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ADVISOR'S BULLETIN

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WHAT'S IN THIS MONTH'S NEWSLETTER

WHAT EVERY FINANCIAL PROFESSIONAL NEEDS TO KNOW ABOUT MODIFIED ENDOWMENT CONTRACTS (MECs)

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Permanent life insurance is a useful financial tool. As we've outlined in the past, cash value life contracts can help many of our clients achieve their overall financial security objectives. For most the availability of the death benefit—regardless of the insured's age—helps to bolster long-term financial plans.

For some the lifetime tax-advantaged access to the cash value is a significant plus that influences the purchase decision. "Normal" permanent life insurance offers both tax-deferred cash value growth and tax-advantaged access to cash values during one's lifetime.

When is cash-value life insurance not normal? A modified endowment contract (MEC) has some different tax characteristics that a purchasing client needs to understand and to consider. From a client's perspective these are the important questions:

- What is a MEC?
- How is a MEC created?
- Once a contract becomes a MEC, can the status be undone?
- How is a MEC different from a regular cash value policy?

In this month's article we will consider these and other questions about modified endowment contracts.

Please keep reading to find out more and contact me with any questions.

Regards,
Michael W. Lagos, CFP®

WHAT EVERY FINANCIAL PROFESSIONAL NEEDS TO KNOW ABOUT MODIFIED ENDOWMENT CONTRACTS (MECs)

MODIFIED ENDOWMENT CONTRACTS

Here's a brief history of the MEC rules.

Prior to 1988, single-premium life insurance was marketed by some as a serious alternative to deferred annuities and other kinds of investments. The natural tax advantages of life insurance—tax-deferred growth, tax-advantaged access to cash value, and tax-free death benefit—allowed single-premium configurations to illustrate favorably.

The federal government intervened, deciding that the tax advantages of single-premium life insurance gave it an unfair advantage. The MEC rules were created and imposed on policies that were implemented or materially changed on or after June 20, 1988.

What a MEC Is (and Isn't)

To understand what modified endowment contract status is, the starting point is that a MEC is still a life insurance policy.

Since a MEC is designed to be life insurance, a MEC must still comply with the tax code's requirements for life insurance. That means it must comply with all the requirements concerning premium limits and minimum death benefits set forth in Revenue Code Section 7702.

Since a MEC is life insurance, the normal tax advantages available for cash-value products are also available for MECs—unless the tax code says otherwise. Section 72 lists the way MEC taxation differs from regular permanent life products.

How to Make a MEC

One way to make a MEC is to pay too much premium into the policy in its early years.

EXCESS PREMIUMS

The federal government imposes limits on the amount of premium that can be paid into a policy during its first seven years. This premium restriction is sometimes referred to as the seven-pay limit because the federal government imposes these premium restrictions during the policy's first seven years. The seven-pay limit is independent of the guideline premium limit mentioned earlier.

The seven-pay limit rules are contained in Revenue Code Section 7702A.

Life insurance companies will usually permit policy owners to exceed the seven-pay limit. The excess premium will cause the contract to be classified as a MEC. If a policy owner creates a MEC by paying too much premium, the life insurance company will usually notify the taxpayer.

In a situation where the policy owner unintentionally paid premiums in excess of the seven-pay limit, the insurance company may refund the excess premium within a short time window—generally 60 days past the next policy anniversary—to cure MEC status. Once the life insurance contract becomes a MEC and is past the cure deadline, it stays a MEC.

BENEFIT REDUCTION

Another way for a policy owner to create a MEC is to reduce the face amount of the contract within the first seven years. If the policy's death benefits (or other benefits) are reduced at any time during the policy's first seven years, the seven-pay limit must be recalculated as if the reduced benefits were in effect from the contract's inception.

MATERIAL CHANGE

The tax code contains special MEC testing rules when a contract undergoes The premiums paid in previous years would be compared to the seven-pay limit as if the lower death benefit was in effect from the beginning. If the prior premium exceeded the new limit associated with the lower benefit amount, the contract would be considered a MEC beginning at the time the prior premium exceeded the new, lower limit.

a material change. An existing policy—even if it is more than seven years old—is subject to new seven-pay testing after it undergoes a material change.

The new seven-pay limit is calculated by taking into account

- the new, increased benefit amounts,
- the policy's existing cash value, and
- the current age and risk classification of the insured.

Too much premium during the new testing period would make the contract a MEC.

Likewise, any reduction in the policy's benefits within seven years after a material change requires looking back at premiums paid since the material change—and makes the contract a MEC if the post-change premium was in excess of the lower seven-pay limit.

What kind of change is a material change for the purpose of the test? The IRS has not given a comprehensive list. However, the following are considered to be reliable examples:

- Increase in death benefit that is *not* attributable to the normal operation of the contract
- Section 1035 exchange
- Addition of a rider to the contract

A reduction of face amount after the seven-year testing period is not a material change and will not—by itself—cause a contract to become a MEC.

Undoing MEC Status

Once a contract is a MEC, it will stay a MEC forever. However, the tax code does allow for a cure of MEC status caused by excess premium if action is taken within a short period of time. Here's an excerpt from Section 7702A:

> If, in order to comply with the requirements of subsection (b), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of such contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such contract year.

As a matter of administrative practice, many carriers will notify a policy owner if excess seven-pay premiums have been mad, and will allow the taxpayer to ask for a refund of those premiums to fix an inadvertent MEC violation.

The refund technique does not work in all cases, however. If, for example, the policy owner reduces the contract's death benefit in year five, but said reduction causes premium in year three to be over the seven-pay limit, a refund won't solve the problem because it will be coming too late. Some carriers make a practice to double-check with the policy owner prior to implementing a MEC-inducing policy reduction so that an unintentional and incurable MEC trigger is avoided.

MEC Differences from Regular Cash Value Policy

What are the differences between the taxation of a regular life policy and a MEC?

REGULAR LIFE POLICY TAXATION

> Loans and withdrawals from a non-MEC life insurance policy are often promoted as being income tax-free. Revenue Code Section 72(e) (5) governs taxation of distributions from life policies—including dividends and withdrawals. Here's an excerpt with an editorial summary in the parenthesis and key words bolded:
> (5) Retention of existing rules in certain cases
>
> (A) In general
>
> In any case to which this paragraph applies . . .
> the amount (of a withdrawal) shall be included in gross income,
> but **only to the extent it exceeds the investment in the contract.**
>
> . . .
>
> (C) Certain life insurance and endowment contracts
>
> . . . **this paragraph shall apply to any amount not received as an annuity which is received under a life insurance . . . contract.**

This means withdrawals and dividends from a life policy are a recovery of basis first and taxable only after all basis has been recovered.

LOANS

Code Section 72(e)(4) says that loans ARE treated as taxable distributions.

> (4) Special rules for application of paragraph (2)(B)
> For purposes of paragraph (2)(B) –
>
> (A) Loans treated as distributions
> If, during any taxable year, an individual –
>
> (i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or
>
> (ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract,
>
> such amount or portion shall be treated as received under the contract as an amount not received as an annuity.

Boiling this down, the excerpt says that an amount "not received as an annuity" from a deferred annuity contract is taxed gain first.

However, Code Section 72(e)(5) says that for *life insurance*, Code Section 72(e)(4) *does not apply*.

Therefore, reading these sections together, for regular life insurance policies loans are not taxable distributions at all—as long as the policy stays in force.

MODIFIED ENDOWMENT CONTRACTS

Why are the references to the code sections above important? Well, the tax law specifically says this about MECs:

> [I]n the case of any modified endowment contract (as defined in section 7702A)—
> (i) paragraphs (2)(B) and (4)(A) shall apply
>
> > Section 7702A: (d) Distributions affected: If a contract fails to meet the 7-pay test of subsection (b), such contract shall be treated as failing to meet such requirements only in the case of—
> >
> > > (1) distributions during the contract year in which the failure takes effect and during any subsequent contract year. . . .

In other words, the special rule says

- loans are potentially taxable distributions for MECs, and
- withdrawals and dividends are first a taxable distribution of gain.

Finally, Code Section 72 (v) is explicit that the 10 percent pre-59 ½ extra tax applies to the taxable portion of MEC distributions unless the death, disability, or substantially equal distributions based on life expectancy exception applies.

SPECIAL CONSIDERATIONS

Code Section 7702A has a special rule that says the taxpayer must look back for two years prior to triggering MEC status to evaluate prior policy distributions for possible tax effect. A distribution made within that prior time frame may have originally qualified for normal tax treatment but might have to be taxed differently due to the policy's new MEC status.

The special MEC tax treatment of policy loans generates questions from clients. For example, some wonder whether it is better to take loans or withdrawals from MEC contracts. While the scope of that question is broad, the answer is that from a tax perspective, it is usually better to take a withdrawal than a loan from a MEC policy.

Why? Here's an example. Say that Marvin owns a universal life insurance policy that is classified as a MEC. He has paid $100,000 in premiums, and the policy's current cash value is $125,000. Marvin is wondering whether to take a partial withdrawal or a loan from the contract.

If Marvin takes a partial withdrawal of $25,000, the entire distribution will be taxable based on the gain-first distribution rule. If Marvin is younger than 59 ½, he will also be subject to the extra 10 percent tax on the early distribution. That is his only tax result unless and until he takes another distribution.

If, on the other hand, Marvin takes a $25,000 loan against the contract, he will also pay income tax (and potentially the 10 percent extra tax) on the distribution. However, if he lets the loan interest accrue against the policy, the annual interest accrual is likely to be another taxable distribution against the policy in the next year. Why is that?

The policy will have gained interest on its cash value during the year, making the cash value (and the amount of gain) bigger. The increasing loan amount will eat up some or all of that gain, causing the additional taxable amount.

Since loans are treated as taxable distributions from MEC, it is inadvisable from a tax perspective to allow MECs to be subject to a collateral assignment. Such an assignment is thought to be legally equivalent to borrowing against the contract and thus will subject the policy owner to taxes on the gain in the contract.

Managing the Seven-Pay Limit

A prospective policy owner who has access to a lump sum that might be used to make a single funding deposit into the life contract should evaluate whether making the MEC-triggering premium contribution is a good idea.

To avoid MEC status, it is generally sufficient to make five equal annual premium deposits into a policy instead of a lump sum in year one. The policy owner must take care not to exceed the regular guideline limits that apply to the contract.

Some carriers offer premium deposit funds or short-term immediate annuities as conduits to turn a lump sum into an annual life policy premium stream. Such pairings can help the client earmark a large deposit for the life contract but still avoid MEC status.

Marketing the MEC

Permanent life insurance has these advantages:

- Tax-deferred cash value growth
- Tax-advantaged access to cash during lifetime
- Some creditor protection characteristics
- FAFSA-advantaged cash value
- In some cases, tax-advantaged rider benefits
- Income tax-free death proceeds
- Income tax-free acceleration of death proceeds in some cases
- Ability to configure estate tax-free death proceeds

The ONLY disadvantage of the contract being a MEC is that the tax-advantaged access to cash during lifetime is lost. The other pluses are still available. That means a policy owner might intentionally allow the contract to become a MEC in various situations:

1. Access to cash value does not matter, such as when a policy is owned by an irrevocable insurance trust (ILIT).

2. The entity owning the contract doesn't generally pay income taxes, such as when a charity owns the policy.

3. The policy is never expected to be in a position where gain has been developed in the cash value.

4. The policy owner is certain cash value will never be accessed during lifetime.

In such circumstances the potential adverse effects of MEC status might not matter.

CONCLUSION

Life insurance is a versatile financial tool that can help clients manage risks and solve problems.

Where a person is interested in accessing a permanent life policy's cash value during one's lifetime—perhaps to supplement retirement income—in most cases she will want to avoid the policy's becoming a MEC. As advisors, we can help our clients avoid unexpected tax results, help them understand the premium funding alternatives for their life insurance policies and make sensible decisions that maximize their chances of achieving their financial goals.

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Building Protecting and Perpetuating Family Wealth

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