



Additional information on taxation for financial professionals



Under Section 7702 of the Internal Revenue Code, in order for a policy to qualify as life insurance it must satisfy the guideline premium limits of Section 7702(c) and the cash value corridor limits under Section 7702(d). As the cash value gets closer to the full endowment at maturity, i.e. cash value will equal the face amount of the policy, it will fail either the Guideline Premium Limits test or the Cash Value Corridor Limits test.

The year of failure will generally occur early in the life of the policy. Once the policy fails either test, Gerber Life is required to calculate the amount of taxable income that is generated each year.

IRC Section 7702(g)(1) provides that, starting with the first calendar year of failure, the owner of a “failed” policy is currently taxed each year on the policy’s “inside build up,” grossed up as if an annual cost of insurance (COI) charge were about to be taken out of its cash value.

More specifically, IRC Section 2203(g)(1) calculates an includable amount of “income on the contract” for each taxable year as the excess of (A) the sum of the increase in the policy’s net surrender value (ignoring loans) during the calendar year plus the COI for such year over (B) the Premiums Paid for such calendar year.

For the calendar year of failure, the Section 7702(g) Income under IRC Section 7702(g)(1)(C) includes the aggregate amount of all of the policy Section 7702(g) income amounts for all prior calendar years and no such prior annual Section 7702(g) income amount can be negative.

Under IRC Section 7702(g)(1)(D), the COI amount is the mortality charge “stated” in the policy. If no “actual” COI charge is “stated” in the policy, the IRS is likely to use the policy’s guaranteed mortality rates (e.g. 2001 CSO rates) to determine such COI amount for each year.

If Underwriting approves an application for the endowment, the policy owner is provided with a Tax Disclosure and Withholding Election Notice. The notice provides an example of what the taxable income would likely be, given the policy owner’s age, underwriting class, maturity amount and gender, assuming that the premiums were paid annually and at the beginning of each year. Of course, the actual amount of tax for any given calendar year will vary depending upon the effective date of the policy, the timing of the premium payments and the cash value growth of the policy. Gerber Life will provide a Form 1099-R to the policy owner and the IRS for each year that there is taxable income.

When the policy fails IRC Section 7702 testing, another copy of the notice and election form will be sent to the policy owner. A shorter form of the notice will be sent each year that the policy is in effect. Each year, the policy owner has the option of changing his or her election by writing to Gerber Life.





Tax Withholding Requirements

IRS Rev. Ruling 91-17, 1991-1 C. B. 190 takes the position that the insurer is subject to tax reporting and withholding obligations with respect to a life policy that “fails” its IRC Section 7702 limits, and indicates that the insurer needs to get an “election out” form from the owner to avoid tax withholding on such a policy’s Section 7702 income.

The policy owner has two choices for meeting tax withholding requirements. The policy owner can either:

1. Have Gerber Life withhold 10% of the taxable income on his or her behalf, or
2. Elect out of having Gerber Life withhold 10% of the taxable income and instead pay the tax as he or she normally would.

If the policy owner decides to have Gerber Life withhold 10% of the taxable income, it will be done in the form of a policy loan. Withholding is generally 10% of the taxable income in any year during which there is \$200 or more of taxable income. Because the endowment policy does not allow for partial surrenders of cash value, the only way to withhold 10% of the taxable income is by taking a policy loan secured by the policy’s cash value. The policy loan will be charged interest at a rate of 8%. If there is an outstanding loan balance at maturity, the final maturity value will be reduced by the amount of the loan.

If the policy owner elects out of having Gerber Life withhold 10% of the taxable income, the policy owner will need to pay the appropriate amount of tax at the time he or she normally files his or her tax return. However, the policy owner should determine if the amount of taxable income generated by the policy is large enough to require that estimated taxable income taxes be filed. Gerber Life is not in a position to advise whether the policy owner should pay estimated taxes.

In order to buy the policy, the prospective policy owner must consent to having Gerber Life automatically take a loan against the policy if, at any time, the owner wants Gerber Life to withhold taxes. A policy loan to pay taxes will only be put into effect by Gerber Life if the policy owner elects to have Gerber Life perform withholding on his or her behalf.

Modified Endowment Contract

Under IRC Section 7702A, a policy that “fails” the Guideline Premium Limits or Guideline Premium/Corridor Limits test will be considered a Modified Endowment Contract (MEC). If the policy is a modified endowment contract, certain policy transactions may result in the policy owner having to recognize taxable income if and when the policy is in a gain position, i.e. cash value exceeds premiums paid. However, once the policy fails under IRC Section 7702, it is no longer considered a life insurance policy for IRS purposes. Consequently, the rules under IRC Section 7702A no longer apply. It is Gerber Life’s belief that although the policy will be considered a MEC very early on, the policy will not be in a “gain” position and will not result in any taxable income until after it fails under IRC Section 7702.

Death Benefit

If the owner dies before the policy matures but after it no longer complies with IRC Section 7702, the excess of its death benefit amount at the time of death over its net surrender value is generally exempt under IRC Section 7702(g)(2) and Section 101. However, the policy’s Section 7702(g) income for the owner’s year of death is likely to be taxable to the owner’s estate or beneficiaries under IRC Section 691 (to the extent not taxable to the owner).



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