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# At Last — A Permanent MEC Correction Procedure

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## Introduction

On August 6, 2001, the Internal Revenue Service issued Revenue Procedure 2001-42 (Rev. Proc. 2001-42), establishing a permanent avenue for companies to correct inadvertent modified endowment contracts, or MECs. The insurance industry had been without an MEC correction program for over a decade before the IRS published Revenue Procedure 99-27 (Rev. Proc. 99-27) in May of 1999. Rev. Proc. 99-27 was a temporary procedure, however, and when it expired on May 31, 2001, the insurance industry was again without a process to correct inadvertent MECs.

Rev. Proc. 2001-42 is much broader in scope than its predecessor, as certain MECs that were ineligible for correction under Rev. Proc. 99-27 can now be corrected under this new procedure, including corporate-owned life insurance contracts and contracts with funding levels that exceeded prescribed limits defined in Rev. Proc. 99-27 (i.e., the 300% test and the 150% test).

Because of the complexities of administering contracts within the requirements of § 7702A of the Internal Revenue Code, companies will continue to have inadvertent MECs, even those companies that took advantage of Rev. Proc. 99-27. Having a permanent correction program will provide life insurance companies the ability to correct inadvertent MECs and, therefore, provide the tax benefits afforded life insurance consistent with the expectations of their policyholders.

## *Why is a correction procedure necessary?*

The need for a program allowing companies to correct inadvertent MECs has existed since 1988 when Congress enacted § 7702A. Historically, life insurance has been granted certain tax-favored characteristics, including the tax deferral of the inside build-up and the tax-free distribution of death benefit proceeds. In 1988, § 7702A was added to the Internal Revenue Code to create a new class of life insurance called modified endowment contracts. A life insurance contract becomes a MEC when it fails the 7-pay test as defined in § 7702A. Unlike pre-death distributions from a non-MEC, which are taxed on a return-of-premium first basis, distributions from a MEC (including policy loans) are generally taxed on an income-first basis.

Because § 7702A has proven to be very complex and quite difficult to administer, contracts have become MECs inadvertently. These unintentional MECs can arise for a variety of reasons, such as the early payment of an annual premium, errors in administering § 1035 exchanges, or incorrect processing of material changes or death benefit reductions. Other than the statutory provision that allows for the return of excess premium and earnings within 60 days after the contract anniversary, insurers did not have the ability to un-MEC a contract. However, in contrast, § 7702 (Definition of Life Insurance) has a built-in correction procedure under § 7702(f)(8) and never required the issuance of further correction procedures.

## *The Initial Solution: Revenue Procedure 99-27*

For several years, the insurance industry, through the ACLI, sought a program to allow for the correction of unintentional MECs. After several years of discussions, the IRS published Rev. Proc. 99-27 in May of 1999. For details of Rev. Proc. 99-27, please see the article in the August, 1999, issue of the PD Newsletter by Christian DesRochers and Brian King.

Rev. Proc. 99-27 turned out to be less than a wholly desirable solution for the insurance industry. In working with more than two dozen companies that did file under Rev. Proc. 99-27, as well as several companies that did not, we found five principal areas of concern and criticisms regarding the original correction program:

"Sunset Date" – Rev. Proc. 99-27 was a temporary procedure in that companies had a deadline of May 31, 2001, to file their submission to correct inadvertent MECs. In some cases, companies decided not to file because of this time limit. These companies felt they needed more time to find and understand their compliance problems, assemble the appropriate data and calculate the toll charges for the submission. Creating a permanent program without the deadlines imposed by Rev. Proc. 99-27 will provide companies adequate time to identify all inadvertent MECs, make the necessary administrative changes to prevent future inadvertent MECs and assemble a complete filing, satisfying all the reporting requirements imposed by the Revenue Procedure.

"One bite at the apple" – Insurers generally had one opportunity to submit all contracts for correction. This left little flexibility for companies to attack their problem in a "divide and conquer" fashion (e.g., one block of business at a time or one system platform at a time). It was all or nothing.

Limited scope – Most business-owned contracts (i.e., COLI) were not eligible for correction. Additionally, Rev. Proc. 99-27 created two eligibility tests—the 300% test and the 150% test which excluded certain contracts from correction.

> The 300% Test: In order for a contract to meet the requirements of the 300% test of section 4.03(2) of Rev. Proc. 99-27, the amount paid under the contract in any contract year of the testing period cannot exceed 300 percent of the 7-pay premium for the contract year.

The 150% Test: Contracts will meet the requirements of the 150% test of section 4.03(3) of Rev. Proc. 99-27 if the cash surrender value of the contract does not exceed the contract holder's investment in the contract within 3 years after the issuance of the contract or the assumed 7-pay premium for the contract was not more than 150 percent of the correct 7-pay premium for the contract.

Both the 300% and 150% tests were intended to exclude investment rich contracts from correction under this revenue procedure. However, defining the particular parameters for identifying these types of contracts proved difficult. The insurance industry argued against both tests as they could render certain contracts with little or no investment orientation ineligible for correction. Conversely, certain investment-oriented contracts with significant amounts of excess premiums could pass these tests. In the end, however, companies were left with no means of correcting contracts falling into these two categories.

Reporting Requirements and "Toll Charge" Calculation – In order to generate the templates and compute the toll charge required to correct inadvertent MECs, companies needed to access significant amounts of historical policy level information that often proved difficult to obtain (e.g., the taxpayer identification number). For each contract included in the filing, companies were required to provide two reports, or templates. The first template detailed all historical premium transactions and 7-pay premiums. This information was used to identify the excess premium, or overage, which formed the basis for computing the "overage toll charge." The second template detailed the cash surrender value of the contract on each contract anniversary, along with all historical distributions (loans and withdrawals), including amounts reported to the policy owner as taxable. This information formed the basis for computing the "distribution toll charge." The second template also required a description of any material change that occurred as well as a description of the error that resulted in the inadvertent MEC.

For those companies filing a large number of contracts, significant programming efforts were needed in order to access and manipulate the historical information into the required formats for each template. Because the revenue procedure required a paper filing, companies generally filed between two and four pages for each contract included in their filing. Several companies filed closing agreements that included in excess of 10,000 pieces of paper!

Correcting Contracts: The final requirement a company must satisfy under Rev. Proc. 99-27 is that contracts must be corrected within 90 days after the execution of the closing agreement by either refunding excess premium (and earnings) or by increasing the death benefit. What sounds like a straightforward exercise can become quite complicated if your administration system continues to recognize these contracts as MECs, even after refunding the excess premium and earnings. Getting administrative systems to no longer administer these contracts as MECs has proven to be quite difficult for certain systems, particularly those systems that test for compliance from the original issue date each time a transaction is processed.

### *What were the results of Rev. Proc. 99-27?*

Most companies in the insurance industry did not avail themselves of Rev. Proc. 99-27 and still had no process for correcting inadvertent MECs.

Between 50 and 75 companies filed closing agreements with the IRS. Even those companies were left with many contracts that could not be corrected because they were COLI contracts or failed one of the mathematical tests of Rev. Proc. 99-27.

Companies that filed closing agreements were not able to make a supplemental filing if additional MECs were identified after May 31, 2001, or after the original filing was submitted.

In general, the industry was seeking a procedure that provided what § 7702(f)(8) provides for contracts that fail the definition of life insurance. Section 7702(f)(8) provides for a correction procedure that is permanent, allows for multiple submissions over time as problems are discovered, and allows for the correction of virtually all contracts. Rev. Proc. 99-27 provided a stop-gap but fell short of providing a lasting solution.

### *The Permanent Solution: Revenue Procedure 2001-42*

Two months after the expiration of Rev. Proc. 99-27, the IRS issued Rev. Proc. 2001-42. Even though Rev. Proc. 2001-42 carries over the burdensome reporting requirements and toll charge mechanism of Rev. Proc. 99-27, it has the following significant improvements:

Permanent procedure – Rev. Proc. 2001-42 is a permanent program, having no deadlines.

No limit on submissions – Rev. Proc. 2001-42 does not limit companies to a single filing request.

Expanded Scope – Rev. Proc. 2001-42 expands the scope of the correction program by allowing the correction of COLI contracts and eliminating the eligibility tests that contracts were required to satisfy under Rev. Proc. 99-27. Even without these tests, the IRS still has the authority to reject contracts it determines are part of a program to sell investment-oriented contracts or to be in clear violation of rules. This would include contracts that provide for paid-up future benefits after the payment of less than 7 level annual premiums. Companies also found the 300% eligibility rule especially frustrating.



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Other variations from Rev. Proc. 99-27 include the following:

- The deminimis overage earnings definition that applied only to contracts issued prior to January 1, 1999, now applies to all contracts.

- Although Rev. Proc. 99-27 did not differentiate between contracts in or out of the 7-pay test period, the IRS in practice did not require the refund of excess premium and earnings (or an increase in death benefits) on those contracts outside the 7-pay test period. Rev. Proc. 2001-42 explicitly clarifies this treatment: "Contracts within 90 days of the end of their seven-year test period on the date the closing agreement was executed do not require correction." Note that a toll charge must still be calculated and paid on these contracts.

Rev. Proc. 2001-42 recognizes that, despite the best efforts of life insurance companies and policy owners, some policies will become inadvertent MECs. By creating a permanent program, the IRS has created the opportunity for companies that were not able to take advantage of Rev. Proc. 99-27 to "cure" their inadvertent MECs. In addition, those companies that did file will now be able to supplement their filings to include virtually all inadvertent MECs. It is important to note that while the new revenue procedure does re-open the door for companies to bring their in force policies into compliance, the reporting requirements are still voluminous. As is well known by the companies that filed under the old revenue procedure, the cost in terms of necessary resources to meet the reporting requirements can be significant. At the same time, the new procedure addresses a deficiency that has existed in the MEC rules since their enactment by creating a program to "cure" errors—a benefit to insurance companies, policy holders, and the IRS.

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## *Society of Actuaries Announces Triennial Prize*

SCHAUMBURG, ILL. — The Society of Actuaries and its Committee on Life Insurance Company Expenses (CLICE) announces the inaugural $5,000 Arthur Pedoe Life Insurance Company Expense Study Award. The first award will be presented in 2004 for the best paper published between July 1, 2001 and June 30, 2004.

The purpose of the award is to increase awareness of the importance of expense analysis among company management by encouraging informative, high-caliber papers on the subject. The award will be offered once every three years for a paper that is judged to be the best paper on life insurance company expense analysis published by a suitable actuarial publication.

To be considered, a paper must be based on sound actuarial and accounting principles and should be of such caliber as to advance the state of the art of expense analysis and related life insurance financial information. Members of the CLICE will judge entries in conjunction with the editors of the *North American Actuarial Journal* (NAAJ). The CLICE reserves the right not to make an award in any period in which it does not consider any paper worthy of the award.

The award is named for Arthur Pedoe, an actuary who was well known for his studies of life insurance company expenses. Mr. Pedoe was a Fellow of the Institute of Actuaries, the Actuarial Society of America, the Canadian Institute of Actuaries, and the Society of Actuaries where he held the office of Vice President in 1958-59. He spoke frequently at Society meetings on trends in expenses and on the importance of controlling increases in expenses. For this purpose, he developed methods of calculating expected expenses to be compared with actual expenses. These methods were still in general use at his death in 1979.

The Society of Actuaries is a professional, educational, and research organization with more than 16,400 members who practice primarily in the fields of life and health insurance, pensions, employee benefits, and investments.