Fair Market Value of Life Insurance Policies

Estate Freeze – Business Valuation

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With an estate freeze and other non-arm's length transfers of a business, the fair market value of the business is needed for tax purposes. Where a business owns life insurance policies, a business valuation needs to duly reflect the fair market value of any life insurance policies, which can be materially larger than the cash surrender values. A business valuator would be well served obtaining an estimate of fair market value of the life insurance policies from a specialist who is expert in appraising life insurance policies (see publication "Business Valuation").

The valuation of life insurance policies owned by the business may affect tax and estate planning decisions. Where an estate freeze strategy is to be employed on a business that owns life insurance policies, fair market value estimates of the life insurance policies should be obtained to ensure that the strategy will be beneficial and not unintentionally increase tax liabilities.

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**.

Capital Gains Tax on Death of Shareholder

Where a business needs to be appraised for a deemed disposition on death of a shareholder, if the business owns life insurance policies then the fair market value of such a business needs to duly reflect the value of those policies.

Where the life insured under those life insurance policies is the deceased shareholder or is non-arm's length to the deceased shareholder (e.g., spouse or children of the deceased), under the Income Tax Act, the fair market value is deemed to be the cash surrender value immediately prior to death of the shareholder. However, where the life insured under those life insurance policies is arm's length to the deceased shareholder (e.g., business partners or key employees), their value is to be the fair market value immediately prior to death of the shareholder (need a fair market value estimate).

Capital Gain from Estate Freeze

The capital gain with respect to a business that was subjected to an estate freeze will be based on the fair market value of the business at the time of the estate freeze. If the business owns life insurance policies, the fair market value of the business needs to duly reflect the value of those policies at the time of the estate freeze.

Where the life insured under those life insurance policies is the shareholder or non-arm's length to the shareholder, the Income Tax Act provision that deems the fair market value of such policies to be the cash surrender value at death of the shareholder does not apply to the estate freeze transaction. This difference in tax treatment is adverse to an estate freeze.

Example: business with $10 million fair market value plus zero cash surrender value life insurance policy insuring shareholder; policy has $5 million death benefit and $2 million fair market value. Without an estate freeze, for income tax purposes, capital gain relating to the business at the shareholder's death would be based on fair market value of the business at death with the life insurance policy deemed to have no value (i.e., initially $10 million). Conversely with an estate freeze, the fair market value of the life insurance policy would be included, locking in a capital gain based on $12 million.

Scenario 1: fair market value excluding policy at death is $10 million; without estate freeze the capital gain is based on $10 million; with estate freeze the capital gain is based on $12 million; estate freeze disadvantageous.

Scenario 2: fair market value excluding policy at death is $12 million; without estate freeze the capital gain is based on $12 million; with estate freeze the capital gain is based on $12 million; indifferent.

Scenario 3: fair market value excluding policy at death is $14 million; without estate freeze the capital gain is based on $14 million; with estate freeze the capital gain is based on $12 million; estate freeze beneficial.

The benefits of an estate freeze should be weighed against incurring up to $2 million in additional capital gain. An estate freeze would add value if the fair market value of the business increased by more than $2 million prior to the death of the shareholder. An analysis of the likelihood of the shareholder surviving to different points in time would provide useful information in assessing the potential cost / benefit of an estate freeze. An additional $2 million capital gain for the shareholder would be offset by their heir having the base for their eventual capital gain raised by $2 million, but this is small consolation as the objective was to defer not advance capital gains.

Of course, where the life insurance policies are small relative to the total business, the policies will not be an important determinate as to whether to implement an estate freeze.

Fair Market Value vs. Cash Surrender 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, due to the proliferation of low or zero cash surrender value policies, it also occurs 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.