

Part I

Section 72.--Annuities: Certain Proceeds of Endowment and Life Insurance Contracts

26 CFR: §72
(Also: §7702A)

Rev. Rul. 2007-38

ISSUE

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, are the new contracts required to be aggregated with the remaining original contracts under §72(e)(12) of the Internal Revenue Code?

FACTS

In Year 1, Original Company, an insurance company subject to tax under Part 1 of subchapter L, issued to Taxpayer multiple life insurance contracts (Original Contracts) that were modified endowment contracts (MECs) within the meaning of §7702A. 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 §72(e)(11) (redesignated as §72(e)(12) by the Pension Protection Act of 2006, Pub. L. No. 109-280, §844(a), 120 Stat. 780).

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 Company) in an exchange that qualified for nonrecognition of gain or loss under §1035. The new contracts were also MECs within the meaning of §7702A. Taxpayer received no consideration in the exchange.

LAW AND ANALYSIS

Section 1035 provides that no gain or loss is recognized on the exchange of a life insurance contract for another life insurance contract, or for an endowment or annuity contract. Under §1.1035-1 of the Income Tax Regulations, nonrecognition of gain or loss on the exchange of life insurance contracts is limited to cases where the policies exchanged relate to the same insured.

Section 7702A defines a modified endowment contract (MEC) as a contract that meets the requirement of § 7702 but fails to meet the 7-pay test of §7702A(b), or that is received in exchange for a contract that is a MEC. Under §7702A(b), a contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before that time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.

Section 72(e)(10) provides that a MEC is subject to the rules of §72(e)(2)(B) (which taxes non-annuity distributions on an income-out-first basis) and §72(e)(4)(A) (which generally treats loans, assignments, or pledges of any portion of the value of a MEC as non-annuity distributions). Further, under §72(v), an amount received under a MEC may be subject to a 10% additional tax.

Section 72(e)(12)(A)(i) provides that, for purposes of determining the amount that is includible in gross income under § 72(e), all MECs issued by the same company to the same policyholder during a calendar year are treated as a single MEC. Section 72(e)(12) was added to the Code by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), §5012(d)(2), 1988-3 C.B. 324.

The legislative history stated:

In order to stop the marketing of serial contracts that are designed to avoid the rules applicable to modified endowment contracts, the conference agreement provides that all modified endowment contracts issued by the same insurer (or affiliates) to the same policyholder during any 12-month period are to be aggregated for purposes of determining the amount of any distribution that is includible in gross income. In addition, all annuity contracts issued by the same insurer (or affiliates) to the same policyholder during any 12-month period are to be aggregated for purposes of determining the amount of any distribution that is includible in gross income. Finally, the Treasury Department is provided regulatory authority to prevent the avoidance of the rules contained in section 72(e) through the serial purchase of contacts or otherwise.

H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. II-103 (1988), 1988-3 C.B. 593.

The provision was subsequently amended by the Omnibus Budget

Reconciliation Act of 1989 (OBRA), Pub. L. No. 101-239, §7815(a)(5), 103 Stat.

2414 (1989), to strike the term "12-month period" and in its place insert "calendar

year." The OBRA conference report reiterates that the provision applies to contracts "that are issued by the same insurer (or affiliates.)" H. Conf. Rep. No. 386, 101st Cong., 1st Sess. 665 (1989).

In the present case, 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 Company) in the same calendar year (Year 4) and, accordingly, are also treated as a single MEC. The remaining Original Contracts and the New Contracts are not aggregated with each other, however, because they were not issued to Taxpayer by the same company in the same calendar year. 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 §§817(h), 7702, and 7702A.

HOLDING

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 §72(e)(12).

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Luxner at (202) 622-3970 (not a toll-free call).