Section 7702

A Lifeline for Whole Life

Bottom Line

1. Clients who use life insurance as an accumulation vehicle will be able to contribute more money into new policies without becoming a Modified Endowment Contract (MEC). Makes life insurance more attractive/efficient as an alternative savings vehicle with net increases of 5-30 basis points in the cash value internal rate of return (IRR).

2. Whole life will remain a viable product line.

Background

7702 is the section of the Internal Revenue Code that defines life insurance for tax purposes and spells out the relationship between the policy cash value and the amount of death benefit necessary to qualify as life insurance.

The inside buildup of life insurance cash value grows tax deferred. To maximize the tax efficiency of life insurance, a policy should pass two tests. The first test is that a policy must meet the definition of life insurance. The second test is that a policy should avoid becoming a MEC.

There's an important distinction – a policy failing to meet the definition of life insurance loses all tax benefits of life insurance because it's not life insurance anymore. Administratively, a carrier will not let this rule be violated.

A policy can become a MEC yet still qualify as life insurance. MEC policies still receive an income tax free death benefit payment, but accessing policy values loses the bulk of the inherent tax benefits on distributions. Many policies are designed as MECs, but they can be inadvertent as well.

To qualify as life insurance for federal tax purposes, these policies must meet one of two tests selected on the application—the cash value accumulation test (CVAT) or the guideline premium test (GPT). They are designed to force a certain amount of death benefit in relation to the premiums paid and cash value. The calculation of these relationships were hard coded into law back in the 80s. They used interest rates of 4% and 6% in the calculations to set the relationships.

The Consolidated Appropriations Act of 2021 (HR 133), passed in December 2020 amends 7702 allowing insurers to manufacture life insurance policies with lower minimum guaranteed rates. For the most part, this reduction takes the previous guaranteed rate of 4%, drops it to 2% in 2021 for new policies, and ties future rates to periodically updated benchmarks after that.

Why did they need to do this?

Essentially to save the whole life industry. The 7702 rates were set in 1984 when interest rates were much higher. Whole life policies use the CVAT approach to qualifying as life insurance. In essence, the amount of premium paid in whole life must generate a cash value equal to the face amount at policy maturity using guaranteed interest rates and policy charges.

There is another factor at play in whole life called non-forfeiture values. The interest rates used for these calculations utilize a fluctuating rate tied more to a market rate. The nuances of this are infinitely complex, but in essence, the non-forfeiture rates were dropping and driving pricing in whole life to a level that would not let whole life meet the CVAT definition of life insurance.

The new lower 7702 rates brings them below the rates used in non-forfeiture calculations so that whole life can meet the definition of life insurance and comply with the non-forfeiture calculations. The 7702 changes allow whole life to continue to exist. For other permanent product types, the 7702 changes shrink the amount of required death benefit for a given amount of premium. This allows the potential for higher cash value relative to the death benefit without triggering MEC status.

When will it happen?

The change took effect January 1st, 2021 but it may take most carriers 3-14 months to redesign their products and update administrative platforms.

What actually changes?

Actual changes will depend on carrier interpretation of the new laws (yes, there's ambiguity) and whether the carriers alter policy loading in light of the lower death benefit requirements. In general,

- Whole life - premiums will likely increase by as much as 50% (especially in short pay scenarios) and will be more reliant on non-guaranteed dividends vs. guaranteed cash value. The new products will have worse guarantees and better non-guaranteed performance.
- Universal Life/VUL – Maximum non MEC premiums are expected to increase dramatically. This provides clients the option/flexibility to contribute extra premiums if they wish vs. whole life where premiums will increase across the board.
- Long Term Care (LTC) linked products – will be able to put more weight on LTC benefits and less on life insurance.
- Private Placement Life Insurance (PPLI) – like traditional products, PPLI will become more attractive as an accumulation vehicle.
- Compensation – for accumulation products, commissions will likely decrease. Carriers will look to move towards asset based and level commissions.

- Case design – In the past, CVAT was used for death benefit sales and GPT allowed for larger premium contributions for accumulation sales. Now CVAT will likely allow for greater contributions and may gain acceptance in accumulation sales.
- Premium Financing – It depends. This will allow greater flexibility in design but cash value accumulation may only improve by 10-20 bp.

What doesn't change?

- Life insurance did not get cheaper. Clients merely have the opportunity to trade higher cash value accumulation for lower death benefits.
- It does not impact policies purchased to provide the maximum death benefit for the minimum premium, typically used in generational wealth transfer planning.
- In-force policies are not impacted. A client with a 2 year old policy can't suddenly fund the policy at a higher level (unless the policy is reissued as a result of a material modification…this is a major source of carrier interpretation and systems limitations).
- Unfortunately, many life insurance "professionals" will see this as an opportunity to replace older policies and do 1035 exchanges into the new policies. There may be some situations where this makes sense for the client but in our opinion in most cases the costs (admin, commissions, new surrender charges, etc.) of placing a new policy will outweigh any benefits.

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