Fair Market Value of Life Insurance Policies

Equalization of Family Property on Spousal Death and Divorce

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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; it is reckless to arbitrarily use cash surrender value instead of fair market value to equalize family property. To ensure equitable treatment, fair market value estimates should be obtained for life insurance policies owned by the other spouse.

Fair market value is likely to diverge materially from cash surrender value when:

- Policy has low or zero cash surrender value
- Life insured has impaired health
- Life of the deceased spouse was insured

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**.

Fair Market Value of Property

For equalization of family property on spousal death or marriage breakdown, 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 one or both spouses (surviving or deceased) or other persons.

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.

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 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 inequities in the division of family property can occur if the value of a 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 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.

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.

Circumstances Particular to 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. 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 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 $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.

Circumstances Particular to Marriage Breakdown

These circumstances relate to marriage breakdown but they also relate to spousal death for life insurance policies that continue after the death of the deceased spouse (i.e., life insured is the surviving spouse or another person).

Difficulties with Partitioning Property

Dividing a life insurance policy into two pieces, one for each spouse, 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 both spouses into two separate policies insuring each spouse separately, however, this is not necessarily the whole solution to the division 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 spouse and the amounts of ongoing premiums required to be paid. To have an equitable division 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 spouse is healthy and the other unhealthy, the healthy spouse's succeeding policy might have less value than that of the unhealthy spouse).

Difficulties with Shared Ownership

Shared ownership of a life insurance policy is problematic as a solution to the division of this property as it might cause both spouses to be impaired in their ability to deal with their property (take loans, surrender it, sell it, etc.) and one spouse may be harmed by the other not paying their portion of premiums (e.g., cause policy to lapse).

Protecting Interest

When a life insurance policy potentially has a fair market value that is materially larger than its cash surrender value and only the first spouse is the owner of the policy, the second spouse might not have a right to pay any overdue premiums (or even be aware that premiums are overdue) and the negligence of the first spouse in paying premiums could cause a material loss to the second spouse (e.g., not paying a $1,000 monthly premium on a zero cash surrender value life insurance policy with a $1 million death benefit and a fair market value estimate of $400,000 would cause the life insurance policy to lapse without value if the $1,000 premium were not paid within 30 days of its due date). In such circumstances, the second spouse could ask a court to order the first spouse to pay all premiums as due or to make the second spouse a joint owner of the policy so that the second spouse could be notified of overdue premiums and be entitled to pay such premiums.

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