



# Modified Endowment Contracts Guide

## Your Policy and Your Taxes

### What is a MEC?

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) created a new category of life insurance policies, referred to as Modified Endowment Contracts, or MECs. The purpose of the MEC classification was to distinguish between policies purchased primarily for death protection and policies purchased primarily for the tax advantages afforded life insurance cash values. Once a policy is classified as a MEC, it receives less advantageous tax treatment than non-MEC life insurance policies.

### What happens if my contract is a MEC?

**Good News:** MECs are still life insurance and offer tax-free death benefits and tax-deferred cash value accumulation. If your policy becomes a MEC and you do not take any distributions from that policy during the insured's lifetime, you will not experience any adverse tax implications from your contract's MEC status.

**Bad News:** Any pre-death distributions are taxed as "income first" (not basis first), meaning they are taxable to the extent of gain in the policy. In addition, distributions are subject to a 10% tax penalty, except where you, the policy owner, are age 59 1/2 or older or have become disabled. These exceptions from the tax penalty are not available where a policy is owned by a corporation.

**Examples of potentially taxable distributions include:** policy loans (including automatic premium loans), collateral assignments, cash dividends, dividends applied for any purpose other than to reduce the premium on the same contract, full and partial surrenders, and account withdrawals.

### How is MEC status determined?

To determine if a contract is a MEC, a premium limit is set. This limit (referred to as a seven-pay limit or MEC limit) is based on the annual premium that would pay up the policy after the payment of seven level annual premiums. This

limit is calculated based on rules established by the Internal Revenue Code, and it sets the maximum amount of premium that can be paid into the contract during the first seven years from the date of issue in order to avoid MEC status. Under what is known as the MEC test, the cumulative amount paid at any time in the first seven years cannot exceed the cumulative MEC limit applicable in that policy year.

### Example: Exceeding the limit

Imagine you have a \$50,000 flexible premium policy. Let's assume the MEC limit for that policy is \$1,000 each year for the first seven years of the contract. That means you can pay up to \$1,000 in premium each year without triggering MEC status. But, if in the fourth policy year you submit a \$2,000 payment, that causes the total cumulative premium payments (\$5,000) to exceed the cumulative MEC premium limit of \$4,000, and your policy then would be classified as a MEC.

### See table below for a MEC / non-MEC comparison based on this example:

Annual Premium allowable to retain Non-MEC status = \$1,000.00	Policy A Annual Premiums Submitted	Policy A MEC Status	Policy B Annual Premiums Submitted	Policy B MEC Status
Year 1	\$1,000.00	Non-MEC	\$1,000.00	Non-MEC
Year 2	\$1,000.00	Non-MEC	\$1,000.00	Non-MEC
Year 3	\$1,000.00	Non-MEC	\$1,000.00	Non-MEC
Year 4	\$2,000.00	MEC	\$1,000.00	Non-MEC
Year 5	\$0	MEC	\$1,000.00	Non-MEC
Year 6	\$1,000.00	MEC	\$1,000.00	Non-MEC
Year 7	\$1,000.00	MEC	\$1,000.00	Non-MEC
Total	\$7,000.00	MEC	\$7,000.00	Non-MEC

You can see that, even though by the end of seven years, cumulative premiums for both policy A and B are the same, the timing of the premiums paid for Policy A resulted in MEC status. Under the MEC rules, premium simply cannot be paid more rapidly than the seven level annual MEC premiums. And, MEC status **cannot** be reversed by paying less premium in later policy years.

**NOTE:** When the premium payment is applied, MassMutual will notify the owner and offer a refund to prevent MEC status. Specific time frames must be adhered to in order to avoid the MEC classification.

For example, for Policy A above, the excess \$1,000 paid in year 4 could be refunded up to 60 days after the end of policy year 4. By that refund, MEC status could be avoided.

## Material Changes

A contract can be subject to MEC testing even after its first seven years but only if a material change to the contract benefits occurs. Examples of material changes include (but are not limited to): face amount increases, exchange of insured, increase or addition of certain riders and plan changes. Once a material change occurs, a new seven-year testing period is started and a new seven-year MEC limit is calculated. Premiums are then tested during that new seven-year testing period against the new MEC limit.

## Reduction in Benefits

For an individual life policy (a single insured), a reduction in benefits in the first seven years of the contract, or during any seven-year testing period (e.g., following a material change), requires retesting of the policy under the MEC rules. For a joint life policy (two insured individuals), a reduction in benefits requires retesting at any time during the policy's duration.

Retesting means that the reduced benefits are treated as if they existed from the start of the period. The MEC limit is recomputed for the reduced benefit and each past premium actually paid during that seven-year testing period is now retested against the new lower MEC limit. This could cause a MEC to result from premium paid several years prior to the reduction.

Examples of reduction in benefits include (but are not limited to): face amount reduction, partial surrender, cancellation or reduction of qualified additional benefit rider, or a lapse that is reinstated after a specific time frame.

If a contract lapses due to nonpayment of premiums but is then reinstated, the lapse will be treated as a reduction in benefits only if the policy was not promptly reinstated. The deadline for reinstatements is established by the tax law at 90 days from the benefit reduction. Because that time frame is limited, it is always advisable to seek reinstatement quickly.

## Grandfathered Contracts and Loss of Grandfathering

The MEC rules apply to contracts issued on or after June 21, 1988. Contracts issued before that date are considered grandfathered and are not subject to the MEC test. However, certain policy changes can cause these contracts to lose their "grandfathered" status. Such policy changes include death benefit increases that require evidence of insurability and the addition of certain rider benefits.

## *What should I do if my contract enters MEC status due to an excess payment?*

You (the policy owner) will be notified if a payment exceeds the seven pay limit. You will be given an opportunity to authorize the payment and accept the MEC classification, or you may be able to request refund of the excess payment amount that results in the MEC classification. If the excess premium payment is required to maintain the policy's in force status, however, you may need to consider other options to satisfy the required premium (e.g., using policy values through partial surrenders or policy loans). Your agent can explore these options with you. Whatever you choose, you must respond to us within the time frame indicated on the notification that you receive.

## *What should I do if my contract lapses and I wish to reinstate?*

If the policy lapses, the policy owner will receive written notification from MassMutual. It is important for the policy owner to immediately contact his/her MassMutual representative or the MassMutual Service Center, at **1-800-272-2216**, to apply for reinstatement. If the policy is not reinstated promptly (within 90 days from the benefit reduction), it can and often does become a MEC.

## *Who should I call to discuss MEC tax consequences?*

The purpose of this brochure is to provide a general overview of MEC rules. In addition to this guide, however, the resources below may be able to help you make an informed decision based on your circumstances. Ultimately, the MEC status of your policy is your choice.

- If you have questions about the tax consequences created by a MEC contract, you should contact your tax or legal advisor.
- A MassMutual Service Center professional at **1-800-272-2216** can assist in providing information about specific transactions relating to the MEC status of your policy.
- Your MassMutual representative should be able to obtain general information regarding your contract and the impact of premium payments and policy changes as relates to MEC classification.

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