Northwestern Mutual®

Forced-Out Gain

Not all life insurance withdrawals are created equal

Background

Cash withdrawn from a life insurance policy is generally not taxed until the amount withdrawn exceeds the owner's tax basis in the policy (i.e., basis comes out first).[1] However, certain cash withdrawals during the first 15 years of a policy can cause gain in the policy to be taxed when the withdrawal is made, thus forcing out the gain.[2]

Certain cash withdrawals that occur within the first 15 years of the policy and result in a reduction of a policy's death benefit trigger the forced-out gain rule. If the reduction in death benefit causes the policy to exceed a defined ceiling for the ratio of value to death benefit, then any gain in the policy is "forced out." The rule is limited to policies in which the ratio of value to death benefit exceeds a defined recapture ceiling. The recapture ceiling is calculated differently for years 1-5 than for years 6-15.

The forced-out gain rule applies if:

1. A cash withdrawal occurs from the life insurance policy during the first 15 years,
2. The policy has gain in it,
3. The death benefit is reduced, and
4. The policy fails the forced-out gain rules of IRC § 7702(f)(7).

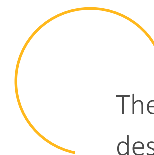
If the forced-out gain rule is triggered, the withdrawal is taxable as ordinary income to the lesser of (1) the amount of gain in the policy; and (2) the recapture ceiling calculated pursuant to the statute.[3] The best way to determine if a withdrawal policy is going to trigger forced-out gain is to have the insurance company provide an inforce ledger.

Northwestern Mutual is required to issue a Form 1099 to report any forced-out gain.

Avoiding the Impact

The policyowner can take several steps to avoid forced-out gain:

1. Wait until the beginning of the 16th year to withdraw cash;
2. Withdraw less cash to avoid the problem;
3. Borrow against the policy and then surrender additions at the beginning of the 16th year to eliminate the loan; or
4. Lower the premiums paid on the policy to minimize the possibility of forced-out gain occurring.



The forced-out gain rule is designed to prevent policyowners from using life insurance primarily as a tax-deferred savings vehicle.

---

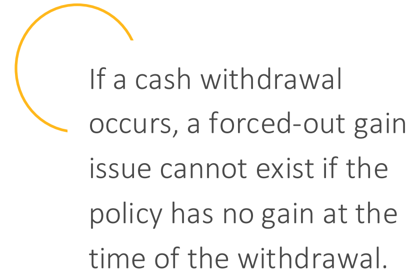
[1] IRC § 72(e)(5). Note that a life insurance policy that is a modified endowment contract is taxed differently.
[2] IRC § 7702(f)(7).
[3] IRC § 7702(f)(7)(B).

Planning with cash dividends, loans, and premium payments

Forced-out gain occurs when value in a policy is too great as compared to death benefit based on statutory rules. Therefore, decreases in death benefit and increases in value can result in a forced-out gain situation when there is a cash withdrawal.

If a cash withdrawal would result in forced-out gain, the policyowner might look to other ways to get cash from a policy. Neither receiving a cash dividend from a policy nor taking a loan on a policy is considered a cash withdrawal that would trigger forced-out gain.

In addition, the payment of premium could result in forced-out gain because it increases the value in the policy. If a premium is due and a withdrawal is contemplated, it is generally advantageous to pay the premium either by (1) applying part of the cash withdrawal to that year's premium, or (2) using cash from other sources only *after* the cash withdrawal occurs. In both cases, the value of the policy will not increase prior to the withdrawal.



Two-year look back rule

Forced-out gain includes a special "two-year look back rule" which considers withdrawals received within two years before the distribution in question. This rule will generally increase the amount of tax due, and it could cause prior non-taxable withdrawals to become taxable.[4] To avoid the potential impact of the two-year look back rule, withdrawals could occur in intervals of 24 months and 1 day during the first 15 years of the policy.

Conclusion

A forced-out gain can potentially occur if (1) too much cash is withdrawn prior to the 16th year and (2) the policy is "cash rich." The best advice is to plan to take withdrawals after the start of the 16th policy year.

This publication is not intended as legal or tax advice. This information is intended solely for the information and education of Northwestern Mutual financial representatives, their customers, and the legal and tax advisors with whom they work. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its Financial Representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities, and life insurance with long term care benefits) and its subsidiaries.
© 2023 The Northwestern Mutual Life Insurance Company, Milwaukee, WI.

Advanced Planning, January 2023

[4] IRC § 7702(f)(7)(E).