Fair Market Value of Life Insurance Policies

Donating a Life Insurance Policy to Charity

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A life insurance policy can have a fair market value that is materially larger than its cash surrender value. A donor is entitled to a donation receipt for the fair market value of a life insurance policy donated to a charity. Settling for a donation receipt in the amount of the cash surrender value may deprive a donor of a significant portion of the tax benefits that accrue from the donation.

Where the fair market value of a life insurance policy exceeds its cash surrender value, there is favourable tax treatment of donation of the policy and of any advantage received in excess of cash surrender value.

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**.

Donating a Life Insurance Policy

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. 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.

The alternative for a donor is to wait until the death of the life insured to donate the death benefit of a life insurance policy by direct designation or by having the death benefit paid to their estate and designated to a charity by will.

Reasons a donor may donate a life insurance policy now instead of waiting until the death of the life insured:

- Want to use tax deduction while living
- Better use tax deduction while living
- Tax planning
- Greater certainty for the charity
- Continuing to pay premiums is a financial burden
- Means of realizing value from zero or low cash surrender value 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 Understatement of Donation Receipts 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 understatement of the donation receipt can occur if the value of a donated life insurance policy 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 property no value will undervalue it by $400,000. If the life insurance policy's value is arbitrarily set to zero, the donor will be denied a $400,000 donation receipt.

Obtaining Fair Market Value Estimates

Fair market value estimates should be obtained for all donated 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.

Tax Consequences of Donation

A donor is entitled to a donation receipt for the fair market value of property donated. When donating a life insurance policy, a fair market value estimate should be obtained for all 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.

On donation, a donor will have taxable income from disposition of the life insurance policy for the excess, if any, of the proceeds of disposition over the adjusted cost basis; for donation, the proceeds of disposition are deemed to be the cash surrender value. Donation creates the same taxable income as if the life insurance policy were surrendered. This is favourable tax treatment in that the excess, if any, of the fair market value over the cash surrender value generates a donation receipt without corresponding taxable income, regardless of the adjusted cost basis of the policy.

Example 1: death benefit $1 million, fair market value estimate $400,000, cash surrender value $250,000, adjusted cost basis $150,000, annual premium $20,000. Donor is entitled to a donation receipt of $400,000. The donor will incur taxable income of $100,000 (excess of cash surrender value over adjusted cost basis). If the donor continues to pay the premiums then the donor will be entitled to donation receipts of $20,000 per year so long as premiums are paid.

The non-refundable tax credit for donation is calculated using the top marginal tax rate. In the example, the $400,000 donation receipt will provide a non-refundable tax credit at the top marginal tax rate and the $100,000 of taxable income will give rise to tax at whatever marginal rates apply to the donor. It should also be noted that donations can be carried forward for up to 5 years beyond the donation year, allowing more opportunity to utilize the non-refundable tax credit available from large donations. In the example, the donor might choose to have $150,000 of the donation receipt applied to the donation year and $50,000 applied to each of the next five years (extra $100,000 in first year to offset taxable income attributed to the donation). In Ontario, at 2006 tax rates, this would generate non-refundable tax credits of $60,240 in the first year and $20,080 in each of the five subsequent years (there are limits and other effects to consider along with potential reduction in Ontario surtax totalling an additional $18,749). The donation receipt for continued payment of premiums would generate additional non-refundable tax credits of $8,032 per year (plus potential reduction in Ontario surtax of $1,250 per year).

The tax benefit gained from a donation will be particular to the donor's circumstances, likewise, the optimal pattern of applying the donation receipt.

Alternatively, donating the death benefit would generate a $1 million donation receipt at death, but nothing in the interim.

Example 2: death benefit $1 million, fair market value estimate $400,000, cash surrender value of $50,000, adjusted cost basis $150,000. Donor is entitled to a donation receipt of $400,000. The donor will incur no taxable income (no excess of cash surrender value over adjusted cost basis).

With Example 2, the non-refundable tax credits and other effects are as described for Example 1 but the difference is that there is no $100,000 of taxable income due to the cash surrender value being less than the adjusted cost basis.

Donation Receipt Limited to Cost

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.

Donate Policy or Donate Death Benefit

A donor should consider whether there are greater tax benefits from donating a life insurance policy now or waiting until death of the life insured. If the entire donation receipt arising from the death benefit might not be able to be used at death of the life insured, it may be better to donate the life insurance policy now; this might be particularly relevant where the death benefit is paid on the first death of two spouses. Also, where the donor is presently incurring a large taxable event (e.g., sale of business or RRSP withdrawal), it may be better to donate the life insurance policy now.

A donor might also choose to donate a life insurance policy now in order to enhance their disposable income while they are living rather than waiting for an improvement at death.

From the perspective of the charity, by donating the life insurance policy to the charity now, the donor gives the charity greater certainty than if the charity only had the possibility of receiving a donation at some later date (designations and wills can change). Further, a well intentioned donor may later be unable to continue to pay the premiums which would cause a loss to the charity if the life insurance policy lapsed, or there may be events that cause the donor to surrender or otherwise deal with the policy. By donating the life insurance policy now, these uncertainties are either eliminated or put within the control of the charity. For example, the charity could continue to pay the premiums on a life insurance policy that it owns if the donor is unable or unwilling to continue paying premiums.

Avoiding Lost Value

Where the fair market value of a life insurance policy is in excess of its cash surrender value, donation of the policy to a charity allows the policyholder to have some of this excess value realized. For example, if a policyholder was unable to continue to pay the premiums of a life insurance policy, they could donate the policy to a charity and obtain a donation receipt for the fair market value. If the fair market value is in excess of the cash surrender value then the charity will get this excess rather than it being forfeited to the insurance company. If the donor cannot make use of the donation receipt, they still would be giving the value of the life insurance policy to a charity rather than forfeiting it to the insurance company.

Example 1: fair market value estimate $400,000, cash surrender value $250,000, adjusted cost basis $150,000. If the life insurance policy was surrendered, the policyholder would receive $250,000 from the insurance company with taxable income of $100,000 (excess of cash surrender value over adjusted cost basis); the other $150,000 of value would be forfeited to the insurance company. If the policyholder donated the life insurance policy to a charity, the policyholder would be entitled to a donation receipt of $400,000 and would incur the same $100,000 of taxable income (excess of cash surrender value over adjusted cost basis).

Example 2: fair market value estimate $400,000, cash surrender value $50,000, adjusted cost basis $150,000. If the life insurance policy was surrendered, the policyholder would receive $50,000 from the insurance company with no taxable income (adjusted cost basis exceeds cash surrender value); the other $350,000 of value would be forfeited to the insurance company. If the policyholder donated the life insurance policy to a charity, the policyholder would be entitled to a donation receipt of $400,000 and again would not incur taxable income (adjusted cost basis exceeds cash surrender value).

In Example 1, the policyholder may have been able to first take a withdrawal from the life insurance policy or a policy loan of up to $250,000 and then donate the policy to a charity and get a donation receipt for $150,000 (could take policy loan up to adjusted cost basis without incurring taxable income, whereas withdrawals would generate taxable income). Besides the tax benefits to the policyholder of donation over surrender, the charity gains $150,000 in value that would otherwise be forfeited to the insurance company.

Getting Cash Back

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 where 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.

A charity might allow the donor some cash back at the time of donation of a life insurance policy. In Example 2 above, if the charity gave the policyholder $200,000 in cash then the donor would be entitled to a donation receipt for $200,000 (and again would not incur taxable income as the adjusted cost basis exceeds the cash surrender value). In the examples, up to $320,000 of cash back could be received without disqualifying the residual from a donation receipt, none of which would increase taxable income, if any. This is favourable tax treatment in that an advantage can be received without affecting the donor's taxable income.

Favourable Tax Treatment for both Donation and Advantage

It is favourable tax treatment for the donor to be entitled to a donation receipt for the fair market value of the life insurance policy, while for purposes of taxable income, disposition is deemed to be a cash surrender value: excess of fair market value in excess of cash surrender value generates donation receipt but does not generate taxable income (ordinary property would be deemed disposed at fair market value instead of at cash surrender value).

It is also favourable tax treatment to be able to receive an advantage from donating a life insurance policy without affecting the donor's taxable income. For life insurance policies with fair market value in excess of cash surrender value (e.g., zero or low cash surrender value policies), this allows a portion of the policy's value to be extracted tax free, with the remainder earning the donor a donation receipt.

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Footnote – the original version of this article was written assuming that a life insurance policy was deemed disposed at fair market value upon donation (using Income Tax Act section 69 (1) like other donated property). This current version is written assuming that a life insurance policy is deemed disposed at cash surrender value upon donation (using Income Tax Action section 148 (7) to override 69 (1)). This current version uses an interpretation that is more tax advantageous to a donor than that used for the original version (excess of fair market value over the greater of cash surrender value and adjusted cost basis is not taxable income whereas it was taxable under prior interpretation). Under this interpretation there is favourable tax treatment for advantages received from donation of a life insurance policy (under the proposed amendment to the Income Tax Act there would be no connection between advantage received and the proceeds of disposition of the life insurance policy); the proposed amendment to the Income Tax Act deals with the equivalent issue where there is an advantage from donation of capital property, but it doesn't for life insurance policies.