Consolidated Appropriations Act Updates to Internal Revenue Code Section 7702

Why is it important to consumers to protect permanent life insurance?

Permanent life insurance comes in two primary forms, whole life and universal life. Whole life insurance typically provides level premiums, guarantees a death benefit, and holds cash value to pay the rising cost of insurance as a policy ages without increasing premiums to the policyholder. Universal Life typically provides flexible premium payments and has an account value that funds its face amount. In both cases, policies are designed to respond to the premature death of a breadwinner or business partner. Not only do permanent life insurance policies also provide tremendous stability to policyholders as a source of funds during economic downturns or market volatility, insurers are able to pool the funds backing the cash and account values to provide a large source of capital to the U.S. economy.

What do sustained, historically low interest rates have to do with permanent life insurance?

Permanent life insurance relies on interest earnings, in addition to premiums, to make sure the policy remains in force until death. The more interest earnings that are available, the smaller the premiums that are necessary to provide and maintain cash value to support permanent coverage. If less interest earnings are available, larger premiums are necessary to ensure such coverage can be maintained. Notwithstanding this fundamental economic point, as described below, the tax law requires specific interest rates that must be assumed in setting tax limits on policy premiums and cash values. COVID-19's impact on already historically low interest rates have pushed the design and funding of permanent life insurance policies to a breaking point, given the tax law limits that existed prior to the changes at the end of 2020. With these changes, the dramatically reduced interest earnings can now be made up for by higher premiums that the policyholder will put in so that policies can reach their intended death benefit over the life of the policy.

What is the purpose of Section 7702?

This is where the tax code defines what qualifies permanent cash value life insurance policies as protection rather than investments. To qualify as life insurance for federal tax purposes, these policies must meet one of two tests that include interest rate requirements, either the cash value accumulation or the guideline premium test. Prior to the recent enactment of changes, the tests incorporated hard-coded interest rates (established when market interest rates were much higher) designed to limit the proportion of cash value to the total face amount of the policy or the amount of premiums that could be paid, thereby ensuring life insurance treatment for tax purposes.

What changes were made to Section 7702?

Section 7702 was written in 1984, when interest rates were 10 percent and higher. In such an environment, use of a four percent interest rate in the cash value and premium limitations made sense. The interest rates that were hard coded in Section 7702 are now indexed to a reference rate in extremely low interest rate environments, so they are more closely tied to current economic conditions. If market interest rates normalize in the future, Section 7702 would revert to prior law prescribed rates that worked well for more than 30 years through more typical interest rate cycles. The changes enacted at the end of 2020 were intended to be a fix in the context of low market interest rates.

Do the changes let wealthy people put more money in insurance products for tax advantages?

The changes will benefit all consumers by ensuring appropriate and actuarially sound relationships between cash value and premium limits to death benefits in very low interest rate environments. No change was made to existing requirements under the guideline premium test that limit the relationship of the cash value to the face amount. This limitation is commonly known as the corridor. It requires that no insurance policy has too much cash value in relationship to the face value. The corridor remains in place, untouched, and safeguards the integrity of life insurance from being used as an investment product. The goal of these changes is to make certain the death benefit of the policy can be fully funded and get to the same outcome that was possible when higher interest rates were available for crediting to guaranteed products.

Who benefits from these changes?

Consumers of any income level seeking permanent protection benefit from the 2020 changes. Without the provision, whole life insurance as it has existed for middle-income families and small businesses would be severely compromised and may no longer exist. Universal life insurance could continue but no one could guarantee that the premiums paid would endow the contract due to low interest rates causing policies to either lapse early or require very large premium payments from elderly policyholders.

What's the forecast for interest rates?

The Federal Reserve has indicated that it sees Treasury rates staying near zero until 2023.

7702 Changes: Essential Lifeline for Consumers

Now more than ever, Americans need ways to secure their financial footing. Millions rely on permanent life insurance to protect their families and small businesses. Congress made recent changes to the tax code to preserve access to this important financial protection for middle-income families and businesses.

What is Permanent Life Insurance?

	Typical Policyholders Middle-income families and small business owners		Source of Stability Guarantees a death benefit, and can be a source of funds to policyholders during economic downturns or market volatility
	Tied to Interest Rates Relies on premiums and interest earnings to fund the policy		Widely Used Product 60 percent of the market is in permanent policies.

Headwinds Facing Permanent Life Insurance

COVID-19's impact on already historically low interest rates pushed the funding of permanent life insurance policies to a breaking point. Here's how:

- The tax code defines what qualifies as life insurance policies. Section 7702 was written in 1984, when interest rates were 10 percent or higher. Consumers could expect premiums to remain low and cash values to grow with high rates of interest.
- Sustained low interest rates impact the funding of permanent life policies. Now what cannot be funded through interest earnings may be replaced by premium dollars.
- The Federal Reserve has indicated that it sees interest rates on Treasuries staying near zero until 2023.

DID YOU KNOW?

No change was made to existing requirements that limit the relationship of the cash value to the face amount, the limitation commonly known as the corridor. It remains in place, safeguarding life insurance from being used as an investment product.

A Lifeline for Families and Small Businesses

Changes to section 7702 of the tax code gave a lifeline to families and businesses. They indexed interest rates, so they float with changes in interest rates.

Consumers of any income level benefit from the 2020 changes. Without the provision – which does not impact existing policies, only new policies – whole life insurance would be severely compromised and may no longer exist. The changes make sure the death benefit of new policies can be fully funded and get to the same outcome that was possible when higher interest rates were available for guaranteed products.