If You Like Annuities, You'll Love a MEC!

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Many agents seem to believe that early funding of a life policy that is classified as a Modified Endowment Contract (MEC) is always bad for the client. After all, lifetime withdrawals from a MEC do not have the same favorable income tax consequences as withdrawals from a non-MEC policy. A full discussion of the MEC rules follows.

But if you think about it, lifetime withdrawals from MECs are identical to the taxation of lifetime withdrawals from deferred annuities – a very popular product. But at the death of the insured or annuitant the MEC contract is a clear winner. This is because the death benefit is income tax-free to beneficiaries while the gain in a non-qualified deferred annuity is taxable to the beneficiaries as IRD (income-in-respect of a decedent).

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This article takes a look at the pros and cons of a Single Premium Life (SPL) Modified Endowment Contract for clients who have a lump sum of money that is suitable for a tax-deferred annuity or life policy. Our belief is that many clients will be better served by choosing a SPL-MEC.

PROS AND CONS OF NON-QUALIFIED TAX-DEFERRED ANNUITIES

Non-qualified deferred annuities provide a number of advantages to annually taxable fixed income products, such as certificates of deposits or passbook savings accounts:

- Annual net yield is highly competitive with other fixed products.
- The annuity enjoys the benefit of tax-deferral during the accumulation phase, which allows more of the client's money to remain in the annuity to earn interest.
- Taxes are paid only when gain is withdrawn, which is totally within the control of the client. Tax-deferral often results in a larger after-tax distribution than a fund with an identical interest rate that is taxed each year.
- Annuities may also allow timing of distributions to minimize inclusion of Social Security benefits into taxation.

Of course there are a number of potential disadvantages to purchasing an annuity:

- Achieving a higher interest rate requires the insurance company to invest in long-term bonds and other fixed investments, which anticipate that the policyholder will leave most funds in the policy for an extended period of time. This limits liquidity in that annuities have a declining deferred sales charge for a stated period of years.

For the client who desires a high current interest rate with the safety of a guaranteed cash value... annuities offer a very positive alternative to other fixed products.

- To provide flexibility and access to account values, most annuities provide limited liquidity through a surrender-charge-free withdrawal window.

- Gain is withdrawn first (thus subject to current taxation) and withdrawals before age 59 ½ are subject to an additional 10% federal surtax.
- A potential income tax disadvantage may come into play if a beneficiary's marginal income tax rate is higher than the annuitant/owner's tax rate because gain is taxed to the beneficiary at his/her marginal tax-bracket as IRD. A number of steps can be taken to spread out this tax-consequence, if desired.

Still, for the client who desires a high current interest rate with the safety of a guaranteed cash value and (with a minimum guaranteed interest crediting rate), annuities offer a very positive alternative to other fixed products. For clients who are older than age 59 ½ the 10% surtax is not an issue, and the benefit of tax-deferral increases the accumulation potential of cash value.

Perhaps that's why the sale of annuities nationwide has increased dramatically in the past decade, with billions of dollars moving into these products.

A POTENTIAL ALTERNATIVE –
SINGLE PREMIUM LIFE TAXED AS A MEC

With that said, there may be an even better alternative for some clients to maximize the value of their "legacy" assets to their heirs.

- Life insurance funded with a single premium is often a favorable alternative to a fixed annuity for those clients who have a lump sum of money that will probably pass to their children because the death benefit is received free of income taxes. This is money the clients want to hold onto "just in case they may need it."
- Because a life insurance policy has such a long time horizon, the return on cash value is often favorable compared to the annuity. Liquidity is available through the surrender of paid-up additions or cash withdrawals.
- With a tax-free death benefit and the opportunity to accelerate benefits for chronic illness, this can be a great way to enjoy the long-term accumulation potential of tax-deferral, with the same order of withdrawal for lifetime surrenders or policy loans, but with a tax-free death benefit.

Consider a hypothetical example (see Table 1 below) using current interest rates and a 2009 dividend scale from a major insurance carrier: Male age 65. $250,000 Single Premium into a deferred annuity paying 5.3% first year, 4.3% thereafter compared to a $25,000 base WL policy with single premium to the paid-up additions rider at 2009 dividend scale (not guaranteed). The base policy premium is paid by dividend surrender each year thereafter. Future dividends and current interest rates are not guaranteed. The annuity "After-Tax Death Benefit" assumes a 32% income tax-bracket (25% federal, 7% state).

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TABLE 1

YR	AGE	ANNUITY NET SURRENDER VALUE	SPL-MEC NET CASH VALUE	ANNUITY BEFORE- TAX DEATH BENEFIT	ANNUITY AFTER-TAX DEATH BENEFIT	SPL-MEC TAX-FREE NET DEATH BENEFIT
1	65	$241,348	$234,040	$263,250	$258,613	$448,665
5	70	$296,425	$288,349	$311,534	$291,843	$493,242
10	75	$384,527	$373,161	$384,527	$341,478	$560,450
20	85	$585,828	$599,766	$585,828	$410,363	$741,452
35	100	$1,148,998	$1,103,743	$1,103,743	$830,545	$1,194,727

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As you can see, the income tax-free death benefit of the SPL-MEC creates a real advantage to the client's beneficiaries, while the cash values of the whole life policy compare favorably with the potential surrender value of the tax-deferred annuity.

A QUICK REMINDER ON MODIFIED ENDOWMENT CONTRACTS (MEC)

- An overfunded life insurance policy (meaning more premium is paid than is needed to guarantee cash value and death benefit to age 121) is classified as a Modified Endowment Contract (MEC) by the federal government.
- Like an annuity, a MEC provides tax-deferred growth of cash values, with gain withdrawn first (and taxed as ordinary income) subject to the premature distribution penalty of 10% for withdrawals of gain before age 59 ½.
- Loans from MEC policies are not advised except for very short-term periods, since interest accrued to the loan will be treated as a current taxable distribution from the policy (to the extent of gain in the policy) subject to ordinary income tax and penalties (if under age 59 ½), even though money is not withdrawn from the contract.
  - Withdrawals in excess of gain reduce basis.
  - Loan repayments increase basis.
- An SPL-MEC policy death benefit is taxed the same as a non-MEC policy; generally received income tax-free by beneficiaries.

SO, IF YOU LIKE AN ANNUITY, YOU MAY LOVE A MEC. HOW BEST TO STRUCTURE IT?

- Some in the industry feel that MEC should be an acronym for "maximum efficiency contract." That's up to you and your client to decide, after completing a thorough suitability review that includes a comparison of other available choices.
- There are generally two distinct types of clients who consider MEC's:
  1. **Maximum Death Benefit:** Clients who want maximum death benefit for a single premium, without regard to cash accumulation. These are often created using a secondary guarantee universal life policy or second-to-die universal life policy with little or no cash accumulation.
  2. **Maximum Cash Value:** Clients who typically hold their cash assets in Certificates of Deposit or Fixed Deferred Annuities, and who do not want to risk losing principal, will generally prefer whole life type products where cash accumulation is the primary objective.

SUMMARY

- MEC enjoys all the tax benefits of an annuity:
  - Tax-Deferred Accumulation
  - Taxable Withdrawals of Gain
  - Tax-Free Withdrawal of Basis
- Plus, tax benefits of life insurance
  - Tax-Free Death Benefit
  - Preferred Taxation for Chronic and Terminal Illness

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NOTE: Because not all clients qualify for life insurance, agents are wise to discuss the many positive advantages of an annuity with a client first. Once the client has concluded that it is in their best interest to buy an annuity, THEN say something like, "There is one other possibility that may or may not be available. It's called a Single Premium Whole Life, and it enjoys all the benefits we've discussed about an annuity, plus a tax-free death benefit and other valuable riders. May I discuss that with you for a moment to see if it has any interest?

If the client says, 'yes,' then talk about the MEC. If your company allows it, many agents collect a check for a no-surrender charge annuity to hold the money until an underwriting decision is reached. If the decision is positive, the money transfers into the life policy. If negative, it transfers into a higher interest rate long-term annuity.

This approach avoids hurt feelings and a potential lost sale when compared to a discussion that leads with an SPL-MEC and the client receives an unfavorable underwriting decision. Following this format presents two positive solutions rather than making the annuity seem second-rate.

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