IRC Section 7702 – The Definition of Life Insurance

To qualify for the favorable tax treatment reserved for life insurance, a contract must comply with the requirements of section 7702 of the Internal Revenue Code.

To comply with section 7702, the contract must either:

1. Satisfy the Cash Value Accumulation Test; or
2. Satisfy the Guideline Premium Test.

The choice of which test will be used must be made at issue and is irrevocable.

Life insurance receives more favorable tax treatment than most other investments. The general intent of section 7702 is to ensure that any contract which is receiving this favorable treatment is actually providing a significant amount of true life insurance.

The net amount at risk in a universal life contract is the difference between the death benefit and the accumulated value – it represents the actual amount of life insurance being provided. As an example, for a level death benefit policy with a face amount of $100,000 and an accumulated value of $20,000, the net amount at risk is $80,000.

Imagine a contract with a death benefit of $1,000,000 and an accumulated value of $999,999. The net amount at risk is $1 – a truly trivial amount of insurance. Section 7702 is designed to prevent such a contract from receiving the favorable tax treatment reserved for life insurance.

The amount of true insurance required by section 7702 declines with attained age – for a given accumulated value a 40 year old is required to maintain a higher net amount at risk than an 80 year old.

The Cash Value Accumulation Test

The Cash Value Accumulation Test establishes a minimum relationship between a policy's accumulated value and the policy's death benefit by implicitly defining a set of corridor factors. These factors are multiplied by the policy's accumulated value to establish the minimum death benefit required. As an example, the corridor factor for a 45 year old male nonsmoker for NL Ultra is 4.11. Thus a policy with an accumulated value of $10,000 must maintain a death benefit at least equal to $41,100. The factors vary by sex, smoking status, and attained age. The factors decline by attained age - the factor for a 99 year old male nonsmoker is 1.02.

Another example – a 45 year old male nonsmoker with a face amount = $100,000 and an accumulated value = $30,000. The death benefit for this policy would be the larger of

1. the policy's face amount, which equals $100,000; or
2. the policy's accumulated value multiplied by the corridor factor, which equals $30,000*4.11 = $123,300.

Thus, the death benefit on this policy would be $123,300. The face amount is no longer defining the death benefit, the corridor factor is – the policy is said to be "in the corridor".

If the accumulated value were only $10,000, section 7702 would require a minimum death benefit of $10,000*4.11 = $41,100. This is less than the $100,000 face amount – thus the death benefit for this policy would be $100,000, equal to the face amount.

The Guideline Premium Test

The Guideline Premium Test also establishes a set of corridor factors. These factors vary only with attained age, and also decline with attained age. These factors are more favorable to the policyholder than the Cash Value Accumulation Test factors – they define a lower minimum death benefit. The corridor factor for a 45 year old male nonsmoker for NL Ultra is 2.15 – significantly lower than the 4.11 defined by the Cash Value Accumulation Test.

However, these lower factors come with a price – the Guideline Premium Test also sets strict limits on the amount of premium which can be paid into the contract. The cumulative premiums paid into a policy are not allowed to exceed the larger of the Guideline Single Premium or the cumulative Guideline Level Premiums.

National Life's universal life policies have traditionally used the Guideline Premium Test – NL Ultra is the first contract that offers both tests. As mentioned above, the choice must be made at issue, and cannot be changed once chosen.

Which Test Makes Sense for my Client?

Unfortunately, the situation is a little too complex to lend itself to simple, foolproof rules-of-thumb. However, the following guidelines should be useful:

1. **In the vast majority of cases, the Guideline Premium Test is the best option –** if you are able to illustrate all scenarios the client is interested in using the Guideline Premium Test, it is the correct choice.

2. **The Cash Value Accumulation Test should be considered in the following situations:**

   - **Large, but uncertain future premium payments are a possibility –** the Guideline Premium Test may not provide the flexibility desired by the policyholder.
   - **Continuation of coverage on a guaranteed basis is a requirement –** the required premiums are generally higher than those allowed under the Guideline Premium Test.
   - **In limited-pay scenarios when the competition is a traditional whole life contract –** whole life uses the Cash Value Accumulation Test – it may be impossible to duplicate the face amount/premium pattern using the Guideline Premium Test.

3. **If in doubt, run illustrations under both tests and compare them.**

4. **If still in doubt, call the Home Office for a second opinion.**