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Will A New Law Increase Retirement Funding Through Life Insurance?

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As last year came to its close, the Consolidated Appropriations Act (CAA) of 2021 was signed into law.[1] Among its many provisions are changes to the way certain life insurance contracts are defined. Across the board, there is a widely-held belief that income tax rates will rise in the near future, resulting in more people utilizing life insurance in the retirement planning process.

Changing the Code

The CAA includes changes to Section 7702 of the tax code, which was enacted in 1984 to define a life insurance contract that qualifies for preferential tax treatment. Life insurance death benefits typically are excluded from income tax. In addition, life insurance policies that contain a specific account, often known as the cash value, also enjoy tax-free buildup of any accumulated value inside the account as well as the opportunity for untaxed withdrawals and policy loans.

To qualify as fully tax-advantaged life insurance under Section 7702, the contract must meet one of two actuarial tests, the Guideline Premium Test (GPT) or the Cash Value Life Accumulation Test (CVAT). These tests impose limits on the amount of premiums paid into a policy and the amount of cash value that can accumulate relative to the death benefit.[2]

Section 7702 also established a minimum interest rate of 4% to be used in calculating the actuarial value of these tests, for the most part. This 4% minimum interest rate, established in 1984, has been the same for more than 35 years, with no changes to account for rate moves since then.

To bring the calculation up to date, the CAA changed Section 7702 from its static 4% model (6% for the GPT in some cases) to a dynamic model tied to a benchmark. A change in rate is permitted once per year, effective with policies issued in 2022, bringing this minimum interest rate into the current low-rate environment.

Under the CAA, policies issued in 2021 can replace the 4% rate with a 2% rate. Note that these 7702 changes do not apply retroactively to policies written before January 1, 2021.[3]

Looking Back

Why is the move to lower interest rates under Section 7702 worth recognizing? To understand, it's important to go back to the early 1980s, when interest rates and federal income tax rates were significantly higher than they are now. Investors (especially high-bracket taxpayers) were increasingly using single-premium life insurance: policies that were paid in full after a sizable upfront outlay.

Most of that premium would go into the cash value, where any investment returns would be untaxed. If cash was needed—perhaps in retirement—it could be accessed without an income tax obligation via loans and withdrawals if specific rules were followed. Taxpayers could "maximum fund" cash value life insurance to put more money into the policy's cash value for untaxed investment growth and untaxed cash flow.

Consequently, Section 7702 was enacted in 1984 to close this perceived loophole, reinforcing the primary purpose of life insurance as a deliverer of death benefits rather than as a tax shelter for investors.

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So, the GPT and CVAT tests were implemented. Broadly, the result was to set a maximum amount of premiums paid in the first status of seven years of a policy to maintain the fully tax-favored life insurance.

If people pay more than the permitted amount of premiums, they have acquired a modified endowment contract (MEC)—under a subsequent tax act passed in 1988.[4] Thus, max-funded life insurance policies (high on cash value, low on death benefits) still exist, right up to a "MEC limit" that can be set accurately using the tax code guidelines.

Suppose someone goes over this limit with premium payments. In that case, they will have a MEC: tax-free cash value buildup and tax-free death benefits still apply, but any distributions of cash value buildup through loans or withdrawals taxed will be subject to income tax. MEC loans are treated as ordinary income; MEC withdrawals are last-in, first-out (LIFO), so income earned inside the policy will be taxed and possibly subject to a 10% penalty before age 59½.

More or Less?

The CAA changes to Section 7702 will affect GPT and CVAT testing. In essence, more money can be deposited into a contract upfront and qualify for life insurance rather than MEC treatment. That may mean more tax-free distributions in retirement from cash value life insurance policies or lower premium payments to receive comparable distributions.

Therefore, the new 7702 rules could increase the appeal of including cash value life insurance in retirement planning. Still, the revised 7702 rules retain a requirement for a substantial death benefit that probably will pass to beneficiaries eventually, untaxed.

The Insurer's Perspective

The changes to Section 7702 may lead to a greater reliance on cash value life insurance in retirement planning. That said, it's important to keep in mind that there is an enormous variety of policies to choose from. Some specific products may be more appealing for max funding than others if the concept seems appropriate for select clients or prospects, so drilling down to an offering's detail will remain crucial.

Consequently, the value of retirement planning with life insurance will depend mainly on the products that come to market under the new Section 7702 rules. Many insurers will welcome the change and may offer appealing options.

Reduced minimum interest rates may be a significant benefit to the industry. Interest rates have primarily been falling for decades, a trend that became even more prominent during the pandemic-induced efforts to stimulate the economy.

Because insurers hold the rates on the underlying investments in order to fund contract liabilities, they have not kept pace with the rates guaranteed on permanent life insurance policies under the old Section 7702. Many companies faced a growing sustainability problem. Some insurers faced design and profitability challenges, but the improved match between required interest rates and reality may lead to a more stable industry, benefiting producers and consumers.

Changing from a static 4% interest rate model to a dynamic market-driven model is likely to improve sustainability for life insurance companies, possibly resulting in a flow of more appealing products for retirement planning. The new life insurance vs. MEC relationship may enable clients and prospects to find products with the potential to generate meaningful tax-free cash flow. If all these potential developments come to pass, the strain faced by life insurance companies in offering long-term life insurance to aid in financial planning and retirement security will be eased under the revised Section 7702.

Moving Onto the Menu

Retirement funding via tax-deferred accounts such as traditional 401(k)s and IRAs undoubtedly will

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continue, but the threat of paying the deferred tax at higher future rates may be daunting. Putting some after-tax money into cash value life insurance may prove to be a thoughtful tactic for setting up untaxed investment income in retirement.

Moreover, clients and prospects who might have been considered too old or not healthy enough for retirement-oriented life insurance might revisit this idea now that mandated interest rates have fallen. The premiums they'll owe for max-funded arrangements may become more reasonable, especially if they're in the market for second-to-die policies that spread potential cash value buildup over the lives of two people.

Other cash value life insurance features, such as split-dollar arrangements and chronic illness riders, also might become more affordable with lower interest rates in the calculation. As always, attention to product details is necessary for making the right decisions.

Sources:

[1] https://www.congress.gov/116/bills/hr133/BILLS-116hr133enr.pdf

[2] https://www.law.cornell.edu/uscode/text/26/7702 Section (b) and (c)

[3] CAA 2021 Title II: Other Provisions Sec. 205 (E) Minimum Rate of Interest for Certain Determinations Related to Life Insurance Contracts

[4] https://www.congress.gov/bill/100th-congress/house-bill/4333 Title V Section 5012 – Treatment of Modified Endowment Contracts

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