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Modified Endowment Contracts (MEC)

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What is a modified endowment contract (MEC)?

Class of life insurance product subject to special (unfavorable) tax treatment

Changes to the tax law in 1988 resulted in certain insurance policies that were funded too rapidly (generally in one large payment) being classified as modified endowment contracts (MECs), and eliminated the use of such policies as short-term savings vehicles by imposing stiff penalties. Prior to enactment of the MEC rules, it was possible to place large amounts of cash into a single premium life insurance policy where the inside buildup grew tax deferred and at death the proceeds passed tax free to the beneficiary. If the money was needed, the cash value was accessible to the policyowner through tax-free lifetime loans or withdrawals. These policies were being used in place of other investment vehicles, the earnings on which were subject to income tax.

Subject to taxation and penalty

Under the current law, money taken from a MEC in the form of policy or premium loans, partial surrenders, assignments, pledges, withdrawals, or loans secured by the policy are subject to income tax and possibly penalties. While a MEC provides a death benefit as with traditional cash value life insurance, it has been stripped of a major feature: tax-free access to cash values.

The MEC rules

Apply to all policies

Policies entered into before June 21, 1988, are not subject to the MEC rules clause unless they undergo a material change . All policies entered into after June 20, 1988, and any policy, whenever issued, that undergoes a material change after June 20, 1988, will be tested under the MEC classification rules.

Once a MEC, always a MEC

Once classified as a MEC, a policy remains a MEC. The policy status doesn't change even if the policy is changed, adjusted, or reconfigured as a policy that would not otherwise be considered a MEC. A policy received in exchange for a MEC is also considered a MEC, even if the policy received under the exchange wouldn't otherwise be considered a MEC.

The 7-pay test determines MEC status

Mandated by government

The test used to determine if a policy is a MEC is called the 7-pay test. The 7-pay test has nothing to do with the actual number of premium payments. Instead, it is a limitation on the total amount you can pay into your policy in the first seven years of its existence. The test is designed to discourage premium schedules that would result in a paid-up policy before the end of a seven-year period.

Tip: *Your insurance company should provide you with information concerning the 7-pay test and its application to your policy.*

Establishes cumulative premium limits

The 7-pay test examines the cumulative amount paid under a contract during the first seven policy years. This amount is compared to the sum of the net level premiums that would have been paid on a guaranteed seven-year pay whole life policy providing the same death benefit.

The following table illustrates the 7-pay test using an assumed net level premium of $1,000 per year and two different premium payment patterns:

Year	7-Pay Test Cumulative Net Level Premiums	Policy 1		Policy 2	
		Annual Premium Paid	Cumulative Premium	Annual Premium Paid	Cumulative Premium
1	1,000	1,000	1,000	1,000	1,000
2	2,000	750	1,750	1,000	2,000
3	3,000	1,000	2,750	1,000	3,000
4	4,000	1,250	4,000	1,750	4,750
5	5,000	1,000	5,000	250	5,000
6	6,000	1,000	6,000	1,000	6,000
7	7,000	1,000	7,000	1,000	7,000

With Policy 1, even though the amount paid in year 4 exceeds the amount of the net level premium, the cumulative premiums paid are still within the limit imposed. The premium paid in year 4 in Policy 2 causes the cumulative premiums to exceed the limitation in the 7-pay test. Even though the total premiums through year seven don't exceed the total limit, the large premium in year 4 causes Policy 2 to be classified as a MEC from that time onward.

Applies in three situations

The 7-pay test must be applied in three situations:

- To initially test all policies entered into after June 20, 1988
- To re-test policies entered into after June 20, 1988, if the death benefit is reduced within the first seven contract years
- To test or re-test any policy (regardless of date entered into) that undergoes a material change in future benefits after June 20, 1988

Avoidable when you follow policy premium guidelines

The net level premium amount used in the calculation for the 7-pay test is based on certain statutory assumptions regarding interest, mortality, and expenses. Your insurance company should inform you of the 7-pay limitations and how they specifically relate to your policy. Many insurance companies offer assistance in tracking policy premiums to avoid MEC classification.

Excess premium returnable within certain time frame to avoid MEC status

If you somehow manage to pay premiums in excess of the guideline amounts for your policy, the excess amount plus any accrued interest can be returned to you by the insurance company and MEC classification avoided. The return of the excess premium must occur within 60 days after the end of the contract year.

Tax consequences of withdrawals from a MEC

Affects all cash value transactions

The MEC rules trigger tax and a penalty when the cash value is accessed through lifetime loans or withdrawals or through use of the cash value as collateral. If you have a policy that is classified as a MEC and you never access your cash value through a lifetime loan or withdrawal, you won't be subject to the tax and penalty.

Imposes tax on last-in, first-out (LIFO) method

Withdrawals, borrowings, or use of cash value as collateral from a policy classified as a MEC results in the immediate taxation of all or a portion of policy gains. Unlike distributions from a non-MEC policy, which are treated as a return of premium up to the amount of the policy basis, distributions from a MEC are treated as coming first from income (earnings) on the policy. The amount of the distribution (to the extent of policy gains) must be included in your gross income and is taxed at the ordinary income-tax rates. Policy gain equals the difference between the cash value and the net investment in the policy (policy basis).

Example(s): *Let's say you bought a policy with a single premium payment of $100,000 (causing it to be classified as a MEC). The policy now has a cash value of $125,000 (policy gain is $25,000). You take out a policy loan for $50,000. You must include the amount of the policy gain of $25,000 in your gross income and this gain will be subject to income tax at the ordinary income-tax rates. With a non-MEC policy, you would be able to withdraw up to your original $100,000 policy basis before you would be subject to income tax on the withdrawal (and loans would not be subject to income tax, even if the loan amount exceeded your policy basis).*

Imposes penalty on transactions before age 59½

In addition to paying regular income tax on the amount of the policy gain, any taxable withdrawals, borrowings, or uses of cash values as collateral before age 59½ are also subject to a 10 percent penalty tax. This penalty tax only applies to the portion of the distribution or loan that is included in gross income.

Example(s): *Continuing the example above, let's say that you are 58 years old and healthy when you take out the MEC policy loan. In addition to regular income tax, you must also pay a penalty of 10 percent on the $25,000.*

Grants certain exceptions to penalty tax

Funds withdrawn as a result of disability, after age 59½, or over a period related to the policyowner's lifetime or the joint lifetime of the policyowner and the beneficiary as part of a series of substantially equal periodic payments made not less frequently than annually are not subject to the penalty tax.

With all the potential headaches, when would you ever want a MEC?

You don't expect to need the money and want to transfer it to the next generation

The typical buyer of a policy classified as a MEC is an investment-oriented individual who probably won't need extra lifetime retirement income. The tax and penalty are triggered when lifetime distributions occur. If there is no cash value access, then there is no tax and penalty applied. A MEC can be a tax-deferred savings vehicle that provides some life insurance. When you die, the death benefit passes to your beneficiary, generally free of income and estate tax. This allows a transfer of wealth that may be taxable under other methods.

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