Consolidated Appropriations Act, 2021: changes to Internal Revenue Code Section 7702

May 11, 2021

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Consolidated Appropriations Act, 2021: changes to Internal Revenue Code Section 7702

May 11, 2021

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Session overview

- Section 7702 high-level refresher
- Why was a change needed?
- Changes to Section 7702 in the Consolidated Appropriations Act (CAA)
- Effect of the changes on funding levels
- Impacts and key considerations for life insurance companies

Section 7702 high-level refresher

Life insurance — qualification rules

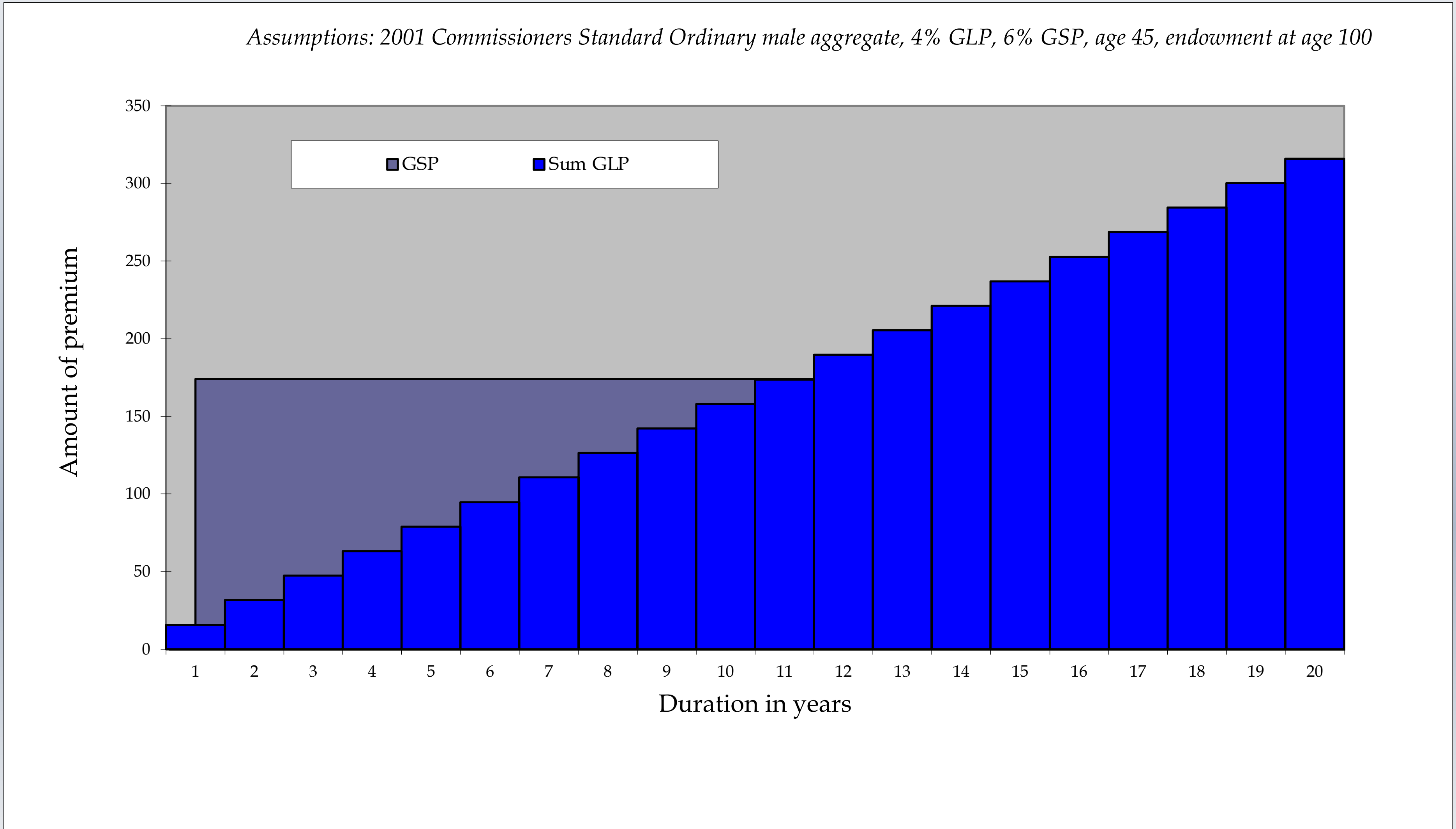
- Internal Revenue Code (IRC) Section 7702
  - Defines a life insurance contact for purposes of the IRC
  - Must be a life insurance contract under “applicable law”
  - Limits the allowable cash value and/or premiums paid
  - Compliance allows for:
    - Tax deferral of “inside build-up”
    - Tax-free receipt of death benefit by beneficiary
  - Two available tests for compliance
    - Guideline premium test (GPT)
      - Limits the amount of premium that can be paid into a policy
      - Minimum death benefit requirement
    - Cash value accumulation test (CVAT)
      - No specific premium requirement
      - Minimum death benefit requirement

GPT

- Premiums paid are compared to the guideline premium limitation to determine qualification.
- The guideline premium limitation at any point in time is the maximum of the guideline single premium or the sum of the guideline level premiums.
  - Guideline single premium (GSP)
    - Single premium to endow
    - Guaranteed mortality charges
    - Charges for expenses and qualified additional benefits
    - 6% interest rate,* or the policy guaranteed rate, if higher
  - Guideline level premium (GLP)
    - Annual level premium to endow
    - Guaranteed mortality charges
    - Charges for expenses and qualified additional benefits
    - 4% interest rate,* or the policy guaranteed rate, if higher
- Section 7702(d) cash value corridor
  - The death benefit must not be less than the policy's cash surrender value multiplied by the applicable percentage proscribed in this section.

*Floor rates for the GSP and GLP changed for contracts issued in 2021 via the Consolidated Appropriations Act, 2021.

Guideline premium limitation per $1,000 of insurance



CVAT

- Policy must comply by the terms of the contract.
- Policy will comply with CVAT if its cash surrender value at any point in time does not exceed the net single premium (NSP) that would fund future benefits.
- NSP at each attained age is calculated based on:
  - Guaranteed mortality charges
  - Charges for qualified additional benefits
  - No expense charges included
  - 4% interest rate,* or the policy guaranteed rate, if higher

*Floor rates for the CVAT NSP changed for contracts issued in 2021 via the Consolidated Appropriations Act, 2021.

Section 7702A — modified endowment contracts

- Section 7702A imposes a premium limitation (the 7-pay premium) on contracts to avoid becoming a modified endowment contract (MEC).
- Contracts with premiums paid in excess of the 7-pay premium limitation become classified as MECs.
- Implications of becoming a MEC
  - Subjects pre-death distributions (including loans) to taxation under annuity rules
  - 10% penalty tax applies to distributions when policyowner is under age 59.5
- 7-pay premium
  - Annual premium paid over seven years to endow
  - Guaranteed mortality charges
  - Charges for qualified additional benefits
  - No expense charges included
  - 4% interest rate,* or the policy guaranteed rate, if higher

*Floor rates for the 7-pay premium changed for contracts issued in 2021 via the Consolidated Appropriations Act, 2021.

Limitations on actuarial assumptions used to calculate the tax limits

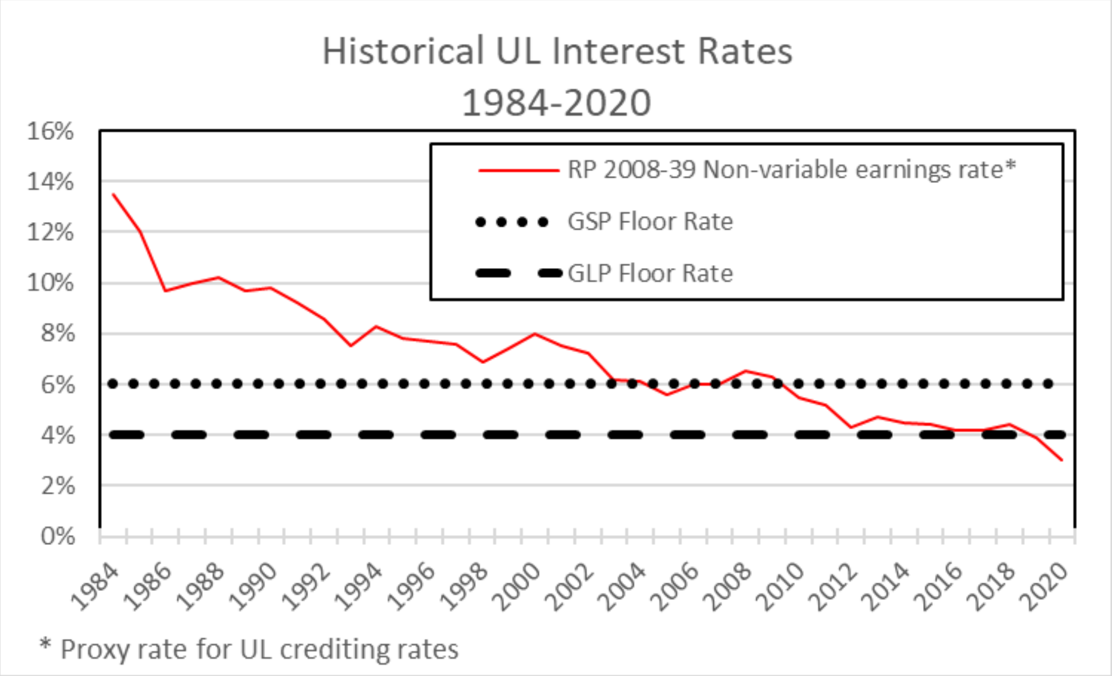
- Contract provisions and guarantees form the basis of the actuarial assumptions.
- Sections 7702 and 7702A impose additional restrictions on actuarial assumptions used in developing the definitional limitations. Some of these requirements have changed over time and vary based on contract issue date.
  - Mortality
    - Originally based on mortality guaranteed in the contract
    - “Reasonable” mortality beginning in 1988, based on Commissioners Standard Ordinary (CSO) tables
      - 1958 CSO (until 1989)
      - 1980 CSO (required starting in 1989)
      - 2001 CSO (required starting in 2009)
      - 2017 CSO (required starting in 2020)
  - Charges for expenses and additional benefits (i.e., riders)
    - Originally based on charges specified in contract
    - “Reasonable” charges beginning in 1988 (i.e., “reasonably expected to be actually paid”)
  - Interest – no changes to the 4%/6% floor until 2021

Why was a change needed?

Why the change?

- The 4% and 6% rates made sense in 1984 since interest rates were in the 12% range at the time. No one envisioned treasuries and other rates going as low as they are today.
- This change was a long time in coming as companies are no longer able to credit at least 4% to flexible premium products. This, coupled with CSO rates that are not much higher than mortality experience meant that Guideline Premium tested policies could easily run out of cash value in later years but be unable to pay more premium due to the GP limits. It also meant that traditional Whole Life policies were becoming less profitable to the insurance company and less attractive to the consumer.
- The exceptionally low interest rate environment brought on by COVID gave the industry an opportunity to get Congress to revise the interest rates in the law quickly without opening up 7702 to other changes. (Congress was already looking at a COVID relief package for various industries).

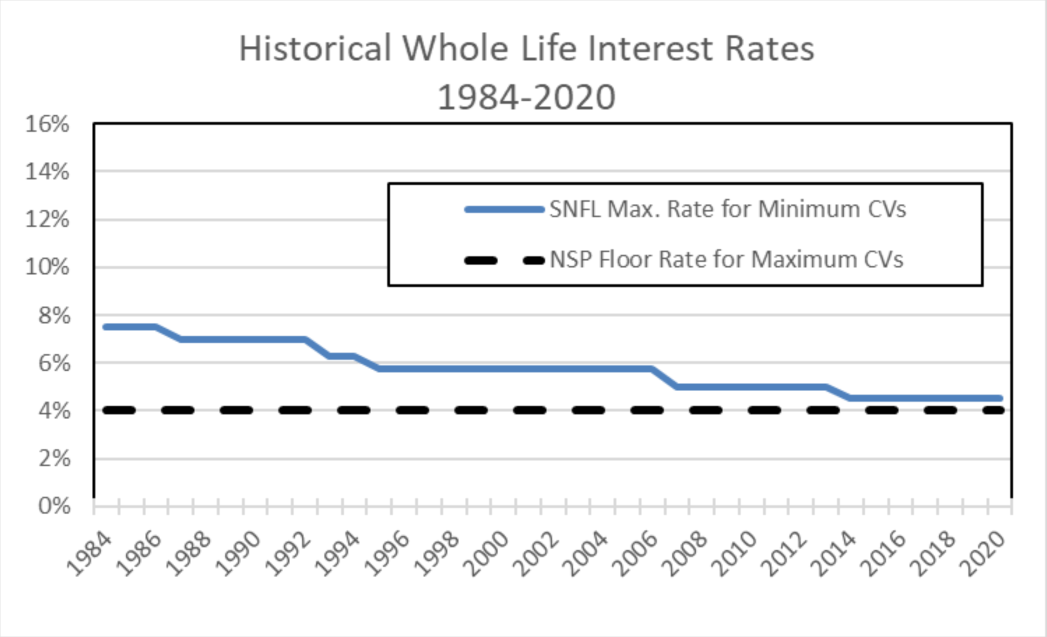
Implications of Declining Interest Rates - UL



- Cash values (CVs) accumulate at interest based on “current” crediting rates set by the insurance company, subject to a minimum guaranteed rate specified in the contract.
- Insurance companies have reacted to the decline in interest rates by:
  - Lowering current crediting rates
  - Lowering guaranteed minimum crediting rates
  - Product innovation (e.g., no lapse guarantees)
  - Increased prevalence of CVAT designs
- In response, policyholders looking to accumulate CV are having to pay higher premiums for cash values to endow.
- However, section 7702’s GPT limits the premium a policyholder can pay (i.e., the guideline premium limit), and in some cases, prevents a policyholder from paying the premium that would be required to generate the cash values needed for a policy to endow.

* Non-variable earnings rates from Internal Revenue Service Revenue Procedure 2008-39

Implications of Declining Interest Rates - WL



- CVs are fixed and subject to dual regulation
  - Federal: Section 7702's CVAT prescribes Maximum CVs
    - Based on NSP Floor Rate
  - State: The NAIC Standard Nonforfeiture Law (SNFL) prescribes Minimum CVs
    - Based on a maximum interest rate defined in SNFL that adjusts as interest rates change
- Interest rates are a key assumption for defining both Minimum and Maximum CVs
  - The CVAT applies a static approach for determining the NSP Floor Rate used to define Maximum CVs (i.e., fixed at 4%)
  - The SNFL utilizes a dynamic approach for determining the interest rate used define Minimum CVs

Changes to section 7702 in the Consolidated Appropriations Act, 2021

What changed? Methodology for determining interest rate assumptions for GPT, CVAT, 7-pay

7702/7702A Interest Rate Assumptions		
Applicable Calculation	**Prior to 2021**	**Post the Consolidated Appropriations Act of 2021**
CVAT NSP / DBF	Greater of the rate or rates guaranteed at issue or 4%	Greater of the rate or rates guaranteed at issue or the Applicable Accumulation Test Minimum Rate
Guideline Level Premium	Same as CVAT rate	Same as CVAT rate above
Guideline Single Premium	Greater of the rate or rates guaranteed at issue or **6%**	Greater of the rate or rates guaranteed at issue or the Applicable Guideline Premium Minimum Rate
Recapture Ceiling NSP	Same as CVAT rate above	Same as CVAT rate above
7-pay Limit	Same as CVAT rate above	Same as CVAT rate above
Necessary Premium Calculations	Presumably follow CVAT and GLP/GSP above	Presumably follow CVAT and GLP/GSP above

- The Applicable Accumulation Test Minimum Rate and the Guideline Premium Minimum Rate are based on the calendar year of issue.
- They may change when there is an “adjustment year” which is the calendar year following a change in the valuation interest rate.

Overview of CAA changes to section 7702

The ***Applicable Accumulation Test Minimum Rate*** (AATMR) is the lesser of: • 4% • The Insurance Interest Rate	The ***Applicable Guideline Premium Minimum Rate*** (AGPMR) is the sum of: • 2% • The ***AATMR***

The ***Insurance Interest Rate*** is the lesser of:

- The ***Section 7702 valuation interest rate*** (Sec. 7702 VIR)
  - The prescribed US valuation interest rate for life insurance with guaranteed durations more than 20 years.
- The ***Section 7702 applicable Federal interest rate*** (Sec. 7702 AFIR)
  - The 60-month average of the applicable federal midterm rates (rounded to the nearest whole percentage point) effective as of the beginning of each of the calendar month ending in December, two years prior the start of the adjustment year.

Key observations:

- The new Floor Rates cannot be greater than the Floor Rates under prior law (i.e., there is a cap on the **AATMR** and **AGPMR**)
- The 2% spread in the cap on the AATMR and AGPMR under prior law is maintained

In 2021, the AATMR is 2% and the AGPMR is 4%. These will change when there is an "adjustment year" which is the calendar year following a change in the valuation interest rate, except for 2021 which was designated by transition rule to use new rates. 2022 has already been determined not to have a change in the ATMR.

Examples

Keep in mind that guaranteed interest may include (in addition to minimum interest crediting rates), loan crediting rates on Loan Accounts, certain guaranteed policy value credits, persistency credits/bonuses and the like. These can the "guaranteed" rates to exceed the Applicable Accumulation Test Minimum Rate and/or the Guideline Premium Minimum Rate.

Guaranteed Min Crediting Rate	Guaranteed Interest or similar Bonus	Loan Crediting Rate	CVAT/GLP Rate	GSP Rate
2.0%	0.5%	2.0%	Consider the whether the bonus makes the guaranteed rate = 2.5%	4.0%
1.0%	0.0%	2.0%	2.0%	4.0%
2.0%	0.0%	2.5%	Consider the loan crediting rate of 2.5%	4.0%
4.0%	0.0%	3.0%	4.0%	4.0%
4.5%	0.0%	3.0%	4.5%	4.5%

CAA 2021 – Historical example

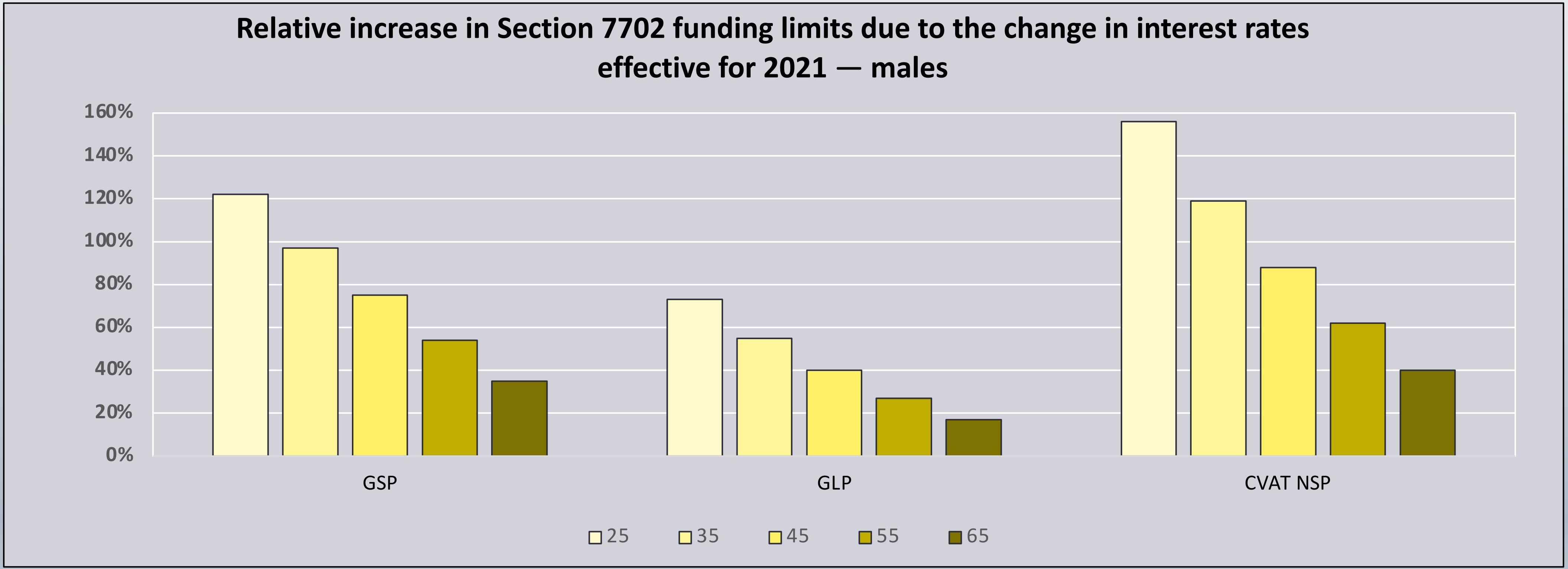
- If operative starting in 1984, the CAA would have created 6 ***Adjustment Years*** *(including 2022)*
- However, only 1 ***Adjustment Year*** (2014) would have changed the ***Applicable Accumulation Test Minimum Rate*** and the ***Applicable Guideline Premium Minimum Rate***.

Adjustment Year	Prescribed U.S. val. int. rate for LI with Guar dur. > 20 yrs.		Sec. 7702 Valuation Interest Rate	Sec. 7702 AFIR	Insurance Interest Rate	Applicable AT Minimum Rate	Applicable GP Minimum Rate
	Rate	Year of Change					
1988	5.50%	1987	5.50%	n/a	5.50%	4.00%	6.00%
1994	5.00%	1993	5.00%	8.00%	5.00%	4.00%	6.00%
1996	4.50%	1995	4.50%	7.00%	4.50%	4.00%	6.00%
2007	4.00%	2006	4.00%	4.00%	4.00%	4.00%	6.00%
2014	3.50%	2013	3.50%	3.00%	3.00%	3.00%	5.00%
2022*	3.00%	2021	3.00%	2.00%	2.00%	2.00%	4.00%

* Since 2021 was a transition year in which the Insurance Interest Rate and the Applicable Guideline Premium Minimum Rate were set to 2% and 4% respectively, no change to those rates are applicable in the Adjustment Year of 2022.

Effect of the changes on funding levels

Change in funding levels from the CAA



- Impact on females is generally consistent with males, with marginally higher percentage increases due to lower overall mortality.
- Note that the increase in CVAT NSPs has the effect of increasing the maximum cash values permitted under Section 7702.

How limits have changed over time

Male age 45 non-tobacco, $1,000,000 face amount						
Mortality and interest assumptions	**Death benefit option 2 GLP**	**% change**	**GSP**	**% change**	**7-pay premium**	**% change**
1980 CSO, 4%	$59,168		$270,848		$52,579	
2001 CSO, 4%	$45,545	-23%	$236,714	-13%	$46,630	-11%
2017 CSO, 4%	$36,735	-19%	$197,130	-17%	$39,579	-15%
2017 CSO, 2%	$49,250	34%	$327,269	66%	$73,002	84%

Male age 55 non-tobacco, $1,000,000 face amount						
Mortality and interest assumptions	**Death benefit option 2 GLP**	**% change**	**GSP**	**% change**	**7-pay Premium**	**% change**
1980 CSO, 4%	$83,502		$393,530		$73,140	
2001 CSO, 4%	$61,861	-26%	$346,505	-12%	$65,262	-11%
2017 CSO, 4%	$49,435	-20%	$285,602	-18%	$55,184	-15%
2017 CSO, 2%	$56,745	15%	$431,430	51%	$86,441	57%

Section 7702 corridor factors

Key considerations for insurance companies

Compliance Implementation Considerations

- For DEFRA testing:
  - If tax interest rates go up, a policy cannot satisfy the definition of life insurance under CVAT without changing to the higher rate for the applicable issue years. Similarly, for GPT, the limits will be overstated in you don't change rates. Must have systems ready by January 1.
  - If rates go down, it is *generally* conservative to continue testing at the higher rates, but it might not always be for guideline premium tested policies. Should talk to internal tax counsel.
- For MEC Testing:
  - If rates go up in a given calendar year, the 7-pay limits for newly issued policies will decrease. Systems must be updated ASAP, so you do not inadvertently create MECs because you tested using an overstated limit.
  - If rates go *down* in a given calendar year, the 7-pay limits for newly issued policies will increase. If systems are not updated, then MEC testing will be done using a 7-pay limit that is understated. This is conservative for policies that do not want to be MECs and limit their payments accordingly. However, for policies that choose to become MECs, this may mean that taxable income is over reported. A company may report a distribution as taxable, when in fact, if they had tested for MEC using the appropriate interest rate, it would not have failed the 7-pay test.
- Will CVAT death benefit factors be updated?
  - Are those shown in your contract? If so, can you change them for inforce policies once a policy is issued if they are contractually guaranteed?
  - Are there filing considerations for updating these factors? The Interstate Insurance Compact issued guidance to help insurers decide what (if anything) they need to file.
  - https://www.insurancecompact.org/documents/fin_2020_1_faq.pdf

Product/Pricing considerations

- Universal life
  - Potential for higher premiums relative to face amount resulting in smaller cost of insurance and per 1000 charges, smaller reinsurance premiums and payouts, lower compensation.
  - Is a product repricing needed before the new rates can be implemented?
  - What about policies already sold in 2021? Should they be updated for the new rates so as not to inadvertently cause MEC and GPT issues?
- Whole life
  - No immediate impact for policies issued in 2021 (which must still use 4% for CVAT and TAMRA)
  - Re-design / re-pricing required for new issues in 2022 due to changes to the SNFL interest rate

Product/Pricing considerations, continued

- Changes to the interest rate structure in Section 7702 address the current challenges for both policyholders and insurance companies in today's low interest rate environment.
  - Universal life
    - Funding limits under the guideline premium and 7-pay test would increase considerably and be based on interest rates that better align with current crediting rates, providing more funding flexibility for policyholders.
  - Whole life
    - Prior to the change, the minimum section 7702 CVAT interest rate used to define maximum cash values and the maximum SNFL interest rate used to define minimum cash values were 4%, limiting the flexibility companies had in whole life product design.
    - After the change, there is now a spread between the minimum CVAT interest rate (2%) and the maximum SNFL interest rate, allowing more flexibility in setting CVs and product features.
    - It is our understanding that the SNFL maximum interest rate is going to be reduced to 3.75%, with a January 1, 2022 required date for newly issued contracts

Marketing and client relations considerations

- Companies will need to determine what, when and how to communicate the impact of the changes to Section 7702 interest rates to their field personnel and policyholders. Some questions to consider include:
  - For the subset of contracts issued in 2021 with tax limits determined under the "old" rates, will the tax limits be corrected for these policies at some point?
    - How will the ability to pay higher premiums be communicated?
    - How will potential incorrect MEC status be communicated and dealt with?
  - Is the field force expecting new products to be able to take advantage of higher funding levels (and higher commissions)?
  - Are competitors able to accept and administer higher premiums calculated under the "new" limits, and how will this affect agent loyalty?
  - Will an exchange program be considered for recently issued (e.g., 2020) contracts to take advantage of higher funding limits?

Systems and operations considerations

- Systems and operations are also affected by the change in interest rates. Determining what systems and procedures are impacted and prioritizing when and how changes will be implemented will be key for many companies. Questions to consider include:
  - When will the administration system be ready to handle premiums in excess of the “old” limits for 2021 issues?
  - If new products are developed to handle the Section 7702 changes, how will implementation fit in with other IT priorities?
  - If new business sales illustrations are ready prior to administration, how will that gap in time be handled?
    - Will higher premiums be accepted via a temporary manual process?
  - Is there a plan in place for contracts that are ready to be issued prior to administrative launch for new rates?
  - Are there downstream implications for system rate changes (e.g., quote systems, annual statements)?
  - Have procedures for implementing future changes been considered? An increase in rates would mean a change would need to be effective January 1 to avoid noncompliance (i.e., the tax limits would be lower based on higher interest rates).

Conclusions

The changes to Section 7702 interest rates brought about by the CAA has impacted insurance companies in many ways, and company leadership needs to be able to sort through the various impacts and prioritize the changes needed to maintain compliance, profitability and client relations, and to ensure systems and procedures continue to operate properly. Companies that navigate these changes effectively will bring together representatives from across the organization and consider the impacts to each area in creating an end-to-end plan to implement this change.

Questions?