# The Deficit Reduction Act of 1984 (DEFRA) and 7702 Testing

By: Brandon Roberts, The Insurance Pro Blog

No single piece of US Federal legislation has rejiggered the playing field for the life insurance industry more than the **Deficit Reduction Act of 1984** or **DEFRA** as it is more commonly referred. It is because of DEFRA that some have decided that it's okay to refer to selling life insurance as setting up a 7702 Private Plan, and it's also because of DEFRA that we have certain design challenges that face us when it comes to cash value life insurance.

DEFRA is also one of the reasons we can point to as evidence that cash value life insurance from a tax preferred wealth accumulation strategy works. In fact, it works so well the federal government felt compelled to act on placing limitations on ones ability to place money into the contracts.

## First, a little History

During the 1970's and 1980's the US Economy experienced a pretty sharp rise in inflation, and a pretty sharp corresponding rise in interest rates. The insurance industries products, well respected for their ability to safely accumulate wealth, had a tough time keeping up with other fixed asset yields and quickly caught loads of criticism. The industry had to act.

Already playing with alternative ideas to revamp a product that had existed for well over 100 years at the time, the industry opened up to a new idea and a new product that removed some of the foundational guarantees upon which whole life insurance is built, but these concessions (the guarantees) came with the ability to earn markedly higher yields.

## Flexible Premiums, Cash Surrenders, and Higher Yields? Oh My!

It doesn't seem special now, but when universal life insurance first appeared on the scene it was quite innovative and perhaps a little controversial (at least to the diehards). You see, prior to universal life insurance, all contracts had fixed premiums and cash surrenders were largely unavailable—if you wanted cash, a policy loan was the only option.

Universal life insurance changed all of that. It introduced a premium that was adjustable, and the option to surrender cash from the policy. The second feature wasn't nearly as groundbreaking (and trouble making) as the first.

Up to this point, life insurance enjoyed substantial preferential tax treatment. But, because premiums were fixed, the policy owner had to make a somewhat sizeable commitment to get these benefits. No the case with universal life insurance.

## Is it Life Insurance?

In fact, the quirky features universal life insurance brought to the table caused some to question whether we should regard universal life insurance as life insurance at all. Due to ones ability to buy a small death benefit policy and then dump a limitless amount of cash into it and reap the benefits of its status as a life insurance contract, there was an obvious worry, and desire to stop a potentially strong and incredibly easily exploited tax loophole.

So, the IRS and friends had a tough question to answer. Were universal life insurance contracts really life insurance contracts, or something else?

## Enter the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

For all its criticisms, the **Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** did answer the looming "is it life insurance" question. And the answer was yes. The industry breathed a collective sigh of relief, but unbeknownst to it, only had two years to make it rain.

## We're from the Government, and We're here to Help

As time marched on, Congress revisited the "is it life insurance" question, and decided to come down hard on this once great tax shelter. Upon passage of DEFRA in the summer of 1984, the industry was now faced with an ugly limit imposed on its products with which it had never before had to deal.

The new answer wasn't no, but rather maybe.

## Revisions 26 USC Section 7702: Cash Value Accumulation Test and Guideline Premium Test

DEFRA brought about a new test that would answer the question. Meaning that some contracts would qualify as life insurance and others would not. The tests sought to limit either cash in the policy relative to the pure amount of life insurance, or the premiums entering the life insurance contract relative to the pure amount of life insurance.

# The Cash Value Accumulation Test

The **Cash Value Accumulation Test** qualifies a contract as a life insurance contract by establishing the minimum amount of death benefit that can exist within a contract relative to its cash surrender value.

For those who are really interested in the exacts, the limitation is: at no time can the cash value in the policy be larger than the net single premium needed for the net amount at risk. There's some technical insurance jargon in there, so let's back up and do it again with plain English.

For those of you who have read the second Modified Endowment Contract article, you know that the net single premium is simply the sum of the expected value of the death benefit (i.e. the death benefit times the probability of death) times an investment return assumption for all years of the contract.

The net amount at risk is simply the different between the death benefit and the cash surrender value. It's the actual amount of money the insurance company has to come up with if you die to pay your beneficiaries the death benefit.
So, cash can never exceed the net single premium that would guarantee the net amount at risk. And also note, there's that word "net" again. Meaning no contingency for expense loading.

Note, because the net single premium is heavily dependent on time, the net single premium will increase exponentially, as we get closer to the maturity date. There are two reasons for this:

1. As we pull closer to the maturity date, the assumed compounding of our guaranteed rate of return has less time to compound. Meaning more money is required to make up the loss of more compounding periods

2. Because the probability of death increases as we pull closer to the maturity date, the expected value of the net amount at risk for each subsequent period will increase.

# The Guideline Premium Test

The **Guideline Premium Test** seeks to place a limit on the amount of premium that can go into a contract and it also places a limit on the amount of cash that can be in a contract. The premium limitations is based on the death benefit of the contract and there are two premiums calculated for this test:

1. The Guideline Single Premium

2. The Guideline Annual Premium

Note: these premiums are <u>not</u> based on the Net Single Premium. Instead they are calculated as follows:

The **Guideline Single Premium** is the single premium needed to fund all benefits of the contract up to the insured's age 95 assuming the higher of 6% annual interest or the contract's guaranteed interest rate.

The **Guideline Annual (or level) Premium** is the level premium needed every year to fund the contracts benefits to the insured's age 95 assuming a the higher of 4% interest per year or the contracts guaranteed interest rate. This amount is cumulative, meaning if the insured/owner chooses not to place the entire guideline annual premium into the contract in one year, he or she does not forfeit the ability to place the rest of the premium into the contract in a later year as it can be added to the maximum in subsequent years. However, the insured/owner cannot place more premium than the guideline single premium into the contract in any given year, even if the guideline annual premium shortage has added up to a larger number than the guideline single premium.

There's a subtle but important difference here, the word "net" is missing from premium. The guideline premium test allows a contingency for expense loading.

## Step Two

The guideline premium test is a two-step test. In addition to a premium restriction, the guideline premium test also imposes a restriction on the amount of cash that can be in the contract relative to the death benefit. The restriction is a ratio of death benefit to cash surrender value that decreases as the insured ages.

The "gap" that must be maintained between the death benefit and the cash surrender value is typically smaller under the guideline premium test than it is under the cash value accumulation test, and because the guideline premium test tends to only be concerned with time to the insured's age 95, the death benefit and the cash surrender value can equal one another after the insured's attained age 95 (in fact the ratio is 115% from attained age 65 and 105% from attained age 70).

## Consequences of DEFRA and 7702 Tests and Consequences of Failing the Tests

The first and most notable casualty of DEFRA and these tests was the long revered endowment contract. Under DEFRA guidelines, endowment contracts violated the cash value accumulation test immediately, and as such were scrapped (but not before making some insurance agents wealthy people by partaking in the largest fire sale the industry has seen within the United States). If a contract fails to remain within the constraints of the 7702 tests, than it loses its status as a life insurance contract and is reclassified as an investment. Once this has happened, the contract no longer enjoys tax-deferred accumulation of cash value (there is a tax due immediately on earnings and one due every year on gain from the policy).

And the way in which gain is calculated under a 7702 test failure is quite nasty. The actual realization is income from the contract, and as such taxed at income tax rates. But there's another gotcha buried in this regulation. Cost of insurance provided by the insurance company is also recognized as taxable income (i.e. the cost of providing the death benefit is now a taxable benefit that you receive as a benefit under your newly classified "investment").

There's also a look back on withdrawals for two years prior to test failure, and if withdrawals were made, they are considered withdrawals to avoid failure and those values are added back into the policy to calculate income realized and taxes due.

It's probably worth noting that due to the largely unattractive features of a failed contract, insurance companies rarely issue these contracts if the fail the test at issue. The only exception to this that I'm aware of is Gerber Life as their College Plan is a bona-fide endowment contract and will violate the cash value accumulation test from issue.

## Can I Choose the Test?

The answer to this question depends on the type of life insurance. For whole life insurance, the current answer is no, all whole life contracts are issued using the cash value accumulation test. The primary reason behind this is the fact that the cash value accumulation test was designed for participating whole life.

At issue is the use of dividends to purchase paid-up additions. The exact explanation behind this requires some detail that is an article all in itself, but the cliff notes version simple is: the death benefit that is associated with a paid-up addition is the cash value accumulation test minimum. The guideline premium test would theoretically most likely cause a higher required death benefit on paid-up additions, and this is already a source of concern for insurers from the stand point of avoiding too much of a guaranteed increasing death benefit through paid-up additions.

Universal Life contracts can generally accommodate both tests and the agent has the ability to choose under which test he or she wishes to qualify the contract as life insurance. This being said, the vast majority of universal life contracts use the guideline premium test to qualify as life insurance as this test was designed to accommodate universal life insurance (as CVAT was designed to accommodate whole life insurance). Once a test is chosen and the contract issued, it cannot be changed.

## How Easy is Failure?

Just like testing for modified endowment contract failures, insurers constantly monitor issued contracted for compliance with DEFRA parameters. If a violation occurs the insured/owner has the ability to remove money from the contract, but removal for DEFRA testing compliance is a little different than removal for TAMRA (MEC) compliance.

Removals that take place to remain DEFRA compliant are commonly referred to as force-outs. And after policy year 15, this doesn't typically pose much of a problem. However, as a measure to prevent large death benefit to accommodate an initial dump in and then an subsequent reduction of death benefit to cut down on insurance costs, the **15 year force-out rule** was implemented. This rule states that any removal of money to avoid DEFRA test failure within the first 15 policy years, must be made on a last-in last-out (LIFO) basis rather than a first-in first-out (FIFO) basis (FIFO is how distributions typically take place from a life insurance contract).

The net effect of this to the insured/owner is a taxable distribution from the contract because any gain must be removed before basis comes out under the force-out rule. Keep in mind this only applies to the first 15 policy years. After that, any withdrawal or force-out to avoid DEFRA violation can be made FIFO.