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Subject: **If Taxpayer Exchanges Multiple MECs for New Contracts Issued by Different Insurance Company, New Contracts Need Not Be Aggregated With Remaining Old Contracts**

Major References: ***Rev. Rul 2007-38*, *2007-25 I.R.B. 1***

MDRT Information Retrieval Index Nos.: *4400.09; 7400.023*

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The Internal Revenue Service has published Rev. Rul. 2007-38 holding that, if a taxpayer that owns multiple modified endowment contracts (MECs) issued by the same insurance company in the same calendar year exchanges some of those MECs for new MECs issued by a second insurance company, the new contracts are not required to be aggregated with the remaining original contracts.

Under the facts set forth in the ruling, in Year 1, Original Insurance Company issued to Taxpayer multiple life insurance contracts (Original Contracts) that were modified endowment contracts (MECs) – *i.e.*, they failed to meet the 7-pay test of Internal Revenue Code Section 7702A(b). The Original Contracts covered the lives of employees, officers and directors who were employed by Taxpayer at the time the contracts were issued. Taxpayer appropriately treated the Original Contracts as a single MEC under the authority of Revenue Code Section 72(e)(11) (now Section 72(e)(12).

In Year 4, Taxpayer exchanged some of the Original Contracts for new life insurance contracts (New Contracts) issued by an unrelated life insurance company (New Insurance Company) in a Section 1035 exchange. The new contracts were also MECs within the meaning of Section 7702A. Taxpayer received no additional consideration in the exchange.

Under Section 72(e), a MEC is subject to the rules that tax non-annuity distributions – including loans, assignments, or pledges of any portion of the value of a MEC - a FIFO or an income-out-first basis. Further, an amount received under a MEC may be subject to a 10% additional tax.

For purposes of determining the amount that is includible in gross income under Section 72(e), all MECs issued by the same company to the same policyholder during a calendar year are treated as a single MEC. According to the legislative history of this "aggregation" requirement (which was added to the Code in 1988) its purposes was "to stop the marketing of serial contracts that are designed to avoid the rules applicable to modified endowment contracts."

In the ruling, the Service noted that the Original Contracts were issued to Taxpayer by the same company in the same calendar year and were, accordingly, aggregated in accordance with § 72(e)(12). After the exchange of some of the Original Contracts for New Contracts, the remaining Original Contracts were still issued to Taxpayer by the same company (Original Company) in the same calendar year (Year 1) and, accordingly, are still treated as a single MEC. Likewise, the New Contracts received in the exchange were issued to Taxpayer by the same company (New Insurance Company) in the same calendar year (Year 4) and, accordingly, are also treated as a single MEC. However, the remaining Original Contracts and the New Contracts are not aggregated with each other, because they were not issued to Taxpayer by the same company in the same calendar year.

The Service also ruled that the result in this case would be the same if, instead of individually issued MECs, the Original Contracts and New Contracts were evidenced by certificates that were issued under a group contract or master contract and that were treated as separate contracts for purposes of the Code provisions relating to the qualification and taxation of life insurance.

Any AALU member who wishes to obtain a copy of the text of Rev. Rul. 2007-38 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org, enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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