When an Insurance Contract "Bites"

Here are three situations I have run into where policy management and good council were missing and the "bite" the client received was quite severe!

Situation #1 - $150,000 1099!

A person had a whole life contract and had a short term cash flow issue so he borrowed from his policy $150,000. The client actually was able to pay the loan and interest back in a relatively short period of time based on one of the selling points of the policy – tax-deferred growth. But at the beginning of the year he received a 1099 for $150,000! A shock, to say the least.

The issue was the policy was a MEC, a modified endowment contract. The MEC rules limit how much cash you may deposit into a life insurance policy relative to the death benefit in the first 7 years of the contract. The MEC rule stipulates that any loan, surrender, assignment, pledge, withdrawal is subject to income tax and a 10% penalty if under 59 ½ to the extent of the gain in the policy. The client was very upset that the insurance company would actually send the money without explicitly signed documentation of the repercussions.

Situation #2 – Death benefit guarantee compromised!

People tend to forget what type of life insurance they buy but the agent shouldn't……I was consulting with an advisor on one of his clients life insurance property (several policies) and found something very disturbing in all the communication. As you can imagine, 2008 was a tough year and the client had emailed the agent to see if it he could skip the premiums on his life insurance policies and the agent replied within a couple of minutes to say absolutely, not a problem, I will take care of it.

Big mistake! One of the policies was a no-lapse guaranteed death benefit type life insurance policy. I informed the advisor that the death benefit guarantee has been compromised and I would recommend to request an inforce ledger for review. By skipping the premium for what was 2 years (through the financial crisis) the death benefit guarantee had been impacted significantly. The guarantee went from age 100 to 91 in this particular case. We requested a quote on how much it would take to restore the death benefit guarantee. It came back that they would have to pay what amounted to triple the annual premium!

Situation #3 - $350,000 1099!

An advisor's client received a $350,000 1099 from the insurance company on his $3mm policy!! Why? Well, the client had deposited $200,000 originally into the policy via a 1035 exchange. This was supposed to be a "paid-up" policy for $3mm. Well, the assumptions were based on a 10% return (the time was 1999) and he thought he could borrow and repay loans. He can do that but he did not pay off all the loans and the interest was capitalized causing a huge cost to the policy. Also, the cost of insurance and the market volatility caused the cash value that was supporting the policy to decrease significantly. The policy simply collapsed from its inability to support the interest charges and cost of insurance.

He received a $3,400 check in the mail and at the end of the year a 1099 for $350,000. This represented the cost basis of $200,000 less $550,000 which was the amount he pulled from the policy via loans and capitalized interest. The agent had left the business and the policy was not reassigned to another agent. Ten years had passed since the last loan activity but the interest was capitalized, the cash value left in the policy suffered market losses and the policy lapsed and presented a surprise to the client.

The Efficient Edge ◆ 120 S. LaSalle ◆ Suite 1710 ◆ Chicago IL ◆ 60603 ◆ P: 312.368.7560 ◆ peter.steger@efficientedge.net
Peter F. Steger CLU, ChFC, REBC – Principal, The Efficient Edge