

The Charitable Remainder Unitrust funded with a Life Settlement Policy The Life Settlement Unitrust

Individuals or companies purchase life insurance for a variety of reasons. The most common reasons are to provide for family if the insured were to pass away prematurely, or to protect a business from financial loss upon the demise of a key employee.

After insurance is acquired and held for several years, there may be changes in life circumstance such that the policy is no longer needed. In these situations it often does not make financial sense to continue paying the high premium payments on the life insurance policy. Upon reaching this point, the insured will either stop paying the premiums or will surrender the policy for cash. If the insured surrenders the policy, the cash value is generally a very small amount compared to the death benefit of the life insurance policy. Up until a few years ago, these were the only options an insured had available.

In the 1980's a new alternative arose in the insurance area -- a viatical settlement. Viatical settlements were a way for terminally ill patients to obtain needed cash by selling existing life insurance policies to viatical settlement companies. A life settlement is similar to a viatical settlement in that it involves the sale of a life insurance policy for an amount that is greater than the cash value, but less than the death benefit. The main difference is that, unlike a viatical, with a life settlement the insured is not terminally ill.

With the payment of a life settlement amount of 20% to 80% of the face value of the policy, an insured could recognize a substantial amount of capital gain on the sale of the policy. This presents the opportunity for some charitable planning to avoid the capital gains tax and benefit to a charitable organization.

If the insured transfers the policy to a Charitable Remainder Unitrust (CRT), he or she would receive a charitable income tax deduction. The deduction would be calculated for a capital asset that has an element of ordinary income in it. The deduction would be based on fair market value less the ordinary income element. This is similar to the case with real estate transfers to a Unitrust, if the real estate has been subject to accelerated depreciation.

How would the fair market value of the policy be determined? Just as with any other asset where a deduction over \$5,000 is claimed, a qualified appraisal would need to be performed. Many readers may be unaware that it is possible to appraise an insurance policy. But, there are individuals and companies out there that perform this type of service. To find one, go to an internet search engine such as Google and search for "life insurance appraiser."

When the policy is transferred to the Unitrust, the policy may be sold to a life settlement company. Because the Unitrust is tax-exempt, the sale of the policy will not be subject to capital gains tax. This nice benefit allows the policy to be sold tax-free and the proceeds invested elsewhere.

Even though the donor did not receive a tax deduction for the full value of the policy due to the ordinary income element, the payout from the trust will be based on the fair market value of the policy in the first year. In the next year, the payout is based on the sale price plus any accumulated earnings. There may be an increase in income for the donor, since the life insurance policy would have not been paying the donor any income.

The transfer of the life insurance policy to a Unitrust provides the donor or insured with the "B-I-C" benefits. These benefits include bypass of capital gain, an increase in income and a charitable deduction that can be used against current income. Further, it allows the donor to use an existing policy that he or she might have otherwise let lapse to support one of his or her favorite charities.

Example

Don and Donna Donor, age 79 and 77, own a universal second-to-die life insurance policy with a face value of \$6 million, a cash surrender value of \$200,000 and a life settlement value of \$800,000. The Donors have already paid \$300,000 in premium payments on the policy. Don is approaching retirement. With Don's upcoming retirement, the Donors no longer wish to continue paying the annual premium of \$75,000 per year and would like to receive a little more income so they can visit their grandchildren. The Donors do not want to lose the value already paid in premiums, but if they surrender the policy, the cash value is very low. Don sits on the board of ABC charity and has been asked to make a gift to the organization.

Don and Donna could transfer the policy to a 5% Unitrust that pays income for their joint lives and then to the survivor. Based on the facts, the Donors would receive a charitable deduction of \$438,464. This deduction will help to offset the

larger amount of income they are receiving while Don is still working. The deduction is based on the premiums paid of \$300,000 and the total value of \$800,000. Since the cash value is lower than the amount of premiums paid, there is no reduction for any ordinary income. Based on a 7% trust return and a life expectancy of 15.3 years, the Donors can expect to receive over \$700,000 in income over their joint lives. In the first year, the Donors will receive \$40,000 of income (5% of \$800,000) plus they do not have to make the \$75,000 premium payment. This provides the Donors with \$115,000 of net positive cash flow in the first year. Further, Don is able to make a wonderful gift to ABC charity. With the 7% trust return and 5% payout, ABC charity can expect to receive over \$1 million at trust maturity.

Conclusion

Life Settlement plans are a new option within the insurance area. They provide a great alternative for people who no longer need the life insurance policies. While the IRS has not yet issued guidance on the type of gain for the difference between the life settlement payment and the cash value, a basic analysis of established tax law should lead to the conclusion that gain from life settlements should be classified as capital gain.

The Unitrust along with the life settlement provides a wonderful opportunity for those that have charitable intent to use unneeded policies to bypass capital gain, receive an increased income and to make a wonderful gift to charity.

If you have a client philanthropically motivated, funding a Charitable Remainder Unitrust with a life product for positioning on the life settlement market may provide an option to accomplish several of their personal and financial goals. Contact me if you need assistance in this area of planned giving.

For help with this issue, contact Edward W. Cotney at the Wordell Law Group. www.WordellLaw.com

Wordell Law Group
204 North Pine Street
Nevada City, CA 95959

530-470-0900 Phone
530-470-0909 Fax