

Exclusion for accelerated death benefits and viatical settlements paid on life insurance contract of terminally or chronically ill

The following discusses two techniques for receiving cash from a life insurance policy while the insured is still alive. These transactions may provide needed funds for medical care or living expenses, especially where the insured is elderly or in poor health. In some cases, the payments will be tax-free.

In one type of transaction, called a viatical settlement, the policy owner (or "viator") sells a life insurance policy to a third party (a "viatical settlement provider"). The buyer is responsible for future premium payments and will receive the proceeds of the policy when the insured dies. Group life insurance may be eligible for viatical settlement, depending on the terms of the policy.

Alternatively, the policy owner may receive an accelerated death benefit directly from the insurance company itself. The insurer may impose restrictions on this option. For example, an accelerated benefit may be available only to insureds with a life expectancy of six months to one year.

In either case, the payment will be less than the face value of the policy. Viatical settlements generally pay between 60% and 80% of face value. The discount taken will depend on the insured's life expectancy, the annual premium, and other factors.

If the insured is terminally ill, payments are tax-free. This applies both for accelerated death benefits and for payments made by a viatical settlement provider (but only if the provider meets licensing or other requirements). A physician must certify that the insured has an illness or physical condition that can reasonably be expected to result in death within 24 months.

If the insured is chronically ill (as defined below), payments are tax-free only if detailed requirements are met. For example, the payment must be for costs incurred for qualified long-term care services. These include both medical services and maintenance or personal care services provided under a prescribed plan of care. Also, the payment must not be for expenses reimbursable under Medicare, other than as a secondary payor.

Payments to a chronically ill individual may be tax-free even if made on a per diem or other periodic basis that isn't linked to expenses. However, for 2007 a \$260 per day "cap" on periodic payments applies for purposes of the exclusion. This comes to \$94,900 for 2007. (For 2006, the cap was \$250 per day; or \$91,250 for the entire year).

A chronically ill individual must be certified by a physician or other licensed health care practitioner (e.g., nurse, social worker, etc.) as unable to perform without substantial assistance at least two activities of daily living for at least 90 days due to a loss of functional capacity, or as requiring substantial supervision for protection due to severe cognitive impairment (memory loss, disorientation, etc.). Thus, a person with Alzheimer's disease might qualify.

Viatical settlements are possible for persons who are not terminally or chronically ill, but the favorable tax treatment described above isn't available. Instead, the settlement is treated as a sale of the policy, and the gain on the sale is taxable.

Also, viatical settlements may be available for so-called "key man" insurance. This is insurance that a company takes out on the life of a key executive or employee. Where the company no longer requires this coverage, it may seek to recoup its investment through a viatical settlement of the policy. In that case, however, tax-free treatment won't apply.