ADVANCED PLANNING

Life Strategies

Modified Endowment Contracts

FAQs

What is a modified endowment contract and how is it taxed?

A modified endowment contract (MEC) is a life insurance contract:

- That was entered into or materially changed after June 21, 1988.
- In which the cumulative premiums paid during the first seven years of the contract exceed the amount needed to provide a paid-up policy based on seven statutorily defined level annual premiums (the 7-pay test). Essentially, the 7-pay test requires a minimum level of insurance per premium dollar for the contract's first seven years.

Unlike distributions and loans from non-MEC policies, lifetime distributions and loans from a MEC contract are treated as coming from gain first and cost basis last (last in, first out (LIFO) treatment). In addition, a 10% additional tax may be imposed. Therefore, where lifetime access to cash value on a tax-favored basis is important, care must be taken when funding a policy or making changes to policy benefits so that the MEC rules are not triggered.

Background

In the late 1970s, insurance companies began developing products that were flexible in nature and that could, in addition to providing a death benefit, be used as investment vehicles. Single-pay life insurance contracts became popular because investment gains inside the policy could be income tax-deferred (taxes not due on any potential gains until the money is withdrawn) while the owner was able to take principal-first, income tax-free distributions. Congress felt the need to establish new controls.

Three important federal tax acts were passed to ensure that the income tax advantages of life insurance were not abused:

- **TEFRA:** Tax Equity and Fiscal Responsibility Act—1982
- **DEFRA:** Deficit Reduction Act—1984
- **TAMRA:** Technical and Miscellaneous Revenue Act—1988

TEFRA: This act established guidelines to determine the maximum amount of premium that may be paid into a flexible premium policy and the minimum death benefit that must be provided in order to qualify for tax-deferred income on cash values, income tax-free death benefits, and other life insurance tax benefits.

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DEFRA: This act tightened up the TEFRA rules by defining taxable versus nontaxable withdrawals. DEFRA also extended qualification testing to all life insurance policies that have cash values. When DEFRA guidelines are exceeded, a policy will not qualify as life insurance. The policy is instead treated as an investment vehicle with the income portion of the investment currently taxable to the policyholder.

TAMRA: This act further tightened the rules by enacting policy premium guidelines (the 7-pay test) that prevent policyholders from paying large amounts (or a single premium) in early policy years and then borrowing the cash value tax-free.[1] A policy with premiums in excess of TAMRA guidelines becomes a MEC.

What is the tax effect of life insurance policy becoming a MEC?

Income-First Taxation. MEC contracts qualify as life insurance (i.e., *death benefits are still generally received income tax-free* under IRC §101(a)). However, if a life insurance policy becomes a MEC, the policyowner may lose some of the advantages of the policy, including tax-deferred growth. In addition, loan and withdrawals can incur penalties.

Lifetime distributions from a MEC are taxed differently than distributions from non-MEC policies. *Distributions are taxed as ordinary income when received to the extent that there is a gain in the contract.*[2] In other words, distributions from a MEC contract are taxed as income first and recovery of basis second until all gain has been withdrawn or borrowed. This is similar to the taxation of an income tax-deferred annuity.

Amounts treated as income-first distributions include:

- Policy loans, whether used for paying premiums or for other purposes
- Loans secured by the policy
- Interest accrued on a policy loan
- Withdrawals
- Policy assignments

Amounts *not* treated as income-first distributions include:

- Dividends retained by the carrier to pay premiums on the contract
- Dividends used to purchase paid-up additions
- Term insurance or other qualified additional benefits
- Surrender of paid-up additions to pay premiums

Additional Tax. Unless the taxpayer is at least 59½ years old or has become disabled, or the distribution is part of a series of substantially equal periodic payments over the life expectancy of the taxpayer or the taxpayer and their beneficiary, any taxable distribution from a MEC will be subject to a 10% additional tax.[3] The surrender of a life insurance policy that is a MEC may also be subject to a 10% additional tax, depending on the client's age and other factors.

[1] IRC §7702A.
[2] IRC §72(e)(10).
[3] IRC §72(v)(1) & (2).

The 7-Pay Test

Each life insurance policy is subject to the 7-pay test when issued and will become a MEC if it fails the test. The 7-pay test compares the cumulative premium paid with the net level premium (the amount necessary to pay up the policy). A policy will fail the test if, at any time during the first seven contract years, the cumulative amount paid under the contract exceeds the sum of the net level premiums.

It is important to understand that the net level premium is not the same as the actual premium paid under the contract. Rather, it is a statutorily defined premium calculated using mandated interest, mortality, and expense assumptions. It is possible that a contract that requires seven level annual premiums will fail the 7-pay test because the statutory net level premium will be less than the actual premium paid.

Once a policy has failed the 7-pay test, it becomes a MEC and remains a MEC for the life of the contract. Even if the MEC policy is exchanged for a new policy, the new policy will be a MEC.

It is important to note that a policy that originally satisfied the 7-pay test may nonetheless become a MEC if the face amount is reduced or if it undergoes a material change, as discussed below.

Death Benefit Reductions. Where there is a scheduled or an unscheduled reduction in the death benefit within the first seven contract years, the 7-pay test must be recalculated for the first seven years as if the contract had originally been issued at the reduced death benefit level. If the policy fails the recalculated 7-pay test, MEC income-first taxation applies to amounts received in the year the contract becomes a MEC and to all distributions in subsequent contract years. In addition, a look-back rule applies MEC taxation to any distribution in the two years before the policy failed the 7-pay test.

Survivorship Policies. A special rule applies to survivorship policies. In the case of a survivorship policy issued on or after Sept. 14, 1989, a new 7-pay test based on the initial premium and the reduced death benefit is required, even if the reduction occurs after the first seven policy years.

Material Changes. When a material change is made in the benefits under the insurance contract that was not reflected in any previous 7-pay test, a 7-pay test must be applied as if a new contract were entered into on the date on which the material change took effect. The new 7-pay premium is adjusted to take into consideration the contract's existing cash surrender value as of the date of the change.

A material change generally includes any increase in the death benefit that requires evidence of insurability or any addition of a benefit or rider. Common examples of a material change are:

- Term life conversions to permanent coverage
- Exchanges of one policy for another, whether taxable or tax-free under IRC §1035

Some increases in the death benefit that are not considered a material change include:

- Increases due to the necessity to fund the lowest possible death benefit and qualified benefits in the first seven years
- Increases due to the crediting of interest or other earnings, including dividends
- Cost-of-living increases based on a broad-based index
- Adding a qualified long-term care insurance rider
- Changes due to the financial insolvency of the insurer

Safety Valve

Even if a policy would become a MEC because of the payment of premiums in excess of the cumulative MEC premium, MEC status can still be avoided if the insurer returns the excess premium paid, plus interest, within 60 days of the end of the year in which the excess occurs. (Although the Code permits the avoidance of MEC status if excess premiums are returned within 60 days of the end of the year in which the excess ends, Prudential's policy is that the excess should be removed within 60 days of remittance.)

Grandfathered Contracts

A policy entered into before June 21, 1988, is not subject to the 7-pay test unless a material change is made to the contract.

When a grandfathered policy is exchanged for a new policy, a material change has occurred and the new policy must be tested for 7-pay compliance. The exchange of a grandfathered policy does not automatically trigger MEC status but rather triggers the 7-pay test.

Policy Exchanges

A MEC cannot be washed clean of MEC status by means of an IRC §1035 exchange. A contract received in exchange for a MEC will also be a MEC.

A properly planned 1035 exchange with no new money will not create a MEC because the cash value existing on the day of the exchange is not treated as a new premium. The 7-pay test must be applied, but the new policy will always pass the test as long as the death benefit remains the same and no additional premiums are paid into the new policy.

A rollover with new money may create a MEC because the 7-pay test must be reapplied.

Similarly, when a policy is less than seven years old and an IRC §1035 exchange is made, and the acquired policy has a reduced face amount relative to the exchanged policy, the 7-pay test must be reapplied retroactively over the 7-pay period. If any premium paid during that period exceeds the new adjusted 7-pay premium, the acquired policy will be a MEC.

Summary

MEC rules are designed to limit the tax advantages of heavily funded and single-pay life insurance contracts. Nevertheless, single-pay contracts still have a useful place in the world of life insurance. Owners of single-pay contracts can still benefit from the tax-deferred cash value build-up and income tax-free death benefits of life insurance (under IRC §101(a)). They just can't access cash values without incurring ordinary income tax.

Single-pay life policies remain especially attractive in estate planning scenarios where the emphasis is on maximizing income tax-free death benefits using the applicable exclusion amounts, and perhaps the generation-skipping applicable exclusion, to pass premium amounts free of transfer taxes to an irrevocable life insurance trust (with Crummey provisions).

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