Life as we know it is changing

Updated IRS codes and their impact on life insurance

The recent passage of the **Consolidated Appropriations Act of 2021 (or the stimulus package)** included changes to Internal Revenue Code Sections 7702 and 7702A. This is good news because it increases the funding limits for policies to qualify as life insurance and allows for higher premiums relative to the death benefit before becoming a modified endowment contract (MEC). Avoiding a MEC means more favorable tax treatment for policy distributions.

What are Sections 7702 and 7702A?

Section 7702 is used by the federal government to determine which policies are MECs and how the proceeds of the policy will be taxed. Depending on the needs and objectives of the client, one of several guidelines is applied when a policy is issued. The most common are:

- **Guideline premium test (GPT)** is used when the primary objective is to highly fund a life insurance policy, accumulate cash value and maximize policy distributions or to pay maximum premiums beyond the 7-pay period.
- **Cash value accumulation test (CVAT)** is used when the primary objective is to highly fund a life insurance policy, yet provide higher long-term death benefits beyond what the GPT provides. It also applies when writing a MEC contract with a goal to maximize the long-term death benefit.

Section 7702A defines what it means for a policy to be a MEC and states that if a policy's premium is under a certain amount (called the modified endowment premium or MEP), then the policyowner gets the additional advantage of having tax-free income from the policy.

What's changing and why?

Since 1984, life insurance carriers have calculated the guideline tests using the IRS-7702 rate of 4% (for CVAT, MEP and GPT level premiums) and 6% (for GPT single premium). As of January 1, 2021, the interest rates were lowered for 2021, and in following years, they will move to a floating rate tied to the economic environment.

Lower rates mean higher premium limits

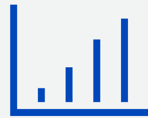
The premium limits are present-value calculations based on the assumptions prescribed in Sections 7702 and 7702A. A lower interest rate assumption increases the value of a present-value calculation. For many indexed or variable universal life clients, the new guideline limits will be increased substantially.

Greater efficiency

This legislation helps carriers continue to deliver valuable products in an environment of persistently low interest rates. By allowing more money to be paid into the policy per $1 of specified amount, life insurance becomes a more efficient accumulation solution for consumers looking for retirement planning options.

What it all means for you

These changes allow your client to either:



Put more premium into a policy with the same death benefit, providing more tax-advantaged savings and growth potential

OR

Lower the death benefit for the same amount of original premium, which saves money in fees

The result is more value from the contract, either through better long-term, cash value growth potential and/or through a potentially better internal rate of return (IRR) on the policy.

Meet Kate

Kate is 35 years old and in excellent health. She would like to max fund her policy, and with the 7702 changes, she has two options that both result in better cash accumulation: Either pay more premium or lower her death benefit.

Example #1: Increasing premiums — In this example, the amount of premium going into the contract increased, offering the opportunity for a greater internal rate of return and higher income later on.

		Post-7702 changes	
	Pre-7702 and 7702A changes	Moderate change	Maximum change
Death benefit	$1 million	$1 million	$1 million
Premium payments (annual)	$21,778	$30,000	$39,712
Potential income (annual)	$156,336	$222,180	$299,424

Example #2: Decreasing death benefit for a minimum non-MEC scenario — In this example, the death benefit decreased while the premium remained the same, offering the opportunity for a greater internal rate of return and higher income later on.

		Post-7702 changes	
	Pre-7702 and 7702A changes	Moderate change	Maximum change
Death benefit	$ 1,147,143	$850,000	$627,174
Premium payments (annual)	$25,000	$25,000	$25,000
Potential income (annual)	$180,984	$183,564	$187,260
Target premium	$11,271	$8,233	$6,075

The case in Example #1 involves the Nationwide IUL Accumulator II 2020 policy for a 35-year-old woman, Preferred Plus, max until age 65, increasing death benefit until year 30 then switching to level, taking declared rate loans from ages 66 to 80 at a 5.96% interest rate. Example #2 uses the same product and client but has her paying a $25,000 premium with a minimum non-MEC decreasing death benefit.

Reach more clients seeking tax-advantaged solutions

Contact your Nationwide wholesaler to discuss the new opportunities available as a result of the 7702 and 7702A changes.

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