Fair Market Value of Life Insurance Policies

Sale of Life Insurance to Corporation

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A tax strategy is for a shareholder to sell a life insurance policy to their corporation. This tax strategy works best with low or zero cash surrender value policies with a relatively high sale price. When pursuing this tax strategy, a fair market value estimate of life insurance policy should be obtained to justify the sale price.

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**.

Tax Planning

A tax planning strategy is for a shareholder to sell a life insurance policy that they hold personally to their corporation.

Taxable Income to Shareholder: the shareholder would have taxable income of the excess, if any, of proceeds of disposition over adjusted cost basis. Since the shareholder and corporation are non-arm's length, the proceeds of disposition is deemed to be the cash surrender value. If the life insurance policy is low or zero cash surrender value, there is likely no tax on sale.

Adjusted Cost Basis for Corporation: due to it being non-arm's length sale, the corporation would be deemed to have acquired the policy for its cash surrender value. If the life insurance policy is low or zero cash surrender value, this could decrease the adjusted cost basis, which can give a favourable tax result on death.

Payment of Premiums: ongoing premiums would be paid by the corporation from retained earnings rather than from the after-tax monies of the shareholder.

Proceeds on Death: on death the proceeds in excess of the adjusted cost basis would be added to the capital dividend account, thereby allowing those monies to be paid as dividends without being taxable. If no sale had occurred, the proceeds of the life insurance policy would have been paid without being subject to taxation. There are a few variables at play, however, if the life insurance policy is low or zero cash surrender value, the sale is likely advantageous.

Sale Price of Fair Market Value Not Cash Surrender Value

A life insurance policy is property. It is reasonable for the corporation to pay the shareholder the fair market value of the property that it acquires.

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 inappropriate to 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. A life insurance policy can be materially undervalued if its value were to be arbitrarily set to the cash surrender value.

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 policy no value will undervalue it by $400,000. If a third party will pay $400,000 for this policy, the policy is clearly undervalued if its value is arbitrarily set to zero.

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.

Example 1

Cash Surrender Value:	Zero
Death Benefit:	$1 million
Fair Market Value:	$400,000
Adjusted Cost Basis:	$250,000

Since the policy has zero cash surrender value, the shareholder incurs no taxable income on sale, whatever the adjusted cost basis. Shareholder sells policy for fair market value, receiving $400,000 of cash from corporation, no taxable income.

Corporation's adjusted cost basis for the policy is zero (the cash surrender value, this is a decrease), assume that it remains zero. When the life insured dies, the corporation's capital dividend account would increase by $1 million. The shareholder, or the heirs, could extract this $1 million without being subject to taxation.

If the shareholder had continued to hold the policy personally, on death the $1 million would have been received without being subject to taxation.

The differences between continuing to hold the policy personally and selling into the corporation are:

- $400,000 of cash extracted from corporation (liquidity gain)
- $400,000 extracted from corporation without being subject to taxation (tax gain)
- Premiums payable after the sale are paid from retained earnings (tax gain)
- On death $1 million of death benefit distributable without being subject to taxation (same as before)

Example 2

Cash Surrender Value:	$200,000	Non-zero CSV
Death Benefit:	$1 million	
Fair Market Value:	$400,000	
Adjusted Cost Basis:	$250,000	

Since the policy has cash surrender value less than adjusted cost basis, the shareholder incurs no taxable income on sale. Shareholder sells policy for fair market value, receiving $400,000 of cash from corporation, no taxable income.

Corporation's adjusted cost basis for the policy is $200,000 (the cash surrender value, this is a decrease), assume that it would decline over time and that it is $100,000 at death of the life insured. When the life insured dies, the corporation's capital dividend account would increase by $1 million less the adjusted cost basis. The shareholder, or the heirs, could extract this amount ($900,000) without being subject to taxation.

If the shareholder had continued to hold the policy personally, on death the $1 million would have been received without being subject to taxation.

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The differences between continuing to hold the policy personally and selling into the corporation are:

- $400,000 of cash extracted from corporation (liquidity gain)
- $400,000 extracted from corporation without being subject to taxation (tax gain)
- Premiums payable after the sale are paid from retained earnings (tax gain)
- On death $900,000 of death benefit distributable without being subject to taxation (tax loss, but more than offset by tax gain at point of sale)

Example 3

Cash Surrender Value: $300,000
Death Benefit: $1 million
Fair Market Value: $400,000
Adjusted Cost Basis: $250,000

Increased CSV, now greater than ACB

Since the policy has cash surrender value greater than adjusted cost basis, the shareholder incurs taxable income on sale of the excess. Shareholder sells policy for fair market value, receiving $400,000 of cash from corporation, taxable income of $50,000.

Corporation's adjusted cost basis for the policy is $300,000 (the cash surrender value, this is an increase), assume that it would decline over time and that it is $200,000 at death of the life insured. When the life insured dies, the corporation's capital dividend account would increase by $1 million less the adjusted cost basis. The shareholder, or the heirs, could extract this amount ($800,000) without being subject to taxation.

If the shareholder had continued to hold the policy personally, on death the $1 million would have been received without being subject to taxation.

The differences between continuing to hold personally and selling into the corporation are:

- $400,000 of cash extracted from corporation (liquidity gain)
- $400,000 extracted from corporation with $50,000 subject to taxation (tax gain)
- Premiums payable after the sale are paid from retained earnings (tax gain)
- On death $800,000 of death benefit distributable without being subject to taxation (tax loss, but consider offsetting tax gain at point of sale)
- Get extra $150,000 out of corporation without tax but had $50,000 subject to taxation at regular income tax rates; compare to paying dividend of $200,000; factor in other benefits but also factor in risk of early death (if death occurred immediately after sale, only $700,000 distributable without being subject to taxation instead of $800,000)

Example 4

Cash Surrender Value: $300,000
Death Benefit: $1 million
Fair Market Value: $600,000
Adjusted Cost Basis: $250,000

Increased FMV

Since the policy has cash surrender value greater than adjusted cost basis, the shareholder incurs taxable income on sale of the excess. Shareholder sells policy for fair market value, receiving $600,000 of cash from corporation, taxable income of $50,000.

Corporation's adjusted cost basis for the policy is $300,000 (the cash surrender value, this is an increase), assume that it would decline over time and that it is $200,000 at death of the life insured. When the life insured dies, the corporation's capital dividend account would increase by $1 million less the adjusted cost basis. The shareholder, or the heirs, could extract this amount ($800,000) without being subject to taxation.

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If the shareholder had continued to hold the policy personally, on death the $1 million would have been received without being subject to taxation.

The differences between continuing to hold personally and selling into the corporation are:

- $600,000 of cash extracted from corporation (liquidity gain)
- $600,000 extracted from corporation with $50,000 subject to taxation (tax gain)
- Premiums payable after the sale are paid from retained earnings (tax gain)
- On death $800,000 of death benefit distributable without being subject to taxation (tax loss, but consider offsetting tax gain at point of sale)
- Get extra $350,000 out of corporation without tax but had $50,000 subject to taxation at regular income tax rates; compare to paying dividend of $400,000; factor in other benefits but also factor in risk of early death (if death occurred immediately after sale, only $700,000 distributable without being subject to taxation instead of $800,000)

The higher fair market value in Example 4 versus Example 3 makes the sale more attractive for Example 4.

Rewards of Sale

The reward will depend on the cash surrender value relative to the adjusted cost basis (cash surrender value below adjusted cost basis is good) and on the fair market value (the higher the fair market value the better).

If the cash surrender value is greater than the adjusted cost basis, a sale will create taxable income and this may cause some uncertainty as to whether there will be a reward (e.g., the timing of the death could be relevant). However, the greater the fair market value, the greater the reward and this can overwhelm the negative effect of any taxable income that might be created by the sale.

A fair market value estimate might be needed to assess the viability of executing a sale.

Risks of Sale

Selling the life insurance policy to a corporation could increase exposure to creditors.

If the corporation does not generate enough earnings to pay the future premiums of the life insurance policy or have sufficient retained earnings for this purpose, additional contributions may need to be made to the corporation.

If the life insurance policy needed to be sold back to the shareholder (e.g., selling corporation), the achieved benefits may be lost along with potential future benefits. For example, if reversing the transaction and the fair market value had increased from $400,000 to $600,000 then the shareholder would need to pay the corporation $200,000 more than had been received and would be subject to taxation on this amount if it were then distributed back to the shareholder.

If at some later date, the policy is surrendered for its cash surrender value, the sale may have lowered the policy's adjusted cost basis and result in a greater level of taxable income on disposition (in Example 1 the adjusted cost basis decreased from $250,000 to zero, which is good for tax planning if policy is kept until death but bad if the policy is surrendered).

The assessment of a sale of a life insurance policy should carefully consider these risks. The advantages and disadvantages of transacting such a sale through a holding company versus an operating company should include consideration of these risks.

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