MassMutual

Estate Planning

Strategies for getting started

Estate planning can be a daunting task filled with acronyms like CRUT, GRAT, ILIT, and other terms that may sound like a foreign language. This guide should help decipher some of those "foreign" terms. Estate planning is one of the most important things you can do for yourself and your family. Without any planning, assets will pass at your death according to the rules of the state that you live in. Depending on the complexity of the estate, this could create some inheritance and tax issues. Therefore, it is important that all adults create at least a simple will that states how they wish assets to be distributed at their death. Nevertheless, the larger the estate is, the more likely that a simple will may not be enough. That is where more complex strategies such as trusts may come in.

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The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

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Once you decide that you are ready to create an estate plan, the next step is to find an attorney. Before you meet with him or her, it is a good idea to do some preliminary work. Make a list of your assets (financial, real property, personal property, and business interests) and think about who you want to give your property to. You should also think about who you want to serve as the fiduciary(ies) for your estate plan (i.e., guardian if you have minor children, executor, and/or trustee).

If you have charitable objectives, you may also want to make sure these objectives are part of your estate plan and are communicated to your personal attorney. Generally, they will have their own planning questionnaires, but your pre-planning can help you to be better prepared for questions your attorney will ask.

This guide is designed to provide a short overview of multiple estate planning techniques from simple to complex that you may want to use in your estate plan.

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Personal Planning

Estate Planning

Estate planning is the process of transferring your estate during life and/or at death to others. The purpose is to utilize the exemptions allowed by the state and federal government to efficiently move assets to heirs with the least amount of inconvenience, taxes and other transfer expenses. For families with minor children, this process would most likely include designating a guardian for the children. Commonly heard terms associated with estate planning are wills, powers of attorney, ILITs, and life insurance.

Grantor

Grantor is a term for the person who is creating and generally funding a trust.

Power of Attorney (POA)

A **power of attorney** is defined as a document that provides another person with authorization to act on behalf of the author or signer of the document in a legal or business matter. The person who gives the power is the grantor of the power and the person who receives it is the agent, also known as the "**Attorney in Fact.**" A power of attorney agreement is written to provide that if the signer is unavailable or unable to make decisions or take action, there is someone who is legally able to act on his or her behalf.

Durable Power of Attorney

A **durable power of attorney** is a common type of power of attorney where the power to act on the signer's behalf will still exist even if the signer becomes incompetent. Without a durable power of attorney, a friend or family member of someone who has become incompetent would have to petition an appropriate court for the authority to act on behalf of the incompetent person. This person would be subject to the oversight of the court until the recovery or death of the incompetent person.

Irrevocable Life Insurance Trust (ILIT)

An **ILIT** is a type of trust that is most often used to own life insurance policies, though it can hold many other types of assets. This type of trust is a common estate planning tool that is often recommended to those who wish to minimize the size of their estate by keeping any life insurance policy death benefits out of their taxable estate. To accomplish this, a life insurance policy is applied for by the trust, or an existing policy is transferred to or purchased by the trust, and the premiums are paid through gifts to the trust by the grantor(s). Since the policy is no longer owned by the grantor, the death benefit is no longer part of the grantor's estate. This, in effect, lowers the size of the grantor's estate, while providing the grantor's heirs with access to a sum of money on their death that they can use to pay estate taxes.

It is important to know that an ILIT is irrevocable. That means once you've created it and funded it, you cannot change your mind and ask for the gift or the life insurance policy to be returned to you. However, the grantor will at least have indirect control over many other aspects of the ILIT. For example, you can specify who your initial beneficiaries are, and you can create the terms under which they will receive benefits. You also get to choose the trustee (or trustees) who will manage your ILIT.

Please note: If an existing policy is transferred to the ILIT and not purchased by the trust, the grantor must survive the transfer by a period of three years, or the policy death benefit will still be includable in the grantor's taxable estate.

Dynasty Trust

A **dynasty trust** is an estate planning tool that may help to provide money to your loved ones for generations to come. Instead of passing money directly to your children at your death, the assets are kept in a trust. The trust helps protect the assets transferred to it from estate taxes, divorce, creditors, and uncontrolled spending, while remaining available for the family for generations. A dynasty trust is a type of an ILIT.

Unlimited Marital Deduction

The **unlimited marital deduction** allows for the transfer of an unlimited amount of property directly to or in a qualified trust for a U.S. citizen spouse without paying gift or estate tax on the transfer. This transfer can take place during life or at death.

A transfer at death for the benefit of a non-citizen spouse can still qualify for the unlimited marital deduction if the property is placed in a Qualified Domestic Trust (QDOT). The surviving spouse must be entitled to all of the income from the QDOT. Any distribution of trust corpus (the assets of the trust other than current income) to the surviving non-citizen spouse, other than for extreme hardship, triggers a deferred estate tax.

Estate Tax Exemption Amount

The **estate tax exemption amount** represents the amount of assets includable in your taxable estate that can be transferred at your death to anyone other than your spouse without having to pay federal estate taxes. This includes assets such as IRAs and other investments, real property, bank accounts, and life insurance that is personally owned. Any assets personally owned over the exemption amount are subject to federal and possibly state estate tax.

The Tax Cuts and Jobs Act of 2017 provides for a federal estate tax exemption amount of $10,000,000 per person ($20,000,000 per married couple), which is indexed annually for inflation. This is due to expire on December 31, 2025. The IRS revises the exemption amount each year based upon cost of living adjustment calculations. Please see IRS.gov for additional information. It is important to note that each state that imposes a tax has its own exemption amount, which may not be the same as the federal amount.

Annual Gift Exclusion Amount

The **annual gift exclusion** is the amount that you can gift to another person on a yearly basis without using any of your lifetime gift exemption (described next). Currently, the exemption amount is $15,000 per year per person (2020). Therefore, if a person wishes to give to three different people, they can gift up to $45,000 per year.

Lifetime Gift Exemption Amount

The **lifetime gift exemption amount** is the amount of assets that you can gift to others during your lifetime without having to pay gift taxes on the gift. Like the estate tax exemption amount previously discussed, the Tax Cuts and Jobs Act of 2017 also increased the exemption per person, indexed for inflation thereafter. This is also due to expire as of December 31, 2025. Please see IRS.gov for additional information.

Please note: Any gifts you make during your lifetime above the annual gift exclusion amount are added back to your taxable estate at death. Your taxable estate is then reduced by the estate tax exemption amount available at the time of death. In essence, the gifts you make during your life pre-use the estate tax exemption available at your death.

Credit Shelter Trust

A **credit shelter trust** is a type of trust that is often used by married couples to pass assets for the surviving spouse and heirs that will not be includable in the surviving spouse's taxable estate. Each spouse can put up to the estate tax exemption amount into his or her credit shelter trust[1]. The trust or trusts are drafted while both spouses are alive but are generally funded at the death of the first spouse with an amount equal to his or her estate tax exemption amount.

The surviving spouse will generally be an eligible beneficiary of the trust income and trust principal if necessary for the surviving spouse's health, education, maintenance and support.

The eventual beneficiaries of this type of trust are usually the children of the grantor. Another term for this type of trust is a **"bypass trust,"** as it bypasses estate taxes at the death of the surviving spouse and is passed to the beneficiaries free of estate tax. This type of trust is most commonly used when marital assets of the couple are near or over the estate tax exemption amount.

A common use for credit shelter trusts is a type of estate planning known as a "Marital A/B Trust" arrangement. Under this arrangement, the credit shelter trust (trust B) will hold the amount of assets up to the estate tax exemption amount, and the marital trust (trust A) will hold the rest of the assets. Many times, both spouses will set up this type of arrangement.

[1] Reduced by any prior gifts in excess of the annual exclusion amount.

Portability of Estate Tax Exemption Amount

Upon the death of the first spouse, the surviving spouse is able to add what is left of the estate tax exemption amount unused by their spouse to their own gift and estate tax exemption amount by making a timely election on the decedent's estate tax return. This is referred to as **portability of a deceased spouse's unused estate exemption amount** (DSUEA). The availability of portability has reduced or eliminated, in some instances, the need to create a credit shelter trust at the death of the first spouse.

Private Split Dollar Planning

Private or family split dollar planning can be an effective way to provide life insurance protection to take care of your family's estate planning needs without requiring you to make large taxable gifts to pay the annual life insurance premium. There is a lot of flexibility in how these arrangements can be set up. A common arrangement has the insured or the insured's spouse as the premium payor, with the insured's ILIT (or sometimes the insured's children) as the owner of the life insurance policy.

This type of planning is used with permanent life insurance. Under a split dollar arrangement, the premium payor owns all of the life insurance policy cash value, both during life and at the death of the insured. The remainder of the policy death benefit is paid to the trust or other beneficiary. When the insured is the premium payor, there is a "deemed" gift each year of the term insurance value of the death benefit that would be paid to the beneficiary if the insured died during that calendar year. If someone else is the premium payor, the arrangement may require that the trust or other beneficiary contribute to the annual premium an amount equal to the term insurance value.

Private Premium Financing

Life insurance policy premiums can be paid partially or fully with loans from the insured to the insured's ILIT. In some instances, it may be beneficial to pay the premiums partially with annual exclusion gifts and partially with loans. The loan must bear interest at least equal to the applicable federal rate (AFR), or an imputed amount of interest will be treated as a gift from the insured to the ILIT under the below market rate loan rules of IRC Section 7872.

The ILIT trustee may use future policy cash values[2] to make payments on the loan to the insured. Regular payments on the loan may be used by the insured to supplement his or her retirement income.

[2] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Qualified Personal Residence Trust (QPRT)

In a **QPRT**, the grantor transfers (gifts) his or her residence to a trust but keeps the beneficial right to use it for a specific period of time that the grantor chooses in the trust agreement. At the end of the term, the residence is given to the beneficiaries of the trust. The goal is to transfer the home to the beneficiaries at a discount from the home's actual value. This is possible because the gift of the residence is reduced by the value of the grantor's right to continue to live in the residence during the term of the trust.

It is important to pick a length of time that the grantor believes that he or she will outlive. If the grantor dies before the term is up, the residence will still be in his estate. If the grantor outlives the term, it will transfer to the beneficiaries free of further estate or gift tax. The grantor can continue to live in the residence, but must begin to pay fair market value rent to the beneficiary, who now owns the property.

Third-Party Premium Financing

Third-party premium financing involves obtaining the funding to purchase a life insurance policy from a third party or financing company. The borrower must sign a formal agreement and is frequently required to provide collateral in addition to the life insurance policy that was purchased. The loan may last from one year to the life of the policy. The financing company pays the premium, then bills the borrower on a monthly, quarterly, or annual basis for the cost of the loan. Traditionally, premium financing is for those who intend to keep the policy to maturity. This is done usually for estate liquidity needs, when a person has a large, mostly illiquid estate (i.e., real estate, partnership share).

Installment Sale to Intentionally Defective Irrevocable Trust (IDIT)

Sometimes called a grantor trust, the **IDIT** involves a sale agreement between a grantor and an irrevocable trust that allows the grantor to make gift tax-free transfers to the trust beneficiaries. The trust is "defective" in that it is designed to be a grantor trust for income tax purposes, and for that reason, it is not a separate entity distinct from the grantor.

Here is how it works: The grantor sets up the IDIT and makes an initial transfer of assets up to his or her lifetime gift amount. This is used as seed money for the purchase of other assets from the grantor by the trust. The trust buys these additional assets in exchange for an installment note payable over a certain number of years. The trustee uses the income generated by the assets in the trust to pay the installment note debt to the grantor. Because the grantor and the trust are the same taxpayer for income tax purposes, all income generated by the assets are reported on the grantor's income tax return. There are no income tax consequences related to the transaction between the grantor and the IDIT.

One reason the installment sale strategy is used is that it can help the grantor reduce the size of his or her taxable estate. This strategy may be suitable for dynasty trusts if the grantor would like to benefit future generations. Also, this technique is very effective when the assets being sold to the trust are capable of being discounted, such as family limited partnership (FLP) or limited liability company (LLC) interests. Sometimes the trust has enough income left over after meeting its payment obligations to the grantor to pay the premiums on a life insurance policy purchased by the trust on the grantor's life. The IDIT trust would function in the same way as the ILIT discussed previously.

Life Insurance for the Blended Family

The majority of families have shifted from the original, biologically bonded mother, father and child, according to The Stepfamily Foundation.[3] This requires a precise type of planning on behalf of the parents to make sure that their assets will be divided as they wish at their deaths. First, it is important to have a will drafted and kept up to date. That will help to ensure that the parents' assets are passed according to their current wishes and they do not leave anyone out due to having an outdated document. With a blended family, one possible strategy is to use life insurance, having a policy or policies with beneficiaries in the amounts that the parents wish to leave each person in the family. This can help to equalize the amount being left to each beneficiary and help to minimize or possibly prevent family strife. The concept of purchasing insurance to even out what is given to each beneficiary is also known as estate equalization.

[3] (www.stepfamily.org/stepfamily-statistics.html)

Estate Planning With Business Assets

Discounting

Discounts are reduced values for some assets that may not have an effective or ready market for several reasons. One of the most common reasons assets can be transferred at a discount is that they are not readily marketable. Marketability is how fast the asset could be converted to cash. The longer it would take to convert, the less marketable it would be. An example of this would be a share of a family-owned small business. It would likely take longer to convert that asset to cash than a share of an investment portfolio. Another reason is if the transferred interest is a minority share in a business. The discount for a minority interest is determined largely by the degree of control that the owner of the minority interest has. The less control one has, the larger the discount. Discounting is also seen in the discussion of family limited partnerships. Determination of the size of a valuation discount begins with an analysis of the fair market value of the underlying assets. Once the fair market value of the assets has been determined, a discount analysis is done to arrive at the fair market value of the gift being made.

Family Limited Partnerships (FLP)

An **FLP** is often used to help facilitate the transfer of assets from one generation to another. The transaction usually begins with the older generation transferring assets to a newly formed limited partnership. When the transfer is made, the older generation will own all of the partnership interests (general and limited partnership interests). At this point, no gifts have yet been made. The older generation then gifts limited partnership interests to the children and/or grandchildren directly or to a trust set up for their benefit. With a limited partnership interest, the children will not have much if any say in the running of the business. They just receive the economic benefit of their share or shares. The older generation with the general partnership interest still has authority over the running of the business.

Because the limited partnership interests are not easily marketable as described in the discounting paragraph, the value for gifting purposes may be less than the same percentage of value of the assets of the partnership for estate tax planning purposes. Often, interests in an FLP may not be transferrable outside the family, hence the term family partnership. Increasingly, LLCs are used in a similar way.

Self-Canceling Installment Note (SCIN)

A **SCIN** involves the sale of a business interest, stock, or an interest in real estate or other asset, typically to one or more family members of the seller or to a trust for their benefit, in exchange for an installment note with a term shorter than the seller's life expectancy. One notable feature is that the note in a SCIN includes provisions for automatic cancellation of the unpaid balance at the death of the seller. The SCIN is a promise, given by a buyer to a seller to buy an interest with a feature that the obligation to make payments ends at the seller's death. If the seller lives longer than the period over which payments are made, the "cancel at death" feature of the agreement is ignored. If the seller dies during the term, the buyer's obligation to make payments ends on the date of death. The goal of this strategy is twofold: first, the exclusion of the unpaid balance of the note from the seller's estate and second, the avoidance of any gift tax on the transfer. So a SCIN helps enable an asset to be kept in the family while its value is frozen for estate tax purposes. This can be particularly useful during economic conditions in which asset values are low at the same time interest rates are relatively low.

Note: There is a cost to the self-cancellation feature of the SCIN. The buyer (borrower) will have to pay either a higher interest rate or an enhanced note value. If the note is fully repaid before the death of the seller, the buyer will have paid more for the asset than if the note did not contain a self-cancelling feature.

Estate Equalization

Estate equalization is used in business and personal planning, which sometimes overlap. In a business planning context, it is used for people whose primary asset is the family business. They often want all of their children to inherit "equal" shares of their estates. That becomes difficult when some of the children are working in the business and others are not. Business owners often feel that their children working in the business should be rewarded for their efforts, yet they do not want the others to be left out. One answer is for the children working in the business to own life insurance on the life of their parent or parents. Upon the death of the parent(s), the children working in the business will use the death benefit amount to buy the business from the parents. With the death benefit amount, the estate of the parent should have enough liquidity to pay expenses and give an equal inheritance to all the children.

This strategy also provides funds to support a surviving spouse who is not actively involved in the business. Another idea is for the actively involved children to own enough life insurance to buy out the interest of their siblings that are not involved. Alternatively, the parent can purchase life insurance to enhance the value of his or her estate enough to provide about the same inheritance for the children that are and are not involved in the business. Depending on the value of the business interest, the parent may not want the death benefit of the life insurance policy to be in his or her taxable estate. In that case, the parent could utilize an ILIT or have the child who is the beneficiary of the policy own it. It is important to look at annual gift exclusion amounts and lifetime gift exemption amounts when using this strategy to help ensure that the funding for the policy is done in a tax-efficient manner.

Grantor Retained Annuity Trust (GRAT)

A **GRAT** is a type of trust that is generally used to help facilitate a transfer of assets to the next generation with lower gift taxes. The trust is established by the grantor to last for a specific number of years (term of trust). During that time, the trustee of the trust will distribute a set amount to the grantor either on a yearly basis or more often as is written in the trust. At the end of the term of the trust, the trustee distributes all remaining assets to the trust's remainder beneficiary or beneficiaries, generally the grantor's children or a trust for the grantor's children. When the grantor puts assets in the trust, he or she is making a taxable gift to the trust. The value of that gift, however, is reduced by the value of the grantor's retained interest (the present value of the distributions to be made to the grantor prior to the termination of the trust).

The larger the retained annuity interest, the more the value of the taxable gift is reduced at the funding of the GRAT. This strategy is more effective in a lower interest rate environment, as the lower the interest rate, the higher the value of the grantor's retained annuity interest, thereby reducing the value of the gift. The GRAT strategy works more effectively when the assets used to fund the trust have good cash flow since the trustee must distribute the specified annuity amount whether out of income or other trust assets. This strategy can be leveraged even further by gifting assets that can be discounted, such as family limited partnership interests or closely held business interests.

Example:

John is 60 years old. He would like to transfer 25% of his $3,000,000 corporation to his son, James. He can gift it to him outright, but then would use some of his lifetime gift exemption. Since this is property that is not easily made liquid, he can take a discount[3] on the gift. If he puts the $750,000 property into a GRAT and takes a 20% discount, his gift into the GRAT would be $600,000. John picks a term of 10 years and an annual annuity interest of 10% or $60,000 per year for the term of the trust and assumes an IRS mandated interest rate of 2.2%. The value of John's annuity is $533,358, resulting in a taxable gift of $66,642. When the trust ends in 10 years, the remaining value will be distributed to James completely gift tax free since the gift was reported when John initially made the gift to the trust.

Buy-Sell Agreement

A **buy-sell agreement** is a contract that is entered into between the owners of a business that governs what is to happen to the business interests in the event one of the owners/shareholders dies, becomes disabled or leaves the business. These agreements are generally funded with disability insurance and life insurance. A buy-sell agreement should state who can buy the exiting owner/shareholder's shares. It should also identify the specific events that would trigger the sale, whether it is death, disability, termination, retirement or an event such as divorce or the bankruptcy of an owner. Lastly, this agreement will state what price is to be paid per share or how the price will be determined at the time of sale.

There are essentially two different types of buy-sell agreements, a cross purchase buy-sell agreement and an entity purchase buy-sell agreement. There are numerous factors involved in the determination of which type of arrangement to use. Therefore, it is important to discuss the alternatives with the attorney drafting the agreement to help ensure the correct decision is made for the specific business involved.

Cross Purchase Buy-Sell Agreement

A **cross purchase buy-sell agreement** is structured so that each owner/shareholder has the primary obligation to purchase the shares of the other. Typically, each owner/shareholder purchases an insurance policy on all of the other owners/shareholders to fund this obligation at death. This is most commonly used when there are only a few people involved in the agreement. For example, if John and Jane were co-owners of a company, John would have an obligation to purchase Jane's shares at her death and own a policy on Jane and vice versa. If George was an owner as well, George would need to buy a policy on both Jane and John, and Jane and John would need to buy on both of the other owners. This would lead to six policies being purchased for this agreement. It depends on the individual situation of the company as to whether this is the most effective strategy. The other option is an entity purchase buy-sell agreement, which tends to be used when more than a few owners are involved.

Entity Purchase Buy-Sell Agreement

An **entity purchase buy-sell agreement** is structured so that the business entity itself has the obligation to purchase the business interests of an owner at death. The business entity typically purchases and is the owner of the policies on all of the shareholders/owners that are involved in the agreement. If Betty, Jane, and Sara own a company, the company would purchase three policies, one on each of them, instead of the six that would be necessary to fund a cross purchase buy-sell agreement. This strategy is used more often when there are larger groups of owners/shareholders involved or where the people involved don't wish to individually own the policies on each other. This strategy may also be used when there is a large difference in what the premiums would cost each owner based on age or health differences. A benefit of this method is that the company pays the premiums on the policies and owns them. Having the company own the policies may add assets to the company's balance sheet, which may be advantageous in obtaining financing, meeting loan obligations, or having a ready source of cash to take advantage of a business opportunity or meet an emergency need.

Charitable Planning

Charitable Remainder Trust (CRT)

A **CRT** is a vehicle that is used for people wishing to make a charitable donation but still retain an income interest for themselves or their non-charitable beneficiary before the gift is made to the charity. There are two types of charitable remainder trusts that we will discuss here, the **charitable remainder annuity trust (CRAT)** and the **charitable remainder unitrust (CRUT)**. A significant difference between these two types of trusts is how the amount of the income interest that is paid to the donor or the donor's beneficiary on an annual basis is calculated. With charitable remainder trusts, it is important to work with an experienced trustee or (tax advisor) who understands how to do the valuations as well as the rest of the recordkeeping requirements involved.

- A **CRAT** is a trust that pays the donor or the donor's beneficiary a fixed amount of income from the trust on a yearly or more frequent basis. There are two choices for when the charity gets the money from the trust, either after a specific period of time or upon death of the donor and/or the donor's successor beneficiary. This flexibility allows the donor to choose whether to receive income for the rest of his or her life or whether the donor would like to see the charity get the money during his or her lifetime.
- A **CRUT** works in a similar manner to the CRAT. The difference is that instead of the donor or other non-charitable beneficiary being paid a fixed amount annually, he or she is paid a fixed percentage (at least five percent) of the value of the trust annually. The value must be calculated once per year on December 31st, for distributions to be made during the following calendar year.
- With either a CRAT or CRUT, at the time the trust is funded the present value of the charitable interest (after subtracting the value of the donor's retained interest) must equal at least ten percent.

Charitable Lead Trust (CLT)

A **CLT** is another vehicle for accomplishing charitable objectives. The principal difference between this type of trust and a charitable remainder trust is that payments are made from the trust to the charity on an annual basis for a specified period of time while the donor is alive. After the term of the trust, the remainder is distributed to the non-charitable beneficiaries specified by the donor when the trust is set up. In many cases, the remainder beneficiaries of this type of trust are the donor's children or other relatives. The assets in a charitable lead trust can either be distributed as a fixed amount per year which is known as a **charitable lead annuity trust (CLAT)** or as a fixed percentage of the trust valued yearly, which is a **charitable lead unitrust (CLUT)**.

Donation of Property

A donor can make a gift of real or personal property to a charity during life. The property is transferred by title, deed, or other method of ownership change to become officially owned by the charity. The donor may be able to get a deduction for the gift of the fair market value of the property that was given subject to the charitable deduction percentage limits. The donation of property is not always just a simple transfer of ownership. One example is using appreciated non-income-producing property such as real estate to fund a charitable remainder trust. Assets gifted into the trust can then be sold by the trustee and reinvested into income-producing assets without triggering a current tax on the gain, although the payments from the CRT will be taxable to the extent that the trust has taxable income or gain. The donor receives an income tax deduction equal to the fair market value of the gifted assets minus the value of the income interest kept by the donor and other secondary beneficiaries.

Charitable Giving With Life Insurance

Naming a Charity as Beneficiary

This is a simple way to utilize life insurance to help make charitable donations. The donor purchases a policy or uses an existing policy and names the charity of their choice as beneficiary. At the donor's death, the charity receives the life insurance death benefit as a donation. The donor continues to pay the premiums on the policy for life. He or she cannot take an income tax deduction for premium payments because they retain an ownership interest in the policy. The donor has the ability to change the beneficiary of the policy at any time during their life.

Gifting an Existing Policy

A donor can take an existing life insurance policy and change the ownership and beneficiary to a charitable organization. The donor would usually continue to pay the premiums for that policy, and when the donor dies, the life insurance death benefit is paid to the charity. By using life insurance, the insured can leverage their dollars to leave a larger gift to the charity of their choice than they may otherwise be able to do if just donating money. Also, the donor may be able to get a deduction for the lower of the value of the policy or the cost basis, subject to the charitable deduction percentage limits. However, if the value of the policy is over $5,000, the donor has to get a qualified appraisal of the policy in order to claim a tax deduction.

Gifting a New Policy

In this case, the donor would apply for a life insurance policy as the insured person. The charity would be the owner and beneficiary of the policy from the beginning. Each year, the donor would gift the equivalent dollar amount of the policy premium to the charity. The charity would then use that money to pay the life insurance premium.

The donor may be able to deduct the amount of the premium on their taxes as a charitable contribution subject to the charitable deduction percentage limits. However, the donor has no ability to change the beneficiary should he or she become disenchanted with the charity that was chosen, nor is the charity obligated to continue paying the premium on the policy. This is important for the donor to remember as the donor is making the choice of charity. Wealth Replacement Trust (WRT)

In some cases, a charitable donor would like to benefit his or her favorite charity but does not want to disinherit his or her family by the amount of the donated gift. Creating and funding a WRT is a strategy by which a donor replaces the property that was gifted to the charity. The way this strategy works is that the donor applies for a life insurance policy equal to the value of the property gifted to the charity. The donor, working with an attorney, establishes an ILIT that will own the life insurance from the time it is issued. If properly designed and implemented, the life insurance will be out of the donor's taxable estate.

One important note is that the donor, as with any irrevocable trust, will have no control over the life insurance once it is in the trust. Thus, it is important for the donor to make sure the terms of the trust reflect his or her wishes before it is finalized.

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