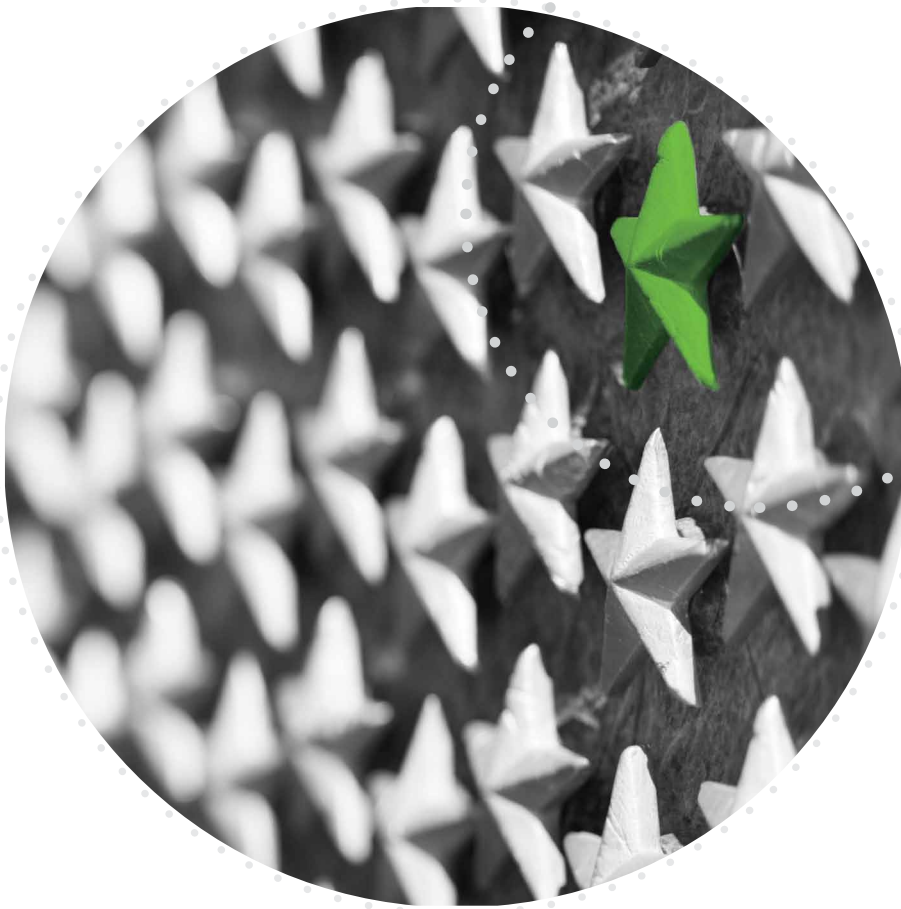




Accelerated Benefits Riders (ABR) Agent Guide



Products issued by

National Life Insurance Company® | Life Insurance Company of the Southwest®

Experience Life®

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Introduction

Life Insurance is a powerful financial tool that can be used to meet many needs. Most importantly, life insurance is used to provide a death benefit to help secure the financial security of your client’s family or business at death. National Life Group addresses more than just the concern of Dying Too Soon however: what about the risk of Becoming Ill?

To help address this need, National Life Insurance Company and Life Insurance Company of the Southwest insurance policies offer Accelerated Benefits Riders (ABR).

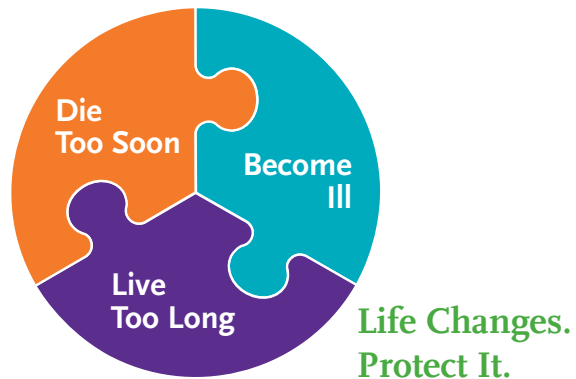
These riders provide the option of receiving a portion of the policy death benefit on a discounted basis, while the insured is still living.

Accelerated Benefits Riders

- Terminal Illness
- Chronic Illness
- Critical Illness

Living Benefits:

Our living benefits story strengthens your business with the ability to help provide your clients with protection from the costs associated with serious illness.



The Accelerated Benefits Riders are optional, may not be available on all products or in all states and may require underwriting. Rider benefits may vary by state.

ABR Quick Reference

Additional Premium Required	No.
Additional Underwriting	We underwrite both Chronic and Critical ABRs when added to the policy. This is typically at issue for individual life contracts and after the first death for survivorship policies.
Restrictions on use of Benefit	No. With the exception of MA.*
Illness Covered	Terminal. Chronic. Critical.
Qualifications	Terminal Illness: 24 month life expectancy (12 months in CT, PA and VT for LSW) (12 months in CT, NY and PA for NL) Chronic: unable to perform 2 out of 6 Activities of Daily Living , or cognitive impairment. Critical: heart attack, stroke, major organ transplant, cancer, blindness, end stage renal failure, ALS.
Activities of Daily Living	Bathing, continence, dressing, eating, toileting, transferring.
Waiting period (refer to ABR section of guide for state specials).	Terminal: No waiting period. Chronic: Waiting period may vary by state, check Chronic Illness section of guide. Typically - policy must be in-force for 24 months before benefits are available. Critical: Waiting period may vary by state, check Critical Illness section of guide. NL–Policy must be in-force for 90 days. LSW–Policy must be in-force for 30 days.
Maximum Lifetime Benefit Per Insured	The maximum lifetime benefit may vary by state. Check ABR Section of Guide. Chronic For NY Only: \$2,000,000 Terminal: \$1,500,000 Chronic: \$1,500,000 Critical: \$1,000,000
Payout	ABR payout limit is based on a discounted value of the death benefit. Refer to the Exercising ABRs section of guide for information on how discounted value is determined.
Maximum Annual Accelerated Benefit per insured/per calendar year IRS per diem limit	Terminal: No annual limit. Chronic: NL - \$120,450 (indexed) for 2014 / LSW - 2% of net death benefit per month, or 24% annually up to the annual limit of \$360,000. Critical: No annual limit.
Product and State Availability	Generally, ABRs are available on all products. ² All ABRs are available in most states. Run illustration for product and state specifics.
Available on policies in qualified plans	All plan types.

* Limitations apply to the use of benefits from Chronic Illness and Critical Illness ABRs in Massachusetts. Refer to the specimen policy forms for the limitations on usage of these benefits.

¹ In Massachusetts, accelerated benefits for Chronic Illness may only be used for Qualified Long-Term Care services which are described as the necessary diagnostic, preventative, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

² Critical Illness not available on ART, NL AssurePlus Protector, NL Estate Provider, NL Ultra Select, or NL Investor Select.

Do you have Living Benefits?



Nicholas, a husband and father of two, suffers a severe heart attack at the age of 54. He uses his critical illness rider. He is able to use this money to cover his medical expenses, and pay off his family's mortgage.¹

Juan and Maria are parents of Antonio, a freshmen entering college. Through policy loans and withdrawals, they are able to access their policy's accumulated value to offset his tuition payments.²



Names and circumstances changed to protect privacy.

¹ Receipt of accelerated benefits will reduce the policy's death benefit and cash value, may result in a taxable event, and may affect your client's, your client's spouse or your client's family eligibility for public assistance programs. Please have your clients consult their personal tax advisor to determine the tax status of any benefits paid under this rider and with social service agencies concerning how receipt of such a payment will affect eligibility for public assistance. Riders are optional, may be subject to underwriting, exclusions and/or limitations and may not be available in all states and on all products.

² Loans and withdrawals will reduce the policy's Cash Value and Death Benefit and may result in a taxable event. Surrender charges may reduce the policy's cash value in early years.



Sophie, at age 79, becomes chronically ill and enters a nursing home. Her chronic illness rider allows her to help pay for her nursing home stay and other medical expenses.³

Isaac's doctor has told him he has less than two years to live. Using the terminal illness rider, he chooses to access his full death benefit to enjoy life to the fullest during his last two years.³



Life events such as these can happen to your clients at anytime, most without warning. With our ABRs, your clients decide how and when to use their benefits.

Names and circumstances changed to protect privacy.

³ The uses of ABR benefits are not limited with the exception that ABR proceeds for chronic illness in the state of Massachusetts can only be used to pay for expenses incurred for Qualified Long-Term Care services.

Qualified Long-Term Care services: the necessary diagnostic, preventative, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Accelerated Benefits Riders (ABR)

The Accelerated Benefits Riders are no additional cost riders that can be added to most National Life Insurance Company (NLIC) and Life Insurance Company of the Southwest (LSW) life insurance policies to help protect the insured from the potential financial devastation of a Terminal, Chronic or Critical Illness.

ABRs may be added either at, or after issue. ABRs added after issue may be subject to additional underwriting.

Always view the National Life Group Illustration System, or go to www.NationalLifeGroup.com to check for state and product availability.

Using the Accelerated Benefits Riders

The cost of treating a serious illness could be financially devastating. Depending on the amount of care needed, a spouse or child may need to work reduced hours – or even stop working altogether – in order to provide care. ABR benefits could be used to reimburse them for loss of income.

There is no restriction placed on the use of the benefits received, with the exception of Chronic and Critical Illness ABRs in Massachusetts. Benefits could be used for anything, such as:

- Making structural changes to a home to accommodate the illness
- Compensating a non-licensed care provider
- Travel, business, or everyday expenses

The amount of Accelerated Benefits available is based on a discounted death benefit amount (not the face value of the policy). The benefit is available up to a maximum lifetime limit, which applies to all policies under a single insured.

An illustration of the discounted death benefit amount given various assumptions can be found through the National Life Group Illustration System.

Take Note

The principle purpose for purchasing life insurance is to provide a benefit upon the death of the insured. ABRs are intended to be marketed as a supplemental benefit. Utilizing ABR benefits reduces the amount of death benefit available under the policy.

Receipt of ABR benefits is based on a completed application for benefits and documentation of the Terminal, Chronic or Critical Illness that we believe supports the requirements for the benefits set forth in the ABR.

Terminal Illness ABR

The Accelerated Benefits Rider for Terminal Illness accelerates the death benefit, on a discounted basis for a Terminal Illness.

An Insured has a Terminal Illness if they have been diagnosed and are suffering from a Terminal Illness that will result in death within 24 months of certification of the terminal illness by a physician.

There is no waiting period for benefits paid under the Terminal Illness Rider.

Benefit Limits:

National Life Insurance Company, or Life Insurance Company of the Southwest, will accelerate the discounted death benefit, not to exceed a maximum amount of \$1,500,000 under all contracts and all ABRs made over the entire lifetime of the insured.

There is no annual limit and the benefit is received as a lump sum.

Refer to exceptions and state specials below.

NL Terminal Illness

An insured must be diagnosed with a Terminal Illness expected to result in death within 12 months of certification of the terminal illness by a physician in: CT, NY and PA.

The benefit is limited to \$500,000 in IL and NJ.

LSW Terminal Illness

The insured must be diagnosed with a Terminal Illness expected to result in death within 12 months of certification of the terminal illness by a physician in: CT, PA and VT.

The benefit is limited to \$500,000 in IL and NJ.

Chronic Illness ABR

The Accelerated Benefits Rider for Chronic Illness accelerates the death benefit, on a discounted basis for a Chronic Illness.

An insured has a Chronic Illness if they have been certified, within the past 12 months, by a licensed health care practitioner, as being unable to perform, without substantial assistance, at least 2 out of 6 activities of daily living (ADLs) for a period of at least 90 consecutive days due to a loss of functional capacity, or requires substantial supervision to protect oneself from threats to health and safety due to severe cognitive impairment for this same period of time.

You will note the insured does not have to be in a licensed facility to receive payment. This is not a reimbursement plan or a disability policy. Once eligibility has been determined, benefit payments are made directly to the policy owner and the policy owner can apply for benefits every 12 months.

Benefit Limits:

National Life Insurance Company or Life Insurance Company of the Southwest will accelerate the discounted death benefit, not to exceed a maximum amount of \$1,500,000 under all contracts and all ABRs made over the entire lifetime of the Insured.

The annual IRS per diem limit that can be accelerated is \$120,450 (indexed) for 2014. This amount may change annually.

Refer to exceptions and state specials below.

Activities of Daily Living (ADLs) – Defined

1. Bathing: ability to wash oneself on a routine basis by sponge bath or in a tub or shower including getting into and out of a tub or shower.
2. Continence: ability to maintain control of bowel or bladder function or, when unable to maintain control, the ability to perform associated personal hygiene, including caring for catheter or colostomy bag.

3. Dressing: putting on or taking off all items of clothing and any necessary braces, fasteners or artificial limbs.
4. Eating: feeding oneself from a plate, cup or table or by feeding tube or intravenously.
5. Toileting: getting to and from the toilet, off and on the toilet and performing associated person hygiene.
6. Transferring: moving in or out of a bed, chair or wheelchair.

Substantial supervision means hands-on assistance or stand-by assistance.

Cognitive impairment is defined as deterioration or loss in intellectual capacity measured by clinical evidence and standardized tests which judge the areas of memory, orientation and reasoning.

NL Chronic Illness

The policy needs to be in force for two years in order to accelerate.

- 30 days in CT, IL, MA, MI, NC, OH, OK, OR, VA.
- Limitation doesn't apply in NJ, NY, PA, KS, LA, MD, MN, UT, or WA.
- NY: see Chronic II for NY.

The benefit can be received as a lump sum if desired (up to the IRS per diem limit). The benefit is limited to \$500,000 in IL and NJ.

LSW Chronic Illness

The discounted death benefit is calculated as 2% of the net death benefit each month or 24% annually, up to the annual limit of \$360,000.

The rider needs to be in force for two years in order to accelerate:

- 30 days in CT, NC, OK and TX.
- Limitation doesn't apply in AR, IL, NJ, TN, VA, KS, LA, MD, MN, UT, WA and PA

Rider not available in NY.

Massachusetts: Chronic Illness

Benefits for Chronic Illness in MA may only be used for Qualified Long-Term Care services which are described as the necessary diagnostic, preventative, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill insured and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

New York: ABR Chronic II*

The ABR Chronic II Rider for the state of New York functions similarly to our standard Chronic Illness Rider with a few exceptions:

- There is no waiting period for this benefit.
- Maximum Lifetime Benefit of \$2,000,000.
- In addition to the inability to perform 2 out of 6 ADLs, a life expectancy calculation must be completed at the time of acceleration.
- Offers a guaranteed paid-up option on any death benefit not accelerated.
- A policy owner can only receive benefits once a year. If a policy owner accelerates benefits, they must wait 12 months to accelerate benefits again.

Once paid up, the policy may not be changed back to premium paying. If the policy owner elects to pay up the policy, all monthly deductions will cease and the following transactions will not be permitted: premiums, loans, face amount changes and option changes. Withdrawals and accelerations will be permitted. Election to convert remaining death benefit to a paid-up status will reduce the amount of the accelerated benefit.

* The ABR Chronic II Accelerated Benefits is part of a life insurance policy with a rider that accelerates the death benefit on the account of chronic illness and is not a health insurance policy providing long-term care insurance subject to the minimum requirements by New York Law, does not qualify for the New York State Long-Term Care Partnership program and is not a Medicare supplement policy.

Critical Illness ABR

The Accelerated Benefits Rider for Critical Illness accelerates the death benefit, on a discounted basis for a Critical Illness.

An insured qualifies under the Critical Illness ABR for:

- Heart attack
- Stroke
- Major organ transplant
- Diagnosed with cancer
- End stage renal failure (kidney failure)
- ALS (Lou Gehrig's disease)
- Blindness

When determining the discounted death benefit, the mortality factor will have four different categories dependent on the severity of the Critical Illness as determined by NLIC or LSW, as applicable:

- Minor
- Moderate
- Severe
- Life Threatening

The highest payout will result from the Life Threatening category.

Benefit Limits:

For Critical Illness NLIC or LSW, as applicable, will accelerate (or convert to reduced paid-up insurance), income tax-free, the discounted death benefit, not to exceed a maximum amount of \$1,000,000 under all contracts made over the entire lifetime of the insured.

There is no annual limit.

Refer to exceptions and state specials below.

NL Critical Illness

No benefit will be paid for a qualifying event that directly results from self-inflicted injury or attempted suicide.

The ABR needs to be in force for 90 days prior to the insured experiencing or being diagnosed with the qualifying event in order to accelerate, unless resulting from an accidental injury:

- 30-day waiting period and no limitation on self-inflicted injury or attempted suicide in: AL, IN, MA, MD, MI, NC, OK, UT, VA, and WA.
- 30-day waiting period and a two-year limitation on self-inflicted injury or attempted suicide: OH, and OR.
- No waiting period and no coverage on self-inflicted injury or attempted suicide: NY, PA, SC, and TX.

The benefit is received as a lump sum.

The benefit is limited to \$500,000 in IL and NJ.

Lou Gehrig's Disease (ALS) is not a qualifier in IL.

Blindness is not a qualifier in MD and VA.

Rider not available in CT.

New Jersey and Illinois: If insured is eligible for ABR Critical in NJ or IL, they will be issued a compact version which includes both Critical and Terminal illness ABR. If the insured is not eligible for critical, they will be issued the Terminal Illness ABR only.

LSW Critical Illness

The rider needs to be in force 30 days prior to the insured experiencing or being diagnosed with the qualifying event in order to accelerate. There is no waiting period if the qualifying event directly results from accidental injury, self-inflicted injury or attempted suicide.

- Two year waiting period if the qualifying event directly results from self-inflicted injury or attempted suicide in: OR.
- No waiting period, but no coverage if the qualifying event directly results from self-inflicted injury or attempted suicide in PA, SC, and TX.

The benefit is paid as a lump sum.

Rider not available in CT and NY.

New Jersey: If insured is eligible for ABR Critical in NJ, they will be issued a compact version which includes both Critical and Terminal illness ABR. If the insured is not eligible for critical, they will be issued the Terminal Illness ABR only.

Massachusetts: Critical Illness

The Critical Illness ABR in the state of Massachusetts has some specific differences.

There is no waiting period in MA, but there is a two-year waiting period if the qualifying event directly results from self-inflicted injury or attempted suicide.

The qualifying conditions in MA are as follows:

1. Coronary artery disease resulting in acute infarction or requiring surgery
2. End-stage renal disease
3. Major organ transplant
4. Permanent neurological deficit resulting from cerebral vascular accident
5. Diagnosis of an invasive malignancy characterized by uncontrolled growth and spread of malignant cells and the invasion of tissue. Cancer does not include:
 - a) Stage A prostate cancer
 - b) Any skin cancer, except invasive malignant melanoma into the dermis or deeper
 - c) Pre-malignant lesions, benign tumors or polyps
 - d) Carcinoma in-situ

ABR Availability

Product Availability

For second-to-die policies all ABRs are not available until after the first death, subject to underwriting and state availability.

Check rider availability for each product you are considering through the National Life Group Illustration System or online at www.NationalLifeGroup.com

There are state special limitations on the availability of all ABR's depending on the amount of coverage the insured has on existing policies with us. Please contact the home office for details.

	TERMINAL	CHRONIC	CHRONIC FOR NY	CRITICAL
FIXED UL				
LSW Foundation	✓	✓	NO	✓
LSW Harbor	✓	✓	NO	✓
LSW Horizon	✓	✓	NO	✓
LSW IncomeBuilder	✓	✓	NO	✓
NL AssurePlus Protector	✓	✓	✓	NO
NL Estate Provider	✓*	✓*	NO	NO
INDEXED UL				
NL FlexLife	✓	✓	✓	✓
LSW FlexLife	✓	✓	NO	✓
LSW SecurePlus Provider	✓	✓	NO	✓
NL LifeCycle Solution	✓*	✓*	✓*	✓*
LSW LifeCycle Solution	✓*	✓*	NO	✓*
NL Ultra Select	✓	✓	✓	NO
LSW SecurePlus Advantage 79	✓	✓	NO	✓
VUL				
NL Investor Select	✓	✓	NO	NO
WHOLE LIFE				
LSW ProtectorLife	✓	✓	NO	✓
NL LifeBuilder	✓	✓	✓	✓
NL LifeBuilder 1	✓	✓	✓	✓
NL ValuGuard	✓*	✓*	✓*	✓*
TERM LIFE				
NL ART	✓	✓	✓	NO
NL L Series	✓	✓	✓	✓
NL GL Series	✓	✓	✓	✓
LSW Term	✓	✓	NO	✓

* Available after first death - Subject to underwriting.

Underwriting

Underwriting for ABRs usually happens at the same time as the policy is being underwritten. For ABRs not added at issue, conversions, and survivorship policies, the ABRs are underwritten at the time that the riders are added to the policy.

For Survivorship policies, ABRs are only available after the first death, subject to underwriting.

Converting Term to Permanent

Conversion of Term policies to Permanent policies is a contractual right. The conversion of any ABRs on the Term policy is not a contractual right. Although our current practice is to convert the ABRs, it is up to the discretion of the company.

Qualifying Under Multiple ABRs

If the insured qualifies under more than one ABR, the policy owner has the option to choose which one to accelerate.

For instance, if the insured qualifies under Chronic Illness and Terminal Illness riders, the policy owner may want to elect Terminal because it would pay a higher benefit in a lump sum.

For LSW, benefits are not available under Chronic Illness if the insured is eligible for any other ABR.

If the policy owner were to elect Chronic Illness benefits, and a year later the insured were to qualify for Terminal Illness benefits, the policy owner would be able to accelerate the rest of their death benefit up to the maximum lifetime benefit. All previous payments under the Chronic Illness would count towards the Terminal Illness maximum lifetime benefit.

Exercising ABRs

Submitting a Claim

The policy owner can submit an ABR claim directly or through the policy owner's NLIC or LSW insurance agent, as applicable.

To report an Accelerated Benefit Rider claim call Customer Relations at **800-732-8939**, or send an email to the claims department at **claims@NationalLifeGroup.com**

Advise the Claims Department of the following:

- Name of insured
- Policy number
- Nature of the illness or injury of the insured
- Onset date of the illness or injury
- Advise which ABR Rider: Terminal, Chronic or Critical

It is important to note that NLIC and LSW reserve the right to have the insured examined by a physician of its choice to affirm the qualifying condition, if necessary.

Once claim forms and medical records are received and an opinion is provided by NLIC's or LSW's Medical Director, the claims examiner will determine whether the insured qualifies for the benefits for which the policy owner applied.

In the event of a Critical Illness, the claims examiner will consult with NLIC's or LSW's Medical Director to categorize the affect of the qualifying event on the insured's future mortality.

Discounting: How ABR Benefit Payments are Calculated

When an ABR benefit is elected, the actual benefit received is based on a calculation that discounts the death benefit.

The discounting calculation reflects the "Present Value" of the policy's death benefit and remaining premiums owed under the policy.

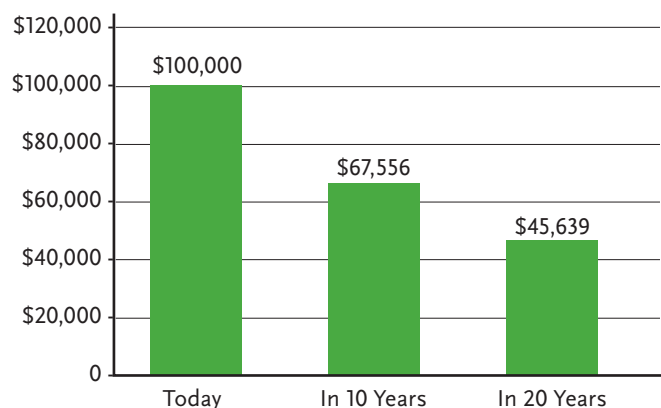
Present Value Concept

How much would you have to invest today to receive \$100,000 at some point in the future? That depends on when the money will be received and the interest rate.

For example, let's look at the present values of \$100,000 received 20 years from now, 10 years from now, or today. These calculations use an interest rate of 4%. The actual interest rate earned on any particular investment will vary:

- If the money is going to be received today, it's worth \$100,000 today.
- However, if it will be received ten years from now, it's worth less than \$100,000 today.
- The graph shows that you would need to invest \$67,556 today to accumulate to \$100,000 in ten years, assuming an interest rate of 4%.
- This is known as the present value concept.

Present Value of \$100,000 to be Received



Calculating ABR Benefit Amount

Calculating the ABR benefit amount involves several things including: the death benefit, mortality, premiums, cash value, any loans on the policy and applicable charges.

1. Death Benefit

The first step is to determine the present value of the policy's death benefit. This is similar to the example above which calculated the present value of \$100,000 to be received at some point in the future. However, a death benefit isn't received at a fixed point in the future.

The point at which the death benefit is received depends on the mortality of the insured.

High mortality means the money is likely to be received sooner than later and so it has a higher present value than low mortality. Because mortality generally increases with age, the present value of the death benefit also tends to increase with age.

2. Premiums

The next step is to calculate the remaining premiums that are due on the policy (if any), for company reimbursement on their "present value".

The calculation is different depending on whether the policy is Whole Life, Universal Life or Term.

After finding the future value of required premiums, the ABR benefit amount is calculated, generally as:

3. Subtract the present value of premiums from the present value of the death benefit.

4. An administrative fee is then assessed and subtracted. The fee varies by state.

5. Subtract any loans or debt on the policy.

Calculation Recap

$$\begin{array}{r} \text{Present value of death benefit} \\ - \text{Present value of remaining premiums} \\ \quad - \text{Fees and loans} \\ \hline = \text{ABR Benefit} \end{array}$$

Life Expectancy vs. Present Value of Death Benefit

The higher the mortality, the higher the present value of the death benefit will be. This is why terminal illness has the highest benefit amount.

Premiums Paid vs. Present Value of Required Premiums

On flexible premium products, the more well-funded a policy is, the less premiums will be due in the future, which will result in a higher ABR payout.

Full Acceleration - What Happens To My Policy?

If a full, lump sum benefit is elected; the death benefit will be fully accelerated, the discounted death benefit will be paid to the policy owner, and the policy will terminate.

Partial Accelerations:

All three ABRs are eligible for partial acceleration.

A partial acceleration is an option for a policy owner who wants to receive part of their ABR benefit while still maintaining a death benefit.

If a partial acceleration is requested, it will follow the same guideline as a full acceleration with some differences. The partial percentage of the full amount requested will be reduced from the original death benefit, as well as the discounted benefit.

For instance, assume the policy has a \$500,000 death benefit. The policy owner needs to accelerate their death benefit to pay for medical bills, but only wants to accelerate half and still maintain a death benefit.

To illustrate this concept, assume after the discounting calculation, the full ABR benefit is \$400,000. The policy owner would receive 50% of that, or \$200,000.

The policy death benefit would also be reduced by 50%, or \$250,000.

The policy owner would receive a \$200,000 ABR benefit, and a \$250,000 death benefit would still be available under the policy.

Examples

Full Acceleration – Terminal and Critical

Death Benefit:	\$500,000
ABR Benefit after Discounting:	\$400,000
Payment to client is:	\$400,000

Lump Sum – Policy Terminates

Partial Acceleration – Terminal and Critical

Death Benefit:	\$500,000
Client wants to accelerate:	50%
Full ABR Benefit after Discounting:	\$400,000
ABR Benefit Received for 50% Acceleration:	\$200,000
Policy Reduced by 50% of original policy value:	\$250,000

Remaining Death Benefit: \$250,000

Partial Acceleration – Chronic

Death Benefit:	\$500,000
Gross Death Benefit at 24% partial acceleration:	\$120,000 (\$500,000 x .24)
Discounted Value of \$120,000 of the Death Benefit:	\$96,000
Benefit Payment:	\$96,000

**Remaining Death Benefit: \$380,000
(\$500,000 – \$120,000)**

Federal Income Taxation of Accelerated Benefit Riders

Since the Health Insurance Portability and Accountability ACT (HIPAA) was signed into law on August 21, 1996, increasing numbers of health-related insurance products and riders have appeared in the marketplace. This in turn has generated widespread confusion as to their income tax treatment.

Federal Income Tax Treatment for ABR Terminal and Chronic Illness

Section 101(a)(1) of the Internal Revenue Code (the “Code”) – the authority for the income tax-free treatment of life insurance death benefits – states this general rule: “gross 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.” Section 101(g)(1)(a) of the Code sets forth another general rule: that any amount received as accelerated death benefits under a terminal illness ABR rider “shall be treated as an amount paid by reason of the death of the insured.” This means that accelerated death benefits for terminal illness are generally treated as having the same income tax exclusion as is accorded to benefits paid at the actual death of the insured.

Exceptions

Of course it would not be the Internal Revenue Code if there were not exceptions. The first exception is where the policy has been transferred for a valuable consideration (the Transfer for Value Rule) and none of the exemptions provided in Section 101(a)(2) are applicable. In other words, if the death benefits would have been taxable at the death of the insured, then amounts received under ABR Terminal Illness while the insured is still alive will be subject to the same treatment.

Example

Assume that Wilma is the original and current owner and beneficiary of a \$500,000 term life insurance policy on Fred. If Fred becomes terminally ill, Wilma can exercise the ABR Terminal Illness Rider and receive income-tax free benefits. If Wilma has previously gifted the policy to Pebbles, and Pebbles becomes the owner and beneficiary, then Pebbles can exercise the rider and receive income tax-free benefits. However, if Wilma sold the policy to Pebbles for its fair market value three years earlier, that would constitute a transfer for a valuable consideration, and all death benefits (accelerated or otherwise) received by Pebbles, less what she paid for the policy (sale price plus ongoing premiums) would be includible in her income.

Section 101(g)(5) creates another exception for business-related policies.

“This subsection shall not apply in the case of any amount paid to any taxpayer other than the insured if **such taxpayer has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee of the taxpayer or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.**”

“This subsection” refers to subsection (g) of Section 101; subsection (g) contains the language that enables ABR benefits to enjoy an income tax exclusion. Thus, the effect of this provision is to make the accelerated benefits includible in the beneficiary’s income.

Example

Mavis Frisbee is the Managing Partner and chief rainmaker of Ben, Jarvis, Green & Ellis, PC, a very successful mid-sized Boston law firm. The firm has purchased a \$2 million key person insurance policy on Mavis, and is the owner and beneficiary. Assuming that the firm has complied with the Employer-Owned Life Insurance rules (including the annual filing of IRS Form 8925), if Mavis dies the firm will collect \$2 million of life insurance death benefits income tax-free. However, there will be a different result if Mavis becomes terminally or chronically ill: **because the firm’s insurable interest in Mavis is based on her being an employee of the firm, exercise of ABR Terminal or Chronic Illness will NOT allow the firm to exclude the accelerated benefits from income.**

Example

A-Rod and K-Rod, well-known professional athletes, are business partners in a thriving chain of bowling alleys. They enter into a cross-purchase buy-sell agreement, with each owning a \$5 million life insurance contract on the other. If K-Rod becomes terminally or chronically ill, A-Rod would not be able to collect income tax-free accelerated benefits under ABR Terminal or Chronic, **because A-Rod’s insurable interest in K-Rod is based on the insured (K-Rod) being financially interested in a trade or business carried on by the taxpayer (A-Rod).**

On the other hand, A-Rod could potentially transfer the contract to K-Rod, using its fair market value as a partial payment for K-Rod’s ownership interest in the business.¹ K-Rod could then exercise the rider and receive income tax-free benefits.

Special Rules for ABR Chronic

To qualify for the income tax exclusion, accelerated benefits riders must comply with a variety of rules, most of which are referenced or contained in Code Sections 101 and 7702B. These include requirements that benefits paid under the riders must be either:

1. For costs incurred by the recipient for qualified long-term care services provided to the insured and not compensated for by insurance or otherwise, or
2. Made on a per diem or other periodic basis within limitations established by the Internal Revenue Service.

Payments made under ABR Chronic attached to a **National Life Insurance Company policy** are limited by the per diem amounts described in (2) above, as well as by the discounted death benefits payable under the rider, and thus should generally qualify for the income tax exclusion.

Payments made under ABR Chronic attached to a **Life Insurance Company of the Southwest policy** are limited to a maximum of 2% of the discounted death benefit payable monthly. If these amounts exceed the per diem limit described above, they enjoy an income tax exclusion only to the extent that they reimburse the recipient for costs described in (1) above.

¹ To the extent that the fair market value of the policy exceeds cost basis, A-Rod may have to recognize the gain.

Federal Income Tax Treatment for ABR Critical Illness

The tax treatment of accelerated benefits for Critical Illness is somewhat less clear and significantly more complicated than the treatment of benefits for terminal or chronic illness. Since neither Section 101 nor 7702B make any mention of critical illness benefits, we have to look in other areas of the Code to find answers.

The only pronouncements we have to date on this issue are four Private Letter Rulings issued by the IRS since the turn of the 21st century. And while PLRs cannot be relied on by anyone other than the recipient as authority, they can provide a strong indication of how the IRS regards an issue and what position it would take on the subject. In this line of PLRs, the IRS' reasoning has been very consistent.

PLR 200339015 and **200339016** are virtually identical, having been written on the same day by the same IRS technical reviewer. In each case, a Critical Illness Rider was attached to a universal life policy and paid for by extra charges imposed against the policy cash value. In these cases, the Critical Illness benefit did NOT represent an acceleration of death benefits, and would not reduce the death benefit paid under the base policy. The Riders did not have any cash value.

In **PLR 200627014**, a Critical Illness Rider was attached to a term contract. The Rider would pay a lump sum of up to \$250,000 (reduced by 50% at age 65) in the event the insured suffered from any one or more of a list of critical illnesses. Again, the Rider had no Cash Value. In this case, the term policy death benefit WOULD be reduced by any benefits paid under the Rider.

Most recently (2009) the Service issued **PLR 200903001** in response to a ruling request submitted by an insurance carrier. In this case, a Critical Illness Rider was to be attached to an "individual, non-participating, flexible premium adjustable life insurance policy." The Rider, which has no cash value, pays a benefit if the insured is diagnosed by a physician as having a qualifying covered condition; any benefit paid reduces the death benefit under the base policy, which terminates if the death benefit is reduced to zero.

Among the more significant representations made by the carrier were the following:

"Taxpayer represents that the Contract and Rider are purchased with after-tax monies, i.e., no premiums are deductible by the owner or attributable to contributions by an employer of an owner which were not includible in the gross income of the owner. Thus, **the Contract and Rider are purchased solely with the owner's after-tax funds.**"

In each of these cases, the Service Ruled that the Critical Illness **benefits would be received income tax-free**, and in all cases virtually the same legal analysis was applied: **the coverage provided by the Critical Illness Rider is treated as accident or health insurance under Code Section 104(a)(3).**

Under Section 104(a)(3) gross income does not include "**amounts received through accident or health insurance** (or through an arrangement having the effect of accident or health insurance) **for personal injuries or sickness,**" so long as these amounts received are

- NOT attributable to contributions by the insured's employer which were not includible in the employee's gross income, or
- NOT received directly from the employer

Both of the 2003 PLRs as well as the 2006 ruling also point to Section 105 of the Code. Section 105(b) provides an income tax exclusion for benefits received for personal injuries or sickness under accident or health insurance plans, to the extent that the insured does not take medical expense deductions for expenses covered by the insurance benefits. Section 105(c) provides an exclusion for amounts received as compensation "for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement" of the insured, so long as the benefits are computed based on the nature of the condition and not on the period of absence from work. The exclusions under subsections (b) and (c) are available regardless of whether the insurance was paid for in whole or in part by employer contributions that were not includible in the employee's income.

Example

Mavis owns a life insurance contract on her own life on which she pays premiums with her own after-tax dollars. If she receives accelerated benefits for Critical Illness, they should be income tax-free.

Example

Mavis owns the same life insurance contract on her own life on which her employer pays premiums under an Executive Bonus Plan. Because the premiums are includible in her income, any Critical Illness accelerated benefits she receives under the contract should be income tax-free.

Example

The law firm still owns that \$2 million key person contract on Mavis (see above). When Mavis suffers a heart attack, the firm accelerates benefits under ABR Critical and pays them directly to Mavis **to reimburse her for medical expenses**. Since the premiums were not includible in her gross income, AND since she's receiving the benefits from her employer anyway, Section 104(a)(3) would appear to require the amounts she receives to be includible in her income. **However, the exclusion appears to be saved by Section 105(b), so long as the amounts received by Mavis are limited to reimbursements for medical expenses paid by her for which she has not claimed income tax deductions.**

Although there is no specific rule about business-related policies in connection with Critical Illness accelerated benefits, **it is likely that the firm must include the accelerated benefits in its income**, since the law seems to be written with an intent to compensate insureds for injuries or sickness. The firm should receive an offsetting deduction under Section 162 (ordinary and necessary business expenses) for the amounts paid to reimburse Mavis for her medical expenses.

Example

The firm decides to set up a Section 79 plan in which Mavis is a participant. Mavis has her heart attack during the five-year funding period when the policy is still connected with the plan. It is unclear whether or not the ABR Critical benefits are "attributable to contributions by the employer which were not includible in the employee's gross income," since Mavis had to include in gross income the value of both the insurance protection and the permanent benefit. On the other hand, the amount she had to include was less than the amount the firm contributed. Even if all or part of the benefits are deemed to be attributable to employer contributions that were not included in her income, so long as the benefits are limited to an amount necessary to reimburse her for nondeductible medical expenses they should be received income tax-free.

Bottom Line

It appears as though, in most cases, accelerated benefits received under an ABR Critical Illness Rider will be treated as amounts received under accident or health insurance, and thus will not be included in the recipient's taxable income. However, where the recipient of the accelerated benefits is anyone other than the insured or a person with respect to whom the insured is a spouse or legal dependent, there is substantial doubt as to whether the benefits will be entitled to an income tax exclusion.

Example: Back to A-Rod and K-Rod (see above). K-Rod develops a critical illness, and A-Rod wants him out. If A-Rod accelerates benefits under ABR Critical Illness, it is likely that the benefits will be includible in A-Rod's income, since the law seems to be written with an intent to compensate insureds for injuries or sickness – not to fund business buyouts.

As described earlier, A-Rod could potentially transfer the contract to K-Rod, using its fair market value as a partial payment for K-Rod's ownership interest in the business. K-Rod could then exercise the rider and receive income tax-free benefits.

Life Insurance in Qualified Retirement Plans

Accelerated Benefit Riders may be added to life insurance contracts in a Profit Sharing Plan. However, there is substantial uncertainty as to the federal income tax treatment of distributions under any of the ABRs.

- In the case of a permanent policy with cash value, distributions under ABR Terminal or Chronic could be characterized as a pro rata distribution of death benefit and cash value. To the extent the cash value portion exceeded the participant's cost basis, that portion could then be taxable. And if the participant were an unincorporated business owner, there would be no offset for cost basis in the contract.
- In the same situation, distributions under ABR Critical might be treated differently: although the carrier treats these amounts as accelerated death benefits, the IRS appears to treat these distributions as amounts received under accident or health insurance. Of course, the same uncertainty arises if the acceleration results in a reduction of cash value; AND it would appear that the distributions would have to be limited to reimbursements for related medical expenses anyway to retain the income tax exclusion, if it were otherwise available.

- The bigger question that arises is whether under the plan provisions there is even a distributable event: Typically, a distributable event would include death, total and permanent disability, separation from service, or plan termination.

For these reasons, the more predictable approach would be to distribute the policy to the participant – assuming a distributable event has occurred – and have the participant accelerate benefits after it has become an individually owned policy.

Example

The firm has had a qualified Profit Sharing Plan in place for many years. Mavis has elected to use some of her account balance to purchase a life insurance policy. When Mavis suffers her heart attack – assuming it triggers a distributable event – the plan trustee distributes the policy to Mavis. Although she must include in income the fair market value of the policy in excess of her basis in the policy (cumulative taxable term costs), when she exercises ABR Critical the benefits should be income tax-free, at least to the extent that they reimburse her for related expenses for which she does not take a medical expense deduction.

Practical Considerations – Federal Income Tax Reporting

From a practical standpoint, the IRS requires insurance carriers to report ABR Chronic and Terminal accelerated benefits on a Form 1099-LTC. Although the guidance is not crystal clear on this point, National Life Group carriers will report ABR Critical accelerated benefits on a Form 1099-R. Note that the form contains no place for the carrier to indicate whether these distributions are taxable or not. **It is the responsibility of individual or business taxpayers (typically policy owners and beneficiaries) to consult their professional tax and legal advisors and report accordingly on their tax returns.**

In those situations where an employer is the policy owner and uses accelerated benefits to reimburse the insured employee for qualifying expenses, the carrier reports with respect to the employer and the employer must report with respect to distributions it makes to the employee.

Income Taxation of Premiums

The National Life Group ABR Riders do not require premium payments. Thus, there are no issues regarding either the deductibility of premiums by the premium payor or the inclusion of premium amounts by the policy owner.

Summary

Most benefits received under **ABR Terminal or Chronic** should be income tax-free, provided that:

- Death benefits under the contract would have been received income tax-free in the event of the death of the insured, and
- The recipient of the benefits has an insurable interest in the insured that is NOT based primarily on a business relationship.

Most benefits received under **ABR Critical** should be income tax-free, provided that:

- They are received by the insured, or by a person with respect to whom the insured is a spouse or legal dependent, as beneficiary.

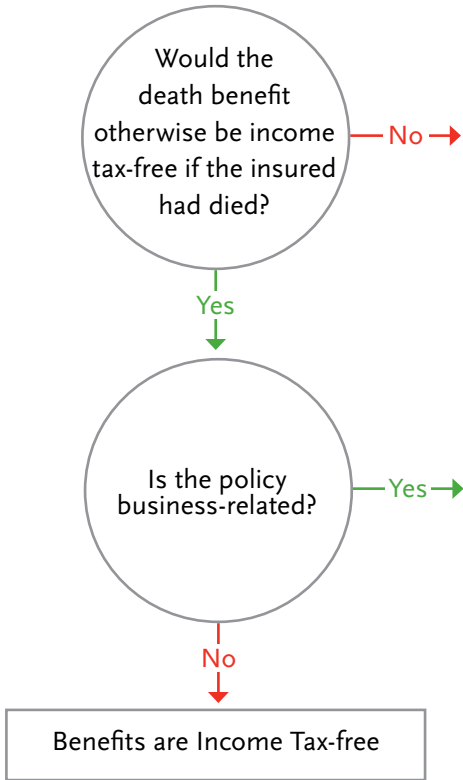
However, the income tax exclusion is limited to amounts necessary to reimburse the insured for expenses paid by the insured and not deducted as medical expenses, if:

- The policy premiums were paid by the insured's employer and not includible in income by the insured, or
- The benefits are received by the insured directly from the employer.

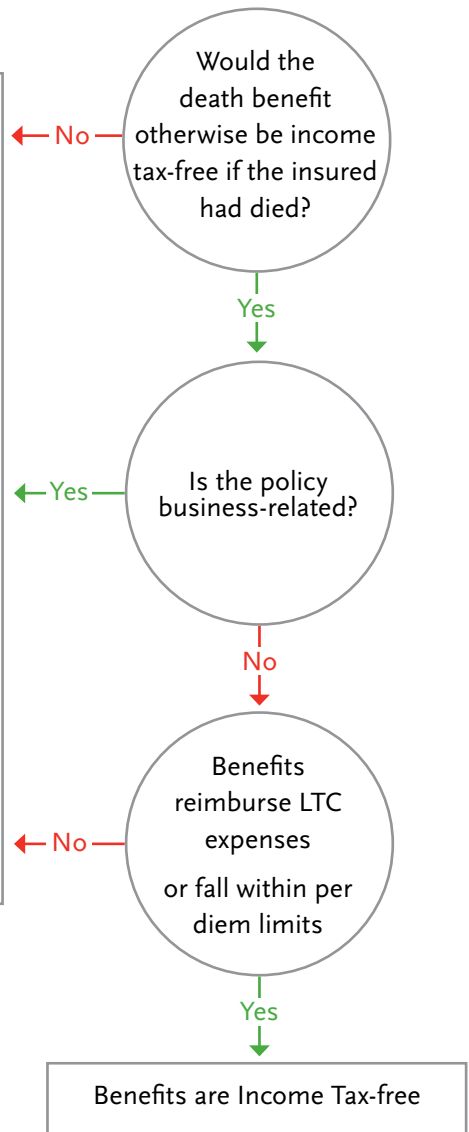
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² NL Group carriers are in the process of reviewing this practice to determine whether ABR Critical benefits are more properly reported on a 1099-R

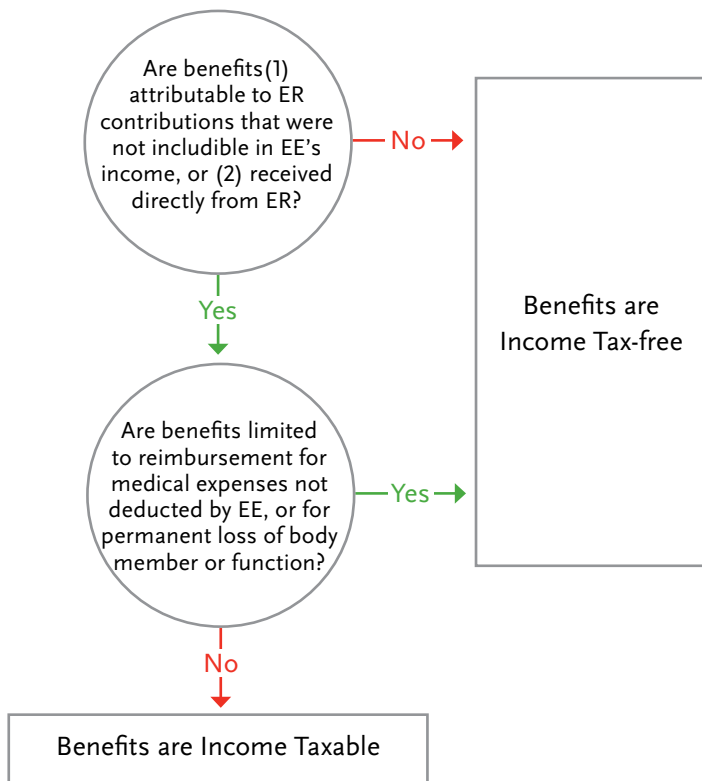
ABR Terminal Illness



ABR Chronic Illness



ABR Critical Illness

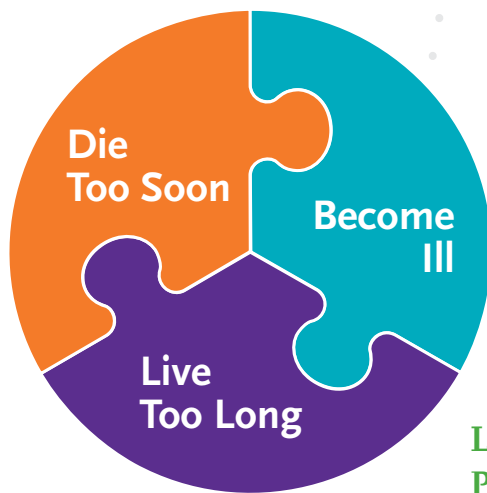


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Call the National Life Group Sales Desk: 1-800-906-3310

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