

Terminal Illness and Life Insurance Benefits

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Traditionally, **life insurance** benefits have been used to protect the interests of heirs and beneficiaries upon the death of the insured. The primary aims of life insurance have been—and still are—provisions for funeral cost coverage, estate tax payment, and income continuation. However, there is a harsh reality for many individuals facing life-threatening illnesses: They may eventually lack the resources to pay for even basic health care.

Two techniques that have been developed are **accelerated benefits** and **viatical settlements**. Both are intended to help ease the financial burden of terminally ill individuals facing large medical expenses, but they differ significantly in terms of structure.

Accelerated Benefits

The concept of **accelerated benefits** was introduced in the late 1980s. Under this provision, “living” benefits may be paid under certain conditions prior to the death of the insured in exchange for a reduction or surrender of the scheduled death benefit of the policy. Common requirements for accelerating benefits include a confirmed diagnosis of terminal illness or a prognosis that confinement in a nursing home will be necessary for the duration of one’s life.

There are generally two types of living benefits: **accelerated death benefits** and **morbidity benefits**. An **accelerated** death benefit provision allows a policyholder with a terminal illness to accelerate some or all of a policy’s death benefits. A morbidity benefit provision provides accident and medical benefits upon the occurrence of an event such as the contracting of a specified illness or nursing home confinement.

Viatical Settlements

In contrast to accelerated benefits, a **viatical settlement** (from the Latin viaticum, meaning “provisions for a journey”) enables a person facing terminal illness to sell his or her insurance policy for cash at a discount from its face value. Under such an arrangement, a viatical settlement company buys the policy from the ill policyholder, maintains the premium payments, becomes the owner and beneficiary of the policy, and receives the death benefit upon the individual’s death.

While accelerated benefit provisions are generally available only for those with life expectancies of less than one year, viatical settlements are usually available for those who have life expectancies of up to three years. With accelerated benefit provisions, the policyholder usually maintains ownership. With a viatical settlement, ownership of the policy is relinquished.

Tax Relief

Until 1996, the general tax rule had been that, unlike a death benefit, receipt of a living benefit would be subject to taxation in the year received. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) contains rules that allow certain “qualified” accelerated benefits to be received income tax free (i.e., such benefits will be treated as if paid by reason of death of the insured).

Specifically, HIPAA exempts from income tax accelerated death benefits from life insurance contracts received on behalf of a **chronically** or **terminally ill** insured. Also excluded from income tax are amounts received by a terminally or chronically ill insured on the sale of a life insurance contract (or assignment of death benefit) to a viatical settlement company.

HIPAA makes a distinction between terminally and chronically ill individuals. A terminally ill person is one who has been certified by a physician as having a physical condition or illness that

can reasonably be expected to result in death within two years.

A chronically ill individual is one certified by a licensed health care practitioner as: 1) being unable to perform at least two **activities of daily living (ADL)** (e.g., eating, bathing, toileting, and dressing) for at least 90 days without substantial assistance; 2) having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services; or 3) requiring substantial supervision to protect against threats to health and safety resulting from severe cognitive impairment. v The exclusion of accelerated benefits for the chronically ill only applies if the benefits are paid under a **rider** (or other provision) of the contract that is treated as a qualified **long-term care (LTC) insurance** contract. Moreover, the exclusion maximum for chronically ill individuals is only for **per diem policies** and not **indemnity policies**. In contrast, in the case of a terminally ill individual, accelerated benefits from a life insurance contract without a long-term care rider can be excluded from taxation.

Gaining Perspective

It is unfortunate that individuals dealing with a terminal illness may sometimes face financial ruin due to the high cost of their medical care. Although opting to take an advanced benefit or viatical settlement may lessen some short-term financial pressures, it may come at the expense of leaving survivors without adequate support. After all, one of the purposes of life insurance is to help provide financial security for loved ones in case of death. Nevertheless, the regulations contained in HIPAA may help reduce some of the emotional stress for those facing terminal illness by helping them preserve some dignity in making difficult choices.