Appendix A

Partnership for Philanthropic Planning Charitable Life Insurance Survey

Date: 9/4/2009

Total number of responses collected: 266

Which of the following types of organizations is your primary employer?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Public University		13.7%	36
Private University		10.6%	28
Small College		4.6%	12
Community/Junior College		0.8%	2
Technical School		0.0%	0
Academy/Secondary School		3.0%	8
Hospital/Health Care Organization		**25.5%**	**67**
Religious Organization		6.1%	16
Social Services Organization		12.2%	32
Environmental Group		2.3%	6
Community Foundation		5.3%	14
Museum, Symphony, Arts/ Cultural Organization		5.3%	14
Private/Family Foundation		1.1%	3
Association		1.1%	3
Other (please specify)		8.4%	22
Not Answered			3
		Valid Responses	**263**
		Total Responses	**266**

Does your organization currently OWN any life insurance policies?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Yes		**55.7%**	**147**
No		44.3%	117
Not Answered			2
		Valid Responses	**264**
		Total Responses	**266**

For each type of policy, please select the response that most closely reflects the number of policies owned and the percent of total that this type of policy represents. (Number of policies)

		0	1 to 10	11 to 20	21 to 30	31 to 40	41 to 50	more than 50	Total
Whole life	Count	3	77	10	6	5	1	9	**111**
	% by Row	2.7%	69.4%	9.0%	5.4%	4.5%	0.9%	8.1%	**100.0%**
Universal life	Count	6	57	6	3	3	2	3	**80**
	% by Row	7.5%	71.3%	7.5%	3.8%	3.8%	2.5%	3.8%	**100.0%**
Variable life	Count	15	23	2	3	1	1	2	**47**
	% by Row	31.9%	48.9%	4.3%	6.4%	2.1%	2.1%	4.3%	**100.0%**
Term life	Count	17	30	1	0	1	1	0	**50**
	% by Row	34.0%	60.0%	2.0%	0.0%	2.0%	2.0%	0.0%	**100.0%**
Unknown	Count	13	11	2	0	1	2	3	**32**
	% by Row	40.6%	34.4%	6.3%	0.0%	3.1%	6.3%	9.4%	**100.0%**
Total	Count	**54**	**198**	**21**	**12**	**11**	**7**	**17**	**320**
	% by Row	**16.9%**	**61.9%**	**6.6%**	**3.8%**	**3.4%**	**2.2%**	**5.3%**	**100.0%**

For each type of policy, please select the response that most closely reflects the number of policies owned and the percent of total that this type of policy represents. **(Percent of all policies)**

		0%	< 10%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%	Total
Whole Life	Count	0	4	2	6	5	4	2	5	6	1	5	26	**66**
	% by Row	0.0%	6.1%	3.0%	9.1%	7.6%	6.1%	3.0%	7.6%	9.1%	1.5%	7.6%	39.4%	**100.0%**
Universal Life	Count	1	4	4	9	5	4	2	0	4	0	1	7	**41**
	% by Row	2.4%	9.8%	9.8%	22.0%	12.2%	9.8%	4.9%	0.0%	9.8%	0.0%	2.4%	17.1%	**100.0%**
Variable Life	Count	6	3	4	3	5	0	0	1	0	0	0	0	**22**
	% by Row	27.3%	13.6%	18.2%	13.6%	22.7%	0.0%	0.0%	4.5%	0.0%	0.0%	0.0%	0.0%	**100.0%**
Term Life	Count	8	4	4	2	1	0	0	0	0	3	0	3	**25**
	% by Row	32.0%	16.0%	16.0%	8.0%	4.0%	0.0%	0.0%	0.0%	0.0%	12.0%	0.0%	12.0%	**100.0%**
Unknown	Count	5	3	0	2	2	1	2	0	0	0	0	2	**17**
	% by Row	29.4%	17.6%	0.0%	11.8%	11.8%	5.9%	11.8%	0.0%	0.0%	0.0%	0.0%	11.8%	**100.0%**
Total	Count	**20**	**18**	**14**	**22**	**18**	**9**	**6**	**6**	**10**	**4**	**6**	**38**	**171**
	% by Row	**11.7%**	**10.5%**	**8.2%**	**12.9%**	**10.5%**	**5.3%**	**3.5%**	**3.5%**	**5.8%**	**2.3%**	**3.5%**	**22.2%**	**100.0%**

What is the total annual premium of all owned policies? (total responses: 121)
Total 4,050,938.64
Median 8,084
Mean 42,197

unknown	23	20%
all fully paid up	2	1%
0	6	5%
$1 to $1,000	10	8%
$1,001 to $3,000	10	8%
$3,001 to $5,000	10	8%
$5,001 to $10,000	15	12%
$10,001 to $20,000	9	7%
$20,001 to $30,000	6	5%
$30,001 to $40,000	6	5%
$40,001 to $50,000	7	5%
$50,001 to $100,000	9	7%
> $100,000	8	6%

What is the total cash value of all owned policies? (total responses: 122)
Total 52,627,700.85
Median 130844.48
Mean 1,496,350

unknown	21	17%
0	2	1%
$1 to $10,000	4	3%
$10,001 to $20,000	9	7%
$20,001 to $50,000	14	11%
$50,001 to $100,000	14	11%
$100,001 to $500,000	24	19%
$500,001 to $1M	8	6%
$1M to $10 M	23	19%
>$10M	3	2%

What is the total death benefit of all owned policies? (Total response: 122)
Total 486,981,598.44
Median 611,956
Mean 3,991,652

unknown	**8**	**6%**
$1 to $50,000	**12**	**10%**
$50,001 to $100,000	**5**	**4%**
$100,001 to $200,000	**13**	**10%**
$200,001 to $500,000	**16**	**13%**
$500,001 to $1M	**16**	**13%**
$1M to $2M	**19**	**15%**
$2M to $3M	**7**	**5%**
$3M to $4M	**7**	**5%**
$4M to $5M	**5**	**4%**
$5M to $10M	**11**	**9%**
$10M to $20M	**8**	**6%**
>$20 M	**4**	**3%**

In the past five years (since 2004), has the amount of death benefit received from policies your organization owns...

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Increased		25.0%	34
Decreased		10.3%	14
Remained about the same		**64.7%**	**88**
Not Answered			130
		Valid Responses	**136**
		Total Responses	**266**

In the past five years (since 2004), has the amount of death benefit received from policies NOT owned by your organization...

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Increased		24.6%	31
Decreased		7.9%	10
Remained about the same		**67.5%**	**85**
Not Answered			140
		Valid Responses	**126**
		Total Responses	**266**

Please choose the value that most closely represents the percentage of total premiums paid by each of the following sources.

		0%		10%	20%	30%	40%	50%	60%	70%	80%	90%	100%	**Total**
Donor	Count	3	2	0	1	2	0	2	2	3	4	23	**86**	**128**
	% by Row	2.3%	1.6%	0.0%	0.8%	1.6%	0.0%	1.6%	1.6%	2.3%	3.1%	18.0%	**67.2%**	**100.0%**
Organization	Count	**30**	11	5	4	1	0	0	0	1	0	3	10	**65**
	% by Row	**46.2%**	16.9%	7.7%	6.2%	1.5%	0.0%	0.0%	0.0%	1.5%	0.0%	4.6%	15.4%	**100.0%**
Other	Count	**18**	4	3	0	2	1	2	0	2	0	1	1	**34**
	% by Row	**52.9%**	11.8%	8.8%	0.0%	5.9%	2.9%	5.9%	0.0%	5.9%	0.0%	2.9%	2.9%	**100.0%**
Total	Count	**51**	**17**	**8**	**5**	**5**	**1**	**4**	**2**	**6**	**4**	**27**	**97**	**227**
	% by Row	**22.5%**	**7.5%**	**3.5%**	**2.2%**	**2.2%**	**0.4%**	**1.8%**	**0.9%**	**2.6%**	**1.8%**	**11.9%**	**42.7%**	**100.0%**

From an asset management perspective, how often does your organization review the policies that you own?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Monthly		0.7%	1
Quarterly		2.1%	3
Annually		**74.3%**	**107**
Never		8.3%	12
Other (please specify)		14.6%	21
Not Answered			122
		Valid Responses	**144**
		Total Responses	**266**

'Other' Responses
policy is paid in full
Every 2-3 years
When an issue arises
just reviewing now for first time. sent letter out.
These policies are 3 y/o and have not been reviewed
Every few years
Not reviewed on a regular basis. Accounting department carries as an asset & requests annual cash values.
Have a quarterly report, but review of policies is on an as needed basis.
annually but less frequently on 1
Just started a review process within the year
not sure-
As needed
3-5 years

as needed
Every other month
Occasionally
bi-annually
We just completed an audit with an outside company also
unknown
when I think about it
Occassionally
not sure
Rarely
3 times per year

Valid Responses	**24**
Total Responses	**266**

If your organization does not currently own any life insurance policies, why not? (select all that apply)

(Respondents were allowed to choose **multiple** responses)

Response	Chart	Frequency	Count
We have never asked for gifts of life insurance.		15.0%	40
Our staff does not have the expertise to evaluate or discuss life insurance gifts.		4.5%	12
We generally find that other types of gifts have more value for our donors and the organization.		12.8%	34
We are aware of other organizations' bad experiences with life insurance gifts.		4.5%	12
Other (please specify)		**15.4%**	**41**
		Valid Responses	**266**
		Total Responses	**266**

'Other' Response
limited by NY insurable interest laws
We are the beneficiary of some policies and have cashed in any policies of which we were the owner/beneficiary.
Just starting to educate donors about life insurance.
The one we had "matured"
Prior to my employment, planned gifts were not an institutional priority
We are the beneficiary and the donors are paying the premiums or have hold the paid-up policies.
We held them for many years, and recently sold them.
too focused on current gifts
We do not promote it as much as other gifts and the marketing efforts in this area have not produced
we communicate this as a gift option but have yet to receive this type of a gift
Organization Director thinks that they are too complicated

We are not aware of any donors yet that have made our org the beneficiary.

Not right fit for donors and us

We're too small to manage these

Donors have named us as beneficiary instead

We had one large policy, which was cashed out. The previous staff had not solicited them with much effort.

We promote beneficiary designations; our PG program is focused on simple gift vehicles

We are named as beneficiaries of policies however, a donor has yet to make an outright gift of policy that they already own. The donors would rather put their charitable $ to work today as opposed to funding a charitable gift that pays out at death

Never had anyone work with donors for any specific gifts - only DAF's

I am marketing them no interest yet

Gifts of life insurance are immediately surrendered for their cash value.

None have been offered despite our efforts

Usually surrender policies for cash value

no gifts so far

Hasn't been selected by donor as a PG vehicle of choice

Solicited but no success yet

None offered or solicited

A few donors have told us that we will be the recipients of paid up policies upon their death.

When received, we cash them in immediately

Our bad experience with innsurance gifts

We';ve never asked and donors haven't given one.

Havn't had a chance to initiate at this institution.

no match there yet

Only low-key articles in newsletter

This office deals primarily with life-income gifts, but we make insurance gift opportunities known to our UCC-related entities.

none have been contributed

A couple of verbal promises from residents but no action taken for us to be owner

We ahve not received any life insurance policies as gifts.

We have received them and cashed them in.

marketing them but no donations yet
Lack of interest on part of our donors.
No donor has opted for an insurance gift.
havent seen the interest from donors
None recieved to date

Valid Responses	**44**
Total Responses	**266**

If your organization does not currently own any life insurance policies, would you accept a policy as a gift?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Yes		**79.1%**	**91**
No		3.5%	4
Other (please specify)		17.4%	20
Not Answered			151
		Valid Responses	**115**
		Total Responses	**266**

'Other' Responses
We accept being named as beneficiary.
Depends as always
Depends on situation
Most likely, but would like to review.
Perhaps.
it would depend on the policy and donor
depends on type and premium obligations

If it was fully paid
Maybe, but onlyif it was completely paid up
Maybe
probably, after careful diligence and consultation w donor
It depends upon the circumstances
Only as an outright gift, not as funding for CGA or CRT
Fdn. reserves right to decline policies requiring ongoing premiums. If accepted, donor must agree in writing on pmt. of premiums.
Would depend. Can't say one way or the other
only if fully paid up
possibly--it depends upon the terms
See above
Need to update gift acceptance policy but would like to be able to accept such gifts
As always, it depends!

Valid Responses	**20**
Total Responses	**266**

Does your organization have a gift acceptance policy for life insurance?

(Respondents could only choose a **single** response)

Are you aware of policies for which your organization is anticipated to be the beneficiary, although you do not own the policy?

(Respondents could only choose a **single** response)

Response	Chart	Frequency	Count
Yes		**58.2%**	**152**
No		41.8%	109
Not Answered			5
		Valid Responses	**261**
		Total Responses	**266**

If you answered 'yes' to the previous question, what is the total anticipated death benefit of these policies?
Total Response: 129

Total	102,138,944.50
Median	200,000
Mean	1,122,405 (one respondent expects to receive $18 million! That affects this average.)

Response	Chart	Frequency	Count
Yes		**79.2%**	**209**
No		20.8%	55
Not Answered			2
		Valid Responses	**264**
		Total Responses	**266**

Unknown	38	30%
$1 to $5,000	6	4%
$5,001 to $20,000	8	6%
$20,001 to $50,000	13	10%
$50,001 to $100,000	13	10%
$100,001 to $200,000	9	7%
$200,001 to $300,000	8	6%
$300,001 to $500,000	7	5%
$500,001 to $1M	10	7%
$1M to $5M	12	9%
> $5M	5	4%

Appendix B
Insurance Product Matrix

Insurance Product Matrix

Policy Type	Yearly Renewable Term	Level Premium Term Life	Universal Life	Variable Universal Life	No-Lapse Guar. Universal Life	Participating Whole Life
Best for	Very short-term needs such as securing a 1-year term loan	Longer-term needs that are clearly not lifetime needs	Lifetime coverage with considerations of budgetary restrictions or the need for flexible payments	Lifetime coverage with little or no budgetary restrictions and a high tolerance for short-term volatility	Lifetime coverage at the lowest possible cost - with no need for flexible premium arrangements or the possibility of an increasing death benefit	Lifetime coverage in which cost is less of a factor than long-term benefits including increasing death benefit and access to cash value
Not best for	Any uncertainty as to how long coverage will be needed	Any uncertainty as to how long coverage will be needed.	When flexible payment opportunity may lead to failure to pay needed premiums	Those with anxiety over volatile market activity	Need for cash value and/or death benefit growth	Need for large amounts of coverage and limited resources to pay premiums. High initial premiums may restrict death benefits in Trusts with few Crummey beneficiaries.
Issues	Presumably a conversion option will not be needed; can be "shopped" on the basis of premium; A M Best rating no less than "A"	Pay for a conversion option in the event the need later becomes lifetime. Can be "shopped" on the basis of premium; A M Best rating no less than "A"	Dilemma: carrier has transferred all the sufficiency risk but retains all the control to make the in-force block of policies "profitable." Do NOT shop on basis of premium; A M Best rating no less than "A"	Illustrations do not reflect effects of volatility. First determine asset allocation and historic rates of return, and then ask for a "Monte Carlo" estimate of a premium that will sustain the policy at least to age 100.	Make certain to understand the conditions under which the guarantee can be lost - and reinstated. A M Best rating no less than "A++"	Purchase from mutual insurance company; consider "paid up additions" for dividend election. A M Best rating no less than "A"
Risk Index	0	0	3	15	0	1.8
Sample Premium - 33-M-Preferred	$385 first year	$590 level - 20 yrs	$6,304/year	$4,824/year	$4,478/year	$13,895/year
Death Benefit at Life Expectancy	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 3,665,327
NPV @ 5% of all cash flows	$ (21,729)	$ (21,761)	$ (27,332)	$ (442)	$ 5,844	$ 67,176

Appendix C
Risk Index Matrix

Par WL	NLG-UL	VUL	
1.8	0	15	Risk Index
0	100	0	0
10	90	0	0.18
20	80	0	0.36
30	70	0	0.54
40	60	0	0.72
50	50	0	0.9
60	40	0	1.08
70	30	0	1.26
80	20	0	1.44
0	90	10	1.5
90	10	0	1.62
10	80	10	1.68
100	0	0	1.8
20	70	10	1.86
30	60	10	2.04
40	50	10	2.22
50	40	10	2.4
60	30	10	2.58
70	20	10	2.76
80	10	10	2.94
0	80	20	3
90	0	10	3.12
10	70	20	3.18
20	60	20	3.36
30	50	20	3.54
40	40	20	3.72
50	30	20	3.9
60	20	20	4.08
70	10	20	4.26
80	0	20	4.44
0	70	30	4.5
10	60	30	4.68
20	50	30	4.86
30	40	30	5.04
40	30	30	5.22
50	20	30	5.4
60	10	30	5.58
70	0	30	5.76
0	60	40	6
10	50	40	6.18
20	40	40	6.36
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

Par WL	NLG-UL	VUL	
1.8	0	15	Risk Index
30	20	50	8.04
40	10	50	8.22
50	0	50	8.4
0	40	60	9
10	30	60	9.18
20	20	60	9.36
30	10	60	9.54
40	0	60	9.72
0	30	70	10.5
10	20	70	10.68
20	10	70	10.86
30	0	70	11.04
0	20	80	12
10	10	80	12.18
20	0	80	12.36
0	10	90	13.5
10	0	90	13.68
0	0	100	15

Appendix D

SAMPLE - GIFT ACCEPTANCE POLICY FOR XYZ CHARITY

XYZ Charity agrees to accept gifts of life insurance policies under the following terms and guidelines:

Ownership-Donor will irrevocably transfer 100% of any transferred policy to XYZ Charity.

Beneficiary-XYZ Charity must be named as an irrevocable beneficiary of no less than____% of any transferred policy. Donor may name up to ____ additional 501(c)(3)
organizations to receive the balance of the death benefit (Total must equal 100%).

Additional premiums, if any, will be paid directly to XYZ Charity by Donor and XYZ Charity agrees to handle all administrative functions of said donated policy including but not limited to the following:

-Remittance of Premiums
-Delivery of Gift Receipt to Donor
-Ordering of in force policy illustrations as needed
-Portfolio rebalancing
-Policy monitoring and review
-Settlements

XYZ Charity will accept policies from life insurance carriers that carry a Best's rating of ____or higher or an equivalent rating from another recognized ratings company.

XYZ Charity agrees to consider gifts of the following types of life insurance from donors:
___Term insurance
___Whole Life Insurance
___Universal Life Insurance
___Guaranteed Universal Life Insurance
___Indexed Life Insurance
___Variable Life Insurance

For gifts of Life Insurance in excess of $________, XYZ Charity agrees to place the name of the Donor, or such appropriate person as he/she selects, in a place of prominence at the site of XYZ Charity. Further, for gifts in excess of $______________, XYZ Charity, will discuss with Donor, their preference for allocation of the proceeds from said gift.

Appendix E

Irrevocable Life Insurance Trust Investment Policy Statement Issues

This Investment Policy Statement sets forth guidelines and procedures for systematic review and long-term management of the trust's assets. The purpose of this Investment Policy Statement (herein IPS) is to:

- Clarify the trust's objectives and the grantor's expectations;
- Specify the grantor's risk tolerance level pursuant to the trust's objectives;
- Set forth the trustee's risk management criteria to achieve the trust's objectives; and
- Establish a procedure for timely monitoring and systematic review of performance results.

This IPS evidences the careful consideration given by both the grantor and the trustee to the formulation and implementation of a prudent asset management strategy. It will serve as a guide to the trustee, outline procedures for prudent administration of trust assets invested in the sole interest of the beneficiaries, and set out the responsibilities of outside advisors and/or providers engaged in the trust operation. This statement will be revised and modified as appropriate on a periodic basis to reflect such factors as changes in the trust objectives, asset performance and suitability, trustee risk management procedures, beneficiary objectives, and tax laws.

Purpose of the Trust

- **Trust Time Horizon**
- **Contributions to the Trust**
- **Trust Distribution Provisions and Beneficiaries**
- **Diversification**

Product Suitability and Risk Management Guide

- **Carrier Risk**
- **Premium Adequacy and Contract Underperformance Risk**
- **Liquidity Risk**

- **Underwriting Risk**

Delegation of Responsibilities

- **Trustee**
- **Attorney**
- **Investment Advisor/Insurance Analyst**
- **Life Insurance Agent**

Policy Monitoring

Policy Modification

Appendix F
Acceptance and Policy Management Features
for different styles of life insurance policies

The following matrix sets out a 3rd party owner's primary policy acceptance and management considerations, and the annual policy performance verification expected by beneficiaries and their professional advisors.

Trustee Acceptance Considerations Policy Management Features	**Guaranteed Products**				**Non-Guaranteed Products**			
	Whole Life	**No Lapse Guarantee Universal Life**	**Level Premium Term**	**Yearly Renewable Term**	**Adjustable Life**	**Universal Life**	**Variable Universal Life**	**Variable Life**
Premium Schedule	Fixed	Fixed	Fixed Period	Increasing	Flexible	Flexible	Flexible	Fixed
Specified Death Amount	Fixed	Fixed	Fixed	Fixed	Flexible	Flexible	Flexible	Fixed
Account Value Management	Carrier	Carrier	None	None	Trustee	Trustee	Trustee	Trustee
Asset Allocation Required	N/A	N/A	N/A	N/A	No	No	Yes	Yes
Illustration Credibility	Yes	Yes	Yes	Yes	No	No	No	No
Actuarial Evaluation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Volatility Simulation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Trustee Management Requirements								
Investment Policy Statement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
TOLI – Specific Procedures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product Suitability	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Premium Adequacy Risk	No	No	No	No	Yes	Yes	Yes	Yes
Monitoring Cycle	N/A	N/A	N/A	N/A	Annual	Annual	Annual	Annual
Carrier Solvency Risk	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Asset Allocation Review	N/A	N/A	N/A	N/A	N/A	N/A	Annual	Annual
Conversion Review	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A
Rating and Rider Review	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Regulatory Review (Institutional)	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Professional Advisor Annual Verification								
Product Suitability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Premium Adequacy	N/A	N/A	N/A	N/A	100%	100%	100%	100%
Death Benefit Adequacy	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Carrier Solvency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Investment Performance Rebalancing	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Yes

Appendix G - Department of the Treasury / IRS Executive Summary of CHOLI study

EXECUTIVE SUMMARY

The Pension Protection Act of 2006 (PPA) mandated a study of charity-owned life insurance (ChOLI) arrangements and required that charities engaging in those arrangements report certain information to the Internal Revenue Service during a two-year period. Accordingly, the Department of the Treasury and Internal Revenue Service solicited public comments regarding the study, designed and issued an information return form, and then reviewed those returns.

This report describes various types of ChOLI arrangements, which may involve annuities as well as life insurance, owned directly or indirectly by a charity. To date, the arrangements for which information reporting has been provided pursuant to the PPA are too few in number to constitute a statistically significant sample for analysis. Consequently, the report relies principally on information that is otherwise available publicly with regard to these arrangements.

The report analyzes the Federal tax law implications of ChOLI arrangements under existing law and the tax policy issues they present. In particular, the report identifies potentially significant conflicts with the requirement that a charitable organization be organized and operated exclusively for an exempt purpose, and that it comply with a proscription on substantial private benefit. The report further notes that the treatment of a charity's return from participation in a ChOLI arrangement as either exempt investment income or taxable income from an unrelated business is not entirely clear under existing law, but that it arguably may be viewed as unrelated business taxable income in certain circumstances.

Finally, the report recommends adoption of the Administration's Fiscal Year 2010 and 2011 budget proposals to revise the "transfer-for-value" rule of Internal Revenue Code section 101(a) to ensure that investors in a ChOLI arrangement -- as well as investors in other types of arrangements involving the transfer of life insurance contracts -- do not inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract in circumstances where those investors have purchased an ownership interest in the underlying policies.

INTRODUCTION

As required by section 1211 of the Pension Protection Act of 2006 (the PPA),[1] the Department of the Treasury (the Treasury) and the Internal Revenue Service (the Service) have undertaken a study of the use by certain tax-exempt organizations of certain types of life insurance arrangements "for the purpose of sharing with investors the benefits of the tax-exempt organization's insurable interest in individuals insured under such contracts with investors." In addition, as required, the study considered "whether such activities are consistent with the tax exempt status of such organizations." The information contained herein is offered in fulfillment of the mandate of PPA section 1211(c)(2) for a report on the study.

Part I of the report describes various aspects of existing Federal income tax and other law with respect to charities and life insurance that are relevant to the analysis of ChOLI arrangements. Part II describes the PPA provisions and their implementation and summarizes public comments on the implementation as proposed. Part III outlines various types of ChOLI arrangements, and Part IV describes data collection under the PPA provisions regarding ChOLI arrangements. Finally, 4 / 22Part V analyzes the federal income tax implications of those arrangements, including a discussion of outstanding policy issues.

I. EXISTING LAW

ChOLI arrangements involve both charities and life insurance, both of which are subject to special tax and other laws. This part of the report sets forth the significant provisions of Federal income tax law applicable to charities and life insurance, with reference to relevant State law, as well.

A. Tax-Exempt Charitable Organizations

Section 501(a) of the Internal Revenue Code (the Code) exempts from Federal income tax organizations (or charities) described in section 501(c)(3)[2] in pertinent part as follows: Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . .

In addition to being exempt from tax, charities are generally eligible to receive contributions, gifts, and bequests that are deductible in computing the income, gift, and estate tax liabilities of the donors. Organizational and Operational Tests

An organization qualifies as a section 501(c)(3) charity only if it is organized and operated exclusively for exempt purposes. In addition, regulations under section 501(c)(3) require that an organization serve a public rather than a private interest.[3]
A charity may satisfy the organizational test by adopting certain formal requirements in its governing documents.[4] For example, the governing documents must limit the organization's purposes to those exempt purposes described in section 501(c)(3) and must not permit the organization to engage in activities that do not further exempt purposes (except to an insubstantial extent). An organization is not organized exclusively for exempt purposes, however, if its governing documents specify purposes that are broader than the purposes specified in section 501(c)(3). The governing documents also must provide that the organization's assets are dedicated to an exempt purpose in perpetuity. An organization's assets are considered to be dedicated to an exempt purpose if, for example, upon dissolution, such assets are distributed for one or more exempt purposes, or to a Federal, State, or local government entity, for a public purpose.

In general, the operational test requires that an organization engage primarily in activities that further its exempt purpose.[5] An organization does not satisfy the operational test if more than an insubstantial part of its activities fail to further an exempt purpose. In addition, to meet the operational test an organization must establish that its activities serve a public rather than a private interest. Finally, an organization must not violate the restrictions against inurement, lobbying, and political activity. Violation of these restrictions means that an organization fails the operational test, is therefore not operated exclusively for charitable purposes, and will not be considered exempt from taxation as a public charity. Prohibitions on Inurement and Substantial Private Benefit
Inurement contravenes the section 501(c)(3) statutory requirement that no part of the net earnings of the charity inure to the benefit of any private shareholder or individual. The regulations define a "private shareholder or individual" as a person having a personal and private interest in the activities of the organization, and the term refers to persons in a position to influence the decisions of the organization -- so-called insiders.[6] Thus, inurement arises when an insider receives benefits from the organization greater than those he or she provides to the organization in return. In such a case, resources of the organization that should be dedicated to the public interest are diverted to private use. A common example of inurement is excessive or unreasonable compensation paid to insiders. There is no de minimis or substantiality exception.

To be recognized as exempt, an organization also must establish that it is not organized or operated for the benefit of private interests, such as those of designated individuals, the creator or his or her family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.[7] Private benefit occurs if more than an insubstantial part of the organization's activities or its assets or revenues of an organization benefit a private individual or entity. The concept of private benefit stems from the language in the regulations providing that an organization is not organized or operated exclusively for exempt purposes "unless it serves a public rather than a private interest."[8] Thus, for example, in a leading case addressing private benefit, American Campaign Academy v. Commissioner, the Tax Court held that a school that trained students to work for a particular political party generated an impermissible private benefit for that party, rather than benefit for the public as a whole.[9] Consequently, the school was not organized and operated exclusively for exempt purposes, even though it had an educational purpose.
Private benefit differs from inurement in two principal ways. First, the concept of private benefit applies to all private individuals or entities, rather than only to insiders. Second, the prohibition on private benefit is not absolute; only private benefit that is more than insubstantial is proscribed.

Unrelated Business Income Tax

An organization described in section 501(c)(3) (a charity) is exempt from Federal income taxation not only on the contributions and gifts it receives, but also on the income that it derives from or that is substantially related to the performance of its exempt function.[10] Exempt function income may include tuition to a school, patient fees to a hospital, or ticket fees to a symphony. Mere fundraising is not substantially related to a charity's exempt function or purpose, but activities that contribute importantly or have a substantial causal relation accomplishment of those exempt functions or purposes are substantially related.[11] For example, performances by students at a school for the performing arts that are an essential part of the students' training may be substantially related to the school's educational function, and therefore income derived from charges for admission to such performances would be exempt from tax.

This tax exemption does not extend, however, to income derived by a charity from any unrelated trade or business regularly carried on by the organization, called "UBTI" or "unrelated business taxable income."[12] Instead, a charity is taxed at the corporate rate on UBTI,[13] which is determined as the gross income derived from such an unrelated trade or business, less the deductions otherwise allowed that are directly connected with carrying on that trade or business.[14] An unrelated trade or business is a trade or business the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational or other exempt purpose or function.[15]

There is an exclusion from UBTI for investment income, such as dividends, interest, royalties, rents, and capital gains.[16] Thus, a charity may earn tax-free income within an investment portfolio. However, as an exception to this exclusion, investment income is included in UBTI if it is derived from or on account of debt-financed property.[17] For example, dividends and gains from securities bought on margin would be included in UBTI.[18] Additionally, investments funded by withdrawing against the cash value of life insurance policies are considered to be debt-financed.[19]

Reporting

Under section 6033, organizations exempt from Federal income tax under section 501(a) generally are required to file annual information returns. Public charities file their information returns on Form 990, Return of Organization Exempt from Income Tax; private foundations file Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation. Certain exceptions to the filing requirements apply. For example, churches are not required to file annual information returns. In addition, organizations whose gross receipts are normally $25,000 or less are not required to file Form 990, although they are required to file an electronic notice (Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ) under new section 6033(j), which was added to the Code by the PPA.

B. Life Insurance

Federal Income Tax Treatment

In general, income earned from a contract that qualifies as a life insurance contract for Federal income tax purposes is taxed more favorably than income earned from other contracts or investments. This favorable treatment dates back almost one hundred years, to the earliest days of the Federal income tax law.[20]

In 1984, Congress enacted section 7702, which defines a life insurance contract for all purposes of the Code as a contract that is a life insurance contract under the applicable law, provided that the contract either (1) meets the cash value accumulation test of section 7702(b), or (2) both meets the guideline premium requirements of section 7702(c) and falls within the cash value corridor of section 7702(d).[21] A contract is a life insurance contract under the applicable law if it is regulated as a life insurance contract under the applicable State or foreign law. The cash value accumulation test, guideline premium limitations, and cash value corridor are actuarial tests that have the effect of limiting the investment orientation of a contract that may qualify as a life insurance contract.
If a contract qualifies as a life insurance contract under section 7702, amounts received under the contract by reason of the death of the insured are generally excluded from the gross income of the recipient.[22] In the case of a transferee of the contract for value (such as a purchaser), this gross income exclusion is limited to the sum of the amount paid for the contract and the premiums and other amounts paid subsequently.[23] The gross income exclusion is not limited in the case of a carryover basis transaction or in the case of a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[24]

In addition, if a contract qualifies as a life insurance contract under section 7702, the inside build-up under the contract (that is, the increase in the contract's cash surrender value) is not taxed to the recipient unless and until it is received. If an amount is received under a life insurance contract "as an annuity," an exclusion ratio applies under section 72(b) to determine what portion of the amount is excluded from gross income because it is a return of the recipient's investment in the contract. If an amount is received under the contract other than as an annuity (for example, as a distribution, surrender, or redemption), the amount received is generally taxed only to the extent it exceeds the investment in the contract.[25]

Section 264 prevents a taxpayer from deducting premiums on a life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract. Section 264 also disallows a deduction for interest on policy loans or other indebtedness with regard to a life insurance contract unless the contract insures the life of a key person of the taxpayer's business. The key person exception applies only to the extent that the aggregate amount of such indebtedness does not exceed $50,000. In addition, the interest deductions of a business other than an insurance company are reduced to the extent interest is allocable to unborrowed policy cash values. An exception to this pro rata interest disallowance applies with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. The reserve deductions of an insurance company are similarly limited.[26]
In general, neither the qualification of a contract as a life insurance contract nor the application of sections 72 or 101 depends on the tax status (e.g., subject to tax or tax-exempt) of the owner of the contract.

Insurable Interest under State Law

As indicated above, under section 7702, qualification as a "life insurance contract under the applicable law" is a prerequisite to qualification as a life insurance contract for Federal income tax purposes. For this purpose, the "applicable law" is the applicable State or foreign law under which the contract is regulated. As a practical matter, this requirement means that an intended life insurance contract that runs afoul of a State's insurable interest requirements (or any other requirements) may not qualify as a life insurance contract and may not be entitled to the tax benefits that apply to life insurance contracts. The administration of insurable interest requirements by the various States is thus an important component of determining the treatment of a life insurance contract in which both a charity and an investor have an economic interest.

In order for a life insurance contract to be enforceable, the original policyholder must have an interest in the continued life of the insured (an "insurable interest"), rather than simply the possibility of gain on the insured's death. Every person has an insurable interest in his or her own life. Insurable interest also may arise in family and marriage relationships, and creditor-debtor and other business relationships.[27]

The requirement of insurable interest is longstanding and limits the purchase of life insurance to those with an interest in the continued life of the insured. Absent such a requirement, a life insurance contract could create an incentive for the policyholder to kill the insured in order to collect the death benefit under the contract.[28]

Under the McCarran-Ferguson Act, the business of insurance is subject to the laws of the several States, and generally is not subject to Federal law.[29] Accordingly, the determination whether an organization (such as a charity) has an insurable interest in an individual (such as a donor) is a matter of State law. In a number of States, a charity has an explicit insurable interest in a consenting donor. Some such State insurable interest statutes define a charity by reference to section 501(c)(3) of the Code;[30] some define a charity by reference to a State statute;[31] and, some define a charity for purposes of insurable interest by describing the activities an organization must be engaged in to have such an insurable interest.[32]

In practice, it is not uncommon for a charity to own or otherwise be in a position to benefit from life insurance on the lives of its donors. For example, a donor may purchase a life insurance contract on his or her own life and donate the contract to a charity, or simply name the charity as a beneficiary. In this way, the charity will receive the death benefit under the contract upon the donor's death. Alternatively, a charity may itself secure life insurance on the life of a donor, based on the donor's history of giving, or based on a large but not-yet-fulfilled pledge, or, in the case of a celebrity, based on the donor's direct, personal assistance in fundraising. These traditional uses of life insurance by a charity generally do not raise public policy, insurance regulatory, or tax policy concerns. As described further below, the PPA defined a class of life insurance contracts -- "applicable insurance contracts" -- that are part of certain ChOLI arrangements. An applicable insurance contract is generally a life insurance contract that is purchased based on a charity's insurable interest in its donor with money provided by an unrelated lender or investor.

II. PENSION PROTECTION ACT

A. Statutory Provisions

From 2004 through 2006, transactions involving charities, investors, and life insurance contracts appeared to be widespread and increasing.[33] In 2006, the Staff of the Joint Committee on Taxation (JCT) released a Technical Explanation of the provisions of the Pension Protection Act of 2006 (PPA) after it passed the House, but before it passed the Senate. The Technical Explanation indicated that there had been an increase in such transactions, citing contemporaneous news articles. [34]
Section 1211 of the PPA added section 6050V to the Code, which required applicable exempt organizations to make an information return regarding acquisition of an interest in certain life insurance contracts in a prescribed time, form, and manner. Section 6050V (d)(3) defines applicable exempt organizations as generally including religious, charitable, scientific, literary, educational, amateur sports or similar organizations, a fraternal society operating on a lodge system, a governmental organization (including an Indian Tribal Government), a Veterans' organization, a cemetery company, or an employee stock ownership plan.[35] Section 6050V(d)(1) defines a reportable acquisition as an acquisition by an applicable exempt organization of a direct or indirect interest in an applicable insurance contract in any case in which the acquisition is part of a structured transaction involving a pool of such contracts. Section 6050V(d)(2) defines an applicable insurance contract as any life insurance, annuity, or endowment contract in which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest (whether or not at the same time). Exceptions apply if (i) all persons directly or indirectly holding an interest in the contract (other than the applicable exempt organization) have an insurable interest in the insured that is independent of the exempt organization, (ii) the sole interest of the exempt organization is as a named beneficiary, or (iii) the sole interest in the contract of each person other than an exempt organizations is as a trustee or beneficiary of certain trusts. [36]
Additionally, section 1211 of the PPA enacted penalties for failure to file an information return required by section 6050V of the Code. In addition to the traditional failure to file penalty, it imposed a penalty of the greater of $100 or 10 percent of the value of the benefit of any contract with respect to which information was required to be included on the return, in the case of intentional disregard of either the filing or correct information reporting requirement.[37] The reporting requirement applied only to reportable acquisitions occurring after August 17, 2006, and prior to August 18, 2008. Finally, the PPA also required the Treasury and the Service to undertake a study of ChOLI arrangements.

B. Implementation of the PPA Provisions

To gather data for the study, and to facilitate the reporting requirements for applicable exempt organizations with respect to applicable insurance contracts under section 6050V, the Treasury and the Service designed proposed Form 8921, Transactions Involving a Pool of Applicable Insurance Contracts, and proposed Form 8922, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V).

The Service publicized the reporting requirements and requested comments on proposed Forms 8921 and 8922 by issuing Notice 2007-24.[38] The Notice also solicited public comments on the congressionally-mandated study to be conducted by the Treasury and the Service under PPA section 1211. In response to the notice, members of the public submitted four comment letters.
After reviewing the public responses, the Treasury and the Service simplified the reporting requirement by consolidating the required information on a single return, Form 8921, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V). Applicable exempt organizations were required to complete Form 8921 for reportable acquisitions of applicable insurance contracts which took place after August 17, 2006, but on or before August 17, 2008.

Most applicable exempt organizations are required by section 6033 (discussed above) to file Form 990. The 2007 Form 990 (line 89f) and the instructions to the 2007 Form 990 (page 49) called attention to an exempt organization's obligation to file Form 8921. The instructions to the 2008 Form 990 (page 69) again identified Form 8921 as one of several "Other Forms that May Be Required."

C. Public Comments

The following is a summary of the comment letters responding to Notice 2007-24.

First, one comment letter argued that ChOLI arrangements pervert the spirit of charitable tax law and State insurable interest laws and enrich investors at the risk of the charities' tax-exempt status.

Second, a comment letter from a trade association supported the use of life insurance products as a fundraising method by charities. While the comment stated that this is good public policy when supported by State insurable interest laws, the letter expressed concern with abusive arrangements where third parties without an insurable interest finance the life insurance policy. The comment letter opposed the use of life insurance policies in arrangements where any party with an insurable interest serves as an accommodation party or conduit.

Third, a comment letter from an industry consultant stated that life insurance is a traditional and respected instrument for philanthropy for non-profit organizations. The comment letter supported full reporting to the Service of information regarding these insurance arrangements, provided the information is kept confidential by the Service. The comment letter requested that the forms used for reporting not be too onerous.

Finally, a comment letter from a charitable organization stated that it relies heavily on insurable interests in its members. The comment letter proposed a modified single form to replace the original two forms proposed by Notice 2007-24. This comment letter also expressed concern about the confidentiality of the information reported.

III. ChOLI ARRANGEMENTS

Having reviewed the applicable law, the report now outlines various types of ChOLI arrangements. ChOLI arrangements have been described in various sources (compiled in the Bibliography, below). An overview of these arrangements is presented in this part, followed by more specific descriptions of several different types.

A. Overview of Transactions

Notwithstanding the wide differences among the known ChOLI arrangements, each transaction at issue here, at a minimum, includes four elements: (1) a charity that has an insurable interest in a large number of donors; (2) investors who seek a profitable return on capital by investing, directly or indirectly, in life insurance contracts; (3) promoters and sponsors of ChOLI arrangements; and (4) a pool of life insurance contracts insuring the lives of a pool of individuals.[39] In general, the charity provides its insurable interest in donors, investors provide capital to purchase life insurance contracts, the promoters bring the parties together (for a fee), and the charity and investors divide the return on the contracts (primarily death benefits) according to the terms of the particular arrangement. There may also be a financing group, independent of the investors, that provides funds needed to pay premiums prior to any sale or assignment of the contract.

The popularity of reported ChOLI arrangements appears to have been concentrated during the period from 2000 through 2005. Since then, these transactions appear to have drawn less attention and the number may have declined. Moreover, the required reporting under section 6050V did not generate much information, as discussed in Section IV of this report. Nevertheless, it is possible to categorize ChOLI arrangements as follows. The most basic form of ChOLI arrangement involves the direct ownership of life insurance contracts by a charity. More complex arrangements involve the indirect ownership of life insurance contracts by a charity through a trust or other special purpose investment vehicle. In addition, some ChOLI arrangements -- typically those involving indirect ownership through an investment vehicle -- include the purchase of annuity contracts as well as life insurance contracts. These various categories of ChOLI arrangements are discussed further below.

B. Arrangements Wherein the Charity Owns Life Insurance Contracts

The simplest form of ChOLI (or FOLI, referring to Foundation-Owned Life Insurance) arrangement involves the direct ownership of life insurance policies by a charity. Most of the reported transactions involve bona fide charities with an established roster of committed donors. For example, a New York Times article discussed an 81-year-old woman who had donated millions of dollars to the United Way over the course of her lifetime.[40] To benefit the United Way upon her death, she allowed herself to be insured for $70 million in return for some portion of the death benefits going to the charity.[41] The article's details on the transaction are sparse, but there were investors involved who received a large portion of the death benefits. The article noted that the woman had participated in more than one of "such pools."[42]

A small number of transactions may involve "charities" that were specifically formed in order to participate in life insurance programs. For example, the founder of the Coachella Valley Society for the Prevention of Cruelty to Animals (SPCA) in California has acknowledged that "[t]he charity itself was really housed to form a home for this [ChOLI] program."[43]

The structure of the ChOLI arrangement wherein the charity owns the policies directly is fairly straightforward but typically involves the charity borrowing the funds used to purchase the life insurance policies. For example, in the case of the Coachella Valley SPCA, the charity recruited some one thousand participants (based on their age, gender, and the insurance company's estimate of their remaining life expectancy) each of whom agreed to have life insurance purchased on his or her life in return for allocation of a $25,000 death benefit to the beneficiaries of the participant. The SPCA then borrowed about $5 million annually at 6.5 percent interest from the Insurance Co. of North America (at that time a unit of Cigna Corp.) to pay the premiums on policies of $275,000 on each of the participants' lives. On the death of the last of the participants, $275 million in death benefits would have been paid, of which $25 million would have been paid to the beneficiaries of the participants. About $190 million dollars was expected to be paid to Insurance Co. of North America to repay the annual $5 million loans used to finance the premium payments. The remainder, expected to be $60 million, would belong to the charity.

The Coachella Valley SPCA was a client of a company named FOLI that, beginning in 1995, marketed plans that called for the charity to borrow or otherwise provide the funds used to purchase the life insurance policies.[44] Pursuant to such an arrangement, another FOLI client, the Osteopathic Medical Center of Texas, borrowed $6 million and put up $2 million of its own money to purchase 1,239 life insurance policies on its employees and supporters.[45] The Center expected to net roughly $200 million over forty years, the bulk of which would start to accrue in thirty years.[46]

In general, the investors in a ChOLI arrangement are seeking the profit potential that actuarial arbitrage can provide but that is otherwise inaccessible due to the insurable interest requirement. In some cases, for example, investors may seek an investment return that is not correlated with the performance of equities, bonds, commodities, or other financial products. The investors' returns may instead be correlated with mortality of a group of individuals.[47]

In other cases, assuming the participants die at the actuarially determined rate, the profits from this class of ChOLI arrangement derive from what is arguably underpricing of the life insurance policies. Underpricing can occur because of a difference between the assumed lapse rate anticipated by the actuaries and the actual lapse rate if the policies are owned by investors. The calculations that factor into policy pricing assume that a certain percentage of policyholders will allow their policies to lapse at some point. For instance, often parents will allow life insurance policies on their own lives to lapse once their children reach adulthood and/or financial independence.[48] In contrast, because investors' returns rely on holding the policies until the deaths of the insured, investors generally do not allow policies to lapse. If a lapse assumption is used to price an insurance policy, and the policy is never allowed to lapse, the policy will have been underpriced relative to the price at which it would have been offered had the actuaries known that the policy definitely was going to be renewed until the death of the insured. Although the profit potential may be small on a single policy (and the longevity risk prohibitive), recruiting enough participants to provide for a reasonably predictable death rate can, in theory, lead to a predictable return. In 2006, a presenter at the annual meeting of the Society of Actuaries noted that one way to deal with an expanding definition of "insurable interest" and life insurance held for investment by charities or others would be to assume a higher percentage of renewal (i.e., a lower lapse rate).[49]

If the policies in ChOLI arrangements were priced "properly" (e.g., assuming a lapse rate more appropriate for policies held by investors), these arrangements generally would provide the returns promised to the charities only if the participants die earlier, on average, than the actuaries anticipated. For instance, Vaughn Henry, an estate planner who has written on ChOLI arrangements, has noted that life insurance as an investment will do better than other investment vehicles "only if people are willing to die early."[50] There is no information available about the long-term success of plans such as those marketed by FOLI for the participating charities. As of 2003, the participants in the FOLI arrangement entered into by the Osteopathic Medical Center of Texas had not died at the rate anticipated. The arrangement entered into by the Coachella Valley SPCA ended in 1999 when the Insurance Co. of North America was acquired and the policies were "surrendered" in connection with the acquisition.[51]

C. Arrangements Wherein a Trust or Other Special-Purpose Vehicle Owns the Life Insurance Contract

In more complex ChOLI arrangements, the charity does not directly own the life insurance policies but rather holds them through a trust or other special-purpose vehicle (SPV) set up specifically to hold the policies. Investors can then own fixed-income shares or debt instruments issued by the trust or SPV.

In the so-called L.I.F.E. Heritage plan, for instance, the proceeds from the sale of fixed-income shares or debt instruments were used to purchase five thousand life insurance policies totaling more than $2 billion on the lives of the charity's donors.[52] Each year for thirty years, the first $1 million of death benefits goes to the charity with the remainder (roughly $2.2 billion) going to the investors at the end of the 30-year period (a return of roughly 8.3 percent on an annual basis).[53] The donors agreed to the arrangement in return for a modest amount of life insurance coverage provided to the donors at no cost.[54] Capital Partners, the plan's sponsor, netted $1.4 million when the plan was put in place.[55] Assuming the payouts occur as the L.I.F.E. Heritage sponsors project, a charity would receive approximately $30 million simply for providing access to the insurable interest that the charity has in its donors.

Depending on the terms of the trust or other special-purpose vehicle, the motivations of both the investors and the charity may be the same as motivations of those parties in an arrangement wherein the charity is the direct owner of the underlying policies. As in the case of charity-owned policies, the returns from these arrangements are not guaranteed. Success, from the point of view of the charity and the investors, depends upon a fundamental mispricing of the policies.

D. Arrangements Involving Both Annuities and Life Insurance Contracts

Certain ChOLI arrangements involve combinations of life insurance and life annuities, referred to in this report as "combination arrangements." In these arrangements, the potential for earnings is based on economic arbitrage between a life insurance policy and a life annuity on the same individual. Thus, combination arrangements may anticipate that the charity market the program to its older donors with "excess insurance capacity."[56] Generally, combination arrangements are funded by borrowing from a bank or a coalition of investors, and promotional materials may describe them as a method for fundraising involving no cash outlay by either the charity or the individual insured.

In a typical combination arrangement, charities or licensed insurance agents solicit the participation of consenting individuals who allow a statutory business trust or other entity to purchase life insurance and life annuity contracts on their lives.[57] Investors purchase securities of the trust or other entity, and charities own a second class of securities. The payments received from the annuity contracts are partially taxed according to the usual life annuity rules, while the net-of-tax proceeds are used to provide investors returns on their investments, to pay the trust's expenses, and to pay the premiums on the life insurance contracts. As consenting individuals die, the death benefits primarily are used to repay investors the portion of their initial investment represented by the policies on the deceased individuals.

In general, approximately 5 percent of the death benefits are paid to the charities specifically designated by the consenting individuals.[58] When the last consenting individual dies, the trust pays any remaining expenses and then distributes any remaining funds to the designated charities. The trust then dissolves. As structured, the consenting individuals do not provide any direct contributions and incur no risk to participate in the combination arrangement. Their participation simply allows the trust to use the insurable interest they have in their lives.

Combination arrangements take advantage of pricing differences in the life insurance and annuity markets. They produce a profit if: (1) the annuity payments exceed the periodic life insurance premiums and debt service paid to investors or other lenders; and (2) the death benefits will exceed the amounts initially invested (and then used to pay promoter fees and to procure the life insurance policies and annuities). This can occur by virtue of arbitrage based on the differing mortality assumptions used in pricing life insurance policies versus life annuities. Acting conservatively, insurers would tend to exaggerate longevity for pricing annuity contracts and exaggerate mortality for the purpose of pricing life insurance contracts. For successful arbitrage to occur under a combination arrangement, effectively the opposite must occur; annuity pricing must reflect a relatively higher expected mortality than life insurance.

Under a combination arrangement, the arbitrage profits are guaranteed, in the sense that the rate of return to investors on a combination arrangement is independent of the date of death of the insured. This means the promised investment returns are guaranteed (given solvency of the insurance companies), but the maturity of the investor's investments is subject to uncertainty. Thus, under a combination arrangement, the promoter need not "outpredict" the insurance company actuaries; the promoter needs only to find inconsistent pricing across different insurers. Under other types of ChOLI, the uncertainty of mortality extends to investment return risk; in general, the longer-lived is the insured, the lower is the resultant return on the investment.

IV. DATA COLLECTION

As noted above, section 1211 of the PPA added section 6050V to the Code, which required applicable exempt organizations to make an information return regarding acquisition of an interest in certain life insurance contracts pursuant to certain ChOLI arrangements. In response, the Service issued Form 8921, Applicable Insurance Contract Information Return (for Tax-Exempt Organizations and Government Entities under Section 6050V). Applicable exempt organizations were required to complete Form 8921 for reportable acquisitions of applicable insurance contracts that took place after August 17, 2006, but on or before August 17, 2008.

Through December 2009, the Service has received Form 8921 submissions from fewer than ten filers. Under taxpayer privacy laws, disclosure of information from individual returns is not permitted, and the small number of responses precludes analysis or aggregation in any meaningful fashion.[59] In any case, such a limited data set would not support significant inferences. Instead, this part of the report discusses possible reasons for the small number of submissions.

It is not clear why so few Form 8921 filings were received by the Service. It is unlikely that applicable exempt organizations were unaware of the section 6050V reporting requirement. In Notice 2007-24, the Service highlighted the reporting requirement and requested comments both on the study that was to be prepared by the Treasury and the Service and on proposed Form 8921 (and 8922, as discussed above). Additionally, in 2007, both Form 990 (line 89f) and the instructions to Form 990 (page 49) called attention to an exempt organization's obligation to file Form 8921. In 2008, the instructions to Form 990 (page 69) again identified Form 8921 as one of several "Other Forms that May Be Required."

In particular, the 2007 Form 990, on line 89f, asked: "Did the organization acquire a direct or indirect interest in any applicable insurance contract?" There was an affirmative answer on over five hundred returns, representing a wide variety of types of organizations, such as hospitals, corporations, trusts, universities, educational organizations, community foundations, internationally-oriented charities, fraternities and sororities. It is unclear why these returns answered yes but did not file the required Form 8921.

Any organization that is found to be delinquent in filing Form 8921 would be subject to penalty under section 6721(a), or in the case of intentional disregard of the filing requirement or correct information reporting requirement, a penalty under section 6721(e)(2)(D), equal to the greater of $100 or 10 percent of the value of the benefit of any contract with respect to which information is required to be reported. Regardless of how the value of that benefit is determined, there appears to have been little incentive for an applicable exempt organization to risk the penalty, since no tax liability was at stake[60] and compliance costs were limited to completing a two-page form for each applicable transaction. The potential applicability of a penalty in any particular case would be ascertained in the course of ongoing compliance activity that, depending on the confidential facts and circumstances of any particular organization or taxpayer, could involve correspondence, compliance checks, or examination. Unless there is reasonable cause for failure to file Form 8921, a penalty for failure to file would follow.

One possible explanation for the discrepancy between the number of affirmative answers to the question on Form 990 and the number of Forms 8921 is that some organizations misinterpreted the question. The Instructions clarify that the question refers to "an applicable insurance contract which is a part of a structured transaction involving a pool of such contracts." However, it may be possible for an organization to acquire an applicable insurance contract within the meaning of section 6050V(d)(2), but not in a "reportable acquisition" within the meaning of section 6050V(d)(1) (i.e., not in a structured transaction involving a pool of such contracts). An organization that interpreted the question more broadly than intended (i.e., to be seeking information about all applicable insurance contracts, whether or not part of a structured transaction) could have answered line 89f affirmatively without filing a concomitant Form 8921. The Service is making the appropriate inquiries to determine if these responders should also have filed Form 8921.

Alternatively, the small number of Forms 8921 received (assuming for this purpose that the proper number was received) may be attributable to one or more of the following factors: First, the market for investor-owned pools of life insurance contracts may have shifted from contracts originated by charities to contracts originated directly by insured individuals. Since 2006, the market has seen an increase in transactions in which an individual is approached by a promoter and encouraged to purchase a life insurance policy with a nonrecourse premium loan. If the individual dies during the term of the loan, a portion of the death benefits under the policy is used to pay off the loan and the remainder is paid to the individual's heirs. If the individual is still alive at the end of the loan term, the policy is sold or transferred to the lender. The individual thus enjoys either free insurance protection or some other economic benefit for participating in the program.[61] It is possible that an increase in these transactions -- and in traditional life settlement transactions in which existing policies are purchased from elderly individuals who no longer need them -- reduced the need for investors to recruit exempt organizations and their donors to gain access to large pools of life insurance policies.

Second, some exempt organizations may have grown concerned about the negative publicity surrounding these arrangements. For the same reason that gambling on human lives has long been contrary to public policy, a number of publications have questioned the propriety of a charity's participation in a transaction in which it essentially sells to investors insurable interests in its donors.[62] Concern about such negative publicity may have deterred some exempt organizations from moving forward with arrangements involving investors and life insurance on their donors.

Third, it is possible that some transactions were either accelerated before the effective date of the reporting requirement, or deferred until after it terminated. Even though the reporting requirement had no effect on the income tax liability of the applicable exempt organization, some organizations may have preferred not to engage in these transactions during the two-year information reporting period to avoid scrutiny of the transactions or of their other activities. It is also possible that the number of transactions began to drop as early as 2005 in response to various related excise tax proposals.

Additionally, as noted above, many of the arrangements rely on exploiting potential mispricing in the life insurance and life annuity markets. Because profits from these types of arbitrage come at the expense of the life insurance companies, some large life insurance companies have encouraged their agents to cease entry into combination arrangements.[63] It is also possible that the companies have begun to change the assumed lapse rate used to price life insurance policies, as at least one actuary suggested in 2006 at the Society of Actuaries annual meeting.[64] This would reduce the amount of profit that can be gained by entering into these arrangements and therefore would be expected to cause a decrease in the number of arrangements.

Whatever the reason for the small number of filings, the Forms 8921 received provide insufficient data to draw conclusions about the participation of charities in these arrangements. Section 1211 of the PPA directs that the study address (1) the use by tax-exempt organizations of applicable insurance contracts for the purpose of sharing with investors the benefits of the organization's insurable interest in individuals insured under such contracts, and (2) whether such activities are consistent with the tax-exempt status of such organizations. The number of responses received represents too small a sample to meaningfully inform the tax policy debate concerning the propriety of an exempt organization's raising funds by participating in these transactions.

V. TAX IMPLICATIONS AND POLICY ISSUES

VI.

This part of the report discusses federal income tax implications of ChOLI arrangements and tax policy issues that may be of continuing concern to Congress.

A. Exempt Status and the Sharing of Insurable Interest

As described in Part I, an organization's qualification as a charity bears on both its Federal tax exemption and its insurable interest in its donors under State law. Generally, an organization that is organized and operated as a charity according to section 501(c)(3) of the Code, Treasury Regulations and common law is exempt from Federal income tax. Moreover, if the Service recognizes an organization as a charity, i.e., a tax-exempt organization described in section 501(c)(3), the organization may have an insurable interest in its donors pursuant to State insurance law.

Because a charity has an insurable interest in a potentially large group of people (generally, its donors), the charity may purchase a large number of life insurance contracts, benefiting from the inside build-up under the contracts and the death benefits ultimately received. To generate this return, however, capital is necessary to pay premiums on the contracts. ChOLI arrangements are designed to allow investors to supply the necessary capital, while the charity supplies the insurable interest. Ultimately, the charity and investors can divide the proceeds.

Significant public policy and insurance regulatory issues may arise, however, with regard to life insurance contracts, such as applicable insurance contracts, that are purchased based on a charity's insurable interest in a pool of its donors but in which investors with no relationship to the donors also have an interest.[65] In the regulatory context, for example, the State of New York Insurance Department concluded that an arrangement in which a trust would be sponsored by one or more charities (the Sponsor) for the purpose of borrowing money and purchasing life insurance policies (Policies) and single-premium annuities (Annuities) on a pool of donors did not conform with that State's insurable interest requirements. The Department's opinion letter noted, in particular, that "a significant portion of the proceeds of the Policies and Annuities must be diverted to provide the bondholders with a return on their investment," and that the Sponsor's ownership interest" is compromised by the fact that the Sponsor must assign its rights under the Policies and Annuities to the Issuer Trust, which in turn must pledge them as collateral."[66]
For similar reasons, an organization's involvement in a ChOLI arrangement may call into question its compliance with the organizational and operational tests for exempt status, i.e., whether the organization is organized and operated exclusively for exempt purposes, and whether it has violated the prohibitions on inurement and substantial private benefit.

Organization and Operation Exclusively for Exempt Purposes

A ChOLI arrangement may be viewed as a sharing of insurable interest in donors, which is a charitable attribute, with investors, who are not charities. At some point, the pool of life insurance contracts in which a charity invests may be so large, may cover so many individuals, and may require so substantial an investment by unrelated investors, that the organization can no longer be treated as organized and operated "exclusively" for charitable purposes, as required by section 501(c)(3). Rather, the organization may effectively be serving an unrelated purpose -- the facilitation of investment by private investors in life insurance contracts. Even though some States treat a charity as having an insurable interest in any consenting donor, in some cases the charity's actual relationships with its insured donors may be so attenuated that those relationships in fact are more valuable in enabling the purchase of life insurance than in providing funding for the charity's operations. This issue is even more relevant where the charity must borrow funds in order to afford the premiums paid to insure its donors. Although the fact of borrowing does not necessarily bear on insurable interest, such leverage permits the purchase of life insurance that is arguably beyond the means of the charity or the needs of the charity (other than to meet financial obligations to lenders or investors) and disproportionate to the contributions of the underlying donors.

Resolution of this issue may depend in part on whether the charity's financial involvement in the arrangement is viewed on a "gross" basis (taking into account the total death benefits and other returns on the underlying life insurance contracts), or on a "net" basis (taking into account only the financial returns that are enjoyed by the charity). Existing legal authority does not address this question. A "net" approach, however, would arguably obscure in many cases the extent of a charity's role in facilitating private investment and the significance of that role relative to the charity's exempt functions -- difficult though that may be to measure. While it is impossible to generalize in the absence of meaningful data, it would appear that a charity's participation in a ChOLI arrangement may conflict in many cases with the "exclusive" purpose requirement.

Inurement and Private Benefit

By all accounts, the amount of money that flows to charities from ChOLI arrangements is much smaller than that which is anticipated to go to the private investors.[67] For example, in the L.I.F.E. Heritage plan discussed above, at the beginning of the arrangement, the charity anticipated $30 million over the course of thirty years ($1 million per year).[68] The investors, however, expected to receive $2.2 billion over that same time period.[69] Thus, at the beginning of the arrangement, in undiscounted terms, the charity expected to receive only slightly more than 1 percent of the benefits from the arrangement. Similarly, in the life insurance/ annuity combination arrangements described above, only approximately 5 percent of the death benefits went to the participating charities.[70]

The disparity in the relative returns derived by the investors in a ChOLI arrangement and the participating charity raises the question of whether these arrangements inherently violate the proscriptions on inurement and substantial private benefit. On the one hand, the respective contributions of the charity (insurable interest) and the investors (capital) may be hard to value, and thus there may be no obvious principle by which to prorate the proceeds between them. On the other hand, if the effect of the arrangement is that the charity serves merely as a vehicle through which investors can generate profits, that presents a question of charitable status.
Inurement. As discussed previously, Federal tax law provides that no part of the net earnings of a charity shall inure to the benefit of any individual who has a private interest in the charity's activities (a so-called insider). Assuming that a ChOLI arrangement is

otherwise permissible, it could run afoul of this proscription on inurement if charity officers or other individuals in a position to influence the charity's operation became investors or otherwise profited from the arrangement. This determination would necessarily be made, however, on a case-by-case basis, taking into account the facts of the particular situation. While new general restrictions could be devised to preclude all charity officers and other persons with influence from investing in ChOLI arrangements, the Treasury and the Service are not aware of any evidence to suggest that inurement is a systemic problem with these arrangements or that existing law is insufficient to address it.

Private Benefit. Treasury Regulations also stipulate that a charity may not be organized or operated for the benefit of private interests. A private benefit may be permissible if it is merely incidental to charitable activity, but a substantial private benefit is impermissible.[71]

A ChOLI arrangement is designed as an investment vehicle and by its nature benefits private investors. This private benefit derives in large part from the use of the charity's insurable interest in its donors, an attribute it would not have in the absence of its charitable activities and, in most cases, its concomitant tax-exempt status. Questions presented by this circumstance include whether this private benefit may be substantial enough in any particular case, in comparison to the charity's exempt activities, to justify revocation of the charity's tax-exempt status or, more generally, whether charities should simply be prohibited from engaging in these transactions in order to preclude this possibility.[72]

Although particular arrangements differ, the fact that most ChOLI arrangements involve a large pool of insurance contracts tends to mean that the value of the overall investment is substantial. Moreover, as noted above, the proportion of the overall return from the arrangement that is allocated to the investors is typically much greater than that allocated to the charity.

Two factors may explain this disproportionality. First, in many of the arrangements, the charity bears no risk of loss. For example, in the L.I.F.E. Heritage plan, the charity receives the first $1 million each year in death benefits.[73] Thus, if there is a substantial risk that annual death benefits will be $1 million or less, the investors would bear a much greater amount of risk than the charities do. That greater risk may justify a correspondingly larger expected return.

Second, charities often do not have the financial ability (or, perhaps, the risk-tolerance) to enter into ChOLI arrangements with their own funds. At least one of the charities entering into a FOLI with outside investors did so because it could not afford to pay the premiums on its own.[74] Thus in at least some cases the presence of the investors is necessary for the charity to receive any returns. It is not clear, however, that alternative investments could not provide charities with returns of comparable magnitude and risk, without requiring the involvement of substantial numbers of a charity's donors and substantial amounts of third party funds. In fact, the apparent decline in the popularity of ChOLI arrangements over the past five years or so suggests that charities have indeed opted for alternative investments. Comparison of the private benefit from any particular ChOLI arrangement to the exempt activities of the charity involved necessarily requires an examination of the particular facts. Moreover, as described earlier, relatively little information was provided through the PPA information reporting requirement. Nonetheless, the available evidence suggests that the private benefit from ChOLI arrangements tends to be substantial in absolute terms and that potentially offsetting benefits to the charities, such as providing a type of investment return that would otherwise be unavailable, are not significant.

B. Income from ChOLI Arrangements as UBTI

As described earlier, an organization described in section 501(c)(3), a charity, is exempt from Federal income taxation not only on the contributions and gifts it receives, but also on the income it derives from the performance of its exempt function. This exemption does not extend, however, to UBTI, which is the gross income derived from an unrelated trade or business regularly carried on by it, less the deductions otherwise allowed that are directly connected with carrying on that trade or business.

Whether a charity's returns under a ChOLI arrangement constitute UBTI is not entirely clear, due in part to factual differences among the various arrangements and in part to the UBTI provisions themselves. In some cases, the arrangement may be treated as debt-financed, because the charity has borrowed funds in order to acquire the life insurance policies and, in the case of combination arrangements, annuities. In those cases, net returns from the arrangement would be UBTI, except to the extent they are otherwise excluded from gross income pursuant to the Code provisions governing the taxation of life insurance. Thus, UBTI would not include the death benefits under a life insurance policy or the value of the inside buildup, both of which are generally excluded from gross income.[75] If, however, the charity receives payments under annuities acquired with borrowed funds, those payments generally would be taxable as UBTI.

In the absence of debt-financing, UBTI would include gross income from the arrangement only if it constitutes an "unrelated trade or business" that is "regularly carried on." Although many ChOLI arrangements may not rise to the level of a "trade or business" that is "regularly carried on," it is possible that in some cases the business activities conducted in insuring a charity's donors could rise to the level of a regularly carried on trade or business.[76]

Moreover, if the charity is not the owner of the life insurance contracts, it is necessary to determine not only whether the charity's involvement rises to the level of a "trade or business" that is "regularly carried on," but also the nature of the charity's return under the arrangements, i.e., whether it constitutes investment income. Economically, the better characterization of a charity's return under many ChOLI arrangements may be as compensation from investors for providing access to the charity's insurable interest in its donors. This would suggest that, for tax policy purposes, any funds received by the charity may be best characterized as services income, rather than investment income.

Alternatively, if an insurable interest were considered property, the appropriate characterization would be by analogy to rent or the sale of property. In Grigsby v. Russell,[77] Justice Holmes wrote for the U.S. Supreme Court that a life insurance policy could be transferred to a person without an insurable interest because "[t]o deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hands." Because life insurance policies had become "one of the best recognized forms of investment," the Court saw fit to consider the policy "property."[78] If an insurable interest similarly should be characterized as property, then for tax policy purposes, it may be more appropriate to analogize funds that charities receive in a ChOLI arrangement to funds received from the rent or sale of property -- and thus potentially as investment income. As discussed previously, however, that property -- the charity's insurable interest in its donors -- exists solely by virtue of the organization's charitable and tax-exempt status. Thus, an approach which views a ChOLI arrangement as involving the rent or sale of a charity's insurable interest necessarily implicates the other issues discussed previously relating to the organization's exempt status, i.e., potential conflict with the requirement of organization and operation exclusively for an exempt purpose and the prohibition on substantial private benefit.

C. Role of Tax Benefits in the Profitability of ChOLI Arrangements

Another important question for purposes of this report is whether the profits derived from ChOLI arrangements rely in any way on the tax benefits provided to charities or to the benefits paid upon death from a life insurance policy. In other words, do the investors receive any tax benefits (whether directly or indirectly) by entering into these arrangements? The analysis differs somewhat depending on whether the ChOLI arrangement involves direct ownership of life insurance (and possibly annuity) contracts by the charity, or indirect ownership by the charity through a trust or other investment vehicle.

Direct Ownership

The most significant benefit associated with owning a life insurance contract is the exclusion from gross income of amounts received under the contract by reason of the death of the insured. This exclusion from gross income is generally not a factor where the owner of the contract is a tax-exempt organization (unless the income is debt-financed) or otherwise indifferent to the receipt of taxable income. Rather, as discussed earlier, profitability depends on either underpricing of the policies or the early deaths of the arrangement's participants.

More specifically, in a transaction in which the policies originate and are at all times owned only by the charity, neither the exclusion from gross income of death benefits under section 101(a) nor the exemption under section 501(a) for charities seems to play a role in the profitability of the arrangement. Because charities are already tax-exempt (except in the case of UBTI, discussed above), the tax exemption afforded death benefits does not provide any added benefit to charities engaged in a ChOLI arrangement.[79] While the exclusion can be beneficial in situations where a charity chooses to borrow funds in order to acquire life insurance policies (so that returns would otherwise be debt-financed UBTI), it does not appear that leverage is essential to the profitability of the arrangement. In fact, it is possible that the exclusion under section 101(a) may make life insurance policies less attractive to charities. To the extent life insurers can price their policies higher because of the tax-preferred nature of their returns, charities would pay a higher price with no accompanying tax benefit. At least one estate planner has pointed out that because charities are already tax-exempt, "they are usually better off with other investment vehicles."[80]

Indirect Ownership and Transfer-for-Value

The analysis is essentially the same with respect to the charity in a transaction in which the insurance policies are held by a trust or other special purpose investment vehicle (SPV). Again, the ChOLI arrangement does not provide any tax benefit to the charities, which are already tax-exempt.

In those situations, however, investors may have an interest in the trust or SPV through ownership of either equity interests or debt instruments. Few of the published reports about ChOLI arrangements have focused on tax reporting by the investors, and less is known about this aspect of the arrangements. One commenter has stated that part of the financial success of combination arrangements "depends on the favorable tax treatment of the annuity and life insurance as separate" in a situation where the trust is set up by the charity and would therefore be tax-exempt.[81] Other commenters, however, have characterized combination arrangements as being profitable by virtue of exploiting inefficient pricing of the life insurance and life annuity contracts, without mentioning any tax benefits.[82] If, for instance, the life annuity contract is purchased with a high mortality assumption (i.e., the annuitant is expected to die quickly) while the life insurance contract is purchased with a low mortality assumption (i.e., the annuitant is expected to live for a longer period of time), then the disparity would provide for an arbitrage opportunity that does not depend upon the annuity income being tax-exempt or otherwise tax-preferred. If the returns provided to investors were tax-exempt, the returns would, of course, be greater (except to the extent those returns go to already tax-exempt investors). Promoters of the plans generally maintain, however, that tax benefits do not contribute to the profitability of the plans.

Due to the insufficiency of the data resulting from information reporting under the PPA, the Treasury and the Service could not independently verify whether investors (or anyone else) were in fact claiming the benefit of the gross income exclusion for death benefits in ChOLI arrangements. However, to the extent that a contract was purchased based on a charity's insurable interest in its donor, and was later owned (including through an investment vehicle) by an investor with no other relationship to the donor, one would expect the transfer-for-value rule to limit the availability of that exclusion. As described previously, a transferee-for-value under section 101(a)(2) is permitted to exclude death benefits from gross income only to the extent of the consideration paid for the contract, plus premiums and other amounts paid subsequently.[83] In this way, a transferee for value (i.e., a purchaser) is taxed on the economic income from owning the contract. Exceptions apply in the case of transferred basis transactions, or transactions in which a life insurance contract is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Where a ChOLI arrangement involves ownership of life insurance contracts through a trust that includes investors unrelated to the insured or the original policyholder, the applicability of the transfer-for-value rule may be unclear, in part due to the possible absence of a "transfer" within the meaning of the rule and in part due to the possible applicability of one or more of the exceptions noted above. For example, a transfer of a life insurance policy to a partnership in which the insured is a partner is excepted from the transfer-for-value rule, even if the transfer is a sale. And in some cases a transfer by a charity of an ownership interest in a trust holding life insurance contracts may not rise to the level of a "transfer" under the transfer-for-value rule.

The Administration's Fiscal Year 2010 and 2011 Revenue Proposals include a proposal to modify the existing exceptions to the transfer-for-value rule of section 101(a)(2) to ensure that exceptions to the rule would not apply to buyers of policies.[84] Under the proposal, the transfer-for-value rule would limit the gross income exclusion for death benefits even if, for example, the transfer is to a partner of the insured or to a partnership in which the insured is a partner. The proposal primarily addresses transactions involving sales of life insurance contracts that were entered into based on the insured individual's insurable interest in his or her own life. For example, in a life settlement transaction, an individual may sell to a life settlement company a cash value life insurance contract that has been in force for many years and is no longer needed. Or, in a so-called stranger-originated life insurance (StOLI) transaction, an individual may enter into a life insurance contract using funds borrowed with an up-front arrangement that anticipates the contract will revert to the lender, typically after a two-year contestability period. The proposal would ensure that investors in these transactions will be treated as transferees for value under section 101(a)(2).

Although the proposal is not specifically directed at charity-originated arrangements, similar tax policy issues arise in those variations of the transactions in which the underlying life-insurance contracts are originated based on the charity's insurable interest in its donor, but are economically transferred to unrelated investors. From the standpoint of an investor who owns life insurance contract but has no relationship with the insured individual, it is not particularly relevant whether the contract was originally purchased based on the individual's insurable interest in his or her own life or based on a charity's insurable interest in the individual as a donor. What matters is that the investor receives a death benefit without regard to any financial or other relationship with the insured individual. The case for a gross income exclusion for death benefits grows still weaker in situations where the investor owns not one, but dozens, hundreds or thousands of such life insurance contracts on strangers, at which point the stream of death benefits represents little more than a contingent cash flow on an investment. In such a case, the transfer-for-value rule should operate to ensure that the investor is taxed on its economic income from the transaction, i.e., the excess of the death benefits received over the total amounts paid with regard to the contracts. The Administration's proposal is designed to ensure this result and, by its terms, would apply to ChOLI arrangements.

D. Excise Tax Proposals

Finally, this section summarizes several excise tax proposals advanced in recent years in response to general concerns similar to those outlined above.

In February 2005, the Treasury proposed an excise tax on ChOLI arrangements. Is the proposal, an excise tax of 25 percent would have been imposed upon any person who received death benefits, dividends, withdrawals, loans, or surrenders under a life insurance contract, if (i) a charity ever had a direct or indirect ownership interest in the contract, and (ii) a person other than a charity ever had a direct or indirect interest in the same contract (including an interest in an entity holding an interest in that contract). The proposed excise tax would not have been deductible for Federal income tax purposes, and the amount of excise tax paid would nothave been included in the policyholder's investment in the contract. The proposed excise tax would not have applied to situations in which: (i) each non-charity involved in the arrangemenhad an insurable interest in the insured independent of the charity; (ii) each non-charity's only interest in the life insurance contract was as a named beneficiary; or (iii) the transaction was exempt from the excise tax under regulations prescribed by the Secretary, based on factors including the arms' length nature of the transaction, the relative economic benefits to the charity and non-charity participants, and the likelihood of abuse.[85]

On May 10, 2005, Senators Charles Grassley (R-Iowa) and Max Baucus (D-Mont.) introduced a bill, S. 993, that would have amended the Code to impose an excise tax on certain tax-exempt organizations or other non-exempt persons which acquire a direct or indirect in any life insurance, annuity, or endowment contract, in the amount of 100 percent of the acquisition costs of the interest. Senate bill S. 993 would have allowed an exception from the excise tax for individuals with insurable interests, named beneficiaries, and trust beneficiaries. S. 993 would have required these tax-exempt organizations and other non-exempt persons to file certain information returns with the Service.

On November 18, 2005, the Senate passed a bill, S. 2020, the Tax Relief Act of 2005, which contained a proposal, in section 312, that would have imposed an excise tax on certain tax-exempt organizations that acquire a direct or indirect interest in any life insurance, annual or endowment contract, in the amount of 100 percent of the acquisition costs of such interest. S. 2020 would have allowed an exemption from the excise tax for individuals with insurable interests, named beneficiaries. S. 2020 would have required these organizations to file information returns with the Service relating to the acquisition of the interests.

None of the three proposals described above has been enacted into law,[86] although legislative interest in imposing an excise tax along these lines may have dissuaded charities investors from establishing new ChOLI arrangements. Nevertheless, it is worth noting that the imposition of an excise tax (unless its magnitude is so large as to be clearly punitive) may indicate implicitly that ChOLI arrangements are not improper under existing law but instead should merely be discouraged in the circumstances to which the excise tax would apply. To the extent that specific tax policy concerns can be identified, an approach that applies appropriate restrictions or prohibitions -- perhaps accompanied by an excise tax to be imposed on violation of those restrictions and prohibitions -- may ultimately be more understandable by affected parties and therefor more effective.

CONCLUSION

This report has discussed ChOLI arrangements, based on public comments, reports, and other sources. It is apparent that there are a number of respects in which ChOLI arrangements may be viewed as inconsistent with the policies underlying the Federal income tax benefits for charities and life insurance.

A ChOLI arrangement may be appealing to a charity as a creative way to raise funds to finance its charitable activities. It may appeal to investors by producing a rate of return that is not correlated with other investments and that, in some cases, permits the exploitation of mispricing inherent in an insurer's product offerings. The magnitude of the investors' interests in the insurance policies, compared with the charities' interests, raises questions, however, that are critical to the charity's exempt status, including potentially significant conflicts with the requirement of organization and operation exclusively for an exempt purpose and with the prohibition on substantial private benefit. Further, as discussed in the report, the treatment of a charity's return from participation in a ChOLI arrangement is not entirely clear in all cases, but arguably may be viewed as unrelated business taxable income in at least some circumstances.

Finally, the report recommends adoption of the Administration's Fiscal Year 2010 and 2011 budget proposals to revise the "transfer-for-value" rule of Internal Revenue Code section 101(a) to ensure that investors in a ChOLI arrangement -- as well as investors in other types of arrangements involving the transfer of life insurance contracts -- do not inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract in circumstances where those investors have purchased an ownership interest in the underlying policies.