RESEARCH Briefing

IRC Section 7702 Changes: More Than Meets the Eye

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Overview

The change to IRC Section 7702 has wide-reaching effects.

Generally speaking, lowering interest rates means increasing both the maximum cash values and maximum premiums allowed per dollar of death benefit for a policy to qualify for tax-advantaged status.

For whole life insurance, while the change increases maximum allowable cash values, it also increases minimum nonforfeiture cash values.

This change was necessary to help life insurance companies continue to ensure the financial security of millions of Americans by keeping products in step with current market interest rates.

Background

In order for life insurance to retain its important tax-advantaged status for consumers, the contract must pass one of two tests defined in Internal Revenue Tax Code (IRC) Section 7702 (the Definition of Life Insurance). These tests limit the level at which the contract may be funded, either through a premium test or a cash value test. Generally, these rules serve to create a distinction between contracts that are truly for the purpose of life insurance versus those with primarily investment reasons.

The Consolidated Appropriations Act (CAA), which was passed at the end of 2020, contained changes to interest rate assumptions required within IRC Section 7702 Definition of Life Insurance. This is an extremely important development for both consumers and life insurance carriers.

The interest rates outlined within Section 7702 were originally established in 1984 and have been floored at 4 percent and 6 percent until the recent CAA changes. In today's low interest rate environment, those relatively high rates were making it difficult for companies to meet 7702 requirements while still providing competitive cash value accumulation. IRC Section 7702A defines rules for a subset of life insurance contracts, Modified Endowment Contracts (MECs). These are contracts that meet the requirements of 7702, but exceed the 7-Pay Test of 7702A. Living distributions from MECs generally are taxed differently. An increasing number of contracts were becoming MECs due to the current low rates.

Immediate Impacts

The interest rates used in 7702 and 7702A dropped to 2 percent and 4 percent for contracts issued on or after January 1, 2021, and going forward will change periodically with current interest rates. By the time the CAA was passed and signed into law, the effective date was essentially immediate. This caused some confusion in the industry, as some insurers were unaware of the proposed language update in the first place.

Lowering interest rates generally means increasing both the maximum cash values and maximum premiums allowed per dollar of death benefit for a policy to qualify for tax-advantaged status.

MEC premium limits will increase, meaning the amount of premium used to fund a given death benefit will increase. This change will benefit universal life (UL) policies by allowing a higher premium amount to be paid in the policy before hitting the MEC premium limit. For whole life (WL) policies, this could mean a return of short-pay WL.

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Multiple Changes in Disguise

While on the surface the implications of the change seem to be limited to the calculations of maximum cash values and maximum premiums for Definition of Life Insurance purposes, there is a domino effect from the change that drove the true necessity for the updated language.

In addition to the federally mandated maximum cash values, state nonforfeiture laws require a minimum cash value to be paid out upon lapse or surrender of a whole life policy. This, in combination with maximum 7702 cash values, creates a range of cash values whole life insurance carriers can use.

The interest rate built into the minimum nonforfeiture cash values periodically changes with the current interest rate environment, unlike the interest rates built in to maximum cash values that, as we mentioned, were floored at a static 4 percent and 6 percent.

As interest rates have generally decreased since 1984, so has the interest rate in the minimum nonforfeiture cash values. A lower interest rate, all else being equal, results in higher cash values. As such, just considering the impact from interest rates, the minimum nonforfeiture cash value has been increasing over time while the maximum 7702 cash value has remained static.

As minimum cash values increase and maximum cash values allowed by 7702 remain static, the range of cash values has substantially decreased over time and was starting to converge. In 2020, the nonforfeiture interest rate was 4.5 percent, while the 7702 interest rate was 4 percent. This left companies with very little pricing flexibility.

In June 2020, with interest rates near record lows, the nonforfeiture interest rate was re-set once again. Based on state nonforfeiture law, the interest rate in minimum cash values would have re-set to 3.75 percent, meaning, theoretically, the minimum cash value would be higher than the maximum allowed cash value.

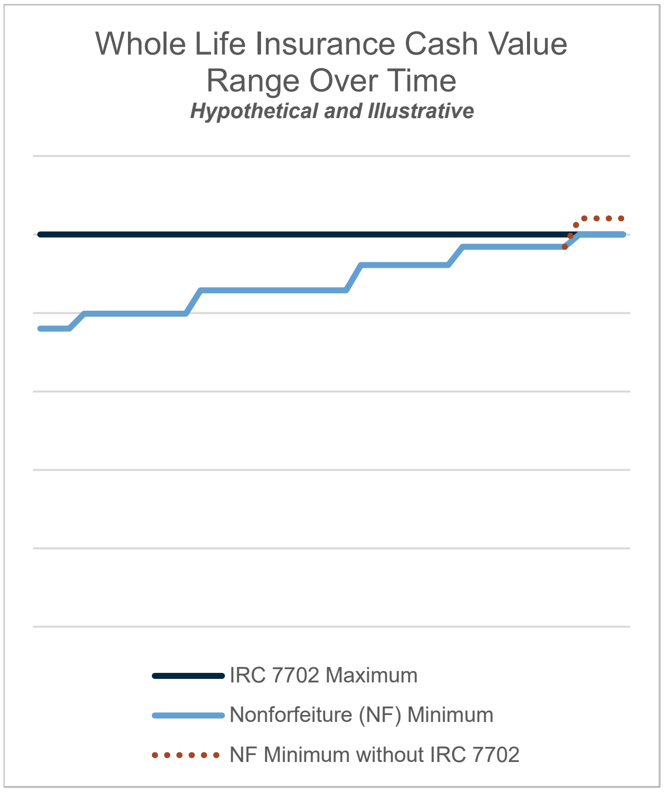
Clearly, this was not possible, as whole life would no longer qualify as life insurance if a 3.75 percent interest rate were used. State nonforfeiture laws recognized this fact and incorporated an interest rate floor of 4 percent to ensure that minimum cash values never exceed maximum cash values.

With 7702 capping cash values at something lower than they otherwise would have been without the tax limit, consumer value declines as guaranteed cash values paid at lapse are not as large as they otherwise would have been, all else being equal.

If interest rates continued to remain very low, the disparity in minimum cash values could have grown, fundamentally altering the value and financial security a whole life insurance policy provides a consumer. A low interest rate environment, during a global pandemic, is not a reasonable time to take financial options away from consumers.

The only way to remedy the situation was to increase the maximum cash value allowed to qualify for life insurance in order for the minimum to be higher; and this was accomplished through the CAA legislation passed at the end of 2020.

So, when looking more closely at the change to IRC Section 7702, it is evident this change was necessary to help life insurance companies continue to ensure consumer financial security by allowing them continued access to new, whole life insurance products that are properly designed and consumer focused.



Over time, the minimum cash values required to be paid to a consumer upon lapse or surrender of a whole life insurance contract have increased, while the maximum cash value allowed by Federal Tax Code has remained the same.

Starting in 2022, without any change to Federal Tax Code language, the minimum cash value would otherwise have been larger than the maximum allowed under IRC 7702, and therefore, capped at the maximum.

This change in Federal Tax Code language increases the maximum cash value, allowing the minimum cash value to increase commensurately with interest rates.

What's Next?

The largest immediate impact to companies selling UL and WL contracts is to change administration systems to correctly identify which policies are Modified Endowment Contracts, based on the new 7702 interest rates. As the interest rate in these calculations has remained static for some time, this could be more difficult for some depending on their new issue and in-force administration technology.

Possible Competitive Landscape Changes

This change has the potential for many ramifications affecting both UL and WL product design and competition. As the life product experts and pricing teams start to dive deeper into the changes to sort out what they really mean from a practical design perspective, we will learn more. In the meantime we can only speculate on what we *may* see change.

Nonforfeiture values for UL were not constrained in the same way as WL, so most UL products are already using a nonforfeiture interest rate that is compliant with the changes. So, the impact to UL will be from the direct changes to the interest rates in the Definition of Life Insurance tests and 7-pay MEC tests. These changes affect behind-the-scenes calculations and may not immediately translate to changes in gross premiums. The effect on gross premiums will be a company-specific decision. Companies will have to decide whether to keep existing products as is, re-design current products with some modifications, and/or create new products. Since UL policies take advantage of both tests outlined in the Definition of Life insurance, the scenarios where one is used over the other may change as more clarity comes with pricing and design. The changes to premium funding patterns may also cause a change to agent compensation and design. Depending on the scope of the changes to the UL products, state filing and approvals may be necessary for some companies.

For WL, the changes to nonforfeiture minimum cash values must be made by January 1, 2022. Due to the extremely quick turn-around time, this will be a huge focus for WL carriers to calculate new minimum cash values, evaluate gross premium levels, and re-file product changes. Similar to UL, gross premiums may not need to be updated but guaranteed cash values will need to be increased.

WL companies now have more pricing flexibility, as the difference between the 7702 interest rate (2 percent) and the interest rate in minimum cash values (3.75 percent) has grown. Pricing flexibility allows companies to design more innovative and distinct products, which is a benefit to the consumer. Companies may also start to look at different short-pay options for WL once again.

Ultimately, time will bring to light the true impact of this change. However, this change was necessary to help life insurance companies continue to ensure consumer financial security by allowing them to keep the products in step with current market interest rates.

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