Fair Market Value of Life Insurance Policies

Estate Taxation and Distribution and Division of Property

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Life insurance policies are property. A life insurance policy can have a fair market value that is materially larger than its cash surrender value. To properly determine taxable income and equitably distribute or divide property, there are circumstances where estates need to obtain fair market value estimates of life insurance policies.

Obtain fair market value estimates for:

Capital Gains Tax : corporate owned life insurance insuring arm's length person

Capital Gains Deduction : corporate owned life insurance insuring non-shareholder

Buy-Sell Agreements : appraisal of life insurance for fair market value agreements

Distribution of Property : appraisal of corporations owning life insurance

Distribution of Property : continuing policies as property for distribution

Continuing Estate : management of continuing policies

Equalization on Spousal Death : determination of family property

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**.

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 and Inequities 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 tax errors and material inequities in the distribution or division of property can occur if the value of a life insurance policy were to be arbitrarily set to the cash surrender value.

Obtaining Fair Market Value Estimates

It may be necessary to obtain fair market value estimates for 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.

Taxation on Disposition

Where a life insurance policy is disposed (e.g., surrender or sale) there is taxable income of the excess, if any, of the proceeds of disposition over the adjusted cost basis.

On death, property is deemed disposed. Interests in life insurance policies are exempted from this provision.

However, where the deceased owned a corporation, the corporation is deemed disposed at fair market value and if the corporation owned life insurance policies then the appraisal of the corporation will need to reflect the fair market value of the life insurance policies. Where the life insured of a policy is the deceased or is non-arm's length to the deceased then, under the Income Tax Act, the fair market value of the policy is deemed to be the cash surrender value immediately prior to death. Otherwise, for corporate owned life insurance policies where the life insured is arm's length to the deceased (e.g., business partners or key employees), it is the fair market value that is used in the appraisal (need a fair market value estimate).

When a deceased owned a life insurance policy that continues after their death (policy insures life of some other person), there is a disposition of the policy when it is transferred to another person. When such a life insurance policy is transferred to any person by will or, if there is no will, to a person who is non-arm's length to the deceased then the transfer is deemed to have been at the policy's cash surrender value (taxable income of the excess, if any, of cash surrender value over adjusted cost basis). An exception is that the transfer is deemed to have been at the policy's adjusted cost basis if the transferee is the surviving spouse (no taxable income in these circumstances). There may be circumstances where a transfer would be deemed to occur at fair market value.

Corporate Owned Life Insurance

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

Capital Gains Deduction

Corporate owned life insurance can impair qualification for the small business corporation and family farm corporation 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 of the corporation 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 corporation, 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 owned by the corporation.

For a life insurance policy that insured the life of the deceased shareholder, the deceased shareholder's health may have been good or bad and their death may or may not have been 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 the life insurance policies can be critical to a succession plan achieving its intent. For example, consider a corporation with two shareholders each owning half of the corporation. The corporation 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. On death of either shareholder, the corporation has a fair market value of $12 million and there is $5 million from life insurance to buy-out the deceased shareholder's $6 million interest (for the deceased shareholder, for taxation, the capital gain will be based on their shares having a value of $5.5 million); the surviving shareholder needs an additional $1 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. On death of the first shareholder (the healthy one), the corporation has a fair market value of $14 million and there is $5 million from life insurance to buy-out the deceased shareholder's $7 million interest (for the deceased shareholder, for taxation, the capital gain will be based on their shares having a value of $6.5 million); the surviving shareholder needs an additional $2 million.

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Scenario 3: same as scenario 2 except that it is the second shareholder (the unhealthy one) rather first shareholder (the healthy one) who dies. On death of the second shareholder, the corporation again has a fair market value of $14 million and again there is $5 million from life insurance to buy-out the deceased shareholder's $7 million interest (for the deceased shareholder, for taxation, the capital gain will be based on their shares having a value of $5.5 million); the surviving shareholder needs an additional $2 million.

Distribution of Property

Where the property in an estate includes continuing life insurance policies (either directly held or through a corporation or otherwise) 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 distribution of property.

The estate should obtain fair market value estimates for all continuing life insurance policies (directly held and in the valuation of corporations that own 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 to be divided equally between two persons where the estate has $500,000 of other property and a life insurance policy. If the life insurance policy has a fair market value of $100,000 then one beneficiary could receive the life insurance policy plus $200,000 of other property while the other beneficiary receives $300,000 of other property.

Example: an estate that consists of a corporation and $10 million of other property is to be divided equally between three children of which two would like to jointly continue the corporation. The corporation had a fair market value prior to the death of the deceased of $7 million ignoring life insurance policies that the corporation 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 corporation (all of these policies have zero cash surrender value and thus the fair market value for determining the capital gain on death of the deceased had been $7 million). If the two continuing policies owned by the corporation each have a fair market value of $1.5 million, the corporation 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 corporation at $14 million). The two children interested in continuing the corporation could each receive half of the corporation 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 corporation, 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.

The different beneficiaries of an estate may have different taxation on receipt of a particular continuing life insurance policy. The disposition may be at cash surrender value or adjusted cost basis, or perhaps fair market value. It may be more tax efficient to distribute particular policies to particular beneficiaries.

Example: a life insurance policy has: cash surrender value of $200,000; adjusted cost basis $150,000; fair market value $300,000. The life insured survives the deceased. If the policy was distributed to a surviving spouse then it would be deemed transferred for tax purposes at adjusted cost basis; no taxable income would arise. If the policy was distributed to any person by will or, if there is no will, to a person who is non-arm's length to the deceased then it would be deemed transferred for tax purposes at cash surrender value; $50,000 of taxable income arises. If it was deemed transferred for tax purposes at fair market value then $150,000 of taxable income arises.

Difficulties with Partitioning Property

Dividing a life insurance policy into pieces, for two or more beneficiaries of the estate, is not usually feasible. Such a division would typically require consent from the insurance company, which may not be forthcoming due to tax rules or administrative difficulties and expense.

Some life insurance policies do grant the option to split policies jointly insuring two or more persons (e.g., insuring two or more children of the deceased) into separate policies insuring each person separately, however, this is not necessarily the whole solution to the distribution of this property as one of the succeeding policies may have a greater value than the other depending on the health and other mortality considerations of each person and the amounts of ongoing premiums required to be paid. To have an equitable distribution of property, a fair market value estimate for each succeeding life insurance policy should be obtained with the difference in the values offset through the division of the other property (e.g., if one person is healthy and the other unhealthy, the healthy person's succeeding policy might have less value than that of the unhealthy person).

Difficulties with Shared Ownership

Shared ownership of a life insurance policy is problematic as a solution to the distribution of this property as it might cause each person to be impaired in their ability to deal with their property (take loans, surrender it, sell it, etc.) and one person may be harmed by the other not paying their portion of premiums (e.g., cause policy to lapse). This problem does not arise with life insurance policies owned by corporations as the corporation is a single entity no matter how its shares are distributed.

Estate Continuing

Where an estate owns continuing life insurance policies and the estate will continue for some period of time, the estate should assess the prudence of continuing paying premiums on these policies. If these policies have a fair market value in excess of their cash surrender value then there is value to preserve by paying premiums (or extract by sale). Otherwise, the estate might be better served by disposing the policies (surrender it or sell it to the life insured or another person for the cash surrender value). If paying the premiums of a life insurance policy is causing the estate a cash strain, the estate might consider extracting value by selling the policy (e.g., to the life insured or other person for its fair market value) or donating it to a charity (donation receipt for its fair market value).

Equalization on Spousal Death

For equalization of family property on spousal death, the value of property, including life insurance policies, is to be used in the determination of family property. In order to ensure an equitable division of property, life insurance policies owned by the spouses need to have their fair market value estimated. The life insured of such policies may be the deceased spouse, the surviving spouse or other persons.

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. If a third party will pay $400,000 for this property, one of the spouses will clearly be inequitably treated if its value is arbitrarily set to zero.

Typically, life insurance policies acquired during the marriage would have their fair market value fully included in family property whereas life insurance policies owned prior to the marriage date would only be included in family property to the extent of the increase during the marriage.

Where spouses own corporations that own life insurance policies, the determination of the fair market value of such corporations needs to duly reflect the fair market value of those life insurance policies (including policies insuring other persons such as business partners or key employees).

Where family law excludes the proceeds from life insurance policies payable on death from family property, the exclusion relates to the spouse as a beneficiary (similar to the position of the spouse as recipient of a gift, inheritance or damages); such exclusions are not a facility to allow spouses to exclude from family property the wealth that they have deposited, accumulated or accrued in life insurance policies that they own.

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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. These life insurance policies include those directly owned by either spouse or indirectly owned through corporations or otherwise.

The deceased spouse's health may have been good or bad and their death may or may not have been 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 $2 million and a $1 million life insurance policy that had a fair market value estimate of $400,000 if the deceased spouse were in good health and $800,000 if the deceased spouse had a particular level of health impairment. In the first case there is $2.4 million of net family property and in the second case there is $2.8 million of net family property. In the first case, the $1 million death benefit will provide $1 million of the $1.2 million that the surviving spouse is entitled to, whereas in the second case, the $1 million death benefit will provide $1 million of the $1.4 million entitlement. 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 $200,000 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 $1 million, short-changed by $200,000 or $400,000.

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. These life insurance policies include those directly owned by either spouse or indirectly owned through corporations or otherwise. The life insured of these life insurance policies may be the surviving spouse, other relatives or business partners.

In the case of a life insurance policy that pays its death benefit on the last to die of the spouses (or on the first to die), the fair market value estimate would use the health of both the deceased and surviving spouse on the day prior to the deceased spouse's death.

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.

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