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CASE DESIGN INSIGHTS

FROM M FINANCIAL

**Cash value accumulation test or guideline premium test:
an important first step in life insurance policy design.**

For producers and case designers employing cash value life insurance in client plans, the irrevocable choice at policy issue between the cash value accumulation test and the guideline premium test determines how clients maximize cash value accumulation, future cash value distributions, and death benefits to the policy's beneficiaries.



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SETTING THE LIMIT

Sections 7702 and 7702A of the Internal Revenue Code set limits on how much premium a policy can hold and still qualify as life insurance for federal tax purposes. Under the code, a contract must meet either the cash value accumulation test (CVAT) or the guideline premium test (GPT) to qualify. Section 7702A determines whether a policy is a modified endowment contract (MEC).¹

If a policy fails to conform to IRC §7702, the death benefit becomes taxable. The contract is neither life insurance nor a modified endowment contract, both of which would otherwise be excluded from taxable income under IRC §101. Instead, the contract is treated as an investment contract, and gains and death benefits are taxed accordingly. If a policy becomes a MEC, the gains in the cash value of the contract would be taxed as ordinary income, on a last-in-first-out basis. Either can result in inefficient use of the policy.

THE CASH VALUE ACCUMULATION TEST: IRC §7702(b)

CVAT measures the relationship between policy cash value and the death benefit. Under CVAT, the policy's cash surrender value may never exceed the "net single premium"² that would be required to purchase those same future benefits.³ The net single premium is a cash value amount that would cause the policy to endow under conservative statutory assumptions.⁴

CVAT Example

- 50-year-old male purchasing a \$1 million policy has a hypothetical net single premium of \$300,000.
- If the cash surrender value exceeded \$300,000 at age 50 for this policy, it would violate CVAT.

Key Considerations

- When designing for pure death benefit, the difference between CVAT and GPT is minimal.
- CVAT designs demonstrate higher early cash surrender value internal rates of return.
- CVAT designs demonstrate higher death benefit internal rates of return just beyond normal life expectancy.
- GPT designs support higher "income" solves and greater internal rates of return after age 65.
- GPT designs require regular policy management in order to optimize performance.
- CVAT policies may require less administrative oversight.

When the cash surrender value exceeds the net single premium, the policy has "hit corridor." When this happens, most CVAT contracts automatically increase the death benefit according to the corridor factor for the insured's gender and attained age set forth in the code. This dynamic is extremely important. It means the insurance company will automatically administer the relationship of cash value to death benefit and keep the policy from becoming an investment contract.

CVAT HIGHLIGHTS	GPT HIGHLIGHTS
Use CVAT for high early cash and ultimate death benefit IRR	GPT may maximize the retirement income taken from the policy and the cash surrender value IRR after age 65.
CVAT policy management doesn't require as much administration as GPT.	Optimizing GPT requires regular policy management.
Death benefit will move with the required corridor calculation.	GPT designs can introduce premium force-outs from the policy, causing unplanned income.

¹ A modified endowment contract (MEC) is a life insurance policy that violates the 7-pay premium test laid out in 7702A(b). The MEC retains an income-tax-free death benefit and inside buildup of cash value but causes negative income tax consequences to withdrawals and loans of policy cash value.

² The term "net single premium" is a misnomer, as CVAT places a limit on a contract's account values but does not create an explicit premium restriction.

³ IRC § 7702(b)(1).

⁴ IRC § 7702(b)(2).

THE GUIDELINE PREMIUM TEST: IRC §7702(c)

GPT limits the premium in relationship to the death benefit. Like the CVAT net single premium, the guideline premiums are intended to be sufficient to fund a policy to maturity under conservative assumptions.

In addition to the premium restrictions, the GPT also limits the relationship between cash value and death benefit. Generally, the corridor factors in the GPT allow for more cash value than the net single premium in the CVAT.⁵

GPT Example

- 50-year-old male purchasing a \$1 million policy has a hypothetical guideline single premium of \$300,000.
- If the premiums paid exceeded \$300,000 at age 50 for this policy, it would violate GPT.⁶

The relationship of cash value to death benefit is commonly referred to as the corridor.

HOW CVAT AND GPT AFFECT THE POLICY DESIGN

CVAT and GPT prevent overinvestment or excessive returns in a life insurance policy. Thankfully, life insurance carriers and their illustration software perform CVAT and GPT calculations to ensure compliant contracts with income-tax-free death benefits.

Still, it's important to understand the difference between CVAT and GPT. If you're using your policy for significant cash value accumulation or future distributions, the choice may make a measurable impact. To demonstrate this, we studied the internal rates of return (IRR) of cash surrender value (CSV) and death benefit for three scenarios.

EXPERT TIPS: DESIGNING WITH GPT



- The premium limitations in the guideline premium test vary by death benefit option. The guideline premiums for an increasing death benefit policy are higher than an equivalent policy using a level death benefit.
- For this reason, many case designers find that the use of the increasing death benefit can result in more efficient cash value growth despite resulting in a higher death benefit.
- The most efficient GPT designs typically start out with an increasing death benefit, followed by a later combination of a reduction in death benefit and a switch to a level death benefit.
- This combination allows the policy to have the advantage of the higher guideline premiums in early years, while minimizing the cost of death benefit in later years.

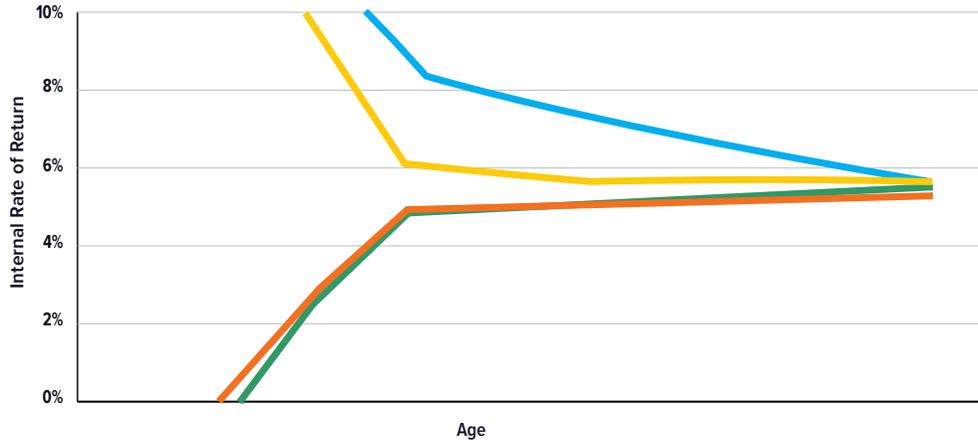
⁵ In the case of GPT, this relationship is governed by corridor factors, a set of factors that vary by attained age and specified in 7702(d).

⁶ GPT also includes a level premium test that scales based upon age.

In these scenarios, IRR measures the discounted rate of cash flows to results in a net present value (NPV) of zero. Each scenario depicts a hypothetical insured male, age 40, paying \$100,000 of premium each year for the first seven years of the policy. Each scenario maximizes cash surrender value IRR.

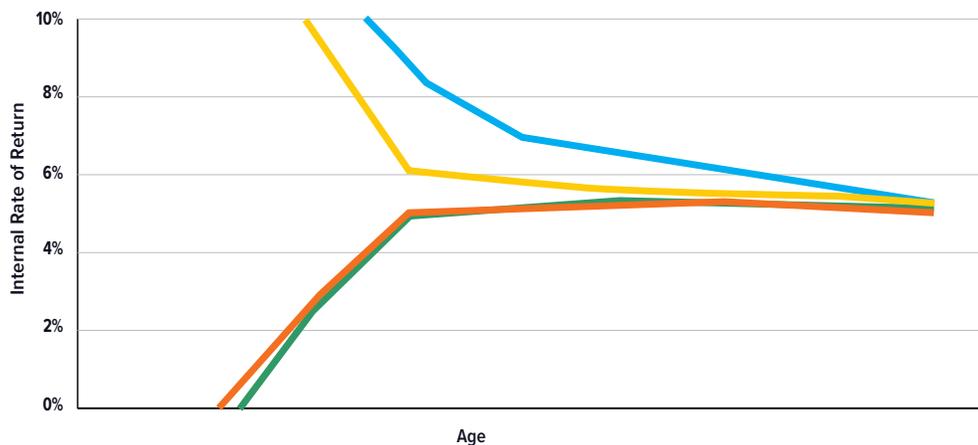
CVAT designs have a level death benefit all years. GPT designs have an increasing death benefit until year 7, at which time the death benefit is decreased and leveled to the minimum allowable death benefit under the test. A 40-year-old's life expectancy is typically between ages 80 and 85.

SCENARIO 1 – DEATH BENEFIT ONLY – NO LOANS OR WITHDRAWALS



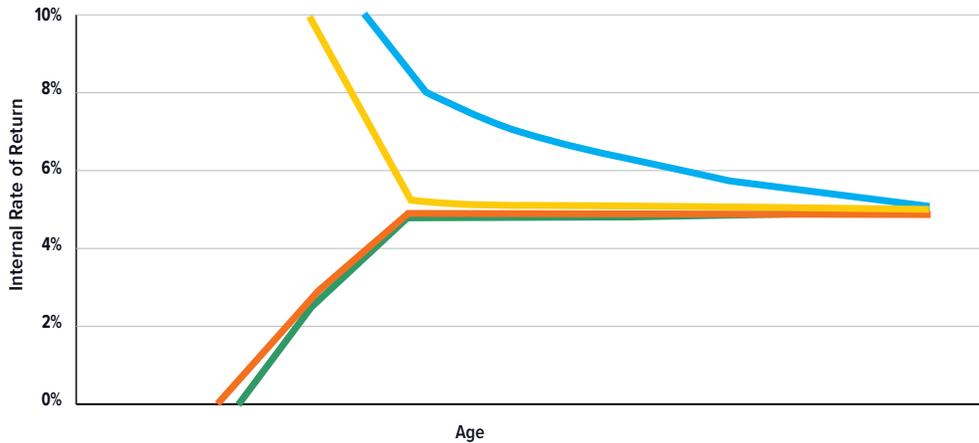
	41	45	50	65	70	75	80	85	90
CVAT CSV IRR	-8.52%	-1.99%	3.15%	5.15%	5.31%	5.41%	5.46%	5.48%	5.47%
CVAT DB IRR	2750.54%	65.00%	21.36%	8.63%	7.59%	6.90%	6.42%	6.08%	5.83%
GPT CSV IRR	-9.68%	-2.96%	2.64%	5.11%	5.33%	5.48%	5.59%	5.67%	5.72%
GPT DB IRR	3174.28%	75.80%	13.83%	6.05%	5.90%	5.70%	5.73%	5.79%	5.83%

SCENARIO 2 – LEVEL DISTRIBUTIONS AGE 66–85 (20 YEARS)



	41	45	50	65	70	75	80	85	90
CVAT CSV IRR	-8.52%	-1.99%	3.15%	5.15%	5.32%	5.39%	5.39%	5.35%	5.27%
CVAT DB IRR	2750.54%	65.00%	21.36%	8.63%	7.09%	6.57%	6.16%	5.83%	5.56%
GPT CSV IRR	-9.68%	-2.96%	2.64%	5.11%	5.33%	5.43%	5.49%	5.50%	5.48%
GPT DB IRR	3174.28%	75.80%	13.83%	6.05%	5.76%	5.60%	5.59%	5.60%	5.56%

SCENARIO 3 – LEVEL DISTRIBUTIONS AGE 66–85 WITH LUMP SUM WITHDRAWALS YEARS 10 AND 15



	41	45	50	65	70	75	80	85	90
CVAT CSV IRR	-8.52%	-1.99%	3.14%	4.96%	5.13%	5.20%	5.21%	5.18%	5.10%
CVAT DB IRR	2750.54%	65.00%	21.15%	7.99%	6.79%	6.32%	5.94%	5.63%	5.38%
GPT CSV IRR	-9.68%	-2.96%	2.62%	4.85%	5.07%	5.18%	5.24%	5.25%	5.23%
GPT DB IRR	3147.28%	75.80%	14.01%	5.66%	5.47%	5.35%	5.34%	5.35%	5.32%

In all three cash surrender value scenarios:

- The cash surrender value IRR favors CVAT until distributions start.
- GPT starts low and crosses over CVAT during and after the income years. The crossover is later in Scenario 3, where lump sum withdrawals are taken, between ages 75–80.

The death benefit scenarios demonstrate the opposite:

- GPT is far more favorable than CVAT in the first seven years.
- After dropping the death benefit after year 7, CVAT has a stronger showing through age 90.
- After age 90, the death benefit IRR flips back to favoring GPT.

Performance Summary

Neither CVAT nor GPT has a clear advantage over all years in either cash surrender value or death benefit IRR. CVAT is stronger in early year cash surrender value IRR and supports stronger death benefit IRR for the majority of time through normal life expectancy and a little beyond.

GPT designs maximize the retirement income taken from the policy and the cash surrender value IRR after age 65.

Administration Summary

CVAT designs do not require much post-issue policy administration. Generally, the death benefit will move with the required corridor calculation.

GPT designs do require extra policy administration. To maximize cash value, the policy face amount is usually leveled and dropped after the premium-paying years. The policy's performance will be affected if an administrator misses those dates. Additionally, if left unmanaged, the GPT design can introduce premium force-outs from the policy. These force-outs usually occur while or after income is taken from the policy. While a premium force-out is an automatic way to prevent the policy from becoming an investment contract, it may cause taxable income.

CASE DESIGN INSIGHTS BY M FINANCIAL

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The IRR on the cash surrender value is equivalent to an interest rate (after taxes) at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the cash surrender value of the policy.

The IRR on the death benefit is equivalent to an interest rate (after taxes) at which an amount equal to the illustrated premium payments could have been invested outside the policy to arrive at the death benefit of the policy.

Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

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