A MATTER OF HIGH INTEREST: HOW A QUIET CHANGE TO AN ACTUARIAL ASSUMPTION TURBOCHARGES THE LIFE INSURANCE TAX SHELTER

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America's lengthy income tax code and financial regulations are notoriously full of special treatment for the politically favored. Academics and policymakers argue the relative merits of different approaches to tax and regulatory policy. Given the complexity of economic life, should the law attempt to be highly tailored and specific? Or does the exacting approach risk getting lost in the weeds? This Article will showcase the limits of a highly technical approach to policy with the first analysis of an almost completely unnoticed sea change in life insurance tax law, one that engorges a tax shelter at a moment of great attention to laws that enable the wealthiest members of society to face lower effective tax rates than their secretaries.

Life insurance has received extremely favorable tax treatment since the inception of the federal income tax. In the 1980s, in response to an increasing wave of policies smuggling traditional investment products into products calling themselves life insurance, Congress formalized a mathematical definition of life insurance policies directly into the Internal Revenue Code (§ 7702). Section 7702, a fully realized actuarial simulation, placed quantifiable limits on the degree to which policyholders could treat a life insurance policy like an investment (such as a mutual fund) rather than as insurance protection.

For decades, the provision was left alone. However, buried in the 2020 COVID-19 omnibus relief bill, Congress included—with essentially no public debate—a change to a key actuarial assumption of the § 7702 test. The result was that § 7702 was made substantially more permissive, giving policyholders much greater leeway to use life insurance policies as conduits for tax-exempt wealth accumulation, rather than mere protection of

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beneficiaries in the event of the worst. After over thirty years of near-total absence of analysis of Congress' life insurance definition in the legal literature, this paper resurrects the history, purpose, and structural limitations of § 7702 and the hyper-technical approach to tax policy it embodies. It further provides the first exhaustive analysis of the new world of life insurance after the stealth § 7702 amendment, one in which swathes of the industry are preparing to—as the Democratic Party eyes loophole crackdowns on the wealthy—leverage their extraordinary tax advantage into a new role at the center of high-end tax avoidance.

I. INTRODUCTION

The basic premise of insurance is that people are concerned about risk—risk of getting sick, of their home being damaged, of their car being broken into—and are therefore willing to pay to reduce it.[1] Life insurance policyholders pay premiums to a life insurance firm in exchange for the agreement that, should the policyholder die while the policy is in effect, the insurer will make a predetermined payment to the policyholder's beneficiary, such as their spouse. Life insurance markets are deep in the United States, with over $1 trillion in direct written premiums in 2020.[2] The primary reasons for most life insurance purchases are the coverage of burial and other death expenses, replacement of lost income and payment of mortgages, and the "transfer [of] wealth to [the] next generation."[3]

This Article is primarily interested in life insurance's role in something other than reducing risk for families: being a tax-advantaged vehicle for savings and investment. Since its inception, payouts from life insurance policies have been exempt from the federal income tax.[4] While the basic form of a life insurance policy is a simple "premiums for death benefit" exchange, there is also a general type of policy, cash value life insurance, that includes an additional savings component. Instead of putting money into a bank account or a mutual fund, a policyholder can put savings into a cash value life insurance policy, where money will be invested and earn returns but will be taxed like life insurance—in other words, not taxed. This differential tax treatment between cash value life insurance and normal investment vehicles creates an obvious arbitrage opportunity: why not simply take a normal investment contract, call it a life insurance policy, and enjoy a tax-free existence?

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[1] Ted O'Donoghue & Jason Somerville, *Modeling Risk Aversion in Economics*, 32 J. ECON. PERSPS. 91, 91 (2018) (stating that the topic of risk aversion is fundamental in economics, which generally treats individuals as being risk averse). *See also* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 263 (1979) (articulating specific patterns of risk aversion such as loss aversion and prospect theory, where people generally weigh the prospect of losses relative to their original position more heavily than they do the prospect of equivalent gains).

[2] NAT'L ASS'N INS. COMM'RS, U.S. LIFE AND A&H INS. ANALYSIS REP. 1–2 (2021), https://content.naic.org/sites/default/files/inline-files/2020%20Life%20Annual%20Industry%20Commentary_0.pdf.

[3] ASHLEY DURHAM, 2015 INSURANCE BAROMETER STUDY 13 (2015).

[4] *See* discussion *infra* Section I.B.1.

For decades, under the Supreme Court's *Le Gierse* doctrine, the job fell to the courts to determine whether a contract would qualify for life insurance's tax-privileged status. However, in the 1980s, rising alarm about insurers pushing the limits of what most people would consider a life insurance policy brought the issue to a head, and the industry was forced to cut a deal.[5] The tax exemption would remain, but to qualify for it, a contract would have to a pass a new, highly mathematical test written directly into the tax code–§ 7702.[6] The new actuarial simulation required the use of deeply technical assumptions, little understood by those not deeply involved with the legislation or the insurance industry. The internal mechanics of § 7702 are so obscure that they have been almost completely out of view of critical scholarly literature since their inception.[7]

Recent events, however, must force renewed scrutiny of § 7702 and its key to unlocking access to some of the most favorable tax treatment of any contract. Hidden inside the 2020 coronavirus omnibus relief package was an almost completely unnoticed amendment to some of § 7702's technical interest rate assumptions, one that substantially relaxes the definition of "life insurance" and allows contracts that look much more like normal investment contracts to claim life insurance tax status.[8]

The § 7702 amendment comes at a time when the life insurance industry, battered by macroeconomic headwinds, has been abandoning "vanilla" life insurance products aimed at the working and middle classes and embracing a new identity as a tax shelter for the affluent. Middle-class families with modest savings are drawn to other places on the menu of tax-preferred investments, like 401(k) plans and Individual Retirement Accounts (IRAs). Life insurance companies, with huge fixed-income asset portfolios, are also disadvantaged by low interest rates, and so have been disadvantaged by the last decade of near-zero rates.[9] The industry is searching for new

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[5] *See* discussion *infra* Section I.B.2.

[6] *See* discussion *infra* Section II.A.

[7] The only law review article to principally engage with § 7702 was published in 1988. Andrew D. Pike, *Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance*, 43 TAX L. REV. 491, 500–01 (1988). The major work done on life insurance policy taxation since the 1980s is a textbook written by actuaries and lawyers, first published in 2004. CHRISTIAN J. DESROCHERS, JOHN T. ADNEY, BRIAN G. KING & CRAIG R. SPRINGFIELD, LIFE INSURANCE & MODIFIED ENDOWMENTS UNDER INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A (2d ed. 2015). The above, which are invaluable, represent almost the entire academic literature on the subject.

[8] *See* discussion *infra* Sections II.B, III.

[9] *See* discussion *infra* Section II.B.1.

avenues to profitability, and its greatest asset in doing so is its distinctive tax privilege, one that was meant for the purpose of expanding protection against the loss of a provider but has been adapted into a way to sell "insurance" with less and less actual insurance in it.

By constructing my own actuarial simulation per § 7702's requirements, I demonstrate that the § 7702 amendment as much as triples the amount of savings policyholders can shield from taxation in a given cash value policy, while correspondingly cutting the responsibility life insurers have to pay out death benefits.[10] The structure of the amendment, moreover, disproportionately rewards those who have the financial means to invest in high-value policies, creating a self-reinforcing cycle attracting the wealthy to the industry. The rise of private placement life insurance policies, marketed explicitly as a wrapper for tax-free investments into restricted asset classes like hedge funds, most directly showcases the new direction of the industry.[11]

While the initial impact of the § 7702 amendment on the federal budget is likely to be modest, it will rapidly swell,[12] and set up life insurance as the next central mechanism for tax avoidance. Recent proposals to tax the wealthy, such as a proposal by President Joe Biden to curb stepped-up basis, have neglected the ability of life insurers to step into the breach, putting the life insurance closer to a massive windfall of funds looking to escape the risk of taxation at death.[13]

How was this transformation accomplished without any prior media coverage, congressional debate, or intervention by public watchdogs?[14] While a variety of factors contributed, from insurer lobbying to the modern Congressional practice of concentrating legislation into gargantuan omnibus bills, the most important factor relates to the structure of § 7702 itself.[15] Section 7702's complexity requires its reader to have expertise in niche subfields like actuarial science, expertise that is overwhelmingly located in the insurance industry. The more mechanical and mathematical the subject, the more plausible neutral-seeming technical edits appear. Statutory structures like § 7702 thus pose problems for democratic accountability, and suggest that in low-salience policy areas, it is even more important to avoid intricate legislation that obscures the purported legislative policy goals.

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[10] *See* discussion *infra* Section III.A.1.
[11] *See* discussion *infra* Section III.A.2.
[12] *See* discussion *infra* Section III.B.1.
[13] *See* discussion *infra* Section III.B.2.
[14] *See* discussion *infra* Section III.C.1.
[15] *See* discussion *infra* Section III.C.2.

This paper revitalizes analysis of § 7702 and its impact on the life insurance sector since its enactment and offers the first investigation of the quiet sea change in cash value life insurance made possible by the 2020 amendment. It makes three arguments against the change: that it is an abuse of the life insurance exemption's intention, that it is a costly upside-down subsidy, and that it sets a template for interest groups to replicate rent extraction through mechanical legislative changes far from the public eye. Lastly, this paper argues that Congress should act to rectify its mistake—not by further obscure revisions to the § 7702 interest rate assumptions but by directly addressing the tax exemption from which the industry derives its comparative advantage as an investment product.[16]

This paper is organized into three Parts. Part I of this article gives an overview of the dynamics of life insurance policies and traces the history of their tax treatment through the adoption of § 7702, including the defensive insurer political coalition that created it. Part II lays out the statutory structure of § 7702 and its limits on abuse of the life insurance form as well as its 2020 amendment that loosened those limits. Part III traces the shift in the life insurance industry from being a mass-market product to one increasingly focused on tax planning for elites and demonstrates how the 2020 amendment's supposedly scientific edit embraces and doubles down on this move. Part III then details the structural flaws in the statutory construction of § 7702 that enabled this silent giveaway, including the inherent difficulty of legislating in the shadow of the "submerged state" and the cloaking effect of technical statutes, and ends with policy recommendations. Part IV concludes the Article.

II. THE STATE PROVIDES: LIFE INSURANCE PRINCIPLES, HISTORY, AND TAXATION BEFORE § 7702

A. BASIC TYPES AND FUNCTIONING OF LIFE INSURANCE POLICIES

Life insurance firms have developed several types of life insurance products over the years; this section will provide a brief overview of the most significant structures of such policies.

Term life insurance is the most basic form of life insurance: it is an exchange of premiums by the policyholder for a guaranteed death benefit paid to the policyholder's beneficiary if the policyholder dies during the

[16] *See* discussion *infra* Section III.D.

length of the contract.[17] For example, a forty-year-old man with a wife and child could take out a twenty-year term policy with his wife as the beneficiary. The man would pay the insurer a specified amount of money per month, and in return, if the man died during the next twenty years, his wife would receive a specified death benefit. The amount of premiums the man would have to pay would be based on a variety of factors, for example, his age.[18] Term insurance is sometimes called "pure"[19] life insurance, as the insurer is fully on the hook for the payout of the death benefit if the policyholder dies during the duration of the policy and the policy contains no features other than the death benefit and premium. Because term insurance is the simplest type of life insurance, it involves the lowest premium payments for a policyholder.

Term life insurance is by a significant margin the primary type of life insurance that Americans purchase and associate with the industry. Roughly half of American households own a term life insurance policy; while this represents the most widely purchased type of insurance, it is a modest decline from forty years ago, when about 58% of American households reported owning such a policy.[20]

In contrast to term life insurance, cash value life insurance includes the exchange of premiums for a death benefit to a beneficiary, but also permits the creation of a 'cash value' of savings that accumulates during a policyholder's life.[21] Policyholders pay more in premiums than they would if they were to purchase a simple term life policy (conditional on an equivalent death benefit), and while some of the payments go to insurer fees for expenses and policy maintenance as they would under term life, the remainder goes to developing a savings account inside of the insurance policy. This savings account will earn a return each year, just as if it was a

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[17] *Types of Life Insurance Policies*, N.Y. STATE DEP'T FIN. SERVS., https://www.dfs.ny.gov/consumers/life_insurance/types_of_policies.

[18] *Id.*

[19] Georgia Rose, *Term vs. Whole Life Insurance: Differences, Pros and Cons*, NERDWALLET (Apr. 20, 2022), https://www.nerdwallet.com/article/insurance/term-vs-whole-life-insurance.

[20] Daniel Hartley et al., *What Explains the Decline in Life Insurance Ownership?*, 41 FED. RSRV. BANK CHI.: ECON. PERSPS. 1 (2017) (basing calculations on survey data from the Survey of Consumer Finances, a triennial survey widely used in government statistics and economic and social science research most recently released in 2019).

[21] *Id.* at 3.

mutual fund account, and the process of this account accruing interest is known as "inside buildup."[22]

The term "cash value life insurance" is an umbrella term for various types of insurance products, including whole life insurance, universal life insurance, variable life insurance, and more. While each type of insurance sets different rules relating to what sorts of financial investment returns are guaranteed for the savings account portion of life insurance, the common thread among them is the presence of the savings account, created from the premium payments of the policyholder within the contractual entity of the life insurance policy. If the policyholder cancels the contract, it will receive the cash value accumulated back, but will likely have to pay fees to the insurer called "surrender charges."[23] The policyholder may also take out loans using the cash value as collateral. If the policyholder dies, the insurer will have to pay out the death benefit (the "face value"), which will include the accumulated cash value (so the insurer will have to pay out of its own coffers an amount equal to the death benefit minus the cash value, called the "net amount at risk").[24] Far fewer Americans own cash value policies than term life policies; only about a fifth of American households own such a policy, down from 37% in 1989.[25]

To illustrate the basic functioning of a cash value policy, this article employs a stylized example from whole life insurance, adapted from an example by tax scholar Andrew Pike.[26] Whole life insurance policies involve an essentially fixed death benefit and guarantee the policyholder a rate of return on the cash value[27] (for example, the insurer might contractually specify that the inside buildup will occur at a rate of 4%). A policyholder

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[22] DESROCHERS ET AL., *supra* note 7, at 13.

[23] *Id.* at 69.

[24] *Id.* at 345. Cash value life insurance contracts generally remain in effect until the policyholder hits a maturity date that is very advanced, such as age 95 or 100, at which point the contract will conclude and the insurer will return the accumulated cash value to the policyholder.

[25] Hartley et al., *supra* note 20.

[26] Pike, *supra* note 7, at 500–01. Pike's example draws from the mortality assumptions and charges found in the 1980 Commissioners' Standard Ordinary mortality table. From the example, I round the numbers used and conduct some simple recalculations, and then reformat the presentation of the results. Life insurance protection fees draw from common information and actuarial tables but vary by insurer, so it is difficult to directly demonstrate what someone's life insurance fees "should" be. I leverage Pike's example for ease of use.

[27] Stephen Michael Shepard, The Wolters Kluwer Bouvier Law Dictionary Desk Edition I (2012 CCH Inc.).

might pay for the policy through specified payments over time (level premium insurance; if the policyholder fails to make the payments, the policy lapses) or pay through a large payment upfront (single premium insurance). Consider the hypothetical example where a thirty-five-year-old policyholder, Steven, decides to purchase a $100,000 whole life policy from life insurance company Insurimax with the beneficiary being his wife, Amy. If Steven dies, Insurimax must pay Amy $100,000. Steven pays for the policy with a single premium of $25,000 that Insurimax specifies as the cost that Steven would have to pay based on the demographic and health information that he turns over to the company. (I use a single premium for simplicity; because of a provision to be explained later delineating a concept known as a "modified endowment contract," single premium policies are often avoided).

There are two basic factors that will guide what happens to the inside buildup of that $25,000 that Steven has paid: the fees paid to the insurer as a cost of insurance protection (for the cost to the insurer of the risk of having to pay out the policy) and the interest that will be credited to the policy. We will assume for this example that the contract between Steven and Insurimax specifies that there will be a 4% return on the cash value of the contract each year. The cost of insurance protection fees are derived from three main criteria: first, the likelihood that the policyholder will die in the next year; second, the payout that the insurer would have to make in the event that the policyholder dies (in general, the specified death benefit minus the accumulated cash value); and third, the income that the insurer expects to earn from its investment of the premium payments.[28] The cost of insurance protection fees are quite small relative to the policy as a whole, but the costs generally grow each year because of the increased actuarial risk that the policyholder will die, which will outweigh the lower cost the insurer would have to bear in the event of a payout (due to the increase in the policy's cash value).[29]

Assume that the cost of insurance protection to Steven is $150 in the policy's first year and increases by $15 a year for the first five years. The trajectory of the hypothetical policy during that initial period is as follows:

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[28] Pike, *supra* note 7, at 496–97.

[29] Pike, *supra* note 7, at 584–87. This long-term trend is visualized over the long term in Pike's Appendix.

Figure 1: Five Years of Steven's Single Premium Whole Life Policy (Hypothetical)					
Year of Policy	**1**	**2**	**3**	**4**	**5**
Face Value of Policy (amount of payout owed to Amy if Steven Dies)	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Premium Contributed by Steven	$ 25,000	$ -	$ -	$ -	$ -
Current Insurance Protection Fees	$ 150	$ 165	$ 180	$ 195	$ 210
Interest (guaranteed 4%, accrues on cash value minus fees paid)	$ 994	$ 1,027	$ 1,061	$ 1,096	$ 1,131
Cash Value	$ 25,844	$ 26,706	$ 27,587	$ 28,488	$ 29,409
Net Amount at Risk to Insurimax (amount of payout that would come out of Insurimax's own funds)	$ 74,156	$ 73,294	$ 72,413	$ 71,512	$ 70,591

The above hypothetical illustrates the general tenets of cash value life insurance, and although the different types of cash value insurance (whole life, universal life, variable life, etc.) differ in many respects, what is important for our purposes are the following observations.

First, cash value life insurance, despite its name, is only partially about insurance protection (the payment of a death benefit to a designated beneficiary by an outside party, the insurer, following the death of the policyholder). Cash value life insurance, as illustrated by the increase in the cash value each year (from the initial premium payment of $25,000 to $25,844 at the end of the first year, and to $29,409 by the end of the fifth year), is also about the accumulation of savings through the earning of returns on that cash value (minus the payment of fees to the insurer). As will be demonstrated later, for tax reasons, it is crucial that the buildup of these savings occurs within the life insurance contract.[30]

Second, because the cash value of a policy is included in the payout that flows to the beneficiary of the contract, the insurer is liable for less of that payout if the cash value of a policy increases. Because Steven paid for the policy in a single $25,000 premium, Insurimax would have to pay $100,000 - $25,000 = $75,000 of its own money, plus the $25,000 in cash value, to Amy if Steven died immediately afterwards (ignoring fees, etc.). After five years of inside buildup, because the cash value of Steven's policy has grown to $29,409, if Steven died, Insurimax would only have to pay Amy $100,000 - $29,409 = $70,591 from its general assets.

From these two observations, we can derive a general principle, one which will be fundamental to understanding why § 7702 was adopted: *the more cash value savings there are in a given cash value insurance policy, the less insurance protection there is from the insurer and the more like an investment vehicle the contract becomes.* The principal reason to structure

[30] *See* discussion *infra* Section I.B.1.

insurance in this manner from an insurance accessibility perspective is that, as a policyholder ages, the actuarial math of increasing probability of death means that term premiums will become more expensive for the policyholder. Packing in higher premiums that enable a cash value buildup early on will enable the policy to carry through the policyholder's full lifespan when it would otherwise be potentially infeasible for the insurer to offer such a policy that would be reasonably affordable to most people.[31] Fundamentally, the more quickly cash value accumulation is allowed, the faster the insurance company can get out of the business of providing actual costly insurance and get into the business of being an asset manager.

The structure of universal life insurance, which is a relatively new type of cash value insurance, is important because of its role in driving insurance tax policy.[32] Pioneered in the 1970s, universal life policies offer substantially more flexibility in both the premiums that policyholders contribute and the benefits that beneficiaries receive. Policyholders generally have the option of not only choosing a death benefit but also changing the death benefit mid-policy if they fulfill certain conditions.[33] If the policyholder misses a payment, the policy does not necessarily lapse, and the policy may permit partial withdrawals from the cash value. The insurer will specify a minimum annual interest rate for the policy. Essentially, universal life policies are a broader umbrella of cash value life insurance policies that are less subject to the relatively strict structure of whole life.

To summarize, while life insurance is most publicly associated with the pure insurance protection of term life, contemporary life insurers also often offer a plethora of cash value life policies, sold to a smaller number of consumers, that incorporate a savings account inside of the policy. Cash value life insurance policies may take the form of fixed-premium, fixed-death benefit policies (like whole life insurance), or its more flexible cousin, universal life insurance. Cash value life insurance, because it relies on policyholders contributing more in premiums up front to bring about inside buildup of the cash value, shifts the role of the insurer away from the provision of death benefits and towards being an asset manager, like a mutual fund. We will next explore how tax policy applies to life insurance policies

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[31] Randall L. Shaw, *Universal Life Insurance: How It Works*, 71 A.B.A. J. 68, 68 (1985).

[32] *See* discussion *infra* Section I.B.2. The first sale of a universal life policy, by a firm renamed to Hutton Life and eventually merged into Pacific Life, occurred in the U.S. in 1978, though policies sold prior to then contained various features of universal life. Paul J. Mason & Stephen E. Roth, *SEC Regulation of Life Insurance Products – On the Brink of the Universal*, 15 Conn. L. Rev. 505, 551 n.186 (1983).

[33] *Id.* at 552.

and how inside buildup has enabled the industry to not only offer products that pool risk and provide security, but also become a facilitator of tax avoidance and sometimes outright tax fraud.

B. LIFE INSURANCE TAX TREATMENT AND THE ROAD TO § 7702

1. The Life Insurance Exclusion from Income

The acquisition of a life insurance policy has been among the most financially blessed of transactions by the federal income tax system, going all the way back to the inception of the modern tax. In 1913, Congress ratified the Sixteenth Amendment, giving the federal government the absolute power to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States."[34] Congress swiftly passed the Revenue Act of 1913, imposing a small, progressive tax that began on individual incomes of over $3,000 a year.[35] In that Act, Congress specifically exempted from income "the proceeds of life insurance policies paid upon the death of the person insured or payments . . . upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract."[36] The great bulk of the life insurance exemption, where the death benefit is completely untaxed, has been protected in every change to the tax code ever since[37] (despite, by the count of an executive of the National Association of Insurance and Financial Advisors, at least 13 "serious" congressional attempts to place limitations on it).[38] The exemption is codified in I.R.C. § 101(a) for death benefits and I.R.C. § 72 for surrenders, where surrenders of cash value up to the amount

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[34] U.S. CONST. amend. XVI. A previous federal income tax, adopted in the 1870s, had been struck down by the Supreme Court in 1895 for being a "direct tax." Pollock v. Farmers' Loan & Tr. Co., 157 U.S. 429, 430 (1895). Following the Supreme Court's ruling in *Pollock*, a cross-party political movement emerged to restore Congress' ability to levy an income tax, culminating in the passage of the Sixteenth Amendment. *See generally* Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 TAX LAW. 295, 296 (2013).

[35] Revenue Act of 1913, H.R. 3321, 63d Cong. § 2(A) (enacted).

[36] *Id.* at 167.

[37] Pike, *supra* note 7, at 493 n.1.

[38] Mark Maremont & Leslie Scism, *Shift to Wealthier Clientele Puts Life Insurers in a Bind*, WALL ST. J. (Oct. 3, 2010, 6:42 PM), https://www.wsj.com/articles/SB10001424052748703435104575421411449555240.

the policyholder has contributed (the "investment in the contract") are untaxed as well.[39]

The inside buildup on a cash value life insurance policy—the returns credited to the assets held inside of the life insurance cocoon—is also excluded from taxable income. This exclusion dates back to the Revenue Act of 1913, where floor debate of the bill made clear the intent to exempt such returns even though the law did not explicitly include such language.[40] Congress' view was that policyholders could not properly be seen as owning the interest income because "to receive that interest income they would have to give up the insurance protection or the annuity guarantees."[41] Congress has made some very modest efforts to put some limitations on this exemption for corporate-owned policies, but has not done so for individuals—indeed, Congress has explicitly rejected proposals to do so, as we will cover in the following section.[42] And despite concerns from commentators about the lack of a firm statutory foundation for this expansive view of tax exemption,[43] non-inclusion of inside buildup in income has long been blessed by the

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[39] I.R.C. § 72(e)(5).

[40] DESROCHERS ET AL., *supra* note 7, at 299 (citing 50 CONG. REC., as reported in JACOB S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1861–1938, at 989 (1938)). The main author of the Revenue Act, Representative Cordell Hull of Tennessee, told another representative, among other remarks, that "the proceeds of life-insurance policies paid on the death of the person insured, and also includes the return of any and all sums which a person invests in insurance and receives back at one time or at periodical times during his life" were included in the life insurance exemption. On another occasion during House floor debate, when asked if "a widow will be required to pay an income tax on the money secured as the result of her husband's death," Hull replied, "[i]t never was contemplated to tax the proceeds of life insurance policies." 50 CONG. REC. 508 (1913). *See also* CONG. RSCH. SERV., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS, 112TH CONG., 2D SESSION, S. PRT. 112–45, at 323 (2012).

[41] CONG. RSCH. SERV., *supra* note 40, at 323–25.

[42] *Id.* at 323.

[43] *See* Pike, *supra* note 7, at 493 n.2 (arguing that "[t]he precise basis for this exclusion is obscure" and "has been questioned for some time"); Lawrence J. Macklin, *An Analysis of Proposals Using Life Insurance: What Works, What May Not Be as Effective as Promoted, and What Does Not Work*, 43 ESTS., GIFTS, & TRS. J. 123, 132 (2018) (noting that non-taxation of inside buildup "has not been expressly or directly codified in the code"). The Joint Committee on Taxation recently stopped formally considering the nontaxation of inside buildup to meet the definition of a tax expenditure because of this lack of statutory basis. *See infra* n.51.

courts[44] and the IRS.[45] Taxpayers may also take out loans using their cash value as collateral without losing this tax-exempt status.[46] The exemption of the death benefit and the inside buildup of money in cash value policies from federal income tax makes life insurance a valuable instrument for tax reduction purposes.

The tax preference for life insurance is so sufficiently strong that it has long been an object of experimentation for the commercially inventive. One signature example: in the famous case *Knetsch v. United States*, an entrepreneurial taxpayer undertook a tax arbitrage scheme by borrowing $4 million to purchase a deferred annuity life insurance product with tax-deferred inside buildup that was scheduled to start actually paying him money when he hit the age of 90.[47] Knetsch would have made back the money he had nominally put in to the policy, using debt financing with tax-deductible interest, in 2,325 years.[48] Knetsch's scheme allowed him to exclude income from his life insurance product (formally, an annuity) while deducting income from his nominal debt expense, or at least it did until the Supreme Court ruled that his transaction constituted a "sham" and his debt interest payments were non-deductible.[49]

Concerns about tax arbitrage schemes caused Congress to enact I.R.C. § 264 in 1954 to prevent tax double-dipping, and following *Knetsch*, Congress further amended § 264 to expand it.[50] Section 264 now provides that taxpayers may not deduct premiums for life insurance products if they are beneficiaries of the policy or deduct any amount accrued on debt undertaken to purchase a life insurance product, and allows for certain exceptions that are outside the scope of this paper. The key point is that while Congress, aided by the Supreme Court, has acted to prevent some of the most egregious tax gaming employing life insurance's tax attributes, it has not

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[44] Macklin, *supra* note 43, at 132 n.3 (citing Cohen v. Commissioner, 39 T.C. 1055 (1963), acq., 1964-1 C.B. 4.); David S. Miller, *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 TAX L. 481, 504 n.81 (2002) (citing *Cohen*, 39 T.C. and Nesbitt v. Commissioner, 43 T.C. 629 (1965)).

[45] Macklin, *supra* note 43, at 132 n.2 (citing I.R.S. Tech. Adv. Mem. 200213010, at 6 (2002) (stating that "taxpayers may defer tax on their policy's inside buildup").

[46] Pike, *supra* note 7, at 503 n.53.

[47] *See* Knetsch v. United States, 364 U.S. 361, 364 (1960).

[48] Daniel N. Shaviro, *The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance, in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES 313, 314 (Paul L. Caron ed., 2003).

[49] *See* Knetsch, 364 U.S. at 366; *id.* at 370.

[50] I.R.S. Tech. Adv. Mem. 200213010, 6 (Mar. 29, 2002).

done so in a way that takes aim at the core tax preference that privileges the life insurance sector in non-"sham" transactions.

To review, life insurance death benefits are not taxable. The return of accumulated cash value to a policyholder at the end of a life insurance contract is not taxable. Cash value surrenders are not taxable up to the policyholder's investment in the contract. Cash value inside buildup is tax-deferred (and, unless surrendered, above the investment in the contract, will fall into a non-taxable bucket). And loans against cash value, which provide liquidity to policyholders, do not interfere with this tax status. The collective drain of tax revenue due to the I.R.C. treatment of life insurance policies is quite substantial, estimated to total about $370 billion from 2016 to 2025.[51] The multibillion-dollar question, then, if life insurance is to be subject to such favorable tax treatment, is: what actually demarcates life insurance policies from other contracts?

2. Defining Life Insurance: From Common Law to Statutory Compromise

Wrangling over a definition of life insurance, previously a job delegated to the courts, has become a matter of political dealmaking.

Prior to the 1980s enactment of § 7702, whether a contract was considered life insurance or not fell to an amorphous test prescribed by the Supreme Court in its 1941 case, *Helvering v. Le Gierse*.[52] The Court did not apply a technical definition, but instead, drawing on the fact that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing," merely stated that "the amounts [the insurer receives] must be received as the result of a transaction which involved actual 'insurance risk'

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[51] U.S. DEP'T TREASURY OFF. TAX. ANALYSIS, THE TAX EXPENDITURE FOR LIFE INSURANCE INSIDE BUILDUP 1 n.2 (2016) (citing U.S. OFF. MGMT. BUDGET, BUDGET OF THE U.S. GOV'T, FISCAL YEAR 2017, ANALYTICAL PERSPS., Table 14-3). The deduction for premiums to employer-provided group term life insurance is a separate tax expenditure that totals another $28 billion over that ten-year span, bringing the total size of the tax expenditure to about $400 billion for the period. I use the set of numbers beginning in 2016 because the Joint Committee on Taxation stopped formally designating the nontaxation of inside buildup of cash value policies as a tax expenditure around this time because of the lack of a formal statutory exclusion, making measurement of the total tax loss more complex in subsequent years. The Office of Tax Analysis report describes this decision, and its counterargument that the tax expenditure designation should continue, on page 2 of its report.

[52] Helvering v. Le Gierse, 312 U.S. 531, 537–40 (1941).

at the time the transaction was executed."[53] In the subsequent decades, new subtypes of life insurance products proliferated, such as extraordinary life, adjustable whole life, combinations of term insurance and annuities, nonguaranteed premium whole life, universal life, and more, to which the IRS generally issued rulings signing off on tax exemption.[54]

The *Le Gierse* test, with its minimalist standard of only requiring non-zero risk shifting by the policyholder and risk distribution by the policy issuer, ran into political headwinds by the 1980s. Public attention to court-enabled tax shelters was cresting and both the IRS and Congress sprang into action to curb many of the most egregious tax base erosions.[55] If the standard for qualifying as a life insurance contract was so lenient that financial institutions could get access to § 101 and § 72 tax treatment by including a bare amount of risk shifting and distributing, then *Le Gierse*, interpreted sufficiently loosely, presented an appetizing opportunity for almost any contract made by knowledgeable lawyers to undergo a modest makeover and call itself life insurance. The IRS, which had blessed universal life contracts by the firm E.F. Hutton Life[56] in 1981 rulings that seemed to expand the definition of life insurance even further, began having second thoughts and issued a memorandum a year later recommending that its Hutton Life rulings be "reconsidered."[57] A crackdown on *Le Gierse* seemed imminent.

The life insurance industry, a perennial heavy lifter in D.C., stepped in to ward off the storm. Life insurers have been highly attentive to their policyholders' tax treatment since the inception of the income tax. During Senate discussion on ongoing lobbying over the Revenue Act of 1913, Mississippi Senator John Williams remarked, ". . . great and rich and powerful life insurance companies of the country have sent broadcast all over the country printed slips, to be signed by every policyholder whom they

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[53] *Id.* at 539.

[54] DESROCHERS ET AL., *supra* note 7, at 309–10.

[55] MICHAEL J. GRAETZ ET AL., FEDERAL INCOME TAXATION 402 (8th ed. 2018) (discussing a variety of tax shelters, "typically involv[ing] a mismatching of deductions and income to produce net losses that offset unrelated income," that taxpayers employed). The Congressional crackdown on such devices culminated in three bills passed in 1982, 1984, and 1986, which ultimately, in the Tax Reform Act of 1986, brought about § 469, a provision that limited losses from "passive activities" in a year to gains from such activities. *Id*. at 424.

[56] E.F. Hutton Life was the first insurer to sell universal life policies. Mason & Roth, *supra* note 32, at 551 n.186.

[57] DESROCHERS ET AL., *supra* note 7, at 311–12 (citing PLR 8116073 (January 23, 1981); PLR 8121074 (February 26, 1981); General Counsel Memorandum 38934 (July 1982)).

have, asking them in another circular to sign and date the same and send it to their Senators and their Representative."[58] Seventy years later, the industry moved to cut off the most adventurous wildcats in its midst in order to preserve the overall exemption, lobbying Congress to pass a stricter set of criteria for universal life policies to receive preferential tax treatment than *Le Gierse* required. Tensions between large, incumbent life insurance providers (many of whom were "mutual" life insurance companies owned by policyholders) and upstarts (often stock companies who specialized in newer types of insurance) had flared for years.[59] Rather than risk an IRS crackdown on universal life policies and face uneasy relationships with the traditional, relatively conservative mutual insurers, universal life providers went to Congress to lobby for the addition of § 101(f) to the I.R.C.[60] Section 101(f), passed in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[61] was a stopgap provision that provided two alternative tests for flexible premium life insurance contracts to become eligible for tax exemption: a cash value accumulation test and a guideline premium and cash value corridor test.[62] These tests will be described in more detail in the next section, as though they were initially temporary measures applying to only flexible premium policies issued prior to 1983,[63] they became the basis for the permanent codification of the definition of life insurance for federal tax purposes.

Following the addition of makeshift § 101(f) to the tax code, the life insurance industry spent years in the political trenches. Democrat Pete Stark

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[58] 50 CONG. REC. 1807 (1913).

[59] In the late 1970s, major insurance firms fought life insurance annuity providers over the tax treatment of investment annuity products. The American Council of Life Insurers (ACLI), the major life insurance trade association, moved to ally with the Carter administration's push to oppose annuities' tax-deferred status. When small insurers that disproportionately sold annuities objected, the ACLI retreated to only object to tax-deferred status for "abuses." Nancy L. Ross, *Annuities Tax Shift*, WASH. POST (April 30, 1978), https://www.washingtonpost.com/archive/business/1978/04/30/annuities-tax-shift/e7ba2436-2906-41cb-8f06-39c1541dc146/. Some mutual companies lobbied for adverse IRS rulings against universal life products in the early 1980s as well. Rex P. Cornelison III, *Federal Income Taxation of Life Insurance Products After the Tax Reform Act of 1984*, GA. STATE UNIV. L. REV. 237, 248 (1985).

[60] DESROCHERS ET AL., *supra* note 7, at 312.

[61] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 266(a)(B).

[62] §§ 266(a)(B).

[63] DESROCHERS ET AL., *supra* note 7, at 313.

of California, the Chairman of the Subcommittee on Select Revenue Measures on the powerful House Ways and Means Committee, suggested in April 1983 that inside buildup of cash value policies should no longer receive an exemption.[64] William B. Harman, a lawyer who served as the Executive Vice President of the American Council of Life Insurers (ACLI) in the 1970s, wrote a tax journal article in 1992 reflecting on the past two decades of life insurance tax reform; the journal described him as being "directly involved in almost all of those changes in one capacity or another."[65] Harman, evaluating the push to tax inside buildup from government and commentators, conceded, "[u]nfortunately, to a degree their argument was bolstered by some elements within the insurance industry that aggressively developed overly investment-oriented life insurance products and marketed them by stressing the beneficial tax treatment available."[66]

Now playing defense, the life insurance sector pushed to intervene, and made a more limited case for exemption preservation in May 1983 hearings before Stark's Select Revenue Measures subcommittee.[67] At the hearings, Stark—who noted they occurred "basically as a result of intense lobbying on the part of both the stock and mutual companies"[68]—opened the discussion with a call for "a complete reexamination of the taxation of life insurance companies and their products."[69] Displaying the bipartisan nature of the discontent with the laxity of the tax regime, the Reagan administration weighed in to agree that things had gone too far and that Congress needed to take action on a life insurance definition.[70]

For the hearing, mutual insurers banded together and were represented by a fourteen company Mutual Company Executive

[64] William B. Harman Jr., *Two Decades of Insurance Tax Reform*, INS. TAX REV. 1089, n.14 (1992).

[65] *Id.*

[66] *Id.* at 1090.

[67] *See generally Tax Treatment of Life Insurance: Hearings Before the Subcomm. on Select Revenue Measures of the H. Comm. On Ways & Means,* 98th Cong., 1st Sess. (1983) [hereinafter 1983 Hearings].

[68] *Id.* at 5.

[69] *Id.* at 2.

[70] John Chapoton, the Treasury Assistant Secretary for Tax Policy, testified that "[i]n extreme cases . . . the [life insurance] policy differs little from an investment account in the name of the policyholder with the insurance company." *Id.* at 26. Chapoton noted support for a Congressional life insurance definition. *See id.* at 60.

Committee,[71] which declared its support for life insurance tax exemptions only applying to "policies whose predominant purpose is the provision of life insurance protection."[72] Specifically, the Executive Committee recommended a definition requiring that life insurance contracts provide death benefits and have cash values that cannot exceed the net single premium for the policy.[73] However, the industry held the line against taxation of inside buildup, and the congressional proposal that followed the hearings, by Stark and Republican Henson Moore, represented a compromise: there would be no taxation of inside buildup, but an adapted version of the TEFRA mathematical cash value and guideline premium tests would become permanent and apply to all life insurance.[74] Senate hearings on the proposal, along many of the same lines, followed six months later.[75] For the price of accepting some mathematically defined limitations on how much a life insurance contract could resemble a straightforward asset management contract, the industry's tax treatment would now have congressionally stamped security.

III. CONGRESS DECIDES: § 7702 AND ITS AMENDMENTS

Part I of this article introduced the history and political economy of the life insurance industry in 20th century America, including the bargaining that led up to the enactment of a statutory definition of life insurance for federal income tax purposes, § 7702. Part II will articulate what, specifically, § 7702 does to limit firms from simply offering investment management

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[71] The members of Executive Committee were Empire State Mutual Life Insurance Company, Equitable Life Assurance Society of the United States, Guarantee Mutual Life Company, The Guardian Life Insurance Company, John Hancock Mutual Life Insurance Company, Massachusetts Mutual Life Insurance Company, Metropolitan Life Insurance Company, Minnesota Mutual Life Insurance Company, Mutual Benefit Life Insurance Company, Northwestern Mutual Life Insurance Company, Phoenix Mutual Life Insurance Company, The Prudential Life Insurance Company of America, and Security Benefit Life Insurance Company. In total, 53 mutual companies said they supported the statement. *See id.* at 163–65.

[72] *Id.* at 156 (the Executive Committee made sure to criticize "that there are products in the marketplace that are primarily short-term investment vehicles masquerading as life insurance" as well).

[73] *Id.*

[74] Harman, *supra* note 64, at n.14.

[75] *Tax Treatment of Life Insurance Products and Policyholders: Hearing Before the Comm. on Finance*, 98th Cong., 2d Sess. (1984).

services under the tax-preferred guise of life insurance, as well as explain why its 2020 amendment substantially weakens this hard-fought balance.

A. THE GRAND BARGAIN: ENACTMENT AND IMPACT OF § 7702

The amended Stark-Moore proposal was passed in the Deficit Reduction Act of 1984 (DEFRA),[76] making the life insurance industry's bargain, codified in I.R.C. § 7702, the law of the land. The law works as follows: first, to be eligible for federal income tax exemptions as a life insurance contract, a contract must first be considered life insurance "under the applicable law,"[77] meaning the state law of the state where the policy was issued.[78] Second, the contract must pass one of two standards, chosen at the inception of the policy: the cash value accumulation test or the guideline premium and cash value corridor tests.[79] The two standards are strictly mathematical simulations, directly writing actuarial calculations into the tax code so as to place concrete bounds on the level of investment orientation a policy can have. An important point to underscore, before looking into the specifics, is that each test functions as a simulation, such that regardless of the actually existing provisions of a specific life insurance contract, that contract will pass the test if its simulated version passes the test. If a contract fails its test, the policyholder will lose the tax treatment accorded to life insurance policies.[80] The main features of each test will be examined in

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[76] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 221, 98 Stat. 494, 767 (codified as amended at 26 U.S.C. § 7702).

[77] I.R.C. § 7702(a) (2020).

[78] DESROCHERS ET AL., *supra* note 7, at 338.

[79] § 7702(a).

[80] Formally, per § 7702(f) and (g), if a contract ever fails its test, the "income on the contract" that occurs in a given year (the "increase in the net surrender value" plus the "cost of life insurance protection" minus the "premiums paid" in that year) will be considered taxable income. *See* § 7702(f)(1); *see also* § 7702(g)(1)(A)–(B). Additionally, per § 7702(g)(2), if a contract that has failed to meet § 7702 pays out a death benefit, the "net surrender value of the contract" that is paid out will also be considered taxable income; only the remaining portion of the death benefit that is paid directly by the insurer will retain its tax exemption. Per § 7702(f)(2)(B), the "net surrender value" of a contract is the amount of money that a policyholder would receive if they surrendered their policy while they were still alive, taking into account the surrender charges specified in the contract, but not taking into account policy loans.

turn.[81] Section II.A.3 will summarize the main features of the test as a flowchart.

1. Placing Limits on Whole Life: The Cash Value Accumulation Test

a. structuring cash value accumulation limits

The cash value accumulation test (CVAT) is the main test for whole life insurance policies, allowing for relatively more cash value accumulation in early years but relatively less in later years.[82] A contract passes the CVAT if its "cash surrender value" never exceeds "the net single premium which would have to be paid at such time to fund future benefits under the contract."[83] The "net single premium" is the amount of money required today to generate the contract's arranged future cash values (remember that the insurer is guaranteeing the policyholder a certain annual return) and to pay for the actuarial mortality costs associated with the contract's death benefit. Essentially, the CVAT restricts the amount of money that can be stuffed into a policy with a given death benefit to the actual amount necessary to support that death benefit. If there were no cash value accumulation restriction whatsoever, a whole life policy could theoretically be written with a $100,000 death benefit where the policyholder simply handed over $100,000 immediately to the insurer. That structure would mean that the life insurer would effectively manage a tax-preferred investment account for the policyholder's $100,000 savings instead of the policyholder going to a mutual fund. The CVAT prevents life insurers from issuing whole life policies in which they would not actually risk having to pay out death benefits because of their having a very high ratio of cash value to death benefit.

In general, to perform the mathematical calculations necessary to determine if a contract passes the CVAT, four main variables are required: the age of the policyholder, the policy benefits (mainly the death benefit), the year's maximal insurance protection fees, and the guaranteed rate at which interest is credited to the cash value (the amount of inside buildup that

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[81] Because of the substantial density of the law and the mathematical calculations that undergird it, the overview of the § 7702 statute is relatively high-level. For a more granular treatment of the statute, see generally DesRochers et al., *supra* note 7; *see also* Pike, *supra* note 7.

[82] Pike, *supra* note 7, at 508.

[83] § 7702(b)(1).

the insurer guarantees will occur each year).[84] Two of these variables, the age of the policyholder and the policy benefits, are easily observable from the policyholder and contract, and are uncontroversial in the statute. The other two require further analysis because of their susceptibility to manipulation by insurance providers seeking to push the limits of the CVAT.

b. simulating mortality and insurance protection rates

I examine insurance protection charges first. Insurance protection charges, as covered in Section I.A, in theory reflect the actuarial cost to the insurer of providing the policy. In a given year there is a certain probability that the policyholder will die, meaning that the life insurer would have to pay out the death benefit, costing it an amount of money equal to the death benefit minus the contract's accumulated cash value. The money charged to the policyholder for providing this service is represented by this charge. However, it is impossible to truly know if a given person will die within a given year, and the insurance protection charge is at the discretion of the insurer. To game the CVAT, an insurer could nominally record very pessimistic probabilities of a person's survival each year, thereby mechanically increasing the reported amount of insurance protection charges to the policyholder and enabling the policyholder to contribute additional premiums to the policy when doing so would otherwise have failed the CVAT. Intuitively, if projections for survival are pessimistic, then the actuarial cost to an insurer for providing the policy increases. Thus, the amount of money that would have to be paid to fund the contract increases, so the net single premium increases.

DEFRA initially did not regulate insurers' use of actuarial assumptions because its authors initially preferred to rely on market competition to discipline unrealistic modeling.[85] After the passage of DEFRA and the Tax Reform Act of 1986, life insurers even ran ads claiming to be the "last remaining tax shelter" and that their single premium policies were "too good to be true;"[86] Congress added further teeth to § 7702 in the

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[84] Pike, *supra* note 7, at 511 (citing KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE INSURANCE (11th ed.1987)).
[85] DESROCHERS ET AL., *supra* note 7, at 318 n.121.
[86] DESROCHERS ET AL., *supra* note 7, at 315.

Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[87] Mortality charges are now required to be "reasonable," with a safe harbor given to charges that do not exceed the charges specified in the "prevailing commissioner standard tables."[88] These tables are set by the National Association of Insurance Commissioners (NAIC),[89] an organization of state insurance regulators, meaning that insurers must adhere to standardized tables for calculation of mortality fees to remain in the safe harbor of CVAT compliance. So, no matter how life insurers internally calculate insurance protection charges in their existing contracts, for the purposes of the CVAT, each contract will be evaluated on a specified mathematical simulation of itself in which the mortality tables used are uniform and trusted.

c. *simulating interest crediting rates*

This article now turns to the treatment of the rate at which interest is credited to a policy's cash value—the inside buildup. It is this aspect of the CVAT (and, as we will see, the guideline premium and cash value corridor tests) that has been the subject of recent change. In whole life policies and other types of insurance, the insurer will credit interest to the cash value of a policy each year (the inside buildup). For example, if the policyholder has $100 in cash value and the insurer credits 7%, the policyholder will then have $107 in cash value. Many policies provide for a minimum annual inside buildup, with the possibility of a larger one (for example, a policy could specify that at least 4.5% a year would be credited). However, similar to the insurance protection fees and mortality charges discussed above, insurers face an incentive to manipulate the guaranteed inside buildup. If the rate of interest used in the calculation is lower, then it will require more in policyholder contributions for the policy to grow towards the same amount of money, so the net single premium increases. By default, when calculating the net single premium, the CVAT employs the "rate or rates guaranteed on issuance of the contract."[90] Therefore, if an insurer were to decrease the guaranteed rate of interest crediting while changing nothing else, the insurer would be able to allow the policyholder to stuff the policy with substantially more cash value and thus reduce the insurer's net amount at risk on the

[87] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5011, 102 Stat. 3342, 3660 (codified as emended at 26 U.S.C. § 7702) [hereinafter TAMRA].

[88] TAMRA, §5011(a), 102 Stat. 3342, 3660 (amending I.R.C. § 7702(c)(3)(B)).

[89] I.R.C. § 7702(f)(10).

[90] § 7702(b)(2)(A).

policy, while permitting the policyholder to receive the preferential tax treatment.

To guard against such manipulations, § 7702 (until 2020) specified that regardless of the actual guaranteed interest crediting rate of a policy, the interest rate to be used in the CVAT calculations would be subject to a lower bound of 4%.[91] To reiterate, if the contractually guaranteed rate of interest crediting to the cash value of a contract was less than 4% (for example, the a policy could guarantee inside buildup of 1% annually), when such a policy would be tested for § 7702 compliance, the policy would be evaluated as if it guaranteed 4%.

The interest rate used in the § 7702 formula has a significant impact on the amount of cash value that can be put into a life insurance contract. For example, in the case of a newly issued whole life insurance policy with a face value of $225,000 to a 25-year-old nonsmoking male, if the interest rate used in the calculation was 6%, the net single premium for that policy (the amount of savings that can be put into that policy) would be about $9,900.[92] If the rate was 4%, the net single premium would be about $25,300—more than doubling capacity to absorb policyholder savings.

DEFRA's 4% lower bound on the interest rate to be used for the CVAT was written directly into the statute, which raises the question: why specifically 4%? Why not 3%? Or 5%? There is no strictly mathematical reason that the simulated lower bound of the interest credited was written to

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[91] Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 221(a), 98 Stat. 767 (adding § 7702(b)(2)(A), which has been since amended).

[92] For this calculation, I use the 2017 Unloaded Commissioners Standard Ordinary Male Nonsmoker ANB Mortality Rates and calculate the net single premium for a newly issued whole life insurance policy with a level face amount. I add no load to the premium (do not factor in expenses or profits) for simplicity, following the recommendation employed in Pike, *supra* note 7, at n.39. I employ the Basic Actuarial Principles net single premium calculation approach for such a policy delineated in DESROCHERS ET AL., *supra* note 7, at 59. The net single premium, for this type of policy, can be calculated as the face value of the policy times product of an interest rate discount with the probability that the policyholder survives to an age 45+t and the probability that the policyholder dies at the age of 45+t, summed over the ages of 45 to 120. The data tables and calculations performed are available online. I checked my calculations with two actuaries to verify their accuracy; I thank Reggie Mazyck and Patrick Nolan in the acknowledgments and here as well for serving as resources. The numbers presented in the text are rounded to the nearest hundred. Online Data and Calculations Appendix https://docs.google.com/spreadsheets/d/11IJ6yAih3cQAQ-ByPjzWJ2_qZx75PqymoRiABWD7C2E/edit#gid=1896335209 (link directs to a Google Sheet with calculations I authored).

be 4%. Section 7702 was a political compromise between the life insurance industry and policymakers who were concerned that the industry was selling products that did not have much insurance in them at all. As Harman, the former Executive Vice President of the ACLI, wrote in 1992, though the statutory limits on insurance risk "involved drawing a somewhat arbitrary line, this was necessary to ensure that [life insurance] contracts did not permit too great an investment orientation."[93]

2. Placing Limits on Universal Life: The Guideline Premium and Cash Value Corridor Tests

The guideline premium test (GPT) and cash value corridor test (CVCT) comprise the main test for universal life insurance policies, allowing for relatively less cash value accumulation in early years but relatively more in later years. To reiterate from an earlier explanation, universal life policies are substantially more flexible cash value policies than traditional whole life, in which policyholders receive discretion to choose the initial premium quantities as well as the death benefit, and may choose to make alterations mid-policy.[94] Many of the concepts employed in the CVAT, including the use of prescribed mortality rate tables and floor restrictions on the interest credited, are employed in the GPT and CVCT for analogous reasons.

a. The Guideline Premium Test

The GPT sets a cap on the cumulative amount of premiums that a policyholder may contribute to a policy in a manner that roughly matches the implicit premium limitations placed by the CVAT.[95] The GPT sets up two standards: the guideline single premium (GSP), which is the premium that would be required to pay up front to support the future benefits of the contract if the payment was made all at once,[96] and the guideline level premium (GLP), which is the annual premium that would be required to be paid to support the future benefits of the contract.[97] The GLP is the greater of the two,[98] and the GPT states that the sum of the premiums that a

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[93] Harman, *supra* note 64, at 902. Harman's quote is directly referring to the statutory limits applied in TEFRA to flexible premium contracts, but also refers to Congress' use of TEFRA's principles to develop § 7702 two years later.

[94] *See supra* Section I.A.

[95] Pike, *supra* note 7, at 519.

[96] I.R.C. § 7702(c)(2)(A).

[97] I.R.C. § 7702(c)(2)(B).

[98] I.R.C. § 7702(c)(2).

policyholder has paid under the life insurance contract cannot exceed the guideline premium limitation, which is the greater of the GSP and sum of GLP premiums paid up to that date.[99] The GPT therefore puts an upper bound on the amount of premiums that a policyholder can contribute to a policy so as to hinder policyholders' ability to accumulate a great deal of rapid cash value while the insurer rapidly reduces its own risk, similar to the structure of the CVAT.

Also in a way that is comparable to the CVAT, the GPT includes several conditions that are in place to stop insurers from gaming the simulation. The GLP must be calculated in a manner that reflects what the required premium would be if premiums were paid each year until the insured "attains age 95."[100] The two main actuarial limitations present in the CVAT, the mortality charges and rate of crediting interest, are present in the GPT as well. Just as in the CVAT, the GPT requires (after the passage of TAMRA) that the GSP and GLP be computed using "reasonable mortality charges" and offers the NAIC-set "prevailing commissioner standard tables" as a safe harbor.[101] Without this restriction on the simulated version of the contract, a universal life insurer could employ excessively pessimistic mortality assumptions to enable additional early premium contributions and corresponding reductions in insurer net amount at risk.

With regard to crediting interest on the policy, the GPT, like the CVAT, provides for a floor on the guaranteed rate of interest credited in the simulated policy subjected to the test to prevent insurers from allowing premium stuffing through artificially low interest. DEFRA prescribed that the rate of interest to be used in calculating the GLP was to be the rate guaranteed on the issuance of the contract, but with a minimal rate of 4%,[102] consistent with the 4% floor employed in the CVAT. This mirroring of the annual interest crediting standard ensures equal tax treatment of otherwise functionally equivalent level-premium policies across whole and universal life. DEFRA prescribed that the minimal rate of interest to be used in calculating the GSP, on the other hand, was to be 6%,[103] or two percentage points higher.[104] Similarly to the 4% lower bound rate of the CVAT, the 4%

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[99] I.R.C. § 7702(c)(1).

[100] I.R.C. § 7702(c)(4).

[101] I.R.C. § 7702(c)(3)(B)(i).

[102] Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(a), 98 Stat. 767 (adding I.R.C. § 7702(c)(4), which has since been amended).

[103] *Id.* (adding I.R.C. § 7702(c)(3)(B)(iii), which has since been amended).

[104] The reason for the higher floor rate for guideline single premiums relative to guideline level premiums may be due to that the relatively strict 6% floor may be

and 6% lower bounds of the GPT are not selected due to any exacting mathematical reason, but are political compromises designed to limit the ability of life insurers to offer essentially untaxed mutual funds.[105]

I re-emphasize here that the 4% (6%) minimum applies to the simulated policy being examined for tax purposes, while the corresponding actual contract is not legally required to credit 4% (6%) or more to the policyholder in that year. Life insurers may execute contracts, such as ones that guarantee returns of less than 4%, on whatever terms they please. If insurers wish for the contract to receive preferential tax treatment, their obligation is to make sure that the contract, once the actuarial simulation of § 7702 is applied, passes the relevant test.

b. The Cash Value Corridor Test

The Cash Value Corridor Test (CVCT), which is to be applied alongside the GPT, is an additional limitation that limits the amount of cash value that can be placed inside of a policy relative to the policy's death benefit. The CVCT gradually relaxes this limit, called the cash value corridor, as the policyholder ages. Formally, the CVCT sets a maximal ratio of the "cash surrender value" (the cash value "determined without regard to any surrender charge, policy loan, or reasonable termination dividends")[106] to the death benefit and specifies a table in the statute for the corresponding maximal ratios for each year.[107] Translated for the reader's ease, the cash value corridor reads:

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balanced by the relatively lenient cash value corridor or that arguably a 6% rate of return is, over the long term, a more justified figure for the market rate. Pike, *supra* note 7, at 521 n.156.

[105] Harman, *supra* note 64.

[106] I.R.C. § 7702(f)(2)(A).

[107] I.R.C. § 7702(d)(2).

Cash Value Corridor		
Age of the Insured as of the Beginning of the Contract Year:	**Death Benefit Must Be At Least This Much Larger Than the Cash Surrender Value (ratio decreases by a ratable portion for each year)**	
	From:	**To:**
0-40	2.5x	2.5x
41-45	2.5x	2.15x
46-50	2.15x	1.85x
51-55	1.85x	1.5x
56-60	1.5x	1.3x
61-65	1.3x	1.2x
66-70	1.2x	1.15x
71-75	1.15x	1.05x
76-90	1.05x	1.05x
91-95	1.05x	1x

For relatively young policyholders, as can be seen from the table, the death benefit must be at least two and a half times the size of the "cash surrender value," and as the policyholder reaches age 95, the ratio is gradually relaxed until the "cash surrender value" is eventually allowed to reach the death benefit. The effect of the CVCT, when used in conjunction with the GPT, is that policyholders' inside buildup is held within certain bounds, with the dual structure working to ensure that creative insurance entrepreneurs do not find loopholes around its structure.

3. Summary of § 7702 Mechanics

To condense the above discussion in subparts II.A.1 and II.A.2, the political compromise of § 7702 requires that, in order to get access to life insurance tax exemptions, a contract must first meet the definition of life insurance under the relevant state law. Then, the contract must pass either the cash value accumulation test (CVAT), generally for whole life policies, or the guideline premium test (GPT) and cash value corridor test (CVCT), generally for universal life policies. These tests are designed to limit the degree of orientation the policy has towards being an investment fund rather than a pure term insurance policy. Life insurers can write their policies how they please, but regardless of how they write them, to pass § 7702, a simulated version of the policy that employs certain mandated actuarial assumptions (the use of NAIC mortality tables and certain minimums on credited rates of interest) must pass one of the available tests. These actuarial assumptions are, on some level, arbitrary but are employed to prevent life insurers from writing policies where, by use of excessively pessimistic mortality tables and excessively low minimum crediting of interest on inside buildup, the insurers may greatly reduce their net value at risk on a given policy through policyholder stuffing of cash value.

The following infographic provides a walkthrough of if a policy passes § 7702:

Does a Contract Pass the § 7702 Test to be Taxed as Life Insurance? (1988-2020 Version)

1. The contract must meet the definition of life insurance "under the applicable law" (i.e. under the relevant state law).

2. The insurer and policyholder must the choose one of two tests by which the contract will be evaluated: (a) the Cash Value Accumulation Test (CVAT) or (b) the Guideline Premium Test (GPT) and Cash Value Corridor Test (CVCT).

a. Under the CVAT, the "cash surrender value" of the contract must be equal to or less than the net single premium that would have to be paid to fund the contract's future benefits. To accomplish this:

i. Calculate the "cash surrender value" by determining how much money the policyholder would receive by canceling the contract and getting their savings in the contract returned to them, ignoring surrender charges or policy loans.

ii. Calculate the net single premium required to fund the contract's future benefits (mainly the death benefit). To perform this calculation, the required variables are the policyholder's age, the policy benefits, the maximal insurance protection fees, and an interest rate.

Maximal insurance protection fees (mortality charges) depend on the actuarial risk of the policy (the risk that the policyholder will die). Mortality charges must be "reasonable" and a safe harbor is given to charges that are equal to or less than charges that would occur if the insurer used the actuarial tables created by the National Association of Insurance Commissioners.

If the insurance policy guarantees to the policyholder that the return on the savings stored in the policy is over 4%, then the interest rate used will be that rate of return. If not, then the interest rate used will be 4%, regardless of what rate of return the policyholder is guaranteed.

b. To fulfill the GPT and CVCT:

i. Under the GPT, there are two standards: the guideline single premium (the amount of money it would take to support the contract's future benefits in a one-time payment) and the guide level premium (the annual amount of money it would take). At a given moment, the sum of the premiums a policyholder has paid towards the policy cannot ever be larger than the greater of the guideline single premium and the sum of guideline level premiums already paid.

Mathematically determining these premiums resembles the calculation of the net single premium of the CVAT (above), including the additional rules placed on mortality charges and interest rates. Regardless of what rate of return the policyholder is guaranteed, in the calculation, the guideline single premium's minimal rate is 6%; the guideline level premium's minimal rate is 4%.

ii. Under the CVCT, the death benefit of the contract must be at least a certain multiple larger than the cash surrender value. This ratio depends on the age of the policyholder and can be consulted in a table in the § 7702 statute.

4. Aftermath: § 7702 as 30-Year Peace

For the life insurance industry, § 7702 was a worthy compromise. As discussed above, while President Ronald Reagan struck a reputation as a tax cutter, he also pushed for reforms to get rid of tax shelters, a major political issue.[108] Among the signature legislation of Reagan's two terms in office was the Tax Reform Act of 1986 (TRA),[109] which reduced general rates of taxation and closed some loopholes; twenty years later, the author of a book on the passage of the Act called it "the broadest revision of the federal income tax in history.[110] Reagan's original proposal for the TRA, announced in May 1985—a year after the passage of § 7702—included four separate proposals for new taxes on life insurance policies and companies, including taxation of inside buildup of cash value policies.[111]

Reagan slammed the nontaxation of inside buildup as going only to "individuals with excess disposable income that allows them to save, and particularly people in high tax brackets," while being unavailable to purchasers of term life insurance and being distortionary for channeling savings into the life insurance industry rather than other financial institutions.[112] But Reagan's life insurance proposals did not survive to the final bill "for a variety of reasons, not the least of which was that Congress had only recently considered and resolved the issue, albeit with the different result," wrote former Executive Vice President of the ACLI William Harman in his retrospective.[113] Section 7702 had fulfilled its purpose. By cutting loose its most extreme elements, the life insurance industry had preserved its most important tax exemptions.

All that remained was some clean-up. As referenced above, in 1988 Congress passed an additional tax reform act, TAMRA, to make various mechanical alterations to recent changes in the tax code.[114] In TAMRA,

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[108] GRAETZ ET AL., *supra* note 55, at 424.

[109] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

[110] Jeffrey H. Birnbaum, *Taxing Lessons, 20 Years In the Making*, WASH. POST (Oct. 22, 2006), https://www.washingtonpost.com/wp-dyn/content/article/2006/10/20/AR2006102001255.html.

[111] WHITE HOUSE, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 253–64 (1985).

[112] *Id.* at 255–56.

[113] Harman, *supra* note 64, at n.21. Harman also cites insufficient revenue from the tax and an argument from the industry that subjecting inside buildup to tax would "effectively destroy the market for the products" as the other principal reasons why the tax was removed from the bill.

[114] TAMRA, *supra* note 87.

Congress added to § 7702 the requirement that mortality charges be "reasonable"[115] to prevent improper cash value stuffing. Congress also responded to post-TRA concerns about the use of single premium cash value contracts by enacting additional restrictions on a subset of life insurance policies subject to early cash value stuffing called "modified endowment contract[s]."[116] After that, § 7702 went completely unmodified for decades (until 2020), with the sole cosmetic change being that the citation to the "prevailing commissioners' standard tables" was moved from a different section of the I.R.C. into § 7702 itself.[117]

This section has told the story of the enactment of § 7702 with the following emphasis: § 7702 is a political equilibrium between (1) Congress, an executive, and a public suspicious that the life insurance industry was playing fast and loose, and (2) a life insurance industry willing (eager, even) to jettison its wayward nephews to preserve its political capital and privileged tax status. This equilibrium was hard-won, the result of extensive political maneuvering, congressional hearings, and four separate major pieces of legislation in seven years (TEFRA in 1982, DEFRA in 1984, TRA in 1986, and TAMRA in 1988). The treaty of § 7702 then lasted for over thirty years, before being quietly and abruptly overhauled with essentially no public discussion or negotiation in 2020, in the midst of the COVID-19 pandemic.

B. The Retreat: the 2020 Amendment to § 7702

This section will first cover changes in the life insurance sector since the 1980s and how those changes laid the foundation for the 2020 § 7702 amendment, and then it will cover the specifics of that amendment.

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[115] TAMRA, §5011(a), 102 Stat. 3342, 3660 (amending I.R.C. § 7702(c)(3)(B)).

[116] *See generally* I.R.C. § 7702A(b) (the modified endowment contract (MEC) definition and its implications are highly technical, but the basic structure is that an MEC is a contract that passes § 7702 but that fails the "7-pay" test, which means the policyholder contributed more in premiums to the contract within the first seven years than "the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums" (essentially, if the policyholder paid enough in the first seven years for the policy's necessary premiums to be fulfilled)). *See also* I.R.C. §§ 72(e)(10) & 72(v)(1) (if a policy receives MEC designation, withdrawals from the cash value and loans against the cash value will be automatically treated as taxable income and will also carry a 10% penalty).

[117] Budget Fiscal Year 2018, Pub. L. No. 115–97, 131 Stat. 2054, title I, § 13517(a)(4) (2017).

1. The Slow Decline of Life Insurance and the End of the People's Investment Vehicle

Despite the continuation of highly tax-favored treatment of life insurance policies, from 1989 to 2013, the percentage of American households that owned a term life insurance policy dropped from 58% to 50%. For cash value policies, the drop was from 37% to 19%.[118]

The reasons for the waning percentages are varied. Insurance economics papers point to the decline of fees in mutual funds;[119] the rise of the internet (enabling more substantial price shopping);[120] the decline of the traditional model of life insurance sales via salesmen;[121] the 1990s introduction of additional tax-advantaged savings vehicles such as Roth IRAs, 529 education plans, and Coverdell Education Savings Accounts;[122] and the decline of interest rates.[123]

The decline of interest rates is of particular concern to the business model of life insurance.[124] Life insurers derive revenue from two main sources: the premiums policyholders pay them and the financial investments that insurers make with those premiums.[125] From the premiums, life insurers invest a gargantuan amount of assets, totaling over $6 trillion in their general accounts.[126] Insurers must invest their assets in a portfolio consistent with

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[118] Hartley et al., *supra* note 20.

[119] *Id.* The authors also find that the decline in life insurance ownership was overwhelmingly not driven by demographic changes in the U.S. (such as the changing incomes, age composition, racial composition, or educational attainment of Americans during the period).

[120] *See generally* Austan Goolsbee & Jeffrey R. Brown, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry*, 110 J. POL. ECON. 481, 481–505 (2002).

[121] Barry Mulholland, et al., *Understanding the Shift in Demand for Cash Value Life Insurance*, 19 RISK MGMT. & INS. REV. 7, 32 (2015).

[122] *Id.* at 31.

[123] Hartley et al., *supra* note 20.

[124] *See generally* Elia Berdin & Helmut Gründl, *The Effects of a Low Interest Rate Environment on Life Insurers*, 40 GENEVA PAPERS RISK & INS. – ISSUES & PRAC. 385 (2015).

[125] JOINT COMM. TAX'N, REVENUE ESTIMATING, https://www.jct.gov/operations/revenue-estimating/ (last visited Nov. 7, 2022).

[126] *Life Insurance Companies, General Accounts; Total Financial Assets, Level*, FRED, https://fred.stlouisfed.org/series/BOGZ1FL544090075Q (last visited Nov. 7, 2022). Some life insurers also have "separate accounts," which hold

their liability risk. In other words, insurers must invest so that they minimize the risk that they will not be able to make payouts related to death benefits and surrenders. Life insurer investment portfolios are therefore notably conservative, with a full three-quarters of general account assets invested in bonds, mostly in corporate bonds.[127]

Because life insurer general account investment portfolios are highly concentrated in fixed-income assets (bonds) rather than equities, their investment returns flag when interest rates are lower.[128] Life insurers' financials suffer if interest rates decline greatly for extended periods of time, as they must still credit interest to policyholders at rates that were guaranteed when promises of higher minimum returns were much more feasible, while being able to offer new policyholders less favorable interest guarantees.[129] In the 1980s, when § 7702 was enacted, the United States federal funds rate was at an all-time high.[130] The rate, and corporate bond yields along with it, have collapsed since then:

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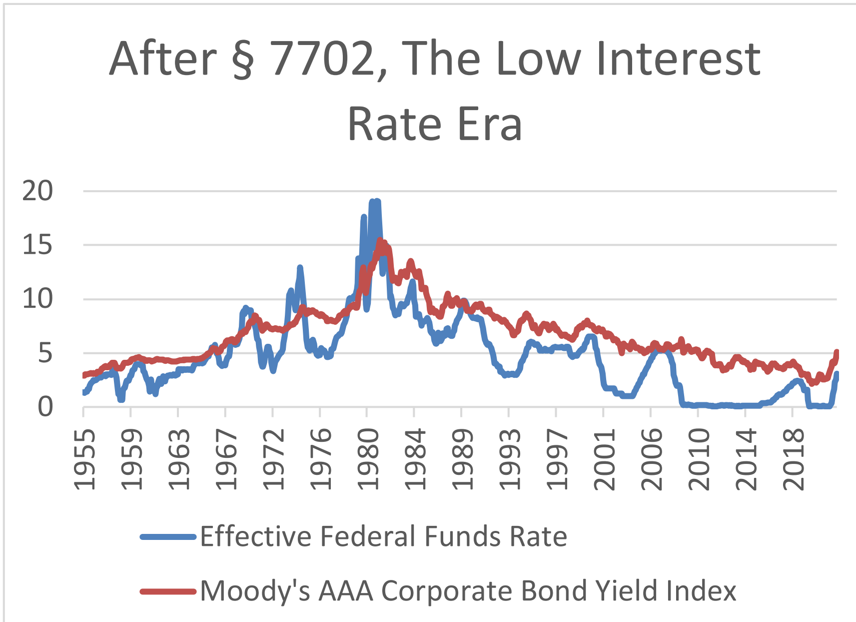
variable annuity-affiliated investments in which the policyholder is bearing the risk.

[127] Robert McMenamin, et al., *What Do Life Insurers Invest In?*, CHI. FED. LETTER (2013).

[128] *Id.*

[129] In countries like Germany, the situation is more extreme. *See generally* Berdin & Gründl, *supra* note 124. *See also* Leslie Scism, *Universal Life Insurance, a 1980s Sensation, Has Backfired*, WALL ST. J. (Sept. 19, 2018, 10:54 AM ET), https://www.wsj.com/articles/universal-life-insurance-a-1980s-sensation-has-backfired-1537368656. The low interest rate era has also increased the financial fragility of insurers due to increased interest risk exposure, particularly among insurers with relatively higher business concentration in products with return guarantees. Ralph S. J. Koijen & Motohiro Yogo, *Global Life Insurers during a Low Interest Rate Environment*, 112 AEA PAPERS AND PROCEEDINGS 503, 503 (2022).

[130] Kate Davidson & Sudeep Reddy, *Paul Volcker, Who Guided U.S. Monetary Policy and Finance for Nearly Three Decades, Is Dead*, WALL ST. J. (Dec. 9, 2019, 7:45 PM), https://www.wsj.com/articles/paul-volcker-who-guided-u-s-monetary-policy-and-finance-for-nearly-three-decades-is-dead-11575901675.



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Some insurers have been selling their traditional life insurance businesses entirely, often to private equity firms.[132] The NAIC has tracked the decline of insurer portfolio yields as well as the decline of the contractually guaranteed rates offered to policyholders.[133]

The problem is deep, and the industry has responded: despite the long-term decline in the reach of life insurance to the American public and

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[131] *Federal Funds Effective Rate*, FRED, https://fred.stlouisfed.org/series/FEDFUNDS (last visited Nov. 7, 2022); *Moody's Seasoned Aaa Corporate Bond Yield*, FRED, https://fred.stlouisfed.org/series/AAA#0 (last visited Nov. 7, 2022). Data used is the monthly series for each index; the last data point available on the date of download was October 1, 2022. AAA bonds are the highest-rated (considered to be the most safe) corporate bonds.

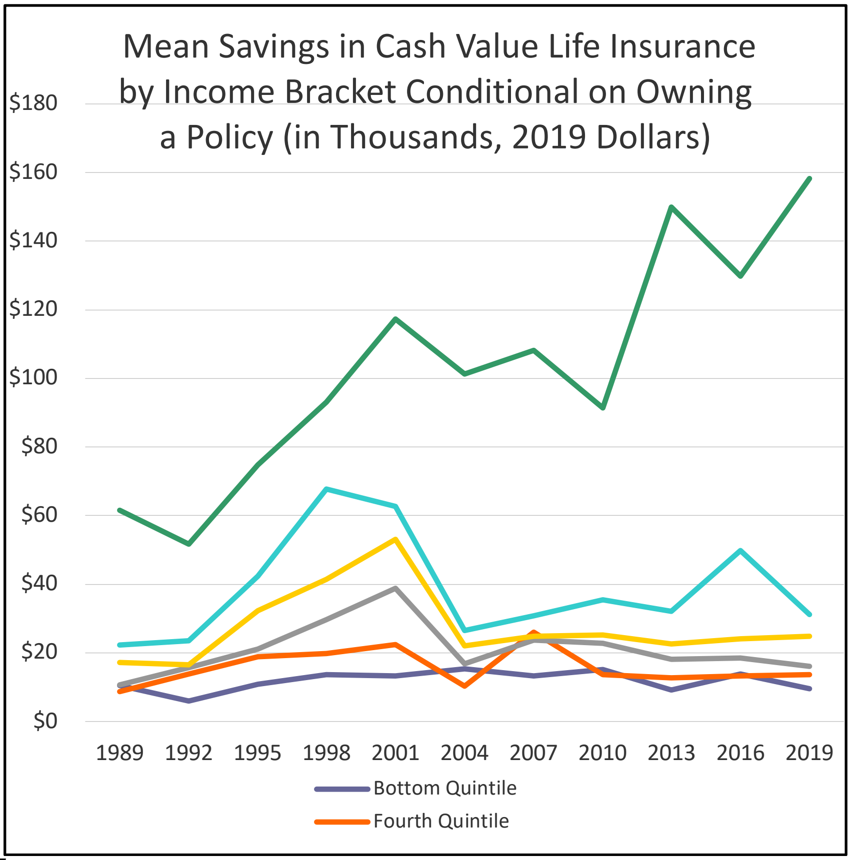
[132] Alwyn Scott, Nivedita Balu & David French, *AIG to Sell Life and Retirement Unit Stake to Blackstone, Another with IPO*, REUTERS (July 15, 2021, 4:03 PM), https://www.reuters.com/business/aig-sell-10-stake-life-retirement-business-blackstone-2021-07-14/.

[133] *Low Interest Rates*, NAIC, https://content.naic.org/cipr_topics/topic_low_interest_rates.htm (last visited Nov. 7, 2022).

decline in insurer returns on investment, total assets owned in the general accounts of the life insurance industry still hit all-time highs nearly every year.[134]

This seemingly paradoxical development is possible because of the increasing amount of premiums and assets flowing into the decreasing number of life insurance policies that remain. From 1989 to 2013, the average face value of term life insurance policies in force increased from \$156,000 to \$353,000, and the average face value of cash value insurance policies in force increased from \$158,000 to \$226,000.[135] The average value of the savings inside cash value policies increased by a much higher percentage than the face values did, going from an average of \$20,000 to \$36,000.[136] (Figures are in 2013 dollars to adjust for inflation). These averages do not tell the full story. Delving into the Survey of Consumer Finances and updating the data to 2019, it becomes apparent that the top decile of incomes has driven almost the entire growth of the average amount of cash value since the 1980s, among policies that remain in force:

[134] FRED, *supra* note 126.
[135] Hartley et al., *supra* note 20.
[136] *Id.*



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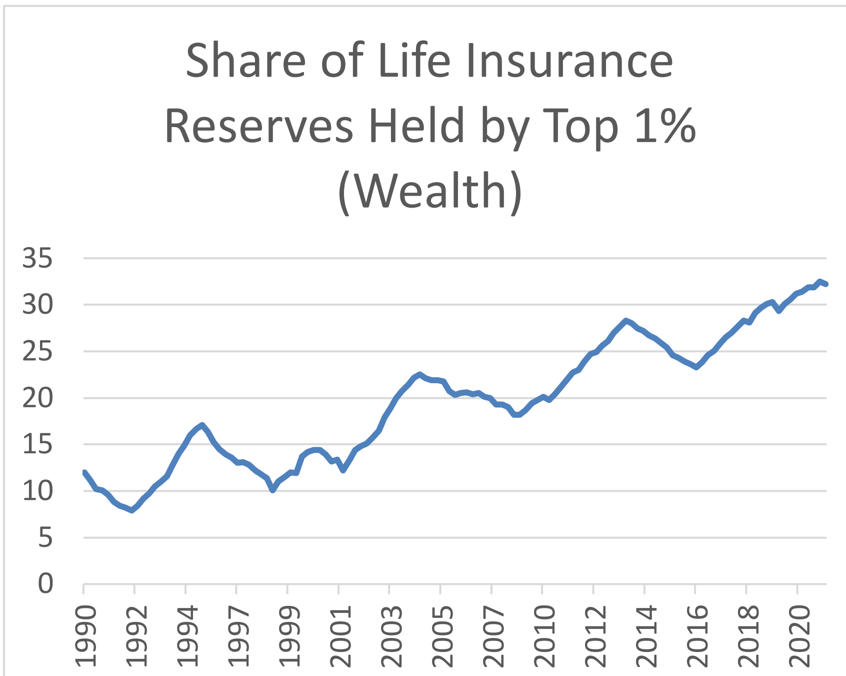
A team of economists, confirming the increasing link between policyholder affluence and cash value ownership, also found that even after controlling for wealth, proxies for financial sophistication predict increased cash value ownership during this period.[138] But most shockingly, during this

[137] *Survey of Consumer Finances, 1989-2019*, BD. GOVERNORS. FED. RSRV. SYS., https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Cash_Value_Life_Insurance;demographic:nwcat;population:all;units:mean;range:1989,2019 (last visited Nov. 7, 2022).

[138] Proxies used, from the Survey of Consumer Finances, were "(1) willingness of the respondent to accept some financial risk, (2) whether the respondent revolves more than 50 percent of their credit card limit, (3) stock

same period, the share of life insurance reserves held by individuals in the top 1% of the wealth distribution skyrocketed from 13% at the end of the 1980s to an all-time high of 32% today.



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In 2010, when the share of reserves held by the top 1% of the wealth distribution was at a then all-time-high of 22%, an article appeared in the Wall Street Journal covering nervousness in some insurance circles about the increasingly upscale nature of the industry once known for providing a safety net for working class and immigrant communities.[140] Multiple current and former insurance executives told reporters that they were concerned Congress would take another look at scaling back the industry's tax preferences, as it had considered doing in the 1980s, and that the industry

ownership, and (4) the SCF interviewer's assessment of the respondent's understanding of personal finance." Mulholland et al., *supra* note 121.

[139] *Share of Life Insurance Reserves Held by the Top 1% (99th to 100th Wealth Percentiles)*, FRED, https://fred.stlouisfed.org/series/WFRBST01123 (last visited Nov. 7, 2022).

[140] Maremont & Scism, *supra* note 38.

would have less political clout to fight back.[141] As it turned out, the opposite would happen. The industry, now more financially dependent on elite customers shopping for maximally tax-efficient savings instruments, would have increased financial incentive to expand the scope of the life insurance tax exemption, and Congress would acquiesce without a fight.[142]

2. § 7702 Amended and the New Landscape of Cash Value Life

The 2020 amendment to § 7702 was passed in the omnibus Consolidated Appropriations Act of 2021 (CAA) on December 27, 2020.[143] The amendment was as follows: the 4% floor threshold for the simulated interest crediting rate used in the cash value accumulation test (CVAT) and guideline level premium (GLP) of the guideline premium test (GPT) was replaced by a new rate called the "applicable accumulation test minimum rate" (AATMA).[144] The 6% floor threshold of the guideline single premium (GSP) of the GPT was also replaced by a new rate called the "applicable guideline premium minimum rate" (AGPMR).[145] The AGPMR is simply the AATMA plus two percentage points,[146] so the difference between the GSP minimum simulated interest crediting rate and the corresponding rate for the CVAT and GLP remains the same as before. The significant change comes from replacing the previous 4% lower bound with the AATMA.

The statutory construction of the new AATMA is convoluted (a summary infographic of AATMA computation is at the end of this Section for simplicity), but its general structure is as follows. While previously, the interest crediting rate to be used in the CVAT and GLP was the rate guaranteed on issuance of the contract with a lower bound at 4%, as amended, the lower bound of the interest crediting rate used in the simulation is based on a formula involving a calculation of long-duration life insurance

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[141] *Id.*

[142] *See* discussion *infra* Sections II.B.2, III.C.

[143] Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, § 205, 134 Stat. 1182 (2020) (amending I.R.C. § 7702). The legislative language of the amendment first appears in the proposed Health and Economic Recovery Omnibus Emergency Solutions Act (HEROES Act), which was formally introduced in the House on May 12, 2020. H.R. 6800, 116th Cong. § 40308 (2020). The language used in the HEROES Act and CAA is identical.

[144] § 205(a)(1), 134 Stat. (amending I.R.C. § 7702(b)(2)(A)); § 205(c)(1), 134 Stat. (amending I.R.C. § 7702(c)(4)).

[145] § 205(b)(1), 134 Stat. (amending I.R.C. § 7702(c)(3)(B)(iii)).

[146] *Id.* at § 205(b)(2) (amending I.R.C. § 7702(c)(3)(E)).

valuation interest rates and U.S. Treasury bond yields which maxes out at 4%.[147] The new formulation thus guarantees that the new minimum interest crediting rate for § 7702 simulation purposes will be at least as low as it was under the old formulation and will be substantially lower in low-interest-rate periods. The mechanical result of the change is that insurers will be able to sell life insurance products with a greater investment orientation and less net amount at risk in low-interest rate periods than they were under the previous § 7702 formulation.

The AATMA is defined as the lesser of "an annual effective rate of 4%" (the floor under the old calculation) and another new concept called the "insurance interest rate."[148] The insurance interest rate, in turn, is defined as the lesser of the "section 7702 valuation interest rate" for the year and the "section 7702 applicable Federal interest rate" for the year.[149]

The § 7702 valuation interest rate for a given year is "the prescribed U.S. valuation interest rate for life insurance with guaranteed durations of more than 20 years," as defined by the NAIC.[150] The valuation interest rate in this context is an assumption about the rate of return on investment of assets purchased with premiums for long-duration life insurance.[151] The NAIC, in an effort to help standardize reserve calculations, puts out a Valuation Manual, and its most recent update came out in 2021.[152] The valuation interest rate the NAIC employs is the output of a formula based on the recent monthly averages of the Moody's AAA (seasoned) corporate bond yield index.[153] As interest rates have declined, the relevant valuation interest rate has declined as well, to 3%.[154] The following infographic presents the calculation of the valuation interest rate: [155]

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[147] *Id.* at § 205(d) (adding I.R.C. § 7702(f)(11)).

[148] *Id.* at § 205(a)(3) (amending I.R.C. § 7702(b)(3)).

[149] *Id.* at § 205(d) (adding I.R.C. § 7702(f)(11)(A)).

[150] *Id.* at § 205(d) (adding I.R.C. § 7702(f)(11)(B)).

[151] AM. ACAD. OF ACTUARIES, ANNUITY RSRV. WORK GRP., REPORT OF THE ANNUITY RESERVE WORK GROUP TO THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS' LIFE AND HEALTH ACTUARIAL TASK FORCE 4 (2009).

[152] *See generally* NAT'L ASS'N INS. COMM'RS, VALUATION MANUAL (2021) [hereinafter Valuation Manual].

[153] WILLIS TOWERS WATSON, PRESCRIBED U.S. STATUTORY AND TAX INTEREST RATES FOR THE VALUATION OF LIFE INSURANCE AND ANNUITY PRODUCTS 4 (2020).

[154] *Id.* at 2.

[155] *See* Valuation Manual, *supra* note 152, at 20-13, 20-14.

Calculating the Valuation Interest Rate:

1. Per NAIC instructions, calculate, for each year:
   a. Valuation Interest Rate = .03 + W*(R1 - .03) + (W/2)*(R2 - .09).
      i. W = a weighting factor (.5 if guaranteed coverage duration is ten or less years, .45 if ten to twenty years, .35 if greater than twenty years).
      ii. R1 = the lesser of R and .09.
      iii. R2 = the greater of R and .09.
      iv. R = the lesser of the monthly average of the last 36 months of the Moody's AAA corporate bond index, ending on June 30 of the prior year, and the last 12 months of the same metric.
2. Round the result in each year to the nearest .25.
3. If the valuation interest rate for a year is only .25 different than that of the previous year, then the rate does not change from the previous year.

It should be noted that because the NAIC is an association of regulators tasked with the stability and preservation of the insurance system, its valuation methods, by its own description, are risk-averse and conservative.[156] In the 1980s, the NAIC's valuation interest rate formula produced a rate of only 6%—at a time when the Moody's AAA corporate bond yield index, on the conservative side of an insurer's general account investment portfolio, was about 9%. When corporate bond yields are below 9%, as they have been in every decade except the 1980s (using a data source that begins in the 1950s),[157] the valuation interest rate formula for long-duration polices simplifies to a quite low number, [.0195 + (the lesser of two averages of recent AAA yield rates * .35)], which does not even reach the actual AAA yield rate until the AAA yield rate hits 3%.[158] The choice of a formula employed elsewhere as highly cautious guidance to avoid future insurer insolvencies outwardly suggests seriousness and prudence but, in fact, encourages the development of policies that the industry feared were too feral in the 1980s.

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156 *See* Valuation Manual, *supra* note 152, at 5 (explaining that "[r]eserve requirements prescribed in the Valuation Manual are intended to support a statutory objective conservative valuation to provide protection to policyholders and promote solvency of companies against adverse fluctuations in financial condition or operating results").

157 FRED, *supra* note 131.

158 Valuation Manual, *supra* note 152. As I = .03 + W*(R1 - .03) + (W/2) * (R2 - .09), when $R < .09$ the latter term in the formula goes to 0 and drops out (because R2 is the greater of R and .09). That leaves I = .03 + W*(R1 - .03) where R1=R and W=.35. Rearranging, the formula simplifies to I = .0195 + .35*R. To solve for the R where I = R, set I = R in I = .0195 + .35*R and simplify algebraically.

Turning to the other prong of the AATMA, the § 7702 applicable federal interest rate is the average, rounded to the nearest whole percentage point, of the "Federal mid-term rates" as of the beginning of the most recent 60 months ending the most recent year in which NAIC revises its valuation interest rate.[159] Federal mid-term rates are the yields of U.S. Treasuries with maturities of three to nine years, officially published every month by the I.R.S.

Again, as in the § 7702 valuation interest rate, the § 7702 applicable federal interest rate formula is structured to produce quite a small numerical outcome. Federal mid-term rates, which decrease in times of expansionary monetary policy, have been less than 4% since January 2008, bottoming out at 0.35% in September 2020.[160] Indeed, interest rates on government debts broadly, but particularly for U.S. Treasuries, have been at record lows (with some ebbs and flows) over the past two decades, with many economists theorizing that a "global savings glut" in countries like China has created a naturally lower equilibrium level of interest.[161]

It should be noted that this article was mainly written in the 2021 period of rock-bottom interest rates, but final edits to this article are being made in early November of 2022, a year that has seen substantial rate hikes (though the federal funds rate remains below already-low mid-2000s rates).[162] If rates continue to spike, because the § 7702 applicable federal interest rate will only update following a year in which the NAIC valuation interest rate changes, there will be a built-in lag for insurers to continue issuing policies using the lower floor. Since 2000, the NAIC has only changed its valuation rate three times (in 2006, 2013, and 2021)[163] because its formula has a built-in delay provision that requires a significant change

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[159] § 205(d), 134 Stat. (adding I.R.C. § 7702(f)(11)(C)).

[160] Rev. Rul. 2008-04, Table 1 I.R.B. 246; Rev. Rul. 2020-16, Table 1 I.R.B. 660; Rev. Rul. 2022-3, Table 1 I.R.B. 449. The federal mid-term rates for each month since January 2000 are available at https://www.irs.gov/applicable-federal-rates.

[161] *See generally* Ben Bernanke, The Global Saving Glut and the U.S. Current Account Deficit (2005), *in* FED. RSRV. BD.; Lawrence Summers, *U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound*, 49 BUS. ECONS. 65, 70–71 (2014).

[162] Jeff Cox, *Fed Approves .75-Point Hike to Take Rates to Highest Since 2008 and Hints at Change in Policy Ahead*, CNBC (Nov. 2, 2022), https://www.cnbc.com/2022/11/02/fed-hikes-by-another-three-quarters-of-a-point-taking-rates-to-the-highest-level-since-january-2008.html.

[163] WILLIS TOWERS WATSON, *supra* note 153, at 14.

in the Moody's AAA bond index before performing a recalculation.[164] Additionally, to reiterate, when the valuation rate does change, the recalculation of the § 7702 applicable federal interest rate will be computed using an average of the most recent five years ending in the December prior to the year of the change, giving the prior low interest rate period great ballast in weighing down the average in a period of rising rates. As with the § 7702 valuation interest rate, the § 7702 applicable federal interest rate ties itself to a common and relevant economic indicator that drives its outcome variable lower and enables the selling of life insurance with less actual insurance in it.

The new rules for § 7702 apply in full beginning in 2022; policies issued in 2021 used a bridge insurance interest rate of 2%.[165]

The following figure demonstrates what the AATMA would have been over the past fifteen years had it been enacted in 2006, as well as what the AATMA is in 2022:

[164] *See* Valuation Manual, *supra* note 152. To restate: the valuation interest rate is rounded to the nearest .25, and if the rate in the next year rounds to being only .25 away from the prior year's rate, then the valuation interest rate does not change. Thus, the new rate must be two units of .25 away in order for the rate to change.

[165] Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, § 205(d), 134 Stat. 1182 (2020) (adding I.R.C. § 7702(f)(11)(E)).

Minimum Allowed Interest Crediting Simulated Rate (CVAT, GLP)				
Year	Under Old 7702 Rule	Section 7702 Valuation Interest Rate	Section 7702 Applicable Federal Interest Rate	Applicable Accumulation Test Minimum Rate (under New 7702 rule)
2006	4%	4%	4%	4%
2007	4%	4%	4%	4%
2008	4%	4%	4%	4%
2009	4%	4%	4%	4%
2010	4%	4%	4%	4%
2011	4%	4%	4%	4%
2012	4%	4%	4%	4%
2013	4%	3.5%	2%	2%
2014	4%	3.5%	2%	2%
2015	4%	3.5%	2%	2%
2015	4%	3.5%	2%	2%
2016	4%	3.5%	2%	2%
2017	4%	3.5%	2%	2%
2018	4%	3.5%	2%	2%
2019	4%	3.5%	2%	2%
2020	4%	3.5%	2%	2%
2021	4%	3%	2%	2%
2022	4%	3%	2%	2%

As the above graphic illustrates, when the NAIC's valuation interest rate decreased by enough in 2013 to warrant a change in the § 7702 valuation interest rate, the resulting change in the § 7702 applicable federal interest rate would have been enough to cut the AATMA in half. Up until the actual enactment of the amendment, the AATMA would have remained at 2%, where it remains as of this writing in November 2022, substantially below the 4% minimum rate prescribed by the old § 7702 statute. The AGPMR, defined to be the AATMA plus two percentage points,[166] would have declined to 4% from 6%, and so would have been reduced by a third.

The following infographic summarizes the navigation of the 2020 § 7702 amendment for the CVAT and GLP tests:

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[166] *Id.*

What Rate of Interest Is Credited to the Policy in the Post-2021 § 7702 Simulation?

If the actual contract guarantees a return of over 4% at issuance, credit that guaranteed return.

If the actual contract does not guarantee a return of over 4% at issuance:

1. Calculate the 'section 7702 valuation interest rate' (calculated by the NAIC; based on a formula that is a function of the Moody's AAA corporate bond yield index).
2. Calculate the 'section 7702 applicable Federal interest rate' (equal to the rounded average of the Federal mid-term Treasury rates of the 60 months prior to the most recent year the NAIC changed the valuation interest rate).
3. Take the lesser of (1) and (2); this is called the 'insurance interest rate'.
4. Take the lesser of (3) and 4%; this is called the 'applicable accumulation test minimum rate' (AATMA).
5. If the actual contract guarantees a return that is not over 4% but is equal to or greater than AATMA, credit that guaranteed return. If not, credit the AATMA rate.

IV. § 7702 GOING FORWARD: FALLOUT AND IMPLICATIONS

This Article has contextualized the adoption of § 7702 as a political compromise made necessary by the economics and tax treatment of cash value life insurance. It has also covered the events that have taken place since then: the slow decline of the life insurance industry from near-universal prominence and the corresponding turn towards a role as a tax shelter for the affluent, and the significant amendment to § 7702 that was enacted in December 2020. But why was this amendment so consequential to § 7702 and (some) life insurance policyholders, and what does its passage illustrate about the new reality of the life insurance industry? Part III will cover the political economy implications of the 2020 amendment and why it crystallizes the industry's turn towards elite service. It will examine the impact that the 2020 amendment may have on future federal budget revenues, and why a Joint Committee on Taxation ten-year projection likely heavily understates its long-term impact. It will also examine the contrast between the passage of the original § 7702, which was a years-long public brawl, and the almost completely unnoticed nature of its amendment, which carries great implications for future design of legislation so as to avoid industry capture. Lastly, it will evaluate the amendment to § 7702 in the public policy context for life insurance's preferential tax treatment and conclude with policy recommendations to address the situation.

A. OPENING THE FLOODGATES: HOW § 7702'S AMENDMENT PUTS LIFE INSURANCE CLOSER TO CENTER STAGE OF TAX AVOIDANCE FOR THE WELL-OFF

1. The Impact of § 7702's Amendment on Cash Value Life Insurance as a Tax Shelter

a. expanding premium stuffing capability

How much less insurance is there required to be in a cash value insurance policy as a result of the change? As of this writing (November 7, 2022), the AATMA remains at 2%. The amount of cash value that a 45-year-old nonsmoking male could put into a whole life policy with a $225,000 face value, as measured by the net single premium, increases from $49,500 at an assumed 4% interest rate to $102,400 at an assumed 2% rate—more than doubling it.[167] (I use a $225,000 face value for the example because it is roughly the face value of the average life insurance policy; I will discuss later in this article that it is much higher face value policies owned by a small subset of policyholders that are likely to take full advantage of the policy change.)[168] For younger policyholders, the difference is even more dramatic, as the increase in net single premiums for a 25-year-old policyholder is from $25,300 to $72,100, nearly tripling the investment capacity of the policy.[169] My direct calculations match the estimates made by industry professionals; policies evaluated under the GP and CVCT tests experience increases in investment capacity only modestly less in magnitude.[170]

The following infographics illustrate the impact of the new 2% floor on net single premiums (and, therefore, on the amount of cash surrender value permitted by the CVAT) on a policy with a face value of $225,000 (a fairly typical policy) and a policy with a face value of $5,000,000 (an atypical policy owned by a wealthy policyholder):

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[167] Online Data and Calculations Appendix, *supra* note 92. Numbers are rounded to the nearest hundred.

[168] Hartley et al., *supra* note 20.

[169] *Id*.

[170] Phil Ferrari, et al., Product Tax and Company Tax Update, Society of Actuaries 2020 Virtual Annual Meeting & Exhibit 15 (2020); Alan Jadhe, *The New IRC 7702 Rules – Did Congress Make Life Insurance More Affordable?*, INVS. PREFERRED (Jan. 14, 2021), https://www.investorspreferred.com/irc7702rules; Michael Liebeskind & Bryan Bloom, *New Law Changes Interest Rate Assumptions for Life Insurance*, WEALTH MGMT., https://www.wealthmanagement.com/high-net-worth/new-law-changes-interest-rate-assumptions-life-insurance.

Impact of a 2% Assumed Interest Rate on Net Single Premiums

Employing the 2017 Commissioners Standard Ordinary unloaded mortality tables associated with a male nonsmoker, the net single premium for a newly issued whole life, policy with a level face amount of $225,000 is:

	If the policyholder is 25:	If the policyholder is 45:	If the policyholder is 65:
If the interest rate used is 6%:	$9,900	$25,500	$64,200
If the interest rate used is 4%:	$25,300	$49,500	$94,500
If the interest rate used is 2%:	$72,100	$102,400	$143,600

Impact of a 2% Assumed Interest Rate on Net Single Premiums

Employing the 2017 Commissioners Standard Ordinary unloaded mortality tables associated with a male nonsmoker, the net single premium for a newly issued whole life, policy with a level face amount of $5,000,000 is:

	If the policyholder is 25:	If the policyholder is 45:	If the policyholder is 65:
If the interest rate used is 6%:	$220,100	$567,200	$1,425,600
If the interest rate used is 4%:	$562,200	$1,100,400	$2,100,100
If the interest rate used is 2%:	$1,602,400	$2,276,200	$3,190,100

[171]

[171] Online Data and Calculations Appendix, *supra* note 92. Numbers are rounded to the nearest hundred.

An increase in investment capacity, because it increases as a ratio of the original capacity, delivers much higher absolute dollar increases of investment capacity to insurance policies with higher face values. As shown above, when dropping the assumed interest rate from 4% to 2%, the 25-year-old male nonsmoker who owns a $225,000 whole life policy will gain about $45,000 in cash value investment capacity, but the one who owns a $5,000,000 policy gains over a million dollars in such capacity. Therefore, the more a person chooses to invest in life insurance, the more valuable the 2020 amendment is to that person. The structure of the amendment creates a self-reinforcing cycle to attract very high net worth individuals to the insurance sector.

The main data source for tracking estimates of the amount of actual cash value people have in cash value life insurance is the Survey of Consumer Finances.[172] The survey is performed every three years and is next scheduled to be released in 2023,[173] at which point policymakers will be able to observe more directly the level of shift into cash value policies that results from the change. Fairly broad insurance sales data from 2021 reports record-breaking sales of new policies,[174] including "a 6.2% increase in the number of whole life policies . . . making the first positive result since 2016" and a 17.1% increase in the "aggregate amount of insurance issued under whole life policies and endowments . . . which stands as the highest year-over-year rate of expansion since 1997."[175] More time and more detailed data will be required to thoroughly evaluate the causal impact of the amendment on sales of the § 7702 change, especially in light of the COVID-19 pandemic, but preliminary evidence suggests a cash value life surge.

b. *a conceptual note on premium stuffing*

A skeptical observer may ask here, following the previous subsection on the impact of the new rules permitting more cash value to be

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[172] Hartley et al., *supra* note 20 (employing data from this survey).

[173] BD. GOVERNORS FED. RSRV. SYS., FR 3059; OMB NO. 7100-0287, SUPPORTING STATEMENT FOR THE SURVEY OF CONSUMER FINANCES (2021).

[174] *LIMRA: First Quarter U.S. Life Insurance Policy Sales Highest Since 1983*, LIMRA (May 27, 2021), https://www.limra.com/en/newsroom/news-releases/2021/limra-first-quarter-u.s.-life-insurance-policy-sales-highest-since-1983/.

[175] Tim Zawacki, *Historic 2021 US individual life, annuity premium growth a tough act to follow*, S&P GLOB. MKT. INTEL. (Mar. 22, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/research/historic-2021-us-individual-life-annuity-premium-growth-a-tough-act-to-follow.

put inside of a given policy, why would that matter to a wealthy person seeking to minimize taxes? If an affluent policyholder wants to increase the amount of cash value it owns, which is subject to highly favorable tax treatment, why couldn't the policyholder simply purchase a larger policy, one where the death benefit would be sufficiently large so as to enable the desired amount of premiums to fit within the § 7702 rules? After all, § 7702's restrictions are relative to "the future benefits under the contract,"[176] and it is true that a person with sufficient resources could afford to purchase a life insurance policy with an extremely high death benefit.[177]

Simply ratcheting up the death benefit of the policy so as to allow for additional premiums and investment capacity, however, is costly.[178] As covered in the explanation of cash value life, insurers charge policyholders fees that correspond to the actuarial cost of the policy, which in turn corresponds to the returns the life insurer is receiving on its investments, the risk that the insurer will have to make a death benefit payout, and the amount of payout that the insurer would have to make.[179] For a given death benefit, when the cash value inside of a policy increases, the net value at risk to the insurer decreases, translating into an (all else equal) lower fee to the policyholder. But when a policy has a higher death benefit, the net value at risk to the insurer increases, requiring higher fees to sustain the policy.

Because the 2020 § 7702 change allows for more premiums to be placed into the policy when AATMA is below 4%, that structure increases the relative attractiveness of cash value policies because the policyholder may make those tax-advantaged contributions while actually lowering the net value at risk to the insurer. This dynamic results in lower fees, which in turn results in faster cash value accumulation *on top of* the higher permitted premium contribution.

In sum, the § 7702 amendment enables insurers to claim favorable tax treatment for products that have moved substantially closer to simply being a mutual fund rather than a term life insurance policy. Policyholders cannot replicate the effect of the amendment by simply purchasing a cash value policy with a higher death benefit alone.

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[176] I.R.C. § 7702(b)(1); I.R.C. § 7702(c)(3)(A).

[177] The Guinness Book of World Records reports that the most valuable life insurance policy in the world has a face value of $201 million. *Mystery Billionaire Takes Out Historic $201 Million Life Insurance Policy*, GUINNESS WORLD RECS. (Mar. 13, 2014), https://www.guinnessworldrecords.com/news/2014/3/mystery-billionaire-takes-out-historic-$201-million-life-insurance-policy-56096.

[178] *See supra* Section I.A.

[179] Pike, *supra* note 7, at 497.

2. The New Political Economy of the Life Insurance Industry

This article has covered the empirical evidence of the increasing reliance of the life insurance industry on elite clientele[180] and the § 7702 amendment's bearing on making cash value an increasing suitable product for tax avoidance.[181] This section on the life insurance industry's ongoing transformation into a more unambiguous vehicle for tax avoidance by the affluent includes with three remarks: first, an analysis of the life insurance industry's argument for the amendment; second, an illustration of the industry's embrace of explicitly patrician private placement life insurance; and third, a contrast with the insurance industry's behavior during the 1980s.

a. industry justification for the § 7702 change

To the extent that the industry has offered a public justification for the § 7702 amendment in the months after its passage, it has argued that the decrease of the required interest crediting rates for § 7702 testing purposes is a technical change made necessary by the collapse in interest rates. ACLI Senior Vice President of Policy Development Paul Graham told the Wall Street Journal that insurer yields "dropped to the point they were bumping up against their ability to pay that 4% interest rate on their policies," and that without the amendment, "whole life as we knew it would be severely compromised and may no longer exist."[182] An ACLI talking points list on the amendment criticizes the "hard-coded interest rates" of the old test, which it emphasizes were written, "when interest rates were 10 percent and higher."[183]

While it is true that life insurer financials have taken a beating from the low interest rate era, this explanation performs a slight of hand. As covered earlier, the previous 4% and 6% § 7702 interest rate floors were not restrictions on actual insurance policies, but were actuarial guardrails solely used for § 7702 simulation testing purposes to make sure that a policy did not have an excessive orientation towards investment rather than actual

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[180] *See supra* Section II.B.1.

[181] *See supra* Section III.A.1.

[182] Leslie Scism, *A Small Tax Change Is a Boon for Permanent Life Insurance*, WALL ST. J. (Jan. 10, 2021), https://www.wsj.com/articles/a-small-tax-change-is-a-boon-for-permanent-life-insurance-11610283602.

[183] AM. COUNCIL LIFE INSURERS, CONSOLIDATED APPROPRIATIONS ACT UPDATES TO INTERNAL REVENUE CODE SECTION 7702, at 1–2 (2021) [hereinafter ACLI Talking Points].

insurance.[184] At no point did § 7702 mandate that a life insurance policy offer any specific minimum return to a policyholder, at 4% or any other threshold. The previous 4% floor was a political compromise to mechanically cap the level of investment orientation rather than insurance orientation that a cash value policy could have.[185]

The ACLI's talking points sheet also argues that "the changes will benefit all consumers by ensuring appropriate and actuarially sound relationships between cash value and premium limits to death benefits in very low interest rate environments."[186] Again, this point is incomplete and misleading. The § 7702 amendment impacts all cash value policies, but the ACLI knows that cash value insurance has already become a product line strongly weighted towards the wealthy, that few middle-and-lower income households purchase cash value policies, and that the middle-and-lower income households who do have them have relatively little savings stored in those policies.[187] Middle and upper-middle class households tend to put more savings into other tax-advantaged vehicles like IRAs and 401(k) plans, which roughly half of American households use.[188] Policyholders of term life insurance, who represent a broader cross-section of the American public,[189] are unaffected by the amendment. Lastly, the structure of the amendment, because it increases cash value investment capacity as a ratio of the prior capacity, offers augmented rewards to very high net worth policyholders who have the means to purchase policies with even higher face values.[190]

Lastly, the ACLI talking points include an argument that the cash value corridor, because it remains unchanged, "safeguards the integrity of life insurance from being used as an investment product."[191] However, the cash value corridor only applies to policies evaluated under the GPT and CVCT dual test, not the CVAT test.[192] Additionally, while it is true that the cash value corridor sets an age-based maximum ratio of accumulated cash value to death benefit for a policy, it is the GPT that sets limits on policyholders' ability under the dual test to take advantage of the flexibility in premium payments of universal life to simply contribute the maximum

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184 *See supra* Section II.A.

185 Harman, *supra* note 64.

186 ACLI Talking Points, *supra* note 183, at 2.

187 *See supra* Section II.B.1.

188 CHERYL R. COOPER & ZHE LI, CONG. RSCH. SERV., RL 46441, SAVING FOR RETIREMENT: HOUSEHOLD DECISIONMAKING AND POLICY OPTIONS 5 (2020).

189 Hartley et al., *supra* note 20.

190 *See supra* Section III.A.1.a.

191 ACLI Talking Points, *supra* note 183, at 2.

192 I.R.C. § 7702(a).

amount of money the CVCT allows up front and let interest take the wheel.[193] The CVCT is still enforced, but the changes to the GPT permit policyholders substantially more freedom to reach those outer limits, as industry members acknowledge.[194]

The villain for life insurers in this story is the low interest rate environment, which, unlike the old rules of § 7702, poses genuine difficulty for policyholders and providers. In a prolonged low interest rate period, to sustain a policy, policyholders will be required to contribute additional premiums so that the premiums can support the contractual death benefit. The requirement to put in additional money to sustain the same policy, or to be told up front that more payments will be required in order to establish a contract, reduces the appeal of cash value life.[195] One might feel sympathy for businesses put in this position, where their profitability depends substantially on interest rates that are out of their control and that have presented significant difficulty for years, but it does not follow that the appropriate policy response is to permit the insurance industry to sell tax-advantaged products with less insurance in them.

b. *private placement life insurance and the turn towards elite professional service*

The impact of the § 7702 amendment will likely be seen most starkly in the areas of insurance that exemplify the industry's trend away from mass-market policies and towards tax-aggressive products aimed at the wealthy. Private placement life insurance (PPLI) is a prominent example. PPLI, a subtype of variable universal life insurance (a type of universal life in which the bulk of the premiums are invested in insurer-approved asset classes and the policyholder assumes more risk), requires individualized negotiation with an insurance provider.[196] The distinguishing feature of PPLI is that

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[193] *See supra* Section II.A.2.

[194] Stu Kwassman, *Recent Change to IRC § 7702 Interest Rates and Impact on Life Insurance Products*, SOC'Y ACTUARIES (Feb. 2021), https://www.soa.org/sections/product-dev/product-dev-newsletter/2021/february/pm-2021-02-kwassman/.

[195] Scism, *supra* note 182.

[196] PPLI should not be confused with private placements as a whole, as the general term "private placement" usually only refers to a sale of securities in a manner that is exempt from registration with the Securities and Exchange Commission. *Private Placements Under Regulation D*, SEC, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements (June 10, 2022).

while most variable universal life policies have a fairly limited selection of assets and funds in which the policyholder can invest, PPLI enables policyholders to invest in highly specialized asset classes, most notably hedge funds.[197]

The main restriction on PPLI is that, under the "investor control doctrine," the assets of a life insurance policy are required to be considered owned by the insurer, not the policyholder, for life insurance tax treatment to apply.[198] A PPLI policyholder cannot therefore have full control over the asset allocation of the policy, though the exact degree of control possible has been contested and the policyholder may select the investment manager, and make initial asset allocations.[199] A PPLI policy must also meet certain investment diversification requirements under I.R.C. § 817.[200]

PPLI providers have long been quite open about the fact that the industry is aimed at eliminating the capital gains taxation of wealthy clients by letting them invest in hedge funds and other specialty investments tax-free. For example, PPLI provider Cohn Financial Group says on its website, "PPLI is designed as a tax efficient instrument, with the death benefit being secondary."[201] Purchasers of PPLI must meet the definitions of "qualified purchaser" and "accredited investor" under federal securities law (essentially, be a multimillionaire)[202] and are generally limited to policyholders who pay over $1 million in premiums.[203]

Information about the scale of the PPLI industry is very limited. In 2006, when the industry was still navigating relatively recent I.R.S. rulings

[197] Scott A. Bowman & Nathan R. Brown, *A Primer on Private Placement Life Insurance*, 88 FLA. BAR J. 52, 52 (2014).

[198] *See* Rev. Rul. 77-85, 1977-1 C.B. 12; *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1985); *Webber v. C.I.R.*, 144 T.C. 324, 325–26 (2015).

[199] Bowman & Brown, *supra* note 197 (citing Rev. Rul. 2003-92; 2003-2 CB 350; Rev. Rul. 2003-91; 2003-2 CB 347; I.R.S. Priv. Ltr. Rul. 200244001; I.R.S. Priv. Ltr. Rul. 9752061).

[200] I.R.C. § 817(h); Treas. Reg. § 1.817-5(a)(1).

[201] *Private Placement Investing*, COHN FIN. GRP., https://cfgllc.com/our-expertise/private-placement-investing/ (last visited Nov. 7, 2022).

[202] Bowman & Brown, *supra* note 197. The definition of an "accredited investor" is complex, but an individual may qualify by having a net worth of over $1 million or an income of over $200,000 a year for the past two years. 17 C.F.R. § 230.501 (2020). An individual can clear the definition of a "qualified investor" by owning $5 million in investments. 15 U.S.C. § 80a-2(a)(51)(A).

[203] Rachel E. Silverman, *Insuring Against Hedge Fund Taxes*, WALL ST. J. (Oct. 18, 2006, 12:01 AM), https://www.wsj.com/articles/SB116113678252396059.

that finally clarified the nature of the investor control doctrine,[204] "industry watchers" estimated to the Wall Street Journal that the size of the onshore PPLI market was a relatively small $4-5 billion.[205] Though small in 2006, PPLI was already attracting the attention of insurance giants like AIG, which offered forty PPLI investment options (called insurance dedicated funds, or IDFs).[206] Today, though individual information on PPLI administration is quite difficult to find publicly, there is evidence that it is increasingly widespread, and not just among niche firms.[207] One PPLI firm boasts that it administers IDFs attached to policies at heavyweights like John Hancock, Mass Mutual, Nationwide, New York Life, Pacific Life, and more.[208] Other major insurers like Prudential and Zurich offer PPLI products as well.[209]

While likely still a relatively small portion of the market (there are only so many people who can clear the securities regulation hurdles for entry), it is also likely that PPLI and structures like it will be the biggest winners of the § 7702 amendment. Six months after its passage, the chief life actuary of Zurich North America told insurance credit rating agency AM Best that his firm "is very active in the high net worth market, where signs point to the changes having the biggest effect."[210]

c. *The New Life Insurance Political Normal*

This Article emphasized, in my retelling of the enactment of § 7702, the role of respected life insurance firms in persuading Congress that life insurance's favored tax treatment should be kept in favor of casting out the most investment-oriented policies.[211] It was the major life insurance incumbents, after all, that had lobbied Congress to pass the precursor to §

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[204] Bowman & Brown, *supra* note 197.

[205] Silverman, *supra* note 203.

[206] *Id.*

[207] Heather Perlberg & Ben Steverman, *Blackstone's Tax-Free Hedge Fund Pitch Woos More Clients,* BLOOMBERG BUS. NEWS (May 29, 2018, 10:08 AM), https://www.bloomberg.com/news/articles/2018-05-29/blackstone-s-tax-free-hedge-fund-pitch-woos-even-more-clients.

[208] *Insurance Companies*, SALI FUND SERVS., https://www.sali.com/insurance-companies/ (last visited Nov. 7, 2021).

[209] Perlberg & Steverman, *supra* note 207; Robert D. Colvin & Michael B. Liebeskind, Introduction to Private Placement Life Insurance (PPLI) (2017).

[210] Terrence Dopp, *US Tax Changes Could Make Life Insurance More Popular*, BEST'S REV. (June 2021), https://news.ambest.com/articlecontent.aspx?refnum=308709&altsrc=2.

[211] *See supra* notes 58–75 and accompanying text.

7702 in the first place, and that had told Congress that some of their brethren had gone too far with offering policies with excessive investment orientations.[212]

Circa 2022, the coalition of the 1980s has shifted dramatically. At least three of the surviving firms that were on the Mutual Company Executive Committee that was so crucial at the 1983 Congressional hearings now offer PPLI.[213] The low interest rate period and transition away from the mass market and towards niche client services for the wealthy has left the industry with little appetite for the defensive political maneuvering of the § 7702 enactment era. And the industry is willing to spend. Per data from the Senate Office of Public Records, in 2020 the life insurance industry spent over $68 million in formally disclosed lobbying, making it one of the most donation-heavy sectors.[214] While it is difficult to discern what fraction of that spending was specifically done on § 7702 (many disclosure reports on specific lobbying issues employ phrases like "tax issues of importance to company" or "issues related to tax reform," which are unclear), it is immediately clear that the § 7702 reform was a focal point for the sector. One insurer, New York Life, spent $2.74 million alone in 2020 on "issues related to section 7702 of the Internal Revenue Code."[215] The ACLI does not fully disaggregate its spending and lobbies on a variety of issues, but it reports spending $3.7 million in total in 2020 on matters including § 7702 and the HEROES Act.[216]

The industry is emboldened by a supportive audience. The Chair of the House and Ways Committee and Chair of the Joint Committee on Taxation during 2020 was Democrat Richard Neal of Massachusetts (as of November 7, 2022, Neal remains in those positions). Neal, whose district

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212 1983 Hearings, *supra* note 67.

213 John Hancock, Massachusetts Mutual, and Prudential.

214 *Summary: Top Contributors, 2021-2022*, OPEN SECRETS, https://www.opensecrets.org/industries/indus.php?ind=F09 (last visited Nov. 7, 2022). Lobbying reports made to the Senate Office of Public Records filed pursuant to the Lobbying Disclosure Act of 1995 are most easily available via Open Secrets. The "Insurance" industry is listed as making $154 million in contributions in 2020, but this category also includes property & casualty and health insurance firms and lobbying organizations. To calculate the $68 million figure, I manually went through the Open Secrets list of insurance organizations that donated over $1 million in 2020 and separated out insurers that have a life insurance line of business and lobbying groups that include life insurance firms, agents, or brokers.

215 *Id.* New York Life spent $1.25 million on the issue in 2020Q1, $540,000 in Q2, $370,000 in Q3, and $580,000 in Q4.

216 *Id.*

includes the headquarters of Massachusetts Mutual, has received more contributions from the insurance sector than any other industry for decades.[217] Neal, also the co-chair of the House Financial Security and Life Insurance Caucus, co-won the 2016 Financial Security & Life Insurance Champion Award from the ACLI.[218] Seven months before the § 7702 amendment was formally proposed, Neal attracted controversy for presiding over a "centennial congressional reception" for the 100th anniversary of life insurer and 2008 congressional bailout recipient AIG, hosted in the hearing room of the Ways and Means Committee.[219]

Given current congressional leadership, there seems to be little congressional pressure to halt the life insurance sector's slow transition away from its cautious 1980s attitude. The economic factors that have eroded traditional mass-market life insurance business lines and pushed the sector towards high-net-worth tax planning, as well as political actors who are disinclined to interfere, have resulted in an ever-more aggressive embrace by the industry of its new role.

B. THE IMPACT OF THE § 7702 AMENDMENT ON FEDERAL TAX REVENUES

1. In the Long Run, We Are All Dead

The § 7702 amendment is likely to deprive the Treasury of billions of dollars in revenue each year, but its full financial impact is likely understated by existing analysis. When the text of the § 7702 amendment first appeared, it did so in the Health and Economic Recovery Omnibus Emergency Solutions Act (HEROES Act)—a House Democratic-supported bill—before being passed into law by the CAA.[220] The Joint Committee on

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[217] *Richard E Neal: Summary*, OPEN SECRETS, https://www.opensecrets.org/members-of-congress/richard-e-neal/summary?cid=N00000153&cycle=2020&type=C (last visited Nov. 7, 2022).

[218] *Reps. Tiberi, Neal Receive Financial Security and Life Insurance Champion Award*, ACLI (January 31, 2017), https://neal.house.gov/media-center/in-the-news/reps-tiberi-neal-receive-financial-security-and-life-insurance-champion (last visited Nov. 7, 2022).

[219] Zachary Warmbrodt, *A Decade After Massive Bailout, AIG Celebrated on Capitol Hill*, POLITICO (Oct. 28, 2019), https://www.politico.com/news/2019/10/28/a-decade-after-massive-bailout-aig-celebrated-on-capitol-hill-060851.

[220] H.R. 6800, 116th Cong. § 40308 (2020). The HEROES Act was sponsored by former Representative Nita Lowey (D-MA).

Taxation (JCT) released an analysis[221] that projected that the passage of the amendment would reduce federal income tax revenues by $3.3 billion over ten years,[222] a small additional amount relative to the hundreds of billions in tax subsidy to the industry in previously existing policy.[223] This Article will argue here that this figure, if viewed in the proper context, does not actually demonstrate that the impact of the amendment will be quite modest, at least for the numerically small clientele who are best positioned to take advantage of it.

A ten-year budget window is likely to give a misleading impression of the long-term impact of a provision like the 2020 § 7702 amendment. The amendment is a change to actuarial assumptions used in interest rates, enabling increased premium stuffing into tax-exempt cash value policies. This means that in each year following the passage of the amendment, the budgetary impact of the passage of the law will be in the taxes not collected on the additional amount of premiums going into cash value policies that would otherwise have produced taxable income.

Life insurance policies are not structured to deliver the bulk of their tax savings up front. Single premium policies are highly discouraged because, as covered above, they would be subject to modified endowment contract restrictions and not receive the full tax benefits of life insurance.[224] Flexible, rising, or level premium policies, which are the norm in cash value insurance, are structures in which payments are made over the course of many years. The tax savings from the credit interest are savings that will

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[221] The JCT is a Congressional committee made up of an equal number of House and Senate members and has a nonpartisan staff. The staff conducts analysis of the budgetary impact of proposed legislation and is required to do so over a ten-year budget window. JCT estimates proceed on the assumptions that Gross National Product is fixed and that all other law remains the same, and take into account likely taxpayer behavioral reactions to the proposed laws. *Revenue Estimating*, J. COMM. TAX'N, https://www.jct.gov/operations/revenue-estimating/ (last visited Nov. 7, 2022).

[222] J. Comm. on Tax'n, 116th Cong., JCX-16-20, at 4 (2020) (referencing the "minimum rate of interest for certain determinations related to life insurance contracts"). The JCT additionally released an analysis of the cost of a subsequent version of the bill and of the CAA that had an essentially identical analysis of the provision. J. Comm. on Tax'n, 116th Cong., JCX-21-20 (2020); J. Comm. on Tax'n, 116th Cong. JCX-24-20 (2020).

[223] U.S. DEP'T TREASURY OFF. TAX ANALYSIS, *supra* note 51, at 1 n.2 (2016).

[224] I.R.C. § 7702A. *See supra* text accompanying note 116.

come from compounding, which are small for quite a while before growing to become massive.[225]

Additionally, during each year of the policy that the policyholder is alive, the tax savings correspond only to the tax savings on the inside buildup. It is, of course, when the policyholder dies that the untaxed death benefit is bestowed (or, if the policyholder hits an age such as 95, the untaxed cash value is returned).[226] The death benefit is a payout far larger than any year of inside buildup, but the median age of a life insurance policyholder is about 48,[227] and the percentage of current policyholders who will die during the next decade is relatively small. Reduced revenues from an increasing number of tax-exempt death benefits will take a long time.

Lastly, as covered earlier, older cash value policyholders also gain relatively little from the § 7702 amendment—it is the youngest generations, policyholders under 40, who are most enabled to open the floodgates with premium stuffing.[228]

While the JCT report does not contain an explanation of its calculations, this trend can also be seen in the year-by-year breakdown it provides. The JCT projected the § 7702 amendment to only cost $8 million in 2021, but each year it increases steadily until 2030 (the final year analyzed), when JCT projects the amendment to cost $791 million.[229] That number will only grow with each passing year. While it is true that the deficit impact of the amendment will be blunted because the principal benefits of the change flow to only the few with the resources to buy very high face value policies, there is also a possible policy change that will open the floodgates into life insurance: repeal of stepped-up basis.

2. Stepped-Up Basis Reform and the Life Insurance Escape Hatch

Stepped-up basis functions as follows. Because capital gains on taxable assets are not considered income until the asset is sold or exchanged,[230] and because the tax basis of property (the starting point from which capital gain is measured) resets to the fair market value when the

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[225] Daniel Hemel, *Tax 101: The Problem of Life Insurance*, SUBSTANCE OVER FORM (May 3, 2021), https://substanceoverform.substack.com/p/tax-101-the-problem-of-life-insurance.

[226] *See* DESROCHERS ET AL., *supra* note 7, at 69.

[227] Hartley et al., *supra* note 20.

[228] *See supra* Section III.A.1.a.

[229] Joint Comm. On Tax'n, 116th Cong., JCX-16-20, at 4 (2020).

[230] I.R.C. § 1001(a)–(b).

owner dies and the property is transferred to its new owner (the "stepped-up basis"),[231] holding on to assets for life and then passing them on through inheritance is highly tax-advantaged. Consequently, many wealthy people employ a tax-minimization strategy with the shorthand "buy, borrow, die."[232] This strategy of relying on loans (with tax-deductible interest) backed by high levels of assets (which lowers the interest payments) instead of selling the assets for liquid cash has proven to be spectacularly successful at helping the extremely affluent cut tax rates, often to single-digits or flatly zero.[233]

In 2021, President Biden proposed a tax plan that would increase long-term capital gains tax rates to ordinary income rates and functionally eliminate stepped-up basis on individuals who earn more than $1 million a year, a severe threat to the "buy, borrow, die" strategy.[234] The threat of ending stepped-up basis is of huge benefit to the life insurance industry because assets delivered by a death benefit from a life insurance policy would be unaffected by such a change: life insurance payouts are untaxed transfers of cash and/or assets to a beneficiary that occur upon death, so they can be thought of as having a de facto step-up in basis, independent of the stepped-up basis provision of the tax code.[235] As tax treatment on most investments would become harsher by ending the formal step-up in basis, life insurance would become much more attractive as a vehicle for passing on wealth. While stepped-up basis repeal was dropped from Biden's plan in Congress,[236] the mere raising of the issue represents a significant new policy

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[231] I.R.C. § 1014(a).

[232] *See generally* Edward McCaffery, *Taxing Wealth Seriously*, 70 TAX L. REV. 305, 306 (2017); Rachel L. Ensign & Richard Rubin, *Buy, Borrow, Die: How Rich Americans Live Off Their Paper Wealth*, WALL ST. J. (July 13, 2021), https://www.wsj.com/articles/buy-borrow-die-how-rich-americans-live-off-their-paper-wealth-11625909583.

[233] Jesse Eisinger, et al., *The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, PROPUBLICA (June 8, 2021), https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax.

[234] DEP'T TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 62 (2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf.

[235] Hemel, *supra* note 225. *See also* Trevor J. Hamilton, *Private Placement Life Insurance: A Potential Tool for Tax Efficiency and Wealth Transfer*, BESSEMER TR. 2–3 (2019), https://www.bessemertrust.com/sites/default/files/2019-04/04_30_19_BT_CL_PrivatePlacementLifeInsurance.pdf.

[236] Kate Dore, *House Democrats' plan drops repeal of a tax provision for inheritances*, CNBC (Sept. 13, 2021 3:46 PM),

direction, and should a future administration succeed in pursuing it, the sky is the limit as to how much money will come pouring in to cash value policies.

C. STATUTORY ASSEMBLY AND THE STRUCTURAL FLAWS OF § 7702

The adoption of § 7702 followed years of public debate, a two-year stopgap bill, and multiple congressional hearings.[237] The 2020 amendment to § 7702, by contrast, involved essentially no public debate or public advance notice. This article argues that the manner in which the amendment was passed showcases a weakness in § 7702's structure: the statutory provision exists at the nexus of several issues, including statutory complexity and the submerged state, that makes it extremely vulnerable to legislative capture. Further, the article argues that almost total lack of controversy about the amendment's successful passage unfortunately presents special interests with a powerful playbook for achieving their agendas.

1. In the Dead of Night: Amending § 7702 Without Anyone Noticing

The § 7702 amendment was originally introduced in the House in May 2020 in the anthology COVID-19 aid package proposal, the Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act,[238] and later signed into law in the omnibus CAA on December 27, 2020.[239] Other than the text of the bills, there is no mention of the proposed change in the congressional record, including floor debates.[240]

A search on Google News for news articles including the text strings "7702" and "life insurance" published between January 1, 2020 and

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https://www.cnbc.com/2021/09/13/house-democrats-plan-drops-repeal-of-a-tax-provision-for-inheritances.html.

[237] *See supra* Section I.B.2.

[238] Health and Economic Recovery Omnibus Emergency Solutions Act, H.R. 6800, 166th Cong. § 40308 (2020).

[239] Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, § 205, 134 Stat. 1182 (2020) (enacted) (adding to I.R.C. § 7702).

[240] CONGRESS.GOV, https://www.congress.gov/search?q=%7B%22source%22%3A%22congrecord%22%2C%22search%22%3A%227702%22%2C%22congress%22%3A%5B%22116%22%2C117%5D%7D (last visited Nov. 7, 2022).

December 26, 2020[241] yields only *two* results with any reference to an amendment,[242] both of which were published on December 22—the day after the bill cleared both houses of Congress.[243] Neither was in a newspaper. The first (and, as of this writing, only) time any reference to the change appears in the Wall Street Journal, the flagship paper of corporate America, is on January 10, 2021, weeks after the law was passed.[244] As of November 7, 2022, no article in the New York Times mentions the change at all.[245] The few other scattered mentions of the possibility of a change that can be found online at all from 2020 are brief mentions by insurance services firms and organizations,[246] the text of the bills themselves, and the JCT financial analysis of the HEROES Act.[247]

As far as anyone who was not specifically working on the change and a few members of the industry knew, there was no reason to suspect an impending substantive change to a provision that had been the subject of a

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241 GOOGLE, https://www.google.com/search?q=%227702%22+%22life+insurance%22&tbs=cdr:1,cd_min:1/1/2020,cd_max:12/26/2020&tbm=nws&ei=Db8YYZOmOtXctQapt6i4Bw&start=0&sa=N&ved=2ahUKEwjT4IrKvbLyAhVVbs0KHakbCnc4ChDx0wN6BAgHEDQ&biw=1440&bih=720&dpr=1, (last visited Nov. 7, 2022).

242 Allison Bell, *CAA 2021 Package Includes Life Insurance Interest Rate Provision*, THINKADVISOR (Dec. 22, 2020, 5:44 PM), https://www.thinkadvisor.com/2020/12/22/cca-2021-package-includes-life-insurance-interest-rate-provision/; Alistair M. Nevius, *Many Tax Provisions Appear in Year-End Coronavirus Relief Bill*, J. ACCOUNTANCY, https://www.journalofaccountancy.com/news/2020/dec/tax-provisions-in-covid-19-relief-bill-ppp-and-business-meal-deductibility.html (Dec. 27, 2020).

243 § 205, 134 Stat. 1182.

244 Scism, *supra* note 182.

245 N.Y. TIMES, https://www.nytimes.com/search?dropmab=false&endDate=20221107&query=%22life%20insurance%22%20%22tax%22&sort=best&startDate=20200101(last visited Nov. 7, 2022).

246 Howard Bard, et al., *ACLI Update*, TAXING TIMES (June 2020), https://sections.soa.org/publication/?m=59625&i=664796&view=articleBrowser&article_id=3705178; *House Democrats unveil HEROES Act coronavirus bill*, EY (May 13, 2020), https://taxnews.ey.com/news/2020-1277-house-democrats-unveil-heroes-act-coronavirus-bill; Ferrari et al., *supra* note 170; Alex Brosseau, et al., *House OKs smaller recovery package as Pelosi-Mnuchin Talks Falter*, DELOITTE TAX LLP (Oct. 2, 2020), https://web.archive.org/web/20220121112505/https://newsletters.usdbriefs.com/2020/Tax/TNV/201002_1.html.

247 H.R. Rep., 116th Cong., JCX-16-20, at 4.

maelstrom to get enacted. Andrew Pike, the scholar and author of the definitive law review article on § 7702 after it was enacted in the 1980s, had not been informed that there was an amendment in the works, let alone that it had passed, until I emailed him, asking to discuss his article.

2. Uncontroversial: Why Was There No Noise about the § 7702 Amendment?

The passage of the 2020 § 7702 amendment is at the intersection of many different strands of law and political science that focus on legislative viability and resiliency. Several factors led to the invisibility of this highly consequential change, and from these factors emerges a playbook that any interest group could attempt to use.

First, the provision was a drop in the bucket compared to the aggregate legislation in which it was placed. The original HEROES Act was over 1,800 pages long[248] and the § 7702 change took up only five of them. The CAA, in which the change became law, was over 2,100 pages.[249] Additionally, the final text of the CAA only became available to members for a few hours before the vote was taken, making a thorough read of the final bill essentially impossible.[250] These factors are commonly bemoaned for letting surprise provisions slip through to benefit special interests in a variety of contexts.

Second, to reiterate from III.A.3.b, the life insurance industry has a remarkable lobbying apparatus and close supporters in Congress, most importantly the current Chair of the Ways and Means Committee and the Joint Committee on Taxation. This political influence goes back a century, all the way to its tax exemption in the first income tax bill following the Sixteenth Amendment.[251] The HEROES Act summary, the one document where Congress has provided any explanation of the change, almost completely follows the life insurance industry's preferred explanation,

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[248] Health and Economic Recovery Omnibus Emergency Solutions Act, H.R. 6800, 116th Cong. § 40308 (2020).

[249] § 205, 134 Stat. 1182.

[250] Luke Broadwater, et al., *Buried in the Pandemic Aid Bill: Billions to Soothe the Richest*, N.Y. TIMES (Dec. 22, 2020), https://www.nytimes.com/2020/12/22/us/politics/whats-in-the-covid-relief-bill.html.

[251] 50 CONG. REC. 1807 (1903).

saying that the change "updates section 7702 to reflect the interest rate environment that has been exacerbated by the current crisis."[252]

Third, provisions like the § 7702 amendment pose a classic collective action problem, that of concentrated benefits and diffuse costs.[253] The beneficiaries of the amendment are specific: cash value life insurance providers and policyholders. The costs of the amendment are most directly seen in foregone revenue to the state, not to any particular constituency. This forgone revenue is likely to be relatively insignificant in the short run (but only the short run),[254] further diluting the urgency of the costs. Additionally, while in one sense other asset managers are also losers in this amendment because they compete with cash value life for savings allocation, products like private placements demonstrate that the increasing appeal of cash value life is not necessarily a zero-sum game for both basic investments like corporate bond indexes as well as specialty asset classes like hedge funds. There is therefore scarce activist constituency to oppose the plan.

The fourth and fifth factors work in tandem and, combined, are what makes § 7702 and its 2020 amendment distinctive. The fourth factor is that the provision, instead of a direct cash outlay, employed an economically identical but much less politically salient tax expenditure. Tax expenditures are tax revenue losses due to exclusions or deductions from base rates, as opposed to a direct spending outlay.[255] Across surveys, many Americans indicate that they simply do not consider tax expenditures to be equivalent to government spending; this concept is known as the "submerged state" because spending done through tax expenditures, rather than cash transfers, is simply much less recognized.[256] For example, many people who use tax deductions, such as the home mortgage interest deduction, will answer "no" in polls to questions about if they have "ever used a government social program."[257] The life insurance tax exclusion and § 7702, like the home mortgage interest deduction, are part of the submerged state. Section 7702

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[252] H. APPROPRIATIONS COMM., 116TH CONGRESS, H.R. 6800, THE HEROES ACT TITLE-BY-TITLE SUMMARY § 308, at 34.

[253] *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 9–16 (1965).

[254] H.R. REP., 116TH CONG., JCX-16-20, at 4.

[255] U.S. DEP'T TREASURY, https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures (last visited Nov. 7, 2022).

[256] *See generally* SUZANNE METTLER, THE SUBMERGED STATE: HOW INVISIBLE GOVERNMENT POLICIES UNDERMINE AMERICAN DEMOCRACY (2011).

[257] Suzanne Mettler, *Our Hidden Government Benefits*, N.Y. TIMES (Sept. 19, 2011), https://www.nytimes.com/2011/09/20/opinion/our-hidden-government-benefits.html.

does not work by cutting a check to holders of qualifying policies each year, but instead works through delineating access to an income exemption located in two other separate tax code provisions, § 101 and § 72. This structure suppresses the public prominence of the significant taxpayer subsidy.

The fifth factor is the sheer inaccessibility of § 7702. Section 7702 and its 2020 amendment are extraordinarily technical and statutorily complex, requiring specialized knowledge about the economics of cash value life insurance, interest calculations, and actuarial principles. The topic of cash value life is already niche, and most Americans cannot pass basic financial literacy tests,[258] let alone evaluate the merits of an actuarial simulator.

Section 7702 is designed such that only a very small subset of people will ever become remotely familiar with the actual details, and while this is true of legislation generally, it becomes a particularly strong impairment to public understanding when the technical barriers are sufficient to inhibit understanding by policymakers who are ordinarily charged with safeguarding legislation's integrity. When a statute or regulation becomes complex enough that the institutional knowledge of its inner workings shifts to the industry it impacts, institutional capture by that industry against overburdened gatekeepers becomes inevitable. This is a chronic problem in financial regulation, where legislation in the hundreds of pages (and accompanying regulations in the thousands) is recurring, resulting in regulatory debacles where deadlines are missed by years and attempts at

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[258] Annamaria Lusardi & Olivia Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52 J. ECON. LITERATURE 1, 9 (2014). Lusardi and Mitchell use a simple three-question survey to test for basic financial knowledge: (1) "Suppose you had $100 in a savings account and the interest rate was 2 percent per year. After 5 years, how much do you think you would have in the account if you left the money to grow: [more than $102; exactly $102; less than $102; do not know; refuse to answer.]"; (2) "Imagine that the interest rate on your savings account was 1 percent per year and inflation was 2 percent per year. After 1 year, would you be able to buy: [more than, exactly the same as, or less than today with the money in this account; do not know; refuse to answer.]"; and (3) "Do you think that the following statement is true or false? 'Buying a single company stock usually provides a safer return than a stock mutual fund.' [true; false; do not know; refuse to answer]." In the United States, only 30% of people in their study could answer all three questions correctly. (The answers are (1) more than $102; (2) less than today; and (3) false.)

clarity become muddled in post-passage chaos.[259] When the purported justification for undebated legislative action is simply the talking points of the affected well-connected industry on niche legislation,[260] the tipping point has passed and the industry is in the driver's seat for the topics over which it has the advantage of insider knowledge.

Not only was § 7702 already far too complex for non-specialists to grasp, but the 2020 amendment makes the situation even worse. Compared to the old version's "4%," its replacement requires two nested "lesser than" statements to change the standard to one that sometimes is identical to the old one but at other times is a floating rate, drawing on two separate data series that each require their own separate explanation and calculation.[261] This further convolution, however, does align with the industry's stated narrative for the change: if the problem is that the required § 7702 rate is too high because interest rates are now too low, shouldn't the rate be able to adjust with the times, so the argument goes. When only four members of the House of Representatives are still serving from when § 7702 was enacted,[262] and the institutional knowledge of the debate at the time has therefore disappeared, the level of deference to a technical explanation offered by an outsider will be substantially higher.

Bringing together these fourth and fifth factors, the § 7702 amendment is a caricature of the submerged state. The amendment changed the lower bound of an actuarial assumption in a simulated cash value life insurance policy from 4% to the lesser of 4% and a metric that is the lesser of a data series dependent upon the Moody's AAA corporate bond yield index and the last several months of medium-term U.S. Treasury yields. This amendment was done in order to set different bounds for the exact types of cash value policies would be eligible for a series of tax benefits, including nontaxation of inside buildup and nontaxation of the death benefit, while plausibly seeming at first glance to comply with the general spirit of the low interest rate era. The test that was relatively accessible, the CVCT, was unchanged. It is not surprising that no one cared about the amendment!

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[259] Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 HOFSTRA L. REV. 25, 26, 57, 68 (2014). A particularly notable example of this process is the Dodd-Frank "Volcker Rule" that attempts to mostly ban banks from performing proprietary trading with their accounts. *Id*. at 69–75.

[260] THE HEROES ACT TITLE-BY-TITLE SUMMARY § 308, *supra* note 252.

[261] I.R.C. § 7702(f)(11).

[262] *Terms of Service for Members of the House of Representatives in the 117th Congress*, CLERK, https://clerk.house.gov/member_info/Terms_of_Service.pdf (last visited Nov. 7, 2022).

Even within the context of the submerged state, if someone had proposed giving cash value life a tax credit, or set up a relatively simple test, that might have gotten some degree of attention. But when the law is structured to be as intricate as possible, that vacuum will be filled by attention to the tangible, such as the months-long controversy over which businesses got to receive Paycheck Protection Program loans.[263] The more a proposal is submerged into the lowest-salience form possible, and the lower the visibility and higher the technicality, the greater the potential for capture.

D. SUMMARY OF OBJECTIONS AND POLICY RECOMMENDATION

To conclude, this Article sums up three objections to the 2020 § 7702 amendment, and offers a policy recommendation and additional observations consistent with those objections.

First, the amendment is an abuse of the life insurance tax exemption, which, if it should exist at all, should have the aim of aiding in the protection of policyholders and their beneficiaries from the worst. The amendment shifts the locus of the § 101 exemption away from actual protection in the event of death and towards products that are simply normal investment policies, draining the exemption of moral content it could have previously at least tried to claim.[264] The amendment reduces the amount of actual insurance protection (net amount at risk to the insurer), but delivers to the policyholder greater tax savings at the cost of federal revenue. This dynamic turns the idea of an "insurance exemption" on its head. Indeed, the changing profile of life insurance ownership and the § 7702 amendment weaken the general case for an inside buildup exemption.

Second, the amendment, with a cost to the federal tax coffers likely to grow into the billions of dollars each year,[265] is an amplification of an upside-down subsidy. Cash value life was always skewed towards the affluent, but this aspect of the insurance industry has become particularly pronounced in the past two decades.[266] The cash value policies that are most able to take advantage of this change are also not the ones that have a relatively small amount of savings with inside buildup, but the minority of

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[263] Emily Stewart, *The PPP worked how it was supposed to. That's the problem*, VOX (July 13, 2020, 8:00 AM), https://www.vox.com/recode/2020/7/13/21320179/ppp-loans-sba-paycheck-protection-program-polling-kanye-west.

[264] Maremont & Scism, *supra* note 38.

[265] *See supra* Section III.B.1.

[266] *Survey of Consumer Finances*, *supra* note 137.

extremely flush policies specifically structured as savings vehicles. Furthering premium stuffing doubles down on a policy that overwhelmingly benefits the affluent more and more, and may do so in a particularly egregious manner if stepped-up basis reform passes.[267]

Third, the amendment rewards a legislative process that minimizes public understanding of the law and accountability for government capture.[268] Members of the community should not be able to extract public rents based on their ability to obscure and confuse policymakers and the public, and legislation should be structured as to maximize the ability for the legislative body to maintain a mastery over its content.

The effort to write actuarial principles into the I.R.C., while admirable, has demonstrated that it is not a sustainable equilibrium. While life insurance providers face legitimate difficulty in selling traditional products in the low interest rate era, the solution cannot be to implicitly sanction the industry's move away from the very products that were the reason for the subsidy in the first place. Unfortunately, given the tenor of Congress,[269] comprehensive reform seems unlikely.

It should be noted that, despite its deep problems, the highly technical approach of § 7702 does have one significant advantage: legislative clarity about which contracts will receive the life insurance tax exemption. Recall that under the old standard for delineating access to the exemption, the *Le Gierse* test, was judicial discretion to decide whether the contract contained sufficient risk shifting.[270] Since the passage of § 7702, there has been almost no litigation over if a policy is or is not in compliance with the provision.[271]

Keeping in mind the advantages and disadvantages of § 7702 in its current state, as a first-best policy proposal, Congress should eliminate the

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[267] *See supra* Section III.B.2.

[268] *See supra* Section III.C.1.

[269] Warmbrodt, *supra* note 219.

[270] *Le Gierse*, 312 U.S. at 537–40.

[271] In a search of cases that reference § 7702 and life insurance on Westlaw, in only two cases did parties disagree on contract compliance under federal tax law. In Buck v. Am. Gen. Life Ins. Co., plaintiffs alleged that faulty procedures by the insurer caused a policy to fall out of § 7702 compliance. No. 117CV13278NLHKMW, 2021 WL 733809 (D.N.J. Feb. 25, 2021). In Muffin Trust v. Mony Life Insurance Company of America, parties disagreed on the requirements of the guideline premium limit. No. SUCV201801106BLS2, 2019 WL 7753754 (Mass. Super. Dec. 31, 2019). There has also been litigation over whether policies that fulfilled § 7702's requirements nonetheless constituted "shams". *See, e.g.*, Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001).

income tax exemption of inside buildup. Given the difficult political circumstances, this Article recommends a proposal of a hard numerical cap, perhaps of $100,000,[272] on the amount of inside buildup that will receive the § 101 exemption. This policy has the virtues of being easy to explain to policymakers and the public and being easy to write into the statute, thus avoiding wading into an actuarial quagmire. It would reduce the regressivity of the subsidy and ensure that a greater fraction of the dollars exempted from tax under § 101 were for insurance protection, while being perhaps more achievable than full inside buildup taxation. The cap would also forestall the possible future scenario of a tsunami of capital from other asset classes into life insurance in an attempt to get around a repeal of stepped-up basis. Attempts to modify the cap in the future would have to modify a statute written in straightforward language, so it would be more resilient, or at least would not go unnoticed. The cap would not interfere with the ability of anyone to provide for their loved ones in the event of their death. In short, it would be a simple but effective way to regain some control of a tax exemption and associated legislative process.

Additionally, though this is not a federal policy recommendation, the structure of § 7702 enables other participants to act to blunt the amendment's impact. Most notably, though the bulk of § 7702 requirements pertain to the actuarial calculations covered at length in this article, § 7702 also requires that to get preferential tax treatment the insurance policy must meet the applicable state law definition of a life insurance policy.[273] So, for example, life insurance policies in New York must abide by New York state law pertaining to life insurance, and in New York flexible premium policies, the policyholder must receive a sixty-one day grace period after making the first payment to pay sufficient premiums to keep the policy in force if the insurer determines that the policy's net cash surrender value is not sufficient to pay the insurance charges.[274]

If a state was concerned about the weakening of § 7702, it could require that any life insurance policy in its state meet the old requirements of the actuarial test for recognition under its law, which would then trigger § 7702's applicable law requirement. A state government could, in effect,

[272] For the distribution of the amount of cash value policyholders have in cash value policies, conditional on having a cash value policy. *See* Online Data and Calculations Appendix *supra* note 92. The mean amount of cash value in the cash value policy of a policyholder in the 80th–89.9th percentile of income is about $31,000, while for the 90th–100th percentile of income it is about $158,000.

[273] DESROCHERS ET AL., *supra* note 7, at 338.

[274] N.Y. Ins. Law. § 3203 (McKinney 2013).

reinstate the old statutory language for federal tax exemption, though only to policies under its jurisdiction. State governments could go further and impose stricter limits on private placement life insurance, such as increasing investment diversification requirements, stripping the policyholder of control of initial asset allocations, or banning PPLI entirely. State-by-state policy is susceptible to geographic gaming by the industry, but the federalism embedded within the § 7702 statute does enable experimentation.

V. CONCLUSION

The life insurance sector forged the Internal Revenue Code § 7702 bargain in the 1980s when overly aggressive new products and marketing by new companies threatened to bring congressional scrutiny to the favorable tax treatment the industry enjoyed. Section 7702's limitations on the amount of pure investment that could be deposited into tax-exempt cash value life insurance policies were carefully constructed to incorporate actuarial science, as well as hard-fought political compromises, into the tax code. After thirty years of declining interest rates and concentrating wealth, it is now the incumbents of life insurance who are aggressively pushing boundaries in the form of new policy design and advocacy for even more lavish tax treatment. Their successful (and almost entirely unnoticed) push to amend § 7702 in 2020 showcases the limitations of such a highly technical and obscure approach. The new § 7702 relies on an even more intricate and inscrutable statute but structures its new formula to enlarge permissible investment orientation, sometimes almost tripling the amount of savings that can be stored into a given policy to avoid taxes. Furthermore, those willing to purchase the highest-value policies are in the best position to benefit from this new legislative world.

The life insurance sector, which has been suffering in the low interest rate era, is leaving behind ordinary Americans and reinventing itself as an investment product for elites, including embracing openly blue-blooded products like private placement insurance. To some degree, the economics of the situation may make this trend inevitable. However, it does not follow that American taxpayers should bless increasingly arcane and top-heavy products with a more expansive definition of "life insurance" that extends a tax loophole to policies that have less actual insurance. Doing so costs the federal budget tax revenue, subsidizes inequality, harms the integrity of the legislative process, and reinforces a template for special interests to disguise special treatment as technical sophistication.