WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Trick or Treat - Modified Endowment Contracts?

MARKET TREND: With greater interest in life insurance policies that can develop higher cash values, knowledge of the tax rules applicable to modified endowment contracts ("MECs") will become increasingly important.

SYNOPSIS: MECs are subject to certain unique tax rules, including the income taxation of withdrawals, policy loans, and other lifetime benefits from a MEC that otherwise would not be subject to tax if drawn from a non-MEC policy. These rules can limit the effectiveness of MECs for clients who wish to access cash value during life. MEC status also can be inadvertently triggered by modifications to existing policies, such as adjustments to death benefits or premium payments, which are intended to address a client's changing needs. Understanding the applicable rules can help clients and advisors choose between MECs and non-MEC policies, avoid unintended changes to a policy's status, and minimize unexpected tax consequences.

TAKE AWAY: MEC status may not be a problem if a client does not need lifetime access to policy cash value. MECs also may be considered as part of planning to fund qualified long-term care benefits or as an alternative to deferred annuities. Given the potential income tax consequences of MEC status, however, insurance advisors may want to coordinate with the client's investment and tax advisors to determine whether a MEC suits the client's overall insurance needs and investment goals, or if potential cash value access is a priority. As a non-MEC policy can later become a MEC, advisors also should continually monitor changes to a client's policy, particularly those involving changes to death benefits or premium payments, to avoid the possible, unintended application of MEC status.

When considering life insurance product options, insurance advisors and clients may instinctively avoid MECs due to the tax rules applicable to cash value withdrawals and loans from these policies. MEC status, however, may not be detrimental to every plan, if the advisors and clients understand why MEC status matters, what can trigger MEC classifications, and how MECs function from both a tax and economic perspective.

WHY DOES MEC STATUS MATTER?

<u>Tax on Lifetime Policy Benefits</u>. Unlike non-MECs, which allow policy owners to first recover their non-taxable "investment in the contract"[1] (i.e., policy basis) when making policy withdrawals, MECs follow a "last in, first out" ("**LIFO**") rule, which requires policy owners to first withdraw taxable income[2] from the MEC. If the MEC has income accumulation, income taxation will be triggered on withdrawals, policy loans, pledges of the MEC as loan collateral, cash dividends, and dividends retained and applied by the carrier to policy loans.

<u>10% Additional Tax</u>. An additional 10% tax also applies to the taxable portion of a MEC distribution, unless the distribution: (1) is made after the policy owner attains age 59½ or becomes disabled or (2) is part of a series of substantially equal periodic payments that are made at least annually for the life expectancy of the policy owner or joint life expectancies of the policy owner and his or her beneficiary (the "**added 10% tax**").[3]

> ***Example 1:*** A spousal lifetime access trust ("**SLAT**") owns a policy insuring the 55-year-old grantor. The gain in the policy is $250,000 (SLAT's basis in the policy of $600,000 - policy cash value of $850,000). To facilitate a distribution to the spousal beneficiary, the trustee takes out a $200,000 policy loan. If the policy is not a MEC, there is no tax on the loan. If the policy is a MEC, the loan is deemed a distribution of $200,000, taxable as ordinary income. Further, the added 10% tax applies to the MEC distribution (10% x $200,000 = $20,000).[4]

<u>Otherwise Similar to Non-MECs</u>. Otherwise, MECs and non-MECs are taxed similarly under appropriate and long-standing tax laws and principles, which provide that cash value growth within a life insurance policy is not subject to income tax, and policy beneficiaries generally receive policy death benefits without imposition of income tax.[5]

SO WHAT IS A MEC?

A MEC is a life insurance contract[6] that: (1) is entered into or ***materially changed*** after June 21, 1988, and (2) fails the "**seven-pay test**."[7] A policy fails this test if at any time in the first seven years, the total premiums paid for the policy exceed the total net level premiums that would have been paid up to that point for a fully paid-up policy requiring seven level annual premiums.[8] The seven-pay test essentially limits the overpayment of premiums in the initial years of a policy.

The clearest example of a MEC is a single premium, fully-paid up policy, which generally would fail the seven-pay test at issuance. A policy, however, can initially meet yet later fail the seven-pay test if policy premiums increase over the first few years or are paid in irregular amounts.[9]

> ***Example 2:*** B's irrevocable life insurance trust buys a life insurance policy on B with a $1,000,000 death benefit. The net level annual premium for the policy is $10,000. In year 1, the trust pays a $10,000 premium – the policy is not a MEC. By year 2, the trust has paid $20,000 in total premiums – the policy is not a MEC. By year 3, the trust has paid $40,000 in total premiums – now the policy is a MEC because it has exceeded the seven-pay premium limit ($10,000 x 3 years).[10]

SHOULD MECS ALWAYS BE AVOIDED?

Not necessarily. MEC status generally is not an issue as long as a client does not desire lifetime access to policy cash values and the policy otherwise satisfies the client's planning objectives (for example, a policy acquired primarily for providing death benefit protection).

In addition, as with non-MEC cash value policies, MECs can be structured with long-term care ("**LTC**") riders that offer benefits to help fund a client's postretirement qualified LTC expenses. Under Code §101(g), qualified LTC benefits can be paid without imposition of income tax, as accelerated death benefits. Because MEC premiums are generally larger in the early years of the policy, more assets are available earlier to fund LTC benefits, and the potential for longer-term growth within the policy is enhanced as compared to a non-MEC product.

Finally, MECs may serve as an alternative to deferred annuities. Like deferred annuities, they are taxed in a similar LIFO manner and subject to the same added 10% tax on distributions prior to age 59½. MECs, however, also provide death benefits that are payable to beneficiaries generally without imposition of income tax.

WHAT FACTORS SHOULD BE CONSIDERED?

Given the potential income tax consequences of MEC status, the selection between a MEC and a non-MEC product should be a careful decision that includes consideration of the following:

- **Need for Cash Value Access**. If the client does not anticipate taking loans against or withdrawals from the policy during life, MEC status may not be important. For lifetime access planning (such as with a SLAT), MEC status likely will not be preferred.

- **Split-Dollar Planning**. As noted, pledges of a MEC as collateral for a loan are taxed as MEC distributions and also subject to the added 10% tax. Thus, where a life insurance policy will be pledged as collateral for a split-dollar loan, MEC status likely is undesirable.

- **Desire for Future Flexibility**. As discussed below, since a MEC stays a MEC, it can limit flexibility in product modification if the client's circumstances change and access to cash value is desired.

- **Investment Considerations**: An investment analysis may be warranted to determine which product would better fit with a client's overall financial goals.

Thus, before a policy sale, insurance advisors may want to collaborate with the client's investment and tax advisors, as many of these factors involve a review of how the insurance product will work with the client's overall, long-term financial plan.

CAN A POLICY'S MEC STATUS CHANGE AFTER PURCHASE?

The answer depends on whether the policy is already a MEC.

Once a MEC, Always a MEC. Once a policy is or becomes a MEC, it remains a MEC, subject to very limited exceptions. For example, if a premium payment caused a non-MEC policy to violate the seven-pay test, and that payment is refunded to the policy owner, with interest, within 60 days after the end of the policy year of the payment, the policy may return to non-MEC status.[11]

Otherwise, MEC status cannot be eliminated, even through a tax-free exchange of a MEC for another policy pursuant to Code §1035 (a "**1035 exchange**"). The new policy received in exchange for the MEC still will be considered a MEC, even if the new policy does not fail the seven-pay test**.**[12]

But Non-MECs Can Become MECs. A non-MEC policy can change to a MEC, ***even if the change is unintended or unexpected***. As noted above, the payment of premiums in excess of the seven-pay limit during the applicable seven-year test period can trigger MEC status. In addition: (1) a material change to the contract (such as an increase in death benefits or qualified benefits, a 1035 exchange, or a conversion from term to permanent coverage) or (2) a reduction in the policy death benefits within the first seven year of issuance (or within the first seven years after a material change in a policy) will trigger another application of the seven-pay test. If the modified policy fails the re-test, it becomes a MEC (see Appendix 1 for a technical discussion of the application of the seven-pay test and triggers for MEC testing).

Any distributions made in the year a policy fails the seven-pay test and all years thereafter, as well as any ***distributions made in the two years before the policy fails the test, will be subject to MEC taxation***, including the added 10% tax, if applicable.[13] Thus, to avoid inadvertent changes in a policy's status, advisors and clients should review the potential for MEC treatment whenever making changes to the life insurance contract, coverage, or premium amounts.

TAKE AWAYS

- MEC status may not be a problem if a client does not need lifetime access to policy cash value. MECs also may be considered as part of planning to fund qualified LTC benefits or as an alternative to deferred annuities.

- Given the potential income tax consequences of MEC status, however, insurance advisors may want to coordinate with the client's investment and tax advisors to determine whether a MEC suits the client's overall insurance needs and investment goals, or if potential cash value access is a priority.

- As a non-MEC policy can later become a MEC, advisors also should continually monitor changes to a client's policy, particularly those involving changes to death benefits or premium payments, to avoid the possible, unintended application of MEC status.

APPENDIX 1: MEC TESTING - APPLICATION & TRIGGERS

New Contracts. The seven-pay test applies to a life insurance policy ***entered into after June 21, 1988*** as of the date of issuance.[14]

Materially Changed Contracts. The seven-pay test applies to a life insurance policy (including a "grandfathered" policy issued on or before June 21, 1988[15]) that is materially changed after June 21, 1988.[16] If the materially changed policy fails the re-test, it becomes a MEC.

The test applies as of the date of the material change, based on the insured's age and the policy death benefit at that time, and triggers the start of a new seven-year period for the policy. If the policy has existing cash value, however, it will reduce the seven-pay premium limit used for testing.[17] Thus, a material change to a policy with substantial cash value could result in a seven-pay premium limit near $0, such that no additional premiums could be paid after the change without triggering MEC status.

Material Changes. "Material changes" to a policy for MEC testing purposes include the following:

- An increase in the policy death benefit (subject to certain exceptions)[18]
- Any increase or addition of a qualified additional benefit[19] (e.g., guaranteed insurability, accidental death or disability, family term coverage, disability waiver benefit)[20]
- Conversion of a policy from term to permanent life insurance coverage[21]
- A 1035 exchange of one policy for another[22]

For MEC testing in connection with a 1035 exchange, the transfer of cash value from the existing policy to the new policy should not be treated as a premium contribution and should not trigger MEC status for the new policy, even if that cash value exceeds the seven-pay premium limit. However, the transferred cash value will reduce the seven-pay premium limit for testing purposes, such that any additional premiums paid with or after the exchange could cause the new policy to become a MEC.[23]

Non-Material Changes. Material changes for MEC purposes do <u>not</u> include:

- Benefit changes due to cost of living increases (which must be specified in regulations not yet issued)[24]
- Increases in benefits attributable to the premium payments necessary to fund the lowest level of death benefit and qualified additional benefits payable in the first seven contract years, or to crediting of interest or other earnings (including policyholder dividends)[25]
- Changes in minor administrative provisions (like timing of policy loan interest payments)[26]
- Changes due to the financial insolvency of the insurance company[27]

Reduction in Death Benefits within First Seven Years. If there are reductions in policy death benefits during the first seven years of a non-MEC policy (or the first seven years after a material change in a policy), the seven-pay test is re-applied as if the policy had been originally issued with the reduced benefit amount.[28] If the policy fails that seven-pay test, it becomes a MEC.

> ***Example 3:*** C buys a non-MEC policy when the annual seven-pay premium limit is $30,000. C pays annual premiums of $25,000 for six years. In year 6, C withdraws $100,000, which reduces the policy's death benefit by $100,000. However, the annual seven-pay premium for a policy with this reduced death benefit is only $20,000. C's policy now fails the seven-pay test, since the $150,000 of total premium he paid for 6 years ($25,000 x 6) exceeds the newly-calculated seven-pay limit of $120,000 ($20,000 x 6). The $100,000 distribution will be subject to MEC taxation, including the added 10% tax.[29]

NOTES

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[1] As defined in Code §72(e)(6), which provides that investment in the contract is the (1) aggregate amount of premiums or other consideration paid for the contract, minus (2) the aggregate amount received under the contract, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.
[2] Under Code §72(e)(3)(A), the amount by which the contract's cash value (determined without regard to surrender charges) exceeds the policy owner's investment in the contract (see definition in Note 1).
[3] Code §72(v).
[4] Note, however, that the policy basis increases by the amount of the subject to tax ($200,000), so that the policy basis after the loan equals $800,000.
[5] *See* Code §101 for income tax rules applicable to life insurance proceeds paid upon the death of the insured.
[6] As defined under Code §7702,which sets forth the requirements for a policy issued after 1984 to qualify as "life insurance" for federal income tax purposes. See *WRMarketplace No. 14-31* for a summary of these requirements.
[7] *See* Code §7702A.
[8] Code §7702A(b). The net level premium is computed pursuant to the rules specified in Code §7702A(c).
[9] *See* Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶12.4.5 (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2015, updated March 2015) (online version accessed on Checkpoint (www.checkpoint.riag.com)).
[10] *Id.*
[11] Code §7702A(e)(B). Also, policies that inadvertently become MECs due to systems limitations or administrative errors can be corrected by the issuing carrier pursuant to Rev. Proc. 2008-39.
[12] Note, however, that ***1035 exchanges of MECs may help limit application of the MEC aggregation rule***s. For MEC taxation, all MECs issued in the same year by the same insurance carrier are treated as a single MEC (Code § 72(e)(12)(A)). Aggregation prevents a client from buying several small MEC policies and more quickly depleting the gain in each (so that future distributions would be nontaxable returns of basis) as opposed to one large MEC policy. However, MECs received in a 1035 exchange from another carrier ***will not be aggregated*** with the MECs issued by the old carrier. Example: Assume Client owns MECs X, Y, and Z, all issued by Old Carrier in the same year. Client 1035 exchanges Y and Z for MECs issued by New Carrier. If Client later takes a distribution from MEC X, MECs Y and Z will not be aggregated with MEC X to determine the taxable portion of the distribution.
[13] Code § 7702A(d)(2).
[14] Code § 7702A(c)(1), which provides that the determination "of the 7 level annual premiums shall be made as of the time the contract is issued, and by applying the rules of section 7702(b)(2) and of section 7702(e) (other than paragraph (2)(C) thereof), except that the death benefit provided for the 1st contract year shall be deemed to be provided until the maturity date without regard to any scheduled reduction after the 1st 7 contract years."
[15] Note that grandfathering status is lost if: (1) if the contract death benefit increases by more than $150,000 over the death benefit under the contract in effect on October 20, 1988 (the seven-pay test would apply as if this were a material change in testing whether this is an MEC), (2) if, (a) on or after June 21, 1988, the death benefit under the contract is increased (or a qualified additional benefit is increased or added) and (b) before June 21, 1988, the owner of the contract did not have a unilateral right under the contract to obtain such increase or addition without providing additional evidence of insurability, and (3) if the contract is converted after June 20, 1988, from a term contract to a

contract providing coverage other than term life insurance coverage without regard to any right of the owner of the contract to such conversion. *See* Donald O. Jansen, Esq. and Lawrence Brody, Esq., "The Often Overlooked Income Tax Rules of Life Insurance Policies," p. 53, Willamette Insights Journal, Autumn 2013.

[16] Code § 7702A(c)(3).

[17] Code § 7702A(c)(3)(A).

[18] Code § 7702A(c)(3)(B).

[19] *Id.*

[20] *See* Code § 7702(f)(5).

[21] P.L. 100-647, Conf. Rpt. at 105.

[22] *Id*. *See also* PLR 9044022.

[23] Advisors also should pay particular attention to 1035 exchanges of grandfathered policies, as the exchange will trigger MEC testing for the new policy and the potential loss of the grandfathered tax protections. See Note 14 above for changes that cause the potential loss of grandfathered protections.

[24] Code § 7702A(c)(3)(B)(ii).

[25] Code § 7702A(c)(3)(B)(ii). This rule, along with the rule cited at Note 24, attempts to avoid classifying as a material change benefit increases that occur automatically under the policy versus changes initiated by policy owner actions.

[26] S. Rep. No. 169, 98th Cong., 2d Sess., vol. 1, 579 (1984). *See e.g.*, PLR 9445013.

[27] *See e.g.*, PLRs 9338018 and 9323022.

[28] Code § 7702A(c)(2) (reduction of death benefit other than for nonpayment of premiums if benefits are reinstated within 90 days after the reduction).

[29] *See* Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, ¶ 4.03[6][a][v] (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through April 2015)(online version accessed on Checkpoint (www.checkpoint.riag.com)).

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