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Why Are the Recent Changes to IRS Code 7702 a Big Deal for High Income Earners?

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▶ Buried deep within thousands of pages of The Consolidated Appropriations Act of 2021 was an exciting change to Section 7702 of the IRS Code, which governs how life insurance is defined and treated from a tax perspective.

While this change has not been widely publicized, perhaps because of its technical nature, it provides a huge opportunity for high-income taxpayers.

The change to Section 7702 effectively enables a life insurance policyowner to fund greater and faster tax-efficient growth in the cash value of a policy than was previously possible, without increasing the death benefit. That, in turn, enables allocating more dollars into a tax-favorable environment without any additional cost of insurance associated with those incremental dollars.

This is a BIG deal!

While the IRS likely wasn't looking to provide taxpayers with an opportunity to pay less taxes, the benefits noted above are an unavoidable byproduct of a necessary change, as you'll see by continuing to read.

When Section 7702 was enacted in 1984, it required insurance carriers to provide a minimum guaranteed interest rate of 4 percent. In other words, premiums paid, net of reasonable expenses, had to result in a death benefit return at the insured's life expectancy of at least 4 percent.

While it might not have been difficult for insurance carriers to invest premium dollars to meet that 4 percent guarantee in the 1980s (when the Moody's Aaa Corporate Bond yield was greater than 12 percent), interest rates have dropped materially since then, with the Moody's Aaa Corporate Bond yield now in the 2 to 3 percent range. This near record low interest rate environment necessitated a reduction of the minimum guaranteed interest rate that Section 7702 requires, from 4 percent to 2 percent.

This reduction gives life insurance carriers the ability to charge higher premiums for the same death benefit. However, for taxpayers interested in tax efficient wealth accumulation, in addition to the death benefit, there is a substantial, though perhaps unintended, benefit. Specifically, significantly more cash can be allocated to a tax advantaged policy, without increasing the death benefit or associated cost of insurance.

Why is that? I'm going to have to get a bit technical here, but stick with me and you'll be glad you did. In order for a policy's cash value to maintain its preferential tax treatment, it must meet the IRS's definition of life insurance by passing either the "cash accumulation test" or the "guideline premium test." For our purposes, I'm going to focus on the former.

A policy meets the cash value accumulation test if the cash surrender value does not exceed the single premium that would have to be paid at such time to fund the policy's death benefit at life expectancy, based on the minimum guaranteed interest rate required by Section 7702. This limits the amount of overfunding a policy can sustain. But since this calculation is now based on a 2 percent vs. a 4 percent requirement, policyowners can fund significantly more in the early years of a policy without requiring an increased death benefit.

When interest rates eventually increase, could Section 7702 change back? Absolutely. However, the minimum guaranteed interest rate is contractual to each policy at the time of issuance. So policies already in force would not be negatively impacted.

Section 7702 simply dictates the minimum guaranteed interest rate insurance carriers need to use for all new contracts. The lower the rate, the higher the premium they can charge, BUT the greater the policy funding that becomes permissible within the IRS's definition of a life insurance policy that carries unique tax advantages.

So what could all this mean for you?

Permanent life insurance has long been used as a tax-efficient planning tool for the wealthy. The changes to Section 7702 provide an opportunity for high income earners to dramatically enhance the efficiency of those benefits. If you think this opportunity may apply to you, we recommend discussing with a financial advisor who is knowledgeable about both the nuances of these legislative changes as well as how to efficiently structure life insurance policies to meet both death benefit and tax-efficient wealth accumulation needs.

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