

EQUITABLE

Advanced Markets

§7702 explained

What you need to know about this trending topic

On December 27, 2020, the Consolidated Appropriations Act (CAA) was signed into law to keep the government funded until late 2021. Within that act are a variety of other pieces of legislation, including numerous COVID-19 relief provisions.

However, also contained in the CAA are provisions related to Internal Revenue Code Section 7702 (§7702). These changes had been lobbied for by both the American Council of Life Insurers (ACLI) and Finseca, among others. These provisions are contained in §205 of the CAA and are the most substantial changes specific to §7702 since it was enacted in 1984.

The overall effect of these changes will be significant. First, insurance companies and their investment portfolios seem likely to have a mostly positive reaction, as new policies issued after the effective date may be less of a financial burden on the companies' reserves. Simply put, and all else being equal, new policies issued after the effective date may require less capital to support them. Also, consumers seeking cash value accumulation may benefit as the newly designed life insurance contracts should have substantially higher modified endowment contract and guideline premium limits. It remains to be seen when these changes are implemented and how they play out, but it is important to understand them and their potential effect.

Equitable's Advanced Markets released an **eNotice** in January that was focused on the CAA where we briefly discussed the changes to §7702. However, these changes are significant enough to the life insurance industry that we believe a dedicated eNotice regarding these changes is merited.

What is Section 7702 of the tax code?

Section 7702 of the tax code was enacted to preserve the integrity of life insurance, allowing it to provide a death benefit while still allowing cash value to accumulate within the contract on a tax-deferred basis. Since it was enacted in 1984, this code section has set the definition of life insurance for income tax purposes. A policy must meet these definitions to qualify for life insurance tax treatment under the Internal Revenue Code (IRC). Virtually every U.S. life insurance company builds its life insurance contracts to meet these definitions before they file for state approvals.[1]

Included in §7702 were a pair of tests that set limits for how much premium could be contributed to a life insurance contract relative to the death benefit:

Guideline Premium Test (GPT) or GPT/ Cash Value Corridor Test

When a policy is issued under this test, two amounts are calculated using assumptions for interest, mortality and other charges as prescribed by §7702:

1 | A single premium needed to mature the policy at the insured's age 100, and

2 | A level annual premium needed to mature the policy at the insured's age 100.

Collectively these are referred to as the Guideline Single Premium (GSP) and Guideline Level Annual Premium (GLAP). Cumulative premiums paid (as precisely defined in Section 7702) cannot exceed the greater of the GSP or the sum of the GLAPs, also known as the Guideline Premium Limit (GPL). Equitable, like other carriers, will refund excess premiums that exceed the GPL (unless needed to keep a policy from terminating).

When a policy is issued under the GPT/Cash Value Corridor Test, not only are premiums paid limited by the GPL, but the death benefit must also never be less than the "applicable percentage" of the cash surrender value (generally defined in §7702 as the policy's account value). The applicable percentages for the Cash Value Corridor Test are set out in a chart in §7702 and are based on the insured's attained age (their age in the current year).

Additionally, changes to a policy, such as a face amount reduction, may require adjustments to the GSP, GLAP and GPL that could change the limits on premiums paid; these may even result in excess amounts of premiums being distributed from the policy (what is known as a "force-out"). Experienced life insurance producers will manage contracts, or work with a life carrier like Equitable, to plan for potential changes from the original design and throughout the life of the policy.

Cash Value Accumulation Test (CVAT)

This alternative test sets out a different net single premium test. The death benefit must always be sufficient to prevent the cash value (generally defined in §7702 as the policy's account value) from ever exceeding the net single premium required to fund future benefits, using assumptions for interest, mortality and other charges as prescribed by §7702. For accumulation-designed life insurance contracts, this has sometimes allowed greater funding than under the guideline premium test if the policyowner is only paying premiums for 7 policy years.

IRC §7702 requires the life insurance companies use specified interest rates previously set at a fixed rate in the tax code when calculated. It is imperative to note contract performance under the 1984 test was assumed to be at 4% annually for CVAT and 6% annually for GPT. At the time the tests were enacted, and as shown in the chart on the next page, interest rates were extremely high relative to today's interest rate levels. Recognizing this, Congress and Treasury set the rates at what they believed were reasonably low rates that would be realistic in a more typical interest rate environment. However, in 1984 Congress did not anticipate the steep drop in interest rates that occurred starting in the 1990s and accelerating through the 2008 and the 2020 financial crisis. As we all know, interest rates currently stand at a near all-time low.

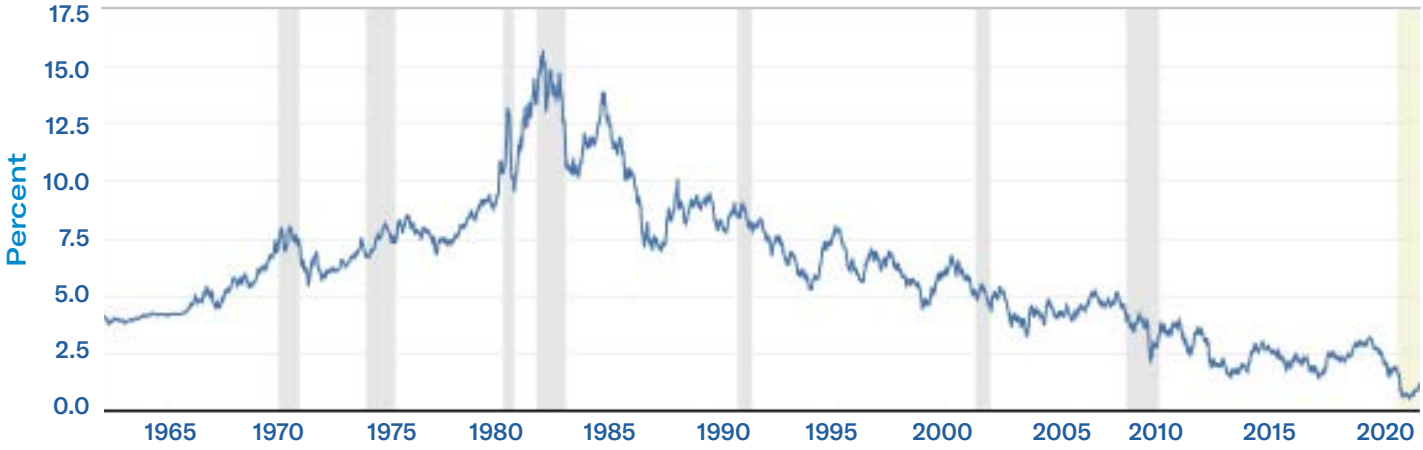
Section 205 of the CAA

Under the new law's "transition rule," the currently applicable 4% and 6% rates will become 2% and 4%, respectively, for new contracts issued starting January 1, 2021. Note: This change doesn't directly affect actual policy interest or investment performance.

Benchmark floating interest rate

The CAA also introduced the concept of a floating "insurance interest rate" that will be further honed by Treasury Regulation. However, it is created by applying a two-prong test. The insurance interest rate is defined as the lesser of the §7702 Applicable Federal Interest Rate (AFIR) for such calendar year.

10-year constant maturity rate



U.S. recessions are shaded. The most recent end date is undecided.
Source: Board of Governeors of the Federal Reserve System (US)
fred.stlouisfed.org

To understand the AFIR, we look at the first prong or the §7702 valuation interest rate. The valuation interest rate is defined as the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years (as defined in the National Association of Insurance Commissioners' (NAIC) Standard Valuation Law) as effective in the calendar year immediately preceding an adjustment year. An adjustment year is defined as the calendar year following any calendar year after the NAIC rate is determined.

That declared number is then compared to the second prong of the test or the §7702 AFIR. That rate is the average (rounded to the nearest whole percentage point) of the applicable federal mid-term rates (as defined in section 1274(d) effective as of the beginning of each of the calendar months in the most recent 60-month (5-year) period ending before the second calendar year prior to such adjustment year). Once compared, the lowest of the two rates is applied. We anticipate the effect of these changes for traditional participating whole life insurance policies may be that they will allow for lower guaranteed cash values, thus allowing for greater current credits or dividends. In addition, for flexible premium life insurance policies, more premium can go into a life insurance contract relative to the death benefit.

However, at present, just a few weeks into these changes, it's difficult to determine if the overall net effects of these changes will be good or bad for a client relative to the current status quo.

The effect of the changes

The effect and timing of these changes on product offerings will take time to implement and emerge. Prior law had been in place for nearly 40 years. During those decades, life insurance products went through many iterations to evolve into the products currently offered. It is possible this new shift will take a couple iterations of products before consumers see the full effect of these changes.

There will also be variations from life insurance carrier to carrier based on their current and anticipated future product lines. Launching a new life insurance contract is an involved process, ranging from developing the product relative to how it might meet market demand, pricing, state filings, administrative systems and forms. The lower death benefit relative to premiums funded could also affect some carriers in the form of reduced policy charges with which to launch and maintain new products. Some carriers may move more quickly than others, but it's not unreasonable to expect the first generation of products will evolve further over the next several years.

Planning for clients

It is hard to say how these changes will be implemented within the industry. For that reason, there's no guarantee this change to §7702 will result in a clear advantage for clients.

Current policyowners should be cautioned against making sudden changes to existing contracts before carefully considering the potential advantages and disadvantages. Any changes might cause a consumer to incur new initial expense charges and surrender charges, new medical underwriting that could result in a better (or worse) underwriting class and new contestability periods. If product lines further evolve, a policyowner who made a sudden change to a first-generation product might find a second or third generation product could have been more advantageous or a better fit, but the trade-off is they may have to yet again face fresh surrender charges and initial expense charges.

Further, waiting for a product change may not be advantageous either. It may not make sense for individuals to buy term contracts or wait as they see how future products evolve. Because of the time it takes to develop life insurance products, and because there may be an evolution over time, it could be several years before products fully evolve. Waiting could result in higher costs as an individual would age and could face a health impairment. Either or both could offset any potential advantage of waiting. Additionally, buying term today with one company could offer some near-term death benefit protection, but a future developed product might be with another company. Although a client may have protected their underwriting status and insurability at Company A, a client would need to re-apply to Company B based on their health some years in the future. Even, if they converted their contract with the same carrier, they would likely need to convert at their future attained age and the cost associated with that age.

Finally, if a client was buying a life insurance contract to also take advantage of the 7702 tax wrapper, in addition to foregoing the death benefit protection, by waiting several years they would also lose years of accumulation potential.

All in all, waiting or buying term in the interim to see how products might evolve in the future could cost a client more by way of higher future premiums and years of lost tax-deferred accumulation.

Conclusion

Equitable, along with the rest of the life insurance industry, is busily studying and preparing for all the changes the CAA of 2021 will bring to the marketplace. This special eNotice is one of many communications you will receive on this topic. The year is less than a few months old and major changes such as the implementation of the “new” definition of life insurance will take time to play out.

1 Section 7702 was then supplemented and amplified in 1988 with §7702A Technical And Miscellaneous Revenue Act (TAMRA) of 1988, that established the concept of Modified Endowment Contract (MEC) and the tax treatment when a policy meets the definition of life insurance, but the funding exceeds the 7-pay limit under §7702A. Where a policyowner is looking to maximum fund a policy, the industry term often used to designate the maximum funding is “maximum non-MEC limits.” The revisions to §7702 will have the effect of increasing this maximum funding before the maximum non-MEC limits are exceeded.

If you have any questions, contact Advanced Markets.

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