

# **Modified Endowment Contract -**

## **A Wealth Transfer Product For The Senior Market**

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When Universal Life was introduced in the early 1980s, cash values were unleashed from the traditional low yielding environment that life insurance companies had enjoyed for decades.

Suddenly illustrations became compelling and life insurance began to be sold as an accumulation vehicle, leveraging the tax-deferred internal build-up of cash values with rates high enough to make the appreciation more dynamic. Aggressive borrowing from the cash values, which were also income tax free at the time, allowed the policyholder current access to substantial cash value gains. Under former rules the interest on insurance policy loans was even tax deductible, provided the policyholder actually paid premiums 4 out of the first 7 years.

Agents found the attractiveness of the package could be enhanced by purchasing a minimum amount of insurance - just enough to obtain the tax deferral of cash values afforded by life insurance, but not enough so that the cost of insurance caused a drag on the investment appeal of the product. Maximizing the internal build-up while minimizing the amount of life insurance purchased became the name of the game.

All that came to an abrupt halt with tax legislation that required the purchase of a substantial amount of life insurance for the contract to retain the full tax advantages of a traditional life insurance policy. Any contract where the amount of insurance purchased was too little to qualify as a true life insurance policy became defined as a "Modified Endowment Contract or "MEC" to use the abbreviation by which the default policy became known.

Under the new rules, a MEC would function for income tax purposes as if it were an annuity with a life insurance rider. The MEC retained tax-deferred build-up of cash values, but gone were income tax free policy loans. By subjecting all MEC policy loans to taxation the sizzle was gone from "have your cake and eat it too" strategies to tap accumulation gains. Suddenly, red flashing lights were put on any illustration where the amount of insurance being sold created a danger that the policy might become a MEC. New agents were trained not to sell MECs, even if the reason a MEC was to be avoided was never too clear. MECs are bad - that was all the trainee needed to know.

### *Generational Wealth Transfer - The MEC Finds a Niche In the Senior Market*

For years, the MEC languished, neglected in the backwaters of interest sensitive products that followed the marketing success of universal life. A growing need in the Senior Market has begun to refocus attention on the MEC. The very characteristics that made the MEC unattractive to aggressive life insurance customers made it just right for the sleepier Senior Market. The need was simple – annuities perform exceptionally well as tax-deferred retirement accumulation vehicles, but annuities were never designed to excel in wealth transfer to the next generation. Children and grandchildren inheriting annuities face substantial income tax penalties on interest earnings.

Creative marketers began to reconsider that only a life insurance vehicle could transfer wealth from one generation to the next income tax free. Yet, life insurance is typically difficult to underwrite at advanced ages, given anticipated health problems that come with aging, and often

prohibitively expensive. Enter the MEC. By design, the MEC reduces the amount of life insurance that comes with the contract. Although a MEC forfeits income tax free loans, the MEC retains income tax free death benefits. Upon analysis, the loss of income tax free loans was not a serious detriment in the Senior Market. Put simply, seniors are generally borrowing-adverse. Viewed through the lenses of the Senior Market, the MEC is simply an annuity with a life insurance rider.

The product becomes perfect for wealth transfer. Seniors buying MECs are underwritten for less insurance, only the relatively small amount of life insurance above the cash value that exposes the company to risk. The mortality cost for the life insurance coverage is worth the gain in income tax free transfer to beneficiaries. The senior buying a MEC retains ownership and has full access to cash via withdrawals or via loans, with the income tax penalty on both reduced by what is most likely the senior's lower tax bracket.

The opportunity for the MEC expands when we consider how few annuitants ever enter pay-out contracts. Most annuities involve money that retirees do not plan to utilize in their lifetimes. All too many annuity owners die with their annuity investment untouched. Had annuity owners transferred their money into a MEC during their lifetime, the adverse income tax consequences for their beneficiaries could have been avoided. Moreover, given the multiplying factor of the death benefit, the total amount transferred as a death benefit in a MEC could be expected to be much larger than the annuity's final accumulation value, even before taxes.

A MEC is a logical choice for a senior who realizes that funds saved for retirement will ultimately be inherited by the next generation. The choice is simple: pass on to children and grandchildren a larger amount income tax free as a death benefit in a MEC or leave a smaller accumulation value in a tax deferred vehicle to be inherited by beneficiaries who will inherit a sum further reduced by the bite of income taxes upon receiving the inheritance.

Beneficiaries who understand the benefits of a MEC might go so far as to consider financial advisors as irresponsible if the advisors do not suggest a MEC alternative to their Senior clients who allow a substantial amount of retirement savings to sit in investment vehicles that will never be more than income tax deferred. MEC marketers should feel free to explore many different retirement pools for possible conversions - not just annuities, but IRAs and a whole host of pension fund alternatives, including 401(k) and Keogh funds.

### *Facing the MEC Tax Bite*

Because MECs are life insurance contracts, 1035 tax-exempt transfers from tax-deferred vehicles such as annuities are not allowed. Clients who move from annuities to MECs must take constructive receipt of the funds and pay income tax on any realized gains. Many financial advisors view this as a negative and are reluctant to explain to their clients why paying a tax might be in their best interest.

The answers are fairly clear. To begin with, most seniors fully understand that their annuity and other tax deferred retirement funds will ultimately face a tax when they are used. The MEC transfer is most appropriate when the beneficiaries and their ultimate gain are fully in the picture. Seniors are typically in a reduced tax bracket. Even after paying income tax on tax-deferred gains, substantial earnings are likely to remain. These earnings when translated into a MEC death benefit are likely to be magnified by a factor likely to be greater than 1.5. In other words, every \$1.00 invested in a MEC, even at age 80, is likely in many MECs to result in \$1.50 or more in death benefit. This death benefit is then income tax free to the beneficiaries. The ultimate gain realized by the beneficiaries will be much greater than if the income tax bite on the tax deferred funds simply been ignored by the seniors in a decision not to think about the ultimate tax effect.

As in most financial planning, not thinking about taxation is maybe more pleasant, but certainly more risky. The MEC, presented to prospects honestly and with full explanation of tax considerations, has substantial benefits when the ultimate users of the saved funds are likely to be the beneficiaries and not the seniors themselves.

### *Financial Planning Dimensions of the MEC Sale*

Financial advisors willing to master MEC sales open a new door with their retirement customers. The first goal in retirement financial planning is to assist clients in accumulating sufficient funds to make their retirement financially comfortable. Often this is more than accomplished. Often seniors end up with accumulated retirement funds for which they have no specific spending plans. This money just sits there, with the tax collectors waiting patiently until the funds are transferred to the next generation.

Seniors need to understand that the MEC is a hybrid financial product - one whose accumulation aspects act like an annuity and whose transfer characteristics are clearly those of a life insurance policy. Paying the tax bite on tax-deferred funds and repositioning the funds into a MEC are a simple means to accomplish a tax-efficient wealth transfer to the next generation. Much simpler than living trusts or other legal structures designed to facilitate the wealth transfer goal, the MEC is simply the sale of another product, one whose unique characteristics merit consideration by all seniors who face wealth transfer opportunities.

Granted, most seniors are tax-adverse and will be reluctant to withdraw funds from annuities and other tax-deferred vehicles when doing so creates a taxable event. Creative financial planners will want to bring beneficiaries into the discussion. When beneficiaries realize that MEC death benefits pass to them income tax free, at a higher multiple value than the investment into the MEC, the beneficiaries can generally be recruited into convincing their parents that biting the tax bullet is the wise decision in this instance.

Seniors also typically feel that they are beyond the years when life insurance is required. Nor are seniors anxious to undergo the physical examinations required for underwriting. The MEC by reducing the amount of pure risk the insurance company must take eases the distasteful life insurance aspects of the sale.

Experienced financial planners know that wealth transfer has always been a door they should open with clients as their clients advance in age. Passing through the wealth transfer door with a new product in hand requires the courage not to allow clients to sit tight with investments already made, investments that hopefully have appreciated nicely and would continue to do so in their tax-deferred setting. Moreover, passing through the wealth transfer door with the MEC in hand will require a changed mind-set for agents conditioned to view MECs as bad - not to mention the hurdles life insurance sales always involve. Yet considering the degree to which the advantages outweigh the disadvantages, the MEC merits a strong place in the arsenal of every responsible financial planner seeking to advise clients entering life's final phase.

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