Insurance and Annuities

LIFE INSURANCE PREMIUM LIMITS (MECs)

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The Situation…

- Permanent life insurance contracts enjoy a special tax benefit: Cash value growth is not currently taxed.
- When the contract has accumulated sufficient cash value, the owner may take low-interest, nontaxable loans. However, the loans, along with accruing interest charges, lower the policy's cash value and potentially shrink the death benefit.

A Problem…

- The tax benefits associated with cash values have led some policyowners to begin using life insurance not primarily for death protection, but instead as a tax-favored investment.
- As a result, premiums paid into the contracts could grow to many times the amount required to pay for the insurance, with the excess going into the cash value to accumulate tax deferred. The policyowner could then borrow from the cash value without tax consequences.

Imposed Limitations…

- As this practice grew, Congress began to see it as a means of using life insurance for tax avoidance rather than for its primary role of preventing financial loss at the death of the insured.
- To discourage the practice, Congress imposed limitations on how much money a policyowner can pay into a life insurance policy.
- Section 7702 of the Internal Revenue Code addresses this cap. If the owner exceeds certain limits, the policy becomes a "Modified Endowment Contract," or MEC.
- A MEC—even a single-premium life insurance policy—can still qualify for the income tax-free death benefit and tax-deferred buildup generally available for life insurance policies.
- Certain distributions are subject to special rules:
  - Withdrawals—even by loan—are subject to income taxation if there is gain in the policy.
  - Taxable gains must be taken from the policy first, before already-taxed premiums may be withdrawn.
  - Until the gains are completely exhausted (by withdrawals or loans), the owner must include all amounts received in gross income.

The Result…

- The IRS imposes a 10% penalty tax on withdrawals or loans received from a MEC subject to certain exceptions. There is no penalty if:
    - The policyowner becomes disabled or has reached age 59½.
    - The amounts received are in a series of substantially equal periodic payments for the policyowner's life or life expectancy, or the joint lives or life expectancies of the policyowner and beneficiary.
- The limits imposed on MECs are not generally stated as a certain dollar amount, but by comparing the cumulative premiums actually paid during the first seven years with the cumulative net level premiums permitted during the same period.
- This is called the "7-pay test." To meet these requirements, policy premiums must be small enough—and sufficiently spread out in time—that they pass the test using accepted actuarial guidelines.
- Insurance companies determine the limits of the permitted net level premium amounts at the time the policy is issued, based on the MEC rules.

Other Conditions…

- If there is a "material change" in the policy (e.g., an increase in the benefits provided, or new benefits added), the policy is considered a new contract as of the date of the material change. The 7-pay test must again be satisfied, starting on that date.
- If there is a benefit reduction during the contract's first seven years, the MEC definition is applied as if the contract had originally been issued at the reduced benefit level. However, this does not apply to a reduction attributable to the non-payment of premiums if the benefits are reinstated within 90 days.

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An Illustration…

	Policy 1 Annual Premiums Paid	Policy 1 Cumulative Premiums Paid	Policy 2 Annual Premiums Paid	Policy 2 Cumulative Premiums Paid	7-Pay MEC Limit (Cumulative)
Year 1	$2,000	$2,000	$2,000	$2,000	$2,000
Year 2	$2,000	$4,000	$1,000	$3,000	$4,000
Year 3	$1,000	$5,000	$2,000	$5,000	$6,000
Year 4	$3,000	$8,000	$2,000	$7,000	$8,000
Year 5	$3,000	$11,000	$1,500	$8,500	$10,000
Year 6	$2,500	$13,500	$2,000	$10,500	$12,000
Year 7	$1,000	$14,500	$3,000	$13,500	$14,000
Both Policy 1 and Policy 2 are flexible premium policies with a death benefit of $100,000. (These figures are for illustrative purposes only.)					

- The illustration shows one policy that meets the 7-pay test and another that does not. The annual net level premium for each policy is $2,000, but over the 7-year period, the owners pay varying amounts, as shown.
- By the 5th year, the owner of Policy 1 has paid excessive premiums, with a cumulative total—$11,000—that's greater than the permitted 7-pay limit of $10,000.
- Unless the excess premium in year 5 is refunded on a timely basis, Policy 1 becomes a MEC and is no longer eligible for some of the tax benefits afforded a life insurance policy.
- Policy 2 stays within the limits the whole time, so there are no negative consequences.

The Bottom Line…

In recognizing the value of life insurance as a means of extending financial protection at an insured's death, Congress has granted certain tax concessions. But it has made clear that these can be curtailed if a life insurance purchase is considered to be a method of avoiding taxes.

LIFE INSURANCE PREMIUM LIMITS (MECs)

Summary

What Are Life Insurance Premium Limits and MECs?

Life insurance policies enjoy certain tax benefits that aren't available in other financial vehicles. One of these is a tax-free buildup of cash value that can be withdrawn through nontaxable loans.

However, if the owner of a life insurance policy pays excessive premiums in order to increase the cash value, the policy will become a Modified Endowment Contract, or MEC. A MEC can still qualify for the income tax-free death benefit and tax-deferred inside buildup generally available for life insurance policies, but the earnings in the MEC are subject to taxation when withdrawn.

To discourage the use of life insurance policies as tax-deferred investment vehicles, Congress has placed limits on the premium amounts that may be paid over a seven-year period. When an owner exceeds those limits, the policy becomes a MEC.

How Do These Limits Work?

When a life insurance policy is first issued, the insurance company determines the maximum net level premium amounts permitted by the MEC rules for that particular policy, using accepted actuarial guidelines. The annual premium payments must stay within those limits during the first seven years of the policy. If they do, the policy has met what is called the "7-pay test."

The 7-pay test compares cumulative premiums actually paid during the policy's first seven years and the cumulative net level premiums permitted for that same period. The test applies at issue (hence the first seven years) but another seven-year period begins upon any material change in the policy.

If at any point during the seven years the cumulative premiums paid exceed the permitted amount, the policy becomes a Modified Endowment Contract subject to adverse tax consequences—unless the excess is refunded on a timely basis.

What Are the Consequences?

When a policy becomes a MEC, all earnings taken from the cash value—even by loan—are subject to current income taxation. If parts of the cash value are withdrawn, the earnings are deemed to be taken first, before any of the principal which has already been taxed. Under this approach, until all earnings are withdrawn and taxed, no withdrawal is attributed to the nontaxable principal.

Also, any amount withdrawn is subject to a 10% penalty tax unless the policyowner is disabled, has reached age 59½, or the withdrawal is a Section 72(t) distribution (i.e., part of a series of "substantially equal periodic payments" made for the policyowner's life or life expectancy or the joint lives or life expectancies of the policyowner and beneficiary).

Why the Rules?

In recognizing the value of life insurance as a means of extending financial protection at an insured's death, Congress has granted certain tax advantages. But it has made clear that these advantages can be lost if a life insurance purchase is considered primarily a method of avoiding taxes.

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