COMMITTEE REPORT:
INSURANCE

By **Jon B. Mendelsohn**

How Charities Decide to Keep, Surrender or Sell Donated Life Insurance

A life settlement may be an overlooked option

I recently attended a charitable planning conference that brought together the top professionals from the charitable development sector with experienced attorneys, financial planners and accountants who work with charitably minded clients. One of the most well-attended sessions was a panel focused on innovative ways to generate immediate charitable gifts beyond the standard strategies, namely by using non-cash assets. The session description included a section related to an orderly process for managing and maximizing life insurance gifts. As an independent life insurance valuation and life settlement professional with over 25 years of experience in the industry, I was glad to see this! For too long, life insurance has been a taboo subject that many charities shy away from, or they have a one-step process of immediately surrendering the policy for the cash value without any analysis. However, with approximately 51% of the U.S. population owning life insurance,[1] it's simply too large of an asset class to omit from charitable planning discussions with donors, particularly in light of the tremendous opportunities.

Common strategies to donate a life insurance policy include:

(1) The original owner changes the policy ownership and beneficiary to the charity. The charity can then decide if they wish to continue paying premiums or if they prefer to cancel the coverage and receive the cash surrender value.

(2) The donor maintains ownership of the policy and makes the charity a partial or full beneficiary. This allows the donor to control ongoing premiums and adjust the charitable contribution amount, if desired.

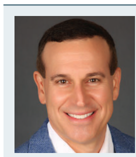
Third Overlooked Option

A third and often overlooked option is for a policy owner to consider a life settlement. The current policy owner can sell the life insurance policy and receive a buyout for an immediate cash payment higher than the cash surrender value and less than the death benefit. The original policy owner or the charity that owns a donated life insurance policy can explore a life settlement option. The first step is to receive a nonbinding appraisal of the life insurance policy that will indicate value. No medical exam is required for the insured, and there are no requirements to continue down the life settlement path if the range of value isn't appealing. A charitable life settlement might be an option when:

- There's insufficient cash in the policy to pay the required premiums.
- The donor can no longer make premium payments.
- The charity has a need for the funds today.
- A policy owner wants to donate the policy for a deduction because it's no longer needed.

A life settlement can free up future premium dollars for other planning opportunities. If the donor exchanges the life insurance policy for cash through a life settlement, the donor can reallocate those dollars to their charitable giving.

The charity can exchange an existing donated policy for cash through a life settlement. This can



Jon B. Mendelsohn is the chief executive officer of Ashar Group LLC

be especially useful when policies don't perform as projected or when the policy was believed to be paid up. Typically, it's brought to attention when there isn't enough cash value and escalated premiums become due. These challenges have caused some charities to stop accepting insurance gifts altogether.

Unlocking Unrealized Value

A life settlement can unlock unrealized value in the life insurance policy. Here's one best-case scenario example of how it can work:

A wealth advisor and attorney had a 79-year-old client who had gifted away most of their wealth, so they no longer needed their $5 million life insurance policy for estate-planning purposes. The advisor and attorney completed an analysis of what cash reserves would be needed to pay premiums to keep the coverage or if it made more sense to surrender the policy for the $250,000 of cash value. As part of the analysis, they had an independent policy valuation, which uncovered a life settlement value of $1.5 million. This unlocked immediate value to the client that they could allocate to charitable planning goals and free up the $150,000 annual premium that had been budgeted for keeping the policy. This became a win-win as the client invested the additional $1.25 million (difference between cash value and life settlement value) and redirected $12,500 per month of previous premium dollars to multiple charities rather than paying for a life insurance policy they no longer needed. The client was able to witness how the charities benefited from the donations and was featured in one charity's newsletter and honored at a gala, which motivated other donors to make additional gifts. It was a win for all parties.

Break-Even Analysis

A charity's financial decisions should be based on a reasonable process and all available data points. Keeping or selling an existing donated life insurance policy is no different. There should be a crossover analysis of when it makes sense to continue paying premiums at the current level, reduce the death benefit, surrender the policy or consider a buyout in a life settlement. This break-even analysis should be facilitated with the assistance of qualified allied professionals (financial advisors, attorneys, tax and life insurance agents who work closely with charities) or an independent consultant who can alleviate this technical work from the charity and its staff. These professionals should have an extensive understanding of longevity, as that will directly impact the projected time frame for premiums to be paid. The longer the life expectancy, the more premiums will be required in the future. The team should have a process for requesting current policy information and illustrations.

Most importantly, when considering a life settlement, the charity and insured must ascertain the professionals' experience level. Have they completed a few transactions or thousands? Do they have access to a database of comps for which similar policies are sold in the life settlement market? Does their process yield the highest offer if they sell the policy?

Monitoring Donated Policies

It's important for charities to monitor their life insurance policies. Here's a real-life example of what can happen if they don't.

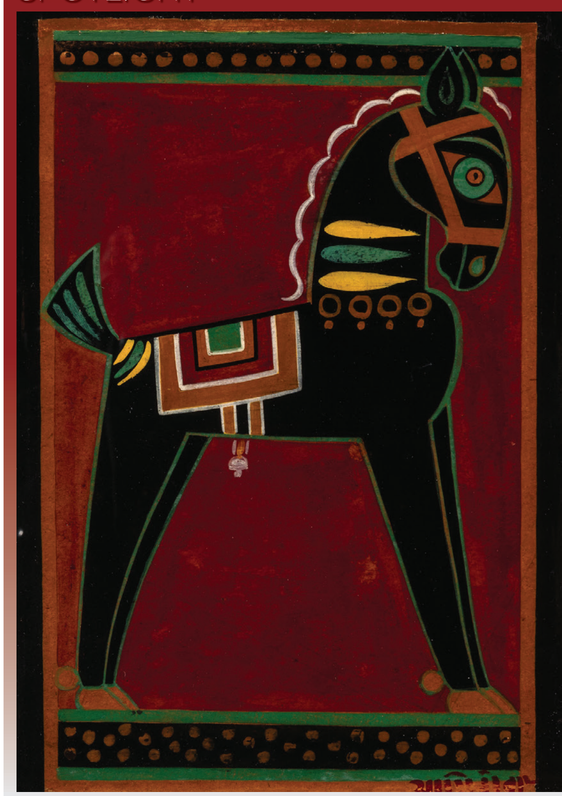
SPOTLIGHT

Ruff Play

Dog Family by Nguyen Tu Nghiem sold for $8,320 at Doyle Fine Art & Photographs auction on Dec. 5, 2024 in New York City. Nghiem is considered one of the founding fathers of Vietnamese fine art. He painted Vietnamese folklore in a European post-Impressionist style and was particularly known for painting in lacquer.

In a conversation I had with a university foundation, the head of planned giving shared that they had over 20 life insurance policies donated over the years, and it had become difficult to report back to the CFO whether additional premiums would be due and when they would expect to receive the payouts. The annual statements were filed each year, and the illustrated premiums were paid based on the original illustration provided at the donation. This resulted in some very close calls in which policies almost lapsed due to the impact of the low interest rate environment on policy values. There were even a few tragic situations in which policies were surrendered due to limited timing for exploring solutions to restructure the policies so they could stay in force longer. The charitable planning team relied on experts to make recommendations about other hard-to-value assets, equities, artwork and real estate. Why couldn't they do the same for life insurance? Doing so would help avoid the cancellation of donated policies and preserve relationships with donors who otherwise wouldn't see the intended proceeds go to the charity.

SPOTLIGHT



Poker Face
Black Horse by Jamini Roy sold for $8,960 at Doyle Fine Art & Photographs auction on Dec. 5, 2024 in New York City. An Indian artist, Roy began his career as a commissioned portrait painter. He transitioned from painting in the Western style he was trained in to a style based on Bengali traditions. He created some 20,000 paintings in his career!

Completing the Analysis

Monitoring and valuing life insurance can save a charity millions in unnecessary premiums or prevent the charity from losing out on future death benefit payouts. A timely and ongoing analysis can provide choices to stay on course or restructure the policy so it lasts longer when necessary, like when the insured is living longer than anticipated. Due to the multi-decade low interest rate environment, many policies didn't deliver the projections illustrated when the policy was first issued. In addition, life expectancy assumptions were incorrect, and wealthier clients lived longer than expected, which resulted in either more premiums being due or policies being canceled:

> Life expectancy increases continuously with income. A study from 2016 of 1.4 billion de-identified tax records, from 1999-2014, found that the life expectancy gap between individuals in the top and bottom 1% of the income distribution in the United States is 15 years for men and 10 years for women.[2]

Practice tip: Rely on allied professionals and consultants to follow a process that can minimize mistakes and identify improvement areas. They'll need to have a strong understanding of life insurance product types and the pros and cons of each plan. The key factors include maturity dates (lapse age), riders that may be included, the insurance company responsible for paying the claim, the insurance company's financial strength, how the policy values are credited, expected premiums, confirmation of premium payments applied and confirmation of owner and beneficiary designations.

Although generally simplistic, term policies also need to be reviewed. Additional key factors for term policies include the type of term policy, riders available, level term period, conversion dates and conversion options. Unlike the permanent products mentioned above, the premium payment is critical. If the premium payment is missed or paid too late, beyond the grace period, the policy will lapse. Permanent policies that are seasoned and appropriately funded may not lapse with a single missed premium.

The basics of the analysis for all policies should include:

1. A current year annual statement
2. Life insurance illustration(s) obtained from the insurance company. The illustrations should include:

    - A projection of current policy performance with anticipated future premium
    - A projection solving for the premium to keep the policy in force to maturity
    - A projection solving for a reduced death benefit to maturity paying the anticipated premium
    - A reduced paid-up quote/illustration (whole life only)
    - Confirmation of the beneficiaries

Health is the most critical data point determining a life insurance policy's rating when a policy is issued. When monitoring a policy, an ongoing health data point helps charities decide how to maintain the insurance throughout the donor's life. Unlike most investment vehicles, the return is a moving target because of the life expectancy/longevity of the donor(s). According to the Brookings Institute, males born in 1940 who are in the top 10% of mid-career income earners can expect to have an average life expectancy of 12 years longer than their counterparts at lower income levels.[3] As a charitable planner, would it be helpful to know that the client you're working with has a life expectancy of approximately a decade longer than standardized mortality tables indicate? Would it impact how you evaluate a potential donation of life insurance? Would it affect how you manage your portfolio of donated life insurance policies? How do you create a valid plan if you don't know how long you're planning for? Do your donors have objective data that give them a range of how long they might live? If they knew that range, would it change your conversations with them?

A starting point in determining the donor's health is to use the initial insurance company's underwriting rating as a baseline. However, in some cases, the underwriting may have been done 10-to-40 years ago. If so, and the size of the life insurance policy is significant, it may be wise to enlist a third party to do a non-invasive health evaluation with the donor's consent. This doesn't require a medical exam like when obtaining a newly issued life insurance policy. Once the basic policy assessment and longevity data point are determined, a potential internal rate of return can be calculated for the charity. The allied professionals can compare the current policy status with the original gift agreement and illustration (if available). A policy can be "on track" or "off track." A CFO can review this type of information when analyzing recommendations related to life insurance.

> If the charity decides to go ahead with a life settlement, it will liquidate the policy for more than the cash surrender value but less than the death benefit.

Underperforming Policies

A policy may not be performing as intended because:

- The initial design was poor, or the original crediting rate changed.
- The donor hasn't made the agreed-on gifts/premiums.
- The donor didn't pay attention to the insurance policy for a prolonged time.
- The insurance company made changes to its internal policy charges.

- There have been significant changes to the insurance carrier's financial ratings.

Potential remedies for underperforming policies include:

Reducing the death benefit. This can be an effective way to extend policy longevity. Typically, this will reduce the internal cost of insurance, and the anticipated annual premium will allow the policy to extend the lapse age.

Increasing the premium. This remedy may entail an uncomfortable conversation with the donor of the policy; however, it's the easiest way to extend policy longevity.

Having the charity pay the increased premium. This remedy is reserved for particular situations. For example, a donor has a very short life expectancy, and the policy is about to lapse.

Surrendering the policy. This remedy occurs after evaluating the above options if the donor is in good health and is no longer willing or able to pay premiums and the charity has a use/need for immediate cash value. A life settlement analysis should be done before any surrender takes place.

Replacing the policy. This is an option if the donor is still in average-to-good health. Occasionally, a new insurance policy in the market could reduce or eliminate the premium with an Internal Revenue Code Section 1035 tax-free exchange. A qualified life insurance agent should be consulted for this option.

Life Settlement

If the charity decides to go ahead with a life settlement, it will liquidate the policy for more than the cash surrender value but less than the death benefit. This option eliminates the future premium obligation. The charity receives a lump sum for the policy. The life settlement market is highly regulated. Licensed sell-side advisory firms can guide the charity through the process. Their prime function is to facilitate a policy auction with licensed buy-side advisors. This is similar to a charity liquidating real estate, artwork or other assets in an auction. The sell-side advisors have a fiduciary responsibility to generate the highest value for the charity.

"Presenting the Options," p. 45, illustrates the charity's options to keep, surrender or sell a donated policy (that is, proceed with a life settlement).

Demonstrating Stewardship

When charities treat life insurance as an asset rather than an administrative liability, it can create engagement opportunities with existing and prospective donors that go beyond the standard campaign (that is, campaigns that ask for cash, ruling out donors who have illiquid assets but may be able to donate their life insurance policies). The life settlement option can be especially appealing to donors who have illiquid assets. Charities should create a systematic process when accepting life insurance gifts. They should leverage tools and resources that uncover opportunities that can be used in newsletters, websites and traditional mail campaigns.

Charities need to document:

- The number of life insurance policies that have been donated to their organization
- Where the life insurance information is saved and itemized for future review
- Whether a break-even analysis has been completed periodically on each policy to confirm it performs as expected
- The individual responsible for confirming premium payments and updating policy values
- Whether there are policies with maturity risk that have a high likelihood of the insured outliving the policy
- The type of return they can expect from any given policy
- Whether they're holding policies with financial ratings that would be considered junk bonds
- How they're communicating with donors about their life insurance gifts
- The existing protocols to ensure new insurance gifts perform as projected
- Whom their donors work with for life insurance valuation

Donor Outreach

Charities can add meaningful educational content to their newsletters or consider sending a personal letter to their top donors. Imagine a situation in which a donor has named the charity as a partial

Presenting the Options

Keep, surrender or consider a life settlement

Male, age 79 | $5 million survivorship universal life (female deceased) | Annual premium = $150,000

KEEP	SURRENDER	LIFE SETTLEMENT POLICY AUCTION
Continue paying $150,000 annual premium for an undetermined time frame	Receive $250,000 cash surrender value (CSV) and reallocate premiums to charity	Receive $1.25 million over CSV Reallocate all or a portion of $150,000 premiums to charitable planning
$0 No life settlement, but full death benefit	**$250,000** + Eliminate premium burden	**$1.5 million cash buyout** + Eliminate premium burden

— Ashar Group LLC

beneficiary, and the charity is unaware. Instead of the donor canceling the policy if their financial situation changes, there could be an opportunity for the charity to complete a life settlement. The charity can then share a successful outcome in a newsletter or at their annual gala highlighting the donor and their ability to see how the charity is benefiting from the proceeds of the life settlement while they're living.

Practice tip: At tax time, donors are often unaware that an Internal Revenue Service Form 8283 appraisal is required for any life insurance donated to charity. Furthermore, the donor is responsible for obtaining and filing the Form 8283 appraisals. Any life insurance donation valued at more than $5,000 must have an appraisal completed by a certified appraiser. The charity could include a one-page memo in its newsletter that outlines the IRS requirements. This is an excellent way to foster existing relationships and reach out to potential new donors the charity hasn't contacted recently.

Benefits for Charities

Charities can differentiate themselves in a crowded marketplace by exploring the opportunities that exist when viewing life insurance as an important non-cash asset class to discuss with their important donors and professional advisors. There are opportunities for increased charitable contributions and relationship-building with allied professionals, particularly among financial planners and life insurance professionals. There's also the ability to increase and deepen stewardship engagement with important donors.

Charities that already own policies need to be proactive to seek advice about opportunities or issues. By treating life insurance like other property and monitoring its performance, they can determine if it's best to keep, surrender or sell an existing life insurance policy. Allied professionals have a tremendous opportunity to include a life insurance valuation and longevity analysis in their policy review process for charitably minded clients. Through proactive education, the charitable market will continue to realize significant growth by incorporating life insurance and life settlements into their overall giving strategies.

Endnotes

1. LIMRA 2024 Life Insurance Fact Sheet, *www.limra.com/siteassets/newsroom/liam/2024/2024-life-insurance-fact-sheet.pdf.*
2. Raj Chetty, Michael Stepner, Sarah Abrahams, et al., "The Association Between Income and Life Expectancy in the United States, 2001-2014," *Journal of the American Medical Association*, 315 (14), 1750-1766 (2016).
3. Barry P. Bosworth, Gary Burtless and Kan Zhang, "What growing life expectancy gaps mean for the promise of Social Security," Brookings (Feb. 12, 2016), *www.brookings.edu/articles/what-growing-life-expectancy-gaps-mean-for-the-promise-of-social-security/#:~:text=Worse%20still%20is%20that%20the%20gap%20has,benefits%20provided%20to%20low%2D%20and%20high%2Dearnings%20workers.*