's adjusted gross income (AGI). The deduction that the donor receives for a policy with cash value is the LESSER of the cash value or the total premiums paid. This amount can be ascertained in several different ways. First, the charity should request Form 712 from the life insurance company directly. The company will not send it unless requested but it does contain the current policy values and the total premiums paid to date. The second method is to have the company prepare an "in force" policy illustration. This should contain roughly the same data but is also helpful in projecting the policy out into later years. This can be valuable information in certain types of policies that may or may not be paid up. Note that some cash value policies may have premiums that are meant to continue after the donation and these policies must be carefully evaluated before the gift is accepted by the charity. The ability to meet the future financial obligation to keep the policy in force as well as the return on investment must be weighed by the charity.

Policies on which the donor has a loan - that is, they have borrowed some of the cash value of the policy and have not paid it back - present a different income tax scenario. These policies fall under the bargain sale rules. The transfer of a policy with a loan will create taxable ordinary income to the donor for the amount of the loan since the debt is being "forgiven" and an income tax charitable deduction for the remaining basis in the policy.

Many donors own individual term insurance. Term insurance is pure insurance with no cash value accumulation. It still may be a viable idea to transfer a term insurance policy to charity. From an income tax perspective, it is unclear what the deduction for the policy should be. Arguably, it is the amount of any unearned premium. For example, if a term policy has a $1,000 premium due and payable and the donor irrevocably transfers the policy on the day the premium is due and paid, then 100% of that premium should be deductible since is as yet unearned by the insurance company. If the donor pays on January 1st but transfers on June 30th of the same year, the $500 of the premium has been earned by the insurance company (that is, it has provided coverage for exactly half of the coverage period) and therefore the unearned half, or $500, should be deductible by the donor.

Many employers offer group term policies for their employees. The same basic rules apply to gifts of group term insurance as apply to personal term insurance. A donor may irrevocably assign his interest to charity. However, since the donor doesn't own the policy, it is not necessary to transfer ownership in the policy. In this case, the donor should be entitled to an income tax deduction for any unearned premium.

Policies gifted to charities having a value of greater than $250 fall under gift substantiation requirements. Technically, the valuation of the policy must come from a disinterested party to the transaction. This means that the issuing insurance company's estimate of value is probably not an adequate valuation. Nor should it be an agent of the issuing company. The safest valuation should come from an independent source such as an independent actuary or appraiser.

Estate and Gift tax rules are somewhat easier to sort out. If a donor retains a policy and names a charity as either the sole beneficiary, a partial beneficiary or even a contingent beneficiary, the insurance proceeds will be in the donor's estate when he dies, but the esatate will receive an offsetting estate tax charitable deduction for that amount which passes to the charity.

If the donor irrevocably transfers the policy to a charity, the donor may be entitled to both an income tax deduction for the lesser of cash value or premiums paid *and* the

policy should be excluded from the donor's estate for estate tax purposes. If, however, the donor dies within three years of making the gift, the face value of the policy will be included in his estate but then receive an estate tax charitable contribution for the same amount.

Chapter 3

Life insurance as an asset class in the context of charity/foundation investment portfolios

Introduction

Stock values rise and fall on a daily basis, giving rise to short-term risk and market value volatility for which some charity/foundation investors experience substantial anxiety. If an institution has a reasonable time horizon, the long-term growth statistics tell a more satisfying story. For example, from 1980 through 2009, total equity returns of Large Cap stocks (comparable to the S&P500™) reflected a 11.24% compound annual rate of return.[6] However, this historic observation of significant long-term equity returns (and the underlying volatility) is only part of the story. Inflation and fees can significantly reduce the real *real* return of any investment (taxes represented 1.78 % of the reduction in return in the cited study but are not a concern for 501(c)(3) organizations). Thus, for the 11.24% nominal return for large cap equities in this 30-year period, more than 1/3 of that return was taken away by a compound rate of inflation 3.69%. Investment fees of another .56% reduce the apparent double-digit return to a *real* compounded return of 6.99%.

In contrast to the investor willing to incur risk, there was a shockingly low reward for those at the beginning of this 30-year period seeking an investment strategy with less short term risk and volatility. A portfolio comprised of completely safe U. S. Treasury Bonds had a gross 20-year compound rate of return of 9.68%, but just 5.43% after accounting for inflation and fees. Short-term U. S. T-Bills suffered the most: a gross 5.49% resulted in a *real* real return of just 1.24 after inflation and fees. In the last few years since the "Great Recession," short-term interest rates calculated on this basis have been less than 0%.

---

[6] *A Study of Real, Real Returns,* Thornburg Investment Management, Volume 17, August 2010.

It is intuitively obvious that diversifying one's investments might avoid the worst effects of a market "crash." Stocks and Bonds have historically been the main ingredients of diversification. Worried about volatility risk? Buy bonds. Worried about securing adequate long-term returns? Buy stocks. But just how to diversify? Diversify when? Only from the perspective of the end of the year can it be determined which of these major types of investments would have produced the better return if acquired at the beginning of the year. The lack of a workable method to diversify a portfolio with the objective of maximizing returns in the context of a known level of risk-taking gave rise to the development of Modern Portfolio Theory (MPT). This paradigm shifting approach to investment methodology (utilizing an "efficient frontier") was introduced by Harry Markowitz in 1952. In 1990, he shared a Nobel Prize with Merton Miller and William Sharpe for what has become one of the best known approaches to portfolio selection.[7]

An inherent part of MPT is to assess an existing portfolio by its component "asset classes." Most advisors agree that the primary asset classes include Equities (common stocks), Fixed Income (bonds and mortgages), and Money Market (cash). Some experts extend the list to include Guaranteed (annuities), and Real Estate. Each of the primary asset classes have sub-categories; for example, equities can be further categorized as Large Cap, Small Cap, International, etc. As a matter of caution, a portfolio would consist of assets that are diversified amongst these asset classes. The *type* of diversification, however, can have a significant affect on portfolio performance. Diversification can be quantified, ranging from "+1.0" for assets that have similar volatility/return characteristics and are perfectly and positively correlated (market forces will "pull" asset values in the same direction and are in "lock-step") to "– 1.0" for those assets that have similar volatility/return characteristics and are perfectly negatively correlated (market forces will "push" asset values in different directions). Assets that neither "push" nor "pull" will be close to a correlation rating of "0.0" and are considered un-correlated. While

---

[7] *Asset Allocation,* Roger C. Gibson, McGraw Hill 2000. Third Edition.

perfectly negatively correlated assets don't really exist, asset combinations that have "negative tendency" will generally produce a better long-term return/risk relationship than will more positively correlated assets. The return of a portfolio consisting of such assets will be the weighted average of the returns of each asset, but the volatility of the portfolio will be less than the weighted volatility of the individual assets.[8]

Life insurance as an asset class

For this brief explanation of MPT and the categorization of asset classes, we believe that life insurance meets the important criteria of this designation:

- The death benefit is cash (itself a major asset class) at the precise time it is needed and *without* valuation adjustment based on up or down phases of the equity or bond markets;

- The living benefits – the cash value – take on the asset class attributes of the policy itself. A universal life or whole life policy's cash value has the dominant characteristic of a fixed account with a minimum guaranteed return. A variable universal life policy's cash value is itself a portfolio with the opportunity to reflect the asset allocation of the policy owner;

- The unique characteristics of life insurance relating to 501(c)(3) institutions - the availability of policy cash values and the inherent leverage of relatively low periodic payments into a capital sum – are attributes that allow a life insurance policy the tendency to be at least uncorrelated

---

[8] *Ibid.* Further: An example of potential negative correlation could include certain periods of time when bond prices fall due to lower demand during a period in which equity values are rising (in part because of higher demand). Again in this example, when stock values rise, all things being equal bond prices may fall since there is less demand for them compared to stocks. Correspondingly, when stock values fall, new bond prices may rise as they become a "haven" for those selling out of their stocks. An example of positively correlated assets might be a portfolio in which there are 1000 shares of Panasonic and 1000 shares of Sony. While there might be modest diversification in the case of "bad press" about one or the other, market forces such as inflation spikes, labor union resolutions, and shifts in consumer attitudes are likely to affect *both* companies in the same way.

against most other asset classes;

- The death benefit is based on the event of death – not a market event which in turn can cause a change in value.

- Permanent life insurance intended for a lifetime can produce at least as favorable a long-term return with less risk within a portfolio of equity and fixed components than a portfolio without life insurance (a favorable efficient frontier result.)

Life Insurance and Efficient Asset Allocations: Building an Efficient Investment Portfolio by including Life Insurance

Charitable institutions use a combination of current contributions and income from portfolio investments to pay for the expenses of paying salaries and overhead for the organization. Investment strategies will include a spectrum of fixed and equity asset classes to maximize yield, temper volatility, and provide the needed income stream for current expenses. Many such institutions recognize the potential value of life insurance, but may be concerned that it "ties up" resources. This section will explore whether there is a synergy of investment *plus* life insurance that can serve at least as well – and with less volatility and market valuation risk – as a portfolio that does not contain life insurance. To avoid getting mired in too much jargon and statistical complication, the following analytical discussion will simply compare an existing portfolio of fixed and equity elements *with* and *without* permanent life insurance.

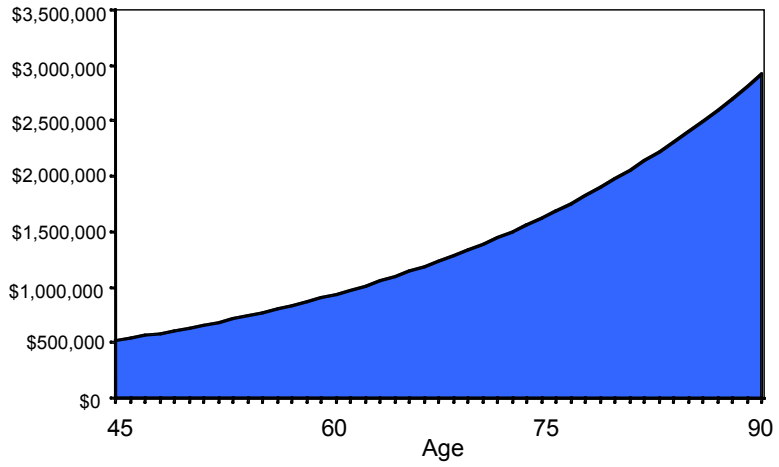
Analysis

We will use the example of a 45-year old male in good health (and in a relatively high income tax bracket) and an endowment fund whose investment portfolio includes $500,000 of intermediate duration bonds as a portion of the portfolio's fixed

asset class component. The current yield of 4% produces a non-taxable cash flow of $20,000. While it is unrealistic to assume level interest rates over the next 40+ years of this investor's life expectancy for this asset class (which would produce fluctuations in the value of the bonds), the income from the initial bond acquisition will remain constant over the life of the bonds. We note that with respect to the life insurance policy alternative, neither the guaranteed cash value, the guaranteed value of paid-up additions cash value (once created), nor the total death benefit (once created) is subject to market value adjustments.

A projection of portfolio growth over the donor's lifetime (life expectancy + 5 years is age 89) suggests that the institution's bond portfolio would accumulate to an asset value $2,920,588 if simply left to accumulate at the nominal assumed return of 4%.

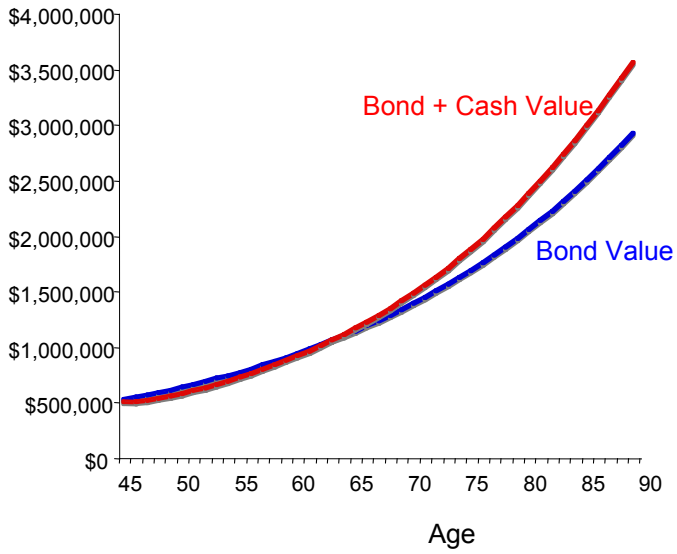
Value of bond component with income purchasing more bonds



Alternatively, the $20,000 of initial bond income could be used to purchase a participating whole life policy.[9] This next graph reveals that the all-bond option produces slightly more asset value than the bond+cash value alternative for the first 19 years.

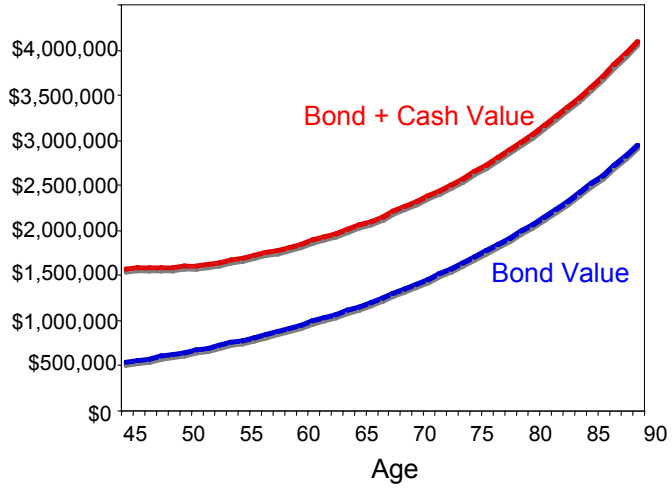
Asset values of bond with and without Life Insurance

[9] A similar analysis was employed with the use of Par WL, UL, NLG-UL, and VUL with similar risk characteristics for the non-guaranteed portion of a policy. The use of life insurance policy values used in this section are Par WL , which produced the best projected results of the various policy styles.



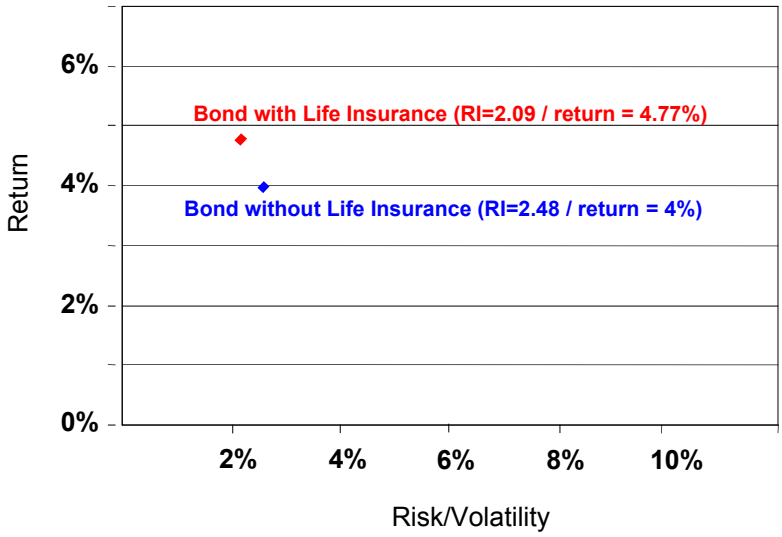
Of course, the death benefit produces a significantly greater result in every year:

Legacy value of Bond + Death Benefit of Life Insurance



As the next graph demonstrates, there is synergy in funding a life insurance policy from the income stream of a component of the fixed portfolio. It produces a more favorable result than if the policy weren't part of the portfolio: the return is higher and the risk is lower for the existence of needed life insurance.

In a classic view of an efficient asset allocation (in this case the Intermediate Bonds +Life Insurance vs. Bonds alone) based on legacy value at life expectancy + 5 years:


6%
4%
2%
0%
Return
Bond with Life Insurance (RI=2.09 / return = 4.77%)
Bond without Life Insurance (RI=2.48 / return = 4%)
2%
4%
6%
8%
10%
Risk/Volatility

Chapter 4

Efficient choices - portfolios of life insurance policies

As previously noted, when constructing an investment portfolio, it's a well-established principle of Modern Portfolio Theory that appropriate (or "optimal") diversification is how investors maximize returns for a given amount of risk. Modern Portfolio Theory "…stresses that it is wise to invest in a broad array of diverse investments.[10]" A sophisticated form of this type of diversification is called "Efficient Frontier" analysis in which assets with different correlations are used to produce expected rates of return with lower volatility than that which could be expected from just one of those assets. A similar process of diversification can be applied to the efficient selection of life insurance policies intended for lifetime uses, especially (from a practical standpoint) when acquiring total life insurance in excess of $3 - $5 million.

A life insurance policy has 4 dominant attributes: 1) its "price" (premium outlay); 2) its "cost" – (the net of the premium outlay and resulting cash value; 3) its likely death benefit (as generated by dividends or the cash value "pushes" the IRC Sec. 7702 "corridor"); and 4) any risk (to the policy owner) associated with the investments used to support the policy reserves. The specific mixture of these attributes result in a "style" of policy.

Table 7 demonstrated that NLG, universal, variable universal, and participating whole life are styles of permanent insurance that produce a "better buy" than term insurance for lifetime needs. But which style is "best?"

It should be obvious that no *one* style of insurance could be "best" for all circumstances or situations. Rather, the type(s) of insurance should be tailored to the

---

[10] "Asset Allocation: Balancing Financial Risk," Third Edition, by Roger C. Gibson, McGraw Hill, 1996; page 8.

insurance buyer's unique mix of considerations about these attributes.
Each of the 4 dominant forms of life insurance present different combinations of these attributes. Quantitatively they might be considered[11]:

	Price (Premium Outlay)	Cost (NPV (Premium/CV)	Potential for Increasing DB @ LE	Investment Risk
No Lapse Guarantee Universal Life				
Life Expect.	Lowest	Highest	None	Lowest
Age 100	Lowest	2nd Highest	None	Lowest
Universal Life (minimally funded)				
Life Expect.	2nd Lowest	2nd Highest	Some	Low
Age 100	2nd Lowest	Highest	Some	Low
Variable Universal Life				
Life Expect.	2nd Highest	2nd Best	Good	High
Age 100	2nd Highest	Best	Good	High
Par Whole Life				
Life Expect.	Highest	Best	Excellent	Very Low
Age 100	Highest	2nd Best	Excellent	Very Low

If the institution's focus is on lowest actual outlay for policies it is going to maintain, NLG may be the best selection, yet for best cost, it might consider WL or VUL. Similarly, if risk tolerance is relatively low, consideration of the amount of inherent risk might dictate NLG – yet this style can produce the highest cost. No one style contains elements that will satisfy the various combinations of considerations.

The starting point for selecting from a range of policy styles is to determine the appropriate amount of policy investment "risk" the institution is willing to take. (It is assumed that carrier selection will depend heavily on financial stability, therefore

[11] 33-M-NSP

we will focus solely on the investment risk underlying the selection of a policy style):

- As suggested in the above table, NLG has no investment risk (that is to say, the investment risk is the insurance company's and *not* the policy owner's – unless of course the adverse investment experience is so severe that the carrier becomes insolvent). Assuming the selection of a financially superior insurance company, we would assign NLG a "Risk Index" of 0.

- At the other end of the spectrum, a VUL entirely utilizing an S&P500™ Index sub account typically has a standard deviation (a measurement of risk) of 15%; we would assign such a VUL allocation a "Risk Index" of 15.

- Participating whole life is comprised of two components: the underlying guaranteed policy which, as with NLG has no explicit investment risk, and a non-guaranteed dividend whose risk of meeting dividend projections is most closely associated with an investment in investment-grade bonds. As indicated in the last section, we assign a "Risk Index" of "1.8" to participating whole life policy a "Risk Index" of 1.8 (blending the underlying guarantees of the base whole life policy with the bond-like portfolio returns of the non-guaranteed dividend scale).

- Because the UL policy doesn't offer sufficient unique or advantageous attributes compared to the other policy styles, it will not be considered in this context.

Appendix C includes the complete Matrix of Risk Indices demonstrating all the possible ratios of NLG, VUL, and Par WL as components in a portfolio of policies ranked by "Risk Index." For ease of explanation, we will divide the range of "Risk Indices" into 4 narrative labels: Conservative (0 to 3.9), Balanced (4.0 to 7.9), Growth (8.0 to 11.9), and Aggressive Growth (12 to 15). Note that these are Risk Indices and

not rates of return merely allowing us to identify and stratify risk.

A process for determining a reasonable, responsive, and effective blend of policies for maximization of desired qualities would be as follows:

1. What is the risk tolerance and time horizon of the institution's investment portfolio, using the labels described above? For the first example, we'll assume that the response is "4" – in other words, the lowest range within "Conservative" (and comparable to a 20/80 mix of fixed and equity asset classes in a general portfolio).

2. Determine which of the following is the greater priority: Lowest premium outlay, development and access to cash value, or the ability to generate excess death benefit. Since the existence and access to cash value is closely linked to the ability to generate increases in death benefit (Section 7702 of the IRC) we will combine the cash value and death benefit criteria for the following choices:

    a. Lowest premium outlay; or
    b. Development and access to cash value and subsequent ability to generate excess death benefit[12]

3. From the Risk Index Table, select a matrix ranging from 3 steps below to 3 steps "above" the Risk Index closest to "4."

---

[12] The linkage of the accumulation of cash value and the potential for increasing death benefit over time exists in Participating WL because of the possibility that the insurer's investment return above its cash value guarantee will provide an opportunity for a declared dividend, which in turn spawns the purchase of paid up additions and increased Death Benefit. Universal life (both traditional and variable) may experience increased death benefits due to IRC Sec. 7702. This Section requires an age-based ratio of death benefit to cash value, and when policy cash values approach the death benefit, the required "corridor" of death benefit will rise accordingly. Unlike participating whole life, however, when the underlying asset value of the sub-accounts decline in a "down" market, previous death benefit increases may reverse back to the stipulated policy amount, since "corridored" death benefits fluctuate with the account (cash) value.

The following example demonstrates the process of "mixing" life insurance styles to obtain an efficient result for a **"Balanced"** Risk Index with respect to a $50 million portfolio of life insurance policies:

Here we assume that the charitable institution indicates a Risk Index of 7 (comparable to a 60/40 mix of equity and fixed asset classes in a general portfolio).

With a view to the different "mixes" of product styles in the chosen risk matrix: if lowest premium outlay is the greater priority, we'll focus on the NLG column and maximize the amount of NLG suggested in the matrix. This results in 50% NLG with the accompanying 0% WL and 50% VUL.

Par WL	NLG	VUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

If, on the other hand, availability and access to cash value – as well as the potential for an increasing death benefit over time – is of greater importance, we'll focus on the Par WL column and maximize the amount of WL suggested in the matrix. This results in 60% WL with the accompanying 0% NLG and 40% VUL.

Par WL	NLG	VUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

By selecting an appropriate mix of policies based on the underlying Risk Index, the resulting cumulative premium, cash value, and death benefits of these mixes allows the insurance buyer to achieve a more favorable result than would occur from the exclusive selection of one type of policy or another. A results summary is shown below:

Risk Factor 7		Lowest Prem		Access to CV/ Increasing DB
Total Prem	$	1,145,000	$	1,584,800
LE DB	$	97,923,500	$	132,995,810
Risk Index		7.50%		7.08%
NPV to LE *	$	3,976,915	$	4,944,626

Observations

1. We assign Risk Indices to policy styles in order to provide an objective basis within which to clarify the different attributes of the various forms of permanent life insurance. Once the institution has stipulated an appropriate Risk Index for the purchase of a portfolio of policies, it can then rank its considerations of price, cost, "upside" death benefit, and access to cash value to help determine the ideal mix of policies that will best serve their tolerance for risk and desire for "reward." This is a process with which the institution's investment committee is well acquainted.

2. As can be seen, the portfolio of policies has been optimized within a given range of Risk Indices for a desired premium outlay budget and considerations of access to cash value and increasing death benefit.

3. It might appear that it takes some effort to mix policy styles to derive the most efficient blend based on risk tolerance. It would be fair to ask: "Why not just buy a VUL and adjust the sub-account selection to match investment risk?"

- Many buyers of life insurance have a subjective concern about the "risk" of supporting a foundation asset with an aggressive investment approach. Further, it may not simply be the investment risk concerning the investor, but the consideration – rational or not – of depending on a policy that has no guaranteed premium, not to mention a policy style that's been labeled "risky." Technically, of course, it is possible to accomplish the underlying objective of matching risk tolerance and "return" optimization by purchasing, appropriately allocating, and carefully managing a VUL policy. But some buyers of life insurance may want guaranteed components, which a VUL can only simulate but not replicate.

- A VUL policy may – based on its allocation and market volatility acting on the policy's sub-accounts – be at the extreme of policy risk. A key issue is that the entire death benefit is subject to investment risk in the event the policy is not able to sustain itself based on premiums paid, assessed expenses and insurance charges, and portfolio gains or losses. At the other end of the risk spectrum, WL and NLG policies do not put the death benefit at risk as long as the required premium is paid.

4. While the mixing of policy styles based on Risk Indices can be a productive approach to getting the best result consistent with risk tolerance, it's also important to again point out that cash values in a participating whole life policy are not subject to market value adjustments (wherein fixed values fall when interest rates rise and fixed values rise when interest rates fall). This is true even though the insurance company's investment portfolio, underlying its ability to declare and pay a dividend, is subject to market value adjustment.

Chapter 5

Life insurance, once acquired, must be periodically managed, evaluated and maintained

It's notable that most articles and discussions about life insurance are focused on whether it is needed, and if so, how to buy it as cheaply as possible. Or if the policy already exists, whether it should be replaced with a more "modern" version. Of great importance (but receiving little attention) is the need to have an ethically and objectively directed *process* of ongoing evaluation. This includes observing but not relying on non-guaranteed in-force illustrated "numbers" - and employing independent, actuarial-based *processes* by which life insurance can be managed and assessed for a more realistic expectation over the lifetime of the insured.

Since an underlying strategy of this paper is to apply to life insurance the concepts and terminology of broader financial planning and investment management, it is not enough to focus on the up-front (i.e. time of purchase) evaluation process without recommending a process by which lifetime "in-force" progress will be measured. Indeed, in the authors' respective consulting practices, even those who are paid and charged with professional stewardship of life insurance assets will often not have a "reasoned investment strategy" with respect to charity-owned policies. Often there are no written, formal processes by which policies will be evaluated. By contrast, the typical institutional *investment* manager has very specific and personalized investment policies to guide asset allocation, review criteria, and specify triggers for redeployment and/or reallocation for the client's *investment* portfolios. The skills and processes applied to investment portfolios need to be applied to a charity's management of life insurance, taking into account each unique policy type's (or style's) property *rights.*

In-force policy illustrations have typically been the primary (if not exclusive) tool by which non-guaranteed policy sufficiency has been measured. But as discussed in this paper, policy illustrations are of minimal value in projecting the effect of volatile market conditions - whether for interest credits or equity returns. Not only will future market conditions inevitably affect both policy costs and underlying earnings, they will in turn affect the level of funding premiums. Thus, the likely sustainability of the policy over the insured's lifetime will be in jeopardy when using in-force policy illustrations and underlying non-guaranteed projected expenses. This is especially true when evaluating minimally funded policies, which comprises the vast majority of universal, variable universal, and equity indexed policies - as well as whole life policies with term riders in excess of 20% of the total death benefit.

Institutional trustees are guided by the Uniform Prudent Investor Act as enacted by most states. A charity's investment manager also has a duty to apply professional management to the assets placed under her care for the ultimate benefit of the charitable institution. At a minimum, the following life insurance assessment tools and monitoring/management processes should be required of a charity's investment manager:

1. Charity-owned life insurance should include a Life Insurance Investment Policy Statement, confirming the charity's expectations, considerations and instructions regarding such key issues as change in the insurance carrier's financial strength, what procedure to follow if annual gifts are temporarily or permanently suspended, the timeframe in which unsustainable policies should be remediated, and whether remediation should focus on rebalancing sustainability with changes in death benefit or enhanced premium gifts. Further, personalized longevity-matching techniques will allow for important cash flow management of policy premiums for an insured with impaired health.

2. If policies are or can be investment-oriented (i.e. EI, VWL or VUL), there should be - at a minimum - instructions about the charity's intention with respect to time horizons, range of investment risk, and a targeted long-term return that is consistent with the recommended risk levels. Guidance should also be provided regarding the criteria to use in asset evaluation, as well as memorializing the practical manner in which the charity's rights and obligations will be executed as directed in the trust agreement. There may be other issues specific to the charity, that should be contemplated in the establishment of its investment portfolio, specifying which assets will include life insurance.

3. Charities should periodically address their policies based on policy design. For example, VUL should be evaluated at least annually on the performance of the portfolio of sub-accounts *as well as* monitored on the expense component of the policy. Even underlying premium sufficiency guarantees (NLGUL) require annual confirmation that the guarantee is still in place. Whole life policies with significant amounts of blended term insurance should be evaluated more frequently than such policies that have no term insurance and for which there are no policy loans. In addition, consider:

    a. Does the life insurance policy remain suitable for the purpose set out in the Life Insurance Investment Policy Statement?

    b. Are scheduled premiums adequate to sustain the policy to contract maturity?

    c. If the policy requires self-directed investment of the premium and cash value into sub-accounts, have sub-accounts performed within an acceptable range for the asset classes and the planned asset allocation?

    d. Have returns in the self-directed sub-accounts been further assessed with "monte carlo" volatility testing to make certain that constant rate, in-force

illustrations don't distract from an emerging *funding deficiency?* For example, an in-force illustration's assumption of a long-term average gross return of 8% may suggest a funding level that shows the policy sustaining beyond the insured's life expectancy, when in fact more sophisticated analysis suggests that the same funding level causes policy lapses to statistically occur 10 and even 15 years *prior* to life expectancy.

e. Have the insurance company's financial ratings deteriorated?

f. If there is a significant enough deviation in performance that the policy is in jeopardy to meet its long-term sustainability objectives, a third-party expert should be retained (if such expertise is not available "in house") to make recommendations that will include remediation alternatives. The resulting decisions - lower the death benefit, increase the premium, or consider replacing the policy with a lower-premium *guaranteed* policy - can only reasonably be made with actuarially appropriate analysis that is independent of policy illustrations.

4. In-force policy illustrations and updated reports from the major financial rating agencies will be a useful start in the periodic review of life insurance. But any realistic attempt to fulfill the primary responsibility of the trustee - assuring the viability of trust assets for the benefit of the beneficiaries - requires *actuarial evaluation* of the policies. Going far beyond an in-force illustration projected with constant numbers that will change over time, actuarial evaluation includes statistical analysis (i.e. volatility testing of equity-based policies and undulation testing of fixed return policies), benchmarking long-term cost of insurance and other expenses with peer policy styles and peer carriers. We would typically recommend the use of professional life insurance policy managers, and such managers will typically charge a flat annual fee per policy, or assess fees in the range of 5 - 25 basis points of the death benefit based on policy style and size.

5. Life insurance agents historically have rarely had the resources and ability to facilitate a high level assessment of the charity's need to manage its life insurance assets. Charities should expect agents to initiate periodic reviews, but the charity will generally also require independent, actuarially-based services through advisors versed in this rapidly emerging technology.

6. Variable universal life policies are especially vulnerable to lapse before the insured's death if policies are underfunded *and* if the underlying sub-accounts are not actively managed. This dilemma anecdotally accounts for 90% or more of all variable policies still in force in the U.S. In order for a variable policy to meet its fundamental expectation to deliver a death benefit, policy management must include not only initial asset allocation and subsequent rebalancing, but include assuring that the fundamental allocation continues to meet the charity's risk/reward criteria. Since many insurance agents lack the experience or resources to make specific investment selection recommendations, it is critical for those considering variable policies to obtain professional management of the sub-accounts. We would typically recommend the use of investment managers with whom investors are actively engaged. It should be anticipated that such managers will charge fees - typically 1% of net asset value - comparable to what is paid for investment portfolio management.

Chapter 6

Life insurance acceptance issues: Enumerating a gift acceptance policy for life insurance by category of policy style

Most non-profits maintain some form of "gift acceptance" policy outlining the type of assets they are willing to accept as gifts, and the criteria under which they will accept those gifts. For instance, some charities will accept real estate gifts, while others find dealing with this type of gift too cumbersome. Before accepting a gift of life insurance, a charity should have a clearly delineated set of criteria to determine whether or not a policy would be a good asset to receive.

Any gift of life insurance has many issues that should be taken into consideration. Not only are there various types of policies (as discussed in prior chapters) but the financial efficacy of every policy must also be examined. It is not unusual for donors to seek an exit strategy from a failing policy by attempting to give it away. A well-structured, well-crafted policy acceptance will provide the charity with guidance on which policies fall within their criteria.

While doing research for this white paper the authors were unable to identify any gift acceptance policies for life insurance that were more than two sentences long. The following discussion of acceptance policy, while generic in nature, can be adopted to the specific charitable organization's needs.

GIFT ACCEPTANCE ISSUES POLICY FOR XYZ CHARITY

XYZ Charity agrees to accept gifts of life insurance policies under the following terms and guidelines:

All gifted policies will be accompanied by a current, in-force illustration and other evidence that the policy is still a valid life insurance contract. Ideally, there should be no loans, collateral pledges or other encumbrances on the policy at the time of the gift without substantial further analysis. In addition it would be desirable to obtain:

- An understanding of the health of the insured at the time of transfer (as evidenced by a general health questionnaire)

- Future gift intentions/commitment with respect to future premium support. If it is the grantor's intent to define the death benefit, the policy needs to be evaluated *in advance* for its ability to meet grantor and charity expectations. On the other hand, if the grantor intends to donate fixed future premiums for UL/VUL/EI style policies, premium commitments should be balanced with an appropriate death benefit to assure long-term policy sufficiency.

Ownership: Donor will irrevocably transfer 100% of any policy to XYZ Charity and will forfeit any further rights to said policy. Such transfer document will be acknowledged and signed by the donor's spouse. In addition, the transfer document will be acknowledged and signed by any beneficiary registered with the insurance company immediately prior to the transfer. The donor will be responsible for obtaining - generally from the insurance company - a valuation assessment for tax purposes as of the date of the transfer of the policy. The charity will not provide such valuation.

Beneficiary: XYZ Charity must be named as an irrevocable beneficiary of no less than____ % of any transferred policy. Donor may name up to ____ additional 501(c)(3) organizations to receive the balance of the death benefit (total must equal 100%).

Once the policy has been transferred, premium donations, if any, will be paid directly to XYZ Charity by Donor and XYZ Charity agrees to handle all administrative functions of said donated policy including but not limited to the following:

- Remittance of Premiums
- Delivery of Gift Receipt to Donor
- Ordering of in-force policy illustrations as needed
- Portfolio rebalancing
- Policy monitoring and review
- Claims

XYZ Charity will accept policies from life insurance carriers that carry a "COMDEX" rating of __ or higher when there are two or more ratings from a recognized ratings company.

XYZ Charity agrees to consider gifts of the following types of life insurance from donors whether on a single life or on joint lives:

___Term insurance
___Whole Life Insurance
___Universal Life Insurance
___Adjustable Life Insurance
___Guaranteed Universal Life Insurance
___Equity Indexed Life Insurance
___Variable Life Insurance

For gifts of Life Insurance in excess of $_____, XYZ Charity agrees to place the name of the Donor, or such appropriate person as he/she selects, in a place of prominence at the site of XYZ Charity. Further, for gifts in excess of $_____, XYZ Charity, will discuss with Donor, their preference for allocation of the proceeds from said gift.

Appendix F is a chart provided to suggest a charity's primary policy acceptance and management considerations, and the annual policy performance verification that should be expected by the charity's Board of Directors and/or Finance/Investment Committee.

Chapter 7

Charitable life insurance schemes - "we've got a way of raising millions of dollars for your charity" - The Good, The Bad, and The Ugly

One of the financial dangers facing charities is discerning between legitimate and illegitimate "schemes" that have been offered by life insurance promoters in the name of creating substantial endowments for the organization. The term of art is CHOLI (Charity Owned Life Insurance). Appendix G contains the Department of the Treasury / IRS 2010 Executive Summary of its CHOLI study, which was mandated by the The Pension Protection Act of 2006 (PPA). The PPA also required that charities engaging in those arrangements report certain information to the Internal Revenue Service during a two-year period. While not all CHOLI schemes are "bad," in the past, such planning schemes as "Charitable Split Dollar" have ultimately generated public embarrassment and loss of good will from key donors. After 2500 years, the ultimate human condition of Aristotle's day still prevails: "… we are drawn to the attractive impossibility rather than the less attractive probability."[13]

Unfortunately, the prevalence of such schemes tend to give the life insurance industry a bad name and have kept charities wary of even legitimate and reputable life insurance professionals. Certainly charities must be cautious with whom they deal, and it is difficult to differentiate the promoters from the true professionals. Therefore, it seems appropriate to focus on a few of the more notorious "too good to be true" schemes that have been circulated by life insurance sales organizations in the charitable sector. Many of them come with names that have fancy acronyms and are accompanied by slick brochures and multi-media presentations. It is not to say that all of them are bad, but it is important to heighten awareness so that caution and due diligence can be applied to every proposal.

Charities are often approached with the idea of "no cost" insurance that appear to produce very large gifts. Usually this type of plan involves several elements: first, a

[13] The actual quote is "A likely impossibility is always preferable to an unconvincing possibility."

group of donors who have not utilized all of their insurance *capacity*.[14] This group of donors normally needs to consist of at least twenty five individuals, and is confined to a narrow age range (typically 45 to 75). Second, needs to be a "lead" donor, typically a high net worth (at least $10 million) individual, who is willing to pledge an amount of collateral that will cover financing for the insurance on the pool of donors. Third, a willing bank serving as lender for the financed insurance. Finally, of course, there is the insurance company and agent who will put the policies in place. In theory the collateral is pledged, money is borrowed from the bank to pay premiums, and as the pool of insureds dies, the loans are paid off and the charity collects the remaining proceeds. Some CHOLI schemes may also provide a "front-end" bonus to the charity allowing the program to be initiated on its behalf.

While this type of program is often sold as "free," there are many complications that cause them to be anything *but* "free."

First, the unintended consequence for the lead donor who pledges collateral is often an impairment of *his* personal future borrowing power. And, tracking those assets and maintaining the collateral is a big responsibility and can be a large burden for the lead donor. Additionally, what happens if the lead donor dies?

Second, the pool of donors has utilized their excess insurance capacity, sometimes without realizing they have impaired their ability to acquire life insurance for their own purposes in the future. If family circumstances change (e.g. divorce and the start of a "new" family), donors may become resentful of the charity and wish to cancel their policy. What happens then?

Third, there have been a substantial number of lawsuits against insurance companies and third-party owners (corporations, trusts, and charities) of substantial life insurance by surviving spouses and beneficiaries when policy proceeds are *not* paid to the family or for their benefit. Charities may find themselves embroiled in lengthy and costly litigation if caution isn't taken at the outset of the acquisition to make certain that all

---

[14] Capacity is the amount of life insurance an insured is allowed to purchase with respect to such factors as net worth, life expectancy, future earning potential, and avocation.

possible parties at interest have acknowledged that *this* policy will not benefit them. (see Chapter 6 for policy acceptance)

Fourth, policies usually don't perform as projected in the sales illustration. Depending on the type of insurance used, cash values may not accumulate at the projected rate, tying up the collateral for a longer period, requiring more premium than planned, which in turn requires more borrowing and, ultimately less money for the charity and a lot of unhappy donors. Of course, the loan interest rates will rise or fall, even though the typical financial analysis assumes no volatility in borrowing rates. This means the cost of borrowing to pay premiums may rise dramatically, in turn very likely causing the entire program to underperform expectations - *or fail completely.*

Clearly there are numerous moving parts and variables to be considered when reviewing this type of plan. These programs are neither good nor bad in and of themselves, but must be reviewed thoroughly and carefully to assure that all risks are understood and deemed acceptable.

Another popular approach to charities is to utilize a life insurance policy coupled with an immediate annuity, with the intention of creating an arbitrage between the annuity payout and the insurance premium. That is, an insured makes a deposit into an annuity which will pay the entire insurance premium less expensively than if the insured simply paid the insurance amount alone. While this may sound unreasonable, it is occasionally possible - due to the different mortality tables used for purposes of underwriting life insurance and issuing annuities - to discover favorable underwriting or mortality table *arbitrage*. However, this is another instance where this type of "program" can be over-sold. It is *not* logical to assume that this type of arrangement will be applicable to everyone. Also, it represents another instance where excess insurance capacity is utilized without the donor really being aware of the implications of that decision.

There are many other ideas that have come and gone and there are more that are sure to follow. The best advice is that whenever a scheme is proposed to enrich the charity's resources with a broad-based sale of life insurance to grantors - deploy a common sense test of "is this too good to be true?" Approach each plan carefully utilizing 3rd party,

independent experts to evaluate each proposed opportunity. If the plan promoters resist independent assessment, that is almost *always* a tipoff that no further effort should be expended. Some approaches will require a signed confidentiality agreement before promoters will even discuss the concept - which should be entered into with caution and the advice of counsel. Even if meriting further exploration, it is imperative to perform thorough analysis, seek outside opinions as to risks that are not revealed in the promotional literature, ask rigorous questions, and do everything a prudent and professional investor would do prior to making any major investment.

Chapter 8

Premium financing

A recent addition to the sale of life insurance, especially larger policies, has been the promotion of "premium financing." Premium financing involves using a third-party lender to borrow policy premiums, and then using the policy death benefit or cash value to ultimately pay back the loan. While this sounds (and is) extremely complex, the appeal to the consumer is that they are often led to believe that they are getting the life insurance for "free". It should be obvious that just like everything else in life, there is no "free."

There have been, and continue to be promoted, numerous variations of premium financing. Many structures exist with the basic proposition that the person insured will have little, if any, out of pocket costs for the purchase of a large life insurance policy. Premium dollars are borrowed from a lender, often tied to a recognized loan rate index, such as a One-Year LIBOR (London Interbank Offered Rate). This rate may be fixed for a period of years or may float periodically. Normally, premium financed policies are at LIBOR plus some additional amount that reflects the borrower's credit history or borrowing capacity, often ranging from 150 to 350 basis points or more.[15] Additionally, the insured must often post collateral, either by pledging a securities account or by a Standby Letter of Credit. The lender also receives an assignment of a portion of the death benefit that will pay back the loan plus interest at the death of the insured.

While all of this may sound attractive, there are many variables that come into play in this type of transaction. Many of the clients who would benefit from a financed premium structure lack liquidity and cash flow because their wealth is often tied to real estate or other illiquid business assets. Yet it is exactly for this reason that they often lack assets that banks are willing to accept collateral. While this may not appear to be a significant issue, as the balance of the loan grows over time it can produce real challenges. Further, while LIBOR rates are broadly accepted and

[15] For example, a one-year LIBOR of 1.5% plus 250 basis points results in a loan interest rate of 4.0%

published, they also are subject to volatility as with any other interest rate. As interest rates rise and the unpaid loan balance rises simultaneously, it is conceivable that the entire amount of the policy's cash value will be needed to pay off the indebtedness, leaving nothing for the intended beneficiaries.

Other variables include the performance of the life insurance policy itself. Fixed policies, that is those that pay an interest rate determined by the insurance carrier, may have internal interest rates that are lower than the borrowing rate for periods of time. This means that the loan costs will ultimately consume policy values entirely unless some action is taken. One recent remedy is to use policies that are "indexed", usually to some common index such as the S & P 500. However, indexed policies don't return 100% of the index but usually some fraction of it. While this may reduce the interest rate risk, it may just re-cast it as market risk. While most indexed policies guarantee that the return will never be negative, costs of insurance and other fees can quickly reduce policy values during difficult market periods.

As it involves charities, premium financed life insurance can be a risky proposition. There have been several "schemes" that have involved charities and premium financed life insurance. Charity Owned Life Insurance (CHOLI) is probably the most common. Under this plan, insurance is purchased on donors who agree to let the charity utilize some of their insurability and an outside financing program. While these offerings may seem attractive on the surface, experience has shown that the charities can be put in a very bad position and irritate their donors at the same time. The pay off in death benefit can be a fraction of what's expected because of the same risks associated with other premium financing structures. That is, the compounding of accrued interest on the debt erodes the face value of the policy over time.

In addition, what many benefactors don't realize (and aren't told) is that every individual has what is known as "insurance capacity." This is an arbitrary number set by the insurance companies that limits the total amount of life insurance any one person can purchase. For instance, an individual who is 70 years old and has a $2 million net worth won't likely be allowed to purchase $10 million of life insurance. This would provide too much benefit based on his circumstances. When a premium

financing program such as CHOLI is undertaken, some of each person's insurance capacity is used up. Therefore, if that individual is unaware of this and seeks to acquire more life insurance for family or business needs, they may be foreclosed from that option because of the CHOLI insurance that's in place. Certainly, the disclosure of this complication and its consequences are vital information that must be carefully communicated to any insured. Inserting the charity into the middle of this transaction can lead to unintended bad feelings between donor and charity and charities need to be very cautious in their approach and communication with potential participants.

.

Chapter 9

Life Settlements

Not all life insurance policies become death claims. It's been anecdotally observed within the life insurance industry that fewer than 5 percent (and possibly fewer than 3%) of term policies are in force at the time of the insured's death, primarily because of replacement with other policies, elimination of need, or the inexorable increase in the cost of maintaining non-guaranteed premium policies at older ages. By definition, there is no cash value in a term policy; when it is dropped or terminated, there is no further value to the policy owner. This was the case until a "secondary market" for life insurance, commonly known as life settlements, emerged in the 1990s - itself evolving from Viatical settlements. A term life insurance policy about to lapse for non-renewal could be worth as much as 25 percent of the policy's death benefit on the life of someone over age 70 – with impaired but not immediately life-threatening health issues – who no longer needed the policy. As a result of life settlements, a whole new industry has emerged, introducing "fair market value" as a term of art into policy terminology.

Because of the emerging secondary market in life insurance policies, life settlements have literally breathed new life and value into about-to-lapse policies. In the typical life settlement, the ideal candidate is over age 65, has experienced a deterioration of health but is not terminally ill, has a life insurance policy with a death benefit of at least $250,000, and no longer needs or can afford the policy. The University of Pennsylvania's Wharton School estimated that in 2002 policy owners received $242 million more in sales proceeds than would have been forfeited to insurers.

The subject policy can be either term or permanent. Only 10 percent of issued Universal Life policies have turned into death claims in the 25 years that this policy form has existed, and Conning & Company found "…that more than 20 percent of the policies owned by seniors have life settlement values in excess of their cash surrender values." While it is not within the scope of this paper to further discuss life settlements, it is important to note a study conducted by Deloitte Consulting

LLP and The University of Connecticut in which it asserts that "… the intrinsic economic value [of a policy held until death] always exceeds the life settlement value.[16]"

Scope of the market. The most recent numbers (2007) indicate that the life settlement market processed approximately $13 billion of death benefit purchases. Before the economic downturn of 2008-2009, it was estimated that the settlement market would approach $160 billion by 2012.[17] However, with less investment capital available, the market may have at least temporarily plateaued. Whatever the ultimate size of this secondary market for life insurance, life settlements are here to stay and represent a significant and often confusing opportunity for policy owners.

There are many life settlement companies, brokers and other resources - the potential overlap of which may overwhelm the public. Further, there is little regulation to protect the consumer from some of the more aggressive life settlement approaches.

Settle or surrender? Often, life insurance policies are poorly maintained by their owners. This may be because they don't fully understand the implications of the financial commitment they have made at the time of purchase. Frequently, the agent who sold the policy is no longer involved and the policy does not perform as well as the sales illustration suggested. This is usually discovered when the insured receives a notice from the insurance company that a premium much greater than originally expected is due in order to prevent the policy from lapsing for lack of sufficient cash value or premium to sustain the policy further. When faced with this decision, many policies are simply allowed to lapse. Alternatively, as retirement resources dwindle and the policy owner determines that the policy is no longer necessary (or simply unaffordable), a permanent policy might be surrendered for its cash value. This is often the point where the discussion of a life settlement *option*

---

[16] Deloitte Consulting LLP and the University of Connecticut "The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value," 2005

[17] *Ibid.*

might begin, since the policy owner presumably seeks to maximize the benefit she can extract from discontinuing the life insurance policy.
A life policy's death benefit is generally determinable at the point the insured dies (and assuming the policy is still "in force"). If a third party is willing to "buy" the policy in advance of such death, and pay the premiums in exchange for receiving the death benefit in the future, the transaction could be beneficial for both seller and buyer. Essentially, this is what a proper life settlement process would facilitate.

What is often problematic for the seller is the lack of transparency within the transaction. As previously suggested, there is little regulation in this relatively new industry, and sellers are often unsophisticated about such technical issues as personalized life expectancy and usually have no idea what the right value of a policy is or should be in the settlement market. Agents often receive significant compensation in transacting these sales - in the worst examples a settlement broker might receive *more* than the seller! - and no informed seller should consider moving forward with such a sale without the buyer's transaction transparency, full disclosure, and maintenance of privacy. It should be obvious that the seller must always be anonymous to the purchaser and vice versa.

Pricing. The buyer - often a sophisticated financial institution - is making an informed investment decision based on the measured life expectancy of the insured. With a large enough pool of policies, actuarial certainty about the number of deaths that will occur should create predictable investment returns. While it may be unnerving for the seller that someone is holding "a bet to die" on their life, if the net offer for the purchase of an unneeded or unaffordable policy is greater than the policy's surrender value, the benefit should be obvious. Less obvious is whether the offered value is *the best possible offer,* and retaining an independent (fee-only) consultant may be the best means of assuring the appropriateness of the presented "best offer.'

Charities and settlements. Settlements can be a good solution for policy owners, including charities. Some donated policies simply may fall outside of the parameters of the life insurance portfolio of a given charity, whether at the outset of

the policy donation or at some point in the future. Settlement may provide a charity with needed cash beyond the cash value of a policy or it may relieve a charity of a premium burden that would be unsustainable.

Chapter 10

Whom do you trust?

Life insurance is generally marketed through a number of different *channels* which can be somewhat confusing to the ultimate consumer. Further, the qualifications, ethics, reputation and expertise of any individual insurance representative must be evaluated before a charity transacts business with such a person. Generally, life insurance is sold by either agents or brokers. Agents typically represent just one major insurance company, i. e. Northwestern Mutual. Brokers, on the other hand, can, and often do represent many different companies. This does not make one group better or more proficient than another. Nor does it suggest that there is a right or wrong way to offer life insurance. In fact, the single biggest decision regarding the purchase of life insurance by charities is likely to be the trustworthiness and expertise of the person selling the insurance. Further, charities must understand that while some insurance representatives may be known publicly as agents and others as brokers, technically they all operate under the rules of "agency" and their allegiance and responsibility is, and must be, to the insurance company they are representing, not to the individual(s) or institutions to whom they are offering to sell insurance. While a broker may claim to be impartial as to which company he or she may be representing, he or she still owes a primary duty to the recommended insurance company.

It is very important that the life insurance representative be someone of the highest character and credibility who places the best interests of his clients before himself. While there are many professional credentials available to life insurance agents, and while they carry some degree of importance in assessing the skills of a particular professional, character and background of the agent has the greatest importance. Any representative worthy of consideration will gladly provide as much information and as many references as asked for. The major professional designation for life insurance agents is CLU (Chartered Life Underwriter), along with academic degrees (MBA or Ph.D. in insurance), or exam-based certification programs such as FSA (Fellow of the Society of Actuaries). Additional designations may include CIA (Certified Investment Analysis) or CFP (Chartered Financial Planner), but these designations are not as

specific to insurance expertise and individuals with only these designations should explain their insurance expertise.

Of course the other key consideration when accepting (or purchasing) a life insurance policy is the life insurance company itself. The financial strength of the company, its stability and ultimately its ability to pay its claims, are important factors to consider. Several ratings services exist and their opinions can be helpful in assessing a company. They also can be very different from each other. The four mainstream ratings companies are A. M. Best's, Moody's, Standard & Poors, and Fitch. COMDEX is a third-party service whose reports are generally available from insurance agents, and these reports are helpful in reconciling "letter grade" differences between the agencies by providing a consolidated view of financial strength vis a vis all other carriers. A COMDEX of 98 - an extremely high financial strength rating composite - indicates that the subject insurance company's current financial strength is higher than 98% of all carriers who have current ratings from two or more of the traditional insurance rating agencies.

A charity may want to consider engaging an independent consultant to deliver a financial strengths report on an insurance carrier, as well as assessing underlying policy expense and growth factors (compared to the policy illustration or in-force report) when a significant amount of policy holdings exist or are being contemplated. Recent economic history has demonstrated that large companies can fail very rapidly and diversification among various strong carriers is likely to be a good strategy so that over exposure to a single carrier is limited.

Appendix A

Partnership for Philanthropic Planning
Charitable Life Insurance Survey

Date: 9/4/2009

Total number of responses collected: 266

Which of the following types of organizations is your primary employer?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Public University		13.7%	36
Private University		10.6%	28
Small College		4.6%	12
Community/Junior College		0.8%	2
Technical School		0.0%	0
Academy/Secondary School		3.0%	8
Hospital/Health Care Organization		**25.5%**	**67**
Religious Organization		6.1%	16
Social Services Organization		12.2%	32
Environmental Group		2.3%	6
Community Foundation		5.3%	14
Museum, Symphony, Arts/ Cultural Organization		5.3%	14
Private/Family Foundation		1.1%	3
Association		1.1%	3
Other (please specify)		8.4%	22
Not Answered			3
		Valid Responses	**263**
		Total Responses	**266**

Does your organization currently OWN any life insurance policies?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Yes		**55.7%**	**147**
No		44.3%	117
Not Answered			2
		Valid Responses	**264**
		Total Responses	**266**

For each type of policy, please select the response that most closely reflects the number of policies owned and the percent of total that this type of policy represents. (Number of policies)

		0	1 to 10	11 to 20	21 to 30	31 to 40	41 to 50	more than 50	Total
Whole life	Count	3	77	10	6	5	1	9	**111**
	% by Row	2.7%	69.4%	9.0%	5.4%	4.5%	0.9%	8.1%	**100.0%**
Universal life	Count	6	57	6	3	3	2	3	**80**
	% by Row	7.5%	71.3%	7.5%	3.8%	3.8%	2.5%	3.8%	**100.0%**
Variable life	Count	15	23	2	3	1	1	2	**47**
	% by Row	31.9%	48.9%	4.3%	6.4%	2.1%	2.1%	4.3%	**100.0%**
Term life	Count	17	30	1	0	1	1	0	**50**
	% by Row	34.0%	60.0%	2.0%	0.0%	2.0%	2.0%	0.0%	**100.0%**
Unknown	Count	13	11	2	0	1	2	3	**32**
	% by Row	40.6%	34.4%	6.3%	0.0%	3.1%	6.3%	9.4%	**100.0%**
Total	Count	**54**	**198**	**21**	**12**	**11**	**7**	**17**	**320**
	% by Row	**16.9%**	**61.9%**	**6.6%**	**3.8%**	**3.4%**	**2.2%**	**5.3%**	**100.0%**

For each type of policy, please select the response that most closely reflects the number of policies owned and the percent of total that this type of policy represents. (Percent of all policies)

		0%	< 10%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%	Total
Whole Life	Count	0	4	2	6	5	4	2	5	6	1	5	26	**66**
	% by Row	0.0%	6.1%	3.0%	9.1%	7.6%	6.1%	3.0%	7.6%	9.1%	1.5%	7.6%	39.4%	**100.0%**
Universal Life	Count	1	4	4	9	5	4	2	0	4	0	1	7	**41**
	% by Row	2.4%	9.8%	9.8%	22.0%	12.2%	9.8%	4.9%	0.0%	9.8%	0.0%	2.4%	17.1%	**100.0%**
Variable Life	Count	6	3	4	3	5	0	0	1	0	0	0	0	**22**
	% by Row	27.3%	13.6%	18.2%	13.6%	22.7%	0.0%	0.0%	4.5%	0.0%	0.0%	0.0%	0.0%	**100.0%**
Term Life	Count	8	4	4	2	1	0	0	0	0	3	0	3	**25**
	% by Row	32.0%	16.0%	16.0%	8.0%	4.0%	0.0%	0.0%	0.0%	0.0%	12.0%	0.0%	12.0%	**100.0%**
Unknown	Count	5	3	0	2	2	1	2	0	0	0	0	2	**17**
	% by Row	29.4%	17.6%	0.0%	11.8%	11.8%	5.9%	11.8%	0.0%	0.0%	0.0%	0.0%	11.8%	**100.0%**
Total	Count	**20**	**18**	**14**	**22**	**18**	**9**	**6**	**6**	**10**	**4**	**6**	**38**	**171**
	% by Row	**11.7%**	**10.5%**	**8.2%**	**12.9%**	**10.5%**	**5.3%**	**3.5%**	**3.5%**	**5.8%**	**2.3%**	**3.5%**	**22.2%**	**100.0%**

What is the total annual premium of all owned policies? (total responses: 121)
Total 4,050,938.64
Median 8,084
Mean 42,197

unknown	23	20%
all fully paid up	2	1%
0	6	5%
$1 to $1,000	10	8%
$1,001 to $3,000	10	8%
$3,001 to $5,000	10	8%
$5,001 to $10,000	15	12%
$10,001 to $20,000	9	7%
$20,001 to $30,000	6	5%
$30,001 to $40,000	6	5%
$40,001 to $50,000	7	5%
$50,001 to $100,000	9	7%
> $100,000	8	6%

What is the total cash value of all owned policies? (total responses: 122)
Total 52,627,700.85
Median 130844.48
Mean 1,496,350

unknown	21	17%
0	2	1%
$1 to $10,000	4	3%
$10,001 to $20,000	9	7%
$20,001 to $50,000	14	11%
$50,001 to $100,000	14	11%
$100,001 to $500,000	24	19%
$500,001 to $1M	8	6%
$1M to $10 M	23	19%
>$10M	3	2%

What is the total death benefit of all owned policies? (Total response: 122)
Total 486,981,598.44
Median 611,956
Mean 3,991,652

unknown	**8**	**6%**
$1 to $50,000	**12**	**10%**
$50,001 to $100,000	**5**	**4%**
$100,001 to $200,000	**13**	**10%**
$200,001 to $500,000	**16**	**13%**
$500,001 to $1M	**16**	**13%**
$1M to $2M	**19**	**15%**
$2M to $3M	**7**	**5%**
$3M to $4M	**7**	**5%**
$4M to $5M	**5**	**4%**
$5M to $10M	**11**	**9%**
$10M to $20M	**8**	**6%**
>$20 M	**4**	**3%**

In the past five years (since 2004), has the amount of death benefit received from policies your organization owns...

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Increased		25.0%	34
Decreased		10.3%	14
Remained about the same		**64.7%**	**88**
Not Answered			130
		Valid Responses	**136**
		Total Responses	**266**

In the past five years (since 2004), has the amount of death benefit received from policies NOT owned by your organization...

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Increased		24.6%	31
Decreased		7.9%	10
Remained about the same		**67.5%**	**85**
Not Answered			140
		Valid Responses	**126**
		Total Responses	**266**

Please choose the value that most closely represents the percentage of total premiums paid by each of the following sources.

		0%		10%	20%	30%	40%	50%	60%	70%	80%	90%	100%	Total
Donor	Count	3	2	0	1	2	0	2	2	3	4	23	**86**	**128**
	% by Row	2.3%	1.6%	0.0%	0.8%	1.6%	0.0%	1.6%	1.6%	2.3%	3.1%	18.0%	**67.2%**	**100.0%**
Organization	Count	**30**	11	5	4	1	0	0	0	1	0	3	10	**65**
	% by Row	**46.2 %**	16.9%	7.7%	6.2%	1.5%	0.0%	0.0%	0.0%	1.5%	0.0%	4.6%	15.4%	**100.0%**
Other	Count	**18**	4	3	0	2	1	2	0	2	0	1	1	**34**
	% by Row	**52.9 %**	11.8%	8.8%	0.0%	5.9%	2.9%	5.9%	0.0%	5.9%	0.0%	2.9%	2.9%	**100.0%**
Total	Count	**51**	**17**	**8**	**5**	**5**	**1**	**4**	**2**	**6**	**4**	**27**	**97**	**227**
	% by Row	**22.5 %**	**7.5%**	**3.5%**	**2.2%**	**2.2%**	**0.4%**	**1.8%**	**0.9%**	**2.6%**	**1.8%**	**11.9%**	**42.7%**	**100.0%**

From an asset management perspective, how often does your organization review the policies that you own?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Monthly		0.7%	1
Quarterly		2.1%	3
Annually		**74.3%**	**107**
Never		8.3%	12
Other (please specify)		14.6%	21
Not Answered			122
		Valid Responses	**144**
		Total Responses	**266**

‘Other’ Responses
policy is paid in full
Every 2-3 years
When an issue arises
just reviewing now for first time. sent letter out.
These policies are 3 y/o and have not been reviewed
Every few years
Not reviewed on a regular basis. Accounting department carries as an asset & requests annual cash values.
Have a quarterly report, but review of policies is on an as needed basis.
annually but less frequently on 1
Just started a review process within the year
not sure-
As needed
3-5 years

as needed
Every other month
Occasionally
bi-annually
We just completed an audit with an outside company also
unknown
when I think about it
Occassionally
not sure
Rarely
3 times per year

Valid Responses	**24**
Total Responses	**266**

If your organization does not currently own any life insurance policies, why not? (select all that apply)

(Respondents were allowed to choose **multiple** responses)

Response	Chart	Frequency	Count
We have never asked for gifts of life insurance.		15.0%	40
Our staff does not have the expertise to evaluate or discuss life insurance gifts.		4.5%	12
We generally find that other types of gifts have more value for our donors and the organization.		12.8%	34
We are aware of other organizations' bad experiences with life insurance gifts.		4.5%	12
Other (please specify)		**15.4%**	**41**
		Valid Responses	**266**
		Total Responses	**266**

‘Other’ Response
limited by NY insurable interest laws
We are the beneficiary of some policies and have cashed in any policies of which we were the owner/beneficiary.
Just starting to educate donors about life insurance.
The one we had "matured"
Prior to my employment, planned gifts were not an institutional priority
We are the beneficiary and the donors are paying the premiums or have hold the paid-up policies.
We held them for many years, and recently sold them.
too focused on current gifts
We do not promote it as much as other gifts and the marketing efforts in this area have not produced
we communicate this as a gift option but have yet to receive this type of a gift
Organization Director thinks that they are too complicated

We are not aware of any donors yet that have made our org the beneficiary.

Not right fit for donors and us

We're too small to manage these

Donors have named us as beneficiary instead

We had one large policy, which was cashed out. The previous staff had not solicited them with much effort.

We promote beneficiary designations; our PG program is focused on simple gift vehicles

We are named as beneficiaries of policies however, a donor has yet to make an outright gift of policy that they already own. The donors would rather put their charitable $ to work today as opposed to funding a charitable gift that pays out at death

Never had anyone work with donors for any specific gifts - only DAF's

I am marketing them no interest yet

Gifts of life insurance are immediately surrendered for their cash value.

None have been offered despite our efforts

Usually surrender policies for cash value

no gifts so far

Hasn't been selected by donor as a PG vehicle of choice

Solicited but no success yet

None offered or solicited

A few donors have told us that we will be the recipients of paid up policies upon their death.

When received, we cash them in immediately

Our bad experience with innsurance gifts

We';ve never asked and donors haven't given one.

Havn't had a chance to initiate at this institution.

no match there yet

Only low-key articles in newsletter

This office deals primarily with life-income gifts, but we make insurance gift opportunities known to our UCC-related entities.

none have been contributed

A couple of verbal promises from residents but no action taken for us to be owner

We ahve not received any life insurance policies as gifts.

We have received them and cashed them in.

marketing them but no donations yet
Lack of interest on part of our donors.
No donor has opted for an insurance gift.
havent seen the interest from donors
None recieved to date

Valid Responses	**44**
Total Responses	**266**

If your organization does not currently own any life insurance policies, would you accept a policy as a gift?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Yes		**79.1%**	**91**
No		3.5%	4
Other (please specify)		17.4%	20
Not Answered			151

Valid Responses	**115**
Total Responses	**266**

'Other' Responses
We accept being named as beneficiary.
Depends as always
Depends on situation
Most likely, but would like to review.
Perhaps.
it would depend on the policy and donor
depends on type and premium obligations

If it was fully paid
Maybe, but onlyif it was completely paid up
Maybe
probably, after careful diligence and consultation w donor
It depends upon the circumstances
Only as an outright gift, not as funding for CGA or CRT
Fdn. reserves right to decline policies requiring ongoing premiums. If accepted, donor must agree in writing on pmt. of premiums.
Would depend. Can't say one way or the other
only if fully paid up
possibly--it depends upon the terms
See above
Need to update gift acceptance policy but would like to be able to accept such gifts
As always, it depends!

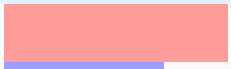
Valid Responses	**20**
Total Responses	**266**

Does your organization have a gift acceptance policy for life insurance?

(Respondents could only choose a **single** response)

Are you aware of policies for which your organization is anticipated to be the beneficiary, although you do not own the policy?

(Respondents could only choose a **single** response)

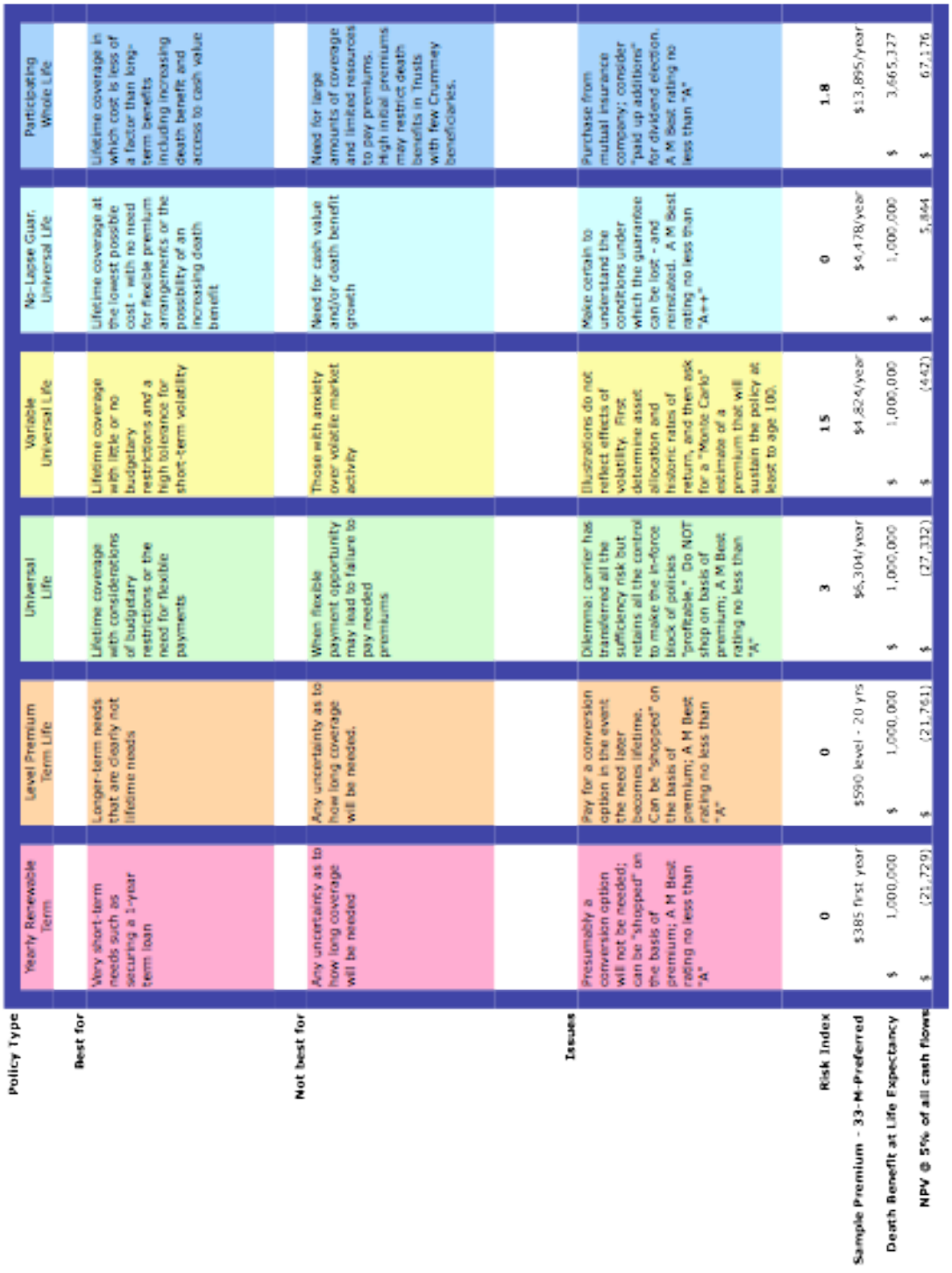
Response	Chart	Frequency	Count
Yes		**58.2%**	**152**
No		41.8%	109
Not Answered			5
		Valid Responses	**261**
		Total Responses	**266**

If you answered 'yes' to the previous question, what is the total anticipated death benefit of these policies?
Total Response: 129
Total 102,138,944.50
Median 200,000
Mean 1,122,405 (one respondent expects to receive $18 million! That affects this average.)

Response	Chart	Frequency	Count
Yes		**79.2%**	**209**
No		20.8%	55
Not Answered			2
		Valid Responses	**264**
		Total Responses	**266**

Unknown	38	30%
$1 to $5,000	6	4%
$5,001 to $20,000	8	6%
$20,001 to $50,000	13	10%
$50,001 to $100,000	13	10%
$100,001 to $200,000	9	7%
$200,001 to $300,000	8	6%
$300,001 to $500,000	7	5%
$500,001 to $1M	10	7%
$1M to $5M	12	9%
> $5M	5	4%

Appendix B
Insurance Product Matrix



Insurance Product Matrix

Policy Type	Yearly Renewable Term	Level Premium Term Life	Universal Life	Variable Universal Life	No-Lapse Guar. Universal Life	Participating Whole Life
Best for	Very short-term needs such as securing a 1-year term loan	Longer-term needs that are clearly not lifetime needs	Lifetime coverage with considerations of budgetary restrictions or the need for flexible payments	Lifetime coverage with little or no budgetary restrictions and a high tolerance for short-term volatility	Lifetime coverage at the lowest possible cost - with no need for flexible premium arrangements or the possibility of an increasing death benefit	Lifetime coverage in which cost is less of a factor than long-term benefits including increasing death benefit and access to cash value
Not best for	Any uncertainty as to how long coverage will be needed	Any uncertainty as to how long coverage will be needed.	When flexible payment opportunity may lead to failure to pay needed premiums	Those with anxiety over volatile market activity	Need for cash value and/or death benefit growth	Need for large amounts of coverage and limited resources to pay premiums. High initial premiums may restrict death benefits in Trusts with few Crummey beneficiaries.
Issues	Presumably a conversion option will not be needed; can be "shopped" on the basis of premium; A M Best rating no less than "A"	Pay for a conversion option in the event the need later becomes lifetime. Can be "shopped" on the basis of premium; A M Best rating no less than "A"	Dilemma: carrier has transferred all the sufficiency risk but retains all the control to make the in-force block of policies "profitable." Do NOT shop on basis of premium; A M Best rating no less than "A"	Illustrations do not reflect effects of volatility. First determine asset allocation and historic rates of return, and then ask for a "Monte Carlo" estimate of a premium that will sustain the policy at least to age 100.	Make certain to understand the conditions under which the guarantee can be lost - and reinstated. A M Best rating no less than "A++"	Purchase from mutual insurance company; consider "paid up additions" for dividend election. A M Best rating no less than "A"
Risk Index	0	0	3	15	0	1.8
Sample Premium - 33-M-Preferred	$385 first year	$590 level - 20 yrs	$6,304/year	$4,824/year	$4,478/year	$13,895/year
Death Benefit at Life Expectancy	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 3,665,327
NPV @ 5% of all cash flows	$ (21,729)	$ (21,761)	$ (27,332)	$ (442)	$ 5,844	$ 67,176

Appendix C
Risk Index Matrix

Par WL	NLG-UL	VUL	
1.8	0	15	Risk Index
0	100	0	0
10	90	0	0.18
20	80	0	0.36
30	70	0	0.54
40	60	0	0.72
50	50	0	0.9
60	40	0	1.08
70	30	0	1.26
80	20	0	1.44
0	90	10	1.5
90	10	0	1.62
10	80	10	1.68
100	0	0	1.8
20	70	10	1.86
30	60	10	2.04
40	50	10	2.22
50	40	10	2.4
60	30	10	2.58
70	20	10	2.76
80	10	10	2.94
0	80	20	3
90	0	10	3.12
10	70	20	3.18
20	60	20	3.36
30	50	20	3.54
40	40	20	3.72
50	30	20	3.9
60	20	20	4.08
70	10	20	4.26
80	0	20	4.44
0	70	30	4.5
10	60	30	4.68
20	50	30	4.86
30	40	30	5.04
40	30	30	5.22
50	20	30	5.4
60	10	30	5.58
70	0	30	5.76
0	60	40	6
10	50	40	6.18
20	40	40	6.36
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

Par WL	NLG-UL	VUL	
1.8	0	15	Risk Index
30	20	50	8.04
40	10	50	8.22
50	0	50	8.4
0	40	60	9
10	30	60	9.18
20	20	60	9.36
30	10	60	9.54
40	0	60	9.72
0	30	70	10.5
10	20	70	10.68
20	10	70	10.86
30	0	70	11.04
0	20	80	12
10	10	80	12.18
20	0	80	12.36
0	10	90	13.5
10	0	90	13.68
0	0	100	15

Appendix D

SAMPLE - GIFT ACCEPTANCE POLICY FOR XYZ CHARITY

XYZ Charity agrees to accept gifts of life insurance policies under the following terms and guidelines:

Ownership-Donor will irrevocably transfer 100% of any transferred policy to XYZ Charity.

Beneficiary-XYZ Charity must be named as an irrevocable beneficiary of no less than____% of any transferred policy. Donor may name up to ____ additional 501(c)(3) organizations to receive the balance of the death benefit (Total must equal 100%).

Additional premiums, if any, will be paid directly to XYZ Charity by Donor and XYZ Charity agrees to handle all administrative functions of said donated policy including but not limited to the following:

-Remittance of Premiums
-Delivery of Gift Receipt to Donor
-Ordering of in force policy illustrations as needed
-Portfolio rebalancing
-Policy monitoring and review
-Settlements

XYZ Charity will accept policies from life insurance carriers that carry a Best's rating of ____or higher or an equivalent rating from another recognized ratings company.

XYZ Charity agrees to consider gifts of the following types of life insurance from donors:
___Term insurance
___Whole Life Insurance
___Universal Life Insurance
___Guaranteed Universal Life Insurance
___Indexed Life Insurance
___Variable Life Insurance

For gifts of Life Insurance in excess of $_____, XYZ Charity agrees to place the name of the Donor, or such appropriate person as he/she selects, in a place of prominence at the site of XYZ Charity. Further, for gifts in excess of $_____, XYZ Charity, will discuss with Donor, their preference for allocation of the proceeds from said gift.

Appendix E

Irrevocable Life Insurance Trust
Investment Policy Statement Issues

This Investment Policy Statement sets forth guidelines and procedures for systematic review and long-term management of the trust's assets. The purpose of this Investment Policy Statement (herein IPS) is to:

- Clarify the trust's objectives and the grantor's expectations;
- Specify the grantor's risk tolerance level pursuant to the trust's objectives;
- Set forth the trustee's risk management criteria to achieve the trust's objectives; and
- Establish a procedure for timely monitoring and systematic review of performance results.

This IPS evidences the careful consideration given by both the grantor and the trustee to the formulation and implementation of a prudent asset management strategy. It will serve as a guide to the trustee, outline procedures for prudent administration of trust assets invested in the sole interest of the beneficiaries, and set out the responsibilities of outside advisors and/or providers engaged in the trust operation. This statement will be revised and modified as appropriate on a periodic basis to reflect such factors as changes in the trust objectives, asset performance and suitability, trustee risk management procedures, beneficiary objectives, and tax laws.

Purpose of the Trust

- **Trust Time Horizon**
- **Contributions to the Trust**
- **Trust Distribution Provisions and Beneficiaries**
- **Diversification**

Product Suitability and Risk Management Guide

- **Carrier Risk**
- **Premium Adequacy and Contract Underperformance Risk**
- **Liquidity Risk**

- **Underwriting Risk**

Delegation of Responsibilities

- **Trustee**
- **Attorney**
- **Investment Advisor/Insurance Analyst**
- **Life Insurance Agent**

Policy Monitoring

Policy Modification

Appendix F
Acceptance and Policy Management Features for different styles of life insurance policies

The following matrix sets out a 3rd party owner's primary policy acceptance and management considerations, and the annual policy performance verification expected by beneficiaries and their professional advisors.

Trustee Acceptance Considerations Policy Management Features	Guaranteed Products				Non-Guaranteed Products			
	Whole Life	No Lapse Guarantee Universal Life	Level Premium Term	Yearly Renewable Term	Adjustable Life	Universal Life	Variable Universal Life	Variable Life
Premium Schedule	Fixed	Fixed	Fixed Period	Increasing	Flexible	Flexible	Flexible	Fixed
Specified Death Amount	Fixed	Fixed	Fixed	Fixed	Flexible	Flexible	Flexible	Fixed
Account Value Management	Carrier	Carrier	None	None	Trustee	Trustee	Trustee	Trustee
Asset Allocation Required	N/A	N/A	N/A	N/A	No	No	Yes	Yes
Illustration Credibility	Yes	Yes	Yes	Yes	No	No	No	No
Actuarial Evaluation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Volatility Simulation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Trustee Management Requirements								
Investment Policy Statement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
TOLI – Specific Procedures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product Suitability	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Premium Adequacy Risk	No	No	No	No	Yes	Yes	Yes	Yes
Monitoring Cycle	N/A	N/A	N/A	N/A	Annual	Annual	Annual	Annual
Carrier Solvency Risk	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Asset Allocation Review	N/A	N/A	N/A	N/A	N/A	N/A	Annual	Annual
Conversion Review	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A
Rating and Rider Review	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Regulatory Review (Institutional)	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Professional Advisor Annual Verification								
Product Suitability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Premium Adequacy	N/A	N/A	N/A	N/A	100%	100%	100%	100%
Death Benefit Adequacy	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Carrier Solvency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Investment Performance Rebalancing	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Yes

Appendix G - Department of the Treasury / IRS Executive Summary of CHOLI study

EXECUTIVE SUMMARY

The Pension Protection Act of 2006 (PPA) mandated a study of charity-owned life insurance (ChOLI) arrangements and required that charities engaging in those arrangements report certain information to the Internal Revenue Service during a two-year period. Accordingly, the Department of the Treasury and Internal Revenue Service solicited public comments regarding the study, designed and issued an information return form, and then reviewed those returns.

This report describes various types of ChOLI arrangements, which may involve annuities as well as life insurance, owned directly or indirectly by a charity. To date, the arrangements for which information reporting has been provided pursuant to the PPA are too few in number to constitute a statistically significant sample for analysis. Consequently, the report relies principally on information that is otherwise available publicly with regard to these arrangements.

The report analyzes the Federal tax law implications of ChOLI arrangements under existing law and the tax policy issues they present. In particular, the report identifies potentially significant conflicts with the requirement that a charitable organization be organized and operated exclusively for an exempt purpose, and that it comply with a proscription on substantial private benefit. The report further notes that the treatment of a charity's return from participation in a ChOLI arrangement as either exempt investment income or taxable income from an unrelated business is not entirely clear under existing law, but that it arguably may be viewed as unrelated business taxable income in certain circumstances.

Finally, the report recommends adoption of the Administration's Fiscal Year 2010 and 2011 budget proposals to revise the "transfer-for-value" rule of Internal Revenue Code section 101(a) to ensure that investors in a ChOLI arrangement -- as well as investors in other types of arrangements involving the transfer of life insurance contracts -- do not inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract in circumstances where those investors have purchased an ownership interest in the underlying policies.

INTRODUCTION

As required by section 1211 of the Pension Protection Act of 2006 (the PPA),[1] the Department of the Treasury (the Treasury) and the Internal Revenue Service (the Service) have undertaken a study of the use by certain tax-exempt organizations of certain types of life insurance arrangements "for the purpose of sharing with investors the benefits of the tax-exempt organization's insurable interest in individuals insured under such contracts with investors." In addition, as required, the study considered "whether such activities are consistent with the tax exempt status of such organizations." The information contained herein is offered in fulfillment of the mandate of PPA section 1211(c)(2) for a report on the study.

Part I of the report describes various aspects of existing Federal income tax and other law with respect to charities and life insurance that are relevant to the analysis of ChOLI arrangements. Part II describes the PPA provisions and their implementation and summarizes public comments on the implementation as proposed. Part III outlines various types of ChOLI arrangements, and Part IV describes data collection under the PPA provisions regarding ChOLI arrangements. Finally, 4 / 22Part V analyzes the federal income tax implications of those arrangements, including a discussion of outstanding policy issues.

I. EXISTING LAW

ChOLI arrangements involve both charities and life insurance, both of which are subject to special tax and other laws. This part of the report sets forth the significant provisions of Federal income tax law applicable to charities and life insurance, with reference to relevant State law, as well.

A. Tax-Exempt Charitable Organizations

Section 501(a) of the Internal Revenue Code (the Code) exempts from Federal income tax organizations (or charities) described in section 501(c)(3)[2] in pertinent part as follows: Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . .

In addition to being exempt from tax, charities are generally eligible to receive contributions, gifts, and bequests that are deductible in computing the income, gift, and estate tax liabilities of the donors. Organizational and Operational Tests

An organization qualifies as a section 501(c)(3) charity only if it is organized and operated exclusively for exempt purposes. In addition, regulations under section 501(c)(3) require that an organization serve a public rather than a private interest.[3]
A charity may satisfy the organizational test by adopting certain formal requirements in its governing documents.[4] For example, the governing documents must limit the organization's purposes to those exempt purposes described in section 501(c)(3) and must not permit the organization to engage in activities that do not further exempt purposes (except to an insubstantial extent). An organization is not organized exclusively for exempt purposes, however, if its governing documents specify purposes that are broader than the purposes specified in section 501(c)(3). The governing documents also must provide that the organization's assets are dedicated to an exempt purpose in perpetuity. An organization's assets are considered to be dedicated to an exempt purpose if, for example, upon dissolution, such assets are distributed for one or more exempt purposes, or to a Federal, State, or local government entity, for a public purpose.

In general, the operational test requires that an organization engage primarily in activities that further its exempt purpose.[5] An organization does not satisfy the operational test if more than an insubstantial part of its activities fail to further an exempt purpose. In addition, to meet the operational test an organization must establish that its activities serve a public rather than a private interest. Finally, an organization must not violate the restrictions against inurement, lobbying, and political activity. Violation of these restrictions means that an organization fails the operational test, is therefore not operated exclusively for charitable purposes, and will not be considered exempt from taxation as a public charity. Prohibitions on Inurement and Substantial Private Benefit
Inurement contravenes the section 501(c)(3) statutory requirement that no part of the net earnings of the charity inure to the benefit of any private shareholder or individual. The regulations define a "private shareholder or individual" as a person having a personal and private interest in the activities of the organization, and the term refers to persons in a position to influence the decisions of the organization -- so-called insiders.[6] Thus, inurement arises when an insider receives benefits from the organization greater than those he or she provides to the organization in return. In such a case, resources of the organization that should be dedicated to the public interest are diverted to private use. A common example of inurement is excessive or unreasonable compensation paid to insiders. There is no de minimis or substantiality exception.

To be recognized as exempt, an organization also must establish that it is not organized or operated for the benefit of private interests, such as those of designated individuals, the creator or his or her family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.[7] Private benefit occurs if more than an insubstantial part of the organization's activities or its assets or revenues of an organization benefit a private individual or entity. The concept of private benefit stems from the language in the regulations providing that an organization is not organized or operated exclusively for exempt purposes "unless it serves a public rather than a private interest."[8] Thus, for example, in a leading case addressing private benefit, American Campaign Academy v. Commissioner, the Tax Court held that a school that trained students to work for a particular political party generated an impermissible private benefit for that party, rather than benefit for the public as a whole.[9] Consequently, the school was not organized and operated exclusively for exempt purposes, even though it had an educational purpose.
Private benefit differs from inurement in two principal ways. First, the concept of private benefit applies to all private individuals or entities, rather than only to insiders. Second, the prohibition on private benefit is not absolute; only private benefit that is more than insubstantial is proscribed.

Unrelated Business Income Tax

An organization described in section 501(c)(3) (a charity) is exempt from Federal income taxation not only on the contributions and gifts it receives, but also on the income that it derives from or that is substantially related to the performance of its exempt function.[10] Exempt function income may include tuition to a school, patient fees to a hospital, or ticket fees to a symphony. Mere fundraising is not substantially related to a charity's exempt function or purpose, but activities that contribute importantly or have a substantial causal relation accomplishment of those exempt functions or purposes are substantially related.[11] For example, performances by students at a school for the performing arts that are an essential part of the students' training may be substantially related to the school's educational function, and therefore income derived from charges for admission to such performances would be exempt from tax.

This tax exemption does not extend, however, to income derived by a charity from any unrelated trade or business regularly carried on by the organization, called "UBTI" or "unrelated business taxable income."[12] Instead, a charity is taxed at the corporate rate on UBTI,[13] which is determined as the gross income derived from such an unrelated trade or business, less the deductions otherwise allowed that are directly connected with carrying on that trade or business.[14] An unrelated trade or business is a trade or business the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational or other exempt purpose or function.[15]

There is an exclusion from UBTI for investment income, such as dividends, interest, royalties, rents, and capital gains.[16] Thus, a charity may earn tax-free income within an investment portfolio. However, as an exception to this exclusion, investment income is included in UBTI if it is derived from or on account of debt-financed property.[17] For example, dividends and gains from securities bought on margin would be included in UBTI.[18] Additionally, investments funded by withdrawing against the cash value of life insurance policies are considered to be debt-financed.[19]

Reporting

Under section 6033, organizations exempt from Federal income tax under section 501(a) generally are required to file annual information returns. Public charities file their information returns on Form 990, Return of Organization Exempt from Income Tax; private foundations file Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation. Certain exceptions to the filing requirements apply. For example, churches are not required to file annual information returns. In addition, organizations whose gross receipts are normally $25,000 or less are not required to file Form 990, although they are required to file an electronic notice (Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ) under new section 6033(j), which was added to the Code by the PPA.

B. Life Insurance

Federal Income Tax Treatment

In general, income earned from a contract that qualifies as a life insurance contract for Federal income tax purposes is taxed more favorably than income earned from other contracts or investments. This favorable treatment dates back almost one hundred years, to the earliest days of the Federal income tax law.[20]

In 1984, Congress enacted section 7702, which defines a life insurance contract for all purposes of the Code as a contract that is a life insurance contract under the applicable law, provided that the contract either (1) meets the cash value accumulation test of section 7702(b), or (2) both meets the guideline premium requirements of section 7702(c) and falls within the cash value corridor of section 7702(d).[21] A contract is a life insurance contract under the applicable law if it is regulated as a life insurance contract under the applicable State or foreign law. The cash value accumulation test, guideline premium limitations, and cash value corridor are actuarial tests that have the effect of limiting the investment orientation of a contract that may qualify as a life insurance contract. If a contract qualifies as a life insurance contract under section 7702, amounts received under the contract by reason of the death of the insured are generally excluded from the gross income of the recipient.[22] In the case of a transferee of the contract for value (such as a purchaser), this gross income exclusion is limited to the sum of the amount paid for the contract and the premiums and other amounts paid subsequently.[23] The gross income exclusion is not limited in the case of a carryover basis transaction or in the case of a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[24]

In addition, if a contract qualifies as a life insurance contract under section 7702, the inside build-up under the contract (that is, the increase in the contract's cash surrender value) is not taxed to the recipient unless and until it is received. If an amount is received under a life insurance contract "as an annuity," an exclusion ratio applies under section 72(b) to determine what portion of the amount is excluded from gross income because it is a return of the recipient's investment in the contract. If an amount is received under the contract other than as an annuity (for example, as a distribution, surrender, or redemption), the amount received is generally taxed only to the extent it exceeds the investment in the contract.[25]

Section 264 prevents a taxpayer from deducting premiums on a life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract. Section 264 also disallows a deduction for interest on policy loans or other indebtedness with regard to a life insurance contract unless the contract insures the life of a key person of the taxpayer's business. The key person exception applies only to the extent that the aggregate amount of such indebtedness does not exceed $50,000. In addition, the interest deductions of a business other than an insurance company are reduced to the extent interest is allocable to unborrowed policy cash values. An exception to this pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. The reserve deductions of an insurance company are similarly limited.[26] In general, neither the qualification of a contract as a life insurance contract nor the application of sections 72 or 101 depends on the tax status (e.g., subject to tax or tax-exempt) of the owner of the contract.

Insurable Interest under State Law

As indicated above, under section 7702, qualification as a "life insurance contract under the applicable law" is a prerequisite to qualification as a life insurance contract for Federal income tax purposes. For this purpose, the "applicable law" is the applicable State or foreign law under which the contract is regulated. As a practical matter, this requirement means that an intended life insurance contract that runs afoul of a State's insurable interest requirements (or any other requirements) may not qualify as a life insurance contract and may not be entitled to the tax benefits that apply to life insurance contracts. The administration of insurable interest requirements by the various States is thus an important component of determining the treatment of a life insurance contract in which both a charity and an investor have an economic interest.

In order for a life insurance contract to be enforceable, the original policyholder must have an interest in the continued life of the insured (an "insurable interest"), rather than simply the possibility of gain on the insured's death. Every person has an insurable interest in his or her own life. Insurable interest also may arise in family and marriage relationships, and creditor-debtor and other business relationships.[27]

The requirement of insurable interest is longstanding and limits the purchase of life insurance to those with an interest in the continued life of the insured. Absent such a requirement, a life insurance contract could create an incentive for the policyholder to kill the insured in order to collect the death benefit under the contract.[28]

Under the McCarran-Ferguson Act, the business of insurance is subject to the laws of the several States, and generally is not subject to Federal law.[29] Accordingly, the determination whether an organization (such as a charity) has an insurable interest in an individual (such as a donor) is a matter of State law. In a number of States, a charity has an explicit insurable interest in a consenting donor. Some such State insurable interest statutes define a charity by reference to section 501(c)(3) of the Code;[30] some define a charity by reference to a State statute;[31] and, some define a charity for purposes of insurable interest by describing the activities an organization must be engaged in to have such an insurable interest.[32]

In practice, it is not uncommon for a charity to own or otherwise be in a position to benefit from life insurance on the lives of its donors. For example, a donor may purchase a life insurance contract on his or her own life and donate the contract to a charity, or simply name the charity as a beneficiary. In this way, the charity will receive the death benefit under the contract upon the donor's death. Alternatively, a charity may itself secure life insurance on the life of a donor, based on the donor's history of giving, or based on a large but not-yet-fulfilled pledge, or, in the case of a celebrity, based on the donor's direct, personal assistance in fundraising. These traditional uses of life insurance by a charity generally do not raise public policy, insurance regulatory, or tax policy concerns. As described further below, the PPA defined a class of life insurance contracts -- "applicable insurance contracts" -- that are part of certain ChOLI arrangements. An applicable insurance contract is generally a life insurance contract that is purchased based on a charity's insurable interest in its donor with money provided by an unrelated lender or investor.

II. PENSION PROTECTION ACT

A. Statutory Provisions

From 2004 through 2006, transactions involving charities, investors, and life insurance contracts appeared to be widespread and increasing.[33] In 2006, the Staff of the Joint Committee on Taxation (JCT) released a Technical Explanation of the provisions of the Pension Protection Act of 2006 (PPA) after it passed the House, but before it passed the Senate. The Technical Explanation indicated that there had been an increase in such transactions, citing contemporaneous news articles. [34] Section 1211 of the PPA added section 6050V to the Code, which required applicable exempt organizations to make an information return regarding acquisition of an interest in certain life insurance contracts in a prescribed time, form, and manner. Section 6050V (d)(3) defines applicable exempt organizations as generally including religious, charitable, scientific, literary, educational, amateur sports or similar organizations, a fraternal society operating on a lodge system, a governmental organization (including an Indian Tribal Government), a Veterans' organization, a cemetery company, or an employee stock ownership plan.[35] Section 6050V(d)(1) defines a reportable acquisition as an acquisition by an applicable exempt organization of a direct or indirect interest in an applicable insurance contract in any case in which the acquisition is part of a structured transaction involving a pool of such contracts. Section 6050V(d)(2) defines an applicable insurance contract as any life insurance, annuity, or endowment contract in which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest (whether or not at the same time). Exceptions apply if (i) all persons directly or indirectly holding an interest in the contract (other than the applicable exempt organization) have an insurable interest in the insured that is independent of the exempt organization, (ii) the sole interest of the exempt organization is as a named beneficiary, or (iii) the sole interest in the contract of each person other than an exempt organizations is as a trustee or beneficiary of certain trusts. [36] Additionally, section 1211 of the PPA enacted penalties for failure to file an information return required by section 6050V of the Code. In addition to the traditional failure to file penalty, it imposed a penalty of the greater of $100 or 10 percent of the value of the benefit of any contract with respect to which information was required to be included on the return, in the case of intentional disregard of either the filing or correct information reporting requirement.[37] The reporting requirement applied only to reportable acquisitions occurring after August 17, 2006, and prior to August 18, 2008. Finally, the PPA also required the Treasury and the Service to undertake a study of ChOLI arrangements.

B. Implementation of the PPA Provisions

To gather data for the study, and to facilitate the reporting requirements for applicable exempt organizations with respect to applicable insurance contracts under section 6050V, the Treasury and the Service designed proposed Form 8921, Transactions Involving a Pool of Applicable Insurance Contracts, and proposed Form 8922, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V).

The Service publicized the reporting requirements and requested comments on proposed Forms 8921 and 8922 by issuing Notice 2007-24.[38] The Notice also solicited public comments on the congressionally-mandated study to be conducted by the Treasury and the Service under PPA section 1211. In response to the notice, members of the public submitted four comment letters. After reviewing the public responses, the Treasury and the Service simplified the reporting requirement by consolidating the required information on a single return, Form 8921, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V). Applicable exempt organizations were required to complete Form 8921 for reportable acquisitions of applicable insurance contracts which took place after August 17, 2006, but on or before August 17, 2008.

Most applicable exempt organizations are required by section 6033 (discussed above) to file Form 990. The 2007 Form 990 (line 89f) and the instructions to the 2007 Form 990 (page 49) called attention to an exempt organization's obligation to file Form 8921. The instructions to the 2008 Form 990 (page 69) again identified Form 8921 as one of several "Other Forms that May Be Required."

C. Public Comments

The following is a summary of the comment letters responding to Notice 2007-24.

First, one comment letter argued that ChOLI arrangements pervert the spirit of charitable tax law and State insurable interest laws and enrich investors at the risk of the charities' tax-exempt status.

Second, a comment letter from a trade association supported the use of life insurance products as a fundraising method by charities. While the comment stated that this is good public policy when supported by State insurable interest laws, the letter expressed concern with abusive arrangements where third parties without an insurable interest finance the life insurance policy. The comment letter opposed the use of life insurance policies in arrangements where any party with an insurable interest serves as an accommodation party or conduit.

Third, a comment letter from an industry consultant stated that life insurance is a traditional and respected instrument for philanthropy for non-profit organizations. The comment letter supported full reporting to the Service of information regarding these insurance arrangements, provided the information is kept confidential by the Service. The comment letter requested that the forms used for reporting not be too onerous.

Finally, a comment letter from a charitable organization stated that it relies heavily on insurable interests in its members. The comment letter proposed a modified single form to replace the original two forms proposed by Notice 2007-24. This comment letter also expressed concern about the confidentiality of the information reported.

III. ChOLI ARRANGEMENTS

Having reviewed the applicable law, the report now outlines various types of ChOLI arrangements. ChOLI arrangements have been described in various sources (compiled in the Bibliography, below). An overview of these arrangements is presented in this part, followed by more specific descriptions of several different types.

A. Overview of Transactions

Notwithstanding the wide differences among the known ChOLI arrangements, each transaction at issue here, at a minimum, includes four elements: (1) a charity that has an insurable interest in a large number of donors; (2) investors who seek a profitable return on capital by investing, directly or indirectly, in life insurance contracts; (3) promoters and sponsors of ChOLI arrangements; and (4) a pool of life insurance contracts insuring the lives of a pool of individuals.[39] In general, the charity provides its insurable interest in donors, investors provide capital to purchase life insurance contracts, the promoters bring the parties together (for a fee), and the charity and investors divide the return on the contracts (primarily death benefits) according to the terms of the particular arrangement. There may also be a financing group, independent of the investors, that provides funds needed to pay premiums prior to any sale or assignment of the contract.

The popularity of reported ChOLI arrangements appears to have been concentrated during the period from 2000 through 2005. Since then, these transactions appear to have drawn less attention and the number may have declined. Moreover, the required reporting under section 6050V did not generate much information, as discussed in Section IV of this report. Nevertheless, it is possible to categorize ChOLI arrangements as follows. The most basic form of ChOLI arrangement involves the direct ownership of life insurance contracts by a charity. More complex arrangements involve the indirect ownership of life insurance contracts by a charity through a trust or other special purpose investment vehicle. In addition, some ChOLI arrangements -- typically those involving indirect ownership through an investment vehicle -- include the purchase of annuity contracts as well as life insurance contracts. These various categories of ChOLI arrangements are discussed further below.

B. Arrangements Wherein the Charity Owns Life Insurance Contracts

The simplest form of ChOLI (or FOLI, referring to Foundation-Owned Life Insurance) arrangement involves the direct ownership of life insurance policies by a charity. Most of the reported transactions involve bona fide charities with an established roster of committed donors. For example, a New York Times article discussed an 81-year-old woman who had donated millions of dollars to the United Way over the course of her lifetime.[40] To benefit the United Way upon her death, she allowed herself to be insured for $70 million in return for some portion of the death benefits going to the charity.[41] The article's details on the transaction are sparse, but there were investors involved who received a large portion of the death benefits. The article noted that the woman had participated in more than one of "such pools."[42]

A small number of transactions may involve "charities" that were specifically formed in order to participate in life insurance programs. For example, the founder of the Coachella Valley Society for the Prevention of Cruelty to Animals (SPCA) in California has acknowledged that "[t]he charity itself was really housed to form a home for this [ChOLI] program."[43]

The structure of the ChOLI arrangement wherein the charity owns the policies directly is fairly straightforward but typically involves the charity borrowing the funds used to purchase the life insurance policies. For example, in the case of the Coachella Valley SPCA, the charity recruited some one thousand participants (based on their age, gender, and the insurance company's estimate of their remaining life expectancy) each of whom agreed to have life insurance purchased on his or her life in return for allocation of a $25,000 death benefit to the beneficiaries of the participant. The SPCA then borrowed about $5 million annually at 6.5 percent interest from the Insurance Co. of North America (at that time a unit of Cigna Corp.) to pay the premiums on policies of $275,000 on each of the participants' lives. On the death of the last of the participants, $275 million in death benefits would have been paid, of which $25 million would have been paid to the beneficiaries of the participants. About $190 million dollars was expected to be paid to Insurance Co. of North America to repay the annual $5 million loans used to finance the premium payments. The remainder, expected to be $60 million, would belong to the charity.

The Coachella Valley SPCA was a client of a company named FOLI that, beginning in 1995, marketed plans that called for the charity to borrow or otherwise provide the funds used to purchase the life insurance policies.[44] Pursuant to such an arrangement, another FOLI client, the Osteopathic Medical Center of Texas, borrowed $6 million and put up $2 million of its own money to purchase 1,239 life insurance policies on its employees and supporters.[45] The Center expected to net roughly $200 million over forty years, the bulk of which would start to accrue in thirty years.[46]

In general, the investors in a ChOLI arrangement are seeking the profit potential that actuarial arbitrage can provide but that is otherwise inaccessible due to the insurable interest requirement. In some cases, for example, investors may seek an investment return that is not correlated with the performance of equities, bonds, commodities, or other financial products. The investors' returns may instead be correlated with mortality of a group of individuals.[47]

In other cases, assuming the participants die at the actuarially determined rate, the profits from this class of ChOLI arrangement derive from what is arguably underpricing of the life insurance policies. Underpricing can occur because of a difference between the assumed lapse rate anticipated by the actuaries and the actual lapse rate if the policies are owned by investors. The calculations that factor into policy pricing assume that a certain percentage of policyholders will allow their policies to lapse at some point. For instance, often parents will allow life insurance policies on their own lives to lapse once their children reach adulthood and/or financial independence.[48] In contrast, because investors' returns rely on holding the policies until the deaths of the insured, investors generally do not allow policies to lapse. If a lapse assumption is used to price an insurance policy, and the policy is never allowed to lapse, the policy will have been underpriced relative to the price at which it would have been offered had the actuaries known that the policy definitely was going to be renewed until the death of the insured. Although the profit potential may be small on a single policy (and the longevity risk prohibitive), recruiting enough participants to provide for a reasonably predictable death rate can, in theory, lead to a predictable return. In 2006, a presenter at the annual meeting of the Society of Actuaries noted that one way to deal with an expanding definition of "insurable interest" and life insurance held for investment by charities or others would be to assume a higher percentage of renewal (i.e., a lower lapse rate).[49]

If the policies in ChOLI arrangements were priced "properly" (e.g., assuming a lapse rate more appropriate for policies held by investors), these arrangements generally would provide the returns promised to the charities only if the participants die earlier, on average, than the actuaries anticipated. For instance, Vaughn Henry, an estate planner who has written on ChOLI arrangements, has noted that life insurance as an investment will do better than other investment vehicles "only if people are willing to die early."[50] There is no information available about the long-term success of plans such as those marketed by FOLI for the participating charities. As of 2003, the participants in the FOLI arrangement entered into by the Osteopathic Medical Center of Texas had not died at the rate anticipated. The arrangement entered into by the Coachella Valley SPCA ended in 1999 when the Insurance Co. of North America was acquired and the policies were "surrendered" in connection with the acquisition.[51]

C. Arrangements Wherein a Trust or Other Special-Purpose Vehicle Owns the Life Insurance Contract

In more complex ChOLI arrangements, the charity does not directly own the life insurance policies but rather holds them through a trust or other special-purpose vehicle (SPV) set up specifically to hold the policies. Investors can then own fixed-income shares or debt instruments issued by the trust or SPV.

In the so-called L.I.F.E. Heritage plan, for instance, the proceeds from the sale of fixed-income shares or debt instruments were used to purchase five thousand life insurance policies totaling more than $2 billion on the lives of the charity's donors.[52] Each year for thirty years, the first $1 million of death benefits goes to the charity with the remainder (roughly $2.2 billion) going to the investors at the end of the 30-year period (a return of roughly 8.3 percent on an annual basis).[53] The donors agreed to the arrangement in return for a modest amount of life insurance coverage provided to the donors at no cost.[54] Capital Partners, the plan's sponsor, netted $1.4 million when the plan was put in place.[55] Assuming the payouts occur as the L.I.F.E. Heritage sponsors project, a charity would receive approximately $30 million simply for providing access to the insurable interest that the charity has in its donors.

Depending on the terms of the trust or other special-purpose vehicle, the motivations of both the investors and the charity may be the same as motivations of those parties in an arrangement wherein the charity is the direct owner of the underlying policies. As in the case of charity-owned policies, the returns from these arrangements are not guaranteed. Success, from the point of view of the charity and the investors, depends upon a fundamental mispricing of the policies.

D. Arrangements Involving Both Annuities and Life Insurance Contracts

Certain ChOLI arrangements involve combinations of life insurance and life annuities, referred to in this report as "combination arrangements." In these arrangements, the potential for earnings is based on economic arbitrage between a life insurance policy and a life annuity on the same individual. Thus, combination arrangements may anticipate that the charity market the program to its older donors with "excess insurance capacity."[56] Generally, combination arrangements are funded by borrowing from a bank or a coalition of investors, and promotional materials may describe them as a method for fundraising involving no cash outlay by either the charity or the individual insured.

In a typical combination arrangement, charities or licensed insurance agents solicit the participation of consenting individuals who allow a statutory business trust or other entity to purchase life insurance and life annuity contracts on their lives.[57] Investors purchase securities of the trust or other entity, and charities own a second class of securities. The payments received from the annuity contracts are partially taxed according to the usual life annuity rules, while the net-of-tax proceeds are used to provide investors returns on their investments, to pay the trust's expenses, and to pay the premiums on the life insurance contracts. As consenting individuals die, the death benefits primarily are used to repay investors the portion of their initial investment represented by the policies on the deceased individuals.

In general, approximately 5 percent of the death benefits are paid to the charities specifically designated by the consenting individuals.[58] When the last consenting individual dies, the trust pays any remaining expenses and then distributes any remaining funds to the designated charities. The trust then dissolves. As structured, the consenting individuals do not provide any direct contributions and incur no risk to participate in the combination arrangement. Their participation simply allows the trust to use the insurable interest they have in their lives.

Combination arrangements take advantage of pricing differences in the life insurance and annuity markets. They produce a profit if: (1) the annuity payments exceed the periodic life insurance premiums and debt service paid to investors or other lenders; and (2) the death benefits will exceed the amounts initially invested (and then used to pay promoter fees and to procure the life insurance policies and annuities). This can occur by virtue of arbitrage based on the differing mortality assumptions used in pricing life insurance policies versus life annuities. Acting conservatively, insurers would tend to exaggerate longevity for pricing annuity contracts and exaggerate mortality for the purpose of pricing life insurance contracts. For successful arbitrage to occur under a combination arrangement, effectively the opposite must occur; annuity pricing must reflect a relatively higher expected mortality than life insurance.

Under a combination arrangement, the arbitrage profits are guaranteed, in the sense that the rate of return to investors on a combination arrangement is independent of the date of death of the insured. This means the promised investment returns are guaranteed (given solvency of the insurance companies), but the maturity of the investor's investments is subject to uncertainty. Thus, under a combination arrangement, the promoter need not "outpredict" the insurance company actuaries; the promoter needs only to find inconsistent pricing across different insurers. Under other types of ChOLI, the uncertainty of mortality extends to investment return risk; in general, the longer-lived is the insured, the lower is the resultant return on the investment.

IV. DATA COLLECTION

As noted above, section 1211 of the PPA added section 6050V to the Code, which required applicable exempt organizations to make an information return regarding acquisition of an interest in certain life insurance contracts pursuant to certain ChOLI arrangements. In response, the Service issued Form 8921, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V). Applicable exempt organizations were required to complete Form 8921 for reportable acquisitions of applicable insurance contracts that took place after August 17, 2006, but on or before August 17, 2008.

Through December 2009, the Service has received Form 8921 submissions from fewer than ten filers. Under taxpayer privacy laws, disclosure of information from individual returns is not permitted, and the small number of responses precludes analysis or aggregation in any meaningful fashion.[59] In any case, such a limited data set would not support significant inferences. Instead, this part of the report discusses possible reasons for the small number of submissions.

It is not clear why so few Form 8921 filings were received by the Service. It is unlikely that applicable exempt organizations were unaware of the section 6050V reporting requirement. In Notice 2007-24, the Service highlighted the reporting requirement and requested comments both on the study that was to be prepared by the Treasury and the Service and on proposed Form 8921 (and 8922, as discussed above). Additionally, in 2007, both Form 990 (line 89f) and the instructions to Form 990 (page 49) called attention to an exempt organization's obligation to file Form 8921. In 2008, the instructions to Form 990 (page 69) again identified Form 8921 as one of several "Other Forms that May Be Required."

In particular, the 2007 Form 990, on line 89f, asked: "Did the organization acquire a direct or indirect interest in any applicable insurance contract?" There was an affirmative answer on over five hundred returns, representing a wide variety of types of organizations, such as hospitals, corporations, trusts, universities, educational organizations, community foundations, internationally-oriented charities, fraternities and sororities. It is unclear why these returns answered yes but did not file the required Form 8921.

Any organization that is found to be delinquent in filing Form 8921 would be subject to penalty under section 6721(a), or in the case of intentional disregard of the filing requirement or correct information reporting requirement, a penalty under section 6721(e)(2)(D), equal to the greater of $100 or 10 percent of the value of the benefit of any contract with respect to which information is required to be reported. Regardless of how the value of that benefit is determined, there appears to have been little incentive for an applicable exempt organization to risk the penalty, since no tax liability was at stake[60] and compliance costs were limited to completing a two-page form for each applicable transaction. The potential applicability of a penalty in any particular case would be ascertained in the course of ongoing compliance activity that, depending on the confidential facts and circumstances of any particular organization or taxpayer, could involve correspondence, compliance checks, or examination. Unless there is reasonable cause for failure to file Form 8921, a penalty for failure to file would follow.

One possible explanation for the discrepancy between the number of affirmative answers to the question on Form 990 and the number of Forms 8921 is that some organizations misinterpreted the question. The Instructions clarify that the question refers to "an applicable insurance contract which is a part of a structured transaction involving a pool of such contracts." However, it may be possible for an organization to acquire an applicable insurance contract within the meaning of section 6050V(d)(2), but not in a "reportable acquisition" within the meaning of section 6050V(d)(1) (i.e., not in a structured transaction involving a pool of such contracts). An organization that interpreted the question more broadly than intended (i.e., to be seeking information about all applicable insurance contracts, whether or not part of a structured transaction) could have answered line 89f affirmatively without filing a concomitant Form 8921. The Service is making the appropriate inquiries to determine if these responders should also have filed Form 8921.

Alternatively, the small number of Forms 8921 received (assuming for this purpose that the proper number was received) may be attributable to one or more of the following factors: First, the market for investor-owned pools of life insurance contracts may have shifted from contracts originated by charities to contracts originated directly by insured individuals. Since 2006, the market has seen an increase in transactions in which an individual is approached by a promoter and encouraged to purchase a life insurance policy with a nonrecourse premium loan. If the individual dies during the term of the loan, a portion of the death benefits under the policy is used to pay off the loan and the remainder is paid to the individual's heirs. If the individual is still alive at the end of the loan term, the policy is sold or transferred to the lender. The individual thus enjoys either free insurance protection or some other economic benefit for participating in the program.[61] It is possible that an increase in these transactions -- and in traditional life settlement transactions in which existing policies are purchased from elderly individuals who no longer need them -- reduced the need for investors to recruit exempt organizations and their donors to gain access to large pools of life insurance policies.

Second, some exempt organizations may have grown concerned about the negative publicity surrounding these arrangements. For the same reason that gambling on human lives has long been contrary to public policy, a number of publications have questioned the propriety of a charity's participation in a transaction in which it essentially sells to investors insurable interests in its donors.[62] Concern about such negative publicity may have deterred some exempt organizations from moving forward with arrangements involving investors and life insurance on their donors.

Third, it is possible that some transactions were either accelerated before the effective date of the reporting requirement, or deferred until after it terminated. Even though the reporting requirement had no effect on the income tax liability of the applicable exempt organization, some organizations may have preferred not to engage in these transactions during the two-year information reporting period to avoid scrutiny of the transactions or of their other activities. It is also possible that the number of transactions began to drop as early as 2005 in response to various related excise tax proposals.

Additionally, as noted above, many of the arrangements rely on exploiting potential mispricing in the life insurance and life annuity markets. Because profits from these types of arbitrage come at the expense of the life insurance companies, some large life insurance companies have encouraged their agents to cease entry into combination arrangements.[63] It is also possible that the companies have begun to change the assumed lapse rate used to price life insurance policies, as at least one actuary suggested in 2006 at the Society of Actuaries annual meeting.[64] This would reduce the amount of profit that can be gained by entering into these arrangements and therefore would be expected to cause a decrease in the number of arrangements.

Whatever the reason for the small number of filings, the Forms 8921 received provide insufficient data to draw conclusions about the participation of charities in these arrangements. Section 1211 of the PPA directs that the study address (1) the use by tax-exempt organizations of applicable insurance contracts for the purpose of sharing with investors the benefits of the organization's insurable interest in individuals insured under such contracts, and (2) whether such activities are consistent with the tax-exempt status of such organizations. The number of responses received represents too small a sample to meaningfully inform the tax policy debate concerning the propriety of an exempt organization's raising funds by participating in these transactions.

V. TAX IMPLICATIONS AND POLICY ISSUES
VI.

This part of the report discusses federal income tax implications of ChOLI arrangements and tax policy issues that may be of continuing concern to Congress.

A. Exempt Status and the Sharing of Insurable Interest

As described in Part I, an organization's qualification as a charity bears on both its Federal tax exemption and its insurable interest in its donors under State law. Generally, an organization that is organized and operated as a charity according to section 501(c)(3) of the Code, Treasury Regulations and common law is exempt from Federal income tax. Moreover, if the Service recognizes an organization as a charity, i.e., a tax-exempt organization described in section 501(c)(3), the organization may have an insurable interest in its donors pursuant to State insurance law.

Because a charity has an insurable interest in a potentially large group of people (generally, its donors), the charity may purchase a large number of life insurance contracts, benefiting from the inside build-up under the contracts and the death benefits ultimately received. To generate this return, however, capital is necessary to pay premiums on the contracts. ChOLI arrangements are designed to allow investors to supply the necessary capital, while the charity supplies the insurable interest. Ultimately, the charity and investors can divide the proceeds.

Significant public policy and insurance regulatory issues may arise, however, with regard to life insurance contracts, such as applicable insurance contracts, that are purchased based on a charity's insurable interest in a pool of its donors but in which investors with no relationship to the donors also have an interest.[65] In the regulatory context, for example, the State of New York Insurance Department concluded that an arrangement in which a trust would be sponsored by one or more charities (the Sponsor) for the purpose of borrowing money and purchasing life insurance policies (Policies) and single-premium annuities (Annuities) on a pool of donors did not conform with that State's insurable interest requirements. The Department's opinion letter noted, in particular, that "a significant portion of the proceeds of the Policies and Annuities must be diverted to provide the bondholders with a return on their investment," and that the Sponsor's ownership interest" is compromised by the fact that the Sponsor must assign its rights under the Policies and Annuities to the Issuer Trust, which in turn must pledge them as collateral."[66]
For similar reasons, an organization's involvement in a ChOLI arrangement may call into question its compliance with the organizational and operational tests for exempt status, i.e., whether the organization is organized and operated exclusively for exempt purposes, and whether it has violated the prohibitions on inurement and substantial private benefit.

Organization and Operation Exclusively for Exempt Purposes

A ChOLI arrangement may be viewed as a sharing of insurable interest in donors, which is a charitable attribute, with investors, who are not charities. At some point, the pool of life insurance contracts in which a charity invests may be so large, may cover so many individuals, and may require so substantial an investment by unrelated investors, that the organization can no longer be treated as organized and operated "exclusively" for charitable purposes, as required by section 501(c)(3). Rather, the organization may effectively be serving an unrelated purpose -- the facilitation of investment by private investors in life insurance contracts. Even though some States treat a charity as having an insurable interest in any consenting donor, in some cases the charity's actual relationships with its insured donors may be so attenuated that those relationships in fact are more valuable in enabling the purchase of life insurance than in providing funding for the charity's operations. This issue is even more relevant where the charity must borrow funds in order to afford the premiums paid to insure its donors. Although the fact of borrowing does not necessarily bear on insurable interest, such leverage permits the purchase of life insurance that is arguably beyond the means of the charity or the needs of the charity (other than to meet financial obligations to lenders or investors) and disproportionate to the contributions of the underlying donors.

Resolution of this issue may depend in part on whether the charity's financial involvement in the arrangement is viewed on a "gross" basis (taking into account the total death benefits and other returns on the underlying life insurance contracts), or on a "net" basis (taking into account only the financial returns that are enjoyed by the charity). Existing legal authority does not address this question. A "net" approach, however, would arguably obscure in many cases the extent of a charity's role in facilitating private investment and the significance of that role relative to the charity's exempt functions -- difficult though that may be to measure. While it is impossible to generalize in the absence of meaningful data, it would appear that a charity's participation in a ChOLI arrangement may conflict in many cases with the "exclusive" purpose requirement.

Inurement and Private Benefit

By all accounts, the amount of money that flows to charities from ChOLI arrangements is much smaller than that which is anticipated to go to the private investors.[67] For example, in the L.I.F.E. Heritage plan discussed above, at the beginning of the arrangement, the charity anticipated $30 million over the course of thirty years ($1 million per year).[68] The investors, however, expected to receive $2.2 billion over that same time period.[69] Thus, at the beginning of the arrangement, in undiscounted terms, the charity expected to receive only slightly more than 1 percent of the benefits from the arrangement. Similarly, in the life insurance/ annuity combination arrangements described above, only approximately 5 percent of the death benefits went to the participating charities.[70]

The disparity in the relative returns derived by the investors in a ChOLI arrangement and the participating charity raises the question of whether these arrangements inherently violate the proscriptions on inurement and substantial private benefit. On the one hand, the respective contributions of the charity (insurable interest) and the investors (capital) may be hard to value, and thus there may be no obvious principle by which to prorate the proceeds between them. On the other hand, if the effect of the arrangement is that the charity serves merely as a vehicle through which investors can generate profits, that presents a question of charitable status. Inurement. As discussed previously, Federal tax law provides that no part of the net earnings of a charity shall inure to the benefit of any individual who has a private interest in the charity's activities (a so-called insider). Assuming that a ChOLI arrangement is

otherwise permissible, it could run afoul of this proscription on inurement if charity officers or other individuals in a position to influence the charity's operation became investors or otherwise profited from the arrangement. This determination would necessarily be made, however, on a case-by-case basis, taking into account the facts of the particular situation. While new general restrictions could be devised to preclude all charity officers and other persons with influence from investing in ChOLI arrangements, the Treasury and the Service are not aware of any evidence to suggest that inurement is a systemic problem with these arrangements or that existing law is insufficient to address it.

Private Benefit. Treasury Regulations also stipulate that a charity may not be organized or operated for the benefit of private interests. A private benefit may be permissible if it is merely incidental to charitable activity, but a substantial private benefit is impermissible.[71]

A ChOLI arrangement is designed as an investment vehicle and by its nature benefits private investors. This private benefit derives in large part from the use of the charity's insurable interest in its donors, an attribute it would not have in the absence of its charitable activities and, in most cases, its concomitant tax-exempt status. Questions presented by this circumstance include whether this private benefit may be substantial enough in any particular case, in comparison to the charity's exempt activities, to justify revocation of the charity's tax-exempt status or, more generally, whether charities should simply be prohibited from engaging in these transactions in order to preclude this possibility.[72]

Although particular arrangements differ, the fact that most ChOLI arrangements involve a large pool of insurance contracts tends to mean that the value of the overall investment is substantial. Moreover, as noted above, the proportion of the overall return from the arrangement that is allocated to the investors is typically much greater than that allocated to the charity.

Two factors may explain this disproportionality. First, in many of the arrangements, the charity bears no risk of loss. For example, in the L.I.F.E. Heritage plan, the charity receives the first $1 million each year in death benefits.[73] Thus, if there is a substantial risk that annual death benefits will be $1 million or less, the investors would bear a much greater amount of risk than the charities do. That greater risk may justify a correspondingly larger expected return.

Second, charities often do not have the financial ability (or, perhaps, the risk-tolerance) to enter into ChOLI arrangements with their own funds. At least one of the charities entering into a FOLI with outside investors did so because it could not afford to pay the premiums on its own.[74] Thus in at least some cases the presence of the investors is necessary for the charity to receive any returns. It is not clear, however, that alternative investments could not provide charities with returns of comparable magnitude and risk, without requiring the involvement of substantial numbers of a charity's donors and substantial amounts of third party funds. In fact, the apparent decline in the popularity of ChOLI arrangements over the past five years or so suggests that charities have indeed opted for alternative investments. Comparison of the private benefit from any particular ChOLI arrangement to the exempt activities of the charity involved necessarily requires an examination of the particular facts. Moreover, as described earlier, relatively little information was provided through the PPA information reporting requirement. Nonetheless, the available evidence suggests that the private benefit from ChOLI arrangements tends to be substantial in absolute terms and that potentially offsetting benefits to the charities, such as providing a type of investment return that would otherwise be unavailable, are not significant.

B. Income from ChOLI Arrangements as UBTI

As described earlier, an organization described in section 501(c)(3), a charity, is exempt from Federal income taxation not only on the contributions and gifts it receives, but also on the income it derives from the performance of its exempt function. This exemption does not extend, however, to UBTI, which is the gross income derived from an unrelated trade or business regularly carried on by it, less the deductions otherwise allowed that are directly connected with carrying on that trade or business.

Whether a charity's returns under a ChOLI arrangement constitute UBTI is not entirely clear, due in part to factual differences among the various arrangements and in part to the UBTI provisions themselves. In some cases, the arrangement may be treated as debt-financed, because the charity has borrowed funds in order to acquire the life insurance policies and, in the case of combination arrangements, annuities. In those cases, net returns from the arrangement would be UBTI, except to the extent they are otherwise excluded from gross income pursuant to the Code provisions governing the taxation of life insurance. Thus, UBTI would not include the death benefits under a life insurance policy or the value of the inside buildup, both of which are generally excluded from gross income.[75] If, however, the charity receives payments under annuities acquired with borrowed funds, those payments generally would be taxable as UBTI.

In the absence of debt-financing, UBTI would include gross income from the arrangement only if it constitutes an "unrelated trade or business" that is "regularly carried on." Although many ChOLI arrangements may not rise to the level of a "trade or business" that is "regularly carried on," it is possible that in some cases the business activities conducted in insuring a charity's donors could rise to the level of a regularly carried on trade or business.[76]

Moreover, if the charity is not the owner of the life insurance contracts, it is necessary to determine not only whether the charity's involvement rises to the level of a "trade or business" that is "regularly carried on," but also the nature of the charity's return under the arrangements, i.e., whether it constitutes investment income. Economically, the better characterization of a charity's return under many ChOLI arrangements may be as compensation from investors for providing access to the charity's insurable interest in its donors. This would suggest that, for tax policy purposes, any funds received by the charity may be best characterized as services income, rather than investment income.

Alternatively, if an insurable interest were considered property, the appropriate characterization would be by analogy to rent or the sale of property. In Grigsby v. Russell,[77] Justice Holmes wrote for the U.S. Supreme Court that a life insurance policy could be transferred to a person without an insurable interest because "[t]o deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hands." Because life insurance policies had become "one of the best recognized forms of investment," the Court saw fit to consider the policy "property."[78] If an insurable interest similarly should be characterized as property, then for tax policy purposes, it may be more appropriate to analogize funds that charities receive in a ChOLI arrangement to funds received from the rent or sale of property -- and thus potentially as investment income. As discussed previously, however, that property -- the charity's insurable interest in its donors -- exists solely by virtue of the organization's charitable and tax-exempt status. Thus, an approach which views a ChOLI arrangement as involving the rent or sale of a charity's insurable interest necessarily implicates the other issues discussed previously relating to the organization's exempt status, i.e., potential conflict with the requirement of organization and operation exclusively for an exempt purpose and the prohibition on substantial private benefit.

C. Role of Tax Benefits in the Profitability of ChOLI Arrangements

Another important question for purposes of this report is whether the profits derived from ChOLI arrangements rely in any way on the tax benefits provided to charities or to the benefits paid upon death from a life insurance policy. In other words, do the investors receive any tax benefits (whether directly or indirectly) by entering into these arrangements? The analysis differs somewhat depending on whether the ChOLI arrangement involves direct ownership of life insurance (and possibly annuity) contracts by the charity, or indirect ownership by the charity through a trust or other investment vehicle.

Direct Ownership

The most significant benefit associated with owning a life insurance contract is the exclusion from gross income of amounts received under the contract by reason of the death of the insured. This exclusion from gross income is generally not a factor where the owner of the contract is a tax-exempt organization (unless the income is debt-financed) or otherwise indifferent to the receipt of taxable income. Rather, as discussed earlier, profitability depends on either underpricing of the policies or the early deaths of the arrangement's participants.

More specifically, in a transaction in which the policies originate and are at all times owned only by the charity, neither the exclusion from gross income of death benefits under section 101(a) nor the exemption under section 501(a) for charities seems to play a role in the profitability of the arrangement. Because charities are already tax-exempt (except in the case of UBTI, discussed above), the tax exemption afforded death benefits does not provide any added benefit to charities engaged in a ChOLI arrangement.[79] While the exclusion can be beneficial in situations where a charity chooses to borrow funds in order to acquire life insurance policies (so that returns would otherwise be debt-financed UBTI), it does not appear that leverage is essential to the profitability of the arrangement. In fact, it is possible that the exclusion under section 101(a) may make life insurance policies less attractive to charities. To the extent life insurers can price their policies higher because of the tax-preferred nature of their returns, charities would pay a higher price with no accompanying tax benefit. At least one estate planner has pointed out that because charities are already tax-exempt, "they are usually better off with other investment vehicles."[80]

Indirect Ownership and Transfer-for-Value

The analysis is essentially the same with respect to the charity in a transaction in which the insurance policies are held by a trust or other special purpose investment vehicle (SPV). Again, the ChOLI arrangement does not provide any tax benefit to the charities, which are already tax-exempt.

In those situations, however, investors may have an interest in the trust or SPV through ownership of either equity interests or debt instruments. Few of the published reports about ChOLI arrangements have focused on tax reporting by the investors, and less is known about this aspect of the arrangements. One commenter has stated that part of the financial success of combination arrangements "depends on the favorable tax treatment of the annuity and life insurance as separate" in a situation where the trust is set up by the charity and would therefore be tax-exempt.[81] Other commenters, however, have characterized combination arrangements as being profitable by virtue of exploiting inefficient pricing of the life insurance and life annuity contracts, without mentioning any tax benefits.[82] If, for instance, the life annuity contract is purchased with a high mortality assumption (i.e., the annuitant is expected to die quickly) while the life insurance contract is purchased with a low mortality assumption (i.e., the annuitant is expected to live for a longer period of time), then the disparity would provide for an arbitrage opportunity that does not depend upon the annuity income being tax-exempt or otherwise tax-preferred. If the returns provided to investors were tax-exempt, the returns would, of course, be greater (except to the extent those returns go to already tax-exempt investors). Promoters of the plans generally maintain, however, that tax benefits do not contribute to the profitability of the plans.

Due to the insufficiency of the data resulting from information reporting under the PPA, the Treasury and the Service could not independently verify whether investors (or anyone else) were in fact claiming the benefit of the gross income exclusion for death benefits in ChOLI arrangements. However, to the extent that a contract was purchased based on a charity's insurable interest in its donor, and was later owned (including through an investment vehicle) by an investor with no other relationship to the donor, one would expect the transfer-for-value rule to limit the availability of that exclusion. As described previously, a transferee-for-value

under section 101(a)(2) is permitted to exclude death benefits from gross income only to the extent of the consideration paid for the contract, plus premiums and other amounts paid subsequently.[83] In this way, a transferee for value (i.e., a purchaser) is taxed on the economic income from owning the contract. Exceptions apply in the case of transferred basis transactions, or transactions in which a life insurance contract is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Where a ChOLI arrangement involves ownership of life insurance contracts through a trust that includes investors unrelated to the insured or the original policyholder, the applicability of the transfer-for-value rule may be unclear, in part due to the possible absence of a "transfer" within the meaning of the rule and in part due to the possible applicability of one or more of the exceptions noted above. For example, a transfer of a life insurance policy to a partnership in which the insured is a partner is excepted from the transfer-for-value rule, even if the transfer is a sale. And in some cases a transfer by a charity of an ownership interest in a trust holding life insurance contracts may not rise to the level of a "transfer" under the transfer-for-value rule.

The Administration's Fiscal Year 2010 and 2011 Revenue Proposals include a proposal to modify the existing exceptions to the transfer-for-value rule of section 101(a)(2) to ensure that exceptions to the rule would not apply to buyers of policies.[84] Under the proposal, the transfer-for-value rule would limit the gross income exclusion for death benefits even if, for example, the transfer is to a partner of the insured or to a partnership in which the insured is a partner. The proposal primarily addresses transactions involving sales of life insurance contracts that were entered into based on the insured individual's insurable interest in his or her own life. For example, in a life settlement transaction, an individual may sell to a life settlement company a cash value life insurance contract that has been in force for many years and is no longer needed. Or, in a so-called stranger-originated life insurance (StOLI) transaction, an individual may enter into a life insurance contract using funds borrowed with an up-front arrangement that anticipates the contract will revert to the lender, typically after a two-year contestability period. The proposal would ensure that investors in these transactions will be treated as transferees for value under section 101(a)(2).

Although the proposal is not specifically directed at charity-originated arrangements, similar tax policy issues arise in those variations of the transactions in which the underlying life-insurance contracts are originated based on the charity's insurable interest in its donor, but are economically transferred to unrelated investors. From the standpoint of an investor who owns life insurance contract but has no relationship with the insured individual, it is not particularly relevant whether the contract was originally purchased based on the individual's insurable interest in his or her own life or based on a charity's insurable interest in the individual as a donor. What matters is that the investor receives a death benefit without regard to any financial or other relationship with the insured individual. The case for a gross income exclusion for death benefits grows still weaker in situations where the investor owns not one, but dozens, hundreds or thousands of such life insurance contracts on strangers, at which point the stream of death benefits represents little more than a contingent cash flow on an investment. In such a case, the transfer-for-value rule should operate to ensure that the investor is taxed on its economic income from the transaction, i.e., the excess of the death benefits received over the total amounts paid with regard to the contracts. The Administration's proposal is designed to ensure this result and, by its terms, would apply to ChOLI arrangements.

D. Excise Tax Proposals

Finally, this section summarizes several excise tax proposals advanced in recent years in response to general concerns similar to those outlined above.

In February 2005, the Treasury proposed an excise tax on ChOLI arrangements. Is the proposal, an excise tax of 25 percent would have been imposed upon any person who received death benefits, dividends, withdrawals, loans, or surrenders under a life insurance contract, if (i) a charity ever had a direct or indirect ownership interest in the contract, and (ii) a person other than a charity ever had a direct or indirect interest in the same contract (including an interest in an entity holding an interest in that contract). The proposed excise tax would not have been deductible for Federal income tax purposes, and the amount of excise tax paid would nothave been included in the policyholder's investment in the contract. The proposed excise tax would not have applied to situations in which: (i) each non-charity involved in the arrangemenhad an insurable interest in the insured independent of the charity; (ii) each non-charity's only interest in the life insurance contract was as a named beneficiary; or (iii) the transaction was exempt from the excise tax under regulations prescribed by the Secretary, based on factors including the arms' length nature of the transaction, the relative economic benefits to the charity and non-charity participants, and the likelihood of abuse.[85]

On May 10, 2005, Senators Charles Grassley (R-Iowa) and Max Baucus (D-Mont.) introduced a bill, S. 993, that would have amended the Code to impose an excise tax on certain tax-exempt organizations or other non-exempt persons which acquire a direct or indirect in any life insurance, annuity, or endowment contract, in the amount of 100 percent of the acquisition costs of the interest. Senate bill S. 993 would have allowed an exception from the excise tax for individuals with insurable interests, named beneficiaries, and trust beneficiaries. S. 993 would have required these tax-exempt organizations and other non-exempt persons to file certain information returns with the Service.

On November 18, 2005, the Senate passed a bill, S. 2020, the Tax Relief Act of 2005, which contained a proposal, in section 312, that would have imposed an excise tax on certain tax-exempt organizations that acquire a direct or indirect interest in any life insurance, annual or endowment contract, in the amount of 100 percent of the acquisition costs of such interest. S. 2020 would have allowed an exemption from the excise tax for individuals with insurable interests, named beneficiaries. S. 2020 would have required these organizations to file information returns with the Service relating to the acquisition of the interests.

None of the three proposals described above has been enacted into law,[86] although legislative interest in imposing an excise tax along these lines may have dissuaded charities investors from establishing new ChOLI arrangements. Nevertheless, it is worth noting that the imposition of an excise tax (unless its magnitude is so large as to be clearly punitive) may indicate implicitly that ChOLI arrangements are not improper under existing law but instead should merely be discouraged in the circumstances to which the excise tax would apply. To the extent that specific tax policy concerns can be identified, an approach that applies appropriate restrictions or prohibitions -- perhaps accompanied by an excise tax to be imposed on violation of those restrictions and prohibitions -- may ultimately be more understandable by affected parties and therefor more effective.

CONCLUSION

This report has discussed ChOLI arrangements, based on public comments, reports, and other sources. It is apparent that there are a number of respects in which ChOLI arrangements may be viewed as inconsistent with the policies underlying the Federal income tax benefits for charities and life insurance.

A ChOLI arrangement may be appealing to a charity as a creative way to raise funds to finance its charitable activities. It may appeal to investors by producing a rate of return that is not correlated with other investments and that, in some cases, permits the exploitation of mispricing inherent in an insurer's product offerings. The magnitude of the investors' interests in the insurance policies, compared with the charities' interests, raises questions, however, that are critical to the charity's exempt status, including potentially significant conflicts with the requirement of organization and operation exclusively for an exempt purpose and with the prohibition on substantial private benefit. Further, as discussed in the report, the treatment of a charity's return from participation in a ChOLI arrangement is not entirely clear in all cases, but arguably may be viewed as unrelated business taxable income in at least some circumstances.

Finally, the report recommends adoption of the Administration's Fiscal Year 2010 and 2011 budget proposals to revise the "transfer-for-value" rule of Internal Revenue Code section 101(a) to ensure that investors in a ChOLI arrangement -- as well as investors in other types of arrangements involving the transfer of life insurance contracts -- do not inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract in circumstances where those investors have purchased an ownership interest in the underlying policies.