The document discusses the complexities of tax implications surrounding life insurance policies, particularly in light of evolving regulatory frameworks and judicial interpretations. It highlights the historical role of life insurance as primarily an economic protection tool, which has shifted towards being an investment vehicle, necessitating accurate determination of tax basis upon policy sales. The authors, Mitchell M. Gans and Jay A. Soled, propose a new model called the "policy-investment theory," which differentiates between acquisition costs and ongoing insurance costs, arguing for its superiority over the existing "aggregate premium theory." They emphasize that the Internal Revenue Code (IRC) lacks a clear methodology for calculating tax basis, leading to confusion and inconsistency in IRS guidance. The document outlines that taxpayers selling life insurance policies for less than total premiums paid cannot deduct losses, as the tax basis is considered the cash surrender value, not the aggregate premiums. This principle has been upheld in court cases, where courts denied loss deductions based on the reasoning that the portion of premiums representing insurance protection is excluded from the tax basis.

The discussion extends to the treatment of policy surrenders, where similar rulings apply, and highlights the IRS's support for the policy investment theory, which posits that mortality charges should not reduce the tax basis. The document critiques the aggregate premium theory for failing to recognize the distinction between acquisition and upkeep costs, proposing the hypothetical term method to determine the investment component of premiums. This method aligns with how insurance companies categorize premium payments and is suggested as a fair approach for taxpayers disposing of policies. The text also addresses the implications of recent court decisions and IRS regulations, particularly regarding the treatment of life insurance transactions under the Chevron and Skidmore standards of judicial deference. It notes that the IRS has historically been granted favorable treatment in tax matters related to life insurance, including tax exemptions on policy proceeds and cash value accumulation.

The document further discusses the impact of federal estate tax law changes on life insurance policies, particularly in the context of the AIDS epidemic and the rise of the life settlement industry. It highlights the growing trend of life settlements, where policyholders sell their life insurance policies, and introduces premium financing techniques that raise tax implications for the insured. The text critiques the current law under IRC § 72, which treats surrenders and sales differently, suggesting that Congress should amend this to ensure consistent tax outcomes. The authors advocate for clarity in the tax treatment of life insurance dispositions and propose legislative action to standardize the proposed hypothetical term method for both policy surrenders and sales. They conclude that without such changes, the IRS should revoke existing guidance and issue new regulations to ensure fair and consistent tax treatment of life insurance policies, particularly as they relate to the emerging life settlement market and premium financing techniques.