PROFORMEX

7702 and You - Seize the Opportunity to Delight Your Policy Owners

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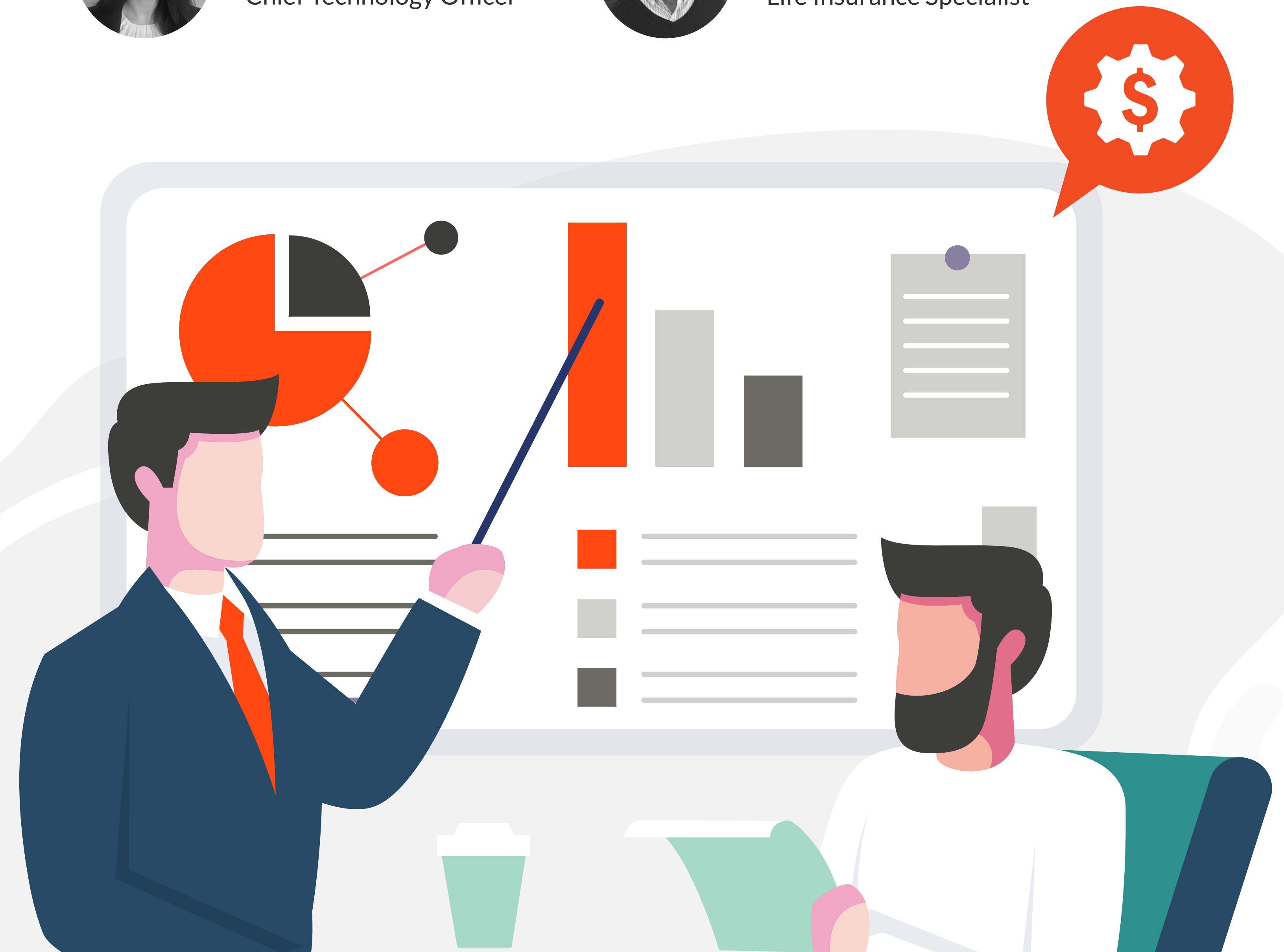

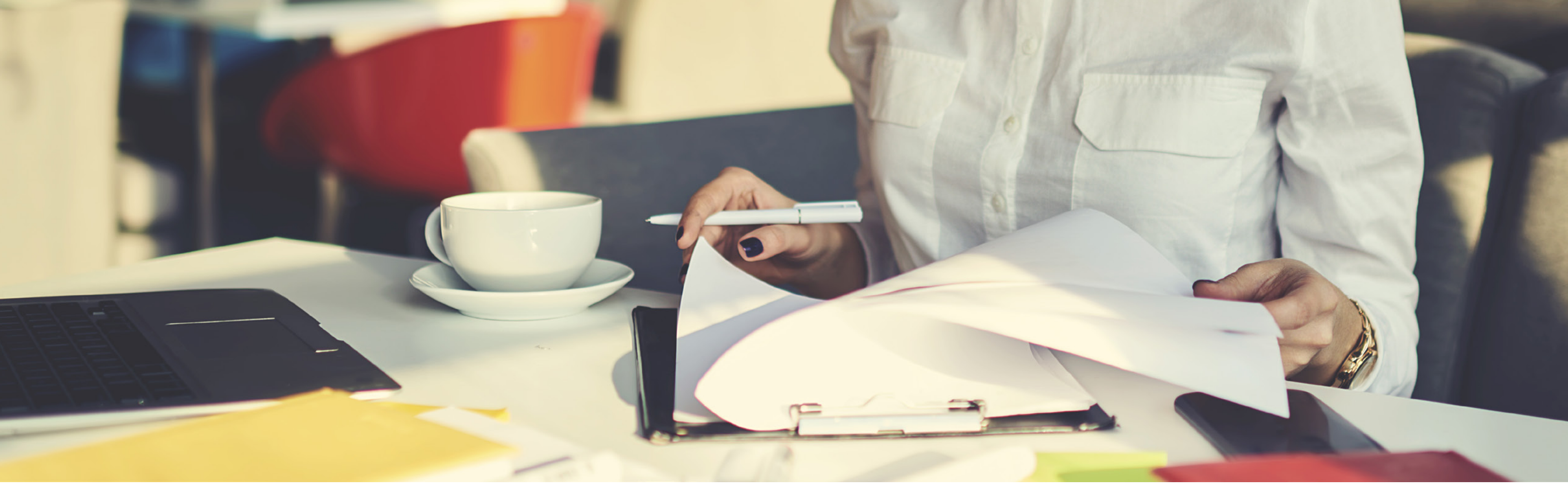

Revision to the IRS tax code for illustration rates – what is it and why now?

Internal Revenue Code Section 7702 ("Section 7702") spells out the conditions that must be met for a financial contract to be treated as tax-advantaged life insurance. Of particular relevance, Section 7702 sets limits on the amount of money that can accumulate under a life insurance policy, to attempt to prevent bad actors from setting up contracts that operate like standard investments but are treated as life insurance for preferential tax purposes.

While admirable in intent, this original language in Section 7702, developed in 1984, relied on an interest rate environment that looks very different from today's persistent, low interest rate world. Fortunately, via the Consolidated Appropriations Act, 2021, Congress has modified Section 7702 to better reflect current macroeconomic trends. In so doing, Congress has provided new opportunities for carriers, advisors, and certain policy owners.

A portion of Section 7702 set a minimum crediting rate of 4% that carriers could use when projecting future account face values. That, along with planned premiums a policy owner would contribute to the policy on an annual basis, set the lapse timeline for the policy. For Whole Life products, it affected projections on whether a policy would endow by age 100 (or 120 for newer products). A key component is that the total cash into the product is capped, and the premiums paid into the policy must be below a certain threshold.

When the actual crediting rate drops significantly, as it has in recent years, carriers are locked into the Whole Life products that were planned with a 4% return if the owner continues to pay the planned premium. The premium payments also cannot increase above the set contribution cap – if an interest rate drops by 2%, the premium payment is still fixed by the prior cap. The impact to carriers makes the case for dropping the minimum interest rate that can be used in illustrating new products. If the minimum-allowed illustrated rate is more in line with recent lows in actual rates, some risk of strain from underperforming Whole Life policies can be mitigated. The changes to Section 7702 that passed in late 2020 and went into effect on January 1st do exactly this and allow carriers to illustrate products at a lower assumed crediting rate.

The lowered minimum-possible illustrated rate also means a policy owner can contribute more money in premiums to the policy. Remember, for Whole Life policies the cap is based on the illustrated rate plus the planned premium. If the illustrated rate drops, the window for contribution widens. This can be a huge benefit for a policy owner who has purchased the product for cash accumulation. It gives the owner an opportunity to contribute more cash with the tax benefit afforded by the product.

While we've focused on Whole Life as an opportunity to outline a part of the impact of the Section 7702 change, other life products that have interest credits are also affected. Check out any of the references linked below for a broader discussion of the changes that went into effect.

What does this mean for policy owners?

Owners with policies placed under new regulation would have a window to add more cash to the policy in the near term compared to older products. This will particularly benefit owners who:

- Have chosen a policy for its cash accumulation and have a policy that was placed under the prior minimum illustrated rates

- Have the benefit of time and expect the policy to remain in force long into the future

- Have the flexibility to contribute additional cash to the policy in the near term

What does this mean for Agents and Advisors?

Advisors who have clients with accumulation products will be able to discuss the benefits of new products and find opportunities for products that are a better fit when they exist. The most productive conversations will happen when the Agent or Advisor is armed with information before the discussion starts.

Knowing the right client profile will make sure Advisors are spending time wisely with clients who are more likely to be interested in these new products. Finding the right client could be as simple as knowing their needs because there is an existing, active relationship between the Advisor and client. There also may be cases where the Advisor isn't aware of which clients may have purchased products for their accumulation value. Or maybe a client exhibits behavior where their current policy coverage and payments suggest they could benefit from an accumulation product under new guidelines, but the client is unaware of the new legislation. In both cases, having up-to-date information about the clients' current policies will help Advisors outline benefits for the client in a personalized manner, as well as enable Advisors to suggest new products that are tailored to each client's need.

Advisors will also need to be aware of new products when they roll out. The adjustment to Section 7702 went into effect on January 1, 2021, but carriers will need time to both develop new products and get them approved. This process could take months and isn't as simple as placing a product after the first of the year. As advisors are finding their clients who will benefit, they will also need to keep a close eye on when carriers have released new products into the market that take advantage of the tax code changes.

Prepared with a list of the right clients, up-to-date information about their clients' policies in a secure and centralized platform like Proformex, and knowledge of the new products as they roll out over the coming months, Advisors will be able to delight clients by showing personalized attention and opportunity brought forth by a recent regulatory change that individuals would otherwise not notice.

About the Author - Dr. Amanda Yoho

Dr. Amanda Yoho is the Chief Technology Officer at Proformex, an in force policy management solution. Since joining in January 2020, she has focused on building out proprietary analytics around life insurance policy lapse risk, architecting a scalable data platform focused on in-force policy management, and growing a cohesive team of curious, results-oriented data scientists.

Prior to joining Proformex, Amanda was the Director of Research Informatics with IBM Watson Health, where she supported the business in curating, enhancing, and gaining insights from the largest clinical dataset available for commercial research. She earned her Ph.D. in theoretical physics from Case Western Reserve University (CWRU), where her research centered on detecting anomalies in cosmological data through simulation of the earliest moments of the Universe. She retains a connection to the university through her service as a CWRU Institute for the Science of Origins fellow.

About the Author - Kevin W Kelley

Kevin Kelley has more than 35 years of experience in the insurance industry, including 20 years spend as an insurance agent, eight years doing case design experience for a variety of carriers, and five years as a life insurance wholesaler. He is licensed in life and health insurance and variable products. Kevin has served in his current position with Proformex as a Life Insurance Specialist for almost two years.

About Proformex

Proformex is the leading inforce management platform offering data aggregation, analytics, and portfolio monitoring for life insurance and annuities. The platform is purpose-built to help independent life insurance and advisory firms protect their clients' best interest and ensure regulatory compliance by monitoring individual policy performance, identifying at-risk policies, and uncovering new sales opportunities. Our automated solutions make inforce management more efficient, more profitable, and results in better experiences for policy owners.

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