

MODIFIED ENDOWMENT CONTRACTS (MEC'S)

PERTINENT INFORMATION

- ❑ Mr. Kugler is considering \$250,000 of life insurance.

GOALS AND OBJECTIVES

- ❑ Mr. Kugler wants to make substantial payments into the policy during the first several policy years, and then make no further assumed payments, while continuing the death benefit protection until his death.
- ❑ He would also like the opportunity to build cash value on a tax-deferred basis. He would also like to have the ability to take cash distributions up to his cost basis without recognizing any taxable income.
- ❑ He would like to review the following:
 - ❑ The main features of the proposed life insurance functions.
 - ❑ The advantages of avoiding characterization as a Modified Endowment Contract (MEC).

PROPOSED ARRANGEMENT

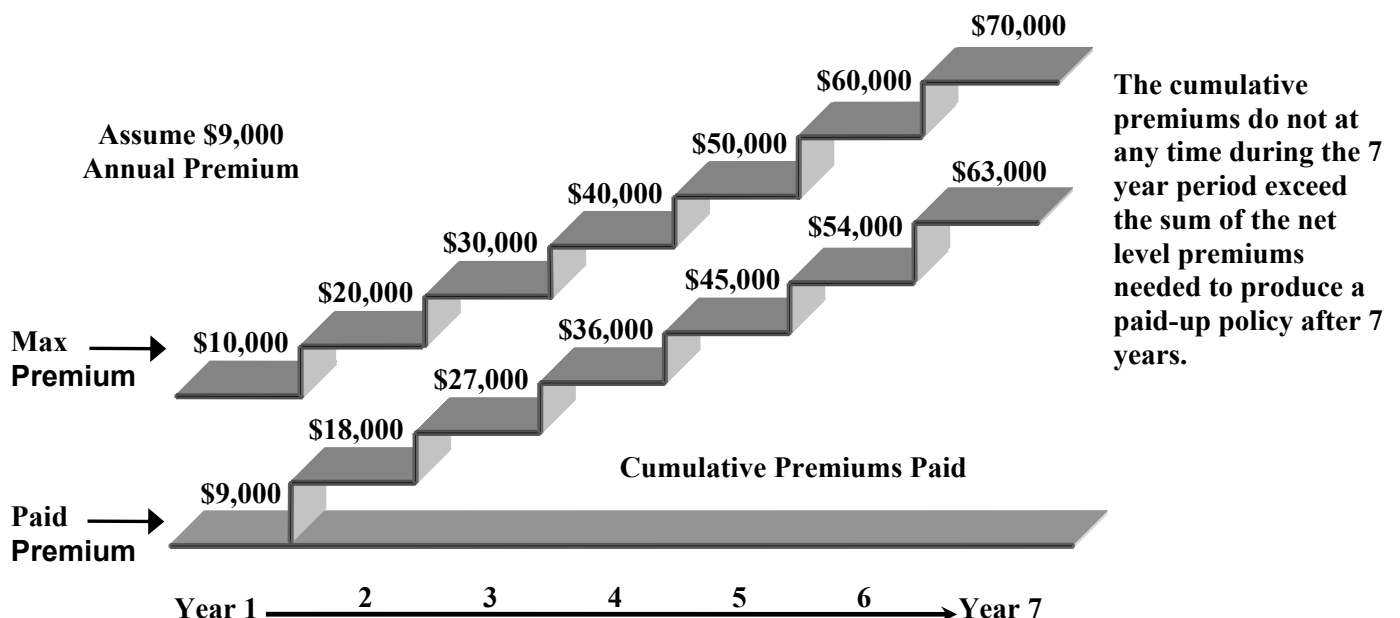
- ❑ Purchase a permanent life insurance policy that meets the definition of life insurance under IRC Section 7702, and avoids characterization as a Modified Endowment Contract (MEC) under IRC 7702A.

MAIN FEATURES OF THE POLICY

- ❑ Under IRC Section 7702A, a life insurance contract will be a MEC if it fails to meet the “seven-pay test.”

SEVEN PAY TEST

- ❑ A life insurance contract will fail the seven-pay test if, **at any time during the first seven years**, the accumulated amount paid under the contract exceeds the sum of the net level premiums that would be needed to result in a paid-up policy after 7 years. Stated simply, the seven-pay test is designed to discourage the use of a premium schedule that would result in a paid-up policy before the end of a 7-year period.
- ❑ Example: Assume the life insurance company’s net level premium to obtain a paid-up \$250,000 policy in seven years is \$10,000 per year, or a total of \$70,000 for 7 years.



- ❑ The amount paid into policy would total \$63,000, which is less than \$70,000; therefore the policy passes the seven-pay test and is *not* a MEC.
- ❑ If there is a reduction in benefits under the contract within the first seven contract years, the seven-pay test is applied as if the contract has originally been issued at the reduced benefit level.
- ❑ Once the first seven-year period passes, if there is a material change in the benefits or terms, the contract will be treated as a new contract entered into on the day the material change was effective. The seven-pay test must be met again with appropriate adjustments to reflect the cash surrender value of the contract. A material change is defined as any increase in the death benefit under the contract, or any increase in, or addition of, a qualified additional benefit under the contract.
- ❑ A policy exchange under IRC Section 1035 is considered a material change under the MEC rules. The cash value of the old policy will be considered in testing whether the newly issued policy is a MEC.
- ❑ Once a policy is classified as a MEC, it will remain a MEC for the balance of the policy life. The MEC status is irrevocable. If the policy is transferred via a 1035 exchange, the new policy will also be classified as a MEC.
- ❑ Note: If the policy includes a term insurance rider the total life insurance coverage (base policy and rider) may be considered under the seven pay test.

ADVANTAGES OF AVOIDING CHARACTERIZATION AS A MEC

- ❑ Generally, policy distributions up to cost basis are not subject to income tax during the insured's lifetime.
- ❑ Policy loans are not subject to income tax during the insured's lifetime unless the policy is terminated prior to death and has a built in gain.

DISADVANTAGES OF QUALIFYING AS A MODIFIED ENDOWMENT CONTRACT

- ❑ The cash value continues to grow on a tax-deferred basis. However, withdrawals (including loans and pledges or assignment of the policy) from a MEC are taxable as income to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract. Thus distributions are taxed on a LIFO (last in, first out) accounting basis rather than FIFO (first in, first out) basis as under non-MEC policies. Under the LIFO, method the gain is distributed before the cost basis.
- ❑ In addition, a distribution made within two years prior to the failure of the seven-pay test is considered a distribution in anticipation of a failure of the test, and is taxed as above.
- ❑ A 10% penalty is imposed on any amount received by a taxpayer under a modified endowment contract that is includable in gross income, unless the distribution is made after the taxpayer becomes disabled, attains age 59 ½, or the distribution is part of a series of substantially equal periodic payments made for the taxpayer's life or life expectancy, or joint lives or joint life expectancies of the taxpayer and his beneficiary (IRC Section 72(v)).
- ❑ In effect, any distribution from a modified endowment contract has income tax treatment similar to that in an annuity contract.
- ❑ Even though the policy is a MEC, the cash value grows on a tax-deferred basis, and the death benefit is not subject to income tax, except for cases involving the Transfer-for-Value Rule.
- ❑ If the cash value remains in the policy during the insured's lifetime, there will be no negative tax impact to the MEC status. (Note: If the policy subsequently fails to qualify as life insurance, undistributed gains are taxable.)