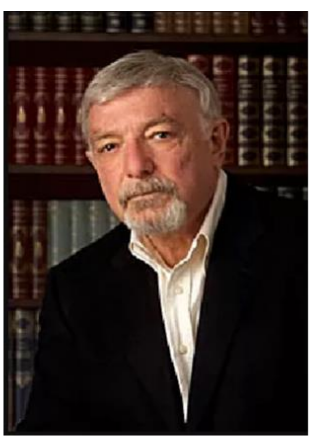
The Superfluous Insurance Contract

Unnecessary policies, especially personal and group term insurance, can be a great source of wealth for not-for-profit organizations and major tax deductions for donors. Not everyone can make a major bequest to his or her alma mater, hospital or favorite charity but many individual households or estates maintain term and cash value insurance policies that are no longer covering a need or are bleeding the assets.

The Commodity Itself

Term originally purchased for a now retired key man or originally designed to fund a now defunct buy/sell agreement is normally cast aside and lapsed for no value. This coverage for a senior with mild to serious health problems can and probably should be carefully reviewed as a source of funds through use of the secondary market mechanism. In this light, group term life policies, hidden among the mix, are usually available for conversion and, through the secondary market vehicle, can also be a significant resource for fiscal and tax planning.

Every day many are diagnosed with a chronic disabling illness such as early stage cancer, advanced heart disease, amyotrophic lateral sclerosis (ALS), all of whom are unable to work due to increased declining health conditions and are forced to leave a full- time job position with existing term group life insurance benefits. In most cases they are not informed about their group policy conversion rights and privileges under the federal consolidated omnibus budget reconciliation act (COBRA). COBRA often provides for keeping the amount of the term group life insurance as an individual permanent policy with the insurance carrier through either portage or conversion and, importantly, the insured usually has a mere 31 day window of opportunity from date of actual termination to exercise this option or the group policy will be discontinued and lost. Unfortunately, many people who are unaware of this provision often walk away and lose sizable policies (up to $500,000) that may have been a valuable asset which may have been converted into a cash settlement.



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A past case that I came across involved the wife of an insured who contacted an estate advisor to review their family's potential sale of a group term life insurance policy. At the time of the initial consultation the wife of the insured indicated that her husband just two weeks left on the job due to a newly diagnosed late stage cancer condition.

Once the group policy was converted to a permanent policy the estate advisor obtained the insured's medical records and had the policy looked at for settlement offers. The policy death benefit amount was $100,000.00 and the gross cash offer achieved for the family was $60,000.00. Unbelievably, had the wife of the insured waited just a few more weeks to be in contact with the group term carrier the term policy conversion period would have been lost and the policy worth nothing! Although this setting was not a donor issue the format is applicable.

For health challenged donors the gifting of term and cash value life policies, beyond the tax deductions, can help meet estate and personal financial planning objectives. In some cases, they also allow for the building of a less costly legacy using worn-out assets that may no longer be needed. More than 70% of all life insurance policies, including group and secondary-market policies, are lapsed for nonpayment because they no longer meet any pressing estate planning or business planning needs. As noted in 2006 by the Insurance Information Institute (www.iii.org), a per-year lapse ratio of 7.7% (38.5% lapses in five years) is the industry standard, down from 8.75% per year for the period 1995–2000. Additional material suggests the lapse rate is 3% per year for individuals over age 65.

Death, Taxes and Planned Giving

Where possible maintaining these out-of-date as well as newly written life insurance policies are a great source of new money for not-for-profits. Empirical mortality tables have the uncanny knack of being correct. It's not a matter of whether the insured is going to die, it's when, and if the portfolio of policies is sufficiently diversified, we even know what year that might be within a reasonable margin. Regardless of whether the policy is term insurance, some form of cash-value insurance, assignable old group policies or even the senior settlement payouts from the secondary market, life insurance is a viable tool to the estate planning community.

In the case of cash value insurance the decision as to whether to sell will hinge on whether more can be secured from a settlement than by surrendering the policy. Often this is the case — the proceeds will usually be an amount less than the death benefit and greater than the cash value on surrender — but this is not always so.

The reason: taxes. In 2009, the IRS issued Revenue Ruling 2009-13, which increased the proportion of sale proceeds subject to capital gains tax. In an example provided by The Weinberg Group, a policy that sells for $80,000 and has an adjusted basis of $64,000 would yield after-tax proceeds of $72,000 after the ruling, versus $74,000 before the ruling. This amount, less the broker's commission, could yield a net distribution inferior to that of the cash surrender value, making the life settlement a poor choice. However, changes to the tax code increasingly favor life settlements, a trend that's evident on the question of estate taxes.

A report released in March by market research Conning shows that ownership of cash value life insurance among the top 10 percent of U.S. households (as measured by net worth) fell to 34 percent in 2013 from 61 percent in 1989. The study attributes the decline to periodic increases in the estate tax exemption (now $5.43 million per individual, up from $625,000 in 1989), indicating that paying estate taxes motivated purchases of life insurance for many of the high net worth.
Ruling 2009-13 determines the tax consequences for the surrender of a life insurance policy and for the seller in a life settlement transaction.

This ruling disconnects and then reassembles how the Service defines those characteristics of the sale that result in ordinary income tax treatment and those that result in capital gains treatment. Dealing with the complex social and financial aspects of the life insurance contract, the rulings suggest that the allocation of different categories of tax liability will depend not only upon a complete analysis of the individual economic facts but will also go to the motive behind the original purchase of the policy and the rationale for the current sale.

Revenue Ruling 2009-13,

<u>Situation 1</u>

- On January 1 A buys a life insurance policy with a family member as the named beneficiary;
- A has all rights to change ownership and beneficiary, take out a loan, or surrender for value;
- A paid $64,000 in aggregate premiums and has received no distributions nor borrowed any funds against the policy;
- On June 15 of year 8, the contract was surrendered for $78,000 of cash surrender value which reflected the subtraction of $10,000 of “cost-of-insurance” charges.

By applying Section 72(e) the IRS states that upon the surrender of the policy A had received $14,000 of ordinary income.

Cash Surrender Value $78,000
Less Premiums Paid <u>($64,000)</u>
Equals Gain $14,000
Character: Ordinary Income

<u>Situation 2</u>

- Same facts as Situation 1 except on June 15 of year 8, A sold the life policy for $80,000 to an unrelated person who would suffer no economic loss upon A’s death
- It is noted that Section 72 does not apply to amounts received from the sale of a life insurance policy.
- A paid total premiums of $64,000. Under Section 1016(a)(1), proper adjustments must be made for any expenditures, receipts, losses, or other items properly chargeable to capital account, in this instance, the cost of the pure life insurance protection during A’s ownership of the policy.
- $10,000 was subtracted from the cash surrender value as “cost-of-insurance” charges bringing A’s adjusted basis to $54,000.
- The IRS still treated part of the gain as ordinary income, under the “substitute for ordinary income doctrine”, limiting the amount that would be recognized as ordinary income as if the contract were surrendered (i.e., to the inside build-up under the contract) and applying capital gains treatment to any amount recognized on the sale a

life insurance policy to the extent that it exceeds the “inside build-up” under the contract.

Amount Realized (Sales Proceeds) $80,000
Cash Surrender Value $78,000
Premiums Paid (Basis) $64,000
Less Cost of Insurance <u>($10,000)</u>
Equals Adjusted Basis $54,000
Total Gain $26,000
Less Ordinary Income
Portion of Gain <u>($14,000)</u>
Equals Capital Gain Portion $12,000

<u>Situation 3</u>

- Same facts as Situation 1 except the contract was a level premium 15 year term insurance policy with no cash surrender value. On June 15 of year 8 the policy was sold for $20,000 to an unrelated person who would suffer no economic loss upon A’s death.
- The monthly premium was $500, A paid $45,000 in through the June 15, Year 8 sales date.
- A’s adjusted basis was equal to the total premiums paid less the charges for the provision of insurance before the sale.
- Absent other proof the cost of insurance is presumed to equal the monthly premium under the contract of $500. The cost of insurance during 89.5 months equaled $44,750 and as $45,000 in premiums were paid the adjusted basis on date of sale is $250.giving rise to A recognizing a long term capital gain of $19,750.

Amount Realized on Sale $20,000
Premiums Paid (Basis) $45,000
Less Cost of Insurance <u>($44,750)</u>
Equals Adjusted Basis $250
Gain $19,750

- The surrender of any cash value policy triggers ordinary gain that is the difference between the total amount realized from the insurer and the seller’s adjusted basis (net investment in the contract).
- The sale of a cash value policy recognizes gain as the difference between the amount realized from the sale and the policy owner’s adjusted basis which is then determined by subtracting the cost of the insurance during the pre-sale period from the total premiums paid.
- With the sale of a cash value policy the ordinary gain will be recognized to the extent of the policy’s cash surrender value with any recognized gain above the policy’s cash surrender value to be taxed as a capital gain.

- When a cash value policy is surrendered the IRS asserts that it is the cash surrender value that contains the "cost-of-insurance" charges collected by the issuer for periods ending on or before the surrender of the contract. This "cost-of-insurance" amount is then subtracted from the amounts paid in thereby reducing the owner's basis. (The IRS does not stipulate the method of calculating this "cost-of-insurance" for cash value policies at this time). At the sale of a cash value policy, this reduction in basis gives rise to an additional gain which, if the policy was held for more than one year, is treated as long term capital gain.

When a policy that is settled in the secondary market is gifted to a charity this constitutes an added windfall in the form of an enhanced deduction.

As to a term policy, the amount received from the sale is adjusted by the unexpired portion of the last premium which is the difference between the premiums paid and the cost of the pre-sale insurance coverage, therefore, as there is no cash value and therefore no ordinary gain, any benefit from the sale of a term policy, will be taxed as a capital gain.

Defective Deductions

Historically, misguided valuations and resulting flawed deductions have been based on the policy's total death benefit, or the policy cash value or settlement value from the secondary market, without noting how the original cost affects the amount of the deduction. In other cases, policies with revocable beneficiary designations have been accepted by less-sophisticated charitable organizations and been deducted by the donor. And in yet other cases, policies have been attributed to insurance companies that have never existed.

Although there is no specific format for an appraisal of an insurance policy, it is important to address items of information that are required to be in the appraisal as specified in Notice 2006-96. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of § 170(f)(11)(E)(i)(II) if, for example, it is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation. Additional information is available at www.appraisalfoundation.org. In addition, AICPA members may be subject to standards of valuation or calculation engagements under Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset.

Qualified appraisals are a concern for taxpayers donating noncash charitable gifts of all kinds. But because life insurance has in the past been valued by insurance agents and CPAs without the training and credentials now required under the PPA, some advisers unaware of the requirements may inadvertently subject their clients and themselves to potentially draconian penalties. Furthermore, life insurance can be prone to incorrect valuation because of the plethora of types of policies available, ownership and beneficiary issues and misunderstanding of valuation methods of how to apply fair market valuation principles. Many CPAs may be more attuned to providing an estimate of the value of business interests and other types of assets rather than those required for life insurance policies. This article, therefore, is intended to help you and your clients navigate this murky minefield.

In general, the deductible amount of a donated life insurance interest is its fair market value, which is the amount an insurance company would charge for a comparable contract. If the policy has a cash surrender value, that amount is considered fair market value if the donee intends to cash the policy rather than hold it as an investment. Otherwise, for fully paid-up whole-life polices, fair market value is considered to be replacement cost. A policy that is not fully paid-up is typically valued at the lesser of either total premiums paid or the “interpolated terminal reserve,” an amount designated by the insurer to fulfill its obligations under the contract. It is similar to the cash surrender value and is available from the insurer. In any case, however, the value can be no greater than the policy’s cost basis. A term insurance policy’s value is typically the amount of future premiums that would be paid to maintain the policy.

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