

Marmer Penner Inc. Newsletter

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Exercise Caution When Valuing Life Insurance Policies

It is not uncommon to see “quick-and-dirty” valuation calculations of a corporation that owns one or more life insurance policies, that value the life insurance policies using two simplifying assumptions:

1. Term policies have no value; and
2. Policies with a cash surrender value (“CSV”) have a value equal to the CSV.

Calculations using these simplifying assumptions will render approximate results only in certain circumstances. It is important to understand that relying on these two assumptions all the time can sometimes lead to materially incorrect (typically lower) results.

The CSV of a life insurance policy should be thought of as an offer to the insured to ‘buy back’ the policy – think of it as a carrot that the insurance company dangles in front of the policy holder; sometimes, the insurance company is happy to have the policy holder cash in the CSV, because it relieves the insurance company of a larger future obligation i.e. the payout of the death benefit on the death of the insured.

In the extreme, consider a corporation that owns a life insurance policy with a \$100,000 CSV and a \$1,000,000 death benefit that is payable on the death of the insured, a 95 year old shareholder. Obviously, it would make sense for the corporation to maintain the policy (subject to whatever premiums are necessary) rather than cash out the CSV.

In situations where a company owns insurance policies on individuals who are elderly, or have suffered a decline in health, in most cases, the present value of

receiving the proceeds on death (and therefore the value of the policy) will be higher than the CSV, and as such, the stated CSV (which can be zero in the case of a term policy), must be replaced with the actuarial value of the payout of the death benefit for valuation purposes. In these cases, actuarial determinations are required. This situation is common in family control business situations, where the elder patriarch or matriarch of a business has arranged his or her affairs such that one or more insurance policies allow for the payment of taxes on the death of the elder shareholder. In these cases, the payment of the imminent death benefit was planned many years before, and can be significantly in excess of the stated CSV. The existence of life insurance policies may also have an impact on the calculation of contingent income taxes because all or a portion of the death benefits may be distributed as a non-taxable capital dividend.

Furthermore, it is important to understand that there may be life insurance policies that are owned by a corporation that do not necessarily have recurring premiums being paid. This is because insurance policies can be fully "paid-up", i.e. the related premiums for a life insurance policy can be effectively prepaid years beforehand, leaving the corporation as the owner without visible ongoing premiums being paid. It is important to know about all policies owned by corporations, including those that do not have ongoing premiums showing as expenses or which may not have been capitalized on the balance sheet. In other words, it is not always possible to identify all life insurance policies owned by a corporation by looking at the corporate financial statements.

When it is determined that a corporation owns insurance policies that may have a value in excess of their CSV, special expertise from an actuary, or a life insurance professional who is familiar with the nuances of unique policy terms, may be required. There is also a growing secondary market for life insurance policies, which may allow for the fair market value of a life insurance policy to be determined as of a given valuation date.

Marmer Penner Inc. is pleased to announce that Claudio Martellacci, CPA, CA has joined our firm. Claudio has practiced in the areas of audit and personal and corporate income tax at two of the largest firms in the GTA since 2009. Claudio is enrolled in the CBV program and his hourly rate is \$195.

This newsletter is not intended to substitute for proper professional planning. It is intended to highlight areas where professional assistance may be required or enough to discuss at the next hoedown. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.