SAMPLE
Insurance Audit

Audit of Insurance contracts
SunLife XXXXXX
SunLife YYYYYY

Par

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NOTE: The information in this report has been modified in order to protect the confidentiality of the client. However the modifications are not material enough to change the conclusions and results of this report.

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1.0 Mandate

The mandate consists 1) of reviewing the past management of policy xxxxxxx and policy yyyyyyy sold by the Sun Life Advisor xxxxxxx licenced in the province of Nova Scotia.2) of determining the Fair Market Value of these two policies and 3) of determining whether the Fair Market Value should be realized now or at a possible future date in the future.

1.1 Policies covered by the mandate

a) Policy #xxxxxx issued by Sun Life on July 13th 2000 with a death benefit of $200,000 as a Universal Life policy on the life of John with John as the owner.

b) Policy #yyyyyy issued by Sun Life on July 13th 1995 on the life of Henry (son of John) as a Whole life participating policy with the death benefit of $100,000 with John as the owner.

1.2 Exclusions

The information used in doing this mandate was solely comprised of annual statements for the current year and previous year. We were not provided with the contract, original illustration or any inforce illustrations. It is understood that such additional documents would have permitted us to provide a more accurate Fair Market Value particularly in the case of policy #YYYYYY. Any errors or omissions resulting from the absence of these documents are the sole responsibility of the signee giving this mandate.

In particular, the absence of the original illustration does not permit us to evaluate how the policy was sold and whether it was possible to achieve what was actually planned. We have however included as a matter of information, material misrepresentations made by the insurance companies to promote the selling of Universal Life. We strongly advise that you read this section carefully which explain why Universal Life is not a tax shelter in order to minimize the amount of taxes paid each on your cash values.

2.0 Licensing of agent HHHHH

Life insurance agent HHHHHH is licensed to sell insurance in the province of Nova Scotia. When your policies were sold, agent HHHHHH was a captive Sun Life agent meaning that he only sold Sun Life policies and was under the supervision of a Sun Life branch. Agent HHHHHH license was therefore and is still sponsored by Sun Life. Please note there is no registry in Nova Scotia that allows the public to check the licensing status of insurance agents and unless we are allowed to interview agent HHHHHH, this only represents our best guess.

In the reverse merger between Sun Life and Clarica, the Sun Life branch system to which agent HHHHHH belonged disappeared and the Sun Life agents were offered the option of becoming independent agents or continuing to be captive by joining the captive Clarica agent distribution who would now operate under the name of Sun Life. Our investigation indicates that agent HHHHHH decided to remain captive.

Insurance Licensing varies by province. In Nova Scotia:

1. Life insurance agents cannot act as brokers
2. To be licensed in insurance in Nova Scotia, all agents must be sponsored by an insurance company whose representative signs the application in respect of an insurance license.
3. After two years, the sponsored agent may act as an agent of an insurance company that is not sponsoring his license subject to the conditions and limitations set in his agent contract signed with the sponsoring life insurance company. The agent while being able to act as an agent of multiple insurance companies still cannot act as a broker.
4. Our investigation reveals that agent HHHHHH does not hold a mutual fund licence. We believe strongly that this represents a risk since the financial advice in regards to investment and retirement planning that you are getting from agent HHHHHH will be heavily influenced by the products he can sell casting a shadow on the objectivity of this agent. This does not apply to advice in regards to life insurance.
5. Considering the financial loss of $90,000, we believe that agent HHHHHH acted within the apparent authority delegated by Sun Life with "Apparent Authority" defined as: "Apparent authority (also called ostensible authority) exists where the words or conduct of the principal would lead a reasonable person to believe that the agent was authorized to act, notwithstanding the fact that the principal and ostensible agent had never discussed such authority".
5. We have found no indication that Sun Life restricted the apparent authority of agent HHHHHH since we found no communications to you that would suggest otherwise. In Mignault versus Great West Life, judge Keyser stated that insurers have an obligation to inform policy owners of any changes or limitations on the authority of an agent.

3.0 Executive Summary

You currently are the sole shareholder of corporation ABC. Corporation ABC does not own any assets aside from the liquidities created from the employment income paid by employer XXX to this corporation and representing half of your yearly income. The other half of your yearly income is provided by your business which is not incorporated and where business assets worth more than $1 million are personally owned. When you were questioned on your corporate structure, you could not provide any information to us as to your goals and objectives in adopting such a corporate structure.

While we do not need this information to conduct the audit of your insurance policies, we strongly suggest that you sit with your tax advisor to clearly understand your corporate structure and taxes that would result from this structure. While your business assets would probably qualify as a "Qualified Property" for the purpose of the capital gain exemption, you should discuss this with your tax advisor in order to gain a better understanding of any estate planning issues.

Our insurance audits of the past management and past performance of the two policies have revealed serious issues. For your policy #xxxxxx, your financial advisor has shown an extremely poor knowledge of the investments offered in the Universal Life he sold. Your premiums paid were invested into a bond fund for 15 years. You have achieved an annualized return of -2.28% which resulted in a loss of $15,000. In addition, as shown in the section of our report discussing this issue, you have lost an additional $25,000 considering that the money should have been invested into the guaranteed account with a minimum rate of return of 3%.

For policy #yyyyyyy, on the life of your son, your financial advisor recommended that you used the dividends to reduce the premium payable. This was poor advice when it is clear that you had the income available to pay for this premium. Instead it should have been shown to you how the dividends could have been used to purchase additional insurance. These dividends would have purchased a minimum of $150,000 of additional insurance (this number is an estimate as we do not have past dividends history and insurance cost, but we believe the number of $150,000 to be conservative). With a total death benefit of $250,000, the Fair Market Value of this policy would have been 2.5 times higher which would have allowed you to withdraw an additional $45,000 tax free from your corporation upon the transfer of this policy.

As indicated in the report, we believe that the policy #yyyyyy with a Fair Market Value of $30,000 could be transferred to your corporation allowing you to withdraw $30,000 from your corporation on a tax free basis. The main advantage of doing this transfer, now versus later, is that the Adjusted Cost Base of this policy is above its cash value which means there would be no taxable consequence on the disposition of this policy. However this Adjusted Cost Base will soon be quickly decreasing.

For your policy #xxxxxx, the Adjusted Cost Base is almost zero and a significant amount of taxes would be due on the disposition of the policy and transfer to your corporation. While your policy has a Fair Market Value of $65,000, the $25,000 cash value would be fully taxable. You could consider waiting to transfer the policy to your corporation until there is a significant change in your insurability. We have included a Fair Market Value estimate at year 10 and 20 based on 100% and 200% change in insurability.

To conclude, it is clear that the lack of knowledge and training of your advisor has cost you an amount around $90,000. It would be easy to condemn this advisor which is your right while seeking to recover this loss.

We however feel that we have a duty to inform you that there is a reason why such advisors are not knowledgeable in managing existing policies. The reason is because companies such as Sun Life are actively denying the tools, training or education to such advisors. It is clear that it is Sun Life and not the advisor who has gained the most from the mismanagement of your policy.

We have approached Sun Life and other companies offering to train their advisors for free but they are not interested. We have created a tool to enable advisors to manage the Fair Market Value of the policy but no insurance companies want to promote this tool. We have approached Advocis, the association representing financial advisors in Canada, and they also have shown little interest in improving the knowledge of their members. We feel this information is extremely important to consider in choosing the appropriate legal avenue to deal with this. We are available to provide sworn testimony in regards to this and any other facts or observations contained in this report.

4.0 Audit Past performance and past management

The present section constitute an audit of the past performance provided by policy XXXXX and policy YYYYYY

4.1 Need for insurance

The need for insurance would apply to your policy XXXXXX. You did not provide us with the need analysis pertaining to the sale of this $200,000 of permanent insurance on your life. We therefore cannot state whether this amount of insurance was justified. We however believe that there is a high probability that the amount of insurance was too low in relation to your needs on July 2000. If this was the case, this permanent insurance should have been integrated with term insurance.

Currently, the permanent insurance of $200,000 is not needed for protecting your family. It has therefore become a VALUABLE estate tool. Whether you have enough insurance to protect your estate should be determined by your tax advisor in conjunction with your financial advisor.

4.2 Past performance and management of policy XXXXXX

a) After our interview with you, it is clear that the Universal Life policy sold to you was made on the representation that the Cash Values growing within the Universal Life were tax sheltered. This constitutes a material misrepresentation. Premiums paid to this policy were subject to a provincial tax and cash values growing within your policy was subject to accrual taxation under the form of an annual federal tax called the Investment Income Tax (IIT). This tax is hidden within the Management Expense Ratio applying to the investment funds offered by your policy. We estimate the IIT to be around .75% applied every year against your cash values whether or not you have in fact lost or made money.

IIT, while refunded by the federal government upon the lapse of an insurance policy to avoid double taxation since the cash value above the ACB must be included in income, is paid to the insurer and not paid to you. Your Sun Life policy has no provisions to refund the tax that you have paid back to you upon policy surrender.

We suggest strongly that if you continue to pay the same level of premium, therefore accumulating significant cash values in this policy, that you select the account providing a minimum interest rate guarantee of 3%. By selecting this account, since there is no spread in the 3% to pay the IIT, the insurer becomes responsible to pay this tax. It comes from their bottom line and NOT YOURS.

b) Premiums paid less premium tax, cost of insurance and admin fees (referred as net premiums) were invested originally in the Bond fund. This investment allocation has not changed in the last 15 years. Based on your last annual statement, your annualized return for the last 15 years was -2.28%.

Applying this annualized return to the annual net premiums, we have estimated that you have lost $15,000.

The Bond fund offered by Sun Life has a Management Expense Ratio of 3%. In talking to you, we have asked you to define the return that you would expect from a Bond fund for 15 years. You expressed a return of 6% which is possible to achieve based on historical returns.

However to make this return and this is not disclosed on the illustration, you have to subtract the 3% MER and this would have provided you with a 3% net return. As a result, based on your expectations, selecting a Bond fund did not provide any potential for UPSIDE performance while providing for a lot of DOWNSIDE performance CONSIDERING THAT THE POLICY PROVIDED YOU AN ACCOUNT WITH A 3% INTEREST RATE GUARANTEE.

Considering that for 15 years you could have earned exactly the rate of return you were seeking, a 3% rate of return, the amount of the investment loss increases to $35,000. We strongly suggest that if a 3% return is the return you are still satisfied with, that you change to the guaranteed account offering this 3% guaranteed rate of return.

c) Other: We have found no other concerns with your policy XXXXXX. How the policy was sold was not reviewed as we were not provided with the original illustration.

4.3 Past performance and past management of policy #YYYYYY

a) Policy sold to a child: Many parties in the financial industry including the regulators questioned the ethics behind selling permanent insurance for children. All our research in this matter and our analysis have proven that permanent insurance should be sold to children and considering the amazing dividend scale in 2000 or the high long term interest rate used in the pricing of Universal Life, only people who know nothing about insurance would have argued that permanent insurance was NOT a good option for children. In this respect, life agent HHHHHH provided the right advice. The way this insurance was set up was however very disappointing.

b) Use of the dividends to reduce premiums: This was a poor way of setting up a policy. This is akin to selling a Ferrari while restricting its driving to a country road at 10 km per hour.

If the dividends had been used to buy insurance, the death benefit would today be at a minimum $250,000. This policy, as stated in the FMV evaluation part of this report, would have been $75,000 instead of $30,000.

Considering the cost of $7000 premiums paid over 20 years, this $45,000 increase in Fair Market Value would have constituted a 10.1% rate of return.

c) We have found no other concerns with the past management of this policy.

5.0 Fair Market evaluation of policies

5.1 Methodology

Our methodology to evaluate the Fair Market Value of a policy is the replacement cost which considers the price a third party would pay to obtain similar coverage. The replacement cost is then adjusted adding the valuation of CSV, conversion rights, guarantees and other policy terms.

We believe this is the only method that meet the definition of Fair Market Value as defined by CRA in *Information Circular 89-3, Policy Statement on Business Equity Valuations: "Fair market value 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."*

We have to disclose that some actuaries believe that replacement cost should not be used because it is only relevant to the seller but not to the buyer, and therefore is not relevant to the FMV assessment. This is false. In an opposite transaction, where the policy is transferred from a corporation to a former employee, the employee would certainly consider the replacement cost before accepting the transfer of the policy. What works one way must work the other way.

As a result, we do believe that replacement cost is the critical component of the FMV of a life policy. In past experiences, we have not seen more than a 10% difference between replacement cost evaluations and actuarial evaluations.

5.2 Taxation overview

It happens often that there is an ownership change involving a life insurance policy between a corporation and shareholder. This is why that are many provisions in the Income tax Act that deal with this subject.

When there is a change of ownership between corporation and shareowner, provision 85(1) of the Income Tax Act (ITA) states that it is impossible to transfer the life policy as a rollover at the adjusted cost base of the policy. Since this option is not available this transfer will be done at the Fair Market Value (FMV) of the policy. Circular 1C89-3 describes the factors that will be considered in the evaluation of the Fair Market Value. Paragraph 15(1) ITA confers to the shareholder a taxable benefit if the corporation pays to the shareholder a sum of money higher than the Fair Market Value. As a result, it is very important to do an evaluation of the FMV of the life policy before such transfer is made.

When there is a change of ownership involving a life insurance policy, this change will be treated as taxable disposition of the policy. A transfer to a corporation is not specified as an exception and therefore there will be a taxable disposition. 148(1) of the ITA

requires the policy owner to add to his income the gain resulting from the disposition of a life insurance policy. Such gain is the portion of the cash surrender value higher than the adjusted cost base of the policy.

After the disposition of the policy, we can proceed to transfer this property to the corporation. This transfer is made at the Fair Market Value of the policy. This amount represents the amount that will paid by the corporation to the shareholder. This amount will include the policy's cash value in addition of any other variable such as replacement cost. Section 15.1 of the ITA describes the transactions that may create taxable benefit for the shareholder. One of these transactions include all payments in excess of the Fair Market Value of a property sold or transferred to the corporation

5.3 Interest

The discounted rate used in the evaluation must be linked to long-term investment rates. The insured John is 55 years old, which gives him a life expectancy of over 30 years. The period therefore should cover a time horizon of at least 30 years. The lower the interest rate used, the greater the FMV.

In this case an appropriate discounted rate is the Government of Canada long-term bond rate on 2016-02-04 of 1.97% with a market margin of +3%. For Henry, with a life expectancy of over 60 year we have added a margin of 4%

5.4 Mortality

Mortality is used to discount the following formula : FMV = Present Value (Premiums payable for a hypothetical new policy with the same features as the existing policy) – Present Value (Premiums payable for the existing policy).We used the CIA 1997–2004 Mortality Tables for male non-smoker for both policies. We also proceeded on the assumption that both insured were insurable without any form of ratings as per our discussion. However, applying for a new life insurance policy could uncover any number of adverse conditions that could impact your insurability and this would increase the FMV of these policies.

5.5 Lapses

While in an actuarial evaluation, actuaries would consider lapses of the product with the fact that your Universal Life issued in 2000 is lapse supported by a greater lapse rate than what is currently available, such difference is reflected directly in our evaluation using replacement cost.

5.6 Dividends

The policy of Henry is a whole life participating policy. We requested to be provided with inforce projections to age 100 at current scale, current scale -1% and 2%. These illustrations would have provided the information necessary to evaluate the upside potential of this policy. Since we did not have this information, we had to use a very conservative approach to the evaluation of this policy. We feel that with the correct information, the FMV would be 10% to 20% higher than what is reported here. We understand that you will provide us with these illustrations when you have made a decision on your relationship with your advisor.

5.6 Other

The Universal Life has an interest rate minimum guarantee of 3%. Currently minimum interest guarantees hover between 1.75% and 2.5%. It is difficult to calculate the FMV of such guarantee. If you were only paying the minimum premium of the policy, that guarantee would have little value. A person aware of that guarantee would use it. To evaluate this guarantee, we have use an interest rate differential of .5% for the purchase of new insurance based on a 20 pay period.

6.0 Current Results

6.1 Policy XXXXXX : Based on the assumption stated above, we have calculated the FMV of this policy to be $65,000.

A) Deemed disposition of policy upon transfer to corporation

Cash Surrender Value:	$25,000		
Adjusted Cost Base (ACB)	$4,000		
Taxable gain on transfer	$21,000		
Tax payable (50%)		$10,500	

B) Transfer of policy XXXXX at FMV to corporation

Fair Market Value of policy	$65,000		
Paid by corporation	$65,000		
Taxable Benefit	$0		
Tax payable (50%)	$0		
Tax Savings on FMV (50 %)		$32,500	
Net Tax Loss/Savings			$22,000

6.2 Policy YYYYYY : Based on the assumption stated above, we have calculated the FMV of this policy to be $30,000.

A) Deemed disposition of policy upon transfer to corporation

Cash Surrender Value:	$10000		
Adjusted Cost Base (ACB)	$12000		
Taxable gain on transfer	$0		
Tax payable (50%)		$0	

B) Transfer of policy XXXXX at FMV to corporation

Fair Market Value of policy	$30,000		
Paid by corporation	$30,000		
Taxable Benefit	$0		
Tax payable (50%)	$0		
Tax Savings on FMV (50 %)		$15,000	
Net Tax Loss/Savings			$15,000

7.0 Audit: Future management

7.1 Policy XXXXXX

a) Investment option: As previously stated, we do not see any advantage to invest in a Bond fund or equity fund due to the high Management Expense Ratio of the Universal Life partly caused by the existence of an accrual tax of .75%. If you select any equity type of fund, we are warning you that volatility of returns does not mix well with withdrawal under the form of a Cost of Insurance. Such volatility can reduce planned cash values by as much as 25%. You should strongly consider taking advantage of the 3% guaranteed rate of return.

b) While it is advantageous to currently transfer this policy to your corporation, you have to be aware that a change of insurability could significantly impact the Fair Market Value. At your age and considering your profession, such change in insurability is highly probable. Here is a table showing projected FMV in year 10 and 20. Please note that these projections are based on current replacement cost and since pricing of life insurance could change in the future, these values may also changes.

Rating	0%	100%	200%
FMV in 10 years	94,000	$148,000	$198,000
FMV in 20 years	120,000	$206,000	$245,000

*projected FMV include CSVs ($25,000) growing at 3% assuming minimum premium is paid

*These FMV projections are not guaranteed.

8.0 CERTIFICATE

We have audited the past and future performance including establishing the Fair Market Values of the life insurance policies named in this mandate. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. In our opinion, while we did not have access to all the necessary documents, the conclusions of this report are appropriate in particular, we judge that the calculation of the FMV was very conservative and is probably understated compared to the FMV that would have been established if we had been able to get inforce illustrations and policy contract.