



ACCESS FUNDS FROM YOUR LIFE INSURANCE

WHITE PAPER · TAX TREATMENT OF VIATICAL SETTLEMENTS

## Tax-Free Cash from Life Insurance Under Section 101(g)

*A Guide for Tax Professionals and Financial Advisors Working with Seriously Ill Clients*

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### Executive Summary

When a client with a serious or terminal illness sells a life insurance policy on the secondary market, the federal tax treatment of the transaction can produce dramatically different results depending on whether the sale qualifies as a viatical settlement under Internal Revenue Code Section 101(g).

Standard life settlements are taxed in three tiers under the framework of *Rev. Rul. 2009-13* as modified by the Tax Cuts and Jobs Act of 2017 and *Rev. Rul. 2020-05* — with portions taxed as ordinary income and long-term capital gain. By contrast, a qualifying viatical settlement is treated as if it were a death benefit paid by reason of the insured's death, and the proceeds may be excluded entirely from gross income.

For seriously ill clients selling six-figure policies, the after-tax difference frequently runs \$25,000 to \$100,000 or more. For advisors, the practical question is rarely whether the exclusion exists — it is whether the transaction has been structured correctly to capture it. This paper walks through the statutory framework, illustrates the dollar impact through worked examples, and identifies the points at which planning failures most often cost clients the exclusion.

## 1. The Statutory Framework

### Origin and purpose

Section 101(g) was added to the Code by the Health Insurance Portability and Accountability Act of 1996 (HIPAA), effective for amounts received after December 31, 1996. The provision responded to a specific policy concern of the early 1990s: that terminally ill individuals — particularly those facing AIDS-related illnesses at the time — were liquidating life insurance policies under fast-developing viatical settlement arrangements, and the proceeds were being subjected to ordinary tax treatment despite the fact that the seller was, in economic substance, accelerating receipt of a death benefit.

Congress's solution was to treat qualifying viatical settlements as functionally equivalent to death benefits. Under § 101(g)(2)(A), "the amount paid for the sale or assignment" of any portion of a life insurance death benefit to a qualifying viatical settlement provider is treated "as an amount paid under the life insurance contract by reason of the death of such insured" — importing the broad death-benefit exclusion of § 101(a)(1).

### Two qualification paths

The exclusion is available where the insured meets one of two definitions. Both require certification by a licensed medical professional.

- **Terminally ill.** Under § 101(g)(4)(A), an individual is terminally ill if a physician has certified the individual as having an illness or physical condition “which can reasonably be expected to result in death in 24 months or less” after certification. The 24-month standard is the statutory benchmark; certifications referencing this language are the most common documentation path for cancer patients qualifying under the terminal illness category.
- **Chronically ill.** Under § 101(g)(4)(B), cross-referencing § 7702B(c)(2), a chronically ill individual is one certified by a licensed health-care practitioner as either (i) unable to perform at least two activities of daily living — eating, bathing, dressing, transferring, toileting, and continence — without substantial assistance for at least 90 days, or (ii) requiring substantial supervision due to severe cognitive impairment. A care plan must be in place.

There is a meaningful asymmetry between the two paths that advisors should flag early. For terminally ill insureds, the § 101(g) exclusion is **unrestricted**: proceeds may be used for any purpose without affecting the exclusion. For chronically ill insureds, the exclusion is **conditioned on use** — amounts received are only excluded to the extent they are used for qualified long-term care services as defined in § 7702B(c)(1), and subject to per-diem limitations under § 101(g)(3)(D). Many cancer patients with viable terminal-illness certifications should pursue that path rather than the chronic-illness path even when both are technically available.

### Provider licensing requirements

Section 101(g)(2)(B) imposes specific requirements on the *buyer* — the viatical settlement provider — in addition to the requirements on the insured. The provider must be “licensed for such purposes... in the State in which the insured resides.” In states that do not license viatical providers, the provider must comply with sections 8 and 9 of the NAIC Viatical Settlements Model Act and the related Model Regulations (for terminal illness sales), or analogous standards (for chronic illness sales).

Rev. Rul. 2002-82 addresses a critical gap: where a state has enacted a licensing requirement but the provider is not yet licensed under it, the provider is **not** treated as licensed for § 101(g) purposes, and the exclusion is unavailable for sales of policies on insureds residing in that state. This is one of the most common technical traps in the area; the licensing status of the specific buyer in the specific state of the insured’s residence is a threshold question on every transaction.

## 2. The Dollar Impact: Three Worked Examples

The following examples illustrate the after-tax outcomes across three common fact patterns. All examples assume the insured is the original policy owner, premiums paid equal stated cost basis, no policy loans or withdrawals have been taken, and the seller is in the 22% federal ordinary-income bracket with long-term capital gains taxed at 15%. State tax is not included; most states follow the federal Section 101(g) treatment.

### Example A: Universal life policy, terminally ill cancer patient

Insured: 65-year-old with stage IV cancer; physician-certified terminal under the 24-month standard. Policy: \$500,000 universal life, in force 18 years. Cost basis (premiums paid): \$80,000. Cash surrender value: \$50,000. Settlement offer: \$250,000.

	Standard Life Settlement	Viatical Settlement §101(g)
Gross proceeds	\$250,000	\$250,000
Return of basis (tax-free)	\$80,000	\$250,000 (all excluded)
Ordinary income (basis to CSV)	\$0	\$0
Long-term capital gain	\$170,000	\$0
Estimated federal tax	\$25,500	\$0
<b>Net to seller</b>	<b>\$224,500</b>	<b>\$250,000</b>

Section 101(g) preserves **\$25,500** of after-tax proceeds in this scenario — the federal long-term capital gains tax that would otherwise apply to the \$170,000 of gain above basis. The \$50,000 cash surrender value floor is irrelevant under § 101(g) because no ordinary-income layer applies to a fully excluded transaction.

### Example B: Whole life policy, larger transaction

Insured: 72-year-old with advanced metastatic disease; physician-certified terminal. Policy: \$1,500,000 whole life, in force 30 years. Cost basis: \$280,000. Cash surrender value: \$320,000. Settlement offer: \$750,000. Seller is in the 32% bracket; long-term capital gains at 20% plus 3.8% net investment income tax.

	Standard Life Settlement	Viatical Settlement §101(g)
Gross proceeds	\$750,000	\$750,000
Return of basis (tax-free)	\$280,000	\$750,000 (all excluded)
Ordinary income (basis to CSV)	\$40,000	\$0
Long-term capital gain	\$430,000	\$0
Estimated federal tax	\$115,540	\$0
<b>Net to seller</b>	<b>\$634,460</b>	<b>\$750,000</b>

On larger transactions the tax differential scales substantially — here, **\$115,540** of preserved value. For policies originally purchased for estate liquidity that are being sold because the insured's estate now falls below the federal exclusion (\$13.99 million per individual in 2025), this is not a marginal planning consideration; it is the central economic feature of the transaction.

### Example C: Term policy with conversion right, expedited viatical

Insured: 58-year-old with pancreatic cancer; physician-certified terminal. Policy: \$400,000 convertible term, in force 9 years, conversion window still open. Cost basis: \$24,000 in premiums paid (per Rev. Rul. 2020-05, term basis is cumulative premiums). Cash surrender value: \$0. Settlement offer: \$180,000 (after conversion to permanent coverage at closing).

	Standard Life Settlement	Viatical Settlement §101(g)
Gross proceeds	\$180,000	\$180,000

	Standard Life Settlement	Viatical Settlement §101(g)
Return of basis (tax-free)	\$24,000	\$180,000 (all excluded)
Ordinary income	\$0	\$0
Long-term capital gain	\$156,000	\$0
Estimated federal tax	\$23,400	\$0
<b>Net to seller</b>	<b>\$156,600</b>	<b>\$180,000</b>

Two points worth noting on term policies. First, under *Rev. Rul. 2020-05*, basis in a term policy is now treated as cumulative premiums paid, reversing the more restrictive position of *Rev. Rul. 2009-13*. Second, the practical mechanics of converting a term policy to permanent coverage during the viatical sale are time-sensitive and contract-specific — advisors should verify the conversion window and any insurer-imposed restrictions before initiating the transaction.

### 3. Edges, Interactions, and Reporting

#### Interaction with means-tested benefits

Section 101(g)'s income-tax exclusion does not address how proceeds are treated for benefit-eligibility purposes. The same dollars that are not *income* for federal tax purposes are very much *assets* for Medicaid, SSI, and other means-tested programs. For clients receiving or anticipating Medicaid — particularly long-term care Medicaid — unplanned receipt of a six-figure settlement can result in benefits disqualification, transfer-penalty lookbacks, or both. Planning structures (Medicaid-compliant annuities, special needs trusts, irrevocable funeral trusts, properly documented spend-downs) must be established before proceeds arrive. After-the-fact remediation is generally not available.

#### ACA premium tax credits

Section 101(g) exclusion is helpful at the modified adjusted gross income (MAGI) calculation for Affordable Care Act premium tax credit purposes: excluded amounts are not income and therefore do not affect MAGI. This is one area where the chronic illness path, even with its use restriction, can produce a clean ACA outcome that a non-101(g) sale would not.

#### Estate tax considerations

The TCJA-elevated federal estate exclusion (currently \$13.99 million per individual for 2025) means estate tax is no longer the driving consideration for the vast majority of viatical sellers. For ultra-high-net-worth clients with policies held in irrevocable life insurance trusts (ILITs), however, sale mechanics implicate transfer-for-value rules under § 101(a)(2), trustee fiduciary duties, and potential generation-skipping transfer (GST) tax implications. Engage estate counsel before any ILIT-owned policy is sold.

#### Section 6050Y reporting

The TCJA added § 6050Y, which created a new reporting regime for life settlement transactions effective for sales after December 31, 2017. The relevant forms:

- **Form 1099-LS** — filed by the acquirer (buyer) reporting the gross amount paid in any reportable policy sale.

- **Form 1099-SB** — filed by the issuer (insurance company) reporting the seller's investment in the contract and the policy's surrender amount, on notification of the sale.
- **Form 1099-LTC** — used for § 101(g) payments — both accelerated death benefits paid by insurers and amounts paid by viatical settlement providers for sales of policies on terminally or chronically ill insureds.

A transaction qualifying as a viatical settlement under § 101(g) is still a reportable event. Advisors should ensure clients retain all forms received and provide them to the tax preparer; the exclusion is claimed on the return, not effected by absence of reporting.

### State tax treatment

Most states with an income tax conform to the federal treatment of § 101(g) proceeds. A small number maintain rules that may produce different outcomes. State-by-state confirmation is part of any reasonable advisor workup, particularly for clients in states with limited statutory conformity or with viatical-specific licensing schemes.

## 4. Practical Guidance for Advisors

### At intake

Before the client commits to a transaction, three items should be confirmed in writing:

- Physician certification under the relevant § 101(g) standard — terminal under the 24-month benchmark, or chronic under the ADL/cognitive impairment criteria. The certification language matters; generic statements of poor prognosis are not equivalent.
- Provider licensing status in the insured's state of residence, with documentation. Where the state does not license viatical providers, confirm NAIC Model Act/Regulation compliance is documented.
- Coordination with any benefits planning. If the client receives or is positioned to apply for Medicaid, SSI, VA pension, or hospital charity care, that planning should be sequenced before settlement closing, not after.

### Common mistakes that cost the exclusion

- Closing with an unlicensed (or improperly licensed) provider in a state that requires licensing. The Rev. Rul. 2002-82 trap — state enacts licensing, providers not yet licensed — has caught real transactions.
- Pursuing the chronic illness path for a client who could have qualified under the terminal illness path, then using proceeds for non-LTC purposes. The chronic illness exclusion is use-restricted; the terminal illness exclusion is not.
- Treating reporting forms as substantive determinations. A 1099-LS reflects the buyer's reporting obligation, not the seller's ultimate tax treatment. The exclusion is claimed by the seller on the return; absence of a 1099-LTC does not defeat it where the substantive requirements are met.
- Failing to coordinate with policies held in ILITs or other trusts. The trustee is the seller, not the insured; transfer-for-value implications and fiduciary documentation are separate considerations.

### Documentation to retain

For each viatical settlement, the file should include: the physician certification (with explicit language tracking § 101(g)(4)(A) or (B)); the provider's licensing certificate for the insured's state, or documentation of NAIC compliance; the executed sale agreement; all 1099-LS, 1099-SB, and 1099-LTC forms received; and the closing statement showing proceeds, escrow release, and policy ownership transfer date.

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