Episode #184: Will the 7702 Tax Guideline Changes Open the IUL Floodgates?

Video Transcription

Hi, welcome to another episode of "Money Script Monday." My name is Brian Manderscheid. Today, I want to answer the question, "Will the 7702 guideline changes open up the IUL floodgates?" I've always heard in this industry that life insurance is always sold, never bought. That certainly wasn't the case in 2020 during the COVID pandemic. People were worried that if they go to their local Costco to pick up a roll of toilet paper-- a bulk of toilet paper, that they may contract a deadly virus that may potentially end their life, as well as those they care about. Life insurance had increases in sales last year because of clients looking and searching and trying to find people to help them protect themselves and their families. We think we're at the same forefront of a situation with indexed universal life, where people will be coming to you knocking on your door or entering your virtual meetings to get these ideas and concepts about tax diversification and reduce future taxation during retirement, and also providing the coverage to help protect their family.

Will the 7702 guidelines open up the IUL floodgates? To answer that question first, let's talk about what prompted these changes. The 7702 guidelines were set back in 1984, which defined how much premiums you can fund into a life insurance policy and still have all the tax-favored treatment that the IRS has bestowed on life insurance policies. At the time, they had a 4% interest rate that was more of a discount rate to calculate a future value, and that was what was used in life insurance pricing to calculate the guideline premium limits and seven-pay limits a little shortly thereafter. At that time, on January 1st, 1984, the 10-year treasury was about at 12% and a completely different interest rate environment. Hyperinflation, high savings rates, high mortgage rates, high bond rates. Fast forward, 37 years later, we're in a completely different interest rate environment. January 1st, 2021, the 10-year treasury was under 1%. Interest rates have drastically changed. However, the 7702 guidelines were based upon a completely different interest rate environment. What happened is the Consolidated Appropriations Act that was combined within the COVID relief bill that was passed at the end of 2020, snuck in this provision through the lobbying power of our industry to update the 7702 guidelines to be more reflective of today's interest rate environment. What prompted the changes? It was the difficulty of most major whole life companies in offering competitive policies at this interest rate. If you think about it, their general portfolio yield was at or near the 4% interest rate guarantee of the old 7702 guidelines. They had to make sure that

they can not only make a profit, but also provide policies that were beneficial for clients.

Anyone who's competed against whole life recently has seen these proposals where you don't see a lot of value there for the policyholder. These changes should theoretically help those struggling whole life insurance companies. That's what prompted the changes, the lobbying power of the industry, lower interest rate environment. What impact will this have? Let's talk about whole life because that's why these new guidelines were passed. What that's going to do is offer less guaranteed cash value, specifically for those shorter pays like a 10-pay whole life. The trade-off for having lower guaranteed cash value is going to be greater non-guaranteed cash value growth based on current dividends scales. From experience, most people end up buying whole life for the contractual guarantees. Whole life isn't known to offer a lot of upsides, so it's uncertain if this change will possibly impact whole life sales or they'll continue to see declines. For indexed universal life, this is more of a by-product of these changes that were affecting whole life companies. With the 7702 guidelines, what impact will that have? It will essentially reduce the minimum death benefit requirement that exists because of the 7702 guidelines. Said in another way, the same amount of life insurance, our seven-pay MEC limit, our guideline annual premium will increase allowing us to fund more premium in the same amount of life insurance.

Here at LifePro, we commonly work with our advisors on objections that they're getting for indexed universal life. The most common objection we get is that the upfront policy costs are too high. With these changes, by lowering the minimum death benefit requirement that the IRS will allow, that will reduce those life insurance charges, and allow us to most likely sell and serve more policyholders. However, not only are the per thousand charges, the surrender charges, and the cost insurance charges gonna be reduced but also for the advisor, they may also have a reduction in the target premium in the compensation. The IUL carriers currently have a dilemma, and that's kind of what they're figuring out right now is how do we not only improve the experience for the policyholder but also make it fair for the distribution, you the advisor? Do we give all the benefits to the client and just have the advisor make less, or do we have a more balanced approach where we're also benefiting the client, and also making sure that the distribution may at least have a competitive compensation for what they're offering? The insurance companies are currently jockeying for position and they don't want to be the odd man out, and want to see what some of the other carriers are doing, and want to make sure that they're going to be competitive in this new landscape. However, one insurance company has already updated their product to be 7702-compliant, and I want to share with you a case as an example, pre-7702 guideline changes and post, so you can see the difference that it creates.

For this example, I have a 45-year-old male, preferred non-tobacco, a $50,000 a year 10-pay, minimum increasing death benefit for the funding period, switched to level in year 11, dropped the face amount as much as we can within the guidelines. Pre-7702, the minimum death benefit that the IRS required for this insured, this level of funding was roughly $1.3 million. That's what the per thousand fees were based on, the surrender charges, the cost of insurance, and also the target premium. Post-7702, the minimum death benefit is around $800,000, so about $500,000 difference in death benefit or a change of 38%, 38% lowered minimum death benefit requirement based on these new guidelines. What impact will I have on cash value? While it's important that we're protecting our policyholders with life insurance, most clients are buying this for the living benefits of the policy, the tax-free growth, the income-tax-free access, and life insurance as a cherry on top. The internal rate of return on cash value growth in the 20th year was 4.74% pre-7702 changes. The post was 5.10% or a delta of 36 basis points. You may be thinking to yourself, 36 basis points doesn't sound like a lot, but if you think about it, the average cost of all the policy changes over the course of the client's lifetime is usually around 1% give or take, you know, every client's a little different based on the carrier or funding pattern or the insured's health situation, but about 1% is the overall cost drag that all the charges represent over the client's lifetime.

If we're increasing the internal rate of return by 36 basis points, said in another way, we're actually increasing the cost drag by about a third, taking that 1% down to about two-thirds. Given that policy charges tend to be the biggest objection that prospects and clients have, theoretically with better cash value growth, better internal rate of return, lower fees, we should be able to sell and service more policyholders. Additionally, most often clients are using this to provide a supplemental tax-free income to, again, hedge against future tax rate increases. In this situation, same client, same funding, the illustrated income went from $72,000 up to about $76,000. It's about a $4,000 difference on an annual basis, 5.51% change. Think about that over a 30-year retirement, that's $120,000 of additional tax-free income that this policy will be able to provide. That's a pretty significant number for our clients. The charges, cumulative charges at 95 went from $323,000 down to $310,000, which is a change of about 4%. Most of the cost savings are made up by the reduction of the per thousand charges, which are the upfront fees that could be a killer for the early cash value growth and sometimes can cause a client to not move forward with these recommendations. Lastly, the target premium of the compensation went from about $22,000 to about $14,000, which was a 38% reduction, which lined up perfectly with the reduction in the life insurance death benefit.

You can see that these benefits to policyholders don't necessarily benefit the advisor. Per case, they make less on the transaction. We believe that with these changes plus everything going on at a macro-economic level that we'll be able to sell a lot more

cases. Keep in mind that every insurance company is gonna take a different approach. They may benefit the client with the 7702 guideline changes or they may take a more balanced approach where they benefit the client and the distribution, which would be you. To answer the question, will the 7702 guidelines open up the IUL floodgates? We strongly believe the answer is yes. We're at this situation kind of like I mentioned about the term insurance and how life insurance previously was always sold, never bought, we think that with these changes, plus the macro-economic environment going on, we'll have clients knocking on your door or entering your virtual meetings that understand these policies and understand the benefits of tax diversification and tax-free income, and life insurance protection for their family. We think that we're at the forefront of a situation where clients will be very eager to move forward. If you think about it, we've always talked about tax rates going up or maybe the question of will tax rates be higher in the future? We know that tax rates absolutely will be higher. In 2026, the Tax Cuts and Jobs Act sunsets, we know that tax rates are going up for most clients. We also know that the current administration has said that, you know, they campaigned on this, if you make over $400,000 a year, we will raise your taxes.

Our wealthy clients or high-income earning clients know this and are looking for solutions that are going to avoid future taxation. The new Biden tax plan may go in force as soon as 2022, which gives us this window of opportunity to talk to our clients about this oncoming freight train of taxes, and this huge amount of government spending, $4 trillion deficit last year, maybe another $6 trillion this year with the new tax plan plus the infrastructure bill, that's a lot of debt to be added onto our national debt and a potentially big tax increase for our wealthy clients. If you have any questions about the 7702 guideline changes, please feel free to contact your field support representative. We can send you a full, comprehensive analysis on these changes, as well as provide you with some tools and resources to be able to deliver this message in a virtual setting, get in front of more prospects, and talk about the importance of tax planning and tax diversification. With that, thank you very much. We'll see you next time.