Recently Enacted Changes to IRC § 7702: Impact on Life Policies and Reactions by Carriers

As of January 14, 2021

INTRODUCTION

The Consolidated Appropriations Act, 2021 (“The Act”) was signed into law on December 27, 2020. The Act is a $2.3 trillion spending bill that combines $900 billion of COVID-19 stimulus relief with $1.4 trillion omnibus spending and contained therein is a subtle revision to Internal Revenue Code (IRC) § 7702 that could have substantial impact for the life insurance industry.

This provision amends the interest rate under IRC §§ 7702 and 7702A used by life insurance carriers for determining the maximum amount of premium that can be paid into a policy and meet the definition of life insurance (DOLI) under the Cash Value Accumulation Test (CVAT) and Guideline Premium Test (GPT) and that determines classification as a Modified Endowment Contract (MEC).

Note, these changes apply only for policies issued after December 31, 2020; already in-force policies are not eligible.

TOPICS

BACKGROUND OF THE CHANGES

- IRC §§ 7702 and 7702A were first enacted in the 1980s and have not been revised for several decades.

- IRC § 7702 tests for the DOLI by calculating the death benefit based on the cash value at any given point (CVAT), or the single or level premium (GPT), necessary to fund the future policy benefits based on reasonable charges and a prescribed interest rate.

- The prescribed interest rate for CVAT is the greater of 4% and the rate guaranteed in the policy. For the Guideline Single Premium (GSP) under GPT it is the greater of 6% and the rate guaranteed in the policy. For the Guideline Level Premium (GLP) under GPT the rate is the same as for CVAT.

- IRC § 7702A tests for MEC by calculating the 7-pay annual premium which would be necessary to fund the future benefits of the policy based on the lowest death benefit during the 7-pay period, reasonable charges and the same prescribed interest rate as what is used for the CVAT test under § 7702.

- Reasonable charges include mortality charges (not to exceed the prevailing commissioners' standard tables) and charges other than mortality charges which are reasonably expected to be paid based on the company's experience.

- The economic environment in the 1980s was obviously much different than in recent years, the negative consequences of which were exacerbated in 2020 by the COVID-19 pandemic resulting in interest rates getting slashed by the Fed. These pains were primarily being felt by Whole Life carriers.

- Because Whole Life policies are designed to endow at maturity based on guaranteed premiums, charges and interest rates, the base guaranteed calculations match the § 7702 testing calculations for DOLI under CVAT (a 4% guaranteed interest rate is built into the policy).

- Prior to this change, in recent years carriers have been forced to reprice (increase) base Whole Life premiums in response to diminishing investment returns and reserves valuation rates resulting many repriced short pay (e.g. 10 pay or less) policy premiums to exceed the MEC limits at issue since the § 7702A limit used a higher valuation rate.

- For example, MassMutual's popular 10-pay product eventually became a MEC at issue due to repricing which led to the creation of its 12-pay product to spread the base premiums out longer and keep them under the MEC limit while still satisfying the DOLI under § 7702.

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BACKGROUND OF THE CHANGES

- These pricing-testing assumption disparities were creating profitability concerns for carriers which only got worse when the COVID-19 crisis hit, which threatened the ability for carriers to continue to offer competitive Whole Life policies.

- This challenge was less of a concern for Universal Life-based policies since carriers can use the prevailing commissioners' standard tables as the mortality rates for the purposes of §§ 7702 and 7702A testing, which are generally much higher than the carrier's current mortality rates, resulting in sufficiently high limits relative to what is required to profitably sustain a policy at current interest rates and mortality charges. However, as mortality rates have improved over time, the DOLI and MEC limits have decreased so eventually a similar challenge as with Whole Life may have emerged.

- In an era of uncertainty and volatility, the life insurance industry shines due to the financial security it provides to individuals, families and businesses and the tax benefits, availability and affordability of policies are critical for delivering this security. Therefore, change was vitally needed and Finseca, in partnership with the American Council of Life Insurers (ACLI), succeeded by getting it attached to other legislative COVID-19 relief efforts.

DETAILS OF THE CHANGES

- The Act changes the § 7702 interest rate for the CVAT and MEC test to be the greater of "the applicable accumulation test minimum rate" (AATMR) and the rate guaranteed in the policy.

- The AATMR is equal to the lesser of 4%, the valuation interest rate defined in the NAIC Standard Valuation Law, or rate based on a 60-month average of the mid-term Applicable Federal Rate (AFR).

- For calculating the GSP under the GPT, The Act changes the § 7702 interest rate to be equal to the greater of the "applicable guideline premium minimum rate" (AGPMR) and the rate guaranteed in the policy. The AGPMR is the AATMR plus 2%.

- For calculating the GLP under the GPT, the § 7702 interest rate is now equal to the greater of the AATMR or the rate guaranteed in the policy (same as for CVAT and MEC).

IMPACT, IN GENERAL

- The interest rates for CVAT, GPT and MEC testing can now be a floating rate less than the prescribed 4% or 6% static rates that is more reflective of current general account investment yields and reserve valuation rates.

- Whole Life carriers will experience financial relief and can charge appropriate base premiums in the current interest rate environment without violating §§ 7702 and 7702A.

- Ultimately, carriers will have more flexibility to price policies, particularly Whole Life policies, that pass the statutory tests for DOLI and MEC and remain profitable and sustainable in the current interest rate environment which should have a positive overall impact for the industry because it will help preserve the tax benefits, availability and affordability of policies and the financial security they provide to clients.

- One side effect of this change, applicable to both Whole Life and Universal Life-based policies, is that the higher maximum premium limits allowing for more premium to be paid without violating the DOLI or MEC tests should, in theory, impact long-term cash value accumulation potential.

- Carriers are still assessing the scope of any repricing and administrative changes that may be needed so a lot remains to be seen at this point in these regards.

- One carrier mentioned that the higher premium limits have a favorable impact on cash value performance on certain policies but negative impact on others – it may depend on how a given policy is priced and the insured's issue age.

- Target premium per dollar of planned premium may go down due to having a lower face amount-to-maximum premium ratio. If a carrier responds by normalizing the target premium to what it was before the change then the increase in cash value accumulation potential of being able to pay more premium may be muted by the resulting coverage charges. Alternative agent compensation structures may therefore emerge.

- Another carrier mentioned that the task of having to reprice many of their products this year could be daunting and what would have otherwise been their product development calendar for the year may get hijacked by updating products in response to the § 7702 change.

CONSIDERATIONS FOR BUYING POLICIES IN THE INTERIM

- Guaranteed cash values of Whole Life Policies may get devalued because of higher base premiums and a lower interest rate for § 7702 testing but that may lead to more future value in the form of higher dividends (guaranteeing more cash value is more costly to the carrier which means less dividend and vice versa).

- For those considering buying a Whole Life policy it may be advisable to buy a policy before it is repriced and the § 7702 change takes effect if stronger guaranteed cash values are important but keep in mind that the non-guaranteed dividend performance could be stronger post reprice.

- The traditional Universal Life-based policy design for optimizing long-term cash value accumulation potential typically was using GPT with an Increasing Death Benefit Option B switching to Level Option A after last premium accompanied by a face reduction to corridor. Because the prescribed GPT corridor factors were not changed, the net single premium at any point needed to fund future benefits under CVAT will be higher relative to the GPT corridor factors than before. Therefore, the traditional long-term performance gap between CVAT and GPT could shrink and we may see a rise in popularity of CVAT with a Level Death Benefit Option A for cash value accumulation purposes because of the added benefit of having less administration (no Option change or face reduction).

- For those considering a Universal Life-based policy, given that the timing and impact is uncertain at this point regarding specific carriers and products, it may be advisable to continue with any life insurance decisions as planned.

- Regardless, clients should be advised of the potential impact of the changes so they can make an informed decision whether to continue or wait.

ADDITIONAL COMMENTARY OR RESOURCES

The Life Product Review: The Section 7702 Christmas Miracle
By Bobby Samuelson. Published on January 5, 2021

The Wall Street Journal: A Small Tax Change Is a Boon for Permanent Life Insurance
By Leslie Scism. Published on January 10, 2021

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