When to Recommend an MEC (Modified Endowment Contract)- Episode 193

0:00:18 Todd: Hey everybody, welcome back to The Prosperity Podcast, this is No BS Money Guy Todd Strobel. Once again, we have our cohost, bestselling financial author Kim Butler with us today and we're gonna be talking about a question that we've recently received about single premium life insurance. Some of these in the insurance world are known as MECs or modified endowment contracts and there's some confusion here in that I think a lot of times, people automatically just avoid them when there is a time and a place for them. Welcome Kim.

0:00:58 Kim: Hello Todd, happy to chat about this. Yes, what is a challenge I think is that people heard about the idea of the single premium and then they've heard about the idea of how life insurance works and then separately or not at all, they may be aware of this modified endowment contract arena. When in actuality, those three things need to be all put together because a single premium life insurance policy is going to immediately turn into a modified endowment contract and that is not all bad. We have variety of clients that have modified endowment contracts instead of life insurance policies. Some of them got that way on purpose i.e. they put in a single premium and it's now a modified endowment contract. We'll give a quick run down on the difference here in a minute. Some of them got that way by accident because the payers put in too many premiums too much dollars, can't get my English right there, and also too much in the form of a paid up addition and so they accidentally created a modified endowment contract and if those aren't caught either by the policy holder or the owner then they stay that way. Once a MEC, always a MEC.

So let's just give a quick run down. A MEC essentially acts like an annuity, in other words, any cash that's withdrawn or borrowed against is gonna be coming out taxable and you also have 59 ½ age limit on it like you do with annuities and IRAs and other things. Whereas life insurance is you can borrow against it without paying taxes, it's technically tax deferred, we don't really wanna use the tax free word from the cash value standpoint. Now, both the MEC and the life insurance policies are tax free death benefits and so this is where a MEC really shines. If you have somebody that's got a lump sum of money and it's not currently needed and they truly just wanna pass it on or they truly don't think they're gonna need it in their lifetime and they just want it to grow then a modified endowment contract or a MEC is an ideal product to take a lump of money, maybe 50,000 or 100,000 and I would say rough rule of thumb pretty easily double it, wouldn't you say? You've actually probably had more experience with these than I have.

0:03:39 Todd: Depending upon the age and, I mean, all of those factors that determine the life insurance and you still have to qualify. And you can buy, just like any life insurance policy, you can buy a MEC and be the owner of a MEC without being the insured.

0:04:02 Kim: Absolutely. So if somebody has an interest in when the insured dies, whatever age that person is gonna be, then a modified endowment contract is a policy that they can buy and then have the beneficiaries, whoever those people are, get a tax free lump sum upon death of the insured. And it can be a very effective strategy again to pass money along because of that nature.

It’s not as effective for liquidity, for having dollars available today to use for investments or opportunities that come along. And so for a lot of our clients, when they express an interest in the MEC, I end up encouraging them instead to consider putting the lump sum in our bridge loan investments that pay a monthly income and then use that monthly income to pay the life insurance premium and the paid up addition rider thereby generating the liquidity inside the regular life insurance, the non-MEC life insurance, where they can have access to the cash and it is tax deferred. And at the same time, they’re handling their lump sum in a way that is going to generate good for them. A lot of people may get an inheritance or a bonus or just have a lump of money from the sale of a home or variety of things that makes them want to put money in to that single premium product.

And I just recently did a whole bunch of research again just to make sure that my thinking on this was current and there’s definitely some insurance companies out there that offer a single premium product, they offer a two pay product which acts kinda like a single premium. They also offer a prepaid premium account and that can actually help you avoid a MEC because the lump sum that goes in to the prepaid premium account is actually then paying premiums over time.

And what makes a life insurance policy a MEC are two different tests and one is an annual test and then one is a seven pay test. And so if you can stretch your payments out over seven years, even six or five years will get it done then you can avoid a MEC but again, sometimes a MEC is just fine and what you have will do the job, it passes away wealth in a completely tax free manner and the dollars inside the policy can still get a pretty decent return as long as we compare it to other liquid assets. So I’m gonna state here a MEC is not a liquid asset necessarily but it sort of acts like one from a return standpoint and that in today’s world, 2017, you’re gonna be seeing 3 ½% - 4 ½% in terms of an internal rate of return on cash value.

Now, if you’ve been exposed to the indexed universal style of life insurance policies, you’re going to be quoted a lot higher returns than that with some apparent floors and whatnot that may prove to be appealing but they may also not prove to be appealing. And what I found in my research is the index universal life floors are around 1% or 2% but that’s before expenses. And in all cases, when you’re dealing with life insurance, you have underlying expenses that are going to be between 1% and 2%. And so if you have a floor of 2% and an expense of 2%, obviously that’s zero so it really doesn’t matter how much money you’ve got in it, it’s not gonna be growing. And for me and our clients, I would prefer that they actually have their money growing even if it is only growing a little bit and that they’re not subject to the rollercoaster rides of an indexed fund but instead, are having a guaranteed cash value increase and then also a proposed dividend which isn’t guaranteed but has been paid by the whole life insurance companies most of them for well over 100 years so we can be confident in that dividend much more so I think than having confidence in the stock market and it’s “averages”.

0:08:29 Todd: Couple just quick questions. We were talking about the prepaid premium account which I think sometimes is actually almost marketed as a single pay account. Is that money taxable while it's in the prepaid account?

0:08:47 Kim: Excellent question. You're right, it is often marketed that way. And the answer is yes, the money is taxable and in most cases, the money is also not available. So while a lot of prepaid accounts earn 3% – 3 ¼% which is fabulous, much better than having it sit in a bank's savings account, it is going to be taxable and it is not available. It is truly prepaid premium.

0:09:13 Todd: If I were to say have a million dollar face amount on the policy and still have additional cash in the prepaid account, would that be paid to me or be paid to the beneficiary in addition to the million dollars?

0:09:29 Kim: Yes, if death occurred, absolutely, that prepaid account would get paid out at that time.

0:09:36 Todd: Super. So what, I mean, we mentioned the bridge loans, are there any other particular strategies that you would use with your clients to, I mean, a lot of people do come to a financial advisor with a lump sum of cash.

0:09:57 Kim: Absolutely. So it's going to depend on their situation. And if they're truly just looking for a longer term investment and they don't mind having the money tied up for say 5 – 10 years then we would look at the life settlements. The bridge loans as I've said are creating monthly income so those are two totally different types of investments. And then our third favorite place is the liquidity spot and the place to store cash, the most efficient one is cash value of life insurance but this would be a regular life insurance policy not a modified endowment contract. And so as a general rule of thumb, we help people with their life insurance in a non-MEC way but if somebody was more focused on the legacy that they were leaving then a modified endowment contract is a perfect strategy. You can do that either as single premium or not. You don't have to have a lump sum to do a modified endowment contract although I'm gonna guess most people if they are contributing say an annual or a monthly premium then they're probably not going to have a modified endowment contract. But either way, that death benefit can be tax free.

0:11:11 Todd: We're kinda diving in to the deeper more technical side of life insurance, is there a book or another resource you could recommend to kind of help people along in this education?

0:11:23 Kim: Oh, I'm glad you brought that up. Well we have a short version and a long version. So the short version is called Live Your Life Insurance and it's available on Amazon as a Kindle, an audiobook and a physical book. And the long version is called Busting the Life Insurance Lies and it is a story about a family at Thanksgiving and all the discussions that go on around life insurance amongst the various generations and it's got about 38 specific lies around life insurance. Some of them are pro and con and some of them are in the middle and it breaks each one of them down and talks about them. So if somebody's interested and you brought it up well, a more technical view or a little deeper dive, Busting the Life Insurance Lies is the source.

0:12:11 Todd: Super. And Kim, I'm gonna put you on the spot here again today. I know there's a book that you have just for our podcast listeners as well.

0:12:23 Kim: Yes. And that is called Financial Planning has FAILED and it has quite a bit of information about the bridge loans and the life settlements that I've mentioned as well as using your life insurance as a place to store cash. So that is available at partners4prosperity.com/ebook. There's an audio version as well as a download and again, that's partners4prosperity.com/ebook.

0:12:50 Todd: Super. Well thanks so much Kim. I know I learned a lot by listening to you today and I'm sure our listeners have as well. This is the No BS Money Guy Todd Strobel for The Prosperity Podcast saying take care everybody.

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