An Agent’s Guide to Understanding Life Insurance
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I. IRS Life Insurance Tests

In order for policy death benefits to be taxed as Life Insurance it must pass one of two tests: GPT or CVAT. The choice of tests is made at issue and once chosen it cannot be changed. A policy must pass the test for the lifetime of the contract.

In order for lifetime policy distributions to receive favorable tax treatment the policy must pass the 7-Pay Test.

A. Guideline Premium and Corridor Test (GPT)

- The Guideline Premium Test defines the maximum premium allowed by law for the particular scenario.
  - The test employs the greater of the [Guideline Single Premium (GSP)] or [Guideline Level Premium (GLP) x # years]
  - Total Premiums Paid \( n \) ≤ [greater of GSP or ( \( n \times GLP\)]
  - Example: Client plans to pay $5,000 annual premium and the GSP is $50,000 and the GLP is $4,000. The following are the maximum premiums allowed for yrs 11-15 ($5,000 premiums for 10 yrs = $50,000 accumulated premiums thru yr 10):
    
    Yr 11: $0 (GSP=$50,000, GLP=$44,000)
    Yr 12: $0 (GSP=$50,000, GLP=$48,000)
    Yr 13: $2,000 (GSP=$50,000, GLP=$52,000)
    Yr 14: $4,000 (GSP=$50,000, GLP=$56,000)
    Yr 15: $4,000 (GSP=$50,000, GLP=$60,000)
  
- The Corridor test is an evaluation of the policy’s Cash Surrender Value relative to the Death Benefit.
  - The Corridor Requirement, (Account Value x Corridor Factor ≤ Death Benefit), can’t be violated. To prevent a violation of the Corridor Requirement the Death Benefit will automatically increase when necessary.
    
    For the Corridor Factors, see the end of this document.

- Illustration Software: Both the GSP and GLP appear on the bottom of the Policy Info tab of the software whenever the Guideline Premium Test is used and the death benefit is specified. If you solve for the Death Benefit, these amounts are included in the Illustration output. If you would also like to see them on the bottom of the Policy Info tab, input the Solved Death Benefit and these numbers will populate.
B. Cash Value Accumulation Test (CVAT)

- This test states that the cash surrender value of the contract can’t, at any time, exceed the Net Single Premium that would have to be paid to fund the future benefits under the contract.
- The Net Single Premium to fund the Death Benefit is formula driven and not available in a chart like the GPT.
- A Corridor factor for CVAT test can be derived by dividing the Death Benefit by the Net Single Premium.
- The Corridor Requirement, \((\text{Account Value} \times \text{Corridor Factor} \leq \text{Death Benefit})\) can’t be violated. To prevent a violation of the Corridor Requirement the Death Benefit will automatically increase when necessary.
- The CVAT test does not have any premium restrictions
- CVAT compared to GPT typically results in:
  - A higher Death Benefit than GPT around life expectancy; and
  - A lower Death Benefit and Cash Value Accumulation as the Insured approaches age 100.

- Illustration Software: The software will automatically increase the Death Benefit to comply with the CVAT test. This may occur as soon as the end of year one, depending on the relationship of the premium to the death benefit.

C. 7-Pay Test (to determine MEC status)\(^2\)

- This test is to determine if a life insurance contract is a Modified Endowment Contract (MEC) or not.
- A MEC is a life insurance contract that fails to meet the 7 Pay Test. This occurs if the accumulated premiums paid at any time during the first 7 years exceed a certain level premium calculation determined by the formula established by the IRS.
- Example of a non-MEC policy: the IRS 7-Pay/Max Non-MEC Premium is $12,180.79 annually, so yr 1 cumulative premium can’t be > $12,180.79; yr 2 cumulative premiums can’t be > $24,361.58 \((12,180.79 \times 2)\), etc.
- If a contract is a MEC at issue, then it will remain that status for the life of the contract.
- If it isn’t a MEC at issue and the premium stream in the first 7 years doesn’t violate the IRS 7-Pay premium, then it will remain a non-MEC for the life of the contract unless there is a material change in the contract.
- Any material change in the contract can re-trigger the MEC calculation after the first 7 years. Some changes that may re-trigger this calculation are death benefit option changes, death benefit
amount changes, etc. A policy can only be in one 7-pay period at a time.

- One exception to this 7-year period is for second to die policies. These policies determine the MEC status for the entire life of the contract and not just for the first 7 years or when a material change occurs.
- If the policy is used for Death Benefit payout only, then there is no differentiation by the IRS on the tax implications of a MEC or Non-MEC contract.
- If a policy is a MEC then loans, withdrawals, surrenders, and assignments will be taxed as ordinary income to the extent that there is a gain in the contract. A gain exists if the account value, as defined in the policy, exceeds the cost basis (premiums paid). The distributions will assume gain out first, followed by basis (LIFO).
- Also, if a policy is a MEC and the client is < 59 ½, he will be assessed a 10% penalty on any gain from disbursements. This penalty will apply if the owner is an individual or an entity.
- The exception to the above point is if the insured has become disabled or the disbursement consists of substantially equal payments made over the life expectancy of the insured.
- In addition to the above points, a MEC life insurance contract that has outstanding loans will be taxed on the loan interest on a yearly basis.
- Illustration Software: The 7 Pay/Max Non MEC premium is displayed on the bottom of the Policy InfoNet Tab whenever a Death Benefit is specified. If you solve for a Death Benefit this 7 Pay premium is displayed in the illustration output. If you would like to see it at the bottom of this tab, then input the Death Benefit that you solved for and it will populate here.
- Illustration Software: There is a taxable gain supplemental report on our Output so you can view the tax effects of any loans or withdrawals that you are illustrating. This report will be produced regardless if it is a MEC or a non-MEC contract.
II. Common Life Insurance Products

A. Level Term Insurance - Life insurance with a defined term period. Generally the level periods are 10, 15, 20, and 30 years, followed by a period of annually renewable premium rates. After the level term period the client can continue the term coverage usually at an increased premium amount or terminate the policy. During the conversion period, the client can convert, without evidence of insurability, to permanent coverage.

B. Flexible Premium Universal Life Insurance - Life insurance with adjustable death benefits and flexible premiums.
   - Strengths:
     - Outstanding flexibility allowing clients to vary the amount and timing of premium payments within limits.
     - Underlying death benefit guarantees similar to Whole Life Insurance (death benefit guarantees are subject to premium payment requirements)
     - The costs are unbundled so you can see what the company is charging for each benefit portion.
   - Weaknesses
     - Current interest rate decreases may require adjustments to premium payments and/or death benefits
     - On-going policy review required to be certain policy fund value is on track
     - Not as strong cash value guarantees as Whole Life Insurance

C. Indexed Universal Life Insurance - Universal Life Insurance where the account is credited interest based on outside economic indicators (subject to the caps, floors, and participation rates of the company). There is greater upside interest earning potential than fixed UL products. There is an interest floor of at least 0%, which eliminates the downside risk of the client losing money.

D. Variable Life Insurance - Life Insurance where the premium is invested directly into an outside economic indicator. There is greater upside interest earning potential than Indexed UL’s, but also greater downside risk. Variable Life Insurance does not have an interest rate floor so there is a greater downside risk of the client losing portions of their premium investment.
III. Life Insurance Terminology

A. Minimum Premium: The premium required to guarantee death benefit coverage for a specified number of years (minimum no-lapse guarantee period). It is the smallest premium we will accept at policy issue. (Death benefit guarantees are subject to premium payment requirements.)

B. Target Premium: The premium used for funding and determining the agent’s commissions. The first year commission rate is paid on premiums paid up to target premium.

C. Rolling Target: Some products may have a rolling target whereas first year commission is paid on premium paid during the first 2 years up to the target premium established at issue. This feature may require a certain percent to be paid in the first year in order to invoke the rolling target feature.


E. Cash Surrender Value: Account Value – Surrender Charges (if any)

F. Surrender Charges: These charges gradually decline by duration and eventually disappear. The actual charges and number of years vary by product.

G. Net Cash Surrender Value or Surrender Value: Cash Surrender Value less any Outstanding Loans and accrued loan interest.

H. Uses of Surrender Value Funds

- **Withdrawals:** Reduces the Account Value, Surrender Value, and Death Benefit. There is usually an administrative fee for each withdrawal, a minimum withdrawal amount, as well as a possible Surrender Charge if during the Surrender Charge Period.

- **Policy Loans:** Reduces Surrender Value and Death Benefit. These loans are an advance against the Cash Surrender Value of the Policy. The loans can be paid back, if desired.
I. **Death Benefit Options:** The common death benefit options are:

- **Level Death Benefit Option:** The death benefit is the greater of the Specified Amount (original death benefit at issue) or the Account Value multiplied by the Corridor Factor. For most funding scenarios this option provides the maximum cash value accumulation. You may switch from the other Death Benefit Options to Level Death Benefit Option at any time.

- **Increasing Death Benefit Option:** The death benefit is the greater of the Specified Amount + the Account Value or the Account Value x the Corridor Factor. For most funding scenarios this option provides the maximum death benefit protection.

- **Return of Premium Death Benefit Option:** The death benefit is the greater of the Specified Amount + Premiums paid to date or the Account Value x the Corridor Factor. Only available at issue (can change from this option after issue, but can’t change to this option after issue).

J. **Cost of Insurance Charges (COIs):** The mortality charge for the death benefit. These charges generally vary by gender, risk, band, and duration.

- The Cost of Insurance Charge is equal to the Cost of Insurance Rate times the Net Amount at Risk.

- **Guaranteed COI Rates:** Based on the 2001 CSO Mortality Tables and are the largest mortality charges allowed by law.

- **Current COI Rates:** Based on the company’s expected mortality plus a margin.

K. **Net Amount at Risk (NAAR):** It is the difference between the Death Benefit and the Account Value by duration. The following is true for policies where the Death Benefit has not been increased in order to comply with GPT or CVAT:

- **Level DBO:** The NAAR decreases as the Account Value increases. This results in a decrease in the cost of insurance as the Account Value increases.

- **Increasing DBO:** The NAAR is always equal to the Death Benefit. Therefore there is no decrease in the cost of insurance as the Account Value increases.

- **ROP DBO:** The NAAR decreases as the Account Value increases, but not as much as Level DBO because the premium is added to the Death Benefit by duration, thereby increasing the Death Benefit.
L. Credited Interest Rates on Traditional Fixed UL Products and on the Fixed Account of Indexed UL Products

- **Guaranteed Interest Rate:** Minimum rate guaranteed for the contract. The rate is defined at issue and will carry for the life of the contract. Standard Policy Loans will accrue at this rate.
- **Current Interest Rate:** Non-guaranteed rate based on the interest rate the company is currently crediting on the product. Un-loaned account values earn this rate.

M. Credited Interest Rates on the Index Account of Indexed UL Products

- **Guaranteed Interest Rate:** Minimum interest rate used in the calculation of the Index Credit. The Index Floor Rate will be declared by Us for each Index Segment in advance of each Index Period. The Index Floor Rate will never be less than zero percent.
- **Current Interest Rate:** The interest rate is based on the client’s selected Index Selection and Index Crediting Method. The rate is multiplied by the company’s Participation Rate and then the company’s Cap and Floor Rates are applied. Variable Interest Rate Loaned values and un-loaned values earn this rate.

N. Minimum Account Value of Indexed UL Products

- Available on most Indexed UL Products
- If the Account Value is being calculated due to any termination of the Policy the amount in the Account Value will be at least as large as the Minimum Account Value. The Minimum Account Value is determined based on an accumulation at the Guaranteed Interest Rate.

O. Guaranteed and Non-Guaranteed Results on Illustration

- **Guaranteed Columns:** These results are based on the guaranteed interest rate, the maximum mortality cost of insurance charges, and the maximum expenses for the product.
- **Non-Guaranteed Columns:** These results are based on the current interest rate, the current mortality cost of insurance charges, and the current expenses for the product. In the case of IUL products, the interest used is the percent selected by the client subject to maximum rates set by the company for the Index Option and Index Crediting Method.
- **Minimum Account Value:** Products that have a Minimum Account Value will identify on the Tabular Details pages any year in which the Minimum Account Value is used.
IV. North American Current Life Insurance Product Portfolio

A. ADDvantage® 10, 15, 20, and 30 (Policy Form series #LS143AMP)
- Level Term Life Insurance with level premiums during the term period defined (10T, 15T, 20T, and 30T) and then increasing to annually renewable term rates, which are considerably greater than the level term rates.
- Coverage terminates at attained age 95.
- It is convertible to any individual permanent product in our current portfolio during the convertibility period.
- The 10, 15, and 20 year products can be converted until the earlier of Policy Age 70 or the end of the level-premium period, but never less than five years. The 30-year product can be converted to the earlier of the 20th anniversary or Policy Age 70.
- Conversion timeframe examples:
  - Age 45, 30T: convertible for 20 years
  - Age 45, 20T: convertible for 20 years
  - Age 60, 15T: convertible until age 70 (i.e. 10 years)
  - Age 68, 10T: convertible for 5 years

B. Custom Guarantee® (Policy Form series #LS170)
- Fixed UL product designed for lifetime no-lapse guaranteed death benefit coverage. (Subject to premium payment requirements.)
- Only GPT available.
- Level and Increasing DBO options available.
- Software Hint: For lifetime death benefit guarantee, select the “Guarantee DB at age 100” solve.
- Software Hint: For any other premium or death benefit guarantee period, define it on the Solves Tab.

C. Custom TermGUL® (Policy Form series #LS167)
- Fixed UL product designed for choice of low cost coverage or lifetime death benefit guarantee coverage.
  - For low cost coverage: Premium type solve is “$1 at age 100.” This solve would produce the lowest premium needed to accomplish the goal of running to age 100 at the current (non-guaranteed) interest rate.
  - For lifetime guarantee coverage: Add the “Premium Guarantee Rider” located on the Riders tab and then select the “Guarantee DB at age 100” solve.
- Choice of GPT or CVAT.
- Choice of Level or Increasing Death Benefit Options.
D. Custom GrowthCV® (Policy Form series #LS166)
- Fixed UL product designed for cash accumulation
- Can waive surrender charges and table shave\(^4\) from table 3 to standard by adding the Waiver of Surrender Charge Option\(^5\) located on the Riders tab.
- Choice of GPT or CVAT.
- Level, Increasing, and ROP Death Benefit Options available.

E. Custom Accumulator® (Policy Form series #LS165B)
- Fixed UL product designed for large Single Premium in order to qualify for 10 year ROP feature (7 years for issue ages 65+).
- Only CVAT available.
- Level and Increasing Death Benefit Options available.

F. Builder IUL® (Policy Form series #LS172)
- Indexed UL product designed for long-term cash accumulation.
- GPT and CVAT available.
- Level and Increasing Death Benefit Options available.

G. Rapid Builder IUL® (Policy Form series #LS169)
- Indexed UL product designed for early cash accumulation.
- Can waive surrender charges and also table shave\(^4\) from table 3 to standard by adding the Waiver of Surrender Charge Option\(^5\).
- GPT and CVAT available.
- Level, Increasing, and ROP Death Benefit Options available.

H. Guarantee Builder IUL® (Policy Form series #LS175)
- Indexed UL product designed for death benefit guarantees (Subject to premium payment requirements).
- GPT and CVAT available.
- Level and Increasing DBO options available.
- Software Hint: For lifetime death benefit guarantee select the “Guarantee DB at age 100” solve.
- Software Hint: For any other premium or guarantee period define it on the Solves Tab.
I. **Survivorship GIUL (Policy Form series #LS171/LS171W)**

- Second-to-die Indexed UL product design.
- Can either design for cash accumulation or for death benefit guarantees (by adding the Survivor Premium Guarantee Rider [S-PGR]).
- Can waive surrender charges by adding the Waiver of Surrender Charge Option. (The Waiver of Surrender Charge Option is not available if the S-PGR is selected.)
- Only GPT available.
- Level, Increasing, and ROP Death Benefit Options available. The SPGR is not available with the ROP Death Benefit Option.
V. North American Indexed Universal Life Insurance Crediting Methods

A. Annual Point-to-Point Crediting Method
- \[ \frac{(\text{Ending Annual Index Value} - \text{Beginning Annual Index Value})}{\text{Beginning Annual Index Value}} \]
- Apply the Participation Rate
- Apply the Cap and Floor Rates
- Apply any applicable Interest Bonus
- Multiply the result by the Index Segment Account Value

B. Monthly Point-to-Point Crediting Method
- \[ \frac{(\text{Ending Monthly Index Value} - \text{Beginning Monthly Index Value})}{\text{Beginning Monthly Index Value}} \]
- Apply the Monthly Cap Rate
- This calculation is done for each of the 12 months
- Add the 12 monthly capped index rates to derive the 12 month period index growth rate
- Apply the Participation Rate to this sum
- Apply the Floor Rate
- Apply any applicable Interest Bonus
- Multiply the result by the Index Segment Account Value
  
  Note that the cap rate is applied to each month separately and not the total; and the floor rate is applied to the total only and not each month separately.

C. Daily Averaging Crediting Method
- \[ \frac{(\text{Average Index Value} - \text{Beginning Index Value})}{\text{Beginning Index Value}} \]
- Apply the Participation Rate
- There isn’t a Cap Rate (the averaging mechanism allows us to not impose a cap)
- Apply the Floor Rate
- Apply any applicable Interest Bonus
- Multiply the result by the Index Segment Account Value
  
  Note that the Average Index Value is the sum of each business day’s values / # business days in the Index Segment. The first value is on the first business day that follows the beginning of the Index Period. The last value is the first business day that occurs on or after the end of the Index Period.
D. Multi-Index Annual Point-to-Point Crediting Method

- This method uses the S&P 500®, Russell 2000®, and EURO STOXX 50®
- Calculate the following for each index in this Index Group: \[ \frac{\text{Ending Index Value} - \text{Beginning Index Value}}{\text{Beginning Index Value}} \]
- Then the three indices are ranked by performance and multiplied by an Index Weight of 50% of the best performing index, 30% of the 2nd best performing index, and 20% of the worst performing index (even if negative). These 3 results are added together.
- Apply the Participation Rate
- Apply the Cap and Floor Rates
- Apply any applicable Interest Bonus
- Multiply the result by the Index Segment Account Value
## Corridor Factors for Guideline Premium Test

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For help with your sales needs, please contact North American’s Sales Development Team at (800) 800-3656, ext. 10411 or email salessupport@nacolah.com.

1 Neither North American Company nor its agents give legal or tax advice. Please advise your customers to consult with and rely on a qualified legal or tax advisor before entering into or paying additional premiums with respect to such arrangements.

2 For most policies, withdrawals are free from federal income tax to the extent of the investment in the contract, and policy loans are also tax-free so long as the policy does not terminate before the death of the insured. However, if the policy is a Modified Endowment Contract (MEC), a withdrawal or policy loan may be taxable upon receipt. Further, unpaid loan interest on a MEC may be taxable. A MEC is a contract received in exchange for a MEC or for which premiums paid during a seven-year testing period exceed prescribed premium limits (7-pay premiums).

3 In some situations loans and withdrawals may be subject to federal taxes. North American Company does not give tax or legal advice. Clients should be instructed to consult with and rely on their own tax advisor or attorney for advice on their specific situation.

4 When a person applies for life insurance coverage, his or her health is evaluated and a corresponding underwriting rating is applied. This product’s table shaving features allow certain substandard underwriting rates (known as "table ratings") to be improved to a "standard" rating. A "standard" rating generally indicates average health and involves a lower life insurance premium than do substandard ratings.

5 Available for an additional charge per $1,000 per month, depending on issue age and underwriting class.

Indexed universal life products are not an investment in the “market” or in the applicable index and are subject to all policy fees and charges normally associated with most universal life insurance.

The EURO STOXX 50® measures the top 50 blue-chip stocks from the countries participating in the European Monetary Union.

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Refer to the current marketing guides for complete product details: ADDvantage (PR-875), Builder IUL series (PR-1275), Custom Accumulator (PR-1084), Custom GrowthCV (PR-1130), Custom Guarantee (PR-651), Custom TermGUL (PR-1166), and Survivorship GIUL (PR-1435).

ADDvantage plans, Builder IUL, Custom Accumulator, Custom GrowthCV, Custom Guarantee, Custom TermGUL, Guarantee Builder IUL, Rapid Builder IUL, and Survivorship GIUL are issued on policy form series LS143AMP, LS172, LS165B, LS166, LS170, LS167, LS175, LS169, and LS171 without the Waiver of Surrender Charge and LS171W with the Waiver of Surrender Charge respectively; Premium Guarantee Rider is issued on form series LR452. Survivor Premium Guarantee Rider is issued on form series LR460 and the Waiver of Surrender Charge rider is issued on form series LR417A; or state variations by North American Company for Life and Health Insurance, Administrative Office, Sioux Falls, SD 57193. Products, features, riders, endorsement or issue ages may not be available in all jurisdictions. Restrictions or limitations may apply.

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