

# Understanding a chronic illness rider

For anyone who experiences a debilitating chronic illness, having access to a portion of their life insurance proceeds can help reduce the added strain of financial hardship. In recognition of this need, Principal provides a Chronic Illness Death Benefit Acceleration Rider (CIDBAR, or “chronic illness rider”) for many insured individuals at no additional charge on its permanent life insurance products. This allows certain chronically ill individuals to access a portion of the death benefit, generally without being taxed on the distributions.<sup>1</sup>

Most distributions from cash value life insurance policies incur no income tax up to the amount of premiums paid<sup>2</sup> and potential access to cash through policy loans.<sup>3</sup> Policy loans are not taxed while the policy remains in force.

Benefits under a CIDBAR are different. Once a physician certifies that the insured qualifies for them (see below), the benefit can be treated as an income tax-free accelerated death benefit. This treatment does not depend on the insured having basis in the contract or taking loans.

## Requirements

To exercise a chronic illness rider, the insured must (a) be unable to perform at least two of the six activities of daily living<sup>4</sup> (ADLs) for at least 90 days due to a permanent loss of functional capacity, or (b) have a permanent, severe cognitive impairment. A licensed health care practitioner must certify the insured as meeting one of the requirements.

## Income tax treatment

Principal has designed its CIDBAR to satisfy the amount limitation for income tax-free treatment under the Internal Revenue Code (IRC). The amount that can be accelerated under a CIDBAR is subject to an annual dollar limit of the lesser of 20% of the death benefit, or \$153,300 (in 2023, as indexed). This statutory limit applies to each insured, regardless of the number of policies and carriers involved.

If the insured has a policy with another carrier and accesses proceeds under a similar provision, it is possible that the proceeds will exceed the IRC limits and be taxable to the extent of the excess. These benefits would be subject to the general rules for life insurance distributions (i.e., generally basis first, then policy loan treatment may be available, generally meaning no taxation would apply while the policy remains in force). Some insurance carriers allow access to proceeds in excess of the amount that is income tax-free (and such access may be required under state law). The amount available can vary from one life insurance company to another and is based in part on the product design and state of issue, but the underlying statutory limit for income tax free treatment applies, regardless of the amount made available.

## Use of proceeds

Proceeds within the limit can be used for anything, including treatment costs, equipment, rehabilitation, home assistance, or nursing home costs. No receipts or documentation of the use of the proceeds is required.

## Business-owned policy

Generally, the CIDBAR can be exercised on a policy owned by the insured's business. But, there is a business related policy exception to the income tax-free treatment for accelerated death benefits. Basically, if the payment is going to someone (a person or entity) *other than the insured*, and the company's insurable interest in the insured is due to the insured being a director, officer, or employee of the business, or because the insured is financially interested in the trade or business of that person (or entity), then the tax-free treatment does not apply. Typically, this would affect a business-owned policy, such as key person coverage, in which the CIDBAR proceeds are not going to the insured. In that situation, a transfer of the policy to the insured may be recommended before benefits are accessed under this rider.

## Policy held in an irrevocable trust

An irrevocable trust (e.g., ILIT) may access CIDBAR proceeds within the limitations described above, but the proceeds are subject to the terms of the trust. Because an ILIT is designed to remove assets from the estate of the insured, the grantor would not have direct access to the proceeds. However, if the ILIT is designed to provide a spousal lifetime access feature, it may be possible to exercise a CIDBAR and distribute benefits to the spouse. In addition, the requirements for keeping such assets out of the estate of the spouse are stringent and the trust must be designed to take them into account.<sup>5</sup>

## Summary

A CIDBAR offers lifetime access to a portion of the death benefit, at a time when the insured may need it most. The CIDBAR rider is offered to qualifying insured individuals at no additional charge on Principal permanent life insurance products, meaning that if the rider is never used, it costs nothing.

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<sup>1</sup> For details, see [Chronic Illness Death Benefit Acceleration Rider, BB10935](#).

<sup>2</sup> "Basis" often consists of premiums paid, but it can be higher. For example, if a business owner received a policy from the business at its fair market value, that value generally becomes the owner's basis.

<sup>3</sup> Exceptions include forced out gain (during the first 7 years of the policy) and the special treatment that applies to modified endowment contracts.

<sup>4</sup> The six activities of daily living are bathing, continence, eating toileting, dressing, and transferring.

<sup>5</sup> See ["Building ILIT flexibility with a SLAT," BB12606](#) for additional details.



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