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FAIR MARKET VALUE OF A LIFE INSURANCE POLICY

iA Financial Group

WHAT IS THE FAIR MARKET VALUE ("FMV") OF A LIFE INSURANCE POLICY?

According to the Canada Revenue Agency ("CRA"), the FMV of a life insurance policy is the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact[1].

WHEN SHOULD THE FMV OF A LIFE INSURANCE POLICY BE APPRAISED?

There are a number of situations where a life insurance policy's FMV may need to be appraised. For example, a life insurance policy may be appraised as part of a business valuation or upon separation of assets following the termination of a marriage. Moreover, it is often important to establish the FMV when ownership of a life insurance policy is transferred.

WHY DO YOU HAVE TO DETERMINE THE FMV OF A LIFE INSURANCE POLICY?

A life insurance policy is a valuable asset. As such, when ownership of such an asset changes hands, it may result in tax consequences for the transferor and the transferee[2]. These consequences may vary, depending on whether or not there is an arm's length relationship between the two parties[3]. It is therefore important to know the life insurance policy's FMV to assess the impact of the transfer and comply with applicable tax rules.

1 CANADA REVENUE AGENCY, Information Circular, IC-89-3, "Policy Statement on Business Equity Valuations," August 25, 1989, paragraph 3(a).

2 Section 148(1) of the Income Tax Act ("ITA") – upon disposition of an insurance policy, a policy gain is realized by the transferor when the proceeds of disposition exceed the adjusted cost basis ("ACB"). The policy gain is taxed as ordinary income and is 100% taxable. See also the document entitled "Transfer of ownership of a life insurance policy involving a corporation" on the iA Large Case Solutions website at: large-case-solutions.ia.ca.

3 See section 148(7) of the ITA "Disposition at non-arm's length and similar cases" as well as sections 148(8) to (8.2) of the ITA. Under sections 148(8) to (8.2), the transfer of a life insurance policy to a child or spouse may be made without tax consequences in certain conditions.

HOW DO YOU DETERMINE THE FMV OF A LIFE INSURANCE POLICY?

To determine the FMV of a life insurance policy, you need to consult a certified appraiser or actuary. The policyholder should use the services of an independent professional to ensure that the appraisal value is not challenged by the tax authorities. Indeed, insurance companies are not qualified to appraise a life insurance policy neutrally and independently. The valuation must be based on the facts and circumstances of each case. The appraiser or actuary must be objective and exercise good judgment, and their choice of appraisal methods and their analyses must be based on the relevant facts of the policy being appraised[4].

According to the Canadian Institute of Actuaries, there are multiple approaches for determining the FMV of life insurance policies, including Basic, Scenarios, Handling Unusual Policy Features, and Use of Replacement Cost[5]. However, there is no exact method for determining the FMV of a life insurance policy, given the many criteria to consider.

In addition, the CRA identifies multiple factors to take into account when determining the FMV of a life insurance policy, including[6]:

a) cash surrender value

b) policy's loan value

c) face value

d) state of health of the insured and his/her life expectancy (according to mortality tables)[7]

e) conversion privileges

f) other policy terms, such as riders and double indemnity provisions

g) replacement value[8]

4 *Ibid.*, note 1, paragraph. 4.

5 Canadian Institute of Actuaries, Fair Market Value of Life Insurance Policies, Document 213085, September 2013, pp. 17–21.

6 *Ibid.*, note 1, paragraph 40.

7 CANADA REVENUE AGENCY, Interpretation Bulletin, IT-416R3, "Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder," July 10, 1987, paragraphs 4 and 5.

8 *Ibid.*, note 1, paragraph 40.

IMPORTANT CONSIDERATIONS WHEN DETERMINING THE FMV OF A LIFE INSURANCE POLICY:

Cash surrender value

The cash surrender value is one important element to consider when appraising a life insurance policy. Generally, the FMV of the life insurance policy cannot be less than its cash surrender value[9]. In addition, contrary to what one might think, it is generally not possible to assume that the FMV of a policy corresponds to its cash surrender value. As mentioned, the FMV of a life insurance policy is evaluated according to multiple criteria, all of which must be taken into account.

Insured's health

The insured's state of health is also an important factor in determining the FMV of a life insurance policy. For example, it is reasonable to expect that the FMV of a life insurance policy will be higher if the insured's health has deteriorated since the policy was issued or if the person is no longer insurable[10]. According to the CRA, the FMV of a life insurance policy could be appraised at a value close to the death benefit amount if it is determined that the insured's death is imminent. However, the CRA points out that the appraiser should take into account the possibility that the insured may recover[11].

Insured's age

The insured's age influences the FMV of the policy. Generally, the older the person, the higher the FMV may be. Moreover, when determining the replacement cost of a life insurance policy, the appraiser or actuary should take into account the age of the insured who will be older than at the time of the initial subscription. Indeed, the premiums might presumably be higher, which might result in a higher FMV.

Beyond the insured's age, the time elapsed since the policy was issued must also be factored in. Indeed, an insurance policy in effect for several years might presumably have a higher FMV than a recently issued policy.

Socioeconomic environment

Changes in the socioeconomic environment affect the valuation of an insurance policy's FMV. For example, interest rates can put pressure on insurance companies, inflation can lead to higher premium costs and poor mortality experience can also have the same effect. This is part of the reason premium costs change over the years. The FMV of a life insurance policy may reasonably vary over time, even if the coverage remains comparable in all respects.

Other considerations

The type of insurance and conversion privileges affect the FMV of a policy. Paid-up policies, whole life policies and term to 100 policies generally have a higher FMV than short-term term life insurance (e.g., T10, T20, etc.). Moreover, a term life insurance policy with a conversion privilege to permanent life insurance with guaranteed insurability may see its FMV increase.

Joint ownership of a life insurance policy between multiple policyholders will also influence the policy's FMV.

The various riders and guarantees included in a life insurance policy have an impact on the FMV (e.g., level premiums, guaranteed insurability, availability of funds for accumulation, option to increase the face amount, etc.).

Key takeaways

— It is important to appraise the FMV of an insurance policy before proceeding with a transfer of ownership to determine the tax consequences.

— The FMV of a life insurance policy must be determined by a qualified independent professional (actuary or certified appraiser).

— There are many criteria to consider when appraising a life insurance policy.

9 *Ibid.*, note 5, p. 8.
10 *Ibid.*, note 8, paragraph 5.
11 *Ibid.*, note 1, paragraph 41.

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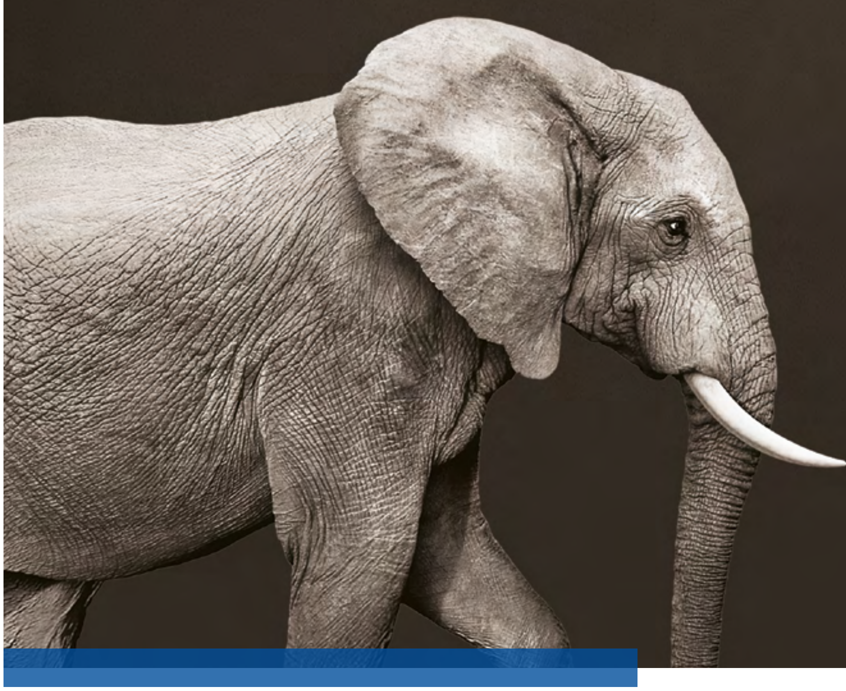

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