Singer ***Wealth*** Management

Modified Endowment Contracts

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History:

Modified endowment contracts were created in 1988 as the result of Congress attempting to curb the use of a popular life insurance tax shelter. Life insurance had been blessed by Congress with tax-free growth, tax-free death benefits, and tax-favored withdrawals. Many life carriers tried to take advantage of this feature in the late 1970s by offering single-premium universal life products that featured substantial cash value accumulation (these were the predecessors of today's modified endowment contracts). Policy owners could then withdraw both the interest and principal as a tax-free loan, as long as the policy did not lapse before the owner's death. Of course, this strategy effectively allowed the policy to function as a large-scale tax shelter. Investors were placing their assets into these contracts and were essentially avoiding all taxes on all of the gains forever. However, Congress did not agree that life insurance should be used in this manner and therefore passed the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). This act created limits on how much money could be placed into life insurance contracts and altered the tax treatment of life insurance policies that were overfunded. These overfunded life insurance contracts became known as modified endowment contracts, or MECs.

Before this law was passed, all withdrawals from any cash-value insurance policy were taxed on a first-in-first-out (FIFO) basis. This meant that the original contributions that constituted a tax-free return of principal were withdrawn before any of the earnings. But TAMRA placed limits on the amount of premium that a policy owner could pay into the policy and still receive FIFO tax treatment. Any policy that receives premiums in excess of these limits automatically becomes an MEC. Owners of life insurance policies were counseled to avoid overfunding their life insurance contracts in order to maintain preferable tax treatment on their policies. However, for those looking for tax-efficient growth of assets, and not necessarily looking to acquire a life insurance policy, MECs continue to be a very attractive asset.

Tax Treatment: The MEC still possesses very favorable tax treatment even after the passage of TAMRA. Similar to its cousin the deferred annuity, all interest earned in the contract grows tax deferred. Withdrawals are taxed last in first out. That means that all gains come out first and are taxable as ordinary income. Also gains withdrawn prior to age 59 ½ are taxed at a 10 percent higher rate than normal income. However, the huge tax advantage over deferred annuities occurs at death. Unlike deferred annuities, which are taxable to the extent there are gains in the contract, MECs have an income-tax-free death benefit.

New Developments: Although MECs are designed for cash accumulation, they also typically come with a sizable death benefit that exceeds the account value. Since their creation, MECs have been used primarily as wealth transfer vehicles because of their tax-free death benefit. The growth of these contracts has historically been interest-rate sensitive. In times of high interest rates they offered more interest to policyholders, and in times of low interest rates they became less attractive. Also, these contracts typically came with an upfront load and/or surrender charges, which meant the MECs had to be essentially long-term investments. The following are some new developments that have made the MEC even more attractive.

- Higher interest opportunity: Instead of paying interest based on prevailing low interest rates, insurance companies are offering interest rates that are tied to stock indexes like the S&P 500 and the Eurostoxx 50. However, while contract owners may receive double-digit interest in the years the stock markets go up, they don't lose any interest in the down years. Now, owners of MECs can potentially receive much higher interest than they otherwise would in a low interest rate environment.
- No surrender charges: Another recent development is that a few companies are now offering MECs that have no upfront load and no surrender charges. This means that deposits are essentially liquid and can be removed at any time without any penalty.
- Long-term care benefits: Several insurers are allowing contract owners to receive additional benefits to cover long-term care expenses in the event they suffer a permanent cognitive impairment or are unable to perform 2 out of 6 activities of daily living. This is a very significant benefit as many people today are very concerned about providing for the expenses of future long-term care needs.

Index Crediting Methods: As mentioned before, the index crediting method provides an opportunity to make higher interest rates than traditional crediting methods in a low interest rate environment. Currently equity index universal life and modified endowment contracts offer more attractive crediting methods than index annuities. It is not uncommon to find contracts that offer annual point-to-point crediting methods with very attractive double-digit caps. Annual point-to-point typically includes a reset feature that will lock in the gains in the "up years" and reset the index value each year. So, in the "down years," interest is earned from a new, lower starting point. A cap is a limit on the amount of interest that will be credited to the contract owner in a given year. The higher the cap, the higher the expected interest rates will be. Historically, if you were hoping to earn 8 percent interest per year, you would need an annual cap of approximately 12.5 percent.

Costs: Contract owners pay an expense charge for the benefits that are provided by the contracts. The total expenses will typically vary between 1.5 percent and 2.5 percent per year based on the age and health of the insured. However, many of the contracts will guarantee a minimum interest rate that exceeds these insurance costs.

Potential Drawbacks: Unlike a traditional universal life contract, which pays interest that is predicated on prevailing interest rates, and which will pay a stable rate of interest each year, indexed crediting methods could produce less interest if there are many years when the stock index fails to appreciate. Additionally, the insurance companies are typically permitted to adjust the crediting methods downward, and they also reserve the right to increase insurance costs in the future. However, despite retaining this flexibility, the trend in the industry has been to lower insurance costs to reflect recent unanticipated increases in life expectancies. Finally, in order to qualify for this type of insurance product, the insured must submit to medical underwriting, typically at the insurance company's expense.

Ideal Uses:

- Alternative to money markets, short-term bonds and savings accounts: Because certain contracts have no upfront loads and no surrender charges, and also offer a minimum interest rate, they can serve as an alternative to other short-term liquid assets.
- Alternative to stock investments: Some contracts offer relatively attractive crediting methods that offer the opportunity to achieve double-digit returns in the up years, yet not lose due to market activity in the down years. Therefore, this could serve as a portion of one's long-term growth strategies.
- Alternative to municipal bonds: For those looking for tax-favored assets, modified endowment contracts grow tax deferred, have a tax-free death benefit and, unlike bonds, do not lose value if interest rates increase.
- Long-term care supplement: One of the most attractive ways to own long-term care insurance is in combination with life insurance. Traditional long-term care policies provide no benefit to those who pass away without having needed long-term care. Hybrid long-term/life insurance policies will not only provide a long-term care benefit if the insured needs it, but will provide a tax-free death benefit as well, even if long-term care was never needed.
- College savings plan for grandkids: If you are trying to save for a grandchild's education, it may be risky to invest in equities, especially if the funds are needed within the next few years. These contracts not only have an attractive risk-adjusted expected return, but have a significant tax-free death benefit as well.
- Estate-planning tool: For those looking to maximize the value of the estate that is left to their heirs, these contracts provide a significant income-tax-free death benefit to the beneficiaries.

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