How are distributions from modified endowment contracts (MECs) taxed?

Generally, distributions from MECs are taxed differently than distributions from policies that meet the seven pay test. Distributions, including loans, from an MEC are taxable as income at the time received to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract.[[1]](#footnote-1) Basically, this means that distributions from MECs are taxed as income first and recovery of basis second. The investment in the contract is increased to the extent that a distribution was includable in the taxpayer’s income. A loan that is retained by the insurance company to pay policy premiums is considered an amount received under the contract.[[2]](#footnote-2)

Distributions made during the contract year and any subsequent contract year in which the contract fails the seven pay test are taxed as discussed above. In addition, under IRS regulations, distributions in anticipation of a failure of the seven pay test also are taxed as above. A distribution made within two years prior to the failure of the seven pay test is a distribution made in anticipation of a failure.[[3]](#footnote-3)

This manner of taxation for distributions does not apply to the assignment or pledge of an MEC to pay burial or prearranged funeral expenses if the contract’s maximum death benefit does not exceed $25,000.[[4]](#footnote-4)

For the purpose of determining the amount includable in gross income, all MECs issued by the same company to the same policyholder within any calendar year are treated as one MEC. This rule does not apply generally to contracts purchased by a trust described in IRC Section 401(a) that is exempt from tax under IRC Section 501(a), purchased as part of an IRC Section 403(a) plan, or described in IRC Section 403(b), or to an individual retirement annuity or an individual retirement account.[[5]](#footnote-5)

# Penalty Tax

A 10 percent penalty tax is imposed on any amount received by a taxpayer under an MEC that is includable in gross income unless the distribution is made after the taxpayer becomes disabled, attains age 59½, or the distribution is part of a series of substantially equal periodic payments made for the taxpayer’s life or life expectancy or the joint lives or joint life expectancies of the taxpayer and the taxpayer’s beneficiary.

1. IRC Sec. 72(e)(10). [↑](#footnote-ref-1)
2. H. R. Conf. Rep. No. 100-1104 (TAMRA ’88) *reprinted in* 1988-3 CB 592. [↑](#footnote-ref-2)
3. IRC Sec. 7702A(d). [↑](#footnote-ref-3)
4. IRC Sec. 72(e)(10)(B). [↑](#footnote-ref-4)
5. IRC Sec. 72(e)(12). [↑](#footnote-ref-5)