# CVAT & GPT – What's It All About?

**Question**: What are CVAT and GPT and why are they important?

**Answer**: CVAT is the abbreviation for Cash Value Accumulation Test, and GPT is the abbreviation for Guideline Premium Test. These terms refer to the two basic alternatives for determining whether a product meets the requirements to qualify as a life insurance contract. Both tests define the relationship between cash value and death benefit that is required at all times for a contract to qualify as life insurance but, as we will see later, they do it using two different approaches.

**Question**: What happens if a product fails to meet one of these two tests?

**Answer**: If a product fails to meet either the CVAT or GPT test, it is no longer taxed as a life insurance contract. Instead, it is taxed as an investment. (Prudential's systems will notify a policyholder before a policy reaches this status, allowing the policyholder to take corrective action, if desired.) Most life insurance contracts enjoy tax-deferred growth of policy values and income-tax-free death benefits. In contrast, annual growth in most investment contracts is taxed currently as ordinary income, and any profit at death (i.e., gain over basis) is also taxed as ordinary income.

Most life insurance contracts are designed so that they will ALWAYS meet either the CVAT test or the GPT tests and will qualify as a life insurance contract.

**Question**: If most life insurance policies will always meet one of these two tests, does it really matter which test is chosen?

**Answer**: Yes. The test selected can have a significant impact on premiums, cash values, and death benefits. In addition, the choice of which test should be used must be made by the issue date. **Once the policy is issued, the choice cannot be changed – so the initial choice is important.**

**Question**: So the choice is important. What is the basic difference between CVAT and GPT?

**Answer**: The basic difference is that CVAT limits <u>cash value</u> relative to the death benefit while GPT limits <u>premiums</u> paid relative to the death benefit.

The CVAT test will maintain a *net single premium* relationship between the cash value and death benefit. In other words, for every dollar of cash value, the death benefit must be at least the amount that could be purchased on a guaranteed basis using the cash value as a net single premium. You may be familiar with

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traditional participating whole life products that use dividends to purchase paid-up-additions (PUAs). The PUA purchase is a net single premium transaction that uses the cash dividend to buy a piece of paid-up life insurance. The amount of paid-up insurance varies based on the attained age of the insured. This is the same relationship that is required by the CVAT test. The cash value determines the minimum death benefit based on the attained age.

The GPT test defines limits on premiums paid based on the death benefit. For a given death benefit, GPT defines a *guideline single premium* and a *guideline level premium*. Payment of premiums in excess of these amounts is not permitted. The GPT test also defines the relationship between the cash value and the death benefit. Unlike CVAT where the cash value determines the minimum death benefit, with GPT, the death benefit limits the permissible cash value based on a *corridor* percentage test. Put another way, with GPT, the death benefit limits the premiums that can be paid, or the cash value that can exist, at any attained age.

**Question**: Whew… I'm not an actuary and I never will be. Can you just tell me when to choose CVAT and when to use GPT?

**Answer**: Here are some general guidelines for choosing CVAT or GPT:

Use <u>CVAT</u> when:
- Your client doesn't want any limitations on the amount of premium that can be paid into a life insurance policy. Note: there are still premium limitations if your client does not want the policy to become a modified endowment contract (MEC).
- Your client prefers to maximize the policy death benefit at life expectancy.
- Your client chooses a level death benefit and wants to pay the maximum *7-pay* premium in years 1-7.

- Your client wants to make substantial first year drop-ins or has a large IRC § 1035 exchange rollover and prefers to minimize the initial death benefit.

Use <u>GPT</u> when:
- Your client wants to use a variable death benefit and pay maximum level, ongoing annual premiums for more than 10 years.
- Your client is more interested in lifetime cash accumulation and maximum policy distributions than maximizing the policy's death benefit.
- Your client wants to pay the *7-pay* premium for much longer than the initial 7 years.
- Your client wants to maximize the cash value and death benefit in later policy years.

Consider the following two examples. The first example compares the illustrated DEATH BENEFIT in three different scenarios. Bold numbers identify the *leader*:

PruLife UL Plus, Male 45, PNS, Pay $25,000/yr for 15 yrs. Minimum Non-MEC Death Benefit[1] – 5.35% Illus. Interest Rate

| Illustrated Death Benefit | CVAT - Level Death Benefit | GPT - Level Death Benefit | GPT – B to A Death Benefit[2] |
|---|---|---|---|
| Yr 10 / Age 55 | 747,729 | **1,448,138** | 817,972 |
| Yr 20 / Age 65 | 1,246,635 | **1,448,138** | 1,045,032 |
| Yr 30 / Age 75 | **1,587,627** | 1,448,138 | 1,233,948 |
| Yr 40 / Age 85 | 2,078,631 | 1,717,972 | **2,083,690** |
| Yr 50 / Age 95 | 2,719,804 | 2,783,639 | **3,376,555** |

As described above, CVAT generally illustrates a larger death benefit as you approach life expectancy, but GPT generally illustrates a larger death benefit at later durations.

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[1] *Minimum Non-MEC DB (death benefit) is the minimum death benefit you can have to avoid the policy being treated as a modified endowment contract.*
[2] *Variable DB (Option B) years 1-15 with change to Level DB (Option A) in year 16 and thereafter.*

This second example compares the illustrated CASH VALUE in the same scenarios. Bold numbers identify the *leader*.

**PruLife UL Plus, Male 45, PNS, Pay $25,000/yr for 15 yrs. Minimum Non-MEC Death Benefit[1] – 5.35% Illus. Interest Rate**

| Illustrated Cash Value | CVAT - Level Death Benefit | GPT - Level Death Benefit | GPT – B to A Death Benefit[2] |
|---|---|---|---|
| Yr 10 / Age 55 | 283,401 | 262,780 | **289,519** |
| Yr 20 / Age 65 | 659,595 | 613,179 | **674,087** |
| Yr 30 / Age 75 | 1,072,721 | 982,176 | **1,153,223** |
| Yr 40 / Age 85 | 1,676,316 | 1,636,164 | **1,984,467** |
| Yr 50 / Age 95 | 2,428,397 | 2,756,078 | **3,343,123** |

If cash accumulation is the primary objective, using GPT and a variable death benefit (option B) during the premium-paying period produces the highest illustrated cash value at all durations. If we were to illustrate a solve for maximum policy distributions, the last scenario (GPT – B to A death benefit change) will generally produce the highest illustrated distributions.

**Question**: What if the client really doesn't have any strong preferences on these issues? Or what if I don't really know with any certainly what the client's premium payment plans are? Which should I choose?

**Answer**: If there is no clear emphasis on the amount of the death benefit at life expectancy vs. at age 121… if there is no clear preference for long-term cash value over a long-term death benefit… if there are no definite plans to access cash value for supplemental retirement income[3]… if there is nothing to make it clear which test should be selected…

**In other words, when in doubt, select the default choice in our ISP illustration system, GPT, instead of CVAT. GPT generally results in lower COI (cost-of-insurance) charges and higher cash values over a long period, particularly at the later policy years when a policy may hit the definition of life insurance corridor. The COI charges are lower because there is a lower net amount at risk.**

Another alternative is to run a Summary Report in ISP, changing only the definition of life insurance so that you and your client can see the impact of choosing GPT or CVAT.

**Still unsure which test to select?** Contact your advanced marketing unit with the particulars of a case. We will be happy to discuss the alternatives for your case and suggest an appropriate choice for your client.

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[2] *Variable DB (Option B) years 1-15 with change to Level DB (Option A) in year 16 and thereafter.*

[3] *Withdrawals and loans reduce policy cash values and death benefits, may affect any policy guarantees against lapse, and may have tax consequences.*