Life

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What does Section 7702 mean for you?

Frequently asked questions

The recently passed Consolidated Appropriations Act of 2021 included several updates which will positively impact the life insurance industry through updates to rates, policy funding, and potentially actual policy performance.

Q. How does the Consolidated Appropriations Act of 2021 impact the life insurance industry?

A. The Consolidated Appropriations Act of 2021 (the "Act") included a change to Internal Revenue Code Section 7702 rates used in calculating qualification for tax-favored treatment of life insurance. Furthermore, there is also a change to Internal Revenue Code Section 7702A which determines the premium limit used to evaluate whether the policy qualifies as a Modified Endowment Contract (MEC). These changes are intended to align the rates used in these key calculations with the current interest rate environment.

Q. What are the rates that are being changed?

A. Section 7702 requires a life insurance policy to meet one of two tests to be considered life insurance for federal income tax purposes: Cash Value Accumulation Test (CVAT) or the Guideline Premium Test (GPT). There is only one rate used in calculating compliance with CVAT. For GPT, compliance is determined based on the greater of the guideline single premium and the guideline level premium. The calculation of each of these amounts includes a rate that the Act modified as well.

Section 7702A defines a premium limit that is used to determine whether a policy is treated as a Modified Endowment Contract. This limit, frequently referred to as the "7-Pay Test", is determined using the same interest rates used as CVAT in the 7702 calculations described above. Since the interest rate used in the CVAT test is changing, the interest rate used in the 7702A 7-Pay Test calculation is changing as well.

Q. How are the rates being changed by the Act?

A. The Act makes changes in two parts. First, it establishes a new method of setting CVAT, GPT, and 7-Pay Test rates based on existing rate benchmarks. Second, the Act creates a transition rule that applies for an interim period. It is important to note that all of these rates are minimum and the greater of guaranteed policy rates and these rates are used in the actual calculation. The table below shows the change to the minimum rates used in the calculation.

	The Prior Rate Rule (applies to policies issued on or before December 31, 2020)	**The New Rate Rule** (subject to change each Adjustment Year)	**The Transition Rate Rule** (January 1, 2021 until the first Adjustment Year occurs)
Cash Value Accumulation Test	4%	The Applicable Accumulation Test Rate (AATR) which is the lesser of 4% or the insurance interest rate*	2%
Guideline Single Premium	6%	The AATR plus 2%	4%
Guideline Level Premium	4%	The AATR	2%
7-Pay Test	4%	The AATR	2%

* The insurance interest rate is determined based on the lesser of long-term life rates established under the NAIC Valuation Law and a federal mid-term interest rate defined in IRC Section 1274(d).

Q. How long will the transition rates last?

A. The transition rule became effective for policies issued beginning on January 1, 2021. How long these rates last depend on whether there is an Adjustment Year. When an Adjustment Year happens, the transition rule ends and the new rate rules will apply. The earliest the transition rule will expire is December 31, 2021.

Q. What is an "Adjustment Year"?

A. An Adjustment Year occurs when the insurance interest rate is changed due to a change in a rate that is defined in the NAIC Standard Valuation Law. When an Adjustment Year happens, the rates used in calculating CVAT, GPT, and 7-Pay Test are adjusted. Also, when the first Adjustment Year occurs the transition rate rule will expire.

Q. Did the Act make any other changes to Section 7702 or how life insurance is treated generally?

A. No. The Act only made changes to how the rates in calculating CVAT, GPT, and the 7-Pay Test are determined.

Q. What are the impacts of these changes?

A. Broadly speaking, the primary impact of the changes to Section 7702 for the foreseeable future is a reduction in the rates used for the CVAT, GPT, and 7-Pay Test. With these rates reduced when compared to the prior rules in place, it will have the following implications:

1. Guideline limits will increase which will allow more premium to be paid in a policy and still qualify as life insurance. These reduced rates will also allow more premium to be paid into a policy before it becomes a MEC.
2. The same amount of premium can be put in a policy with a lower specified amount. This means more cash value and less net amount at risk. A lower net amount of risk reduces the cost of insurance which makes the cost of carrying the policy lower when compared to the prior rules.

Overall, the changes are particularly positive for those seeking to maximize building potential cash value in life insurance.

Q. When will North American's products reflect this change?

A. North American will be incorporating these new rates product-by-product with plans to have this change applied to all impacted products by the end of 2021.

Q. Which products will this impact?

A. The updates to Section 7702 will impact all currently marketed indexed universal life (IUL) and universal life (UL) products sold on or after January 1, 2021. IUL and UL policies sold prior to January 1, 2021 are not subject to these new rates.

Indexed Universal Life Insurance products are not an investment in the "market" or in the applicable index and are subject to all policy fees and charges normally associated with most universal life insurance.

For most policies, withdrawals are free from federal income tax to the extent of the investment in the contract, and policy loans are also tax-free so long as the policy does not terminate before the death of the insured. However, if the policy is a Modified Endowment Contract (MEC), a withdrawal or policy loan may be taxable upon receipt. Further, unpaid loan interest on a MEC may be taxable. A MEC is a contract received in exchange for a MEC or for which premiums paid during a seven-year testing period exceed prescribed premium limits (7-pay premiums).