Fair Market Value and Other Calculations

Taxation of Non-Canadian Life Insurance Policies

Michael Hawkins F.C.I.A., F.S.A., BMath

An individual who owns a non-Canadian life insurance policy or life annuity has special tax considerations during residency in Canada as well as at the time they cease to be resident in Canada.

Hawkins Consulting Corporation provides the fair market value estimates and other calculations that are needed for the taxation of non-Canadian life insurance policies and life annuities. To learn more about these services, visit **www.lifevaluator.com** or call **905.337.8200**.

Non-Canadian Life Insurance Policy

The Income Tax Act defines a "life insurance policy in Canada" to be a policy where the person whose life is insured was resident in Canada at the time of issue.

A resident of Canada who owns non-Canadian life insurance policies is typically someone who previously resided outside of Canada and acquired life insurance policies prior to moving to Canada.

Example 1: U.S.A. citizen relocates to Canadian office and becomes resident in Canada. Policies that were acquired prior to relocation while residing in U.S.A. are non-Canadian life insurance policies.

Example 2: Canadian citizen returns from abroad. Life insurance policies acquired while non-resident in Canada are non-Canadian life insurance policies.

Disposition on Immigrating and Emigrating

When an individual becomes or ceases to be resident in Canada, the Income Tax Act deems certain property to be disposed. Some life insurance policies are granted an exclusion from being deemed disposed while others are deemed disposed at either cash surrender value or fair market value.

Excluded

There is an exclusion from deemed disposition for a "life insurance policy in Canada".

Example: if an individual acquired a policy during their residency in Canada, it is excluded from being deemed disposed should this individual cease to be resident in Canada; no special Canadian tax considerations.

Cash Surrender Value

A non-Canadian life insurance policy that insures the policy owner or another person who is non-arm's length to the policy owner (at issue or at time of change in residency) is deemed by the Income Tax Act to be disposed of for its cash surrender value. The adjusted cost basis (as defined by the Income Tax Act of Canada) for such a policy needs to be maintained during residency in Canada to determine taxable income arising from any disposition of the policy during residency and to determine taxable income, if any, should the policy owner cease to be resident in Canada.

Example: if an individual had acquired a policy insuring their own life or their spouse's life while non-resident in Canada, the policy is deemed disposed upon becoming or ceasing to be resident in Canada for its cash surrender value. For example, cash surrender value is $100,000 upon becoming resident in Canada; the starting adjusted cost basis is $100,000; this adjusted cost basis will change during residency and, for example, might be $125,000 upon ceasing to be resident in Canada; if the cash surrender value is $200,000 upon ceasing to be resident in Canada, then there would be a deemed disposition that would give rise to $75,000 of taxable income (ending cash surrender value less ending adjusted cost basis).

Hawkins Consulting will calculate the adjusted cost basis (proactively maintain or retroactively determine) of a non-Canadian life insurance policy during residency in Canada.

Fair Market Value

Other non-Canadian life insurance policies are deemed to be disposed of at fair market value. There would only be a small minority of policies in need of a fair market value estimate except that Canada Revenue Agency has stated that the deeming of disposition at cash surrender value was not intended to include multi-life policies. Canada Revenue Agency has stated that it interprets the Income Tax Act as not allowing disposition to be deemed to be the cash surrender value when a policy insures more than one life. Thus for any non-Canadian life insurance policy that insures multiple lives, a fair market value estimate is required upon becoming and ceasing to be resident in Canada. It is common for spouses to both be insured under the same policy on a joint last-to-die basis for estate planning purposes; these are multi-life policies and as such are deemed disposed of at fair market value.

In such a circumstance, upon becoming resident in Canada, the starting adjusted cost basis of the policy is the fair market value (versus the cash surrender value for a single life policy). The adjusted cost basis will need to be maintained during residency in Canada to determine taxable income arising from any disposition of the policy during residency and to determine taxable income, if any, should the policy owner cease to be resident in Canada. The fair market value of the policy upon ceasing to be resident in Canada is the amount at which the policy is deemed disposed (versus the cash surrender value for a single life policy); the excess of this ending fair market value, if any, over the ending adjusted cost basis is taxable income.

Example: if an individual had acquired a policy insuring their own life and their spouse's life while non-resident in Canada, the policy is deemed disposed upon becoming or ceasing to be resident in Canada for its fair market value. For example, fair market value is $100,000 upon becoming resident in Canada; the starting adjusted cost basis is $100,000; this adjusted cost basis will change during residency and, for example, might be $125,000 upon ceasing to be resident in Canada; if the fair market value is $275,000 upon ceasing to be resident in Canada, then there would be a deemed disposition that would give rise to $150,000 of taxable income (ending fair market value less ending adjusted cost basis).

Hawkins Consulting will:

- Estimate fair market value of the policy as of date becoming resident in Canada;
- Calculate the adjusted cost basis of the policy during residency in Canada; and
- Estimate fair market value of the policy as of date ceasing to be resident in Canada.

Accrual Taxation

A life insurance policy is exempt from accrual taxation so long as its accumulating fund does not exceed a specific threshold. For a policy issued in Canada, the issuing insurer will maintain a policy's exempt status or else determine the taxable income accruing each year. Most policies issued in Canada are designed to be exempt from accrual taxation or have features that the insurer will use to maintain exempt status. However, for a typical non-Canadian life insurance policy, it will not be issued in Canada and thus there will not be support from the issuing insurer to ensure that the policy is exempt under the Income Tax Act of Canada or, if not exempt, to determine the taxable income accruing to the policy each year as specified by the Income Tax Act of Canada.

For a non-Canadian life insurance policy, the policy owner needs to annually determine whether the policy is exempt from accrual taxation. If it is exempt then no annual taxable income will be attributable to the policy during residency in Canada. This test is complex and is dependent on the entire history as well as the potential future of the policy. Where a life insurance policy has flexible features (e.g., dividend options of a participating policy; premium, withdrawal and other features of a universal life policy), the policy owner might be able to take certain actions to maintain a policy's exempt status.

If a life insurance policy is not exempt from accrual taxation, each year during residency in Canada there will be taxable income attributable to the policy equal to the excess of the accumulating fund over the adjusted cost basis. An annual calculation of the accumulating fund and the adjusted cost basis is needed to determine the taxable income.

A typical non-Canadian life insurance policy will be denominated in a foreign currency (e.g., U.S.A. dollars). Currency exchange fluctuations will add uncertainty to the exempt status of a policy and may cause policies that would otherwise be exempt to become non-exempt. For a non-exempt policy, currency exchange fluctuations will add uncertainty and volatility to the taxable income attributable to the policy.

Hawkins Consulting will:

- Test a policy to determine if it is exempt from accrual taxation;
- Calculate annual taxable income of a policy that is not exempt from accrual taxation; and
- Provide technical support to keep an exempt policy from becoming non-exempt.

Dispositions

A disposition of a life insurance policy may give rise to taxable income. Dispositions include cash withdrawals, surrender, policy loans and change in ownership. To determine taxable income arising from a disposition, the adjusted cost basis of the policy is needed and, for certain dispositions, the accumulating fund of the policy is also needed. For a policy issued in Canada, the issuing insurer will maintain the adjusted cost basis and the accumulating fund. However, for a typical non-Canadian life insurance policy, it will not be issued in Canada and thus the adjusted cost basis and accumulating fund, as defined by the Income Tax Act of Canada, will not be available from the issuing insurer.

For a disposition of a non-Canadian life insurance policy, the policy owner needs to determine the adjusted cost basis and, for certain dispositions, the accumulating fund.

Hawkins Consulting will:

- Calculate the adjusted cost basis (proactively maintain or retroactively determine) of a policy during residency in Canada (including estimating the fair market value of the policy as of date becoming resident in Canada if necessary); and
- Calculate the accumulating fund of a policy at the time of disposition (this may be available from a determination of whether policy is exempt from accrual taxation).

For certain dispositions, it might be beneficial to the policy owner to obtain a fair market value estimate of the policy at the time of disposition. Refer to other articles available at **www.lifevaluator.com** for more information.

Life Annuities

Life annuities receive treatment similar to life insurance policies under the Income Tax Act of Canada, with an exception for prescribed annuities. However, as most non-Canadian life annuities are denominated in a currency other than the Canadian dollar, and thus have non-level payments in Canadian dollar equivalent, they do not qualify as prescribed annuities. Life annuities are subject to accrual taxation, requiring annual determination of taxable income. The tax considerations for change in residency and disposition, as described for life insurance policies, are also applicable to life annuities. Hawkins Consulting will prepare the fair market value estimates and other calculations that are needed for the taxation of non-Canadian life annuities.

Different Tax Rules

Where a policy owner last became resident in Canada prior to 1990, a non-Canadian life insurance policy will not be subject to accrual taxation (i.e., no need to test exempt status). On the other hand, if a non-Canadian life insurance policy predates 1990 but the policy owner became resident in Canada after 1989 then the policy will need to have an annual determination of exempt status and taxable income as applicable.

The 1989/1990 differences do not otherwise effect taxation: on becoming or ceasing to be resident in Canada, a non-Canadian life insurance policy will be deemed disposed of at either cash surrender value or fair market value as applicable; and a disposition may give rise to taxable income, determined in the same manner.

There are proposed changes to the Income Tax Act for “foreign investment entities” that, if enacted as proposed, will affect non-Canadian life insurance policies. Discussion of these proposed changes to the Income Tax Act are beyond the scope of this article.

Fair Market Value vs. Cash Surrender Value

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.

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. 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 it can also occur even when the life insured is in good health.

- 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.
