

The CHIEF Plan™ – An Overview by Sam Radin

The CHIEF Plan™ is a financial tool that helps non-profit organizations build endowment funds using special life insurance arrangements. Its central feature is to protect charities from the economic loss caused by the death of committed donors. Donors contribute money, assets and services to charities. On the death of a donor, such contributions cease. It is the risk of such loss that the CHIEF Plan™ addresses.

Let us take the simple case of a generous donor who contributes \$50,000 in cash to his/her favorite charity each year. At the donor's death, the contributions cease. It is this economic loss that the charity seeks to eliminate by managing the risk of the donor's death. If the charity had an endowment fund that produced \$50,000 of annual income, such income would replace the donor's annual contributions. Life insurers believe that the charity's economic loss represents a valid, insurable interest and will issue a policy for this purpose. Assuming an interest rate of 4%, the charity would need a policy in the amount of \$1.25 million to produce the same \$50,000 annually in perpetuity.

Why do insurers look favorably on this type of "charitable insurance"? Traditionally, an individual has an insurable interest in his/her own life and validly may assign a policy to a charity. Such insurable interests, however, are general and do not recognize a narrow and specific loss that the charity would suffer on a donor's death as the CHIEF Plan™ does. In short, the insurers feel comfortable that the policy addresses an appropriate and legitimate need.

The Chief Plan™, however, is not limited to insuring the loss of cash contributions. Many individuals volunteer significant time to provide their knowledge and skills to charities to which they are committed. The president of one charity was a tax lawyer who gave about 25 hours per month, or 300 hours per year. His billing rate was \$550/hour and had a value to the charity of \$165,000. At 4%, the charity would need \$4.125 million to replace the loss of his services.

Now that you have a basic understanding of the rationale for creating the endowment fund, the questions are how to acquire the insurance, including, who is to be insured and how is the insurance to be funded. We well understand that in raising funds, no charity wants to precipitate a conflict between its annual giving and its planned or longer term giving. Nor in these difficult economic times should the charity pressure its committed donors.

Determining Who is to be Insured

To begin the CHIEF Plan™ process, the charity must identify the individual donors whose contributions are to be protected and made permanent through an endowment fund. Ideally, such individuals should be over age 70 so that neither the funding period is too long nor the receipt of the insurance proceeds too remote. Such individuals should be donors with a history of making regular gifts to the charity. Individuals who volunteer their time year after year are also appropriate, and may include individuals who are past or current board members. In either case, the individual must agree to be insured by the charity for its benefit. As a general rule, while we have found that such individuals need not be in the best of health, certain health conditions preclude economically effective life insurance. The ideal individuals are between 75 and 80 years old, but younger and older donors may be insured.

Funding the Life Insurance

Generally, charitable life insurance depends upon premiums that are paid by the insured individual. The CHIEF Plan™ does not. Funding can come from four specific sources:

1. The charity's own funds;
2. Deductible gifts from a donor who is not the insured, referred to as a "Funding Benefactor";
3. A donor advised fund; and
4. Non-deductible advances from a Funding Benefactor.

When a charity funds the life insurance from its own funds, it is making an investment in a life insurance policy. Such an investment is prudent and appropriate for the charity because life insurance is an asset that is uncorrelated to any of the charity's other investments. Further, because the premium amounts and the death benefit are guaranteed, the only variable is when the insurance proceeds will be received, *i.e.*, the donor's death. Like any other investment, the performance can be predicted within an ascertainable range. For example, if the life expectancy of a 72 year-old male is twelve years, or age 84, one standard deviation might be five years. Thus, the individual might die five years earlier at age 79 or five years later at age 89. Two standard deviations would change the range to 74 and 94. In all cases, the internal rate of return on investment (premiums paid) is ascertainable and definite. Such returns should compare favorably with other available investments. Of course, the more individuals who are insured, the greater the ability to predict the returns. This is the essence of life insurance and actuarially predictable mortality.

The charity need not fund the insurance from its funds. Often, other committed donors, such as individuals who would be too young to be insured under the CHIEF Plan™, potentially Funding Benefactors, may choose to make cash gifts to the charity to fund life insurance. Such gifts would be tax deductible to the donor.

A potentially more attractive arrangement involves a Funding Benefactor who wants to help the charity but does not want to make the necessary donation to support the life insurance policy. Under the CHIEF Plan™, it is possible to fund the insurance in such a way that the Funding Benefactor recovers the amounts that were paid in premiums from his/her funds. Such recovery would occur on the death of the Insured Donor. Suppose a charity wanted to acquire a \$5 million policy on the life of an important donor. A Funding Benefactor could elect to pay such premiums on the condition that the premiums were repaid on the death of the Insured Donor. Assume that the annual premiums for such insurance were \$150,000. Each year as the premium was paid, the amount of the policy would increase by the amount of premium paid. If the Insured Donor lived twelve years, the policy would have increased from a \$5 million policy to a \$6.8 million policy. At the death of the Insured Donor the charity would receive \$5 million and the Funding Benefactor would receive \$1.8 million, thereby recovering the cost of the cumulative premiums paid. It is also possible to add a 3% interest factor to the premiums so that the death benefit at the end of the twelfth year would be \$7,192,669, with \$5 million going to the charity and the balance going to the Funding Benefactor. In short, the Funding Benefactor would receive an additional \$392,669. As life insurance proceeds, such additional sum would not be subject to income tax.

As in the case of the Funding Benefactor, a donor advised fund could make available the funds for the premium payment. Depending on the nature of the fund, it

could either make an outright grant in the form of the premiums or it could recover them at the Insured Donor's death.

How Does an Organization Determine Whether the CHIEF Plan™ Is Appropriate?

The Initial Process

The first step is to review your donor base of committed supporters. From this you should develop a list of those individuals whose death would cause your organization to suffer an economic loss whether through the loss of donations or money or services. The list should be further refined to those individuals who are age seventy to eighty-five. Typically, you would contact them to determine if they would be interested in being insured for the benefit of your organization. Assuming that the answer is "yes", you should determine which of the funding sources discussed above would be appropriate.

Some organizations prefer to present the plan to the board before determining the identity of potential insured donors and sources of funding. An advantage of this process is that some insured donors may be board members. Further, when explaining the plan to potential insured donors, it is advantageous to be able to state that the board has considered and approved the plan. Having identified, the potential insured donors, the next step is to obtain their authorization for National Madison to collect their medical histories for *informal* submission to insurance carriers to determine their insurability. Assuming that such individuals are insurable, the next issue is to determine the appropriate amount of insurance by quantifying the economic loss that your organization will suffer at death. National Madison would then prepare a formal application for submission to the appropriate carrier.

Funding Choices

Assuming that the insurance can be acquired on favorable terms, the organization must determine how it will fund the policy premiums. Again, the methods of funding are:

1. The charity's own funds;
2. Deductible gifts from a donor who is not the insured, referred to as a "Funding Benefactor";
3. A donor advised fund; and
4. Non-deductible advances from a Funding Benefactor.

Each of these is non-exclusive. A policy could be funded using one or more of these techniques depending upon your organization's needs and the goals of its supporters.

Due Care

Two parties must conduct the appropriate inquiries as part of implementing the CHIEF Plan™. They are your organization and National Madison. Your inquiry must determine

- whether the plan makes economic sense for your organization, and, if so
- whether the plan raises any particular issues for your organization;

National Madison must determine

- whether it has selected the correct insurance carrier;
- whether the particular insurance product is suitable;
- that the funding design is appropriate; and
- the implementation is correctly documented.

Significant Other Applications

While the CHIEF Plan™ is intended to build endowment funds, several other uses have emerged. One of these has been to coordinate the life insurance with certain extant debt obligations. For example, many charitable organizations have borrowed money by issuing municipal bonds. Typically, such bonds have a thirty year maturity. During the term of the bonds, the organization can manage the debt service but not the principal repayment. Because the insured individuals generally have a life expectancy of fifteen years or less, the life insurance proceeds will be received before the bonds mature. Depending upon the terms of the bond indenture, the life insurance proceeds can be used to repay, redeem, or prefund the bond debt. Assuming that an organization could reduce its bond indebtedness by one-half, the same cash flow that had been used to pay interest can now be used to pay both interest and to create a sinking fund for the principal debt.

Another use is in conjunction with a bond issue. Because the maturity of the bonds is roughly twice that of the life insurance—thirty years to fifteen years—the insurance can be pledged as part of the original financing in order to obtain a lower interest rate.

We have found that there are many other applications of the CHIEF Plan™. Among these is recovering the cost to the charity of providing gift annuity payments. If properly applied, the donor's full gift – not merely the residuum – can be retained.

We have also encountered charities that have large liabilities for employees' post-retirement benefits. Typically, such liabilities are unfunded. The CHIEF Plan™ can be an effective means to defease or offset such liabilities.

Conclusion

As you can see, the CHIEF Plan™ is a flexible financial tool. It can be designed to address your organization's specific needs. We would be happy to discuss how it can benefit your organization.

Thank you.