Modified Endowment Contracts:
Setting Up Your Personal Pot of Gold

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FINDING THE RIGHT FINANCIAL SOLUTION CAN BE DIFFICULT, especially when we're talking about emergency savings. On the one hand, you need some liquidity. On the other hand, you hope never to need it. You want it to be safe, but you'd also like to see it grow. There are many factors to consider when deciding where to stash your rainy-day fund, but a modified endowment contract (MEC) life insurance policy may just be your lucky charm.

WHAT IS A MEC ANYWAY?

Many people aren't familiar with MECs because they weren't designed as a "product," strictly speaking. A MEC describes a life insurance policy that has exceeded federal tax law limits and no longer qualifies for some of the tax advantages the IRS provides for non-MEC life insurance policies. An even shorter description: a MEC is an over-funded life insurance policy.

WHY DOES THE IRS MAKE THIS DISTINCTION?

Permanent life insurance policies have a lot of benefits and tax advantages. One advantage is that you can withdraw funds or borrow against your policy income tax-free. Should you die before you've replaced the funds or repaid your loan, the balance would be subtracted from your death benefit before it passes to your beneficiary.

The IRS allows you to withdraw or borrow against your accumulated cash value, which consists of the premiums you've paid and the interest you've earned along the way. If you overfund your policy by too much, the IRS recognizes that you may be overfunding it intentionally to create this opportunity, which means you're using your policy as an investment vehicle rather than as traditional life insurance. This is often referred to as the seven-pay limit (AKA MEC test limit), contained in Revenue Code Section 7702A.

The IRS makes this distinction because the primary purpose of life insurance is to provide a safety net for families in the event their income-earner(s) pass away. These products are particularly useful for families that haven't accumulated a great deal of wealth or savings, as they may still be in the early stages of their career. If something were to happen to their income during this stage, they may not have a financial cushion that could sustain their lifestyle. Life insurance allows these families to use their current income to secure an influx of cash in the event their income earner(s) can no longer provide for them. When a life insurance policy doesn't pass the MEC test, it's clear that the policy isn't serving its intended purpose, and therefore loses its First-in-First-out (FIFO) tax benefit.

Note: A MEC status doesn't affect the income-tax-free status of the death benefit; it only affects the funds that a policy owner might choose to access during their lifetime.

One rule of thumb to understand the difference between a non-MEC life insurance policy and a MEC life insurance policy is First-In-First-Out (FIFO) versus Last-In-First-Out (LIFO).

Non-MEC life insurance FIFO

The first funds put into the policy are the first to be taken or borrowed against.

FIFO means you're borrowing against your principal first (rather than the interest earned in the policy). By avoiding the interest-earned, you can avoid paying income tax on the funds that you withdraw or borrow. This is a very desirable benefit, especially for someone in a high tax bracket.

MEC life insurance LIFO

The last funds put into the policy are the first to be taken or borrowed against.

LIFO means you're borrowing against your accumulated interest first (rather than your principal). Therefore, your gains are subject to income tax, and you'll owe those taxes in the event you withdraw or borrow against them.

If you're under 59 1/2, any gains you withdraw would also be subject to a 10% early withdrawal penalty.

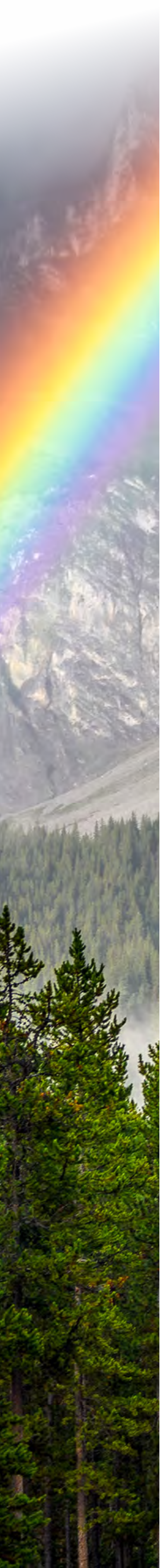
Note: Both MECs and Non-MECs may be subject to surrender charges depending on the carrier and product selected.

A MEC STATUS CAN HAPPEN ON PURPOSE OR ON ACCIDENT

A policy owner may unintentionally overpay their life insurance premiums and exceed the MEC test limit. When this happens, the life insurance carrier has a 60-day window to refund the overpayment to avoid a MEC status, allowing the policy owner to maintain their tax-advantaged withdrawal and loan capabilities. **Note:** Once a policy enters MEC status and passes the 60-day window, the MEC status can't be reversed.

Conversely, a policy owner may elect to put their life insurance policy into a MEC status from day one, especially if they have a lump-sum to deposit. When selecting a MEC, a policy owner may also opt for a lower death benefit to decrease the cost of insurance charges, which will build up their cash value more efficiently. Using a MEC this way allows the policy owner to benefit from a life insurance policy's many advantages while their lump-sum savings grow tax-deferred. This can be particularly appealing to an investor who doesn't want—or expect to need—access to the cash value in their policy during their lifetime.

Note: A MEC policy owner still has access to their cash value; the only caveat is they'd need to pay income taxes on the gains from their withdrawal, along with a 10% penalty if they're under age 59 1/2.



WHAT ARE THE SHARED ADVANTAGES OF A NON-MEC AND A MEC LIFE INSURANCE POLICY?

PROTECTION FROM MARKET RISK

Safe financial solutions are essential in developing a diversified plan and protecting your nest egg from a volatile market. Life insurance products can offer market downside protection, while certain types of policies provide an opportunity to participate in upside market potential.

TAX-FREE DEATH BENEFIT

Many beneficiaries aren't prepared for the tax burden that accompanies their inheritance. The ability to set up a tax-free death benefit for your heirs is an important consideration in estate planning. Life insurance policies and MECs expand your ability to plan for your future and family.

TAX-DEFERRED GROWTH OF CASH VALUE

The ability to grow your lump-sum savings tax-deferred will allow your compounded interest to grow much more efficiently in the long term. Many solutions that offer the benefit of tax-deferral are limited to retirement accounts, such as traditional and Roth IRAs, which have strict contribution limits. MEC and non-MEC life insurance can offer a tax-efficient alternative without contribution limits. This can be a useful retirement planning solution, especially for those who've maxed out their retirement contributions.

CREDITOR PROTECTION FEATURES

Along with its many tax benefits, life insurance and MECs can have significant creditor protection features so that in the event you were sued, your policy may be treated differently from your other assets. The extent of this protection will vary largely from state to state.

TAX-ADVANTAGED RIDER BENEFITS

In general, benefits from riders enjoy the same tax advantages as the policy itself.

WHAT MAKES A MEC SPECIAL?

When you consider using a MEC as a stowaway for emergency funds and excess savings, there are unique advantages that you'd be hard-pressed to find in an alternative financial instrument.

SAVINGS ACCOUNT: Interest-bearing savings accounts aren't what they used to be. Many pay a fraction of a percent, while high-yield savings (HYS) rates still hover around 1% and may lock your money up for months, forfeiting your interest in the event you need your money sooner.[1]

While savings and HYS accounts will provide FDIC insurance and protection against market risk, they'll expose you to inflation and opportunity risk, with virtually no upside potential. There are also very few circumstances in which these products can offer any tax advantages or protection from creditors.

A savings account may be a great option to retain three to six months of living expenses in case of emergency, but as you continue to accumulate wealth, it's advisable to explore more lucrative options for your nest egg.

MONEY MARKET ACCOUNT (MMA): Not to be confused with money market funds, MMAs are bank products (similar to savings or HYS accounts), that offer more competitive interest rates but may place limits on your transactions. MMAs offer similar pros and cons to savings and HYS accounts, with rates under 1% in the current low-interest landscape.[2]

CERTIFICATES OF DEPOSIT (CDS): CDs are a bank product that will pay you a higher interest rate in exchange for you agreeing to leave your money for an extended period, known as the term of the CD. The term can range from one month to a few years, and typically, longer terms offer higher rates. Again, these products share many of the benefits and downsides of HYS and MMA accounts in that they're generally safe with little upside potential (especially in a low-interest environment). Current one-year CD rates are under 1%.[3]

While a CD might be a great option to park funds for a set amount of time—say, while you're saving for a down payment on a home—their limited upside potential and lack of tax advantages make them a less-than-powerful tool for retirement preparation, tax optimization, or estate planning.

MONEY MARKET FUND: Unlike an MMA, a money market fund isn't a bank product but a type of mutual fund that holds low-risk investments and generates income. While these funds are generally considered safe and liquid, they're not recommended to meet long-term investment goals, nor do they offer extensive tax advantages beyond some of their holdings, which may include government-issued bonds.

ANNUITIES: Annuities certainly have their share of advantages and will often prove an excellent alternative for many individuals looking to make the most of their savings. Since annuities are designed to provide a lifetime stream of income after they're annuitized, their protection against longevity risk is unrivaled.

Both solutions boast a wide range of products that offer downside protection and the ability to select contracts that provide an opportunity to participate in upside potential. They're also similar from a liquidity standpoint since both have surrender charges and any withdrawals or loans are subject to LIFO treatment. However, from an estate planning perspective, a MEC provides the ability to leave your heirs a tax-free inheritance, which isn't a feature available with annuities.

BONDS: Like a MEC, bonds can offer reliable protection from market downside and are comparatively illiquid since bondholders are beholden to their maturity dates—often longer than one year—before they can recollect their principal.

Some bonds do offer tax advantages, such as government-issued bonds whose gains may be exempt from federal or municipal taxes. However, from an estate planning perspective, leaving these gains to your heirs without additional measures could result in a large tax burden for your beneficiaries.

Similar to annuities, bonds offer the opportunity to collect income, but they'll expose bondholders to interest rate risk. As we've seen over the past ten years, historically low interest rates have made bonds a less lucrative option than they once were.[4]

There's no shortage of low-risk options for your pot of gold, but finding the right one for your phase of life, risk aversion, time horizon, and need for liquidity can be a challenge. The MEC is an often-overlooked solution that offers a unique combination of advantages with a wide variety of options to suit your specific needs and objectives. The ability to create a MEC from your policy is just one more way that you can tailor these solutions to your specific needs. Of course, in making a decision regarding life insurance or any of the savings options referenced here, it's vital to speak with financial and tax professionals who understand your unique financial situation.

If you think a MEC could be the right solution to grow your pot of gold, speak to one of our financial professionals to discuss how it might be right for you.

[1] https://www.bankrate.com/banking/savings/best-high-yield-interests-savings-accounts/
[2] https://www.bankrate.com/banking/money-market/rates/
[3] https://www.bankrate.com/banking/cds/cd-rates/
[4] https://fred.stlouisfed.org/series/FEDFUNDS

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