PRIVATE FOUNDATIONS AND LIFE INSURANCE

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Introduction

A private foundation is a tool that can be used to create a philanthropic legacy. One way to leverage assets in a private foundation is with life insurance. This article explores the federal excise taxes and other issues connected with implementing a private foundation life insurance program.

The Federal Excise Taxes

The starting point in analyzing any proposed transaction involving a private foundation is to ask whether the use of life insurance will trigger any one or more of the six federal private foundation excise taxes (sometimes called the “49ers” because found in sections 4940-4945 of the tax code). An analysis of each tax follows.

Tax on Net Investment Income (4940)

The 2% excise tax on net investment income (including long and short term capital gains, with no capital loss carryovers/carrybacks) was instituted to cover the cost of regulating private foundations. The regular income tax rules are looked at in determining what net investment income is. Under the regular tax rules, the inside build-up in a life insurance contract is not income until withdrawn, and the proceeds payable upon the insured’s death are excluded from income, unless a transfer for value occurred. The same should hold true for this tax.

Tip: Technically, under the AMT portion of the regular income tax rules, for corporations other than “small corporations”, the inside build-up in a life insurance contract is taxable income (against which the premiums attributed to insurance coverage are deductible). The death benefit is taxable under the AMT rules as well. These departures from the regular income tax rules are nowhere found in the AMT rules applicable to trusts. Therefore, to be extra safe, if not already formed, consider organizing a new foundation that will hold life insurance as a trust.

Note: Whether organized as a trust or corporation, a private foundation’s net investment income is not subject to the 3.8% Medicare surtax.

Tax on Self-Dealing (4941)

Since private foundations do not have a broad donor base looking over their shoulder, this tax is meant to ensure that no insider deals occur. If they do, they must generally be undone after this tax is paid. The main concern where life insurance is involved is upon the transfer of an encumbered policy. In Rev. Rul. 80-132, the IRS held that it is an act of self-dealing where a disqualified person (“DQP”) donates a policy subject to a loan to a foundation. Thus, donations of such policies by DQPs (any of the foundation’s founder, his/her spouse, his/her ancestors, his/her child, grandchild, or great-grandchild, and the spouses of all such children/grandchildren/great-grandchildren) should be avoided. And, though donations of policies subject to loans by non-DQPs (such as the founder’s uncle, sister, niece/nephew, or best friend) will not trigger this tax, income recognition under the bargain sale rules will likely result. Therefore, donations of encumbered policies by DQPs and non-DQPs alike should generally be avoided.

Tax on Failure to Distribute Income (4942)

This is more commonly known as the 5% minimum required distribution (“MRD”). The tax hits the shortfall between the MRD and the actual amount given away. Foundation-held life insurance must be valued annually to compute the annual
5% amount. Since valuation according to the estate tax valuation rules is prescribed, an annual IRS Form 712 from the insurer should suffice.

**Warning:** IRS Form 712 specifies that the value of paid-up and single premium policies is replacement cost. Thus, as the insured ages, the value of the policy (and consequently the 5% MRD) will increase. This increase could be especially dramatic if the insured becomes uninsurable. The same would be true for non paid-up policies, as a switch from ITR may be required. Potential solutions include viatical settlements (the proceeds from which should be exempt from the excise tax on net investment income) and, for paid-up policies, loans from the insured (if a DQP, to avoid the self-dealing rules, the loan must be without interest).

**Tip:** Where annual premiums will be donated each year, be sure that the foundation’s receipt and payment occur between the first and last days of a given month. Since the 5% is applied to average monthly cash balances, and since monthly cash balances are computed by averaging balances on the first and last days of the month, this practice will keep the MRD to the absolute minimum.

**Note:** Unless paid as part of a split-dollar compensation program, life insurance premiums paid by foundations do not count toward the MRD. Thus, the full 5% amount must come from other foundation assets or from outside sources. If the latter because the policy is the only foundation asset, the practice of maintaining zero first and last day monthly cash balances described above should be followed.

**Tip:** To qualify for the higher 50% deduction ceiling that is normally only allowed for cash donations to publicly supported charities, ensure that “MRD donations” are paid out before March 15 of the following year.

**Note:** If it would be easier to pay premiums on foundation-held policies directly to the carrier, this can be done without jeopardizing the income tax deduction.

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**Tax on Excess Business Holdings (4943)**

This tax prevents owners of active businesses from passing their enterprises down to future generations estate tax free. Since life insurance is not an active business enterprise, this tax will not apply.

**Tax on Jeopardizing Investments (4944)**

This tax is meant to ensure that foundations invest responsibly. The standard is “ordinary care and prudence, considering the facts and circumstances at the time and the foundation’s long and short term financial needs.” Though no particular type of investment is singled out, the following will be closely scrutinized: commodity futures, interests in oil and gas wells, options, trading on margin, short-selling. While life insurance is nowhere listed, in Rev. Rul. 80-133 the IRS held that a violation occurred where it was known in advance that at the insured’s life expectancy, more would be paid to the carrier in premiums and policy loan interest than received in death benefit. Thus, for policies that are not paid-up, with each premium payment, the projected policy rate of return at life expectancy should be calculated. If the result is positive, no violation should occur.

**Note:** The jeopardy investment rules do not apply to assets received by gift. Therefore, if a fully paid-up policy received by gift is projected to have a negative rate of return at life expectancy, no violation occurs if the foundation decides to keep the policy.

**Tax on Taxable Expenditures (4945)**

This tax ensures that private foundations spend for charity. The easiest (but not only) way to do this is to pay the MRD to one or more publicly supported charities. Though life insurance premiums are not so spent, they nonetheless fall under an exception for expenditures made to acquire investments. PLR 2002-32036 confirms this.

**Other Issues**

Besides the federal-level “49ers”, the potentially negative effects that inclusion of the death benefit in an insured director/trustee’s federal gross estate
should be examined. In addition, state-level insurable interest and prudent investor rules should be consulted. Each is discussed in more detail below.

**Estate Inclusion**

The death benefit from a foundation-held policy will be included in the insured’s estate either because as a director/trustee, the insured will have possessed incidents of ownership at the time of death, or, less commonly, because the insured will have died within three years of transfer. This is normally not a problem since in either case, a full estate tax charitable deduction will be allowed.

But if the insured’s estate plan depends on qualifying for special tax breaks that are tied to a business interest being at least a certain percentage of the estate, problems could arise. For instance, under IRC section 6166, if a business interest is greater than 30% of the adjusted gross estate, an installment payment plan for the tax on the interest is available. And, under IRC section 303, if corporate stock exceeds 35% of the adjusted gross estate, capital gain treatment for the redemption of such stock is available. Since the estate tax charitable deduction is not used in determining the adjusted gross estate, inclusion of the death benefit could “dilute” a business interest, thereby causing the loss of the IRC 6166 and/or IRC 303 tax breaks.

**Insurable Interest**

For contributions of existing policies this should not be an issue. But where the foundation will be the initial owner from the outset, care should be taken that the applicable state insurable interest statute is complied with. For example, in Michigan, 501(c)(3)s (private foundations and publicly supported charities) have an insurable interest in the life of any individual who gives written consent to the purchase of a policy on his or her life. Such written consent should be delivered to the foundation at or before the time the policy is purchased.

**Prudent Investor Rules**

When it comes to state law rules on investments, if the foundation is organized as a corporation, the state’s version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) should be consulted. Among other things, these rules impose the higher prudent investor standard, including the duty to diversify. Such are nothing new for foundations organized as trusts, since those foundations come under the Uniform Prudent Investor Act (UPIA), which imposes the same rules.

**Tip:** Where it is known that life insurance will be the sole asset of a new foundation, consider organizing the new foundation as a trust. Unlike corporations subject to UPMIFA, trusts under UPIA may waive the duty to diversify, or the entire prudent investor standard, if desired. The best that corporations can do is document annually that, due to special circumstances, the purposes of the foundation are better served without diversification.

**Conclusion**

Whether used to leverage a legacy or to diversify an investment portfolio, life insurance can play a role with most private foundations. To ensure that its role is positive, close attention must be given to the “49ers” and other issues discussed above.

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