Fair Market Value of Life Insurance Policies

Charities and Donated Life Insurance Policies

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A life insurance policy can have a fair market value that is materially larger than its cash surrender value.

Issuing Donation Receipts – when a life insurance policy is donated to a charity, the donor is entitled to a donation receipt for the fair market value of the policy. Limiting the donation receipt to the cash surrender value may deprive a donor of a significant portion of the tax benefits that is to accrue from the donation and may well cause the donor not to make the donation.

Providing Cash Back on Donations – when a donor requests cash back in return for donation of a life insurance policy, the charity should receive a fair market value estimate and related analysis to assess the prudence of any such payment and to understand the characteristics and sensitivities of the policy.

Managing Donated Policies – where a charity owns life insurance policies, a fair market value estimate and related analysis will assist the charity in determining whether to continue paying premiums on policies or what other actions may best serve the objectives of the charity.

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 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. A life insurance policy could be materially undervalued if the value of a life insurance policy were to be arbitrarily set to the cash surrender value. Such an undervaluation could cause a donor to be offered a donation receipt that is materially smaller than their entitlement or could leave a charity making important decisions without full information.

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 the donation receipt were arbitrarily set to zero, the donor would be denied a $400,000 donation receipt.
- If a charity owned this policy and the donor stopped paying premiums: without knowing the fair market value, the charity might allow the policy to lapse through non-payment of premiums and thus forfeit a valuable asset.

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.

Donation Receipts

A donor can donate a life insurance policy to a charity while the life insured is alive. By donating a life insurance policy to a charity, the donor is entitled to a donation receipt for the fair market value of the policy. The donor should obtain a fair market value estimate for all life insurance policies that potentially have a fair market value in excess of their cash surrender value. Regardless, the donation receipt should never be less than the cash surrender value.

If the donor pays premiums on a life insurance policy after the donation date, the donor is also entitled to donation receipts for those premium payments.

Example: zero cash surrender value life insurance policy, death benefit $1 million, fair market value estimate $400,000, annual premium $20,000. Donor is entitled to a donation receipt of $400,000. If the donor continues to pay the premiums then the donor will be entitled to a donation receipt of $20,000 per year so long as premiums are paid.

Life insurance policies are proposed not to be exempted from the proposed "deemed fair market value" amendment to the Income Tax Act. Under the proposal, life insurance policies donated within 3 years of acquisition would only be entitled to a donation receipt for the lesser of fair market value and cost. If a life insurance policy was acquired with a main reason being donation, this limitation would extend for 10 years from acquisition.

Providing Cash Back to Donor

Under the proposed amendments to the Income Tax Act, an advantage of up to 80% of the fair market value of the property donated (or more if approved) can be received by the donor without disqualifying the donation from being eligible for a donation receipt. The donation receipt would be reduced by the amount of the advantage received.

When a donor requests cash back in return for donation of a life insurance policy, the charity should receive a fair market value estimate and related analysis to assess the prudence of any such payment and to understand the characteristics and sensitivities of the policy. For example, a charity may consider giving $50,000 in cash back on a policy with zero cash surrender value if it has a fair market value of $400,000. In making this decision the charity should consider the discount rate in the appraisal, the cash flow requirements to continue the policy and the survival characteristics of the life insured, that is, what are the premiums to be paid, how long might they need to be paid and what options will the charity have to cease premiums or cash out.

Managing Policies

In the circumstance where a charity owns a life insurance policy and where the donor had been paying premiums but has now ceased to pay premiums, a charity should obtain a fair market value estimate and related analysis to assess whether to pay the premiums itself or to otherwise deal with the policy. Without knowing the fair market value of the life insurance policy, the charity may forfeit a valuable asset by allowing a policy to lapse through non-payment of premium. Similarly, a charity could be throwing away money by paying premiums on a life insurance policy when surrendering the policy for its cash surrender value is the best option.

A charity will have the information that it needs to make decisions to best serve the objectives of the charity when it obtains fair market value estimates and related analysis of life insurance policies that it owns.

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