Fair Market Value of Life Insurance Policies

Sale of Corporate-Owned Life Insurance

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

Life insurance policies are property. A life insurance policy can have a fair market value that is materially larger than its cash surrender value. Corporations should obtain fair market value estimates of life insurance policies that are sold or given to shareholders or employees in order to avoid errors in reporting taxable distributions or taxable benefits. A fair market value estimate will also to be useful to a corporation in negotiating the sale price of a life insurance policy.

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**.

Circumstances for Selling

If a corporation is being sold and it owns a life insurance policy insuring the life of a shareholder, prior to the sale of the corporation, it will likely sell the policy to the shareholder. Likewise, if there was a change in the ownership of the corporation (e.g., a partner being bought out), life insurance policies that insure the exiting shareholders would likely be sold to those exiting shareholders.

If a corporation owns a life insurance policy insuring an employee and that employee retires, terminates employment or the policy otherwise no longer serves its original purpose, the corporation might want to extract value by selling the policy to the employee or another person.

A corporation might also sell life insurance policies that it owns if continued ownership impairs its qualification for the small business and family farm corporation capital gains deduction (life insurance policies are included in the qualification test at cash surrender value if insuring the life of a shareholder and otherwise at fair market value).

Sale to Shareholder

When a corporation sells a life insurance policy to a shareholder (or other non-arm's length party), a fair market value estimate should be obtained and used as the basis for determining the sale price. If a life insurance policy were sold below fair market value, the deficiency in the price could be deemed to be a taxable distribution to the shareholder.

If the corporation gives a life insurance policy to the shareholder, a fair market value estimate will provide an estimate of the taxable distribution to the shareholder.

Sale to Employee

When a corporation sells or gives a life insurance policy to an employee, a fair market value estimate should be obtained and used as the basis of determining any taxable benefit that accrues to the employee. The taxable benefit, if any, will be the excess of the fair market value over the price paid by the employee. If there is a taxable benefit, it will affect both income tax and pensionable earnings.

Sale to Third-Party

If selling a life insurance policy to a third-party, the corporation will want to maximize its proceeds from the sale. Obtaining a fair market value estimate will give the corporation valuable information in assessing an offer or it can be used by the parties as a basis for negotiating the sale price.

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. Material tax errors can occur if the value of a life insurance policy were to be arbitrarily set to the cash surrender value.

<u>Example</u>: 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 but the corporation arbitrarily deems the policy to have no value and gives the policy away to a shareholder or employee, the corporation has clearly created a taxable distribution or taxable benefit.

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.

Taxation on Disposition

Where a corporation disposes a life insurance policy (e.g., surrender or sale) there is taxable income of the excess, if any, of the proceeds of disposition over the adjusted cost basis.

If a life insurance policy is sold or given to a person that is non-arm's length (e.g., to a shareholder) then the policy is deemed to have been sold at the policy's cash surrender value. The corporation would have taxable income of the excess, if any, of cash surrender value over adjusted cost basis. For example, if a policy is sold to a shareholder at its fair market value of $400,000 but the policy has zero cash surrender value, there is no taxable income regardless of the adjusted cost basis of the policy. For the acquiring shareholder, the policy will start with an adjusted cost basis equal to the cash surrender value, which in this example is zero.

If a life insurance policy is sold to a person that is at arm's length then the corporation will have taxable income of the excess, if any, of sale price over adjusted cost basis. For example, if a policy is sold for $400,000 and its adjusted cost basis was $250,000 then there would be taxable income of $150,000. For the new owner, the policy will start with an adjusted cost basis of the purchase price of $400,000.
