



When Using Life Insurance as a Supplemental Income Source Be Aware that Withdrawals in the First Fifteen Years May Trigger Taxation Under the "Cash Rich" Rule

Situation: Life insurance is generally thought of in terms of protecting loved ones in the event of premature death. While this is an important aspect of life insurance, it's only part of the story. As an individual's career flourishes and resources allow for personal investing and long-term planning, life insurance may be a component of a person's overall portfolio. It can complement fixed-income assets and help moderate risk and volatility in the total portfolio. However, when taking withdrawals, care must be exercised because withdrawals of basis from a non-MEC (Modified Endowment Contract) life insurance policy can result in taxable income to the policy owner. Consequently, it's important to know when this happens and if there is anything that can be done to avoid the tax.

Solution: Withdrawals in the first 15 years of a policy might be subject to taxation under something called the "cash rich" rule found in IRC § 7702. Fortunately, there are a number of strategies that can be used to avoid the tax. It's just a matter of knowing when to exercise a little caution before taking the withdrawal.

When Should Caution be Exercised?

Generally, withdrawals from a non-MEC policy will not result in taxable income to the policy owner unless they exceed the cost basis of the policy. However, policy owners will periodically "heavily fund" or "overfund"¹ their life insurance policies up to the "7-pay" MEC limits with the idea that they may want to withdraw some of the cash value at some point in the future to help supplement their retirement income. In this situation, an owner of a non-MEC policy might be subject to taxation under the *cash rich rule* and should exercise caution if the withdrawal:

- Occurs in a policy issued or exchanged after 1984.
- Results in a reduction of death benefit.
- Is in the first 15 years of a policy.

If your situation has all the above characteristics, the policy will be tested by the insurance carrier at the time of the distribution to determine whether it is cash rich. It does not necessarily mean any part of the distribution will be taxable, but you should double-check the tax consequences before proceeding with the withdrawal.

The Rule

Now that you have an understanding of the type of situation when caution should be exercised, you might want to know a little more about the rule and how to avoid the tax. *Cash rich testing* is required by Section 7702 of the Internal Revenue Code and applies to non-MEC policies issued after 1984. In basic terms, a policy is considered cash rich when the cash value nears the maximum amount allowable under the tax code's definition of life insurance. It is also known as the *recapture-ceiling test*. The test is generally performed at the time of a withdrawal from a policy, but it may also be performed when there is a face amount reduction, a partial surrender, or a lapse with loan.



According to the cash rich rule, anytime there is a cash distribution in connection with a reduction in benefits within the policy's first 15 years, the policy must be tested to determine a *recapture ceiling*. The withdrawal is then taxable up to the lesser of the following three amounts:

1. The recapture ceiling.
2. The gain in the policy.
3. The amount of the withdrawal.

In Summary

A policy owner can be taxed on withdrawals from a non-MEC life insurance policy if a cash distribution occurs within 15 years of the policy's issuance and if the distribution is coupled with a reduction in the policy's death benefits. Once the 15-year period expires, no immediate taxation will occur on a withdrawal of basis on a non-MEC policy.

¹*A policy is said to be "heavily funded" or "overfunded" when the owner pays substantially more than the required premium.*

²*Unpaid loans and withdrawals will reduce policy values and death benefits. Loans are generally not taxable, but withdrawals are taxable to the extent they exceed cost basis in the contract. Loans outstanding at policy lapse or surrender, prior to the death of the insured, will cause immediate taxation to the extent of gain in the contract.*

What is the Recapture Ceiling?

The recapture ceiling is a dollar amount computed using one of the required methods set forth in Section 7702 of the tax code. The method for determining the recapture ceiling differs depending on whether the distribution occurs in years one through five or in years six through fifteen. The method also differs within years one through five, depending upon whether the policy uses the cash value accumulation test (CVAT) or the guideline premium test (GPT) to satisfy the definition of life insurance.

One thing to keep in mind is that cash rich testing generally affects policies that have been heavily funded where distribution is in the first five years. So, the more heavily funded the policy and the earlier the distribution, the more likely cash rich rules will cause a distribution to be taxable.

How Can Tax be Avoided on a Cash Rich Policy?²

You could simply wait until year sixteen before taking a distribution because the cash rich testing does not apply once you are past the 15th policy year. If waiting for the 16th policy year is not an option, an alternative is to take a policy loan before year 16 and once beyond the 15th policy year, take distributions. Because loans do not typically reduce the policy death benefit, the cash rich testing rule does not apply.

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