INSURANCE 101

TAX TREATMENT TESTING

UNDERSTANDING 7-PAY PREMIUMS & MODIFIED ENDOWMENT CONTRACTS

Cash value life insurance has always provided consumers with the opportunity for tax-deferred growth within the policy that could be accessed when the policy value is sufficient, for any reason, subject to surrender charges and withdrawal fees.

However, in addition to the guideline premium test (GPT) or cash value accumulation test (CVAT), which qualifies a policy as life insurance under the Internal Revenue Code, a cash value life insurance policy is also subject to the 7-pay test. This test determines the amount of premiums that can be paid into a policy and still receive favorable tax treatment. Life insurance policies that fail the 7-pay test are called modified endowment contracts (MECs).

1

Does it qualify as life insurance?

Choose guideline premium test or cash value accumulation

2

Do you wish the policy to maintain its tax-favorable treatment of withdrawals?

Ensure 7-pay test is met

3

Policy is issued and compliance test cannot be changed

TRANSAMERICA®

7-PAY PREMIUMS AND MODIFIED ENDOWMENT CONTRACTS (MECs)

How does the 7-pay test work?

The 7-pay premium limit is a level annual amount of money that can be put into a cash value life insurance policy during each of the first seven policy years (or the first seven years after a material change in the policy, e.g., an increase in the face amount). The test is cumulative, meaning if the policy owner chooses not to place the entire 7-pay premium into the contract each year, that deficit can be added to the policy in a subsequent year, subject to the cumulative 7-pay limit for that year. Keep in mind, the policy is still subject to the limits as defined under GPT or CVAT.

What happens if you put in more money than the 7-pay premium limit?

The policy becomes a MEC.

What does it mean to be a MEC?

A MEC qualifies for income tax-free treatment and provides tax-deferred cash value accumulation. However, should a life insurance policy become a modified endowment contract, then the taxation of withdrawals and policy loans from the MEC is different from, and less favorable than that of a policy that is not a MEC. With a MEC, a withdrawal is taxable up to the gain in the policy first, and any excess is then treated as a tax-free recovery of basis. The amount of any loan, including capitalized interest, taken from a MEC also is treated as a distribution. In addition, distributions made within two years before a contract becomes a MEC are treated as made under a MEC. The reverse occurs with a non-MEC policy. The withdrawal is first a non-taxable return of basis with the excess gain in the policy subject to tax. A policy loan on a MEC is treated the same as a withdrawal. Also taxable, withdrawals from a MEC policy prior to age 59½ can be subject to a 10% penalty. Once a policy becomes a MEC, it will generally remain a MEC.

Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase lapse risk. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

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Under guideline premium test, distributions required as a result of a requested change or transaction may be required in the year of the change and in future years thereafter.

Please refer to Section 7702 of the Internal Revenue Code for details.

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