The Consolidated Appropriations Act
Changes to IRC Section 7702

LIFE INSURANCE

PLANNING OPPORTUNITIES

Consolidated Appropriations Act, 2021
Life insurance contract qualification test

On December 27, 2020, the President signed into law a new piece of legislation called the Consolidated Appropriations Act, 2021 (H.R. 133) “CAA”. The CCA (5,593 pages) includes many stimulus and economic assistance provisions, extends many provisions of the CARES Act, but also includes one provision specific to life insurance that originally appeared in the Health and Economic Recovery Omnibus Emergency Solutions Act (“HEROES Act”) in mid-2020 and passed the House of Representatives in May 2020, but was later rejected in the Senate and never discussed or voted upon. These provisions reappeared in their original form under the CCA and, in short, amend the Internal Revenue Code (IRC) Section 7702; the specific section of IRC that provides guidance to insurance carriers on the interest rate calculations used to determine qualification tests for life insurance contracts.

IRC Section 7702 Background

Section 7702 provides definition into what a life insurance contract must satisfy for it to be treated as a life insurance contract for federal tax purposes. To meet this definition, a contract must be a life insurance contract under applicable law and satisfy, one of two, actuarial tests that were created to impose limitations on the premium amounts that can be paid into the contract and/or the amount of value that can be accumulated relative to the level of death benefit provided by such contract.

Additionally, IRC Section 7702 sets forth certain assumptions for defining these values which includes the minimum interest rates that can be used and were originally prescribed in 1984, when the statute was first enacted, and until now, had remained unchanged even amidst the steadily declining interest rate environment over these past 30+ years that we saw reach unprecedented lows in 2020.

The rate of return life insurance companies have generally been able to generate on the investment assets supporting their contract liabilities are significantly lower than the interest rate assumptions that were built into the IRC Section 7702 actuarial calculations and have created challenges in both, product design and profitability for insurance carriers. Further challenges also exist related to contract funding, whereas policyholders were not able to pay premiums required to keep their contracts in force due to the outdated funding limitations provided within the Section, being especially prevalent in flexible premium permanent life insurance products such as universal life.

Changes Brought Forth Under the CCA

Section 205 of the CAA, amends IRC Section 7702, permitting insurers to now use a dynamic interest rate model to define the statutory minimum interest rate which also provides ability for the allowance of the minimum rate to change over time, brining it more in line with changes in market interest rates overall. By way of the revision, insurers are now able to price product more effectively in the current economic environment and respond appropriately to future environment changes (positive or negative) into the future.

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The Opportunity This Presents

Interestingly, this revised method for calculation, when coupled with the continued low interest rate environment, presents a unique opportunity that benefits carriers, producers, and consumers particularly with cash accumulation life insurance products and makes them a more attractive option for financial professionals to consider incorporating life insurance into their planning strategies.

Prior to January 1, 2021 the interest rate was fixed at 4% for CVAT (Cash Value Accumulation Test), MEC (Modified Endowment Contract), GPT (Guidelines Premium Test), and hard coded at 6% for the GPT single premium test.

Following the revision, IRC Sub-section 7702 reduced the hard coded interest rates 4% to 2%.

Put simply; **Lower interest rate assumptions = Higher premium contribution thresholds.**

Early indications show that the impact of these revised calculation methods raising the qualification guidelines significantly and will allow an insured to fund a permanent life insurance contracts with **up to 60% more** premium this year and going forward compared to years past.

Conclusions

While a lot still remains to be seen, one thing is certain, this change of calculation method will significantly increase the IRR (Internal Rate of Return) of cash value inside life insurance contracts and creates an opportunity for the life insurance industry to now be a serious contender that's worthy of consideration from any financial professional that's looking to create a tax-advantage wealth accumulation plan for their clients.

In the coming weeks, and months, we expect to see a number of changes coming from insurance carriers including adjustments to target premiums, product re-filings (where necessary), and other communications.

We will continue to keep everyone apprised as more information becomes available and continue to develop. In the interim, please contact your AIMCOR member agency with any questions or requests for additional information related to the changes around IRC Section 7702.

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