2017 and 2021 Legislative Changes to the Definition of Life Insurance

American Academy of Actuaries

A PUBLIC POLICY WHITE PAPER

Life Practice Council's
Tax Work Group

MAY 2023

Members of the Tax Work Group, which authored this white paper, include:

Mary Elizabeth Caramagno, MAAA, FSA—*Chairperson*
Kathleen Bachman, MAAA, FSA
Armand de Palo, MAAA, FSA
Barbara Gold, MAAA, FSA
Judith Hanna, MAAA, FSA
James Reiskytl, MAAA, FSA
Marcy Thailer, MAAA, ASA
Mercy Yan, MAAA, FSA, FCIA
Brian Lessing, MAAA, FSA
Tony Litterer, MAAA, FSA
Aria Zhou, MAAA, ASA

The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

American Academy of Actuaries

AMERICAN ACADEMY OF ACTUARIES
1850 M STREET NW, SUITE 300, WASHINGTON, D.C. 20036
202-223-8196 | WWW.ACTUARY.ORG

May 2023

2017 and 2021 Legislative Changes to the Definition of Life Insurance

The Internal Revenue Code (Code) provides certain tax benefits to life insurance contracts that meet the requirements contained in the Code.

The two major tax benefits recognized by federal tax law are:

1) the death benefits paid to a beneficiary are free from income tax in most circumstances; and
2) the interest and other earnings credited to a life insurance policy's cash value are tax-deferred until they are distributed from the policy—i.e., the inside build-up portion of cash value is generally not taxed on an annual basis.

The purpose of this white paper is to provide a summary of the relevant sections of the Code (sections 7702, 7702A); the changes to these sections in the Tax Cuts and Jobs Act of 2017 (TCJA), that became effective January 1, 2018; and the changes to these sections in the Consolidated Appropriations Act of 2021 (CAA) that became effective for contracts issued on or after January 1, 2021.

Background

The Code defines a life insurance contract within section 7702 and further defines a special form of a life insurance contract within section 7702A (i.e., Modified Endowment Contracts). Before these sections of the Code apply, the contract must satisfy the requirements for life insurance under applicable law (usually state or foreign law) where the contract is issued, including satisfaction of insurable interest requirements. When these criteria are met, then section 7702 applies and determines whether or not the contract is treated as life insurance for federal tax purposes.

Note: This white paper does not address the subject of life insurance contracts that are sold to investors.

The tax-advantaged treatment of life insurance has long been part of the Code, but the first Code-based actuarial test arose in 1982 with the enactment of section 101(f), which generally applies to contracts issued before 1985 that provide for flexible premiums. The test did not apply to contracts with scheduled fixed premiums. Section 7702 was enacted in 1984 to impose a tax definition for life insurance for all life insurance contracts regardless of their premium structure.

A contract must comply with one of two actuarial tests in order to satisfy the definition of life insurance set forth in section 7702:

1. Cash Value Accumulation Test (CVAT): CVAT requires that a contract's cash surrender value (CSV) must never exceed its actuarially derived net single premium (NSP). The test is prospective in that, by the terms of the contract, the CSV cannot exceed the CVAT NSP at any point in the future under any circumstance. If the contract form fails to ensure that this is the case, the contract fails the CVAT upon issuance. For this purpose, CSV generally is a contract's cash value without reduction by surrender charges or loans.

2. Guideline Premium/Cash Value Corridor Test (GPT): GPT evaluates the "facts and circumstances" of the policy using a two-pronged test on an ongoing basis. The first component is a comparison of actual premiums paid into the contract with a Guideline Premium Limitation (GPL) at all points in time. The GPL at any time is the greater of the Guideline Single Premium (GSP) and the accumulated Guideline Level Premiums (GLPs) at that time. The accumulated premiums paid cannot exceed the GPL. The second prong of the GPT is a corridor requirement where a ratio between the contract's CSV and the death benefit is maintained, based on factors defined by section 7702(d). This corridor requirement, similar to the CVAT, ensures that there is a minimum net amount of risk in the contract. If either of these two prongs is violated, the contract fails the GPT. It is possible under this test that the contract holder may not be able to pay enough premium to mature the contract under the guarantees, subject to a limited exception that allows for funding only on a yearly renewable term (YRT) basis.

After the 1984 enactment of section 7702, the first substantial revision to the income tax treatment of life insurance was made by the Technical and Miscellaneous Revenue Act of 1988, which imposed new reasonable mortality and expense charge rules and enacted section 7702A defining a modified endowment contract (MEC). New section 7702A generally applied to contracts entered into on or after June 21, 1988. A MEC is still life insurance in that death proceeds generally are tax-exempt and the inside build-up is tax-deferred until there is a distribution, such as a policyholder dividend or a partial surrender. However, all distributions that occur under a MEC are considered gains first and return of premiums (i.e., investment in the contract) thereafter, and a 10% additional tax will typically apply if gains are distributed prior to the taxpayer's age 59½. In addition, under a MEC, loans are treated as distributions. This means that a loan will result in a taxable distribution to the extent there is gain in the contract.

The test to determine whether or not a policy is a MEC is premium-based, as described below:

> 7-Pay Premium Test (7-Pay): The 7-pay test compares accumulated premiums paid during a seven-year testing period to accumulated 7-pay premiums that are based on certain computational requirements set forth in the statute. If the accumulated premiums paid exceed the accumulated 7-pay premiums, the policy is a MEC. Once a contract is outside a testing period, further testing will be necessary if there is a material change to the contract within the meaning of the statute. There are special testing rules for survivorship policies. Also, a contract received in exchange for a MEC will be a MEC.

The derivation of the actuarial premiums—NSPs, GSPs, GLPs, and 7-pay premiums—generally is based upon assumptions prescribed by (and in several respects limited by) the statutes for interest, mortality, Qualified Additional Benefit charges, and, in the case of the guideline premiums, expense charges other than mortality charges. Throughout the years, guidance from the IRS has included Regulations, Revenue Rulings, Notices, Revenue Procedures, and Private Letter Rulings (PLRs). (Some guidance, such as PLRs, is non-precedential.)

The section 7702 changes introduced in the TCJA recognized that as a result of the TCJA tax reserve changes, there was no longer a prescribed mortality table required in the calculation of tax reserves.

The section 7702 changes introduced in the CAA recognized that the original fixed interest rates in the law were no longer reasonable in the persistent low-interest-rate environment, evidenced by a much greater number of universal life contracts being issued that could never mature based on their guarantees. The low-interest-rate environment also presented challenges for whole life insurance given that interest rates used for determining CSVs needed to equal or exceed the CVAT minimum rate. Rather than simply prescribing lower fixed minimum rates, the changes accommodate different interest rate environments through the use of reference rates, both for determining when a change in the minimum rate is necessary as well as for calculating the final minimum rate for a given issue year. CAA left in place the historical rates as a cap for the minimum rates in the future, thus avoiding problems associated with establishing limits in a very-high-interest-rate environment, which would not be sustainable over the entire life of the contract. CAA also left in place the requirement that if a contract included a guaranteed interest rate or rates that exceeded the applicable floor rate, the higher interest rate or rates generally would need to be used in calculating actuarial premiums.

The Tax Cuts and Jobs Act of 2017

Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the calculation of the actuarial premiums—NSPs, GSPs, GLPs, and 7-pay premiums—was to be based on "reasonable mortality charges which meet the requirements prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables." Prevailing commissioners' standard tables were defined in section 807 covering the calculation of tax reserves.

It should also be noted that under the safe harbors of certain IRS notices (e.g., Notice 2016-63), reasonable mortality charges generally could not exceed the mortality charges guaranteed in the contract if they were less than those in the prevailing commissioners' standard tables.

The TCJA made further changes to the reasonable mortality charge rules. Under TCJA, the derivation of the actuarial premiums—NSPs, GSPs, GLPs, and 7-pay premiums—is to be based on "reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables."

Because TCJA no longer requires the use of prevailing commissioners' standard tables in calculating tax reserves, the definition of prevailing commissioners' standard tables was moved to section 7702. Section 7702(f)(10) defines prevailing commissioners' standard tables as "the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued." Note that this means that there can be different prevailing commissioners' standard tables for different types of contracts—e.g., pre-need contracts.

Note: This white paper does not address contracts that use the interim rule of TAMRA (i.e., TAMRA section 5011(c)(2)) to comply with the definition of life insurance rules in section 7702 (e.g., some substandard contracts).

Consistent with section 7702(f)(10) defining "prevailing commissioners' standard tables," because at least 26 states have adopted the National Association of Insurance Commissioners (NAIC) Valuation Manual, new commissioners' standard tables automatically become prevailing as of the first date the Valuation Manual permits them to be used. However, section 7702(f)(10) provides for a three-year transition period when there are new prevailing commissioners' standard tables. Specifically, if the prevailing commissioners' standard tables at the beginning of a calendar year are different from the prevailing commissioners' standard tables as of the beginning of the prior calendar year, a company may use the prior tables for issues during that year and for the next two years. For example, assume at the beginning of 2031, there are new prevailing commissioners'

standard tables. They are not required to be used for the calculation of the actuarial premiums under the definition of life insurance rules (section 7702) and the MEC rules (section 7702A) rules until Jan. 1, 2034 (i.e., for contracts issued on or after that date), but they may be used prior to that date.

IRC section 7702(c)(3)(B)(i) reflects the U.S. Congress' assumption that the mortality tables used for valuation purposes apply as well for purposes of state nonforfeiture laws. However, the statute authorizes the issuance of regulations permitting the use of mortality charges that are different from those specified in the prevailing commissioners' standard tables.

Consolidated Appropriations Act (CAA) of 2021

In response to the persistent low-interest-rate environment, section 7702 (and, by cross-reference, section 7702A) was amended during 2020 to revise the interest rate assumptions applicable for purposes of deriving the actuarial premiums—NSPs, GSPs, GLPs, and 7-pay premiums. This change was effective for contracts issued on or after Jan. 1, 2021. The original adoptions of these sections of the Code included specific minimum (floor) interest rates of 4% for the CVAT NSP, GLP, and 7-Pay and 6% for the GSP, reflecting a much higher interest-rate environment. CAA left in place the historical rates as a cap for the minimum rates in the future, thus avoiding problems associated with establishing limits in a very-high-interest-rate environment. If a contract included a guaranteed interest rate or rates that exceed the applicable floor rate, the higher interest rate or rates generally would need to be used in calculating these actuarial premiums.

The CAA changed to a dynamic methodology to determine all future floor interest rates for these sections of the Code.

For contracts issued in calendar year 2021, the CAA established new minimum interest rates for the calculation of actuarial premiums for section 7702. The minimum interest rate for CVAT NSP and GLP was changed to 2% and for the GSP it was changed to 4%. By way of reference, the minimum interest rate for section 7702A's 7-Pay premium is also 2%. Starting for contracts issued in calendar year 2022 and each year thereafter, the minimum floor interest rates under section 7702 are determined using a dynamic formula.

In order to understand how the dynamic interest rate mechanism functions, assumptions/terminology were included in the CAA:

Reference	Assumptions/terminology	Description
7702(f)(11)(D)	Adjustment Year	The calendar year following any calendar year that includes the effective date of a change in the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years
7702(f)(11)(B), NAIC Standard Valuation Law	Section 7702 valuation interest rate	Prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years as effective in the calendar year immediately preceding an adjustment year
7702(f)(11)(C)	Section 7702 Applicable Federal Interest Rate (AFIR)	The average of the applicable federal mid-term rates effective as of the beginning of each of the calendar months in the most recent 60-month period ending before the second calendar year prior to an adjustment year
7702(f)(11)(A)	Insurance interest rate	Minimum of section 7702 valuation interest rate and section 7702 applicable federal interest rate
7702(b)(3)	Applicable accumulation test minimum rate	Lesser of 4% or the insurance interest rate; this rate is used for CVAT, GLP, and 7-pay premium calculations
7702(b)(3)(E)	Applicable guideline premium minimum rate	Applicable accumulation test minimum rate plus 2%; this rate is used for the GSP calculation

Under this dynamic methodology, there is no reevaluation of the insurance interest rate (floor rate) unless there is a change in the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years (section 7702 valuation interest rate).

Determination of New Floor Rate Under the CAA

Step 1: As of 6/30/20XX,[1] determine whether the statutory valuation rate will change effective 1/1/20XX+1. If there is a change in the statutory valuation rate, continue to Step 2. Otherwise, the section 7702 valuation interest rate and other resulting rates do not change; skip to Step 7 (to consider any impact of contractually guaranteed interest rate(s)).

Step 2: Set the section 7702 valuation interest rate = new statutory valuation rate and update the next adjustment year to 20XX+2.

Step 3: Calculate the 60-month section 7702 AFIR as of 20XX-1. Round to the nearest whole number. If there is a new rate established in Step 1, then set the section 7702 AFIR to the new rounded average section 7702 AFIR. Otherwise, there is no change to the section 7702 AFIR.

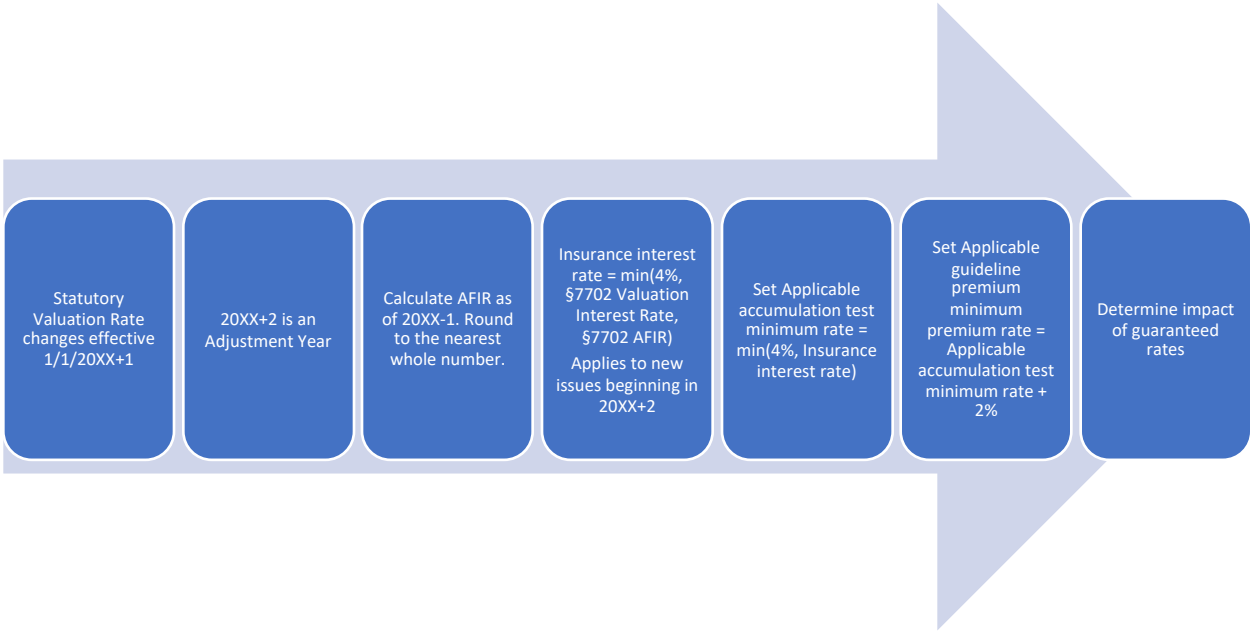
Step 4: Calculate the insurance interest rate for 20XX+2 = min(section 7702 valuation interest rate, section 7702 AFIR)

1 The NAIC Valuation Manual currently relies on 6/30/XX rates and the publication of the manual is expected to be some time after that date. The NAIC could, in the future, change this date.

Step 5: Set the applicable accumulation test minimum rate = min(4%, insurance interest rate)

Step 6: Set the applicable guideline minimum premium rate = applicable accumulation test minimum rate + 2%

Step 7: Determine whether any contract guarantees increase the rate that must be used in calculating the limits



Numerical Examples

Example 1: Change in statutory valuation rate, no change in 60-month average AFIR

Step 1: Assume that the statutory valuation rate increases by 50bp to 3.50%, effective as of 20XX+1.

Step 2: 20XX+2 is an adjustment year and the section 7702 valuation interest rate = the statutory valuation rate effective 20xx+1, which is 3.5%.

Step 3: Calculate the 60-month average AFIR as of December 31st 20XX-1 and round to the nearest whole percentage. For this example, this rounded rate is unchanged from the last determination. The section 7702 AFIR remains 2.00%.

Step 4: Set the insurance interest rate = min(section 7702 valuation interest rate, section 7702 AFIR) = min(3.5%, 2.0%) = 2.0%.

Step 5: Set the applicable accumulation test minimum rate = min(4%, insurance interest rate) = 2.00%.

Step 6: Set the applicable guideline premium minimum rate = applicable accumulation test minimum rate + 2% = 4.0%.

Step 7: Determine the impact of specific contract guarantees: For CVAT, 7-Pay premium and GLP calculations = max(applicable accumulation test minimum rate, rate(s) guaranteed) = max(2.0%,2.0%) = 2.0%. For GSP calculations = max(applicable guideline premium minimum rate, rate(s) guaranteed) = max(4.0%, 2.0%) = 4.0%.

Example 2: Change in statutory valuation rate and change in 60-month average AFIR since the last adjustment year

Step 1: Assume that the statutory valuation rate increases by 50bp to 3.50%, effective as of 20XX+1.

Step 2: 20XX+2 is an adjustment year and the section 7702 valuation interest rate = the statutory valuation rate, which is 3.5%.

Step 3: Calculate the 60-month average AFIR as of December31st 20XX-1, rounded to the nearest whole percentage. In this example, the 60-month average AFIR has increased to 3.46%. After rounding, the section 7702 AFIR is now 3.00%.

Step 4: The insurance interest rate = min(section 7702 valuation interest rate, section 7702 AFIR) = min(3.5%, 3.0%) = 3.0%.

Step 5: Set the applicable accumulation test minimum rate = min(4%, insurance interest rate) = 3.0%.

Step 6: Set the applicable guideline premium minimum premium rate = applicable accumulation test minimum rate + 2% = 5.0%.

Step 7: Determine the impact of specific contract guarantees: For CVAT, 7-Pay premium and GLP calculations = max(applicable accumulation test minimum rate, rate(s) guaranteed) = max(3.0%, 2.0%) = 3.00%. For GSP calculations = max(applicable guideline premium minimum rate, rate(s) guaranteed) = max(5.0%, 2.0%) = 5.0%.

Example 3: No change in the statutory valuation rate from the baseline, but 60-month average AFIR changes

Step 1: Assume that the statutory valuation rate is unchanged from 20XX to 20XX+1. The rate remains at 3.00%.

Step 2: 20XX+2 is not an adjustment year, so the section 7702 valuation interest rate remains the same 3.0% that was established as of the last adjustment year.

Step 3: Because there is no change in the statutory valuation rate and no new adjustment year, this step is not used and the section 7702 AFIR remains 2.0%.

Step 4: Because there is no change in the statutory valuation rate, the insurance interest rate is unchanged as the insurance interest rate min(section 7702 valuation interest rate, section 7702 AFIR) = min(3.5%, 2.0%) = 2.0%.

Step 5: Because there is no change in the statutory valuation rate, the Applicable accumulation test minimum rate is unchanged at the min(4%, insurance interest rate) = 2.0%.

Step 6: Because there is no change in the statutory valuation rate, the applicable guideline premium minimum rate is unchanged as the applicable accumulation test minimum rate + 2% = 4.0%.

Step 7: Determine the impact of specific contract guarantees: For CVAT, 7-Pay premium and GLP calculations = max(applicable accumulation test minimum rate, rate(s) guaranteed) = max(2.0%,2.0%) = 2.00%. For GSP calculations = max(applicable guideline premium minimum rate, rate(s) guaranteed) = max(4.0%, 2.0%) = 4.0%.

Example 4: No change in the statutory valuation rate from the baseline or 60-month average AFIR with a guaranteed rate of 3.0%

Step 1: Assume that the statutory valuation rate is unchanged from 20XX to 20XX+1. The rate remains at 3.0%.

Step 2: 20XX+2 is not an adjustment year and the section 7702 valuation interest rate remains the same 3.0% that was established as of the last adjustment year.

Step 3: Because there is no change in the statutory valuation rate and no new adjustment year, this step is not used and the section 7702 AFIR remains 2.0%.

Step 4: Because there is no change in the statutory valuation rate, the insurance interest rate is unchanged as the min(section 7702 valuation interest rate, section 7702 AFIR) = min(3.0%, 2.0%) = 2.0%.

Step 5: Because there is no change in the statutory valuation rate, the applicable accumulation test minimum rate is unchanged at the min(4%, Insurance interest rate) = 2.0%.

Step 6: Since there is no change in the statutory valuation rate, the applicable guideline premium minimum rate is unchanged as the applicable accumulation test minimum rate + 2% = 4.0%.

Step 7: Determine the impact of specific contract guarantees: For CVAT, 7-Pay premium and GLP calculations = max(applicable accumulation test minimum rate, rate(s) guaranteed) = max(2.0%,3.0%) = 3.0%. For GSP calculations = max(applicable guideline premium minimum rate, rate(s) guaranteed) = max(4.0%, 3.0%) = 4.0%.

Assumption	**Baseline**	**Example 1**	**Example 2**	**Example 3**	**Example 4**
Year of stat val rate change		20XX+1	20XX+1	No change	No change
Section 7702 valuation interest rate	3.00%	3.50%	3.50%	3.00%	3.00%
Adjustment year		20XX+2	20XX+2	No change	No change
Reference Year for section 7702 AFIR		20XX-1	20XX-1	No change	No change
60-month average applicable Federal interest rate as of 12/31/xx-1		2.03%	3.46%	No change regardless of 60-month average AFIR	No change regardless of 60-month average AFIR
Section 7702 AFIR	2.00%	2.00%	3.00%	2.00%	2.00%
Insurance interest rate	2.00%	2.00%	3.00%	2.00%	2.00%
Applicable accumulation test minimum rate	2.00%	2.00%	3.00%	2.00%	2.00%
Applicable guideline premium minimum rate	4.00%	4.00%	5.00%	4.00%	4.00%
Rate(s) guaranteed in the contract	2.00%	2.00%	2.00%	2.00%	3.00%
Final Rates for Limits	**Baseline**	**Example 1**	**Example 2**	**Example 3**	**Example 4**
CVAT	2.00%	2.00%	3.00%	2.00%	3.00%
7-Pay Premium	2.00%	2.00%	3.00%	2.00%	3.00%
GLP	2.00%	2.00%	3.00%	2.00%	3.00%
GSP	4.00%	4.00%	5.00%	4.00%	4.00%

Conclusion

Product development actuaries need to be attentive to changes in valuation mortality tables and valuation interest rates. Changes in the insurance interest rate are intended to reflect broad changes in the interest rate environment, so the rate was intentionally designed to change infrequently. Complete analysis of the reference rates under the dynamic formula, as well as comparison to the contractual guarantees, will be required.

The rates used in the dynamic formula change based on different time horizons and thresholds for redetermination, which means that they may not change in step with each other. While a change in the valuation interest rate will result in an adjustment year, not every adjustment year will result in a change in the statutory minimum rates that must be used under the revision of section 7702.

Disclosure

This white paper covers basic information regarding life insurance policyholder taxation and should not be viewed as a comprehensive document covering all aspects of sections 101(f), 7702, 7702A, or section 205 of CAA, 2021.

American Academy of Actuaries
1850 M Street NW, Suite 300
Washington, D.C. 20036
202-223-8196

ACTUARY.ORG