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The Fifth Factor: IRC §7702 Changes Will Add Demand to an Already Hot Premium Finance Market

Premium Finance demand is surging and changes to IRC §7702 are an accelerant. On December 27th, 2020, the President signed into law the Consolidated Appropriations Act, 2021 (CAA). The legislation included changes to the interest assumptions used in IRC §7702—the Internal Revenue Code (IRC) provision that defines how much premium can be contributed to a life insurance policy. Specifically, IRC §7702 defines the guidelines that must be satisfied for a policy to be treated as a life insurance contract for federal tax law purposes. To meet the requirements, contracts must satisfy one of two complex actuarial tests, known as the Guideline Premium Test (GPT) and the Cash Value Accumulation Test (CVAT). These tests impose limitations on the amount of premiums paid into a contract and/or the amount of cash value that can accumulate relative to the death benefit. IRC §7702 established assumptions for defining the actuarial values, including the use of minimum interest rates.

The minimum interest rates used in §7702 have not changed since its enactment in 1984. Since the passing of §7702 interest rates have declined and today remain at or near historic low levels. To address this situation the CAA 2021 changed IRC §7702 by replacing the fixed 4% and 6% interest rate assumptions with a dynamic interest rate model effective beginning in 2022, thus allowing the interest rates to float over time in keeping with prevailing market rates. Furthermore, beginning in 2021, CAA permits carriers to lower their interest rate assumptions for product design purposes to 2%. It's important to note that this change permits carriers to create new products with lower guaranteed interest rates. The legislation does not apply retroactively to existing policies.

The effect of this reduced interest rate approach will be to effectively increase the amount of premium eligible for deposit into new life insurance policies for any given face amount. This limit also serves to create lower minimum death benefit availability for those seeking to pay a specific amount of premium over a predetermined period.

The ability to increase the amount of premium that can be deposited into a life insurance policy will impact a number of life insurance planning strategies. Specifically, financial professionals should reexamine planning strategies such as loan rescue, Life Insurance as a Retirement Plan (LIRP), deferred compensation, Supplemental Employer Retirement Plan (SERP), split dollar and Premium Financing. While all of these concepts will be positively impacted by the legislation, this year may be the best time to reexamine Premium Finance, specifically given the interest rate environment, as a strategy with high net worth clients.

What is Premium Finance

Premium Financing is a planning strategy typically used by high net worth individuals or businesses to purchase needed life insurance coverage using a loan from a commercial bank. As with all advanced planning techniques, it is not for everyone and should be approached with appropriate due diligence. However, a properly designed and managed premium finance design may offer significant benefits.

Four Factors Driving Premium Finance Demand

In addition to the recent change to IRC 7702, there are at least four other reasons why this may be one of the best times for advisors to talk with their high net worth clients about Premium Finance.

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First, the cost of borrowed funds is a significant factor when determining if premium finance is a suitable strategy. To have value for a client, the cash flow of a financed design must make economic sense based on loan costs, comparative return on capital, liquidity and the risk of borrowing. Today, clients have access to historically low lending rates for premium finance cases. The current interest rate environment may be attractive to customers seeking to fund needed life insurance with minimal disruption to their existing capital and assets, or to business owners who are able to earn more on their existing capital inside their businesses as opposed to paying premium directly.

Most loan rates are generally based on LIBOR plus a spread and typically are not fixed. Although the yields on 10-year Treasuries have ticked up slightly recently, the Federal Reserve has signaled its intention to keep rates near zero for the near future. This creates a unique opportunity to access the potential elongated differential between shorter and longer term interest rates given current Fed policy. This is particularly true given that policy crediting is more closely tied to Treasury yields in the 7 to 10 year maturity horizon, while commercial lending rates tend to be tied to a shorter maturity funding model. With the prospect of historically low interest rates for an extended period of time, today's economic environment may represent an excellent opportunity for suitable clients to consider premium financing as a funding solution for their life insurance needs.

Second, COVID-19 has had a significant impact on nearly every aspect of our lives. From non-essential businesses being shut down to the transition to a virtual workforce we have seen meaningful disruptions to the flow of goods and services. Without question, the insurance industry was also significantly impacted. Insurance carriers were uncertain what the mortality impact would be from the pandemic. Some carriers restricted or even postponed underwriting on certain higher risk ages and larger face amounts. New underwriting guidelines were developed in an attempt to work within the pandemic environment. Without the ability to meet with their financial professional and get their coverage underwritten, many clients put their life insurance coverage purchases on hold.

We are now seeing the light at the end of this long tunnel with three effective COVID-19 vaccines, and the insurance carriers are beginning to remove temporary underwriting restrictions. Given these positive developments coupled with significant pent up demand, customers are beginning to move forward with their insurance plans. This pent-up demand skews heavily towards older clients and those seeking larger death benefits, as they were the most directly impacted by the carriers' pandemic underwriting restrictions. Many of these clients may be suitable for considering premium finance as a funding strategy for their life coverage.

Third, with over 500,000 deaths attributed to COVID-19, the pandemic dramatically raised awareness of the need for life insurance protection. As ownership of individual life insurance coverage has trended downward over the past few decades, the pandemic's psychological impact has driven an increased demand for life insurance protection.

Fourth and finally, the Biden administration, with the benefit of a Democratically controlled House and Senate, has signaled a desire to enact sweeping change to income and estate taxes. Clients are seeing a constant barrage of news headlines, many having significant financial implications such as a reduction in the amount sheltered from estate/gift tax from $11.7 million to proposals between $3.5 and $5 million. Additionally, high income earners are seeing proposals showing an increase in income tax brackets without relief on the Medicare excise tax passed under the Affordable Care Act. Additionally, the ultra-affluent are seeing headlines about the emergence of a Wealth Tax. These proposals are serving as a catalyst to motivate clients to put their financial and estate plans in order. The prospect of the gift tax exemption being substantially reduced dramatically increases the challenge of funding any needed life insurance owned in an ILIT without triggering gift tax obligations. Premium finance may offer an efficient solution, as generally loans to an ILIT to pay premiums do not trigger a gift tax.

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The Fifth Factor Driving Premium Finance Demand: Recent Changes to IRC §7702

The recent change to the regulations under IRC 7702 makes premium finance more attractive for high net worth clients. As previously indicated, one effect of the reduced interest rate change will be to increase the amount of premium that can be deposited—resulting in potentially improved 7-pay MEC premiums relative to death benefit purchased. These modified interest assumptions provide improvement that diminishes with the issue age of the insured. The average age for a typical premium finance insured is approximately 50. As an example, a 50-year old client may see a 50% improvement in their 7-pay premium limit. This additional improvement helps drive down internal Cost of Insurance (COI) charges which, in turn, enhances policy performance. While carriers are just beginning to introduce new products based on the 7702 revisions, the average 50-year-old client may expect to see an improvement of 10 basis points (0.1%) or more in Internal Rate of Return (IRR) at life expectancy, with actual differential impacted by age. This creates an opportunity for enhanced performance, and, properly designed, the client may see an increase in policy values sufficient to better absorb product performance fluctuations.

These new interest rate assumptions don't come without cost to the financial professional. Because the result is often a smaller death benefit for the same premium, the financial professional will likely see a corresponding reduction in target premium. So, while minimum death benefit designs will become more efficient, a negative impact on compensation is also likely. Additionally, reduced death benefits may no longer meet the client's insurance goals. Premium financing is one solution that may allow the death benefit to be restored to the desired level and simultaneously improve the client's out of pocket cashflow. The higher death benefits made economical through premium finance may also restore the target compensation premium for the financial professional.

Finally, the changes to IRC §7702 potentially allow for design simplicity. In the past, most premium finance designs used GPT and an increasing death benefit design that switched to level when the premium payment ended. While the GPT corridor levels are the same with the revised regulations, the corridor levels for the new CVAT are substantially reduced. Consequently, accumulation designs may now consider using a level CVAT approach. A drawback to the old approach is that the policy switch from increasing to level requires the policy owner to make an election, potentially many years in the future. Failure to elect planned changes could have a significantly negative impact on the product's planned performance. A level death benefit design using CVAT with the narrower corridor may allow for a simpler model that not only meets the client's objectives but also mitigates risk for the client and the financial professional. Proper case due diligence may require a comparison of the newer CVAT design with a GPT design (financed or not) to determine which model is a better fit for the client's objectives.

Conclusions

1. Premium finance demand is on the rise and the recent changes to IRC §7702 not only create meaningful planning opportunities in Premium Finance, but have driven increased demand in the market space.
2. Premium finance demand has been driven by 4 key factors including (1) Cost of borrowing and the differential between short and long term interest rates, (2) Pent up demand particularly in older age groups as a result of the COVID-19 pandemic, (3) A change in psychology around the need for life insurance in the post-pandemic mindset, and (4) The emergence of political trending toward increased taxation, particularly in the areas of estate and wealth transfer along with taxes targeting high earners.
3. A fifth factor has now emerged, layering incremental demand for Premium Finance—significant changes to IRC §7702. These changes increase the amount of premium eligible for deposit into new life insurance policies for any given face amount. This limit also serves to create lower minimum death benefit availability for those seeking to pay a specific amount of premium over a predetermined period.
4. Premium Finance represents a meaningful opportunity for financial professionals focused in the high net worth and/or business owner space, with IRC §7702 changes enhancing the opportunity set.

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An expert in premium finance case design and advanced life insurance planning concepts, Chris has helped develop and launch multiple life insurance products, developed some of the life industries most cutting edge illustration output, marketing materials, and tools. Mr. Layeux has been a speaker at numerous industry events, is a published author in National Underwriter and Broker's World, and is a past Director for the Society of Financial Service Professionals, Minneapolis Chapter.

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For more than 30 years Terri has specialized in the appropriate use of life insurance in estate, business and executive benefit plans. Terri's expertise and ability to turn complex life insurance planning techniques into understandable solutions has made her a well-known industry speaker and contributor to financial publications.

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