Fair Market Value of Life Insurance

The Canadian Institute of Chartered Business Valuators

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Agenda

1. Background
2. Valuation method and process
3. Compare FMV to CSV
4. Using FMV in business valuations:
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    b) Capital Gain on Death of Shareholder
    c) Succession Plans
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5. Beyond FMV
6. Question & Answer

Background – Market for Life Insurance

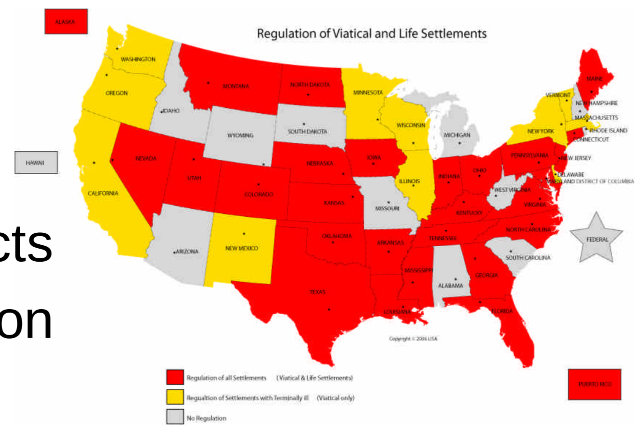
- Primary market – life insurers, agents, brokers, consumers
- Secondary market:
  - Selling an existing policy:
    - don't need it
    - can't afford it
    - want cash
  - Life insurers offer to pay the cash surrender value, but policy can be worth more
  - Secondary market is a well developed industry in U.S.
  - Secondary market is informal in Canada

Background – U.S. Secondary Market

- Started with viatical:
  - Life expectancy < 2 years
  - AIDS in 1990s
- Evolved through 1990's to be primarily senior life settlements:
  - Senior life settlements involve life insureds aged 65+
  - Life insured may or may not have impaired health but life expectancy is limited due to age
- Industry direction:
  - Continues to grow exponentially
  - Thriving due to insufficiency of cash surrender values relative to market price

Background – Regulation and Resources

- U.S. regulation by state
- Canada regulation by province:
  - Anti-trafficking through insurance acts
  - Ontario's attempt at viatical regulation
  - Securities regulations
  - Events and current status



Source: Life Insurance Settlement Association

- Resources:
  - Presentation to CALU November 2007 (www.lifevaluator.com)
  - Life Insurance Settlement Association (www.lisassociation.org)
  - Study Paper on Viatical Settlements, May 2006, Canadian Centre For Elder Law Studies (www.ccels.ca)

Valuation Method

- U.S. market is guide – brokered market
- Price determinants:
  - Policy variables
  - Health of life insured
  - Discount rate
- Examine scenarios that are available to owner, duly considering available options and benefits:
  - Continue policy until death
  - Surrender – CSV is floor for FMV
  - Shades in between

Compare FMV to Cash Surrender Value

Cash surrender value:

- Offer from insurance company to 'buy back' the policy
- Not necessarily any relationship to fair market value
- It is a floor for the fair market value

Circumstances to look for FMV > CSV:

- A life insured having impaired health, can cause fair market value to exceed cash surrender value
- Insurance company may have chosen to give the policy unnaturally low cash surrender values **– very common in Canada**
- External factors such as interest rates can cause cash surrender values to be low

Valuation Method: Price Determinants

Policy variables – review policy, model it

Health of life insured:

- Medical records – existing, no new tests
- Underwriting – specialty firms
- Mortality rates – base tables, adjusted for underwriting

Discount rate:

- market range, adjust for U.S. / Canadian differential
- place case within range: (i) credit quality of insurer
  (ii) riskiness of policy and life insured

Bringing Valuation Together

- Apply the mortality and discount rates to assess the scenarios available to owner using the model reflecting the policy variables
- Scenario generating highest value is selected
- Cash surrender value is always one of the scenarios
- There is a significant premium in the discount rate for the riskiness of the investment and the illiquidity of the asset class

My process: information requirements, consent, underwriting, mortality rates, discount rates, modeling, setting estimate, sensitivities, report

Valuation Method Reviewed

Method used:

- Following a methodology that is a common method used by purchasers in U.S. market to calculate their bid price

Methods considered and discarded:

- Comparatives:
  - No Canadian comparatives available
  - Information on U.S. cases is not in public domain
  - Indirectly used through discount rate
- Replacement cost:
  - Hurdles: matching life insured, matching policy contract
    - these are not commodities to be duplicated
  - Poor measure: looks at value to current owner and not at value to arm's length buyer
    - wrong perspective
    - common to have high replacement cost but zero FMV

Valuing Business with Life Insurance

- Reflect FMV of life insurance policies in business valuation
- FMV can be materially higher than CSV
- Material errors in business valuation can occur if arbitrarily setting value of life insurance policies to CSV, and to zero if there is no CSV
- Obtain FMV estimates for all life insurance policies that potentially have FMV > CSV:
  - Life insured has impaired health
    - **red flag if valuation instigated by a death**
  - Low or zero CSV policies
    - **very common in Canada (e.g., Term-to-100, Level COI UL)**
    - **with these it is common for FMV > CSV even if life insured in good health**

Equalization of Family Property

- Business of either spouse may own life insurance policies
- Business valuation would reflect FMV of life insurance policies owned by business
- Life insured may be one or both spouse or others such as business partners or key employees
  - FMV of life insurance policy depends on health of life insured at valuation date
- Spousal death:
  - Division of property as of day prior to death
  - Use known health as of day prior to death:
    - if life insured is the deceased spouse, what was health?
    - for surviving life insureds, FMV depends on their health

Example – Equalization on Spousal Death

Division of family property example:

Other net family property of $20 million, life insurance policy on deceased spouse with $10 million death benefit and zero CSV

Scenario 1 – deceased spouse had good health

- Policy has FMV of $4,000,000
- Net family property $24,000,000
- Survivor entitled to $12 million, life policy gives $10 million

Scenario 2 – deceased spouse had health impairment

- Policy has FMV of $8,000,000
- Net family property $28,000,000
- Survivor entitled to $14 million, life policy gives $10 million

Using CSV short-changes survivor $2 million or $4 million

Capital Gains on Death of Shareholder

- Shares deemed disposed of on death of shareholder, performing business valuation to determine capital gain
- Need FMV of life insurance policies owned by business
- If life insured is non-arm's length to deceased (e.g., self, children), FMV deemed by Income Tax Act to be CSV
- If life insured is arm's length to deceased (e.g., other shareholders, key employees), need to use FMV

Capital gain will depend on:

- CSV of policies insuring the deceased
- CSV of policies insuring non-arm's length
- FMV of policies insuring arm's length (will depend on heath)

Reference: Canada Revenue Agency's IC89-3, Statement on Business Valuations

Succession Plans

- If a buy-sell agreement uses buy-sell price based on fair market value immediately prior to death, buy-sell price would reflect FMV of life insurance policies owned by the business
- Business valuation for this purpose would need FMV of life insurance policies insuring deceased shareholder and surviving shareholders and all other insureds
- FMV will depend in part on health of life insured:
  - Makes buy-sell price dependent on health of the deceased
  - Makes buy-sell price dependent on health of survivors

Example – Capital Gain, Buy-Sell

Capital gain, buy-sell at FMV example:

2 shareholders, 50/50 ownership, business has FMV of $10 million excluding life policies, life insurance on each with $5 million death benefit and zero CSV

Scenario 1 – both shareholders healthy, one dies

- Each policy has FMV of $1 million
- Corporation has $12 million FMV, DB of $5 to buy-out $6 million
- Deceased shareholder has capital gain of $5.5 million

Scenario 2 – first shareholder healthy, second unhealthy

- First policy has FMV of $1 million, second policy $3 million
- Corporation has $14 million FMV, DB of $5 to buy-out $7 million
- If first shareholder dies: capital gain of $6.5 million
- If second shareholder dies: capital gain of $5.5 million

Distribution of Property from Estate

- Where property of estate includes a business that owns continuing life insurance policies and the estate is to be distributed by proportions, value of distributable property should reflect FMV of continuing life insurance policies owned by the business
- Need FMV of continuing life insurance policies owned by business to ensure equitable distribution of property

Example - Distribution of Property

Distribution of property example:

- Estate to be divided equally between 3 children
- Consists of: (i) business and (ii) $10 million of other property
- Business FMV $7 million prior to death of parent, excluding life policies
- $4 million policy on parent as well as $5 million policies on each of two children who will continue the business
- All policies are zero CSV (business FMV for capital gains is $7 million)
- Two continuing policies each have FMV of $1.5 million
- Business has FMV of $14 million (7+4+1.5+1.5)
- Estate has property of $24 million (14+10): $8 million per child
- Two children each get half of business plus $1 million of other property
- Third child gets $8 million of other property

Using CSV short-changes third child $1 million

Estate Freeze

- A estate freeze is being considered involving a business that owns life insurance policies
- Business valuation at time of freeze would include the FMV of the life insurance policies
- Life insurance policies can affect planning decision:
  - For non-arm's length life insureds, capital gain on death of shareholder uses CSV of life insurance policies
  - If FMV large relative to CSV then locking in a higher capital gain than currently exists
  - Existence of such a policy is adverse to estate freeze

Example – Estate Freeze

Estate freeze example:

Business with $10 million FMV, excluding life insurance policy insuring shareholder with $5 million death benefit, zero CSV and FMV of $2 million

No estate freeze:

- Capital gain at death of shareholder based on FMV of business with life insurance policy deemed to have value of zero
- Initially capital gain based on $10 million valuation

With estate freeze:

- FMV of life insurance policy included at time of freeze
- Locking in capital gain based on $12 million valuation
- Will be potentially advancing rather than deferring taxation
- Analyze likelihood of survival to assess potential cost / benefit

Beyond Fair Market Value

- FMV estimate of life insurance policy is based on best use of the policy, but best use in isolation
- FMV estimate is without regard to other considerations
- Business valuator might consider:
    - Preserving value of key persons
    - Continuing life insurance policy due to tax considerations
    - Potential benefits on capital dividend account
    - Life insurance as part of a larger scheme
- Analysis involved in preparing FMV estimate can provide useful information for additional analysis:
    - Best estimate cash flows
    - Survival probabilities

Resources

Learn more about using the fair market value of a life insurance policy and getting an estimate at **www.lifevaluator.com** :

- Sale of Corporate-Owned Life Insurance
- Sale of Life Insurance to Corporation
- Donating a Life Insurance Policy to Charity
- Charities and Donated Life Insurance Policies
- Equalization of Family Property on Spousal Death and Divorce
- Estate Taxation and Distribution and Division of Property
- **Business Valuation**
- **Estate Freeze – Business Valuation**
- Taxation of Non-Canadian Life Insurance Policies
- Selecting an Appraiser
- Getting a Fair Market Value Estimate

Fair Market Value of Life Insurance
Question & Answer

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