



Retirement Planning Options: Modified Endowment Contracts

Everyone wants a golden retirement. But saving for retirement is no easy task. The baby boomer generation is graying. More and more people are approaching retirement age. With Social Security's assets being consumed and the number of workers that will support it shrinking, we will have to rely more on our personal savings when it's time to retire.

Today, we have a myriad of options to help each of us prepare for the golden years. Yet, without a specific plan of action, many people find themselves falling short when it is time for them to live off of their life's work.

Some of the most powerful retirement strategies are Annuities, Modified Endowment Contracts and the Roth IRA. This article discusses MECs.

Take the time to review your options, and ensure that you're prepared when it's your turn to retire.

Modified Endowment Contracts (MECs)

For nearly two decades, tax-deferred annuities have enjoyed remarkable popularity. Most tax-deferred annuities require a single premium payment in the beginning, which then accumulates on a tax-deferred basis.

However, annuities are not perfect. For instance, if you should pass away while your annuity is accumulating, all deferred taxes on your growth suddenly become due. Annuities with substantial growth could be reduced significantly, and your children and grandchildren could end up with a fraction of your annuity's value after taxes.

For retirement savers looking to preserve a little more wealth for their family, there may be a solution: a type of life insurance policy known as a Modified Endowment Contract (MEC).

In financial circles, MECs are often compared to annuities because of their similarities. In fact, MECs are technically life insurance contracts that have many of the benefits of accumulation found in annuities... but if anything happens to you, your loved ones will usually receive more than your initial premium, not less.

The Basics of MECs. The same insurance companies that issue annuities also underwrite Modified Endowment Contracts. MECs are very similar to annuities in terms of tax-deferred accumulation of your initial premium.

However, the tax code is not very favorable, particularly if the owner passes away during the annuity's accumulation stage. If that happens, all deferred income taxes on growth become due.

MECs are able to overcome this by including an insurance "rider" in the contract, designed to pass the entire account value to your beneficiaries income tax-free. While specific features will vary by company, MECs offer several distinct advantages over deferred annuities and other wealth-accumulation vehicles:

- MECs avoid income taxes during the accumulation stage of your account;
- MECs do not force you to make distributions by a particular age, like some IRAs and 401(k)s;
- MECs allow you to make withdrawals or loans in cases of emergency;
- MECs give you the flexibility to choose between fixed and variable account options;
- MECs provide a lump sum payment to heirs that is tax-free;
- Unlike annuities, MECs can be owned by certain types of trusts without losing their tax-advantaged status
- MECs can provide a retirement income for you, while preserving your legacy for your loved ones.

Reducing Taxes. The Internal Revenue Code provides tax advantages for MECs, regardless of whether you choose a fixed MEC or a variable MEC. Insurance products have always received very favorable treatment by Congress, and MECs are no exception.

Unlike stocks and mutual funds, which are taxed every year, any earnings within your MEC remain untaxed as long as they stay within the MEC account. You choose when to pay taxes, since income taxes on the growth of your MEC are due only upon withdrawal. Over the long haul, this tax-free accumulation can produce dramatic advantages.

Tax-deferral provides this added value, because of the time value of money. Compare the accumulation of a jumbo CD and a MEC, and let's assume both are earning 7%. The CD is taxed on the earnings, reducing your net interest rate. If you're in the 27% tax bracket, you're actually earning 5.11%.

However, for the MEC, it's a different story. Since income taxes are deferred, the MEC is credited with the full 7%.

Of course, CDs have much shorter maturities than MECs, and they're offered by banks (not insurance companies). CDs are also FDIC-insured, while MECs are not. Plus, remember that when funds are finally withdrawn from the MEC, income taxes will be due. However, your MEC money will have worked harder for you, thanks to the time value of money on your side.

Long-Term Strategy. Tax-deferral is wonderful, but there is a small price to be paid in terms of liquidity. MECs are able to grow without annual income taxes being paid, because they are designed for retirement.

Like annuities and traditional IRAs, money placed inside a MEC must remain there past age 59 1/2. If you make a withdrawal from the MEC before that age, the IRS will slap a 10% penalty on any withdrawals made. For this reason, they are not liquid, and should remain in there until you're ready to draw money in the form of retirement income.

It's important to make a distinction between "liquidity" and "flexibility." Because MEC money must remain inside the retirement account past 59 1/2 does not mean you don't have options. To the contrary, many fixed MECs offer a wide variety of payout options to suit your needs.

Variable MECs go one step further, allowing you to choose from several variable accounts. These "variable accounts" are often run by the same professional money managers who run mutual funds. And if you have a favorite mutual fund, chances are the mutual fund manager also runs variable accounts for use in variable MECs.

Let's not forget that as long as your account is accumulating and no withdrawals are made, no Form 1099s reporting income will be generated. At the very least, this maintains a degree of privacy. And, in many states, MECs also offer asset protection from creditors. If anything happens to you, your MEC also avoids probate. Resembling an annuity once more, MECs pass probate-free to your named heirs. This probate bypass will spare your family the time, expense and public exposure that probate can bring.

When purchasing a MEC, it's important to look at the quality of the issuer. If you were buying an annuity or life insurance policy, you'd want a highly-rated insurance company behind your purchase. MECs are no different, since the same insurance companies that offer traditional life insurance and annuities also offer Modified Endowment Contracts.

If you're concerned about your MEC issuer's stability, there are many safeguards already in place by law. For instance, in a variable MEC, each variable account is in a separate custodial trust. Your money is invested with the separate portfolio managers, and is not commingled with the issuer's general accounts.

Once you purchase a MEC, you don't have to keep it forever. Section 1035 of the Internal Revenue Code allows you to switch from one MEC to another without incurring taxes on the growth of your MEC. However, if you switch to another MEC before your guarantee or "maturity" period has expired, you may incur company-imposed surrender charges. Always check those charges carefully before choosing your MEC.

Plus, MEC's usually have a death benefit higher than the actual cash value. This feature is especially useful for variable MECs, since your family may be guaranteed a death benefit greater than the payments you made, no matter what happens with the performance of your variable accounts.