Fair Market Value of Life Insurance Policies

Business Valuation

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A business valuation needs to duly reflect the fair market value of any life insurance policies owned by the business. A life insurance policy can have a fair market value that is materially larger than its cash surrender value. Where a business owns life insurance policies, a business valuator would be well served obtaining an estimate of fair market value of the life insurance policies from a specialist who is expert in appraising life insurance policies.

Hawkins Consulting Corporation provides fair market value estimates of life insurance policies. To learn more about this service, visit **www.lifevaluator.com** or call **905.337.8200**.

To ensure that a valuation reflects best use, a business valuator might compare the fair market value of a life insurance policy to an assessment of the continuing contribution that the policy makes to the value of the business. Hawkins Consulting Corporation can provide appropriate projections for use in such assessments and has the expertise to review and analyze schemes involving life insurance policies.

Related Developments

The secondary market for life insurance policies in the United States of America that began in the late 1980's and which grew and evolved through the 1990's and 2000's has raised awareness that cash surrender values of life insurance policies can materially underestimate fair market value.

In Canada, insurance companies began selling permanent life insurance policies with low or zero cash surrender value in the 1980's and continue to sell such policies in large volumes; the proliferation of these low or zero cash surrender value policies has made it common for life insurance policies to have fair market value in excess of cash surrender value.

Material Errors Arise From Use of Cash Surrender Values

The cash surrender value of a life insurance policy is an offer from the insurance company to 'buy back' the policy. The cash surrender value does not necessarily bear any relationship to the fair market value of the life insurance policy, but as a 'buy back' offer, it causes the fair market value of a policy to be at least as large as its cash surrender value.

The fair market value of a life insurance policy can be materially larger than its cash surrender value. It is reckless to arbitrarily set the value of life insurance policies to the cash surrender value, and to zero if there is no cash surrender value:

- A life insured having impaired health, can cause the fair market value to exceed the cash surrender value;
- The insurance company may have chosen to give the policy unnaturally low cash surrender values; and
- External factors such as interest rates can cause cash surrender values to be low.

The cash surrender value is but one of many variables considered in estimating the fair market value of a life insurance policy. Material errors in the valuation of a business can occur if the value of life insurance policies owned by the business were to be arbitrarily set to the cash surrender values.

Example: zero cash surrender value life insurance policy, death benefit $1 million, fair market value estimate $400,000. Using the cash surrender value to assign the property no value will undervalue it by $400,000.

Obtaining Fair Market Value Estimates

Fair market value estimates should be obtained for all life insurance policies that potentially have a fair market value in excess of their cash surrender value. Life insurance policies are more likely to have fair market value in excess of their cash surrender value where the life insured has impaired health but, due to the proliferation of low or zero cash surrender value policies, it also occurs even when the life insured is in good health.

Equalization of Family Property on Spousal Death or Divorce

For equalization of family property on spousal death or marriage breakdown, the value of property is to be used in the determination of family property. Where spouses own businesses that own life insurance policies, the determination of the fair market value of such businesses needs to duly reflect the fair market value of those life insurance policies. The life insured of such policies may be one or both spouses (surviving or deceased) or other persons such as business partners or key employees.

Spousal Death – Life Insured Deceased

Upon death of a spouse, the division of family property is based on the fair market value of the property the day prior to the death. The health of the deceased spouse the day prior to death would be used in estimating the fair market value of life insurance policies insuring that spouse.

The deceased spouse's health may have been good or bad and their death may or may not be health related. However, it is only the known health and not the cause of death that will be relevant to the fair market value estimate since only the information known up to the day prior to death can be reflected in an appraisal for the day prior to death. Similarly, unknown health information revealed by the cause of death or otherwise revealed post-death will not be relevant to an appraisal effective prior to death.

The fair market value estimate of a life insurance policy can be critical to the division of family property. For example, consider other net family property of $20 million and a $10 million life insurance policy that had a fair market value estimate of $4 million if the deceased spouse were in good health and $8 million if the deceased spouse had a particular level of health impairment. In the first case there is $24 million of net family property and in the second case there is $28 million of net family property. In the first case, the surviving spouse is entitled to $12 million, whereas in the second case $14 million. That is, in this example, the variation in the fair market value of the life insurance policy due to the state of health of the deceased spouse has a $2 million impact on division of family property. In this example, if the life insurance policy had zero cash surrender value and fair market value was not used, the surviving spouse would have only received $10 million, short-changed by $2 million or $4 million.

Spousal Death – Life Insured Surviving

The fair market value of life insurance policies whose life insured survives the death of the first spouse will depend, in part, on the health of the life insured on the day prior to death of the deceased spouse. The life insured of these life insurance policies may be the surviving spouse or other persons such as business partners or key employees.

Capital Gains Tax on Death of Shareholder

Where a business needs to be appraised for a deemed disposition on death of a shareholder, if the business owns life insurance policies then the fair market value of such a business needs to duly reflect the value of those policies.

Where the life insured under those life insurance policies is the deceased or non-arm's length to the deceased (e.g., spouse and children of the deceased), under the Income Tax Act, the fair market value is deemed to be the cash surrender value immediately before the death of the shareholder. However, where the life insured under those life insurance policies is arm's length to the deceased (e.g., business partners or key employees), their value is to be the fair market value immediately before death of the shareholder (need a fair market value estimate).

The following is an extract from Canada Revenue Agency's IC89-3, Statement on Business Valuations:

> According to subsection 70(5.3), in determining the subsection 70(5) value of a deceased's shares (for deaths occurring after December 1, 1982), the value of corporate owned life insurance is its cash surrender value. This applies to the deceased, but where there are two or more shareholders and corporate-owned life insurance is required to fund a stock purchase agreement, one must determine the value of the policies held by the corporation on the other shareholders.
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> The factors to be considered in determining the value of such policies held on the lives of shareholders other than the deceased, should include: (a) cash surrender value; (b) the policy's loan value; (c) face value; (d) the state of health of the insured and his/her life expectancy; (e) conversion privileges; (f) other policy terms, such as term riders, double indemnity provisions; and (g) replacement value.

Example: a business owns life insurance policies on each shareholder and these shareholders are all arm's length to each other. On the death of any one of them, the capital gains tax of the deceased shareholder will depend on cash surrender value of the policy insuring the deceased shareholder and the fair market value of the policies insuring the other shareholders (which will depend in part on the health of these other shareholders).

Also, life insurance policies can impair qualification for the small business / family farm capital gains deduction. Life insurance policies might not be considered to be used primarily in the active business of a corporation. It is the fair market value of life insurance policies that are included in the qualification test for the capital gains deduction. Life insurance policies that insure the life of shareholders are deemed by the Income Tax Act for this purpose to have a fair market value equal to their cash surrender value. This leaves fair market value estimates needed for life insurance policies that insure lives other than the shareholders (this will include both non-arm's length persons such as spouses or children and arm's length persons such as key employees).

Succession Plans

Where there is a buy-sell agreement with a buy-sell price based on the fair market value immediately prior to death, the buy-sell price would reflect the fair market value of life insurance policies owned by the business, including any policies insuring the deceased shareholder. The health of the lives insured would be used in estimating the fair market value of the life insurance policies.

For a life insurance policy that insured the life of the deceased shareholder, the deceased shareholder's health may have been be good or bad and their death may or may not be health related. However, it is only the known health and not the cause of death that will be relevant to the fair market value estimate since only the information known up to the day prior to death can be reflected in an appraisal for the day prior to death. Similarly, unknown health information revealed by the cause of death or otherwise revealed post-death will not be relevant to an appraisal effective prior to death.

Consider a business with two shareholders, each owning half of the business. The business has a fair market value of $10 million excluding the life insurance policies and life insurance with $5 million of death benefit on each shareholder, where the policies are of a zero cash surrender value type.

Scenario 1: both shareholders healthy and each life insurance policy has fair market value of $1 million. The business has a fair market value of $12 million. On death of either shareholder, the deceased shareholder's interest is $6 million. For taxation the capital gain will be based on the deceased's shares having a value of $5.5 million.

Scenario 2: first shareholder is healthy, second shareholder has a health impairment, the life insurance policies insuring their lives have fair market value of $1 million and $3 million respectively. The business has a fair market value of $14 million. On death of the first shareholder (the healthy one), the deceased shareholder's interest is $7 million. For taxation the capital gain will be based on the deceased's shares having a value of $6.5 million.

Scenario 3: same as scenario 2 except that it is the second shareholder (the unhealthy one) rather first shareholder (the healthy one) who dies. The business has a fair market value of $14 million, the deceased shareholder's interest is again $7 million but for taxation the capital gain will be based on the deceased's shares having a value of $5.5 million.

Distribution of Property

Where the property in an estate includes a business that owns continuing life insurance policies and the estate is to be distributed by proportions (e.g., equal parts to all children or by certain percentages to certain persons), then the fair market value of those life insurance policies will be relevant to the value of the business and hence the distribution of property. The valuation of the business should reflect the fair market value estimates for all continuing life insurance policies to ensure an equitable distribution of property. If this is not done, the distribution of property could diverge materially from the mandate.

Example: an estate that consists of a business and $10 million of other property is to be divided equally between three children of which two would like to jointly continue the business. The business had a fair market value prior to the death of the deceased of $7 million ignoring life insurance policies that the business owned; there was a $4 million policy on the deceased as well as $5 million policies on each of the two children who would like to continue the business (all of these policies have zero cash surrender value and thus the fair market value of the business for determining the capital gain on death of the deceased had been $7 million). If the two continuing policies owned by the business each have a fair market value of $1.5 million, the business has a fair market value of $14 million (the $7 million plus $4 million of death benefit plus $3 million for the two continuing policies) and the estate has property of $24 million ($10 million of other property and the business at $14 million). The two children interested in continuing the business could each receive half of the business plus $1 million of other property with the remaining $8 million of other property going to the third child; however, if no value had been put on the two continuing policies owned by the business, by using cash surrender values instead of fair market values, then the estate would have been valued at just $21 million, shortchanging the third child by $1 million.

Beyond Fair Market Value

To ensure that a valuation reflects best use, a business valuator might compare the fair market value of a life insurance policy to an assessment of the continuing contribution that the policy makes to the value of the business.

A fair market value estimate of a life insurance policy is essentially a best use estimate (surrender or continuation to death or some other point and efficient use of options and premium payment) but it is the best use of the policy in isolation and it is without regard to tax considerations of the business that owns the policy or other matters that may be of import to the business.

A business valuator might consider:

- Continuing the life insurance policy versus surrender due to tax considerations;
- Potential benefits to the capital dividend account available from continuing the life insurance policy until death of the life insured; and
- Life insurance policy as a part of a larger scheme.

In assessing the continuing contribution that a life insurance policy makes to the value of a business, the business valuator might require projections of best estimate cash flows (premiums, death benefits) or survival probabilities. This information can be readily extracted from analysis used to make a fair market value estimate. Additionally, the analysis of various options and features of the life insurance policy that is performed in preparing a fair market value estimate may be useful to the business valuator in this regard.

This publication was prepared considering the law of select Canadian provinces. This publication may have limited relevance to a particular circumstance. This publication does not constitute advice.