# Necessary Premiums Test Concept sounds so simple — But is it?

**Your manager asked you to add 'necessary premiums' support to your life insurance administration system. You think, 'sounds simple enough'– but is it?**

When 7-pay premiums regulation was first added to the Federal Tax Code in 1988 under Section 7702A, it was done to discourage policy owner manipulations using life insurance policies to exploit tax-free distributions. US life insurers selling universal life and whole life were required to make major changes to their policy administration systems to support the harsh new regulations.

Changes were sweeping. Virtually all financial – and some non-financial – transactions processed against a new cash-valued life insurance policy were enhanced to calculate new mandatory 7-pay premiums, monitor the 7-pay premium for 'failure' and assignment of the dreaded status of Modified Endowment Contract or MEC. It took decades for some form of processing normalcy to evolve among insurers and for the US Treasury regarding the detailed calculations and trigger events. In this evolution, insurers and regulators defined and clarified:

- What is a base plan, a qualified additional benefit (QAB), a non-qualified additional benefit (non-QAB)?
- What is a material change? What is a reduction event? What service events cause nothing at all?

Insurers offering participating contracts with paid-up additions concepts or automatic face increases suffered disproportionate impact of the new law. Under some product scenarios, when paid-up additions/face increases were innocently purchased, a policy could experience never-ending monitoring of 7-pay premiums over a policy lifetime with increased possibility of going Modified Endowment Contract or MEC status – 'a bad thing.' This was purely due to the math of material change adjustments.

This technical dilemma was unfortunate since purchasing more insurance is 'a good thing' under public policy, especially when purchased as through an automatic-pilot policy design, not due to policy owner manipulations to exploit tax loopholes. Relief was provided to insurers if so elected under the optional 7702A 'necessary premiums test' or NPT.

NPT allows insurers to determine types of increase events that will be deferred and not trigger routine 'material change' recalculation of 7-pay premiums. Under NPT, an alternate calculation is performed that if failed, causes 'deferred' changes to come forward and 7-pay premiums recalculated and 7-years of monitoring to begin again. Sounds simple – right? No – it is not simple or consistent since every insurer can determine which events will be deferred and which will be immediate. Since insurers offer and emphasize different product features, this is logical, but it does not make deployment of NPT easier to understand as any type of industry standard.

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*More insurers are showing interest in the NPT option since the industry further understands the impact of repetitive triggering of material changes over time against in-force contracts and the negative possibility of going MEC status. Do not be surprised if this new level of testing complexity is part of your next administration system enhancement project.*

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