

DYING FOR CHARITY: A NEW BREED OF GOLDEN GOOSE THAT LAYS ROTTEN EGGS?

You will hear phrases such as "Something for nothing," "No risk, nothing to lose," and "A life insurance windfall for charity – without buying a policy – or paying anything at all."

I am referring to "Stranger Owned Life Insurance" (SOLI), also known as Charity Owned Life Insurance (CHOLI).

This is NOT the type of arrangement – where charity is the purchaser, owner, beneficiary and premium payor of life insurance coverage on one or more of its long-time major contributors to ensure the continuation of that donation stream – where such coverage is often a wise and prudent investment, and one I often suggest.

SOLI, which is marketed under many names, is very different. It is a complex and highly speculative broad-based arrangement in which investors co-opt and/or "borrow" the insurable interests of charities to purchase insurance coverage on the lives of hundreds or even thousands of their older, wealthy, charitable-minded, and generous donors.

If these SOLI arrangements are allowed to flourish, humanity itself could be transformed into a financial commodity – with potentially draconian results for the public! (I have also heard of schemes that do not involve charities, where individuals are paid to allow the purchase of insurance on their lives – an even uglier and much more dangerous but inevitable mutation of what I am about to describe.)

Although there are numerous variations on this so-called "win-win" or "something for nothing" theme, some involving trusts and others with LLCs, essentially, it works like this:

- STEP 1:** An investment bank or other financial entity issues securities such as bonds – that investors purchase.
- STEP 2:** The money from the sale of the securities goes into a trust (typically established by the participating charity).
- STEP 3:** The trustee uses trust funds to buy single-premium immediate annuities on the lives of wealthy – and typically older (ages 72 to 90) – donors provided by the charity.
- STEP 4:** The stream of annuity payments is used to buy life insurance on the same donors' lives.
- STEP 5:** Supposedly, the annuities will produce sufficient income to not only pay the life insurance premium – but also provide a sufficient fixed return to the investors on their investment – at least until the donor dies and the insurance proceeds are paid.
- STEP 6:** At the death of an annuitant/insured, the "life only" annuity payment ceases.
- STEP 7:** The insurance proceeds are paid to the trust.
- STEP 8:** The investors recover their investment from the death proceeds received by the trust.
- STEP 9:** If there IS any death benefit remaining at that point, it is paid to the charity. Promoters estimate that the charity's share will be between five and seven percent of the initial face amount.

[NOTE: As early as Steps 3 and 4, the investment bank and participating insurance agents receive fees and commissions.]

LIFE INSURANCE/ANNUITY COMBINATIONS

As noted above, one of the most common variations involves annuities AND life insurance on the same individuals. The money raised from the sale of bond-like securities is used to purchase single premium immediate, straight life (i.e., "life only" payout option) annuities on the lives of supporters of the charity. The income from these annuities is then used to buy life insurance on the lives of the same individuals.

The promoters may try to obtain annuities with exceptionally favorable "impaired risk" rates by presenting those individuals as having lower than standard mortality. (E.g., "He's on his last legs.") Then, they approach a different insurer to purchase life insurance on the same individuals and, by showing them in the most favorable light, try to negotiate the lowest possible life insurance premiums. (E.g., "He's as strong as a horse.") Part of the financial success of the arrangement depends on manipulating (at some point, unethically) this actuarial arbitrage.

The charity – if it sets up the insurance trust – benefits from the tax "arbitrage" under the program. That is, the annuity income received on a non-taxable basis by the tax-exempt trust is – at least according to promoters – certain to be greater than the amount needed to cover the cost of the life insurance premiums each year, plus a sufficient amount to provide annual payments at a fixed rate of return to the investors. So the charity is – in essence – sharing its tax-exempt status to assure a sufficient level of payments to the private lenders/partners in this arrangement.

DIVING INTO THE SHALLOW END OF THE DEAD POOL

Although many charitable uses of life insurance are both legally and ethically proper, there are those for whom such bounds are too restrictive (or not sufficiently broad). Promoters are now engaged in partnering private investor groups with charities in a "for profit" insurance ploy which amounts to statistical gaming and, if allowed to proliferate, would fast-forward us ahead to the past – to a super-sized, modernized, and sanitized version of the long outlawed "dead-pool." (See discussion on the history of insurable interest below.)

By sidestepping or actively instigating changes to insurable interest laws (which have, for very sound public policy reasons, survived for hundreds of years), big moneyed high powered investor groups hope to make life insurance into a mass commodity investment. The investor groups form vast pools of insured lives (namely, supporters of various charities) to capitalize on the unique benefits of life insurance and, by doing so, profit enormously from it.

In most of these so-called "dead pool" arrangements, the odds are high that third-party groups of institutional investors (primarily investment banks, insurance companies, and hedge funds) will receive their share of the "return on investment" sooner – and certainly in a greater amount – than the accommodating charity will receive its share of the benefit (i.e., any remaining proceeds) for which the arrangement is ostensibly designed.

Under such an arrangement, the investors are assured of their return on investment and receive, almost without exception, annual guaranteed payments long before any money is ever paid to the accommodating charities. Yet, without participation by the charities (and the use of the insurability of hundreds or thousands of their supporters), the net financial gains enjoyed by the private investor groups, plan promoters (in the form of upfront and, in some cases, management fees), and insurance and annuity sellers (in commissions), would be unlawful, socially unpalatable, reprehensible as well as unconscionable vis-à-vis public policy, and therefore unachievable.

HOW THE GAME WORKS

As I noted above, there are infinite varieties of this ploy. But in every one, after the promoter and the seller of annuities and life insurance contracts receive their upfront fees (and in some versions annual "management" fees) and commissions, the investor pool, the nameless private individuals and companies who finance the initial purchase of annuities (and subsequent life insurance policies), receives a steady stream of fixed income.

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Eventually, IF the life insurance policies perform as illustrated, IF the insureds die as projected, and only AFTER the investors recover their capital investments, the charity MIGHT receive a (relatively small) percentage of the insurance proceeds.

Some variations give the insured the right to name the beneficiary of a small portion of the death benefit as an inducement to allow the purchase of the policy on his or her life.

Promoters claim that "the insureds pay nothing and it is possible for the charity eventually to receive a large amount of money for its participation in this arrangement" – as justification for what amounts to brokering a "rent-a-life" arrangement on a mass basis.

Seldom do the promoters fully disclose to the charity or the insureds the names of the initial (or secondary market) investors, or what is in it for them, or the full range and magnitude of risks and potential costs to both the charity and its insured patrons. Certainly they do not discuss – as I do below – the overall risk to the insuring public.

BUT DOES (or CAN) THIS ARRANGEMENT REALLY WORK? AND AT WHAT COST?

It is not at all certain that these broad-based CHOLI programs will work. Nobody has PROVED that this ploy will really benefit a charity. There are those who have serious doubts. They question if the policies are, in fact, "priced right," to assure that the investor receives his/her/their investment, AND provide a significant (or meaningful) payoff to the charity.

In other words, for money to be left over for charity after all the smoke clears, it would take (at least on a present value basis) an aggregate amount of death proceeds that is greater than the total premiums paid – under a particular arrangement. Yet, for the insurer to survive and pay its shareholders a profit and its agents a commission, it would have to charge a high enough premium to account for expenses and leave a profit margin. Stated differently, it would have to take in at least as much in premium dollars – and preferably much more – than it pays out.

From an insurer's point of view, how would it assess, for example, its lapse ratio – when the decision to continue or terminate the coverage is in the hands of "investors" and not the policy owners or insureds? If there are multiple insurers involved in a particular arrangement, how would each know for certain what its claims exposure would be when the death benefits and premium payments are aggregated for an entire "dead pool"?

So where does the money to service the investor's debt come from? How about the promoter's fees? Can the promoter, the investor, the insurance agents, the insureds, the insurer, and – yes, if there are remaining death proceeds – the charity – all benefit from the arrangement? How can EVERYONE win?

Can this ONLY work if the policy is miss-priced (or under priced)? Would it only work if deaths were to occur much earlier than would be expected under reasonable actuarial assumptions? (But, in this respect, it would only work for the investors and the charity . . . and would not be a sound business decision for, or an acceptable risk to, the insurer.) Let me state that in another way: CHOLI/SOLI probably would not be a sound business decision for an insurer since it appears to require the insurer to either under-price its product or lower its underwriting standards – to such an extent that it would potentially incur risks that would otherwise be considered unacceptable in its normal price-setting and risk-selection process.

Some important questions that should be answered before a charity proceeds further include: Are there impartial tax and legal opinions provided to the charity concerning the proposed arrangement? Do they cover all the tax and non-tax issues – such as whether or not, and to what extent, the charity's tax-exempt status will be at risk, or what is the overall financial feasibility of the arrangement?

Are the promoter's presentations and/or illustrations accurate as well as unambiguous? If the policies are aggregated, are there individual product illustrations to support and substantiate the numbers in the composite?

Are the names, financial status and ratings of the insurers presented disclosed? If this is such a great idea, why have a number of major insurers flatly refused to become involved with this concept? (If the idea is so sound and the results so certain, why do so many of the promoters require confidentiality agreements? In my opinion, when the promoter of ANY arrangement asks for an immediate consent to nondisclosure, i.e., a confidentiality agreement, that's a sure danger sign.)

What does the study of the charity's independent counsel or actuary show? (A charity that is not willing to spend the money to have the proposed arrangement independently checked and verified is foolish indeed!)

If the charity is the owner of the insurance, is the year-to-year maintenance of the policies both reasonable and prudent? (It has to be to meet "Prudent Investor" rules.) Aside from annual feasibility studies (if available), how will the charity know? Does the charity have to provide any collateral for the arrangement? If so, what kind of asset is acceptable and how much is required? What is the immediate and long-term financial impact on the charity if its assets are used as collateral? What would be the impact if the plan underperformed and some (or all) of that collateralized assets were lost?

Has the promoter mentioned that the charity will likely have sizeable annual legal and accounting costs associated with the program? Does the charity even have access to competent legal, accounting, and actuarial services to properly assess the initial and continuing viability of this program?

Who are the initial third-party investors? What happens if the investors do not get their investments back quickly enough or simply want to switch to a more lucrative deal? To whom will the investor sell his/her/their interest if this arrangement is no longer profitable to the investor? Is the name of the investor TSI? (Tony Soprano Inc.)

Think I'm kidding? Think it can't happen? Think again. The Washington Post reported that a federal grand jury in Baltimore found cause to level charges against a sophisticated and unusual operation in which illegal drug trafficking profits were allegedly laundered by purchasing life insurance policies on the lives of drug users and others, without their knowledge.

At least 17 life insurance policies were acquired over almost a decade and, according to the Washington Post article, a law enforcement official familiar with the case stated, "Some of those individuals did die sudden and violent deaths." The same article included quotes that, "The investigation into the circumstances surrounding those deaths continues . . ." and "Payments from the policies taken out for those who have since died generated hundreds of thousands of dollars."

As for the insureds, are they aware of the impact SOLI/CHOLI has on their insurability? Have they been told that should they need and apply for additional coverage, their existing SOLI/CHOLI coverage would be taken into consideration by the insurer in its underwriting process? Consequently, an insured might then qualify – financially – only for a portion of the needed personal or business coverage, or in a worst case scenario, none at all. In other words, in assessing the real "cost" to an insured, one factor that must be considered is the exhaustive loss, in whole or in part, of his/her insurability.

A LITTLE HISTORY LESSON ON INSURABLE INTEREST

The legal concept of insurable interest dates back to early-18th century England. Back then, people did not generally purchase policies on their own lives. The beneficiary usually owned the contract and often purchased the coverage without the knowledge or consent of the insured.

By the mid-18th century, purchasing policies on strangers had become a popular form of gambling. Investors often placed their money into "dead pools" insuring the lives of well-known public figures, particularly those with gout, drinking problems, or who were likely to be challenged by political enemies and engaged in duels. Such investors were often known to offer targeted insureds lavish dinners and "a drink or two on me"- or to use other means to accelerate the realization of their investment.

In 1774, the English Parliament enacted laws to put an end to such gambling. Similar laws were adopted very early on in the U.S. While the insurable interest laws vary widely from state to state, in general, they deal with three main issues when a policy is purchased on another person's life:

- (1) The owner must have an insurable interest in the insured when the policy is purchased (but unlike property and casualty insurance, in most states the interest generally need not exist when the death benefit is paid);
- (2) The informed consent of the insured is required in most states before the insurance can be purchased; and
- (3) The buyer must have a "reasonable expectation of benefit or advantage from the continued life of another person." A child, for example, would have an insurable interest in the life of a parent.

HOWDY PARTNER

It is very important to remember that the entire transaction involving broad-based SOLI and charities would NOT be sanctioned by law or the courts or hope to enjoy a favorable public opinion – if it took place in another context (be it corporate or government sector). We learned from cases such as Wal-Mart*, Rice, and Mayo – and from scathing and pejorative comments about "dead peasants' insurance" and "janitors' insurance" in the New York Times and Wall Street Journal. Less publicized, but equally disturbing are reports in the Houston and San Antonio newspapers that the State of Texas proposed to meet the shortfall in the state's Teachers Retirement System by insuring its retired teachers under a group life insurance contract. You might say this proposal would align the interests of The State of Texas with the Angel of Death.

None of these third-party institutional investors could engage in this type of transaction without the protective cloak of the charity. In essence, the promoters act as brokers in "renting" the insurable interest the charity has to the investors in return for a possible eventual payment to the charity of a relatively small percentage of the investors' overall investment return.

*It should be noted that the U.S. District Court for the District of New Hampshire dismissed the case of Rice, et al vs. Wal-Mart – mainly on procedural grounds. While a discussion of the case is beyond the scope of this commentary, I do not think that the legal outcome changes the disconcerting notion that the arrangements I'm describing presuppose a third-party (known or unknown) may own significant life insurance coverage on an unrelated individual (by either blood or prior economic connection) and benefit from the insured's death.

LIFE INSURANCE AS A CHARITABLE PLANNING TOOL

There are literally dozens of ways life insurance can be used creatively, legitimately, and ethically to benefit charities. These range from the very simple and easy naming of a charity as sole or partial revocable beneficiary to the sophisticated but specifically Code-sanctioned use of life insurance inside (or in conjunction with) a charitable remainder unitrust. I don't think that broad based charity-enabled SOLI is among the uses of life insurance that is in the best long-term interests of either the charity or the public.

SO WHAT IS WRONG WITH A CHARITY LEASING LIVES OF SUPPORTERS?

Two central themes of charitable tax law are: CHARITY IS ABOUT GIVING, NOT TAKING, and THE TAX-EXEMPT STATUS OF A CHARITY IS NOT FOR SALE OR PRIVATE BENEFIT. A charity's tax-exempt status is not to be used to enrich or benefit an individual (or entity) other than those for whom (or which) the charitable status was granted and intended. That group certainly does NOT include wealthy private investors, or investment consortia.

Nonetheless, the argument is that the charity will now receive money that would otherwise be unavailable. "If you don't go along with this program, you'll get nothing." To me, this sounds all too similar to the phrase I heard many times used by promoters of the now disgraced Charitable Split Dollar, specifically banned by Code Section 170(f)(10). (Oh yes, because of those folks, we all have to understand and live with yet another set of much more stringent and restrictive rules.)

DON'T WORRY ABOUT THE LAW, WE'LL GET IT CHANGED!

We're talking big bucks here. The stakes are so high and the players are so powerful that they are quite willing and able to spend the money and time to convince lawmakers to change state insurable interest laws that are not flexible enough to accommodate their dead-pool or "you don't need to have any family connection or economic interest to insure some stranger's life" schemes.

Promoters of these plans have been actively lobbying at the state level to have officials loosen insurable interest laws to allow these programs. Two states, North Carolina and Tennessee have already changed their laws to allow such plans, and nine additional states are considering a change that would allow charities to assign their insurable interest to outside investors, even when those investors have no interest in the lives being insured – other than playing the numbers game.

We are talking about a huge investment where someone stands to financially gain from a policy on an unknown, unrelated individual's life – and the insured has never met that "someone" – or even knows who he/she (or they) is (or are)!

If state governments manipulate the laws to circumvent the consumer protection purpose behind the rules, it is a game we all lose. The repercussions to the insurance community in the form of further legislation (read: the potential loss of either the tax-deferral on the inside build-up, or the unlimited income tax-free nature of life insurance death proceeds, or both) and negative press could be draconian!

ACLI, AALU, AND NAIFA ALL SPEAK OUT – LOUDLY

I was stunned. In an unprecedented move, and for the first time that I can recall in my nearly 40 years of practice, three of the most representative organizations in the U.S. – all dedicated to advancement and support of the insurance/financial service community, as well as the sale of, and sales opportunities for, their members' insurance and financial service products – spoke out loudly and early, against an arrangement that would sell life insurance and annuities.

They did so, wisely and with good reasons! All three organizations have roundly criticized moves made by state legislators to loosen their insurable interest laws. The American Council of Life Insurers, joined by the Association of Advanced Life Underwriters and the National Association of Insurance and Financial Advisors, has spoken out strongly against state law changes that would allow third-party institutions with no familial or other relationship to the insured to use charities to buy life insurance on individuals in mass numbers.

These three organizations, rightly in my opinion, have stated, in no uncertain terms, that life insurance contracts should only be issued to persons or parties with a familial or recognized economic relationship with the insured, and the issuance of life insurance should not be perverted and allowed to become a mere commoditized investment process.

The proposed state legislation, in short, would weaken modern-day insurable interest laws to the point that they could no longer effectively serve any meaningful, practicable purpose. The proposed state legislation would facilitate transactions that purport to benefit participating charities when, in fact, they provide large, up-front fees to the promoters and annual guaranteed payments to investors, long before any money is sure to be paid to the charity.

RISKING THE TAX-EXEMPT STATUS OF THE CHARITY

Promoters of these arrangements have no stake in the long-term success of the charities they are approaching – other than as facilitators of their sales efforts. So the loss of a charity's tax-exempt status is of no personal and immediate concern – once the sale is made and the fees and commissions are realized.

Charities may believe that there are no income tax consequences as a result of their participation; however, in my opinion, those charities, as tax-exempt entities, may unwittingly be imperiling their tax-exempt status or incurring unrelated business income tax (UBIT) unexpectedly.

At a minimum, questions have arisen as to whether the charities are compromising and jeopardizing their ability to attract major supporters who can make real and concrete donations to the organizations with which they have relationships.

WHY WOULD A CHARITY GET INVOLVED?

Many charities became involved with – and were hurt by – charitable split dollar and charitable reverse split dollar, and I am afraid others may be in danger of doing so with these new "too good to be true" arrangements. There are various reasons why charities are at critical risk of willingly or unknowingly becoming parties to sophisticated life insurance transactions that are not in the best (and long-term) interest of either the charities or their patrons (or the public, for that matter).

First, we are currently in an era when donations for many charities have dropped – in some cases precipitously. There are many causes for this; undoubtedly, stock market uncertainty and volatility of the past few years have greatly slowed and/or reduced the rate and size of charitable contributions.

Second, stock market weakness has diminished, and in some instances ravaged, the value of charities' investment portfolios, particularly those heavy in telecommunication (read WorldCom) and energy (read ENRON) type stocks.

Third, competition among charities for donors' dollars has increased significantly. There are more worthy (and some not so worthy) charities and causes than ever before – all aggressively seeking money.

Fourth, strained and drained staff coupled with shrinking investigative budgets have hobbled and/or crippled many federal and state regulatory agencies. In many cases, other governmental problems and priorities have overshadowed the need, or dampened the will, to provide the necessary oversight of charities and policing of charitable abuses. This was highlighted in the June 22, 2004 testimony at the Senate Finance Committee hearings cited below. Promoters of edgy schemes know that there is statistically minimal risk of serious regulatory audits. (Although I predict this will soon change.)

Fifth, life insurance contracts (such as term and permanent, fixed and variable types of plans) coupled with their myriad uses, are among the most complex and least understood of all the financial products and tools. Almost none but the largest charities have the personnel or staff with sufficient time, knowledge, and experience to investigate both the tax and non-tax implications of the many new life insurance-related plans and arrangements that have been presented to them recently. I am involved with several charities that just do not have – or cannot afford – either in-house or outside counsel, and/or other professionals needed to adequately evaluate and judge the efficacy and workability of every scheme that someone wants to sell to them or their supporters.

In tough economic times, it is easy for a charity to be seduced by possible profits from life insurance-related schemes and "rent out" its charitable insurable interest and exemption status to unscrupulous marketers and promoters. All too easily, ethical and moral elements of the decision-making process may be subverted in favor of what looks like a free and easy ride to boosting a charity's financial bottom line. And the charity may easily ignore or never see how, or to what extent, third-party participants (investors) benefit from the "partnership" – and the risk it is taking by allowing its precious tax-exempt status to be used to enable that private enrichment.

WHAT'S THE RISK TO THE LIFE INSURANCE COMMUNITY?

As I've said repeatedly, the arrangements described above transform life insurance into a third-party investment vehicle, a commodity. Once that happens, there is little reason or justification for Congress and the states to continue the multiplicity of unique tax treatment accorded life insurance (e.g., tax-deferred growth of policy cash value, and the generally unlimited income-tax free nature of death proceeds). The results to the public, your clients, would be devastating!

BUT DON'T TAKE MY WORD FOR IT

Read what the experts have to say. Following are notable quotes from some of the recognized authorities and commentators in the life insurance community as well as those in the field of charitable planning.

In her article, "Dead Pool Donations," Trusts and Estates' Senior Editor, Wendy Davis states,
"For Donors, the value of their lives is put, literally, in someone else's hands – and it's hard to say whose."

Jerry J. McCoy, co-author of the Family Foundation Handbook and former chair of the American College of Trust and Estate Counsel's Planned Giving Committee:

*"Charities are placed in a position of hoping people die."
"It's probably going to be illegal by the end of the year."*

Craig Wruck, chair of the National Committee on Planned Giving's Government Relations Committee:
"Charities are being told they can create money out of nothing and you know intuitively that that's impossible."

Vaughn Henry, nationally known charitable consultant:

"It's because life insurance protects widows, widowers, and children from becoming paupers when the breadwinner dies that it isn't taxable. But that may change if Congress or the Treasury Department thinks life insurance has become nothing more than a wager."

Laura Kalick, chair of The American Bar Association's Subcommittee on Unrelated Business Income Tax:

"If the charity borrows money to buy the life insurance policies, the charity will likely have to pay the IRS tax on unrelated business income – because charities have to pay tax on debt-financed income."

Note that it can be even worse for the charity than having to pay income tax. Third-party financed charitable dead pools may put the charity's tax-exempt status at risk!

Why? As I mentioned above, a charity's money must be used exclusively for charitable purposes. Here, in essence, the charities are bringing in private investment partners and making it possible for those non-charitable partners to realize huge profits – perhaps years before the charity (if ever) realizes a dime.

Mike Nelson of Iowa Savings Bank, author of the special white paper, "Insurable Interest Under Siege said:

"The objection is not that wholesale murder will ensue. Such an assertion only trivializes the debate. The objection is that the third party owner of the policy benefits only from the death of the insured. The essence of sound underwriting is that the owner of the policy and the insurer both are better off if the insured continues to live. Yet the proposed insurable interest changes and attempts to turn life insurance into a third party investment vehicle shatter this harmony and sound philosophy."

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