INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021

The purpose of this GBC Whitepaper is to outline, examine and interpret the **changes to Section 7702 of the Internal Revenue Code** brought about by the passage and signing into law of the "Consolidated Appropriations Act, 2021," effective for all life insurance issued January 1, 2021, and after.

Language changes here, coupled with revisions made by the NAIC to the 2021 Valuation Manual, will have widespread impact on product valuation, design and marketing for a number of years to come.

DISCLOSURE

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This document was developed for the purpose of providing to its intended audience an overview of items related to the topic of key interest rates used for life insurance calculations, including those for reserving and developing nonforfeiture values, as well as for parameters used in the determination of whether a product meets the criteria for life insurance for federal tax purposes. The comments and recommendations included in this document reflect solely the interpretations and views of its authors, and are not intended to represent formal guidance or instruction. This document has not been sanctioned by, or developed in conjunction with, any actuarial or insurance-related authority, industry organization, or governing body.

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DASHBOARD OF RATE CHANGES – Past and Projected

Below are charts summarizing the various rates addressed in this article, including GBC derivations. The goal of these exhibits is to provide a timeline of the key insurance rates affected by changes (7702 or otherwise):

	Citation/	Interest Rate to Use			
Calculation	References	2020 issued	2021 issued	2022 issued	Notes
Cash Value Accumulation Test	S. 7702(b)(2)(A)	rate(s) guaranteed in policy, not less than 4%	rate(s) guaranteed in policy, not less than 2%*	rate(s) guaranteed in policy, not less than 2%*	*Applicable Accumulation Test Minimum Rate for that year
Guideline Single Premium	S. 7702(c)(3)(B)(iii)	rate(s) guaranteed in policy, not less than 6%	rate(s) guaranteed in policy, not less than 4%*	rate(s) guaranteed in policy, not less than 4%*	*Applicable Guideline Premium Minimum Rate for that year
Guideline Level Premium	S. 7702(c)(4)	rate(s) guaranteed in policy, not less than 4%	rate(s) guaranteed in policy, not less than 2%*	rate(s) guaranteed in policy, not less than 2%*	*Applicable Accumulation Test Minimum Rate for that year
7-Pay Test level annual premium	S. 7702A(c)(1)(B)	rate(s) guaranteed in policy, not less than 4%	rate(s) guaranteed in policy, not less than 2%*	rate(s) guaranteed in policy, not less than 2%*	*Applicable Accumulation Test Minimum Rate for that year

NOTE: At the present time (January 2021), we anticipate that the applicable rates for 2023 will be the same as that for 2021-2022, but cannot comment with the degree of confidence as that presented above. Our interpretation of the 7702 amendments is that future changes here are expected <u>only</u> upon a change to the statutory valuation interest rate (due to such a year being labeled as an “adjustment year” by the definition outlined in 7702(f)(11)(D)).

	Citation/			Projected		
	References	2020	2021	2022	2023	Notes
Maximum Reserve Valuation Interest Rate (VIR)	VM-20	3.50%	3.00%	3.00%	3.00%	determined based on Moody's Corporate Average Yield Rates, 12 and 36 month averages
Maximum Nonforfeiture Interest Rate	VM-02; S. 7702(b)(2)(A)	4.50%	3.75%*	3.75%	3.75%	determined based on Valuation Interest Rate; *permitted one-year delay for implementation
Adjustment Year?	S. 7702(f)(11)(D)	N	N	Y	N*	* if no change to VIR for 2022
S. 7702 Valuation Interest Rate	S. 7702(f)(11)(B)	N/A	N/A	3.00%	XX*	* would use "most recent adjustment year"
60-month span of 1274(d) rates, mid-term/ annual compounding, unrounded	S. 7702(f)(11)(C)		Jan-2014 to Dec-2018	Jan-2015 to Dec-2019	Jan-2016 to Dec-2020	
	Various IRS Rev. Rul.		1.940%	2.001%	1.824%	<- tracking the trend here to gauge movement
S. 7702 Applicable Federal Interest Rate	S. 7702(f)(11)(C)	N/A	N/A	2%	XX*	* would use "most recent adjustment year"
Insurance Interest Rate (IIR)	S. 7702(f)(11)(A)	N/A	2%*	2%*	2%*	*2021 value is per Transition Rule; 2022 value determined by formulas; 2023 value assumed at present based on trends
Applicable Accumulation Test Minimum Rate (AATMR)	S. 7702(b)(3)	N/A	2.00%	2.00%	2.00%	= MIN[IIR, 4%]
Applicable Guideline Premium Minimum Rate (AGPMR)	S. 7702(c)(3)(E)	N/A	4.00%	4.00%	4.00%	= AATMR + 2%

NOTE: items listed for 2022 and 2023 are still not “final” for all entries, particularly the valuation and nonforfeiture interest rates—though it is not expected that these would change, given the current levels of benchmark rates, recent trends, and the formula rules which dampen volatility.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

INTRODUCTION AND OVERVIEW

On December 27, 2020, President Trump signed into law the "Consolidated Appropriations Act, 2021" (the "Act"), which contained provisions impacting key components of Section 7702 of the Internal Revenue Code ("7702").

The contents and requirements of 7702—which define a life insurance contract for federal tax purposes—have been in place for over 30 years, with only marginal changes occurring over that span.

However, with the enactment of this new law—specifically Section 205—key benchmarks against which life insurance contracts were measured changed, and the revisions were made effective for all products to be sold a mere five days later.

While outlining several meaningful and material changes to 7702, Section 205 is targeted in its revisions. As expected by its title within the Act ("MINIMUM RATE OF INTEREST FOR CERTAIN DETERMINATIONS RELATED TO LIFE INSURANCE CONTRACTS"), the changes are confined to **redefining the interest rates** used in the computation of 7702's Cash Value Accumulation Test and Guideline Premium Requirements—the (only) two methods by which a contract can be deemed a "life insurance contract" in the eyes of federal tax code.

Specifically, rates which had been static and constant for decades are now both <u>date sensitive</u> and <u>floating (with caps/ceilings)</u>—ostensibly to be more consistent with the economic environment in which a given contract is issued.

Consumer advocates and key industry players have been promoting such revisions for several years, with the ACLI on record endorsing and lobbying for interest-environment-sensitive updates to 7702 (see REFERENCES). Proponents argue that, in an era of persisting low interest rates, the rates fixed within the Internal Revenue Code pertaining to defining life insurance were outdated (i.e., high), and had the effect limiting product flexibility/adaptability and, by extension, competitiveness versus other financial sectors/offerings.

In any event, the revisions will have an immediate and long-lasting impact on the insurance industry, and therefore should be well understood by companies, actuaries, and regulators alike.

The layout of this Whitepaper is as follows:

- restate the **role of 7702** within the life insurance industry
- highlight **which subsections of 7702 are altered and/or added** by the passage/signage of the Act
- address **each of the revised subsections of 7702**, including a walk-through of new terminology and practical implications of the changes, particularly delving into the calculation of the newly-created "Insurance Interest Rate"
- outline how the changes to 7702 **reverberate into other regulatory guidance/requirements** (e.g. IRC Section 7702A and cash/nonforfeiture value determination)

Note, in all instances, <u>the explanations and interpretations provided herein are solely those of Griffith, Ballard & Company</u>—and do not represent official guidance or positions specifically endorsed by the IRS, NAIC or other entities, organizations or individuals, cited or not.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

THE ROLE OF S. 7702 IN LIFE INSURANCE

As part of the Internal Revenue Code, Section 7702 is intended to define life insurance for federal tax purposes (or better said, outline what would *disqualify* a given contract from receiving the favorable tax treatment afforded life insurance contracts).

As stated in 7702(a), a life insurance contract under the law will meet the definition of 7702 only if such a contract:

(1) meets the cash value accumulation test (outlined in 7702(b)), *OR*

(2) meets the guideline premium requirements (outlined in 7702(c)) *AND* falls within the cash value corridor (outlined in 7702(d))

Subsections (e) through (k) present additional definitions, context, and special cases related to these items, but, in general, subsections (b) through (d) encompass the primary bases by which insurers/actuaries design and market—and regulators evaluate—life insurance contracts for the purposes of 7702.

SUBSECTIONS OF S. 7702 REVISED BY THE ACT

A reading of Section 205 of the Act reveals that subsections (a) through (d) are focused on revising the definitions regarding the rates of interest to be used for calculating the 7702-defined benchmarks. Subsection (e) then states that all changes "shall apply to contracts issued after December 31, 2020."

What's notable is that Section 205 is actually quite "surgical" with its revisions. In fact, these changes are **localized to 7702 subsections (b), (c) and (f)**—though the overall impact is rendered more complex by the addition of new terminology, date-sensitive triggers, and the replacement of constant/fixed rates with annually varying, formula-derived rates, which are dependent on periodically published governmental data as inputs.

Below is a brief summary of the amendments to subsections of 7702 made law by the Act:

7702(b)(2)(A):	*changes* definition/basis for interest rate used for Cash Value Accumulation Test (CVAT)
7702(b)(3):	*new subsection:* defining Applicable Accumulation Test Minimum Rate (AATMR)
7702(c)(3)(B)(iii):	*changes* definition/basis for interest rate used for calculating the Guideline Single Premium (GSP)
7702(c)(3)(E):	*new subsection:* defining Applicable Guideline Premium Minimum Rate (AGPMR)
7702(c)(4):	*changes* definition/basis for interest rate used for calculating the Guideline Level Premium (GLP)
7702(f)(11):	*new subsection:* defining Insurance Interest Rate (IIR), which is built from the Section 7702 Valuation Interest Rate (SVIR) and the Section 7702 Applicable Federal Interest Rate (AFIR), both also defined in this subsection

Over the next few pages, we will analyze each of these affected subsections.

We begin the discussion with the latter-most of these revisions: the addition of 7702(f)(11), which contains five subsections (A) through (E), and presents the most "new" material and definitions—in particular, the introduction of the Insurance Interest Rate.

We will then address changes to subsection 7702(b), impacting the Cash Value Accumulation Test, and to subsection 7702(c), impacting the Guideline Premium Requirements—as both of these also depend on the changes implemented in 7702(f).

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

REVISIONS TO S. 7702(f) – Introduction of the Insurance Interest Rate

By far the most consequential change stemming from the Act is the addition of 7702(f)(11), which centers on the definition and development of the **Insurance Interest Rate ("IIR")**. This rate—driven by date-sensitive, moving-average data—establishes the connection to the current environment sought by those proposing/lobbying for changes to 7702. In other words, this subsection is the primary reason 7702 was revised at all.

The IIR for any life insurance contract is assigned/anchored based on its year of issue. According to 7702(f)(11)(A), the IIR is defined *per calendar year*, and is the lesser (minimum) of two other benchmarks:

(i) the Section 7702 Valuation Interest Rate—as defined by 7702(f)(11)(B)—for the "most recent adjustment year" (which can be the calendar year itself), and

(ii) the Section 7702 Applicable Federal Interest Rate—as defined by 7702(f)(11)(C)— for the "most recent adjustment year" (which can be the calendar year itself)

… with 7702(f)(11)(D) defining what constitutes an "adjustment year."

While this reads as being somewhat convoluted, the best way to present and digest these rules/ formulations is to use concrete examples.

➔ For 2021 (i.e., from January 1 through *at least* December 31, 2021), the IIR = 2%

This is straightforward, as codified via by the "Transition Rule" of 7702(f)(11)(E).

Getting this particular item established early is critical: since the rate changes apply to current year new business, insurers already have a need to get their systems—illustration and administrative, to name just two—updated as soon as possible. Furthermore, in the amended 7702, the IIR is now *the* key building block for all the other testing benchmarks (CVAT, GSP, and GLP).

Not as straightforward, however, is determining the IIR percentage for 2022 (i.e., is there a change as of January 1?), 2023, and future years. To provide some insight on this front, we must parse through the definitions outlined elsewhere in subsection 7702(f)(11), with *emphasis added*.

- 7702(f)(11)(D) defines **"adjustment year"** as "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 (as defined in the National Association of Insurance Commissioners' Standard Valuation Law)."
  - ➔ It has been determined/confirmed that the statutory valuation interest rate stated above, effective for 2021, is 3.0%, which is a change from the 3.5% effective from 2013-2020.
  - ➔ Therefore, based on 7702(f)(11)(D), **2022 is an "adjustment year," and both 2020 and 2021 are not.**
  - ➔ By extension, the next/subsequent "adjustment year" would be the year after the next effective year for a change to the valuation rate.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

REVISIONS TO S. 7702(f) – Introduction of the Insurance Interest Rate (continued)

- 7702(f)(11)(B) defines **"Section 7702 Valuation Interest Rate" ("SVIR")**, with respect to any adjustment year, as being "the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years (as defined in the National Association of Insurance Commissioners' Standard Valuation Law) as *effective in the calendar year immediately preceding such adjustment year*."
  - ➔ Since 2022 is an adjustment year, the **2022 "Section 7702 Valuation Interest Rate" would be 3.0%** (i.e., the effective statutory valuation interest rate, as stated above, for 2021—the first year for which it is effective)
  - ➔ By extension, the next/subsequent "adjustment year" would likewise be triggered by a rate change, and the applicable "Section 7702 Valuation Interest Rate" would thus be that (newly changed) rate.
- 7702(f)(11)(C) defines **"Section 7702 Applicable Federal Interest Rate"("AFIR")**, with respect to any adjustment year, as being "the average (rounded to the nearest whole percentage point) of the applicable Federal mid-term rates (as defined in section 1274(d) but based on annual compounding) 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 such adjustment year*."
  - ➔ The 1274(d) monthly rates referred to above can be found/mined from monthly "Revenue Rule" releases posted on the irs.gov website (see REFERENCES)
  - ➔ Since 2022 is an adjustment year, the applicable 60-month period would be from January-2015 to December 2019; the "raw" (unrounded) average of these rates, based in the data we downloaded, is 2.001%, which would result in the **2022 "Section 7702 Applicable Federal Interest Rate" being 2%.**
  - ➔ By extension, the next/subsequent "adjustment year" (call it 20xx) would use the 60-month period from January-20(xx-7) to December-20(xx-3), and the applicable "Section 7702 Applicable Federal Interest Rate" would be obtainable and known well in advance, because of the lag in years as it pertains to data references.

Returning to 7702(f)(11)(A), which defined the IIR based on the above components, we can now determine the IIR for 2022, which is the minimum/lesser of:

(i) SVIR for "the most recent adjustment year" – which is 2022, so use 3%

(ii) AFIR for "the most recent adjustment year"—which is 2022, so use 2%

Therefore, MIN[SVIR for 2022, AFIR for 2022] = MIN[3%, 2%], and thus…

➔ For 2022 (i.e., from January 1 to December 31, 2022), the IIR = 2%

Also note that, barring a dramatic change in the level of market interest rates, 2023's IIR would be expected to be 2% as well—as "the most recent adjustment year" should remain 2022 until there is a change to the statutory valuation rate (i.e., triggering a "more recent" adjustment year), by our interpretation of the amended language.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

REVISIONS TO S. 7702(f) – Introduction of the Insurance Interest Rate (continued)

In short, one can use this algorithm/protocol for determining the IIR for future years (2023 and after), but such forecasts will depend on data availability as well the potential for changes to the statutory valuation rates.

Of course, we need to again state very clearly that the aforementioned algorithm is *our interpretation* of the Act-amended "rules" for the determination of these values, and we welcome feedback from peers and other members of the industry (e.g., NAIC, ACLI, SOA, AAA) as to whether such interpretation is correct/accurate.

REVISIONS TO S. 7702(b) – Impact on Cash Value Accumulation Test calculations

The **Cash Value Accumulation Test ("CVAT")**, per subsection 7702(b), is one of the two mechanisms by which a contract is defined as a life insurance contract for federal tax purposes.

Specifically, when taking into account the current/future death benefits and any 7702-defined "qualified additional benefits," the contract's cash surrender value "may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract" using the interest rate established in subsection 7702(b)(2)(A), which is the rate or rates guaranteed on issuance of the contract, though not lower than a pre-specified floor rate.

Prior to 2021, the floor interest rate was codified as a fixed rate of 4.0%, regardless of year of issue.

Given the low levels of market rates (e.g., investment yields) for several years, the rate(s) guaranteed in products issued over that span have almost universally been *less* than 4.0%, leading to the 4.0% rate "winning out" as the rate to be used in the benchmark calculation.

However, *effective for contracts issued January 1, 2021, and after*, this floor rate was redefined as the **Applicable Accumulation Test Minimum Rate ("AATMR")**, and could now vary by year of contract issue.

Specifically, new subsection 7702(b)(3) defines this for a given year of issue as:

AATMR = MIN[4%, IIR in effect at time the contract is issued]

And, based on our commentary from the prior section, this definition implies that, for the purposes of setting the interest rate to be used when performing the CVAT, insurers must compare contractually guaranteed-at-issue interest rates to a floor rate of 2% for 2021 and 2022 issues—as opposed to a floor of 4% for 2020-and-prior issues.

REVISIONS TO S. 7702(c) – Impact on Guideline Premium Requirement calculations

Like the CVAT, Guideline Premium Requirements are designed to gauge whether a given contract does/does not meet the definition of a life insurance contract for federal tax purposes.

In this case, the insurer needs to monitor whether the accumulated premiums paid under a given contract by a given time do not exceed the guideline premium limitations as defined for that same contract at that same point in time.

Again, like the CVAT, calculations for both the **Guideline Single Premium ("GSP")**, per subsection 7702(c)(3), and **the Guideline Level Premium ("GLP")**, per subsection 7702(c)(4), have been based, in part, on floor rates which have been static/unchanged for decades.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

REVISIONS TO S. 7702(c) – Impact on Guideline Premium Requirement calculations (continued)

Both the GSP and the GLP are to be calculated according to subsection 7702(c)(3)(B)(iii), which mandates using the rate or rates guaranteed on issuance of the contract, though not lower than a pre-specified floor rate.

Prior to 2021, the floor interest rate for the GSP was codified as a fixed rate of 6.0%, regardless of year of issue; for the GLP, the floor interest rate was codified as a fixed rate of 4.0%, regardless of year of issue.

As was the case when analyzing the impact of floor rates for the CVAT, here, too, the floor rates tended to be what was used for the calculations supporting the Guideline Premium Requirements, as they generally exceeded the rate guarantees in the products being evaluated.

However, *effective for contracts issued January 1, 2021, and after*, the floor rates are redefined, as follows:

Floor rate for GSP: redefined as the **Applicable Guideline Premium Minimum Rate ("AGPMR")**; new subsection 7702(c)(3)(E) defines this for a given year of issue as:

AGPMR = AATMR + 2%

This is the same AATMR defined by 7702(b)(3) and discussed in the previous section, and, like that rate, the AGPMR could now vary by year of issue. Based on our commentary from prior sections, this definition implies that, for the purposes of setting the interest rate to be used when calculating the GSP, insurers must compare contractually guaranteed-at-issue interest rates to a floor rate of 4% for 2021 and 2022 issues—as opposed to a floor of 6% for 2020-and-prior issues.

Floor rate for GLP: though the calculation of the GLP remains defined as it was before—citing in 7702(c)(4) that one must use the same process as that for calculating the GSP, albeit "substituting" a different floor rate—note that the substitution language is now revised.

In short, the floor rate to be incorporated for calculation of the GLP, for a given year of issue, is now defined to be the AATMR.

As noted before, the AATMR could vary by year of issue. Based on our commentary from prior sections, this definition implies that, for the purposes of setting the interest rate to be used when calculating the GLP, insurers must compare contractually guaranteed-at-issue interest rates to a floor rate of 2% for 2021 and 2022 issues—as opposed to a floor of 4% for 2020-and-prior issues.

PRACTICAL IMPLICATIONS OF THE REVISIONS

Despite the fact that the amended language made effective by the Act added date-sensitivity and computational complexity to the interest rate definitions/derivations within 7702, it is important to not lose sight of what is being accomplished—namely that the result of these changes should, all things being equal, **improve the tax favorability of life insurance offerings**, and allow for **more flexibility in the design and marketability of insurance products** in this persisting low-interest rate environment.

Indeed, because the interest rates referenced herein are discounting rates within CVAT/GLP/GSP formulas, any lowering of these rates (made possible by the lowering of embedded floor rates) will result in these taxation benchmarks *rising*—thus potentially allowing for **more accumulation of value** before any taxation thresholds are breached, again assuming all other comparable aspects remain unchanged.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

PRACTICAL IMPLICATIONS OF THE REVISIONS (continued)

More simply, what the amendments did was replace rates which had been "fixed"—and at arguably outdated/high levels, based on the present interest rate environment—with something which can "float" in correlation with then-current economic circumstances.

Of note: as was the case with the pre-Act version of 7702, here, too, the interest rate floor definitions have the following relationships:

- **CVAT** and **GLP** calculations reference the same floor rates (was 4%, now **AATMR**)
- **GSP** floor rate is 2% higher than the CVAT/GLP floor rates (was 6%, now **AGPMR = AATMR + 2%**)

As one can see here, the margins between the two floor rates remains 2%, and they move in tandem. Furthermore, under this construct, the floor rates will not exceed values in place as of the pre-Act version of 7702—with "caps" or "ceilings" set at what had been the pre-2021 codified rates (of 4% and 6%, respectively).

In addition, while the relative suddenness and magnitude of this floor rate change is jarring—especially coming, as it does, alongside 2021 changes to interest rates for reserve and nonforfeiture value calculation—note that the amended language and rate definitions appear to take pains to **dampen/reduce volatility and frequency of rate changes**. Specifically, incorporation of a 60-month moving average to generate a key input, whole-percentage-point rounding, and the apparent tethering of the "adjustment year" to changes in the reserve valuation rate (itself governed by rules inhibiting volatility and change-frequency) all assist in keeping these new/redefined rates—the IIR, in particular—stable, a claim which appears supported by our analysis.

With these aspects in mind, here is what we believe to be actionable items related to the 7702 revisions:

1. In the near term, insurers should prepare/schedule **updates to their various systems** (e.g., administrative, illustration, etc.) with these new rates, as they are effective for current (2021) issues. This may require planning, research and consultation (i.e., time/effort), as companies need to determine whether the programming in vendor/internal systems is built for issue-year/date-sensitive entries for these parameters.

   However, as noted above, the expectation is that such changes should result in a contract's tax limitation/ restriction benchmarks "relaxing"—such as a GSP or GLP value *higher* for a (post-revision) 2021-issued policy versus what would have been seen for a (pre-revision) 2020-issued plan, for example.

If guaranteed rate in product is…	…then **Guideline Single Premium** uses: **pre-Act**	**2021**	If guaranteed rate in product is…	…then **Guideline Level Premium** uses: **pre-Act**	**2021**	If guaranteed rate in product is…	…then **7-Pay Test level annual premium** uses: **pre-Act**	**2021**
6% or higher	guar rate	guar rate	4% or higher	guar rate	guar rate	4% or higher	guar rate	guar rate
> 4% but < 6%	6%	guar rate	> 2% but < 4%	4%	guar rate	> 2% but < 4%	4%	guar rate
4% or less	6%	4%	2% or less	4%	2%	2% or less	4%	2%
explore change of min GSP rate in system 6% -> 4%			explore change of min GLP rate in system 4% -> 2%			explore change of min 7-pay rate in system 4% -> 2%		

For these highlighted instances, the rate change should RAISE the premium value for new issues from what it was before

   In other words, in general, any GSP/GLP/CVAT values emerging from systems still using the "old" floor rates are likely to be *conservative*, rather than potentially exposing a 2021 policy shopper/holder to tax consequences—though each insurer/carrier is responsible for monitoring its values/output on this front.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

PRACTICAL IMPLICATIONS OF THE REVISIONS (continued)

2. In the longer term, **product design changes** may be in order, taking advantage of (expected) higher 7702 thresholds which allow for more accumulation of value.

   With ongoing persistence of the lower market interest rates, any near-term revision or reset of the 7702 floor rates—at least to the caps/levels of 2020-and-prior issued policies—is unlikely. This "new normal" of 7702 floor levels should enable insurers to explore design (and market/positioning) opportunities—including the potential for competing with other financial services/sectors, previously "out of bounds" due to taxation/fund-accumulation barriers and restrictions.

ADDITIONAL IMPACTS OF REVISIONS

As noted earlier, there are "downstream" impacts which emerge due to the changes to 7702, stemming from the historical, intertwined relationships between this Code and other important regulations/requirements.

S. 7702A/7-Pay Test Premiums:

Internal Revenue Code Section 7702A ("7702A") outlines the testing criteria by which a life insurance contract—otherwise meeting the definitions and requirements of Section 7702—would be designated as a "modified endowment contract" (or "MEC") and effectively lose some (but not all) of the tax-preferred status/benefits afforded 7702 contracts not designated as such.

Central to 7702A is the **7-Pay Test**, whereby, in a manner similar (but not identical) to the development of the Guideline Level Premium from 7702(c)(4), a level annual premium benchmark is developed, against which is compared the accumulated annual premiums paid, over the first seven (7) years of the contract.

Of note: while the Act did not explicitly address or alter the language of 7702A, life insurance contracts issued on or after 2021 will have 7-Pay Test rules changed by Act-driven changes to 7702, due to an existing provision in 7702A, which states [as per 7702A(c)(1), excerpted]:

"… the 7 level annual premiums shall be made—

(A) as of the time the contract is issued, and

(B) by **applying the rules of section 7702(b)(2)** …"

The above reference from 7702A(c)(1)(B) is to the subsection in 7702 which was amended to replace the 4% fixed rate with the newly defined AATMR for calculations related to the CVAT and GLP. By extension, this change likewise affects the 7-Pay Test of 7702A.

As noted before, the AATMR could vary by year of issue. Based on our commentary from prior sections, this definition implies that, for the purposes of setting the interest rate to be used when calculating the 7 level annual premiums mandated by the 7-Pay Test, insurers must compare contractually guaranteed-at-issue interest rates to a floor rate of 2% for 2021 and 2022 issues—as opposed to a floor of 4% for 2020-and-prior issues.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

ADDITIONAL IMPACTS OF REVISIONS (continued)

VM-02/Nonforfeiture Interest Rate for Life Insurance Policies:

Months before the Act was signed into law, it was well known throughout the industry that there would be changes companies would need to address/implement for life insurance policies issued on or after January 1, 2021.

Specifically, in July, 2020, it was confirmed that the trend line of the Moody's Corporate Average Yield Rate benchmark, at key dates, triggered the following changes:

- the maximum interest rate allowed for the valuation of reserves would be 3.00% (lowered from 3.50%), for nearly all policies issued 1/1/21 and after, as defined via **VM-20 of the NAIC Valuation Manual**, and
- the maximum interest rate allowed for calculating cash/non forfeiture values would be 4.00% (lowered from 4.50%), as defined via **VM-02 of the NAIC Valuation Manual**, though implementation of this rate change could be delayed until 1/1/22.

However, these rates/references were based on then-current interpretations of the language as present in the 2020 Valuation Manual and a draft of the 2021 Valuation Manual.

As it turned out, two changes have now occurred which lead to the maximum rate allowed for cash/nonforfeiture value determination to be 3.75% (rather than 4.00%), to be implemented no later than for issues on or after January 1, 2022. They are:

1. *The NAIC adopted a language change to VM-02, Section 3.A.*, effective for the 2021 Valuation Manual, which altered the definition of the "floor rate" used for determining the final maximum allowed nonforfeiture interest rate.

   For years 2020 and prior, the floor for the nonforfeiture rate was codified as a fixed rate ("…. shall not be less than 4%."). However, the Life Actuarial Task Force ("LATF") formally adopted a proposal to change this floor definition as follows:

   "…shall not be less than the applicable interest rate prescribed to meet the definition of life insurance in the Cash Value Accumulation Test under Section 7702 (Life Insurance Contract Defined) of the U.S. Internal Revenue Code."

   Note, however, these were, for all intents and purposes, equivalent statements at the time this change was adopted.

2. *The passage/signage of the Act*, which changed 7702 effective for January 1, 2021—and thus immediately changed the floor rate for the nonforfeiture rate determination (from 4% to the AATMR = 2% for 2021).

It's worth noting that both of these events had to occur for the nonforfeiture rate to drop to 3.75%; conversely, if only one (or neither) had happened, the nonforfeiture rate would be 4.0%.

INTERPRETING AND PREPARING FOR CHANGES TO IRC 7702 AND 7702A AFFECTING LIFE INSURANCE ISSUED ON OR AFTER JANUARY 1, 2021 (continued)

ADDITIONAL IMPACTS OF REVISIONS (continued)

VM-02/Nonforfeiture Interest Rate for Life Insurance Policies (continued):

At the time the **VM-02 revision** was adopted (June 2020), **7702**—specifically the CVAT floor rate of 4.0%—was not likely to be altered, at least for 2021. What would eventually become Section 205 of the Act was included (in some form) as Section 40308 of H.R. 6800 (H.E.R.O.E.S. Act), originally passed by the U.S. House on May 15, 2020; however, a similar provision was not contained in competing/pending Senate legislation (H.E.A.L.S. Act), and progress on *any* legislation stalled over the summer and fall, even post-election.

Notice of the 7702 changes being part of a resurrected/ debated/ passed bill—let alone now becoming law—has not been well communicated throughout the insurance industry, which is why many companies/players are playing "catch up" when it comes to understanding/addressing the pervasive impact of these already effective provisions.

REFERENCES

Materials referenced or used for the purposes of research and information gathering are cited/linked below:

CAA, 2021: https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-116HR133SA-RCP-116-68.pdf

➔ Section 205 appears on p. 4923-4927 of the PDF (reference pages 2456-2460)

2021 VM: https://content.naic.org/sites/default/files/pbr_data_valuation_manual_current_edition.pdf

➔ VM-02 appears on p. 31 of the PDF

1274(d) Federal Rates: https://apps.irs.gov/app/picklist/list/federalRates.html

➔ Table 1 of each Revenue Rule is displayed on p.2; see mid-term, annual compounding, "AFR" entry

Section 7702 (pre-Act, as of Whitepaper publication date): https://www.law.cornell.edu/uscode/text/26/7702

Section 7702A (pre-Act, as of Whitepaper publication date): https://www.law.cornell.edu/uscode/text/26/7702A

ACLI support of 7702 changes:

➔ Talking Points, May 2020: https://www.acli.com/-/media/ACLI/Public/Files/PDFs-PUBLIC-SITE/Advocacy/TwoPartSolution_InvestmentInAmericasEconomy_052620.ashx?la=en

➔ Letter to NAIC, June 2020: https://content.naic.org/sites/default/files/call_materials/ACLI%20Comments%20on%20APF%202020-07.pdf