



Article from

Taxing Times

February 2018
Volume 14, Issue 1

Guideline Policy Forceouts

Effects on Policy Values and Administration of Universal Life Policies

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Universal Life Insurance and the Guideline Premium Test have been around for a little over 30 years. Now that these policies have matured, there is a growing need to address and re-think how we administer these policies. When the policies were sold, the focus was on the payment of premiums to establish the benefits. But now that clients are older and perhaps even retired, the focus is on maintaining policy value to either maturity or death.

Perhaps more than any other contributing factor, the decline of interest rates over the last 20 or so years to record low levels has impacted policy owners as well as insurance companies, making it difficult for owners to have policies they can maintain into the future. But even if interest rates rise, the increase in performance may not be enough to salvage the value of these policies, because the increase in cost of insurance rates at older ages will outpace the gains from any increase in the interest rate. This is facilitating a re-thinking of the relationship of benefits and cash value by many policy owners.

Managing the inforce block is undoubtedly on many companies' collective conscience. It is in their best interest to help their clients meet their needs, but this cannot be done by the wave of a magic wand. There are many constraints present: the ability to find good assets that raise the interest rates; whether mortality experience can warrant a reduction in cost of insurance rates; the ever-increasing expenses of maintaining the business.

There is an additional constraint, however. As policyholders begin to change their benefits, either as a reduction in benefits to lower costs or through withdrawals and distributions of excess cash value, the Guideline Premium Test values also change. These can create a larger and sometimes unknown

liability for the policy owner, should such changes trigger a forced withdrawal of cash value (Guideline Forceout).

This article will focus on the constraints and effects of the Guideline Premium Test. First, we will define what Guideline Forceouts are and how they arise. Then we can consider the effects on policy values. Finally, we can consider how to administer policies in light of these constraints.

DEFINING A GUIDELINE PREMIUM FORCEOUT

How Does a Guideline Premium Forceout Occur?

Section 7702(c)(1) defines the Guideline Premium Test for a policy as requiring that "the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time." Further, Section 7702(c)(2) defines the Guideline Premium Limitation as the greater of the Guideline Single Premium (GSP) or the sum of the Guideline Level Premiums (GLP) to the date of measurement.

If a policy does not adjust its benefits or make any other changes, the administration of this test is fairly straightforward. By its design the use of the Guideline Premium Test provides for the flexibility of premium payments to Universal Life policies, and is of paramount importance to how these policies are maintained.

This is well established and understood by all. The key provision that we are focusing on in this article, however, is 7702(f)(7)(A), which states that "If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section."

Section 7702(f)(7)(A) defines what is referred to as an "Adjustment Event." It applies to both CVAT and Guideline policies, but in general its effect is critical to the administration of Guideline Policies. The reason for this is that CVAT policies tend to self-correct upon an Adjustment Event, whereas Guideline Premium Test policies do not. The effect on the guideline premiums depends on the amount of change in the benefits and any associated expense charges.

Adjustment Events can come in several different types. The most obvious is due to a benefit adjustment—such as a change in death benefits (including changes in death benefit options such as from an increasing benefit to a level benefit) or riders that are considered as Qualified Additional Benefits. The scope of Section 7702(f)(7) also includes provisions for changes in "other terms" such as a change in expense factors or risk classification, if permissible under the terms of the contract. For purposes of this paper, we will limit ourselves to changes due



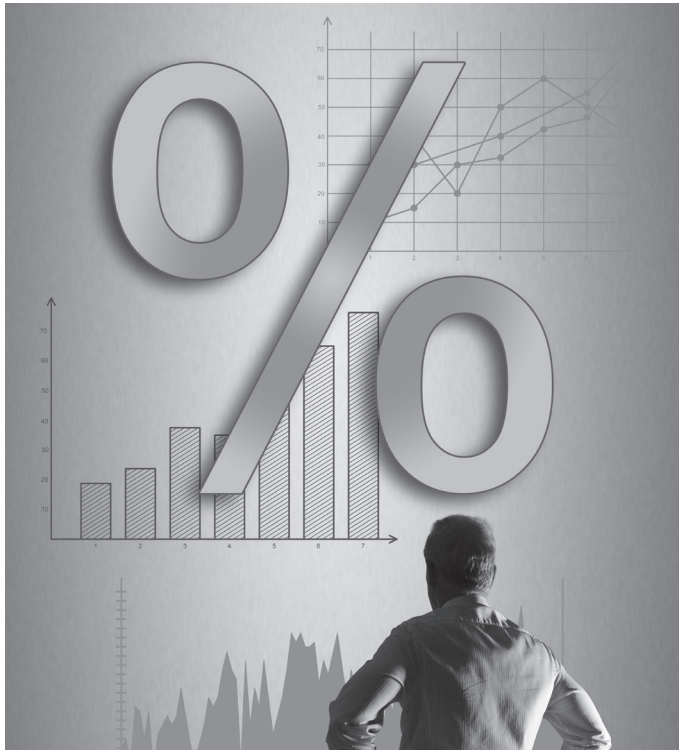
to adjustments in the benefits, as these are the most common and therefore are the most likely to give rise to Guideline Forceouts.

Adjustment Events are calculated using the Attained Age Decrement Method, which is best described in the article by Christian DesRochers¹ and further documented and explained in *Life Insurance and Modified Endowment Contracts*.² Under the Attained Age Decrement Method, the incremental difference in guideline premiums at the benefit adjustment date is added to or subtracted from the existing guideline premiums. For the same change in the benefits, the amount of change in the corresponding guideline premium can become larger the older the insured becomes. This makes perfect actuarial sense—the same coverage costs more as you get older. The result, however, is that there is an increasingly larger swing in guideline values as a policy ages, which can create a negative guideline premium and a reducing Guideline Premium Limit.

This, in turn, can create a Guideline Forceout. If the resulting guideline premiums are negative, then it is necessary to remove cash value from the policy either immediately or over time in order to maintain compliance with Section 7702. Even though Section 7702(f)(1) and 7702(f)(2) refer to sum of the

“Premiums Paid” (Sum of Premiums Paid, or SOPP) and the return of such premiums, the nature of this effort is not to refund premiums but to process a withdrawal of cash value.

Such a withdrawal is similar to, but not quite the same as, a withdrawal under the policy. Like a typical withdrawal, a Guideline Forceout could be taxable to the owner (for example, if the policy is classified as a Modified Endowment Contract). This means that the treatment of the Guideline Forceout relative to the Sum of Premiums Paid in the Guideline Test may be different than the treatment of premiums towards the policy cost basis. In addition, the policy may have a limitation on distributions to not exceed the policy’s net cash value (cash value after reduction for loans). For Guideline Forceout Purposes, the definition of cash surrender value under Section 7702(f)(2) applies, which by definition does not take such loans into consideration.³ Hence, in such high-loaned situations, some of the Guideline Forceout is paid in cash and the balance is treated as a repayment of policy debt. Such repayment of debt is also treated as a deemed distribution of policy value and may become taxable.



WHAT ARE THE EFFECTS OF GUIDELINE FORCEOUTS ON POLICY VALUES

Any reduction in the Guideline Premium Limits can have a long-lasting effect on policy values and become a burden on the policy owner’s ability to maintain their benefits and cash values. Some of the effects that can occur include:

- An immediate distribution of cash value when the Guideline Premium Test Limit is equal to the Guideline Single Premium (GSP).
- A continuing set of distributions under the Cumulative GLP (when the Guideline Level Premium is negative) that may begin immediately or may be deferred for many years.
- Ability to pay premiums, including the premiums to prevent lapse under Section 7702(f)(6).
- Combination events; multiple transactions where each independently does not cause a problem but combined do create a Guideline Forceout condition.

An immediate withdrawal subject to the GSP limit is a situation typically reserved for highly funded policies. What can happen here is more important, insofar as it may trigger either a MEC condition under the reduction retest rules of Section 7702A(c)(2) or a partial taxation under the recapture ceiling rules of Section 7702(f)(7).

The more interesting (but also more nettlesome) case is for those that are subject to a continuing decline in the cumulative

GLP. These withdrawals may begin many years after the actual reduction. Transactions such as these may never happen, as the policy may terminate by surrender, death or lapse due to insufficient policy value before the Guideline Forceout occurs.

But as they say—“Buyer Beware!” Guideline values are locked in, and when these events occur it is very costly to try to unwind them. A policy owner may suggest that they increase their face amount by the same amount of the decrease. However, they will generally need to increase by a larger amount if the increase occurs at a later point in time. For guideline premiums, this is the same effect as what triggers the negative guidelines, just in reverse. For example, say that a reduction in face amount of \$50,000 at, say, age 60 would trigger Guideline Forceouts in 10 years at age 70. If the owner decides that they wish to avoid such Forceouts, they may need to add back \$55,000, \$60,000 or more depending on how long they wait to request such an increase to completely offset the effect of the initial reduction (and assuming they qualify).

The delayed effect of a cumulative GLP Forceout can have a corresponding impact on premiums paid. If a policy decided to both reduce their face amount and increase their premiums to prevent a policy from lapsing, then the crossover of premiums to the cumulative GLP limit will occur even earlier. In effect the policy pays premiums (and a premium load) only to have it shortly returned as a withdrawal, without a corresponding premium load refund.

No description of Guideline Forceouts would be complete without consideration of the premium exception granted in Section 7702(f)(6). This section allows the payment of a premium in excess of the test limit, but only to prevent against a policy from terminating in the current policy year. More importantly, the contract must have no cash surrender value (in the context of Section 7702(f)(2)) at the end of that policy year. Administering this ending cash value is difficult on policies with increasing charges and changing interest rates which is an integral part of Universal Life policies.⁴ So, a policy owner may be able to use this to prevent lapse, but due to increasing costs it may be difficult to maintain over a long period of time.

Lastly, a reduction in the face amount today may limit the ability to do another one tomorrow; what is referred to as a combination event above. For example, consider a policy that has reduced their face to the exact amount needed to prevent a Guideline Forceout (such as suggested below). Their policy is now at the limit where any future reductions would trigger forceouts. Then assume the policy owner requests a withdrawal. Typically, the design of a contract will provide that such withdrawals reduce the death benefit in order to preserve the net amount at risk and prevent anti-selection risk.

This reduction in the face amount then triggers an Adjustment Event which reduces the Guideline Premiums and causes a Guideline Forceout to occur if the amount required as a Forceout exceeds the amount requested as a withdrawal.

These considerations place a pragmatic limitation on what types of solutions a company can provide for their policy owners. No system can adequately predict how a sequence of transactions will affect the long-term capabilities of a policy with any real precision. It is therefore important to design any administrative systems to retain some level of conservative benefit amounts in the calculations to help provide for the changing needs of the consumer.

Solving for Guideline Premiums

A company is very likely to be asked the question—“What benefit can I reduce to without being forced to take withdrawals?” One way is to have your administrative people use the tried and true method of “hunt and peck” for an answer (we have all used goal-seek at one time or another).

As actuaries, this is a solvable problem, and it can be a very useful way to turn what seems like a negative (you will have forceouts) into a positive (but not if you do this instead). In this section we will set up a generalized model for doing such solves.

To help set context, a policy’s life-cycle can be thought of as generally following four stages:

- Stage 1. Premium Paying Period
- Stage 2. Holding Period (no premiums or distributions)
- Stage 3. Distribution Period (withdrawals and/or loans)
- Stage 4. Benefit Maintenance Period (keeping policy from lapsing until death)

Obviously, policies vary widely and for many reasons, but for purposes of solving what benefits serve what purpose this is a particularly useful way to frame the issues.

The math necessary to do such a calculation is relatively straightforward conceptually. First, you do the same routine twice; first for the Guideline Single Premium (GSP) and then for the Guideline Level Premium (GLP). To be conservative, you would generally take the higher face amount from the two solves. You also need to provide a few assumptions as input:

- Guideline Premium Limit Target (GPTgt) = What your ultimate guideline premium limit is assumed to be (either GSP or GLP).
- Sum of Premiums Paid (SOPP) = The cumulative premiums used in testing against the Guideline Premium Limit as of the current date.

- For the GLP, what year the cumulative GLP should equal the GPTgt.

1. Define a Guideline Premium Test Limit Target (GPTgt). This is the defined final result of a GSP or GLP calculation using the Attained Age Decrement method.

The “stage” of the policy is important in how you would set the target. If the policy is in a premium paying mode, then the target may be to accept all projected premiums paid. If instead the policy is in a benefit maintenance mode, you may simply want to solve for the face amount so as to prevent any Guideline Forceouts from occurring.

The goal is in two parts—the Final GPT limit that is needed, and the Duration that the limit should equal the Target.

For example, if the case is to not have any forceouts during the policy’s lifetime, then the targets for each solve are

For GSP solves, set the target to:

$$GPTgt = (SOPP - GSP)$$

For GLP solves, set the target to:

$$GPTgt = \frac{(SOPP - cumGLP)}{Age100 - AttAge}$$

2. Define this in terms of the Attained Age Decrement Method

Using the terminology in the aforementioned TSA Article:⁵

- A = Current GSP or GLP on the policy.
- B = GSP/GLP “After” = value calculated using new Benefit Package as of the Adjustment Event Date.
- C = GLP/GSP “Before” = the existing benefits recalculated but as of the Adjustment Event Date.

The (B-C) portion of this calculation represents the incremental new guideline premium based on the change in benefits. But using the formulation above, the observation is that what we are solving for is the benefits to support the “B” premium.

Thus, we end up with this as our next step

$$GPTgt = A + B - C$$

$$B = GPTgt - (A - C)$$

3. Redefine the “B” premium in terms of the new face amount.

$$B = \frac{F \times \bar{A}_{x+t} + F \times PV(VE) + PV(FE)}{\ddot{a}_{x+t}}$$

Where:

F = the face amount to be solved for

VE = Variable Expenses per unit of Face Amount

FE = Fixed Expenses not related to Face Amount (including QAB charges)

Premium loads are built into the annuity factor.

4. The final solution is therefore:

$$\frac{F \times \bar{A}_{x+t} + F \times PV(VE) + PV(FE)}{\ddot{a}_{x+t}} = GPTgt - (A - C)$$

$$F \times (\bar{A}_{x+t} + PV(VE)) = [GPTgt - (A - C)] \times \ddot{a}_{x+t} - PV(FE)$$

$$F = \frac{[GPTgt - (A - C)] \times \ddot{a}_{x+t} - PV(FE)}{\bar{A}_{x+t} + PV(VE)}$$

Note: the result of a guideline premium solve are calculated without any assumed constraints. The result can be below a policy’s minimum face requirements and can even be negative. Once these solves are computed, a secondary step is necessary to consider these types of constraints based on the contract’s provisions and the company’s administrative practices.

EFFECT ON POLICY ADMINISTRATION

Administering these tests will take a coordinated effort between the tax actuary, legal counsel, systems, client services and company management. You have to consider many things:

- What restrictions (if any) your contract puts on policy activity due to the Guideline Premium Test?
- Are your administrative systems complete, and can they “do the math”?
- What information is provided in an illustration, and more importantly, what information is not?
- How will you communicate such news to an owner, without overstepping and providing them advice?

Administrative Systems and Procedures

Unlike many policy value considerations, the ability to do the math associated with Guideline Premiums does require policy administrative systems, which precludes manual policy calculations.

Administrative systems are built for the here and now. The system processes the transaction, records the new Guideline Premium Values, and tests for immediate compliance. Administrative systems generally rarely have logic to try to project values forward unless you build such logic. That is the purpose of the illustration, but it too is limited to take into account all the possible transactions that may be considered.

If you wish to build administrative safeguards or notifications, your systems need to consider the following:

- Projecting if and when a GPT Forceout event may occur.
- Creating warning messages or other error conditions that notify administrative personnel of impending issues.
- Calculating face amounts (or other benefit packages) that can provide alternate solutions to the client or administrative staff.
- Coordinating this information to illustrated values.
- Providing information to correspondence such as confirmations or statements.

Building these systems is costly and will be competing with other organization objectives. Since the bulk of it may not occur for some time, many may choose to not begin work until the demand is sufficiently high to justify the cost. This becomes a circular problem, as the cost of delaying such activity only increases with time.

The problem is your ability to forecast this demand. In considering administrative system changes and policy procedures, you should first consider performing a study of your inforce block. Stratification of your inforce block by relative funding sufficiency will help you identify those policies that are currently at risk. That is also essential if you need to consider training or augmenting your staff to handle any increased volume of questions or requests.

Also, bear in mind that any such study cannot project the types of actions policy owners may take that could add to the difficulties of administration, particularly when there are few contract limitations to inhibit such activity. As such, a periodic check of your inforce is probably warranted to make sure that any issues you wish to address are not a growing concern.

Illustrations are not the answer

Many people in your organization will assume that the job of projecting forward values belongs to the illustration system. This seems like an easy answer, but it is often not. Instead, you are now risking making your illustration system into an administrative system, which only works if the illustration is complete in its programming and is supported by the administrative systems. For example, a contract may allow for the

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owner to change their benefits at any time, but the illustration cannot process the transaction until the next policy anniversary. In such a case, the illustration cannot be relied upon, but for lack of administrative system information the illustration is relied upon as the only source of information.

When an illustration provides values, there are a few obvious alternatives to start from:

- Allow the transactions and disclose the results.
- Program protective measures to not allow transactions to occur in the illustration.
- Have a “switch” that allows both of the above alternatives.

These are all useful, but again not necessarily complete. Some of the considerations:

- If the GPT Forceout is deemed to occur after the illustration is projected to lapse, the values will not be shown.
- If you place a higher face amount to avoid the transaction, you may not be following the terms of your contract.
- Or, using a higher face amount is not perfect. If there is a subsequent transaction that reduces benefits, the Guideline Forceouts may occur anyway. Consider a policy that does a face reduction to the minimum, and then takes a withdrawal that triggers a further reduction. Since the withdrawal cannot be predicted, and the face amount is a function of the withdrawal itself, there is no clear way to avoid having a forceout event commence.
- Switches are useful for home office personnel, but add a complexity for most producers. This requires training, and on a topic that is not going to garner much attention.

Communication of Guideline Premium Values is Difficult

For an insurance company and their tax actuary, there is a central question about what responsibility the company has to help their policy owners manage their benefits, and what level of information should be provided. Actuaries need to be part of this process, as their expertise in the complex math is necessary to a good explanation of the results provided to the policy owner or producer.

How a company handles these cases poses clear risk to the reputation of the company which could result in litigation against the company. It all hinges on the information that a company provides to the owner, aspects of which include:

- Prior Communication to the owner. Have you told them this information before, or is this new information to them?
- Timing—When is the best time to communicate such information, particularly if the event may never occur?
- What information should you provide?

Perhaps the most important aspect is the style of communication. Imagine the reaction an owner may have to a letter that states the objective truth:

“Your policy is intended to qualify under the Guideline Premium Test of Internal Revenue Code Section 7702. Under this test, the sum of premiums paid cannot exceed your Guideline Premium Limit. If you reduce your benefit, the Guideline Premium Limit is reduced. This may require you to take one or more distributions from your policy in order to remain qualified under the test. Please consult your qualified tax advisor for more information.”

When a client who is older, perhaps on a fixed income, and is generally ignorant of such matters receives this letter, the response is very likely to be negative and, perhaps unfairly, blaming of the insurance company.

History Lesson: Are you a Monday Morning Quarterback?

What information a company feels is needed or required to be provided to an owner has itself changed over time.

Back in the 1980's, insurance policy forms and disclosures were generally shorter and more general than they are now. Much of this has to do with the level of complexity built into the product but also to the lessons that are learned over time.

But if you provide information now that is new to the owner, the natural question is “why didn't you tell me this before?” This question is particularly troubling if the activity that gave rise to the forceout occurred in the past. You may have provided the information, but not in a format that was understandable to the client. Or you may not have provided it at all because of system limitations, statement formats or other constraints. In the case where information was either insufficient or nonexistent this does change the way you would communicate today. The problem only grows more difficult to manage and costs more the later you wait. Add to this that if the information seems conflicting in any way it will be held against you.

Guideline Policy Forceouts

A Case Study

In 1990, Mrs. Olsen purchased a Universal Life Policy that was qualified under the Guideline Premium Test. Her initial purchase was as follows:

- A \$750,000 Face Amount, for a Female Nonsmoker Age 45, under a level face amount (Option 1) death benefit.
- \$10,000 Annual Premium payments for 15 years (to Age 60, in 2004).
- A 10 percent Illustrated Rate that provided benefits to maturity at age 100.
- Provided to her: a GSP = \$150,000 and a GLP of \$15,000.

Mrs. Olsen paid all her premiums as billed to her, and extended premiums for an additional five years until she was age 65 based on illustrations that showed that her policy was underperforming. After 20 years of premium payments, she retired and stopped making payments.

As interest rates neared her 4 percent guarantee, the illustrations still showed declining performance. In 2020, when she turned 75 and after 30 years of ownership, it looks like she would lose her policy completely in a few short years at age 85. Premiums would be too costly, so she instead chose to reduce her benefit by 50 percent, to \$375,000.

A funny thing happened. Her illustration showed her having to take \$15,000 in distributions from her cash value beginning at age 90, and the policy would still lapse at age 92. Her producer explained to her that the Guideline Premium Test Values would reduce when she drops her benefits to a GSP of \$50,000 and a Negative GLP of \$15,000. She would be able to pay premiums to prevent the policy from lapsing, but in her 90s these would be very expensive.

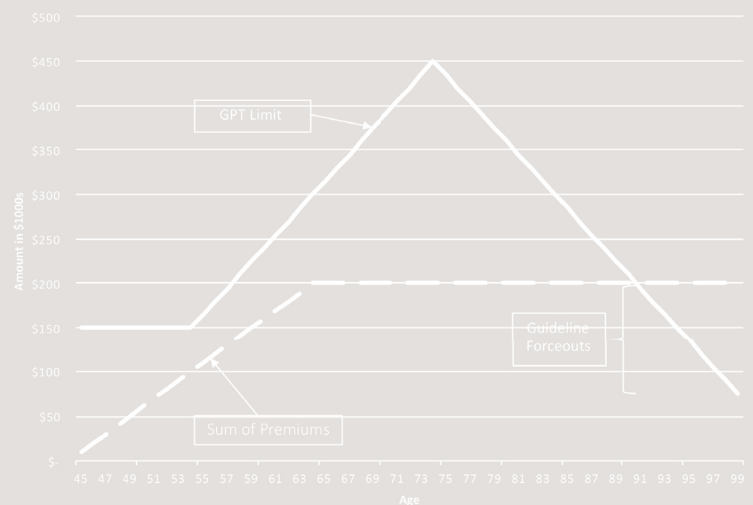
Her conundrum is a difficult one:

- If she keeps her benefit at \$750,000, she has effectively “locked in” the higher cost of insurance costs, and may end up with no benefits at all if she lives long enough.

- But if she tries to cut her costs, she gives up 50 percent of the benefits that may be needed in a short timeframe after all, and may still have to pay premiums later to maintain this lower level of benefits.

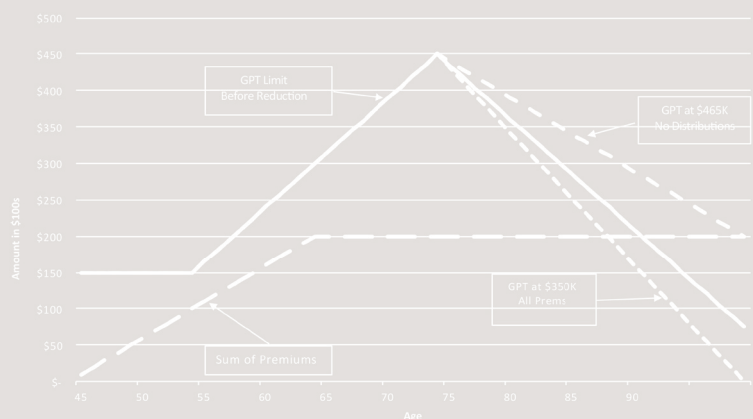
Figure 1 is a graphical way to show how the Guideline Limits have influenced this policy. It is obvious that she had paid premiums well under the Guideline Premium Limit, but the change had a large impact and ultimately causes forceouts to occur.

Figure 1
Forceouts based on 50% reduction to face



When she asks what she can do to both preserve her policy and prevent forceouts, it is possible to use solve for the policy face amounts that can assist in her decision making. Figure 2 provides two alternatives.

Figure 2
Solving for Face Amounts



There are now 3 alternatives provided to Mrs. Olsen:

- Alternative 1: Reduce the benefits from \$750,000 to \$375,000, and take forceouts beginning at age 91.
- Alternative 2: Reduce the face from \$750,000 to \$465,000, and avoid any forceouts. In this case there is higher cost of insurance, but without any forceouts the policy may continue to a longer period.
- Alternative 3: Reduce from \$750,000 to \$350,000. This saves some cost of insurance rates, but the forceouts now begin at age 88.

The question is, what alternatives do you present? In the case of Mrs. Olsen, it would appear that case number 3 would be

the least likely to meet the situation—where forceouts are triggering a potential lapse of the policy. But do you make that assumption for her? Because these alternatives are services provided that are not within the scope of the owner's contract, care must be taken to not cross the line and assume that you know what her needs are. The company is bound only by the terms of the contract, and needs to be very careful in how any recommended benefit changes are disclosed. That said, you are the one who has the ability to provide the information.

So, which alternative would you recommend?

Do We Tell the Owners Now, or do We Tell Them Later?

This is deceptively difficult. In our simple case study for Mrs. Olsen (see sidebar), the Guideline Forceouts are not projected to occur for several years and in the later years of her life.

Let's consider a counterexample: Mrs. Olsen's case was one where the illustration shows the policy taking forceouts and then lapsing. But many cases have so little cash value that even with the changes in benefits they are shown as lapsing before a Guideline Forceout occurs.

In such a case, the illustration won't show the Guideline Forceout at all. The reduction is taken, and if the policy stays in force regardless (interest rates rise, they pay premiums, and so forth), there is a large surprise when it does eventually happen.

Is there an obligation for the company to contemplate results that may not ever happen? The easy argument is no—this is just an illustration and not a contract. However, unless other answers are provided in a different communication format, the illustration will be relied upon. This is the very fine line by which the illustration becomes your administrative solution.

CONCLUSION: WHAT'S A POOR ACTUARY TO DO?

The difficulty in writing an article such as this is that it focuses on a single issue and can seem very alarming as a result. The flexibility of a Universal Life policy is overall a good thing. When used properly, it can help an owner meet their insurance needs. But those needs change over time, and it is quite likely that the owners have not taken the kinds of actions necessary to ensure that their needs are met. This is only exacerbated by the very long period of low interest rates and the corresponding effects on policy cash values. No one could have projected the type of economic conditions that gave rise to these issues.

As policies continue to age, the scope of these issues may only grow over time. Companies are well advised to understand the nature of their business, even when they do not focus on highly funded sales. The cost of not understanding this to your business could be very high indeed.

As the saying goes, "The best defense is a good offense." Guideline Premium problems may be solvable, but only if your company is willing to be proactive and timely in doing so. With proper explanation, solutions can be a way for companies to provide service to their clients to help them meet their needs. This is a service that we actuaries are well-suited to provide to our clients and companies. ■

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ENDNOTES

- 1 "The Definition of Life Insurance Under Section 7702 of the Internal Revenue Code," *Transactions of Society of Actuaries*, Volume XL, page 228.
- 2 Christian DesRochers, John Adney, Brian King and Craig Springfield, *Life Insurance and Modified Endowments under Internal Revenue Code Sections 7702 and 7702A*, Second Edition, Chapter 4.
- 3 Section 7702(f)(2)(A) Cash Surrender Value – The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.
- 4 Note that some of the administrative difficulties can be aided using methods such as a premium deposit fund that holds the premiums outside of the life insurance contract until they are required to prevent lapse. Interest earned on such a fund will typically be taxable.
- 5 *Ibid*, Page 229.