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# Angels of Mercy or Greedy Capitalists? Buying Life Insurance Policies from the Terminally Ill

## I. INTRODUCTION

Through June of 1995, nearly half a million cases of Acquired Immune Deficiency Syndrome (AIDS) have been reported in the United States and the epidemic continues to sweep the nation.<sup>1</sup> Over half of the 476,899 known American AIDS cases have been reported since 1993.<sup>2</sup> Sixty-two percent of these individuals have died.<sup>3</sup> The AIDS epidemic has helped push the health care crisis to the forefront of the American political arena as society fearfully witnesses an increasing population of terminally ill individuals struggle to finance their medical treatment.<sup>4</sup>

In response to the financial hardships burdening AIDS patients and other terminally ill individuals, the "viatical settlement"<sup>5</sup> industry has emerged.<sup>6</sup> Viatical settlement companies<sup>7</sup> operate by purchasing life in-

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1. Centers for Disease Control and Prevention, U.S. Dept. of Health and Human Servs., HIV/AIDS SURVEILLANCE REPORT, Mid-year 1995, at 3.

2. *Id.* at 5, 15. Over 85% of these American individuals confronting the grim reality of living and dying with AIDS are males. *Id.* at 13. Tragically, 6611 of these cases are children under 13 years of age. *Id.* at 5.

3. *Id.* at 14. On an international level, the World Health Organization estimates that 18 million adults and 1.5 million children have been infected with HIV; 4.5 million of these cases have developed into AIDS. WORLD HEALTH ORGANIZATION, THE CURRENT GLOBAL SITUATION OF THE HIV/AIDS PANDEMIC (1995).

4. Lee Ann Dean, Note, *Acquired Immune Deficiency Syndrome, Viatical Settlement, and the Health Care Crisis: AIDS Patients Reach into the Future to Make Ends Meet*, 25 RUTGERS L.J. 117, 120 (1993).

5. A viatical settlement is:

[A]n agreement entered into between a person owning a life insurance policy upon the life of a person with a catastrophic or life-threatening illness or condition and another person by which the policy owner receives compensation or anything of value less than the death benefits of the insurance policy in return for an assignment . . . of the death benefits or ownership of the insurance policy.

CAL. INS. CODE § 10113.1(a) (West 1993).

6. Although approximately 95% of the individuals who viaticate their policies are

surance policies from terminally ill individuals, "viators,"<sup>8</sup> for a lump sum payout of fifty to ninety percent of the policy's face value.<sup>9</sup> This payment is known as the viatical settlement or *viaticum*, which is the Latin word for the Catholic sacrament given to the dying.<sup>10</sup>

In recent years, sophisticated and highly capitalized viatical settlement companies have entered the market. These companies "capitalize through either private funds or [money obtained through] the sale of company stock."<sup>11</sup> The capital is used to purchase life insurance policies from viators.<sup>12</sup> The company then "assumes financial responsibility for premium payments" and becomes both the irrevocable beneficiary of the policy and the policy owner.<sup>13</sup> Upon the death of the insured, settlements typically yield a fifteen to twenty percent return for the viatical company and its investors.<sup>14</sup>

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inflicted with AIDS, people with cancer and other terminal illnesses also enter into viatical settlements. June R. Herold, *Death Benefits the Living/Industry Grows on Terminally Ill's Insurance*, HOUS. CHRON., June 7, 1992, at A9.

7. There are approximately 60 viatical settlement companies operating nationally. Pamela Sherrid, *Enriching the Final Days, an Industry Has Sprung Up to Buy Life Insurance Policies from the Dying. The Idea Is Sound. The Way It Is Practiced Often Is Not*, U.S. NEWS & WORLD REP., Aug. 21, 1995, at 56. To obtain a list of members of the Viatical Association of America, call (800) 842-9811 or (202) 429-5129. *Id.* Information on viatical settlements in California can be obtained by the following companies: Fiedler Financial at (800) 905-0114; Benefit Advocates of Viatical Settlement Advisory Service at (800) 435-8891; and Dignity Partners at (800) 344-6489.

8. Viator is defined as:

[T]he owner of a life insurance policy insuring the life of a person with a catastrophic or life-threatening illness or condition or the certificate holder who enters into an agreement under which the viatical settlement provider will pay compensation . . . in return for the viator's assignment . . . of the insurance policy or certificate to the viatical settlement provider.

LA. REV. STAT. ANN. § 22:202(5) (West Supp. 1996).

9. The amount viators receive for their insurance policies varies from company to company and is based mainly on the life expectancy of the viator. Kathy M. Kristof, *Living for Today; Terminally Ill are Opting to Cash in Policies*, L.A. TIMES, June 20, 1995, at D1. The shorter the anticipated lifetime, the greater the amount of the settlement. *Id.* Although estimates vary as to the total value of policies purchased, the majority of experts estimate it at approximately \$300 million in 1994 and \$400 million in 1995. *Id.*

10. *Cashing in on Death Terminally Ill Sell Policies*, PLAIN DEALER (Cleveland), Aug. 28, 1995, at 4C. Secularly, the word connotes "provisions needed for a journey." *Id.*

11. Shanah D. Glick, *Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?*, 60 U. CHI. L. REV. 957, 957 (1993).

12. *Id.*

13. Carole C. Lamson, *Legal Introduction in Living Benefits in Life Insurance: New Perspectives and Developments*, 65 N.Y. ST. B.J. 16, 16 (1993).

14. Stephanie Anderson Forest, *A Ghoulish Debate Over Cashing in on Death*, BUS. WK., Sept. 19, 1994, at 40.

Additionally, viatical settlement brokers have also established their own role in the industry.<sup>15</sup> Brokers act as middlemen between viatical companies and terminally ill individuals who are interested in viaticating their policies.<sup>16</sup> If "the broker's client enters into a settlement, the brokerage firm exacts a fee for its services."<sup>17</sup>

The insurance industry has also reacted to the increasing number of terminally ill individuals by offering "accelerated death benefits."<sup>18</sup> These benefits allow a policyholder to access twenty-five to one hundred percent of a policy's face value prior to death in either a lump sum or monthly installments.<sup>19</sup> Unlike viatical settlements, if less than

15. A "viatical settlement broker" is:

[A]n individual, partnership, corporation or other entity who or which for another and for a fee, commission, or other valuable consideration, offers or advertises the availability of viatical settlements, introduces viators to viatical settlement companies, or offers or attempts to negotiate viatical settlements between a viator and one or more viatical settlement companies.

N.Y. INS. LAW § 7801(d) (McKinney Supp. 1996). Excluded from this definition is "an attorney, accountant or a person acting under a power of attorney from the viator, retained to represent the viator whose compensation is paid solely by the viator and without regard to whether a viatical settlement is effected." *Id.*

16. Jennifer Berner, *Beating the Grim Reaper, or Just Confusing Him? Examining the Harmful Effects of Viatical Settlement Regulation*, 27 J. MARSHALL L. REV. 581, 585 (1994).

17. *Id.* Some states have put limitations on viatical settlement brokers' participation in the industry and the brokers' access to fees. For example, in Minnesota, "[a] viatical settlement broker must not, without the written agreement of the viator obtained before performing any services in connection with a viatical settlement, seek or obtain any compensation from the viator." MINN. STAT. ANN. § 60A.972 (Supp. 1996); see also N.Y. INS. LAW § 7808(d) (McKinney Supp. 1996). In Vermont, the broker may not collect a fee greater than two percent of the amount paid to the viator on a policy that is the subject of the viatical settlement. VT. STAT. ANN. tit. 8, § 3832(f) (Supp. 1995).

18. Accelerated death benefits have been defined as follows:

[A]ccelerated death benefits are benefits that:

- (a) Are payable to the policy owner or certificate holder during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider;
- (b) Reduce the death benefit otherwise payable under the life insurance policy; and
- (c) Are payable upon the occurrence of a single qualifying event that results in the payment of a benefit amount fixed at the time of acceleration.

OR. REV. STAT. § 743.154(1) (1995). Forty-nine states have enacted legislation authorizing accelerated death benefits. Lamson, *supra* note 13, at 18.

19. Lamson, *supra* note 13, at 18. The percentage paid varies from policy to policy and depends on the type of benefit. Peggy Hollander, *Long-Term Care Insurance and*

one hundred percent of the policy is accelerated, the percentage of unpaid proceeds will remain for the beneficiaries upon the insured's death.<sup>20</sup>

Currently, approximately 215 life insurance companies offer accelerated death benefits.<sup>21</sup> These benefits, however, are typically only offered when the terminally ill individual has a life expectancy of six months to a year.<sup>22</sup> As a result, accelerated death benefits fall short of providing a solution for many terminally ill individuals, such as AIDS patients,<sup>23</sup> whose life expectancy may be greater than a year, but who are nonetheless faced with burdensome long-term medical costs.<sup>24</sup> Thus, the viatical settlement market is necessary to meet the financial needs of

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*Estate Preservation*, available in WESTLAW, CA52 ALI-ABA 427, 441 (1995). The most common percentages are for (1) terminal illness policies, 25%-50%; (2) death, disease, or catastrophic illnesses, 25%; and (3) long-term care such as nursing homes, usually no limit. *Id.*

20. Kristof, *supra* note 9, at D1. The following hypothetical illustrates the treatment of proceeds under a viatical settlement as opposed to accelerated death benefits:

Tom (T) owns a \$100,000 life insurance policy and has a six-month life expectancy. T's insurance provider offers to accelerate 95% of the first 50% of the policy, with the remainder left for the beneficiaries upon T's death. *See id.* Thus, T would receive \$47,500 during his life, and his beneficiaries would receive \$50,000 upon his death. *See id.*

Suppose that instead of opting for accelerated death benefits, T decides to viaticate his policy. The viatical settlement company offers to purchase the policy for 85% of the face value. *See id.* Thus, T would receive a lump sum of \$85,000, and nothing would be left for his heirs. *See id.*

21. Daniel A. Mica, *Pioneer in Accelerated Benefits*, WASH. POST, March 2, 1995, at A20.

22. Hollander, *supra* note 19, at 441. Additionally, accelerated death benefits are sometimes offered to insureds diagnosed with a specific medical condition that would result in a shortened life span absent extraordinary medical treatment. *Id.* Moreover, many providers offer accelerated death benefits for individuals requiring permanent nursing home care. *Id.*

23. This is not to suggest that accelerated death benefits are never offered to patients with AIDS. *See Mica, supra* note 21, at A20. Viatical settlements, however, may be more readily accessible to individuals with AIDS because, with an accelerated death benefit, the life expectancy is generally limited to a year. *See Amey Stone, Personal Business: Smart Money Easing the Economic Burdens of Terminal Illness*, Bus. Wk., May 3, 1993, at 160. Additionally, viatical settlements may offer more money up front because the entire policy is viaticated, as opposed to accelerated death benefits that may only allow partial acceleration of the policy. *See supra* note 20 and accompanying text (giving example of a viatical settlement versus an accelerated death benefit).

24. For a discussion of the growing cost of AIDS treatment, see Dean, *supra* note 4, at 122-27.

these terminally ill individuals with longer life expectancies at a time when they are still able to appreciate a meaningful quality of life.<sup>25</sup>

This Article focuses on the protection of terminally ill individuals who take advantage of the funds offered by viatical settlement companies. Part II discusses the moral debate that has plagued the industry since its inception.<sup>26</sup> Part III addresses recent attempts to regulate the industry to protect viators from exploitation and to ensure the legitimacy of the industry.<sup>27</sup> The footnotes in this section present a detailed survey of individual state regulations. Preferential income tax treatment for early payment of life insurance proceeds is addressed in Part IV.<sup>28</sup> Finally, Part V concludes with suggested steps that can be taken to protect viators and ensure that they receive the greatest amount possible for their insurance policies.<sup>29</sup>

## II. THE MORAL DEBATE

The nature of the industry has sparked a bitter debate between those who believe viatical settlements provide compassionate relief to dying individuals, and those who oppose a company's ability to profit from death.<sup>30</sup> Critics claim that it is "ghoulish" to allow companies to financially succeed by gambling on the life expectancies of others.<sup>31</sup> The need for this service, however, has all but silenced this criticism.<sup>32</sup> Proponents point out that viatical settlement companies provide terminally ill individuals with the opportunity to convert an asset that is otherwise useless to them during their lifetime into cash.<sup>33</sup> This liquidity allevi-

25. Lamson, *supra* note 13, at 16.

26. See *infra* notes 30-55 and accompanying text.

27. See *infra* notes 56-108 and accompanying text.

28. See *infra* notes 109-47 and accompanying text.

29. See *infra* notes 148-54 and accompanying text.

30. Critics of the viatical settlement industry include state insurance regulators and medical ethicists. Forest, *supra* note 14, at 40. In addition, the Securities and Exchange Commission appears wary of the industry and is keeping a close eye on viatical settlement transactions. *Id.*; see, e.g., Securities and Exch. Comm'n v. Life Partners, 898 F. Supp. 14 (D.D.C. 1995) (granting a preliminary injunction against a viatical settlement company for selling unregistered securities). For a general discussion of whether viatical settlements should be considered securities, see Glick, *supra* note 11.

31. Kristof, *supra* note 9, at D1.

32. Sherrid, *supra* note 7, at 56. A recent study of 2661 families with terminally ill members found that over one-third of the families spent almost all of their life savings on medical expenses. *Id.*

33. John Freeman Blake, *Unique Needs Advising Terminally Ill Clients*, NAT'L L.J.,

ates financial burdens so that viators can enjoy a comfortable lifestyle during their final years. Additionally, tapping into these death benefits before death may decrease the state's burden to support extraordinary medical expenses.<sup>34</sup>

Opponents fear that because terminally ill individuals are often in desperate need of money, the viatical settlement companies are in a position to exploit viators easily by offering low settlements.<sup>35</sup> Certain states have responded to this concern by enacting legislation to regulate the minimum discount rates used by the companies in determining settlement amounts.<sup>36</sup>

These opponents and regulating states, however, fail to recognize the risks taken by viatical settlement companies when negotiating settlements. First, potential viators consist primarily of individuals with AIDS and a small number of terminal cancer patients.<sup>37</sup> Because the life span of these individuals varies greatly, and because AIDS is a relatively new disease with still undetermined morbidity patterns,<sup>38</sup> the potential for miscalculation of life expectancy is high.<sup>39</sup> This risk is compounded by the potential for advancement in medical technology that may greatly increase an individual's life span.<sup>40</sup>

Second, viatical settlement companies also run the risk of interest rates rising after negotiation of the settlement, thereby increasing the amount owed on borrowed capital.<sup>41</sup> Additionally, when determining settlement amounts, purchasers must take into account administrative costs, future premium payments, medical assessment costs, attorneys' fees, and the likelihood of litigation after the insured's death.<sup>42</sup> Thus, purchasers must be allowed reasonable profit margins to prevent inter-

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Aug. 5, 1995, at 1.

34. *Living Benefits/Curbing Life Insurance Policy Sales Would Tax Texans*, HOUS. CHRON., June 2, 1995, at 34 [hereinafter *Living Benefits*].

35. Forest, *supra* note 14, at 40.

36. For a discussion on regulating minimum discount rates and their effects on viatical settlements, see *infra* notes 95-108 and accompanying text.

37. Herold, *supra* note 6, at A9; see also *supra* note 6 (noting 95% of viators are AIDS patients).

38. The life expectancy of AIDS patients is very difficult to predict because "progress of the disease depends on the presence or absence of 'opportunistic infections' that the AIDS sufferer's immune system no longer can destroy." John Freeman Blake, *Life Insurance Proceeds can be Received Tax Free Prior to Death Under New Prop. Regs.*, 79 J. TAX'N 156, 157 (1993).

39. Lamson, *supra* note 13, at 16.

40. *Id.*

41. *Id.* Most viatical companies must borrow capital in order to buy the policies and to keep up with premium payments. *Id.*

42. *Id.*

ference with their ability to assess risk.<sup>43</sup> Allowing viatical settlement companies to compete with one another freely rather than requiring them to follow set minimum discount rates protects viators from possible exploitation through competitive settlement rates.<sup>44</sup>

Opponents of the industry also contend that viatical settlements take away post-death benefits from the policy's likely intended beneficiaries: members of the viator's family.<sup>45</sup> Yet, many terminally ill AIDS sufferers do not have children.<sup>46</sup> Additionally, by providing money prior to death, the insured is often able to reduce the financial burden that would otherwise be left to the family.

Critics of the industry claim that viatical settlement companies should not be allowed to purchase policies because they do not hold an "insurable interest"<sup>47</sup> in the life of the insured.<sup>48</sup> Although as a general rule the *purchaser* of an insurance policy must possess an insurable interest in the insured's life, controversy exists as to whether a person without an insurable interest, such as a viatical settlement company, may obtain an insurance policy by *assignment*.<sup>49</sup>

According to opponents, allowing the assignment of policies to viatical companies creates the danger of "hit men" entering the industry to guarantee large profit margins by ensuring early termination of the insured's life.<sup>50</sup> Yet the insurance industry has long been in the practice of providing lifetime disability and annuity payments to certain beneficiaries without an influx of hit men.<sup>51</sup> Additionally, when terminally ill individuals personally enter into viatical settlements, it is presumed that they will refrain from assigning their policies to disreputable

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43. Dean, *supra* note 4, at 117.

44. See generally Berner, *supra* note 16, at 601.

45. For a comparison of a viatical settlement paying zero proceeds upon the death of the insured to an accelerated death benefit allowing partial payment of proceeds to the beneficiaries, see *supra* note 20 and accompanying text.

46. Kristof, *supra* note 9, at D1.

47. An insurable interest when the persons are related includes "a substantial interest engendered by love and affection," and in the case of unrelated individuals, "a lawful and substantial economic interest in having the life . . . of the individual insured continue." ARK. CODE ANN. § 23-79-103(c)(1) to 103(2) (Michie 1992).

48. Lamson, *supra* note 13, at 16.

49. Dean, *supra* note 4, at 117. The majority of states do not require an insurable interest in assignees as long as the assignment is made in good faith. *Id.*

50. Lamson, *supra* note 13, at 16.

51. *Id.*



companies.<sup>52</sup> Finally, state licensing requirements that allow insurance commissioners to oversee all viatical settlement companies conducting business within the state further reduces this risk of hit men.<sup>53</sup>

As shown, opponents' concerns over the viatical settlement industry are greatly outweighed by the benefits to terminally ill individuals who opt to viaticate their insurance policies.<sup>54</sup> Without this option, many terminally ill individuals would be left with no assets to help finance their final years. Opponents seeking to prevent abuse of the system should achieve this goal by regulating the industry rather than by trying to eliminate it.<sup>55</sup>

### III. REGULATING THE INDUSTRY

In an attempt to prevent potential abuses in the newly developed viatical settlement market, several states have passed statutes to regulate the industry.<sup>56</sup> By placing the viatical market under the control of state insurance commissioners or administrators, states are attempting to protect physically and emotionally vulnerable viators from exploitation by viatical settlement companies.<sup>57</sup> Many states have drafted their statutes to ensure that viators are fully informed before they decide to viaticate their life insurance policies.<sup>58</sup> Additionally, the regulations protect viators from unfair competition, guarantee the confidentiality of medical records, and ensure the economic viability of the industry.<sup>59</sup>

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52. Dean, *supra* note 4, at 117.

53. For an in-depth analysis of individual state licensing requirements, see *infra* notes 82-94 and accompanying text.

54. See *supra* notes 30-34 and accompanying text.

55. See *infra* notes 56-108 and accompanying text.

56. See CAL. INS. CODE § 10113.1-2 (West 1993); LA. REV. STAT. ANN. § 22:201-210.1 (West Supp. 1996); MINN. STAT. ANN. § 60A.961-974 (Supp. 1996); N.Y. INS. LAW §§ 7801-7808 (McKinney Supp. 1996); N.C. GEN. STAT. § 58-58-42 (Supp. 1995); N.D. CENT. CODE § 26.1-33.1 (1995); TEX. INS. CODE ANN. § 3.50-6A (West Supp. 1996); VT. STAT. ANN. tit. 8, §§ 3826-3833 (Supp. 1995); WASH. REV. CODE ANN. § 48.102.005-.102.050 (Supp. 1996). Additionally, states may look to the model statute adopted by the National Association of Insurance Commissioners as a road map for enacting their own legislation. MODEL VIATICAL SETTLEMENTS ACT §§ 1-12 (Proposed Official Draft 1993).

57. See Dean, *supra* note 4, at 117.

58. See CAL. INS. CODE § 10113.2(d)(1)-(3); LA. REV. STAT. ANN. § 22:208(1)-(5); MINN. STAT. ANN. § 60A.969(1)-(6); N.Y. INS. LAW § 7807(b)(1)-(6); N.C. GEN. STAT. § 58-58-42(g)(1) to (6); N.D. CENT. CODE § 26.1-33.1-07(1)-(6); VT. STAT. ANN. tit. 8, § 3831(1)-(7); WASH. REV. CODE ANN. § 48.102.035(1)(6).

59. Dean, *supra* note 4, at 117.

### A. General Regulations

Viatical statutes seek to guarantee that viators understand and voluntarily consent to the provisions in the settlement contract before viaticating their policies. This goal is accomplished by requiring viatical settlement companies to procure a witnessed, signed statement from the terminally ill individual attesting that the viator freely consents to the contract, acknowledges the illness, understands the risks and benefits of the settlement, and releases all medical records to the viatical company.<sup>60</sup> The purchaser must also obtain a written declaration from a medical professional affirming that the terminally ill individual is of sound mind and is acting free from undue influence.<sup>61</sup>

Additionally, viatical settlement companies may have an affirmative duty to disclose pertinent information to all potential viators. For example, most states that have passed viatical regulations require the purchaser to disclose possible alternatives to viatical settlements, including accelerated death benefits options, that may be available through the life insurer.<sup>62</sup> The statutes may also require purchasers to inform potential viators of the possible tax ramifications of their decision to viaticate.<sup>63</sup> In light of the recent tax movement in this area, this may be of great importance to viators when determining whether to enter

60. See CAL. INS. CODE § 10113.1(c)(2); LA. REV. STAT. ANN. § 22:209(A)(2); MINN. STAT. ANN. § 60A.970 (subd. 1)(2); N.Y. INS. LAW § 7808(a); N.C. GEN. STAT. § 58-58-42(h)(2); N.D. CENT. CODE § 26.1-33.1-08(1)(b); VT. STAT. ANN. tit. 8, § 3832(a); WASH. REV. CODE ANN. § 48.102.040(1)(b)(i)(v).

61. CAL. INS. CODE § 10113.1(c)(1); LA. REV. STAT. ANN. § 22:209(A)(1); MINN. STAT. ANN. § 60A.970(subd. 1)(1); N.C. GEN. STAT. § 58-58-42(h)(1); N.D. CENT. CODE § 26.1-33.1-08(1)(a); WASH. REV. CODE ANN. § 48.102.040(1)(a).

62. See CAL. INS. CODE § 10113.2(d)(1); LA. REV. STAT. ANN. § 22:208(1); MINN. STAT. ANN. § 60A.969(1); N.Y. INS. LAW § 7807(b)(2); N.C. GEN. STAT. § 58-58-42(g)(1); N.D. CENT. CODE § 26.1-33.1-07(1); VT. STAT. ANN. tit. 8, § 3831(1); WASH. REV. CODE ANN. § 48.102.035(1). For a discussion of accelerated death benefits, see *supra* notes 18-25 and accompanying text. In addition to disclosing accelerated death benefits options, the viatical settlement company may also be required to inform the viator of possible loans secured by the life insurance policy. See, e.g., N.Y. INS. LAW § 7807(b)(2).

63. See CAL. INS. CODE § 10113.2(d)(2); LA. REV. STAT. ANN. § 22:208(2); MINN. STAT. ANN. § 60A.969(2); N.Y. INS. LAW § 7807(b)(3); N.C. GEN. STAT. § 58-58-42(g)(2); N.D. CENT. CODE § 26.1-33.1-07(2); VT. STAT. ANN. tit. 8, § 3831(2); WASH. REV. CODE ANN. § 48.102.035(2). Minnesota, Vermont, and Washington go so far as to require viatical settlement companies to suggest that potential viators seek the advice of a tax advisor. MINN. STAT. ANN. § 60A.969(2); VT. STAT. ANN. tit. 8, § 3831(2); WASH. REV. CODE ANN. § 48.102.035(2).

into a settlement agreement.<sup>64</sup> Additionally, all viatical settlement contracts currently contain a clause that allows the viator to rescind the contract within fifteen to thirty days of the contract date.<sup>65</sup> To prevent this rescission period from becoming a bargaining tool in determining the settlement amount, many states have codified this option to rescind.<sup>66</sup> Most importantly, state regulations require disclosure of the possible adverse effects the settlement may have on the terminally ill individual's access to medical or public assistance programs.<sup>67</sup> Regulations that impose an affirmative duty to disclose "facilitate free and informed decision making" by potential viators.<sup>68</sup>

State regulations also require that all viatical settlement contracts be filed with and approved by the state department of insurance.<sup>69</sup> The

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64. For a discussion of tax treatment of viatical settlement transactions, see *infra* notes 109-47 and accompanying text.

65. Dean, *supra* note 4, at 145.

66. See, e.g., LA. REV. STAT. ANN. § 22:208(4) (stating that the period is the lesser of 30 days from date of execution or 15 days from receipt of proceeds); MINN. STAT. ANN. § 60A.969(5) (same); N.C. GEN. STAT. § 58-58-42(g)(5) (same); N.D. CENT. CODE § 26.1-33.1-07(5) (same). The rescission period varies from state to state. See CAL. INS. CODE § 10113.2(n) (requiring 15 days from date of execution); N.Y. INS. LAW § 7807(b)(5) (requiring 15 days from receipt of proceeds); VT. STAT. ANN. tit. 8, § 3831(5) (mandating seven days from date of execution); WASH. REV. CODE ANN. § 48.102.035(5) (requiring the later of 15 days from date of receipt or 30 days from date of execution).

67. See CAL. INS. CODE § 10113.2(d)(3); LA. REV. STAT. ANN. § 22:208(3); MINN. STAT. ANN. § 60A.969(4); N.Y. INS. LAW § 7807(b)(4); N.C. GEN. STAT. § 58-58-42(g)(4); N.D. CENT. CODE § 26.1-33.1-07(4); VT. STAT. ANN. tit. 8, § 3831(4); WASH. REV. CODE ANN. § 48.102.005.035(4). In New York, for example, the application must state:

Receipt of payment pursuant to a viatical settlement may affect eligibility for public assistance programs such as medical assistance (Medicaid), aid to families with dependent children, supplementary social security income and AIDS drug assistance programs and may be taxable. Prior to applying for a viatical settlement, policyowners should consult with the appropriate social services agency concerning how receipt will affect the eligibility of the recipient and the recipient's spouse or dependents, and with a qualified tax advisor.

N.Y. INS. LAW § 7807(a).

Under the New York law, state public assistance providers cannot require recipients, as a condition of eligibility, to pursue a viatical settlement. Lamson, *supra* note 13, at 16. Additionally, the statute prohibits the New York Department of Social Services from considering an individual's option to viaticate a policy as grounds for refusal of public funds. *Id.*

Most of the regulating states also require the purchaser to inform the viator that the settlement proceeds may be subject to the claims of creditors. See, e.g., LA. REV. STAT. ANN. § 22:208(3); MINN. STAT. ANN. § 60A.969(3); N.C. GEN. STAT. § 58-58-42(g)(3); N.D. CENT. CODE § 26.1-33.1-07(3); VT. STAT. ANN. tit. 8, § 3831(3); WASH. REV. CODE ANN. § 48.102.035(3).

68. Dean, *supra* note 4, at 146.

69. See CAL. INS. CODE § 10113.2(c); LA. REV. STAT. ANN. § 22:205; MINN. STAT.

department then has discretion to disapprove the contract if its provisions are unreasonable, contrary to the interests of the public, or otherwise misleading to the viator.<sup>70</sup> Many of the statutes also give the department of insurance the power to oversee the ongoing business affairs of viatical settlement companies.<sup>71</sup> This power includes the authority to examine records, books, and files to ascertain whether the company is acting in accordance with applicable laws.<sup>72</sup>

Additionally, state statutes protect viators by regulating the flow of the viatical transaction proceeds. For example, immediately upon receipt of documents to effect the transfer of the insurance policy, the regulation may require the purchaser to "pay the proceeds of the settlement to an escrow or trust account managed by a trustee or escrow agent in a state or federally chartered financial institution that is a member of the Federal Reserve System."<sup>73</sup> The funds must be transferred to the viator as soon as receipt of acknowledgment is obtained from the insurer.<sup>74</sup>

Protecting the confidentiality of the viator's medical records is also an important objective of viatical settlement regulation.<sup>75</sup> To illustrate, the New York statute states in relevant part: "All medical information solicited or obtained by any licensee shall be subject to the provisions

ANN. § 60A.966; N.Y. INS. LAW § 7804(a); N.C. GEN. STAT. § 58-58-42(d); N.D. CENT. CODE § 26.1-33.1-04; VT. STAT. ANN. tit. 8, § 3829(b); WASH. REV. CODE ANN. § 48.102.020.

70. See CAL. INS. CODE § 10113.2(c); LA. REV. STAT. ANN. § 22:205; MINN. STAT. ANN. § 60A.966; N.Y. INS. LAW § 7804(a); N.C. GEN. STAT. § 58-58-42(d); N.D. CENT. CODE § 26.1-33.1-04.

71. See CAL. INS. CODE § 10113.2(g); LA. REV. STAT. ANN. § 22:207(a); N.C. GEN. STAT. § 58-58-42(f).

72. See CAL. INS. CODE § 10113.2(g); LA. REV. STAT. ANN. § 22:207(a); N.C. GEN. STAT. § 58-58-42(f).

73. LA. REV. STAT. ANN. § 22:209(e); see also MINN. STAT. ANN. § 60A.970 (subd. 4); N.Y. INS. LAW § 7804(b)(2); N.C. GEN. STAT. § 58-58-42(i); N.D. CENT. CODE § 26.1-33.1-08(4); VT. STAT. ANN. tit. 8, § 3832(d).

74. LA. REV. STAT. ANN. § 22:209(e); MINN. STAT. ANN. § 60A.970(subd. 4); N.Y. INS. LAW § 7804(b)(2); N.C. GEN. STAT. § 58-58-42(i); N.D. CENT. CODE § 26.1-33.1-08(4); VT. STAT. ANN. tit. 8, § 3832(d). A few states expressly require that the purchaser pay the proceeds in a lump sum. See MINN. STAT. ANN. § 60A.970(subd. 5); N.Y. INS. LAW § 7808(b)(3). The Minnesota statute further specifies that payment must be made by certified check or cashier's check. MINN. STAT. ANN. § 60A.970(subd. 4).

75. See CAL. INS. CODE § 10113.2(e); LA. REV. STAT. ANN. § 22:209(B); MINN. STAT. ANN. § 60A.970(subd. 2); N.Y. INS. LAW § 7808(b); N.C. GEN. STAT. § 58-58-42(h); N.D. CENT. CODE § 26.1-33.1-08(2); VT. STAT. ANN. tit. 8, § 3832(b); WASH. REV. CODE ANN. § 48.102.040(2).

applicable to health care providers under the public health law and common law relating to confidentiality of medical information.<sup>76</sup> Allegations brought against two viatical settlement companies demonstrate the necessity for such provisions.<sup>77</sup> State security regulators accused these companies of sending prospective investors “a list of anonymous purported AIDS patients, showing their insurance carriers and coverage amount,” along with the medical records of some of the patients.<sup>78</sup> It is imperative that states prohibit this type of disclosure, not only to protect the confidentiality of the individual’s medical records, but also to preserve the integrity of the viatical industry.<sup>79</sup>

These general viatical regulations are the first step in guaranteeing fair dealing by viatical settlement companies without inhibiting the viator’s ability to take advantage of the market.<sup>80</sup> The regulations seek to ensure that viatical settlement companies do not take advantage of a viator’s vulnerability.<sup>81</sup> Many states have not yet codified viatical regulations, however, leaving much of the terminally ill population without protection from potential abuses by viatical settlement purchasers.

## B. License Requirements

Current viatical statutes require that every purchaser entering into a viatical settlement contract be licensed by the state insurance commissioner to engage in business within the state.<sup>82</sup> In order to obtain a license, the purchaser must file an application and pay an application fee.<sup>83</sup> In California, the insurance commissioner may decline to ap-

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76. N.Y. INS. LAW § 7808(b).

77. Tony Munroe, *Companies Exploiting AIDS for Profit*, WASH. TIMES, Aug. 20, 1992, at C1.

78. *Id.*

79. Dean, *supra* note 4, at 146.

80. *Id.*

81. Berner, *supra* note 16, at 587-88.

82. See CAL. INS. CODE § 10113.2(b)(1) (West 1993); LA. REV. STAT. ANN. § 22:203(A) (West Supp. 1996); MINN. STAT. ANN. § 60A.962(subd. 1) (Supp. 1996); N.Y. INS. LAW § 7802(a) (McKinney Supp. 1996); N.C. GEN. STAT. § 58-58-42(b) (Supp. 1995); N.D. CENT. CODE § 26.1-33.1-02(1); VT. STAT. ANN. tit. 8, § 3827(a) (Supp. 1995); WASH. REV. CODE ANN. § 48.102.010(1) (Supp. 1996).

83. The licensing fee varies from state to state. See CAL. INS. CODE § 10113.2(b)(1) (\$2833); LA. REV. STAT. ANN. § 22:203(B) (\$1000); MINN. STAT. ANN. § 60A.964(subd. 1) (\$750); N.Y. INS. LAW § 7802(b) (\$2500); N.D. CENT. CODE § 26.1-33.1-02(2) (\$250); VT. STAT. ANN. tit. 8, § 3827(b) (\$50); WASH. REV. CODE ANN. § 48.102.010(2) (mandating that fee is determined by the commissioner). After the initial license is given, the viatical settlement company must renew its license each year and pay an additional fee. See CAL. INS. CODE § 10113.2(b)(3) (\$177); LA. REV. STAT. ANN. § 22:203(C) (\$500); MINN. STAT. ANN. § 60A.964(subd. 1) (\$250); N.Y. INS. LAW § 7802(b) (\$1000); N.D. CENT. CODE § 26.1-33.1-02(3) (\$150); VT. STAT. ANN. tit. 8, § 3827(c) (\$50); WASH.

prove the application if, in the commissioner's discretion, "it is determined that it is contrary to the interests of the public to issue a license to the applicant. The reasons for a denial shall be set forth in writing."<sup>84</sup> Under the broad language of the state regulations, even a private investor buying a single policy is subject to the same licensing requirements as a company in the full-time viatical business.<sup>85</sup>

These licensing provisions have proven to be controversial.<sup>86</sup> Opponents contend that licensing requirements stifle a terminally ill individual's opportunity to take full advantage of the viatical settlement industry by excluding willing purchasers from the market.<sup>87</sup> They argue that a smaller number of purchasers means less competition for policy purchases, resulting in settlements that level off at the applicable minimum discount rates.<sup>88</sup> Thus, opponents claim that license requirements prevent viators from receiving the greatest possible return.

Despite opponents' concerns, licensing is not so costly or burdensome as to prevent legitimate businesses from entering the viatical settlement industry.<sup>89</sup> The average fee among states that have enacted licensing regulations is only \$1230 for the initial license and \$354 for

REV. CODE ANN. § 48.102.010(2) (requiring fee as determined by the commissioner).

The commissioner may revoke the license if it is determined, after a hearing, that continued business by the licensee is contrary to the best interests of the public. See CAL. INS. CODE § 10113.2(b)(2); LA. REV. STAT. ANN. § 22:204; MINN. STAT. ANN. § 60A.965; N.C. GEN. STAT. § 58-58-42(c); N.D. CENT. CODE § 26.1-33.1-03; WASH. REV. CODE ANN. § 48.102.010(4)(b).

84. CAL. INS. CODE § 10113.2(b)(2). In California, this inquiry focuses on financial status, past experience in living benefits, and methods for obtaining information from medical providers. Howard J. Saks, *Viatical Settlement Companies Licensed*, 21 EST. PLAN. 186, 186 (1994). Other state regulations also provide stringent licensing requirements. In Louisiana, for example, a license will only be granted after the department of insurance finds that the applicant (1) has provided a detailed plan of operation, (2) is competent and trustworthy and will act in good faith, and (3) has a good business reputation and is qualified to enter the industry. LA. REV. STAT. ANN. § 22:203(F)(1)-(3).

85. For example, the New York provision reads: "No individual, partnership, corporation or other entity may act as a viatical settlement company or broker or enter into or solicit a viatical settlement without first having obtained a license from the superintendent, in accordance with procedures established by regulation." N.Y. INS. LAW § 7802(a).

86. See generally *Living Benefits*, *supra* note 34, at 34.

87. Berner, *supra* note 16, at 605.

88. *Id.* at 606. For a discussion of minimum discount rates, see *infra* notes 95-108 and accompanying text.

89. Dean, *supra* note 4, at 117.

the renewal license.<sup>90</sup> These fees are minimal when compared to the fifteen to twenty percent average return on a viatical settlement purchase<sup>91</sup> and are not likely to discourage even a private single-policy purchaser from entering the market.<sup>92</sup> Additionally, the statutes impose the burden of overseeing the industry on the state departments of insurance rather than on the purchasers themselves.<sup>93</sup> Contrary to opponents' claims, licensing can effectively protect prospective viators by ensuring that only legitimate purchasers enter the market.<sup>94</sup> Therefore, states should continue to codify licensing requirements for all viatical settlement purchasers.

### C. *Minimum Discount Rates*

Viatical regulations sometimes provide the insurance commissioner with the authority to set the minimum discount rates used to determine the amount paid in exchange for assignment of a death benefit under a life insurance policy.<sup>95</sup> In a few states, the statutes themselves provide the minimum discount rates.<sup>96</sup> For example, the Minnesota statute requires the following discount rates: for a life expectancy of (1) less than

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90. The author determined the average fee by adding the fee charged by each state and dividing by the number of states that have set licensing fees. For a list of the exact licensing fee for each individual state, see *supra* note 83.

91. Forest, *supra* note 14, at 40. The following example illustrates the minimal impact of the licensing fee as compared to the average return:

Dot (D), a 55-year-old cancer patient, owns a whole life insurance policy that she wishes to viaticate. Erik (E) enters into a viatical settlement with D. E must pay a \$1500 initial license fee, plus \$300 each year for the renewal fee. E agrees to pay 80% of the \$200,000 face value of the policy. E therefore pays a lump sum of \$160,000 to D. Assume further that D lives for another year during which E is obligated to pay an additional \$2500 in premium payments. Upon D's death, E receives the \$200,000 face value of the life insurance policy. This is \$40,000 more than E paid for the policy. The profit to E equals \$35,700: \$40,000 minus \$2500 in premium payments and \$1800 in license fees (the initial fee and one year's renewal). The licensing fee, therefore, had very little impact on the total profit percentage received by E.

Note that this simple example does not take into account inflation, which would most likely be minimal for a one-year period, nor tax considerations, and is used merely to illustrate the minimal impact of licensing fees.

92. Dean, *supra* note 4, at 145.

93. See *supra* notes 69-72 and accompanying text (discussing the burden imposed on state insurance departments).

94. Dean, *supra* note 4, at 117.

95. See CAL. INS. CODE § 10113.2(f) (West 1993); LA. REV. STAT. ANN. § 22:209(C)(3) (West Supp. 1996); N.C. GEN. STAT. § 58-58-42(j)(2) (Supp. 1995); VT. STAT. ANN. tit. 8, § 3833(2) (Supp. 1995).

96. See LA. REV. STAT. ANN. § 22:209(C)(1); MINN. STAT. ANN. § 60A.971 (West 1996).

six months, 80% of the policy's face value; (2) at least six months but less than twelve months, 70% of the face value; (3) at least twelve months but less than eighteen months, 65% of the face value; (4) at least eighteen months, but less than twenty-four months, 60% of the face value; and (5) twenty-four months or more, 50% of the face value.<sup>97</sup>

Statutes that regulate minimum discount rates have been met with criticism.<sup>98</sup> Although the regulations attempt to provide terminally ill individuals with protection from possible low rates offered by viatical settlement companies, the exact opposite may result. Statutes that deny purchasers reasonable profit margins by interfering with their ability to assess risk<sup>99</sup> discourage viatical settlement companies, as well as additional capital, from entering the industry.<sup>100</sup> The most harmful effect of this is the exclusion from the market of those individuals who need protection most: those terminally ill individuals with life expectancies of longer than two years who are unable to qualify for accelerated death benefits because of their longer life expectancies.<sup>101</sup>

Furthermore, minimum discount rates may likely stifle competition and become the maximum price purchasers will offer for insurance policies.<sup>102</sup> Although competitive prices may result if one company decides to offer higher settlement prices, the incentive to offer higher prices is minimal because the growing terminally ill AIDS population<sup>103</sup> guarantees companies a profitable business.<sup>104</sup> As a result, viators may face a market that systematically sets prices at the minimum discount rates and then uses state regulations to explain the non-competitive nature of the industry.<sup>105</sup>

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97. MINN. STAT. ANN. § 60A.971. To illustrate, assume that Tom (T) owns a \$100,000 policy and has an 18-month life expectancy. A viatical settlement contract must provide T with at least \$60,000 in exchange for ownership of the policy.

98. See generally Berner, *supra* note 16.

99. For a discussion on risks taken by viatical settlement purchasers, see *supra* notes 37-44 and accompanying text.

100. Dean, *supra* note 4, at 117.

101. *Id.* For a discussion of accelerated death benefits, see *supra* notes 18-25 and accompanying text.

102. Berner, *supra* note 16, at 599.

103. See *supra* notes 1-4 and accompanying text for a discussion of the growing AIDS population.

104. Berner, *supra* note 16, at 599-600.

105. *Id.*



Because of these harmful results, statutes should not set, nor give the state insurance commissioner power to set, minimum discount rates.<sup>106</sup> Avoiding minimum discount rates will protect viators by encouraging competitive prices and by bringing new capital into the market.<sup>107</sup> Thus, an industry without minimum discount rates ensures that viators can receive the maximum amount possible for their policies.<sup>108</sup>

#### IV. TAX REFORM

As of January 1, 1997, viators will benefit from preferential income tax treatment of proceeds received pursuant to a viatical settlement.<sup>109</sup> Traditionally, proceeds received from accelerated death benefits or viatical settlements have been treated as taxable income.<sup>110</sup> However, Congress and the Internal Revenue Service have long been debating the tax treatment of insurance proceeds received by a terminally ill individual prior to death. As a result of these debates, the Health Insurance Portability and Accountability Act of 1996 (Health Insurance Act),<sup>111</sup> which goes into effect January 1, 1997, creates an income tax exclusion for accelerated death benefits and viatical settlement proceeds.<sup>112</sup> In order to illustrate how the Health Insurance Act will benefit viators, this section begins with an analysis of the general taxation provisions for proceeds paid pursuant to a life insurance contract.

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106. Dean, *supra* note 4, at 147.

107. Berner, *supra* note 16, at 599-601.

108. *Id.* at 601.

109. *See infra* notes 132-42 and accompanying text.

110. *See infra* notes 114-31 and accompanying text.

111. Pub. L. No. 104-191, 110 Stat. 1936 (1996). The Health Insurance Act adds sections 101(g) and 7702B to the Internal Revenue Code. These sections affect the tax treatment of viatical settlements and accelerated death benefits. *See infra* notes 132-47 and accompanying text.

112. I.R.C. § 101(g) (1997) (effective January 1, 1997).

### A. *Payments Made Incident to Death*<sup>113</sup>

Under section 101(a)(1) of the Internal Revenue Code (Code),<sup>114</sup> benefits paid by reason of the insured's death pursuant to a "qualifying life insurance contract"<sup>115</sup> are excluded from the beneficiary's gross income.<sup>116</sup> One of the requirements for a qualifying life insurance con-

113. This discussion can be best understood if one is familiar with the several different types of insurance policies a viator may own. First, whole life insurance is a type of policy "in which the insured pays a level premium for his or her entire life and in which there is a constantly accumulating cash value against which the insured can withdraw or borrow." BLACK'S LAW DICTIONARY 805 (6th ed. 1990). Ordinary whole life insurance is in effect as long as the insured pays the premiums. HAROLD WEINSTOCK, *PLANNING AN ESTATE: A GUIDEBOOK OF PRINCIPLES AND TECHNIQUES* § 10.8 (3rd ed. 1988).

Second, term life insurance insures "against the risk of dying during a specified period." *Id.* § 10.7. The insured may usually renew the policy after the end of the term, but the premiums will be increased to reflect the insured's age at the time of renewal. *Id.* Thus, term insurance is usually the least expensive when first issued, but the premiums increase as the insured chooses to renew the policy. *Id.*

Less common types of policies are limited pay life insurance and endowment insurance. A limited pay policy requires level premium payments for a specified period of time such as 15, 20, or 30 years. *Id.* § 10.9. These premiums are more expensive than whole life insurance because they are only paid for a specified number of years, but the policy insures the holder's entire lifetime. *Id.* Endowment insurance is similar to limited pay except that the premiums are higher in order to allow for a more rapid cash accumulation. *Id.* § 10.10. When the premium payments are completed, the cash value will equal the face value of the policy, and the insured will be paid even if still living. *Id.*

114. All subsequent textual section references are to the Internal Revenue Code unless otherwise specified.

115. A life insurance contract as defined by section 7702 of the Code includes "complex formulas creating guidelines and safe harbors for the interrelationship of premiums and death benefits, as well as cash values and other investment characteristics." Blake, *supra* note 33, at 1. For a detailed analysis of a life insurance contract as defined by the Code, see Ronald S. Ross, *Accelerated Death Benefits' Tax Treatment Eased*, 23 TAX'N FOR LAW. 229 (1995).

116. I.R.C. § 101(a)(1) (1994). The section reads: "[G]ross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." *Id.*

If a life insurance policy is transferred for consideration, however, the Code requires the purchaser to recognize the income. *Id.* § 101(a)(2). The following example illustrates this transfer for value rule:

Heather (H) purchases a \$100,000 policy on Cheryl's (C's) life from C for \$40,000. H then pays \$10,000 in premiums. Upon C's death, the amount H must recognize is \$50,000: the amount paid by the insurance company (\$100,000), minus consideration paid by H (\$40,000), and minus subsequent

tract is that the insurer must pay the proceeds "by reason of the death of the insured."<sup>117</sup> Because the Code draws the line at the insured's death, proceeds paid "even one minute before death" are typically included as taxable income.<sup>118</sup> Applying these principles to viatical settlements and accelerated death benefits, receipt of these proceeds prior to death has been treated traditionally as a surrender of the policy, requiring the insured to report income to the extent the proceeds exceed the total premiums paid.<sup>119</sup>

### B. Treatment of Viatical Settlement Proceeds

To illustrate, the Internal Revenue Service (Service) issued a Private Letter Ruling in 1994 requiring a taxpayer to include proceeds received pursuant to a viatical settlement as income.<sup>120</sup> The ruling addressed a taxpayer's irrevocable assignment of a life insurance policy to a viatical settlement company for approximately sixty-three percent of the policy's face value.<sup>121</sup> The Service ruled that amounts received from the assignment of the life insurance policy to the viatical settlement company were "not amounts received under a life insurance contract by reason of the death of the insured. Therefore, the exclusion under section 101(a) does not apply to any portion of the gain realized by Taxpayer on the sale of the contract."<sup>122</sup>

The Service instead treated the viatical settlement as a sale of property and applied the applicable provisions.<sup>123</sup> Under section 1001(b), the amount realized on the sale of property is the amount of money, plus

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premium payments paid by H (\$10,000). Note that this rule does not apply if the transferee obtained the property by gift or any transaction in which there was a carry over basis, as in the case of transfers between spouses.

See *id.* § 102.

117. *Id.* § 7702(f)(3). The statute does not specify what constitutes payment "by reason of the death of the insured," although the Internal Revenue Service is given authority to prescribe appropriate regulations. *Id.* § 7702(k).

118. Ross, *supra* note 115, at 229.

119. See I.R.C. § 72(e)(5)-(A) (1994).

120. Priv. Ltr. Rul. 94-43-020 (July 22, 1994).

121. *Id.* The Private Letter Ruling dealt with an AIDS patient who sold his \$100,000 whole life insurance policy to a viatical settlement company for \$63,000. *Sale of a Life Insurance Policy—What is the Basis of Viatical Settlement? L.R. 9443020 (Not a Precedent)*, 112 BANKING L.J. 408, 408 (1995) [hereinafter *Sale of a Life Insurance Policy*]. "The total premiums paid to date was \$40,000 [and] the cash surrender value [was] \$30,000." *Id.* For a discussion on this type of whole life insurance, see *supra* note 113.

122. Priv. Ltr. Rul. 94-43-020 (July 22, 1994). For a discussion on the exclusion allowed for amounts received by reason of the death of the insured, see *supra* notes 114-19 and accompanying text.

123. Priv. Ltr. Rul. 94-43-020 (July 22, 1994).

the fair market value of other property, received pursuant to the sale.<sup>124</sup> The amount realized less the seller's "basis"<sup>125</sup> in the property is the amount of gain on the transaction.<sup>126</sup> The entire amount of gain on the sale of property must be recognized as income.<sup>127</sup>

Applying these principles to the viatical settlement transaction, the Service determined that the amount realized was the amount paid by the viatical company to the viator.<sup>128</sup> The viator's basis was "equal to the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (e.g., dividends) received under the contract that have not been included in gross income."<sup>129</sup> Accordingly, the Service held that the taxpayer must include in his gross income the amount received from the viatical settlement company, minus the taxpayer's adjusted basis.<sup>130</sup> The Service empha-

124. I.R.C. § 1001(b) (1994). "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." *Id.*

125. Basis is a term used "to describe the value assigned to an asset for the purpose of determining gain (or loss) on the sale or transfer or in determining value in the hands of the donee." BLACK'S LAW DICTIONARY 151-52 (6th ed. 1990); see I.R.C. §§ 1011, 1012.

126. I.R.C. § 1001(a) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . .").

127. *Id.* § 1001(c) ("Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.").

128. Priv. Ltr. Rul. 94-43-020 (July 22, 1994).

129. *Id.* "The cost of insurance was approximated by subtracting the cash surrender value \$30,000 from the premiums paid (\$40,000)" which equaled \$10,000. *Sale of a Life Insurance Policy*, *supra* note 121, at 408. Thus, the basis was equal to \$30,000: premiums paid (\$40,000) less insurance protection costs (\$10,000). *Id.* The total gain was therefore \$33,000: the amount received by the viator from the settlement (\$63,000) minus the viator's basis (\$30,000).

130. Priv. Ltr. Rul. 94-43-020 (July 22, 1994); see *supra* note 129 (calculating gain in this Private Letter Ruling). The following example illustrates the Service's ruling:

Peter (P), a terminally ill cancer patient, sells his \$100,000 policy to a viatical settlement company for \$65,000 (65% of its face value). P has paid \$20,000 in premium payments. Assuming that there have been no dividends paid and no costs for insurance protection, P must recognize as income a gain of \$45,000: the amount realized (\$65,000) minus the adjusted basis (\$20,000).

In addition, upon P's death, the viatical settlement company must also recognize gain. As the new beneficiary of the policy, the viatical settlement company would receive proceeds of \$100,000 (the policy's face value). The company's basis in the policy, if it has made no subsequent premium pay-

sized that in viatical settlement transactions, “[n]o portion of the amount received is excluded from income under section 101(a)(1) of the Code.”<sup>131</sup>

### C. The New Provisions

Recognizing the need to assist terminally ill individuals with the rising cost of medical treatment, a new Code provision<sup>132</sup> provides that, as of January 1, 1997, proceeds received from accelerated death benefits or viatical settlements are no longer included as taxable income.<sup>133</sup> Thus, a person diagnosed with a terminal or chronic illness may receive accelerated death benefits<sup>134</sup> or assign a life insurance contract to a viatical settlement company<sup>135</sup> without paying income tax on the proceeds, even though the proceeds are not paid by reason of the death of the insured.<sup>136</sup>

To qualify for the exclusion, the individual must be diagnosed as either terminally<sup>137</sup> or chronically ill.<sup>138</sup> Additionally, the viatical set-

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ments, is \$65,000 (the amount they paid to P). Assuming there have been no dividends paid and no costs for insurance protection, the viatical settlement company would have to recognize \$35,000 in gain: the amount realized (\$100,000) minus the adjusted basis (\$65,000).

131. Priv. Ltr. Rul. 94-43-020 (July 22, 1994). See *supra* notes 114-19 and accompanying text for an explanation of the exclusion under section 101(a)(1).

132. I.R.C. § 101(g) (1997) (effective January 1, 1997).

133. *Id.*

134. *Id.* § 101(g)(1) (effective January 1, 1997).

For purposes of this section, the following amounts shall be treated as an amount paid by reason of the death of an insured:

(A) Any amount received under a life insurance contract on the life of an insured who is a terminally ill individual.

(B) Any amount received under a life insurance contract on the life of an insured who is a chronically ill individual.

*Id.*

135. *Id.* § 101(g)(2)(A) (effective January 1, 1997).

If any portion of the death benefit under a life insurance contract on the life of an insured . . . is sold or assigned to a viatical settlement provider, the amount paid for the sale or assignment of such portion shall be treated as an amount paid under the life insurance contract by reason of the death of such insured.

*Id.*

136. *Id.* For a discussion of proceeds paid “by reason of the death of the insured,” see *supra* notes 114-19 and accompanying text.

137. “Terminally ill” means any “individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification.” I.R.C. § 101(g)(4)(A) (effective January 1, 1997).

138. “Chronically ill” is defined as someone who is unable to perform “at least two

tlement provider must be a person or company "regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts" on the lives of terminally or chronically ill individuals.<sup>139</sup> Additionally, the viatical settlement company must be licensed by the state<sup>140</sup> in which the insured resides or, in the case of a state that does not have licensing requirements, meet the general standard of the Viatical Settlements Model Act of the National Association of Insurance Commissioners.<sup>141</sup> The new Code section also requires viatical settlement companies to pay reasonable amounts for assignment of the viator's policy.<sup>142</sup>

The new tax provisions mark an essential breakthrough for viatical settlement companies. By providing an income tax exclusion for viatical settlement proceeds,<sup>143</sup> Congress and the Internal Revenue Service have recognized the legitimacy of the industry.<sup>144</sup> The income tax exclusion also provides a much needed benefit to potential viators. From a humanitarian standpoint, families facing the tragedy of a terminal illness and struggling to finance extraordinary medical costs should not be further burdened by taxation.<sup>145</sup> As a more practical matter, access to viatical settlements is critical to those terminally ill individuals who do not have health insurance.<sup>146</sup> Tax incentives will save federal

activities of daily living . . . due to a loss of functional capacity." I.R.C. § 7702B(c)(2)(A)(i) (effective January 1, 1997). "Activities of daily living" include tasks such as eating, bathing, and dressing. *Id.* § 7702B(c)(2)(B)(i)-(vi) (effective January 1, 1997).

The excludable amount for a chronically ill individual is capped at \$175 per day (\$63,875 annually), adjusted for inflation. *Id.* § 7702B(d)(4) (effective January 1, 1997). Accelerated benefits paid to a chronically ill individual are excludable if the payment is for actual costs of long-term care that are not compensated for by insurance. *Id.* § 101(g)(3) (effective January 1, 1997).

139. *Id.* § 101(g)(2)(B)(i) (effective January 1, 1997).

140. For a discussion of individual state licensing requirements, see *supra* notes 82-94 and accompanying text.

141. I.R.C. § 101(g)(2)(B)(ii)(II) (effective January 1, 1997); MODEL VIATICAL SETTLEMENTS ACT §§ 8-9 (Proposed Official Draft 1993).

142. I.R.C. § 101(g)(2)(B)(ii)(II) (effective January 1, 1997). For a discussion of the adverse consequences of setting minimum discount rates, see *supra* notes 95-108 and accompanying text.

143. See *supra* notes 132-42 and accompanying text.

144. For an analysis of the debate over the industry's legitimacy, see *supra* notes 30-55 and accompanying text.

145. Wayne M. Gazur, *Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill*, 11 VA. TAX REV. 263, 292 (1991).

146. 141 CONG. REC. E 13-02 (daily ed. Jan. 4, 1995) (statement of Rep. Kennelly).

dollars by encouraging these individuals to access their life insurance policies in order to pay their health care costs rather than rely on public assistance.<sup>147</sup> For these reasons, the new Code provisions advance the legitimacy of the viatical settlement industry.

## V. CONCLUSION

As the terminally ill population continues to increase rapidly,<sup>148</sup> the need for the viatical settlement industry becomes essential. Although opponents question the morality of profiting from death,<sup>149</sup> viatical settlement companies allow viators to convert an asset to cash that is otherwise unavailable to them during their lives. For many terminally ill individuals, this is the only financial option available.

Viatical legislation should focus on protecting viators who wish to viaticate their policies in order to finance the high cost of living with a terminal illness. While some states have placed regulations on the market to ensure the legitimacy of the industry,<sup>150</sup> many states have yet to take the necessary regulatory steps to protect viators. These regulations include licensing requirements, mandatory disclosure of pertinent information, confidentiality of medical information, and continuous oversight by state insurance commissioners.<sup>151</sup>

States should also refrain from setting minimum discount rates for determining viatical settlement amounts.<sup>152</sup> Although aimed at preventing abuses, minimum discount rates actually impede a viator's ability to obtain the highest possible payout.<sup>153</sup> Finally, viators should take advantage of the new Code section that provides an income tax exclusion for accelerated death benefits and proceeds received pursuant to a viatical settlement.<sup>154</sup> These changes will protect terminally ill individuals who choose to sell their life insurance policies in order to maintain a comfortable lifestyle during their final years.

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147. *Id.*

148. For a discussion on the frightening spread and mortality rate of the AIDS virus, see *supra* notes 1-4 and accompanying text.

149. See *supra* notes 30-31 and accompanying text.

150. For a detailed analysis of individual state regulations, see *supra* notes 56-94 and accompanying text.

151. See *supra* notes 56-94 and accompanying text.

152. Minimum discount rates are discussed *supra*, notes 95-108 and accompanying text.

153. See *supra* notes 98-108 and accompanying text.

154. See *supra* notes 132-47 and accompanying text.