Modified Endowment Contract

What Is a Modified Endowment Contract?
A modified endowment contract (MEC) is a tax qualification of a life insurance policy whose cumulative premiums exceed federal tax law limits. The taxation structure and IRS policy classification changes after a life insurance policy has morphed into a modified endowment contract.

Understanding Modified Endowment Contract (MEC)
A modified endowment contract (MEC) is the term given to a life insurance policy whose funding has exceeded federal tax law limits. In other words, the IRS does not consider this to be a life insurance contract anymore. The change in classification was brought about to combat the use of the "life insurance" designation for the purposes of tax avoidance.
Specifically, a life insurance policy is considered a MEC by the IRS if it meets three criteria:

1. The policy is entered into on or after June 20, 1988.
2. It must meet the statutory definition of a life insurance policy.
3. The policy must fail to meet the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) 7-pay test.

The seven-pay test determines whether the total amount of premiums paid into a life insurance policy, within the first seven years, is more than what was required to have the policy considered paid up in seven years. Policies become MECs when the premiums paid to the policy are more than what was needed to be paid within that seven-year time frame.

**Important:** The IRS requires a life insurance policy to comply with a strict set of criteria in order to qualify as an MEC.

Life insurance policies entered into before June 20, 1988, are not subject to the payment of premiums over the money allowed under federal laws. However, the renewal of an older life insurance policy after this date is considered new and must be subjected to the seven-pay test.

**Tax Implications of a MEC**

The taxation of withdrawals under the MEC is similar to that of non-qualified annuity withdrawals. For withdrawals before the age of 59 1/2, a premature withdrawal penalty of 10%
interested in tax-sheltered, investment-rich policies, and do not intend to make pre-death policy withdrawals.

Unlike traditional life insurance policies, taxes on gains are regular income for MEC withdrawals under last-in-first-out (LIFO) accounting methodology. However, the cost basis within the MEC and withdrawals is not subject to taxation. The tax-free death benefit makes MECs useful for estate planning purposes, provided the estate can meet the qualifying criteria. Furthermore, policy owners who do not take withdrawals can pass on a significant sum of money to their beneficiaries.

Related Terms

**Single-Premium Life Insurance**
Single-premium life insurance charges the policyholder just one lump-sum premium payment to guarantee the death benefit. [more](https://www.investopedia.com/terms/s/single-premium-life-insurance.asp)

**Section 1035 Exchange**
A 1035 exchange is a tax-free exchange of an existing annuity contract, life insurance policy, or endowment for another of like kind. [more](https://www.investopedia.com/terms/s/section-1035-exchange.asp)

**Understanding Death Benefits**
A death benefit is a payout to the beneficiary of a life insurance policy, annuity or pension when the insured or annuitant dies. [more](https://www.investopedia.com/terms/u/understanding-death-benefits.asp)

**Defining Cash Surrender Value**
Cash surrender value is the sum of money an insurance company pays to the policyholder or account owner upon the surrender of a policy/account. [more](https://www.investopedia.com/terms/d/defining-cash-surrender-value.asp)

**Variable Life Insurance**
Variable life insurance is a permanent life insurance product with separate investment accounts, and often offers flexibility regarding premium remittance and cash value accumulation. [more](https://www.investopedia.com/terms/v/variable-life-insurance.asp)

**Statutory Employees: What You Need to Know**
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