February 1, 2021 21-017

Year-End Updates to - Internal Revenue Code (IRC) Section 7702

What is IRC Section 7702 and 7702A?

IRC Section 7702 sets forth tests to define whether a life insurance contract may be treated as a life insurance contract for federal tax purposes. Implemented in 1984, the tests were enacted to limit the investment orientation of a life insurance policy. A life insurance contract can satisfy Section 7702 either by the Guideline Premium Test (GPT) or the Cash Value Accumulation Test (CVAT). Any policy that does not meet one of the two actuarial tests under Section 7702 (GPT/CVAT) will lose the favorable tax treatment of a life insurance policy. In 1988, Section 7702A further clarified how cash value distributions beyond basis are to be taxed if the policy is a Modified Endowment Contract (MEC).

IRC Section 7702 sets forth certain assumptions under the actuarial tests, including the use of minimum interest rates that were prescribed in 1984, when the statute was originally enacted, and interest rates were at record highs. The interest rate assumptions used in the original Section 7702 guidelines to calculate the limits were set at 6% for GPT Single Premium and 4% for CVAT/MEC and GPT Level Premium.

What is changing?

A change to the interest rate assumptions in Section 7702 was included in the Consolidated Appropriations Act, 2021 (CAA 2021) signed into law December 27, 2020, where the fixed minimum interest rates used to apply the tests under Section 7702 were changed to a market-based rate called the “Insurance Interest Rate” which is the lower of two alternative rates: Section 7702 Valuation Interest Rate and Section 7702 Applicable Federal Interest Rate.

Effective January 1, 2021, the insurance interest rate is defined as 2% and may now be used to calculate adherence for the 2021 calendar year. Beginning in 2022, the market-based rate calculation will take effect; however, for 2022, the insurance interest rate has been calculated to be 2%.

The changes are for new sales and do not impact the calculations used for policies issued prior to January 1, 2021.

Impact to AIG policies

We are in the process of evaluating the potential impact of these changes on our product portfolio and planning implementation throughout 2021.

Stay tuned for additional information on these changes.

What is the impact of these changes?

These changes will impact all life insurance policies issued on or after January 1, 2021. These changes will generally allow for more premiums to be paid into permanent policies for the same death benefit without triggering a life insurance test violation or a MEC violation. Said another way, the same premium amount will result in a lower minimum non-MEC death benefit, effectively making some cash value accumulation products more efficient in certain scenarios.