



## Want to Access Policy Cash Value? Beware of the MEC Rules

**Situation:** Over the past several years a number of life insurance carriers and marketing organizations have been promoting the use of life insurance as a source of cash in retirement: accessing values when the market takes a down-turn on a tax-free basis. Since more economists believe that recession might be around the corner, now is a good time to brush-up on a tax rule that can cause unnecessary taxation.

Where lifetime access to cash values on a tax favored basis is important, care must be taken when funding a policy or making changes to policy benefits. Why? Because, excessive funding and some policy changes can cause the policy to be taxed as a Modified Endowment Contract (MEC). MECs are subject to certain unique tax rules. Specifically, lifetime distributions and loans from a MEC are treated as coming from gain first, subject to ordinary income tax. In addition, a penalty tax of 10 percent may be imposed.

Some planning techniques purposefully trigger MEC status at the inception of the contract and carrier illustrations will typically alert advisors and clients of this fact. In addition, MEC status can be inadvertently triggered by subsequent modifications to existing policies that are intended to address a client's changing needs. Consequently, advisors should continually monitor changes to a client's policy to avoid unintended application of MEC status.

Given the income tax consequences of MEC status it's important that financial advisors have a working understanding of the MEC rules. This *Counselor's Corner* will describe what causes a policy to become a MEC and how a MEC is taxed. In addition, we will discuss a retirement income technique currently being promoted as taking advantage of a loophole in the MEC rules which might be too good to be true.

**Solution:** Before we get into a discussion of what causes a policy to become a MEC, it's helpful to know what transpired prior to its enactment that caused Congress to pass the MEC legislation. In the late 1970s, insurance companies began developing products that were flexible in nature and that could be used as investment vehicles. In particular, single-premium life insurance contracts became popular because investment gains inside the policy could be deferred while the owner was able to take principal-first, income tax-free distributions. Congress felt the need to establish controls. This resulted in the passage of three federal tax acts (TEFRA – 1982, DEFRA – 1984, and TAMRA – 1988) designed with the intent to ensure that the income tax advantages of life insurance were not abused. The third act, TAMRA, established the MEC rules.

### What is A Modified Endowment Contract? What Triggers MEC Status?

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

- entered into or materially changed after June 21, 1988, and
- which fails the "seven-pay test."<sup>1</sup>

A policy fails the seven-pay test if the cumulative premiums paid during the first seven years of the contract (or the first seven years after a material change) exceed the amount needed to provide a paid-up policy based on seven statutorily defined level annual premiums.<sup>2</sup> Essentially, the 7-pay test limits the overpayment of premiums by requiring a minimum level of insurance face amount per premium dollar. A common example of a MEC is a single premium policy. However, it's important to note that a policy can fail the 7-pay premium test at a later date if premiums increase or are paid in an irregular amount.



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

**Grandfathered Contracts Can Become MECs.** 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.

**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:

- An increase in the policy death benefit (with some exceptions);
- Any increase or addition of a qualified additional benefit/rider (i.e., guaranteed insurability, disability waiver).
- Term life conversions to permanent coverage; and
- Exchanges of one policy for another, whether taxable or tax-free under IRC § 1035.

Some increases 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

**Death Benefit Reductions.** Where there is a scheduled or an unscheduled reduction in the death benefit within the first seven contract years (or the first seven years after a material change), the 7-pay test must be recalculated as if the contract had originally been issued at the reduced

death benefit level.<sup>3</sup> If the policy fails the recalculated 7-pay test, MEC income-first taxation applies.<sup>4</sup> For example, assume a policy is acquired where the MEC premium limit is \$30,000 and annual premiums of \$25,000 are paid for 6-years. In the year six \$100,000 is withdrawn, which reduces the face where the 7-pay annual premium is \$23,000. This causes the policy to become a MEC subjecting the gain in the withdrawal to be subject to tax (and possibly 10% penalty).

**A special rule applies to survivorship policies.** In the case of a survivorship policy issued on or after September 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.

**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. Once a policy becomes a MEC it remains a MEC for the life of the contract. Even if it is exchanged for a new policy the new policy will be a MEC.

A properly planned exchange of a non-MEC with **no new money** will not create a MEC since the cash value existing on the day of the exchange is not treated as 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. In contrast, an exchange 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, 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.

**Safety Valve – Return of Premiums.** If a policy would become a MEC because of the payment of premiums in excess of the cumulative MEC premium, MEC status can 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.<sup>5</sup>



## What Are the Tax Consequences of A MEC?

**Tax on Lifetime Distributions.** 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.**<sup>6</sup> 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 a 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 (i.e., change of policy ownership, collateral assignment of policy)

### 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

**Penalty Tax.** Unless the taxpayer is at least 59½ years old, 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 his beneficiary, any taxable distribution from a MEC will be subject to a 10% penalty.

**Look Back.** A look back rule applies MEC taxation to any distribution in the two years before the policy failed the 7-pay test in addition to MEC taxation in the year it fails and all future years where there is a distribution.<sup>8</sup>

**Tax Otherwise Same as Non-MEC.** MEC and non-MEC policies are otherwise taxed the same. Specifically, the cash value inside a life insurance policy and death benefit received by beneficiaries is generally income tax-free.

## Retirement Income Strategy: Clever Use of MEC Loophole or Too Good To Be True Illustration “Illusion”

This author has reviewed many concepts where life insurance is acquired using distributions from qualified retirement accounts. In most cases the objective is to create an income tax-free legacy for heirs instead of a tax bill. Now that it is also possible to add a long-term care or chronic illness rider to life insurance, clients are expressing greater interest in these techniques.

Most of the qualified plan distribution strategies are structured to provide the maximum amount of death benefit for a minimum premium amount to create a death benefit legacy for heirs so MEC is rarely an issue.<sup>9</sup> However, one concept promoted by a couple of carriers utilizes the policy cash value to create an income tax-free retirement income for the retirement plan participant utilizing a minimum face non-MEC policy structure. While this strategy may comply with the letter of the MEC legislation, small changes in the illustration assumptions put the policy at risk of lapse with significant tax recognition. Because of the risks associated with this concept this author does not recommend its use.<sup>10</sup> So what is the structure of this strategy you ask?

The strategy starts with a qualified plan participant or IRA owner taking taxable distributions from his/her account and using the full distribution to pay premiums on a life insurance policy. The policy is structured as an increasing “option B” minimum non-MEC face using the GPT (guideline premium test) definition.<sup>11</sup> In year 2 the policy owner takes a policy loan to pay the tax due on the first year plan distribution in addition to taking a taxable qualified plan distribution and using the full amount to pay premiums. This premium payment structure is also used for policy year 3. Starting in year 4 no qualified plan distributions or policy premiums are paid. However, in year 4 a policy loan for tax due on the third-year plan distribution is taken followed by a death benefit option change from “B” (increasing) to “A” (level). Following the death benefit option change in year 4 the policy face amount is reduced to the lowest amount possible. Beginning in year 5 income tax-free policy distributions structured as loans are made to the insured’s age 100. Eventually, at the insured’s death proceeds are paid to the beneficiary income tax-free.





**Example.** A male age 60 standard risk buys a \$1,295,968 index universal life policy from a carrier permitting variable loan interest rate. Three annual premiums of \$100,000 are paid with funds acquired from his IRA. In policy years 2, 3 and 4, \$30,000 is borrowed from the policy to pay the tax due on the IRA distributions. In policy year 4 the death benefit option is changed from increasing to level when the death benefit is \$1,508,758, followed by a face amount reduction to \$261,090. Beginning in year 5, and continuing for the next 35 years, annual loans of \$24,000 are received income tax-free by the insured.

For MEC purposes a reduction of death benefit in the first 7 years usually causes the 7-pay test to be recalculated as if the contract had originally been issued at the reduced death benefit level. In our example, the \$100,000 premium clearly exceeds the 7-pay limit for a \$261,000 face amount policy, but MEC taxation is not triggered. The reason MEC taxation is avoided is because prior to the face amount reduction the death benefit change from “B” to “A” triggered a material change. **A material change in the first 7-years followed by a death benefit reduction requires a recomputation of the 7-pay test back to the date of the material change, rather than the date of the policy issue, even though the periods overlap.** Consequently, the policy distributions are not subject to MEC taxation.<sup>12</sup>

While the series of steps utilized by this strategy may comply with the letter of the law; the structure creates significant risk of policy lapse if policy crediting rates (or loan interest spread) actually received is less than the rate assumed in the illustration. In fact, in the example described above a minor decrease in crediting rate caused the policy to lapse prior to life expectancy. Furthermore, a policy owner cannot contribute additional premiums to “rescue” the policy because the GPT definition limits the amount of premium a carrier can accept. A lapse of the policy will result in recognition of all the policy gain as ordinary income.

**In Summary.** MEC rules are designed to limit the tax advantages of heavily funded and single-pay life insurance contracts. Nevertheless, MEC contracts still have a useful place in the world of life insurance. Owners of MEC 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.

<sup>1</sup> §7702A. Note: All MECs issued in a single year by the same carrier are treated as a single MEC.

<sup>2</sup> §7702A(b).

<sup>3</sup> The death benefit reduction rule appears to apply only during the first 7 years on a single life policy unless there is a material change. Absent a material change, a death benefit reduction after the first 7-years has no effect – a death benefit reduction itself is not a material change. However, a material change restarts the 7-year testing period. Apparently, a material change in the first 7 years followed by a death benefit reduction requires a recomputation of the 7-pay test back to the date of the material change, rather than the date of the policy issue, even though the periods overlap.

<sup>4</sup>It should be noted that during the first 15 years of a policy a withdrawal when accompanied by a face amount reduction may be subject to income first taxation even if the policy does not become a MEC. The withdrawal in first 15-years rule and the MEC rules overlap. However, the first 15-years rule does not apply to policy loans whereas the MEC rules applies to both loans and withdrawals.

<sup>5</sup>IRC § 7702A(e)(B). In addition, policies that inadvertently become MECs due to administrative errors or systems limitations can be corrected by the issuing carrier Rev. Proc. 2008-39.

<sup>6</sup>IRC § 72(e)(10). Distributions in the year the policy becomes a MEC and all years thereafter, as well as distributions in the 2-years before the policy failed the test will be subject to MEC taxation.

<sup>7</sup>IRC § 72(v)(1).

<sup>8</sup>IRC § 7702A(d)(2).

<sup>9</sup>Until recently the primary issue with pension distribution concepts designed to provide heirs with a legacy has been with justifying the face amount applied for by financial representatives. Specifically, instead of applying for a face amount based on the estimated tax liability caused by the pension, the face amount is often based on the maximum face amount the after-tax (net amount) distribution can acquire. This fails to consider the financial underwriting aspects. A more recent concern is that after April 2017 financial representatives will need to comply with the DOL fiduciary rules when using distributions from qualified accounts to acquire life insurance.



<sup>10</sup>At a minimum the financial advisor should disclose the tax and economic risks to the client.

<sup>11</sup>Option B or Option 2 is a death benefit structure where the policy face increases by the cash value growth. GPT life insurance definition structure (in contrast with CVAT cash value accumulation test) is often used when the desire is to create the maximum policy cash value.

<sup>12</sup>It should be noted that a reduction in face amount prior to the death benefit option change will cause the policy to be a MEC.

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