Modified Endowment Contracts

Life insurance policies issued on or after June 21, 1988 may be defined as "modified endowment contracts" (MECs) if the cumulative premiums paid during the first seven years (7-pay test) at any time exceed the total of the net level premiums for the same period.

As an example, assume that the net level premium for a policy is $1,000 per year and the following payments are made by two different policy owners.

	7-Pay Test	Policy Owner A		Policy Owner B	
Year	**Cumulative Net Level Premiums**	**Annual Premium**	**Cumulative Premiums**	**Annual Premium**	**Cumulative Premiums**
1	$1,000	$1,000	$1,000	$1,000	$1,000
2	2,000	500	1,500	1,000	2,000
3	3,000	1,000	2,500	1,000	3,000
4	4,000	1,500	4,000	1,500	4,500
5	5,000	1,000	5,000	500	5,000
6	6,000	1,000	6,000	1,000	6,000
7	7,000	1,000	7,000	1,000	7,000

In the policy owner A example above, even though the premium paid during the fourth year exceeds the annual net level premium of $1,000, the cumulative premiums do not exceed four times (for the four years) the net level premium; and, therefore, this is not a modified endowment contract.

In the policy owner B example above, however, the premiums paid in the fourth year cause the cumulative premiums paid to exceed the cumulative net level premiums allowed and thus cause this contract to become a modified endowment contract.

Additional 7-pay test periods will be required if the policy is materially changed.

Taxation of Modified Endowment Contracts

Withdrawals from modified endowment contracts (including loans) will be taxed as current income until all of the policy earnings have been taxed. There is also a 10% penalty tax if the owner is under age 59½ unless payments are due to disability or are annuity type payments.

Well-designed premium payment schedules can avoid the modified endowment contract treatment and retain the benefits which are unique to the life insurance contract.

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