Stock Market Performance, Cash Rich Testing & Life Insurance Withdrawals

Recent stock market performance has led to above average returns on many IUL and VUL policies. While this is great for the long-term performance of the policy, financial professionals and their clients need to be aware of the impact this may have when planning to make a withdrawal from a policy. Most of us understand the basic rule for taxing withdrawals from life insurance policies that are not modified endowment contracts (MECs): withdrawals are not taxable to the extent they do not exceed the cost basis of the policy. But you may be surprised to learn that, even for non-MEC policies, withdrawals that are less than the policy's cost basis may have tax consequences if the policy is cash rich.

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 Rule

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; or (3) the amount of the withdrawal.

Basically, the IRS treats the cash value at the time of the withdrawal as if it were the cash value of the policy after the reduction in benefits, after certain adjustments (defined in the test). If the cash value exceeds the limits allowable for the reduced-face policy, the excess is taxable up to the amount of the withdrawal.

What is the recapture ceiling?

The recapture ceiling is a dollar amount computed using one of the required methods set forth in Section 7702(f)(7) 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 15. 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. So, the more heavily funded the policy, the more likely cash rich rules will cause a distribution to be taxable.

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When do you really need to worry about cash rich testing?

For a quick answer, ask the following four questions:

- Was the policy issued (or exchanged) after 1984?
- Is the policy a non-MEC?
- Has the policy been in-force for less than 16 years?
- Will the withdrawal cause a reduction in the death benefit?

If the answer is yes to *all four*, the policy will be tested at the time of the distribution to determine whether it is cash rich. That does not necessarily mean any part of the distribution will be taxable, but you may want to double check before advising a client about taking that withdrawal in the above circumstances. It is recommended that an inforce illustration be run and a tax gain quote be obtained to confirm the withdrawal does not create a taxable event.

What if you want to take distributions and the policy is determined to be cash rich?[1]

It is possible that you could take a lesser amount and not violate the recapture-ceiling test, or you could simply wait until year 16 before taking a distribution because the cash rich testing does not apply once you are past the 15th policy year. If waiting until the 16th policy year is not an option, an alternative is to take a policy loan prior to 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.

Summary

Where there is a reduction in benefits with an associated distribution on a non-MEC life insurance policy in the first 15 years, the recapture rules under Code Section 7702(f)(7) may be triggered. In those circumstances, the normal non-MEC tax rules do not apply and the cash distributed may be taxable to the extent of gain. Once the 15-year period expires, no immediate taxation will occur on a withdrawal of basis on a non-MEC policy to the extent the distribution is a return of cost basis on the policy.

An inforce illustration and tax gain quote should be requested prior to any withdrawal to confirm the withdrawal will not create a taxable event.

For questions regarding cash rich testing, the recapture ceiling or any advanced concept or strategy, please contact Prudential's Advanced Planning team at 800-800-2738, option 4.

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[1] *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.*

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