

Should Viatical Settlements Be Part of Your Estate Plan?

A viatical settlement is the sale of a life insurance policy by the policy's owner before the insured's death. In the past, viatical settlements were most often made by the terminally ill who needed the proceeds to pay medical bills and living expenses. However, since the enactment of the Health Insurance Portability and Accountability Act of 1996, the number of viatical settlements has increased. Now such settlements are being used by insureds for estate planning purposes. Viatical settlements can provide an estate planning option after the discovery of a terminal illness, when other estate planning options may be unavailable due to the short period of time remaining.

Viatical settlements are gaining in popularity because the law now provides that their proceeds are excluded from the recipient's gross income because the payments are treated as payments on account of the insured's death. The amount of the exclusion depends on whether the insured is terminally ill (where death is expected within 24 months) or chronically ill (where function is severely limited). A full exclusion is available if the insured is terminally ill, but only a partial exclusion is provided if the insured is chronically ill.

The amount the policy owner receives through a viatical settlement will be greater than the cash surrender value of the policy, but less than the face amount of the policy. The exact amount depends on how long the insured is expected to live, whether any future premiums are payable on the policy and on other factors, such as current interest rates. The purchaser of a policy, most often a viatical settlement company or the insurance company that issued the policy, is then entitled to receive the proceeds of the policy on the insured's death.

Making the Most Of Settlement Proceeds

Consider the situation where an insurance policy is owned by an irrevocable life insurance trust. Through the use of viatical settlement proceeds, the trust, if authorized, could obtain the liquidity to purchase a minority interest in the insured's closely held company. This transaction could have several estate planning benefits, including minority interest discounting and the discontinuation of cash outlays for insurance premiums. In addition, the gift tax annual exclusion that would otherwise have been used to protect the transfers of funds to the trust to pay insurance premiums would now be available to accelerate other gifting programs. If the settlement amount is reduced proportionately by the premium expected to be paid by the viatical settlement company, the insured is, in effect, able to prepay premiums without transfer tax consequences.

Finally, a nonappreciating asset -- the life insurance policy -- would be replaced with a potentially rapidly appreciating asset -- an interest in a closely held business. A near-death transaction could be accomplished, using substantial minority and marketability discounts with presumably less exposure to a challenge by the Internal Revenue Service (IRS) than similar death-bed gifting programs. For instance, if a purchaser is willing to pay 20% less than the face value on a policy to the irrevocable life insurance trust that owns the policy, and the proceeds are used to purchase a minority interest in the insured's closely held business at an assumed 40% discount, then estate tax is saved on the difference between those discounts.

For example, if the business is worth \$5 million and the face amount of the insurance policy is \$2 million, then the insurance trust would have available \$1.6 million (\$2 million less 20% of

\$2 million). It could then use that amount to purchase 49% of the company for \$1.47 million (49% of the \$5 million company is \$2.45 million; that amount, less a 40% discount, is \$1.47 million). The amount removed from the estate therefore is \$980,000 (\$2.45 million less \$1.47 million). The savings are partially offset by the \$400,000 discount received by the purchaser. Note that the actual “cost” of the \$400,000 is higher due to the fact that those funds would otherwise have been estate tax free, but that higher amount would in turn be offset by the fact that the life insurance proceeds may not have been appreciating.

Should You Consider A Viatical Settlement?

If your estate planning options may be otherwise limited by a terminal illness, consider the use of viatical settlements. Carefully analyze the above considerations to determine whether a viatical settlement would make economic sense in each particular situation.

If you have any questions regarding whether a viatical settlement is an appropriate estate planning tool for you, please call us. We can help you weigh the pros and cons of this and other options. Also, for related information on how and why to place your life insurance policy in a trust for your beneficiaries, please use the response form on page 6 to request “Make Sure Your Life Insurance Provides Protection - Not Tax Headaches.”