ALERT!

This article was written in 1998. Since then, Congress has enacted Internal Revenue Code section 170(f)(10), essentially prohibiting CRSD transactions effective February 8, 1999. Further, transfers to charity made prior to February 8, 1999, pursuant to CRSD transactions have been held to be nondeductible (*Addis v. Comm'r.*, 118 TC No. 32 (6/10/02); *Weiner v. Comm'r.*, TC Memo 2002-153 (6/18/02)). While it is now clear that CRSD is not a viable technique, this article is useful in that it provides an analytical framework which planned giving professionals can use to evaluate other "creative" gift schemes.

"The Overselling of Charitable Reverse Split -Dollar Insurance" Erik Dryburgh, Adler & Colvin, *Journal of Taxation of Exempt Organizations*, Volume 10/Issue 1, July/August 1998,

The Overselling of Charitable Reverse Split-Dollar Insurance

ERIK DRYBURGH
Adler & Colvin

ERIK DRYBURGH is a partner in the San Francisco law firm of Adler & Colvin.

A new "charitable gift" idea is rapidly gaining popularity across the country. The gift carries many labels, but is often called "charitable reverse split-dollar insurance" (CRSD). A significant number of the author's nonprofit clients have been approached at least once regarding a CRSD gift.

CRSD plans have been around for many years, but have become much more common recently. Unfortunately, much of the analysis and legal opinions that are presented to the charity as part of the proposal are directed at the issues facing the insured donor, and do not address the issues facing the charity.

CRSD GIFTS

CRSD arrangements generally are presented to donors who own closely held corporations, although a closely held corporation can be established to facilitate the arrangement if the donor does not own one already. In its most simple form, a CRSD gift begins with the donor purchasing a whole or universal life insurance policy. The donor and the company then enter into a "split-dollar agreement," under which the corporation agrees to pay a certain portion of the annual premium payments. The corporation's premium share is the amount that, under the Treasury's PS-58 tables (Rev. Rul. 55-747, 1955-2 CB 228), represents the annual cost of the renewable term portion of the insurance policy. In consideration for this agreement, the donor assigns a portion of the death benefit to the corporation.

In addition, the donor and the corporation agree that the corporation should "pre-pay" its share of the premiums. Premiums that would normally be paid over 20 to 30 years will instead be paid in five or ten. This creates an "unearned premium account," which represents the premiums that the insurance company has not yet earned but that have nevertheless been paid. This account grows for the five- or ten-year period during which the corporation overpays the premium. It is then spent down by the insurance company over the following years to pay for those years' premiums.

The split-dollar agreement also provides that, should the insured die while there is a balance in the unearned premium account, it will be paid to the corporation in addition to its share of the death benefit. Finally, the donor is allowed to borrow a significant portion of the policy value, but that amount is limited to ensure that the corporation's share of the death benefit and unearned premium account remains in the policy.

This split-dollar arrangement becomes a CRSD when the corporation assigns all of its rights and duties in the split-dollar agreement to a charity. At the same time, the donor lets it be known that he or she will make annual cash gifts to the charity in an amount equal to the charity's premium payment. All CRSD proposals acknowledge that no agreement to make these contributions can be binding on the donor, but make it clear that the charity can rely on the donor's continued "generosity."

There are many variations on the above theme, involving insurance trusts, partnerships, and other legal entities. Nonetheless, the basic concepts and legal risks are the same.

Example. The following example is very similar to a CRSD proposal the author reviewed recently. In addition to changing the names to protect the innocent, the fact pattern has been altered in one other significant respect—the real charity was also asked to pay $5,000 in legal fees associated with structuring the transaction! This element was deleted in the following example, as most proposals have not included this request.

Facts. The donor is John Street, age 45. Street or his corporation will make contributions to the charity totalling $203,224. The charity will use the contributions to make premium payments on a life insurance policy, of which Street is the insured and owner. The premium payments are accelerated; instead of paying premiums over a period of approximately 25 years, payments of a substantially larger dollar amount are to be made over four years. Because the premium payments exceed the amount actually required to purchase the policy in the early years, an unearned premium account is created, which includes the excess premiums and the earnings on them.

Under an irrevocable assignment, the charity will receive an interest in the policy equal to (1) $500,000 of death benefit, payable on the death of Street, plus (2) the unearned premium account, if any. If Street terminates the policy, the charity will receive the

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

unearned premium account. The year-by-year specifics of the arrangement are shown in Exhibit I on page 15.

Consequences to charity. The financial consequences to the charity of this proposed gift are as follows:

1. If Street terminates the policy before his death, the charity receives the unearned premium account. As shown in Exhibit I, this amount is always less than the amount paid to date by the charity as premiums.

2. If Street dies before reaching his life expectancy, the charity will receive the $500,000 of death benefit plus the unearned premium account, the value of which depends on the date of death. For example, if death occurs in Year 10, the charity receives just under $665,000 ($500,000 plus $164,937). If death occurs in Year 20, the charity receives approximately $579,000.

3. Once Street lives approximately 25 years, the unearned premium account vanishes. The charity's benefit from that date forward is only the $500,000 death benefit.

Thus, if Street lives out his life expectancy, the charity will receive a death benefit that is approximately twice the sum of the premium payments it has made. Given Street's long life expectancy, the charity's rate of return on its investment would be approximately 2.5%—roughly the current rate of inflation. If Street terminates the policy, the charity loses money because it receives back something less than its investment in the policy. Only if Street dies before living out his life expectancy will the charity recoup the premiums invested plus a reasonable rate of return (which would vary depending on the date of death). The "best case" scenario (only as far as the charity's finances go) is for Street to die in Year 4. In that situation, the charity will have paid premiums of approximately $203,000 and will receive approximately $691,000.

ISSUES FACING THE CHARITY

Any charity participating in a CRSD gift will face significant legal risks. The fact that there is an "expectation" but not a "commitment" that the donor will make annual contributions equal to the charity's premium payment puts the charity in a dilemma. It must decide whether its position is that (1) the donor's contribution and the charity's premium payment are separate and distinct events, or (2) they are linked together.

Payments are separate events. This horn of the dilemma assumes, as the CRSD materials contend, that the contribution is an unrestricted gift and that the charity is investing in the policy with its own funds as part of its overall investment strategy.

If the charity wishes to proceed under this view, its board of directors needs to consider its fiduciary duty under state law to manage the charity's funds in a prudent manner. This duty is generally enforceable by the charity and the state Attorney General's office. While the exact language and details of the duty may vary from state to state, the majority of the states impose some sort of "prudent investor" duty on a charity's

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

directors. For example, the relevant law in California is contained in Corporations Code section 5231, which provides that "a director shall perform the duties of a director . . . in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Section 5240 of the California Corporations Code further provides that in investing a charity's funds, the board shall "[a]void speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital."

Given that it is virtually impossible for the charity to ever earn any meaningful return on the funds used to make premium payments under a split-dollar agreement like the one in the example, doing so would be a clear breach of fiduciary duty. In California and many other states, the Attorney General's office has the authority to investigate a charity's investments. If it finds that the board or a particular officer or employee is responsible for authorizing an imprudent investment, it can (and in some situations, will) seek reimbursement from the responsible director, officer, or employee.

Additionally, a charity can lose its exemption under Section 501(c)(3) if it engages in activities that result in private inurement or undue private benefit. Private inurement occurs when the assets or income of a charity inure (or pass) to the benefit of an individual deemed to be an insider. Whether the donor of a CRSD gift would be deemed an insider has not been resolved, but the IRS certainly believes that a donor may be an insider. In its Exempt Organizations Handbook (IRM 7751, section 381.1(2)), the IRS noted that the prohibition against private inurement precluded the acquisition of a charity's funds by its "trustees, officers, members, founders, or contributors." The companion doctrine of private benefit is applied to prohibit a tax-exempt organization from providing a substantial economic benefit to an individual, whether or not the individual exercises control over the organization.

In a CRSD gift, the charity is investing its funds in an insurance policy from which it will most likely receive only a modest return. All of the earnings associated with the invested funds will be paid to the donor as loans from the policy or to his or her heirs as beneficiaries of the death benefit. In the proposal on which the example above was based, the death benefit payable to Street's heirs at his death would have been approximately $3 million. In short, the charity is paying all of the premium but is receiving only a small portion of the policy value, with the balance of the policy value being paid to the donor's heirs. This would appear to be a clear case of private inurement, private benefit, or both. To avoid the problem, the charity should acquire a share of the policy benefits commensurate with its share of the premium payments—100%.

Payments are linked. Is the charity better off contending that, in fact, it never actually had unfettered control over the use of the cash contributions? Clearly, the charity is unlikely to receive the cash unless it agrees to invest it in the policy. In fact, one of the proposals reviewed by the author stated that if the charity does not make the premium payments, it would be "unlikely" that future contributions would be made. The existence of this

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

understanding might relieve the board of its fiduciary liability and preclude a finding of private inurement or private benefit if the charity can demonstrate that the understanding constituted a legal obligation to pay the premium.

If the charity has an obligation to use the funds to pay premiums, however, it cannot also claim that the funds constitute an unrestricted contribution. The charity in this situation is merely a conduit between the donor and the insurance company. The only benefit that the charity receives is being named as a recipient of policy benefits, payable at some point in the future. Naming a charity as a beneficiary of a life insurance policy is a gift of a partial interest that, under Section 170(f)(3), does not qualify for a charitable income tax deduction.

Nonetheless, a key element of any CRSD is that the donor can deduct the payments made to the charity and used to pay the premiums. To claim the deduction, Section 170(f)(8) requires the donor to obtain a receipt from the charity acknowledging receipt of the full amount of the cash "contribution." Many CRSD proposals even provide the charity with a sample form of receipt for this purpose. At best, a charity offering such a receipt would be in violation of Section 6115, which requires that the charity disclose on the receipt all return benefits provided to the donor for a contribution and place a value on the return benefit. Disclosing the return benefits provided to the donor (i.e., investment of the funds in a policy primarily benefiting the donor and his family) would make it clear that no deduction is available. Failure to provide a proper receipt can result in the imposition of penalties. At worst, the charity may be liable for knowingly issuing false receipts and thus aiding and abetting tax fraud.

ISSUES FACING THE DONOR

In addition to the issues facing a charity participating in a CRSD gift, it is worth mentioning the primary issue facing the donor: What, if any, charitable deduction is generated by a CRSD gift?

The proponents of CRSD gifts argue that the donor is making unrestricted gifts of cash, and is entitled to a full charitable deduction. An alternative view is that the only gift is of a nondeductible interest in the policy death benefit. Which view will prove successful may depend on whether the IRS can employ the step-transaction doctrine to collapse the various elements of the CRSD gift.

One of the leading step-transaction cases in the charitable giving area is the Palmer case, 62 TC 684 (1974), aff'd on other grounds 523 F.2d 1308, 36 AFTR2d 75-5942 (CA-8, 1975). In Palmer, a donor gave shares of his closely held company to his controlled private foundation, and immediately caused the company to redeem the shares. While the redemption was clearly expected, there was no obligation to have the shares redeemed. The Tax Court thus respected the transaction as a gift of appreciated stock followed by a redemption, as opposed to a partial liquidation and gift of cash. The IRS acquiesced to Palmer in Rev. Rul. 78-197, 1978-1 CB 83, setting out a bright-line legal test—whether, at the time of the gift, the donee is legally bound to complete the expected transaction or

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

can be compelled to do so. Because there is no legal obligation that the charity use the contributions to pay CRSD premiums, Palmer and its progeny would appear to support the donor's claim to a deduction.

Palmer is not without its exceptions, however. In Blake, 967 F.2d 473, 51 AFTR2d 83-445 (CA-2, 1983), aff'g TCM 1981-597, an individual gave appreciated securities to a charity, which then sold the securities and used the proceeds to purchase a yacht from the donor at a price well in excess of its value. The IRS recharacterized the transaction as a gift of the yacht and a sale by the donor of the securities, arguing that the charity was a mere conduit for the sales proceeds. The Second Circuit sustained the Service's position, holding that the charity was legally obligated to purchase the yacht. More important, it also held that, even if the charity were not obligated to purchase the yacht, the fact that the transactions were undertaken according to an understanding arrived at in advance was sufficient. As the court noted, what distinguishes Blake from Palmer is that Blake did not merely expect that the charity would sell the donated property, but expected that the donated property (or its sales proceeds) would be immediately returned to him.

In a CRSD gift, the donated cash is invested in an asset (the insurance policy) that is wholly owned by the donor. Additionally, the donor has access to the value of the policy via a loan. It would not be unexpected for the IRS to argue that the donated cash was, in essence, returned to the donor, and that Blake is the applicable law.

Several proposals that the author has reviewed have acknowledged that there is a risk that a donor's income tax deductions may be denied. The result would, of course, be an understatement of tax, triggering additional tax plus interest. In addition, the penalty provisions of Section 6662 could apply if the understatement is large enough and the donor cannot demonstrate substantial authority for the reporting position.

Even those CRSD proposals that acknowledge the income tax risk fail to mention another potentially more devastating risk—the loss of the donor's gift tax deduction. Section 2522(c)(2) denies a gift tax deduction for gifts of partial interests, similar to the Section 170(f) restrictions applicable to income tax deductions. Imagine the reaction of a donor who discovers not only that he or she gets no income tax deduction for his or her "contribution," but owes gift tax on it as well.

CONCLUSION

For CRSD gifts (and most other gifts as well), the charity should not pay the legal fees of the donor's counsel. Payment of these fees even further reduces the charity's return, as well as raising additional quid pro quo issues.

The charity should agree to participate in a CRSD gift only if it makes clear to the donor that (1) it does not consider itself bound to pay any premiums and (2) the board will evaluate its options for the investment of the contributed funds as part of its overall investment strategy, consistent with its fiduciary obligations.

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

If, despite this warning, the charity actually receives a CRSD gift, it should seriously consider pursuing an alternative investment. Additionally, the charity must issue a receipt that accurately reflects what it receives. If the funds are not used to pay the policy premium, the receipt can appropriately reflect an unrestricted gift of cash. If the charity pays the policy premium, however, the receipt should reflect a nondeductible gift.

Charities that have already accepted a CRSD gift need to evaluate the propriety of the investment and whether the charity is willing to continue sending receipts reflecting a gift of cash. The charity should review the split-dollar agreement to determine what its obligations are and the process, if any, for terminating the arrangement. As an alternative to terminating the arrangement, the charity may be able to assign its interest under the split-dollar agreement back to the donor or his related entity.

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

Exhibit I: Details of the CRSD Plan in the Example on Page 2.

	Donor	Charity				Individual
Year	Charitable Cash Donation	Unearned Premium Account	Death Benefit	Total Benefit	Premium Payment	Death Benefit
1	$50,806	$ 48,160	$500,000	$548,160	0	$ 504,549
2	$50,806	$ 96,118	$500,000	$596,118	0	$ 514,341
3	$50,806	$143,850	$500,000	$643,850	0	$ 529,619
4	$50,806	$191,342	$500,000	$691,342	0	$ 550,874
5	0	$187,759	$500,000	$687,759	0	$ 573,825
6	0	$183,887	$500,000	$683,887	0	$ 598,617
7	0	$179,700	$500,000	$679,700	0	$ 625,335
8	0	$175,168	$500,000	$675,168	0	$ 654,137
9	0	$170,258	$500,000	$670,258	0	$ 685,172
10	0	$164,937	$500,000	$664,937	0	$ 718,597
11	0	$159,166	$500,000	$659,166	0	$ 754,603
12	0	$152,904	$500,000	$652,904	0	$ 793,383
13	0	$146,108	$500,000	$646,108	0	$ 835,122
14	0	$138,733	$500,000	$638,733	0	$ 880,045
15	0	$130,719	$500,000	$630,719	0	$ 928,398
16	0	$122,012	$500,000	$622,012	0	$ 980,398
17	0	$112,549	$500,000	$612,549	0	$1,036,329
18	0	$102,259	$500,000	$602,259	0	$1,096,474
19	0	$ 91,074	$500,000	$591,074	0	$1,161,112
20	0	$ 78,902	$500,000	$578,902	0	$1,230,563

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

21	0	$ 65,668	$500,000	$565,668	0	$1,305,154
22	0	$ 51,270	$500,000	$551,270	0	$1,385,238
23	0	$ 35,600	$500,000	$535,600	0	$1,471,184
24	0	$ 18,552	$500,000	$518,552	0	$1,563,398
25	0	$ 1	$500,000	$500,001	0	$1,662,270
26	0	0	$500,000	$500,000	0	$1,748,050
27	0	0	$500,000	$500,000	0	$1,839,607
28	0	0	$500,000	$500,000	0	$1,937,256
29	0	0	$500,000	$500,000	0	$2,041,327
30	0	0	$500,000	$500,000	0	$2,152,146
31	0	0	$500,000	$500,000	0	$2,270,057
32	0	0	$500,000	$500,000	0	$2,395,399
33	0	0	$500,000	$500,000	0	$2,528,509
34	0	0	$500,000	$500,000	0	$2,669,717
35	0	0	$500,000	$500,000	0	$2,819,361
36	0	0	$500,000	$500,000	0	$2,977,776
37	0	0	$500,000	$500,000	0	$3,145,242

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com