

Abstract: Someone who's terminally or chronically ill may lack the funds to cover significant medical costs. It may be possible, however, to sell insurance to a viatical settlement provider who will then arrange with an investor to buy the policy. This article explains how such "viatical settlements" work, including the tax impact.

Viatical settlements: A funding mechanism for medical costs

Someone who's terminally or chronically ill may lack the funds to cover significant medical costs. Although insurance policies have historically been held for the death benefits, it may be possible to sell a policy to a viatical settlement provider. This way, the individual can secure much-needed and generally tax-free cash while still alive.

Buyers and sellers

Viatication allows a terminally ill person to sell an existing life insurance policy to an investor for more than its cash surrender value but less than its net death benefit. The buyer continues to pay the premiums and receives the life insurance proceeds upon the death of the insured. Many companies currently buy the policies themselves or serve as brokers to match buyers and sellers for a fee.

In identifying a potential seller, many viatical companies limit their selection to terminally ill individuals with a certain remaining life expectancy (for example, 24 months or less). This is because the company wants to minimize its risk that the individual will outlive his or her life expectancy, resulting in a lower return from the purchase of the life insurance policy for the company.

Factors to consider

To determine whether it would be advantageous to sell a policy, the insured should consider factors such as:

- His or her cash needs,
- The discount in the value of the death benefit,
- The possibility that payments will disqualify him or her for Medicaid benefits, and
- Access to the payments by his or her creditors.

(Regarding the last point, the cash value while it remains in a life insurance contract may not be subject to the claims of creditors.)

Tax consequences

Amounts received under a life insurance contract on the life of terminally ill (or within limits, chronically ill) individuals are excluded from gross income for federal income tax purposes. A similar exclusion applies to the sale or assignment of any portion of a death benefit to a viatical settlement provider if the insured is chronically or terminally ill and the payments in question are funded by and diminish the life insurance policy's death benefit.

However, the exclusion doesn't apply if the accelerated death benefits are paid to someone other than the insured individual and the recipient has a business or financial relationship with the insured.

Rules and issues

Viatication is a complex and sensitive topic. Let us help you navigate the applicable rules and issues.

© 2017