ALLEN BAILEY & ASSOCIATES, INC.

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Much Ado About Nothing?

The Consolidated Appropriations Act, 2021

Revisions to Internal Revenue Code §7702

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"Hi, I'm from the government. I am here to help." Ronald Reagan once stated that those are the most terrifying words in the English Language. In the insurance industry (and at AB&A), many of us tend to agree with Reagan's rhetoric. 'Help' in the form of revised Internal Revenue Codes create apprehension and uncertainties. Our first response to these changes often becomes "How Much Will This Cost?" and "By When?"

Reagan introduced such legislation to 'help' our industry in the form of TEFRA/DEFRA (detailed below) in 1982 and 1984, respectively. Since then, our industry has abided by and administered policies using the definition of life insurance that was established about the same time Ronnie offered his musing some 40 odd years ago.

Jump forward to current day, and we once again are being 'helped' in the form of The Consolidated Appropriations Act (CAA) – 2021, which was signed on December 27, 2020. Succinctly, this bill changes Internal Revenue Code Section §7702, life insurance contract qualification testing. The most prominent change introduces a market-driven, floor interest rate (plus a 2% margin in the guideline single premium) that replaces the fixed 4% floor, effective immediately. These new floors *can* be used for policies issued in 2021 when performing the qualification testing. In 2021 this market-driven floor has been set at 2%.

CAA changes are intended to be in companies' best interest. It does not take an actuary (or someone like an actuary but with an accompanying personality) to conclude that allowing higher funding limits is, generally, in everyone's interest. That part is easy. Common sense suggests, "Why wait?" At AB&A, we believe the urge to rush, accompanied with any angst to 'be in compliance,' is unnecessary. These feelings should be replaced with a measured approach to understanding CAA.

The real question to answer is, *"Are the CAA changes useful?"* Our discussion attempts to provide a direct answer to that question and the one posed in this paper's title.

If our work achieves its goal then upon completion, we hope the reader will be able to confidently respond to these questions and better contribute to any dialogue addressing the changes incurred by the CAA, 2021.

Background – History Leading to the Act

Life insurance has always had (and still has) certain advantages over other types of investment vehicles. These include:

- Tax deferred growth in cash values
- First In-First Out treatment of distributions of the cash value
- Policy loans free of any tax considerations
- A death benefit paid to a beneficiary that is exempt or free of any income tax

The McCarran-Ferguson Act (1945) returned to the states jurisdiction to regulate the insurance industry. This remained unchanged until Universal Life was introduced in the 1970's. This innovative design, combined with double-digit interest rates, resulted in practices that caused Congress to take action.

The result was a passage of three acts:

1. TEFRA (Tax Equity and Fiscal Responsibility Act – 1982)
2. DEFRA (Deficit Reduction Act – 1984)
3. TAMRA (The Technical and Miscellaneous Revenue Act – 1988)

TEFRA and DEFRA brought us the compliance testing terminology: The Cash Value Accumulation Test (CVAT), and Guideline Premium Test (GPT). TAMRA gave us the definition of a Modified Endowment Contract (MEC) and the 7-Pay Test.

These three acts were designed to eliminate dumping large amounts of money, significantly greater than the face amount, into a policy's account value and calling the result life insurance. These acts also require a net amount of risk that is calculated using legislated mortality and interest standards. Unless policies comply with these requirements and others, they are no longer life insurance and the advantages listed above no longer apply.

These three acts also required significant investment of monies and time for new testing and new (or modified) systems, including significantly more robust sales tools. If companies wanted to stay in the life insurance business (as defined in §7702) they had no choice but to comply.

CAA Details and 7702 Revised Testing Rules

Each of the following sections explains changes in the act that apply to Section §7702 qualification testing. We begin by discussing the new dynamically determined Insurance Interest Rate (the IIR). Other rates used in Section §7702 testing flow from the IIR and the rate it establishes. These additional rates of interest, those which are a function of the IIR, impact specific calculations that are used in the compliance testing (and identified in the requisite location below).

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The IIR and its Impact on Qualification Testing

Given the rate environment during their development, the life insurance qualification tests prescribed fixed floors at 4% for CVAT and Guideline Level Premium (GLP) calculations and 6% for Guideline Single Premium (GSP) calculations.

To modernize these tests, the dynamic benchmark Insurance Interest Rate (IIR) was created and is now linked to the §7702 qualification testing.

The IIR is the lessor of two market-driven benchmarks:

1. NAIC's Valuation Interest Rate for a calendar year; and
2. The Applicable Federal Interest Rate.

For 2021 and 2022, the IIR is 2.00%. It is also important to note that the process to determine future IIR changes is structured in such a way to provide stability, similar to the valuation interest rate determination process.

How does the IIR fit in? The CVAT/GLP's fixed floor of 4% has now been redefined to the *lessor of* 4% and the IIR. The fixed floor of 6% for GSP has been redefined as 2% plus the floor used for CVAT/GLP. **This means that for 2021 and 2022, the floor is now 2% for CVAT/GLP and 4% for GSP calculations.**

For products with guaranteed accumulation rates less than 4%, this reduction in the floor will increase the permissible cash values/funding limits. Companies can choose to avail themselves immediately of these changes.

For those products with guaranteed accumulation rates at 4% or higher, companies can now decide whether to refine products to enhance those funding limits and/or increase cash values.

Impact on the 7-Pay Test Today

A Modified Endowment Contract (MEC) is an insurance policy that fails the 7-Pay Test, and one that subsequently loses some of life insurance's valuable tax advantages over other investment vehicles. The test compares the annual premiums to be paid over the first seven contract years to a level annual premium benchmark prescribed in Section §7702A. This prescribed calculation did not change from the signage of the CAA, but it is directly linked to the sections amended by it. This link being that **MEC testing uses the same rate used for the CVAT, now the greater of the guaranteed accumulation rate at issue *and 2%* (the new floor).**

This change can significantly increase the amount of accumulated premium permissible within a contract before being deemed a MEC and benefit limited-pay contracts in particular.

Impact on the Maximum Nonforfeiture Rate Tomorrow

In July 2020, the maximum nonforfeiture rate was confirmed to decrease from 4.50% to 4.00% and understood industry wide to go into effect no later than 2022. However, due to the signing of the CAA *and* a critical revision in the NAIC's Valuation Manual language, **the interpreted maximum nonforfeiture rate is now 3.75%, to be implemented for issues on or after January 1, 2022.**

This year, in anticipation for being ready by January 1, 2022, insurers should assess whether reducing their nonforfeiture rate to the maximum of 3.75% is most appropriate or whether a larger reduction is warranted to meet the product's objectives with the new limitations in effect. A practical limit could be to set the nonforfeiture rate equal to the minimum valuation interest rate.

General Conclusion/Observations

1. Any given Society's management should be generally familiar with provisions and changes to §7702 testing.

2. Unlike recent changes, CAA 2021 is thought to help insurance companies. This is the reason there is no grace period. But neither should there be some false sense of the need to 'rush to comply.'

3. Changes to products should be assessed on a case-by-case basis. If there are any situations where the company is consistently turning away monies, then these higher funding levels can be utilized.

4. Lower interest rates and higher cash values on traditional products should be analyzed closely before adoption, particularly if returning monies to clients is a non or very infrequent issue. Higher cash values have a price.

5. Companies that do utilize lower guaranteed interest rates need to ensure that proper relationships – both in pricing and in application – maintain the necessary relationships one to the other.

6. Other than ensuring cash values are as great as those generated at a 3.75% interest rate no later than 1/1/2022, a company in compliance on 12/26/2020 will remain in compliance with CAA for the balance of 2021 and likely through 2022 even if no other changes to compliance testing is undertaken.

Assumptions/Limitations/Warranties

The reader should recognize that this paper represents our firm's opinion and is the result of our analysis and experience. This new legislation is still being interpreted by various organizations and legislative experts. We are not qualified nor are we attempting to provide legal counsel. Similarly, we are not tax experts and claim no specific qualification to offer tax advice. But we do hope this discussion will help our clients understand the specific §7702 changes, the impact these have on certain products, and the implication for modifications to illustration and administrative systems, if any.

We acknowledge it is possible interpretations exist that differ from our own. If so, we encourage such a colloquy and welcome any clarifying discussion.

What is Your Answer to the Question that Titles this Paper?

How would your Society answer the question that opens this colloquy? Personally, we feel strongly the answer is both "yes" and "no."

Overfunding issues may present themselves infrequently in many Societies. But we believe that the many Societies are more concerned with sales of any type. Focusing effort on an issue that rarely occurs could be a colossal waste of resources in 2021, maybe even into 2022. Fraternals without Universal Life products and with Traditional products using nonforfeiture factors at 4.0-4.5% may not want to make any changes for §7702 testing. Developing products with lower rates and nonforfeiture factors is likely to serve only as a distraction for other pressing business topics much more important and crucial today.

However, Societies that have Universal Life products with fund accumulation rates guaranteed below 4% and/or other Traditional products where monies are consistently returned, these changes to §7702 funding limits are just what the doctor ordered. Moreover, monies invested to update products and systems could be well worth the dollars spent.

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