Modified Endowment Contract (MEC)
Aggregation Rules

Howard D. Stern, FSA
Senior Vice President & Actuary
The Pangburn Group

Life insurance contracts are afforded special treatment under current tax law. Death benefits are received tax free, and the policy cash value grows tax deferred prior to death. In addition, funds may be withdrawn from the policy tax free via loans or partial surrenders up to "cost basis" (typically sum of premiums paid) before any tax is due (FIFO taxation).

The situation is somewhat different for a policy classified as a Modified Endowment Contract. While MEC policies still enjoy tax free death benefits and tax deferred cash value growth, a MEC policy will be taxed first on distributions via loans or partial surrenders up to the "gain in the policy" (cash value less cost basis, i.e., LIFO taxation). Additionally, corporate owned policies will be subject to an additional 10% income tax.

Policies are considered MECs if they fail what is commonly known as the "7 Pay Test".(1) The MEC Aggregation Rules adds additional complexity:

Basic MEC Aggregation Rule: All MECs issued by the same insurance carrier in same calendar year to the same policyholder are treated as one policy for MEC taxation consideration.(2)

In other words, when processing a surrender, withdrawal, policy loan, pledge, etc. from 1 MEC policy, you must aggregate all the above categorized MEC policies in computing the "gain" for LIFO taxation. The result is that you cannot access basis ("basis" is typically the premiums which are recovered tax free) on any 1 policy until the gain from all policies have been removed. This could result in a total Cash Surrender Value (CSV) being taxed upon the surrender of a specific policy, as opposed to only the excess of the CSV over its premium basis being taxed.

The MEC aggregation rules could be of particular importance when banks purchase BOLI, since, in most cases, these policies are by their nature issued as MECs.

Example: Assume a bank purchases 10 MEC policies from Carrier A in 2000, each with an initial premium of $100,000 (aggregate basis of $1,000,000). In 2010, each policy has a cash surrender value of $160,000, or aggregate cash surrender value of $1,600,000.

With MEC aggregation rules, you forget about the individual policy for tax purposes, and you aggregate the policies. Consequently, all 10 policies are considered 1 policy when calculating taxable income due to a surrender, partial withdrawal, loan, pledge, etc from any 1 or more policies.

2010

- On 12/31, Bank surrenders 1 complete policy with a CSV of $160,000.
- MEC Basis before surrender/withdrawal= $1,000,000
- MEC CSV before surrender/withdrawal= $1,600,000
- MEC Gain = $600,000 (CSV less Basis)
- All 10 policies are considered 1 policy when calculating taxable income due to a surrender, partial withdrawal, loan, pledge, etc. from any 1 or more policies.

- Any withdrawal, surrender, loan, pledge, etc. up to $600,000 in 2010 (on any, some, or all the policies combined since we are effectively considering all the policies as 1 policy), will result in ordinary income tax on that amount, PLUS 10% penalty, with any excess withdrawn/surrendered, etc. as a tax free return of basis.
- Without the Aggregation Rule, the policyholder would have paid income tax on $60,000 (i.e., the single policy gain of $160,000 of CSV, less the premium of $100,000), plus 10% penalty.
- With the Aggregation Rule, the policyholder pays tax on the full $160,000 surrender, plus 10% penalty, because the first $600,000 surrendered is considered "gain."
- MEC Basis after transaction (9 policies remaining):

    (1) Beginning Basis of $1,000,000, Less
    (2) Premium basis of surrendered policy of $100,000, Plus
    (3) Pro-rata share of Gain that was taxed (9/10ths of $160,000): $144,000
    (4) Equals New MEC Basis: $1,044,000

TABULAR SUMMARY OF POLICY SURRENDER		
	Without Aggregation	**With Aggregation**
Cash Surrender Value Received	$160,000	$160,000
Taxable Amount	$60,000	$160,000
Tax Free Amount	$100,000	$0

2011

- On 12/31, a partial withdrawal is made of $150,000 is made from 1 policy.
- Assume CSV at 12/31 is $1,498,000 (i.e., approximately 4% growth of the 9 remaining policies. Each policy has a CSV of $166,445)
- All 9 remaining policies are considered 1 policy when calculating taxable income due to a surrender, partial withdrawal, loan, pledge, etc. from any 1 or more policies.
- MEC Basis before surrender/withdrawal = $1,044,000
- MEC CSV before surrender/withdrawal = $1,498,000
- MEC Gain = $454,000 (CSV less Basis)
- Any withdrawal, surrender, loan, pledge, etc. up to $454,000 in 2011 (on any, some, or all the policies combined since we are effectively considering all the remaining policies as 1 policy), will result in ordinary income tax on that amount, PLUS 10% penalty, with any excess withdrawn/surrendered, etc. as a tax free return of basis.
- Without the Aggregation Rule, the policyholder would have paid income tax as follows:
    - Single policy CSV: $166,445
    - Single Policy Basis (Premium): $100,000
    - Single Policy Gain: $66,445 (CSV less Basis)
    - Taxed on first $66,445 (which would have been "gain") of withdrawal plus 10% penalty
    - Remaining amount of withdrawal of $83,555 ($150,000 less $66,445) received tax free as a return of Basis.
- With the Aggregation Rule, the policyholder pays tax on the full $150,000 withdrawal, plus 10% penalty, because the first $454,000 surrendered is considered "gain".
- MEC Basis after transaction: $1,194,000 (Beginning Basis of $1,044,000 plus $150,000 taxable gain).

TABULAR SUMMARY OF POLICY WITHDRAWAL		
	Without Aggregation	**With Aggregation**
Cash Surrender Value	$166,445	$166,445
Withdrawal Received	$150,000	$150,000
Taxable Amount	$66,445	$150,000
Tax Free Amount	$83,555	$0

(1) IRC Section 7702A- If the accumulated amount paid under the life insurance contract during the first 7 years exceeds a statutory amount, the contract is classified as a MEC.

(2) IRC Section 72(e) (12)

The Pangburn Group does not provide legal, accounting, tax, broker-dealer or investment advisory services. The Pangburn Group is not engaged in the practice of law. Consequently, the information provided herein is not intended to present an opinion on legal, tax, accounting or investment matters. Such information provided by The Pangburn Group should be verified with your tax investment professionals or legal counsel before any action is taken with respect to this guidance.