LIFE SETTLEMENTS, VIATIONALS & TAXES

You must read this before you sell a policy on the secondary market.

Understanding the estate and income tax implications of viaticals and life settlements opens a wealth of financial planning opportunities and prevents what could be a taxing transaction.

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The viatical/life settlement industry provides life insurance policy owners access to a secondary market for their policies, creating an infusion of cash when the need for the insurance becomes superfluous. But, as with any income-generating process, there are tax implications that must be addressed. The key is understanding the difference between viatical and life settlement transactions and anticipating how they will affect your client's overall financial plan.
VIATICS UP CLOSE

The word "viatical" is derived from the Latin word "viaticum," which means "supplies for a difficult journey." A viatical settlement is the purchase of a life insurance policy by an independent company. The policyholder names the purchaser as irrevocable beneficiary of the policy being purchased. Using viatical settlements to lighten the income or estate tax burden of the terminally or chronically ill may indeed ease the way. The Internal Revenue Code (IRC) defines a viatical settlement provider as "a person or company that regularly buys or takes assignment of life insurance contracts on the lives of the terminally or chronically ill and meets detailed standards."

Section 101(g)(4)(A) of the IRC deems a person terminally ill if he or she is certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months of the date of certification.

The IRC defines an individual as chronically ill if the person meets one of these three standards:
- The individual has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform without substantial assistance at least two activities of daily living for at least 90 days due to the loss of functional capacity;
- The individual has a similar level of disability as determined by the IRS in consultation with the Department of Health and Human Services or
- The individual requires substantial supervision to protect him or others from threats to health and safety due to severe cognitive impairment.

Most policies can be sold through the viatication process. However, certain new individual policies that are not part of their period of contestability, some group policies and policies written by financially shaky insurance companies may not meet the criteria for purchase by a viatical settlement company.

LIFE SETTLEMENTS UP CLOSE

Life settlements are a little different. A life settlement usually describes a transaction involving an insured who is not terminally or chronically ill and is generally over the age of 65. Since they don't deal with the terminally ill, participants in a life settlement transaction can realize unexpected capital gains or income taxes.

Keep in mind, because regulations vary, this definition of life settlement is not consistent in all states. For example, some states use the term "viatical settlement" to refer to the sale of all life insurance policies, regardless of the health status of the insured.

But based on this general definition, during a life settlement transaction, a provider purchases an existing policy for an amount that is greater than the policy's cash surrender value or greater than the amount the policy owner would receive if he or she allowed the policy to lapse. In the case of a term product, this is any amount greater than zero.

Prior to the establishment of the life settlement industry, if a senior owned a policy that was no longer wanted, needed or affordable, there was no option but to lapse, cancel or surrender the policy back to the carrier for the cash surrender value. Now, if a life insurance policy becomes too expensive, is not performing up to the expectations of the policyholder or the original need for the policy no longer exists, a policyholder can sell it and receive more cash than the surrender value would have provided.

A noteworthy difference between viatical and life settlement transactions is that the buyer of a viatical settlement has a greater chance of being paid the full policy proceeds in the short term. For this reason, buyers are willing to pay much more for viatical settlements than for life settlements, since there is no expectation of an immediate payout with the latter. Plus, the buyer may be forced to wait years or decades — often with an annual premium outlay in the meantime — until the policy pays its death benefit.

TAX RULES FOR LIFE SETTLEMENTS

As discussed earlier, with life settlements the insured is not necessarily terminally or chronically ill, so the tax rules for the life settlement proceeds may result in the policy owner owing federal income tax. Life settlements usually involve three layers of taxation.

The first, zero tax up to the owner's cost basis, generally refers to total premiums paid into the contract. The IRC regards this as a return of capital. If the premiums paid exceed the surrender value, this is considered a capital loss and may be treated as such. The second layer of taxation is ordinary income from the basis to the policy's cash surrender value. The IRC regards this as income. The third layer comes from long-term capital gains from the higher of either the cash surrender value or the federal income tax basis to the net settlement proceeds. If there is no CSV or if the CSV is lower than the cost basis in the policy, then the taxable income is the dollar difference between the settlement amount, minus the cost basis of the policy. That amount is treated as a capital gain. The IRC regards this as the disposition of a capital asset. (See "Life Settlement Taxation Mini-Case" on page 40 for an example).

TAX RULES FOR VIATICS

Amounts received under a life insurance contract on the life of an individual who is terminally or chronically ill are excluded from the insured's gross income as amounts paid by reason of the death of the insured. A similar exclusion applies to amounts received for the sale or assignment of any portion of a death benefit under a life insurance contract to a viatical or life settlement provider.

In the case of chronically ill individuals, the income tax exclusion applies only if detailed requirements are met. For example, the distribution from the life insurance policy must be for costs incurred by the payee for qualified long term care services provided for the insured for that period. The tax-free benefit would be offset by any long term care costs indemnified by insurance or other providers. Under the terms of the contract, the payment must not be a payment or reimbursement of expenses reimbursable under Medicare (except when Medicare is a secondary payor or the arrangement provides for per diem or other periodic payments without regard to expenses for qualified long term care services).
A payment to a chronically ill individual will qualify for the income tax exclusion if it is made on a per diem or other periodic basis without regard to the expenses incurred during the period to which the payment relates. In fact, most long term care is delivered on a per diem basis. However, the amount of payments that may be excluded is subject to a dollar limit. The 2004 limit is $220 per day or $80,300 per year. This amount is derived from a 1996 base of $63,875 per year ($175 per day for per diem contracts). The limit will be adjusted for inflation in future years and matches the tax exempt amount that may be provided from traditional long term care insurance policies.

In certain circumstances, the income tax exclusion does not apply to amounts paid to any taxpayer other than the insured. If the payee has an insurable interest in the insured’s life because the insured is a director, officer or employee of the payee, or because the insured holds a financial interest in any trade or business carried on by the payee, the exclusion does not apply.

PUBLIC BENEFITS
A caveat: Receipt of payment under a viatical settlement may affect eligibility for public assistance programs such as Medicaid, aid to families with dependent children, supplementary Social Security income and AIDS drug assistance programs. It also may be taxable and subject to claims of the payee’s creditors. Before applying for a viatical settlement, policyholders should consult with the appropriate social services agencies concerning how receipt could affect the policy owner’s eligibility and that of the policy owner’s spouse or dependents.

CHARITABLE GIVING
It is generally advantageous to donate highly appreciated assets to charity because the donor receives a current income tax deduction equal to the fair market value of the asset, rather than the donor’s cost basis to acquire the asset. Unfortunately, such assets are likely to be income-producing assets like securities and real estate. How likely is it that a chronically or terminally ill individual would be able to part with such income in order to accomplish the charitable transfer and enjoy the federal income tax charitable deduction?

Selling an existing life insurance policy may free up highly appreciated assets to satisfy the donor’s charitable goals. (See “Charitable Giving Mini-Case” on page 42 for additional information.)

ESTATE TAX PLANNING
A general IRC rule states that when an individual who does not live more than three years following the transfer of an existing policy to a third person (or an irrevocable trust), the transfer will not be effective in keeping the life insurance policy out of the insured’s gross estate for federal estate tax purposes. For example, Alice owns a $500,000 life insurance policy. Her estate is in the 48 percent marginal federal estate tax bracket. Because of the IRC rule, she will only be able to pass on $260,000 to the beneficiaries of the policy.

But, with the sale of the policy, Alice steers around the three-year rule and opens a world of financial planning possibilities because viation is a sale for fair market value.

Why life settlements?
Here are a few reasons why a healthy older client might consider trading in a life insurance policy for cash:
• The policy is no longer needed or wanted
• To pay for health care costs
• To supplement retirement income
• Premium payments have become unaffordable
• A change in estate planning needs

Viaticating the policy may provide additional value to the insured’s family and reduce estate taxes because the life insurance policy, an intangible asset, is converted into cash that can be given to family members in the form of a tax-free annual exclusion. In addition, it can be “spent down” by the recipient or a combination of the two. (See “Estate Tax Mini-Case” on page 42 for an example.)

BUSINESS PLANNING WITH VIATICALS
Any person or entity owning a life insurance policy may viatiate that policy. A third party, for example the trustee of an irrevocable trust, may sell the policy and receive the proceeds free from federal income tax. The third party or trustee entering into the settlement may use the proceeds to purchase assets from the estate, potentially at a discount. This technique is especially effective when the insured holds an ownership interest in a closely held business or partnership. In such cases, valuations for federal estate tax purposes often range between 30 and 40 percent below the book value of the business. (See “Business Planning Mini-Case” on page 42 for an example.)

While it’s important to understand how a life or viatical settlement could impact your clients’ tax situation, if this type of transaction becomes a viable option, expert tax advice may be the most critical element of all.

Remember that these are general guidelines and cannot be relied upon as fact. State level income tax rules vary among the individual states. w

Life Settlement Taxation Mini-Case
Presume Catherine, age 66, owns a life insurance policy with a cash surrender value of $10,000. Since acquiring the policy, Catherine has paid premiums totaling $120,000. A life settlement provider will pay Catherine $500,000 for the policy. As a result, Catherine will realize capital gains of $380,000:
$500,000 - $120,000 = $380,000

Let’s look at another example in which both capital gains and ordinary income tax may apply. Assume that George, 65, owns a life insurance policy that has a cash surrender value of $100,000. George paid premiums totaling $90,000 into the contract. A life settlement provider offers George $500,000 for the policy. In this case, $10,000 is taxable to George as ordinary income and $400,000 as capital gain:
$100,000-$90,000 = $10,000
$500,000-$100,000 = $400,000
Viatical & Life Settlement Mini-Cases

CHARITABLE GIVING MINI-CASE
Alfred suffers from lung cancer and is not expected to live beyond the next few years. He owns shares of a preferred stock with a fair market value of $70,000 and a tax basis of $20,000. Alfred also owns a life insurance policy with a $100,000 face value.

Assuming Alfred is in the 48 percent marginal estate tax bracket, if he does nothing, the amount passing to the beneficiaries is $88,400:

\[(\$170,000 \times 0.52) = \$88,400\]

Let's assume Alfred can sell his life insurance policy for $70,000. This “replaces” some of the securities he planned to donate to the American Cancer Society. Presuming his annual income is sufficient, he receives a $70,000 income-tax deduction. This results in an income tax savings of $24,500. The tax savings plus the settlement proceeds add up to $94,500:

\[\$24,500 + \$70,000 = \$94,500\]

If Alfred's goal is to maximize estate tax savings, he can make annual exclusion gifts at $11,000 per recipient, per year (indexed) or spend down the $94,500. In other words, it may be sensible to sell a policy and donate the cash generated from the sale to charity. This would provide an increased charitable deduction versus the donation of the policy itself. Not to mention that most charities would prefer cash rather than an insurance policy.

ESTATE TAX MINI-CASE
Alice owns a $500,000 life insurance policy and her estate is in the 48 percent marginal federal estate tax bracket. Alice sells her $500,000 insurance policy and receives 70 percent of the face value ($350,000). Now she can make annual exclusion gifts from the $350,000 to her four children, their spouses and her 10 grandchildren during the remaining two years of her life expectancy, tax free. In addition, her estate can pass the after-tax value of the premiums not spent in maintaining the policy, as well as the earnings (after income and estate tax) on the declining balance of the $350,000 viatical proceeds over her remaining life expectancy.

BUSINESS PLANNING MINI-CASE
Suppose Charles, a wealthy man with a terminal illness owns 100 percent of CCC Inc., a closely held corporation valued at $2 million. If the stock is included in Charles’ gross estate, presuming he dies in 2004, the estate tax on the stock is $960,000:

\[(\$2,000,000 \times 0.48) = \$960,000\]

Let's say the trustee of an irrevocable life insurance trust has control of a $1 million life insurance policy on Charles’ life. If the trustee viaticates the policy and receives an $800,000 settlement, he can use the proceeds to acquire a portion of the closely held business from Charles.

Because the trustee is purchasing a minority interest in a business that is not readily marketable, the trust interest may be discounted. Let’s say in this case it’s 35 percent. Thus, the trustee is able to buy 49 percent of the business from Charles for just $637,000:

\[(49\% \times \$2,000,000 \times 0.65) = \$637,000\]

As a result of this strategy, Charles’ estate includes 51 percent of CCC Inc. Assume that interest is valued with a 10 percent premium. Relative to the strategy, Charles’ estate includes $1,122,000 from the business interest and $637,000 in cash:

\[(\$1,020,000 \times 1.1) = \$1,122,000\]

Even if Charles makes no annual exclusion gifts before dying, his estate is reduced by $241,000:

\[\$2,000,000 - \$1,759,000 = \$241,000\]

The resulting estate tax savings is $115,680:

\[(\$241,000 \times 0.48) = \$115,680\]

Suppose now that Charles makes a gift of a 2-percent minority interest in the company. This would be valued for gift tax purposes at $15,000:

\[(\$2,000,000 \times 0.02 \times 0.65) = \$15,000\]

As a result, Charles’ estate now includes only a 49-percent minority interest in the company with an estate tax value of $637,000 rather than $1,122,000:

\[(\$2,000,000 \times 0.49 \times 0.65) = \$637,000\]

This results in a reduction of the estate tax base of $485,000 but with an increase in Charles’ adjusted taxable gifts of a mere $15,000. The net reduction of taxable transfer is $470,000. This creates an additional savings of $225,600:

\[(\$470,000 \times 0.48) = \$225,600\]

In total, the estate planning strategy accomplished through the viatical settlement reduces the estate tax by $341,280:

\[\$115,680 + \$225,600 = \$341,280\]

By giving up $200,000 through the viatical, rather than receiving the death benefits from Charles’ life insurance policy, the beneficiaries have saved $141,280:

\[\$341,280 - \$200,000 = \$141,280\]