THE NONQUALIFIED ADVISOR

An Independent Resource for Plan Sponsors and Participants of Nonqualified Plans

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IRS Eases MEC Tax Provision

Under IRC Section 72(e)(12), modified endowment contracts (MECs) issued by the same insurer (or affiliates) to the same policyholder during any 12 month period are aggregated (i.e. treated as a single policy) for purposes of determining the taxable gain or loss on surrender or distribution of a policy.

In a recent revenue ruling, the IRS described a situation where an employer purchased a series of MEC policies from an insurance company. The employer properly recognized the policies as policies aggregated under Section 72(e)(12). In a subsequent year, the employer exchanged several policies for new MEC policies issued by another carrier. The exchange qualified as a tax-free exchange under Section 1035.

At issue was whether the employer's new policies would be aggregated with the old policies under Section 72(e)(12), or whether they could be treated as separate MEC contracts under Section 7702.

The IRS concluded that the original contracts that remained with original carrier would be aggregated and new contracts with the new carrier would be aggregated; however, the new contracts and the old contracts would not be aggregated because the policies were not issued in the same calendar year.

This ruling does not represent a significant change to the current taxation of MECs; however, it clarifies the treatment of MECs in a 1035 exchange. It also poses some interesting questions on distribution from multiple policies and could provide some opportunities to reduce the amount of gain recognized in a surrender or distribution situation.