Thousands of pages deep in the underbelly of the COVID relief bill lies a significant change to IRC Section 7702. Here is why it matters...

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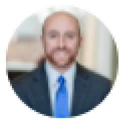

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Thousands of pages deep in the underbelly of the COVID relief bill lies a significant change to IRC Section 7702. Here is a quick summary on what it is, why it matters and what's to come.

What is IRC Section 7702?

Section 7702 of the U.S. Internal Revenue Service (IRS) Tax Code defines what the federal government considers to be a legitimate life insurance contract and is used to determine how the proceeds are taxed. The proceeds of policies that do not meet the government's definition are taxable as ordinary income

If you're in the life insurance business, you've heard the term "MEC" (Modified Endowment Contract). For accumulation-driven plans, a "MEC" is something that advisors try to avoid at all costs, as it differentiates the vehicle from an insurance product to an investment vehicle. When that happens, the FIFO (first in, first out) tax status reverts to less-favorable LIFO (Last in, first out), where gains are accessed first within distributions, and tax penalties exist for withdrawals taken before age 59 ½. To avoid a MEC, a properly designed accumulation plan is funded to maximum, non-MEC levels. The purpose of doing this is to overfund the plan, which should reduce internal expenses and promote cash value growth.

What is the change to IRC Section 7702?

The change is related to how much cash can be held within a policy before it violates the MEC limits. MEC limits were created using interest rate assumptions that date back to when the law was written in the mid 1980s. We are in a very different interest rate environment today, so the new law provides insurance companies the ability to use an interest rate that is more in line with the current market.

What is the result of this change?

In short, this interest rate assumption will allow permanent life insurance policies designed for accumulation to be more heavily funded before reaching MEC limits and violating the definition of life insurance.

How will this benefit me and my clients?

This change is not expected to have an immediate impact. Life insurance carrier software will need to be updated and each insurance company must determine how these changes will affect their product offerings. With that said, a few of the expected benefits include:

- If a person wants to accumulate cash inside of a life insurance policy, they will be able to put more dollars in relative to the death benefit than they could before these changes were made. More significant funding should equate to better cash growth.
- Future IRR on cash values should become stronger
- Whole life short-pay scenarios, in particular, should become more available in the market.

What's the catch? Is there a downside?

The "catch" is that it is probable that commissions will be reduced and calculated differently than they are today. In addition, as with any accumulation plan, the following downsides have to be considered:

- Most plans still will not offer automatic distributions that consider the overloan protection rider.
- The behavior of the policy owner (when taking loans and withdrawals) can create an "overloan" situation that could lead to serious tax consequences.
- The insurance company will still maintain significant control over non-guaranteed elements to include (1) COI, (2) expenses and (3) crediting rates.