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*569 A NEW MODEL FOR INDENTIFYING BASIS IN LIFE INSURANCE POLICIES: IMPLEMENTATION AND DEFERENCE

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The life insurance marketplace has changed significantly. Many insureds who once held their policy until death or surrendered it to the issuing company during life now instead sell it to a third-party investor. As a result, the computation of a policy's tax basis has become increasingly important. Yet, surprisingly, the Code fails to provide a methodology for making this determination. The IRS has endorsed one approach in its published guidance but has failed to adhere to it in its private letter rulings. This paper calls for a new model. After suggesting legislation, the paper explores alternative implementation strategies against the backdrop of deference jurisprudence. It concludes that, absent legislation, the IRS should withdraw its published guidance and incorporate the proposed model in regulations.

*571 I. Introduction

In order to compute the gain or loss on the sale or disposition of an asset, a taxpayer is required to determine the investment's basis. [FN1] While ordinarily straightforward, at least as a theoretical matter, making this determination can be particularly problematic in the case of a life insurance policy. Since so many taxpayers own life insurance policies, it is somewhat puzzling that the basis-calculation principles in this context are not more fully developed.

In the past, this uncertainty did not have practical implications. The vast majority of taxpayers either held their policies until death or allowed them to lapse. In either case, there was often no need to compute gain or loss, mooting the need to determine basis. As a result, the Internal Revenue Service (IRS) and the courts had few occasions to consider the issue.

In recent years, the function of life insurance has changed, however. Whereas it once provided economic protection for surviving family members in the event of a premature death, [FN2] it now also frequently serves an important investment function. [FN3] It is thus not surprising that life insurance policies are now, like other investments, often sold in the marketplace. [FN4] As a result of these changes, it is important to reexamine and clarify the application of tax basis principles in the life insurance context.

The aim of this paper is to consider these tax basis principles in both descriptive and normative terms. To this end, we have organized the paper into sections. In Section II we explore general tax basis rules and, in particular, the tax basis principles applicable to life insurance. In Section III we argue in favor of *572 what we call the policy-investment theory. In Section IV, we illustrate the application of this theory and call for a Code amendment that would eliminate the inequity under current law that treats policy surrenders more tax favorably than policy sales. In the absence of such an amendment, in Section V we focus on implementation through a different route, suggesting that the IRS withdraw a taxpayer-friendly revenue ruling and that it promulgate a new regulation; we also examine recent developments in deference jurisprudence and the Tax Court's resistance to the Supreme Court's administrative law precedents. In Section VI, we discuss the changing nature of life insurance and emergence of a new premium-financing technique. In Section VII, we offer our conclusions.

II. Computing Tax Basis

Accurate tax basis identification is important because gains and losses are measured by the difference between the amount realized and an asset's tax basis. [FN5] A higher tax basis is desirable because it translates into smaller taxable gains and larger tax-deductible losses. Thus, tax basis determinations directly impact a taxpayer's tax burden.

In theory, identifying an asset's tax basis should be relatively easy; after all, tax basis represents the investment a taxpayer has in an asset. For example, if a taxpayer purchases a tractor for $10,000, $10,000 represents the taxpayer's investment in the tractor and is thus the tractor's initial cost basis. [FN6] In practice, however, determining an asset's tax basis is often quite nettlesome: [FN7] application of the tax basis rules can be extraordinarily complex and time-consuming. [FN8]

In the case of life insurance, practical application is not the issue - rather, it is the unsettled nature of the law itself that is problematic. To illustrate, consider the following example: Suppose a taxpayer purchases a $1 million whole life insurance policy. Suppose further that the annual premium associated with maintaining the policy is $10,000 and that the cash surrender value grows $6,000 each year because $4,000 of the premium is attributable to the cost-of-insurance protection. [FN9] At the end of year ten, what should the taxpayer's tax basis be in the life insurance policy if it were sold for $150,000?

*573 Some commentators argue that the taxpayer's tax basis in the policy is $100,000, reflecting the aggregate premiums paid (i.e., 10 x $10,000) - hereinafter referred to as the aggregate premium theory. [FN10] After initially utilizing the aggregate premium theory in published guidance, [FN11] the IRS has begun to argue in private letter rulings that the taxpayer's tax basis in the policy should be $60,000, which reflects the aggregate premiums paid less the annual cost-of-insurance protection (i.e., 10 x ($10,000 - $4,000)) - hereinafter referred to as the policy investment theory. [FN12]

In part A, we survey the set of authorities that frame the debate; in part B, we describe how those who champion the aggregate premium theory support their point of view; and in part C, we describe how the IRS supports the policy investment theory.

A. Set of Authorities That Generally Frame the Debate

In 1920, before the courts began to grapple with the issue, the government issued an important ruling. In the ruling, Office Decision 724, [FN13] a corporation sold policies insuring the lives of its officers. Emphasizing that no deduction had been taken for the premium payments and that the sales price was less than the aggregate amount of premiums paid, the government ruled that the sales proceeds were not taxable. In doing so, the government in effect endorsed the aggregate premium approach. Although the ruling does not explicitly indicate whether gain or loss was at issue, the most natural reading is that a taxpayer in the posited situation should experience neither.

In Reverend Ruling 70-38, [FN14] the IRS indicated that it would continue adhering to the position taken in Office Decision 724. The ruling posits the same facts as in the Office Decision except that it makes one additional assumption: the policies were sold at a price equal to their cash value. Like the Office Decision, the ruling emphasizes that the sales price is less than the amount of aggregate *574 premiums and goes on to conclude that the sale thus does not generate any gross income. Most important, the additional assumption contained in the ruling does not suggest an abandonment of the aggregate premium approach adopted in the Office Decision [FN15]

Having set forth this background, we next analyze the consequences associated with the disposition of life insurance policies, first in those cases in which taxpayers experienced losses and second in those cases in which taxpayers experienced gains.

1. Analysis of Cases in Which Taxpayers Experienced Losses

In the context of computing losses, the IRS essentially ignored its own administrative rulings and instead gravitated towards adopting the policy investment theory. The policy investment theory, with its elimination of mortality charges from basis (i.e., the annual amount paid for insurance protection), effectively protects taxpayers from converting nondeductible cost-of-insurance into a deductible loss. [FN16]

The first case, Standard Brewing Co. v. Comm'r, [FN17] involved facts similar to those in the Office Decision and the revenue ruling. The corporate taxpayer had taken out a life insurance policy on the lives of its officers. [FN18] The total premiums paid were $11,178.50, and the policy was subsequently surrendered for its cash value of $6,647. [FN19] The taxpayer attempted to deduct the $4,531.50 difference between these two figures (i.e., $11,178.50 and $6,647). [FN20] The IRS disallowed this deduction and the Board of Tax Appeals upheld this position, stating that "[t]o the extent the premiums paid by the petitioner created in it a right to a surrender value, they constituted a capital investment. To the extent they exceeded the surrender value, they constituted payment for earned insurance and were current expenses." [FN21] In effect, the court held that the taxpayer's basis was equal to the policy's cash surrender value (i.e., $6,647), and the insurance protection portion of the premium *575 (i.e., $4,531.50) was an extinguished asset. The taxpayer, therefore, did not sustain an allowable loss on the sale.

With a single, and ultimately unimportant, exception, [FN22] the government handily won every subsequent case on this issue. Three cases, namely, Keystone Consolidated Publishing Co. v. Comm'r, [FN23] Century Wood Preserving Co. v. Comm'r, [FN24] and Summers & Moore v. Comm'r, [FN25] involved the sale of life insurance polices at a price equal to their cash surrender values, which were far less than the aggregate premiums paid by the taxpayers. In each case, as in Standard Brewing, the taxpayer sought to deduct as a loss the difference between the (higher) aggregate premiums paid and the (lower) sales proceeds received. The courts, however, uniformly denied the deduction, holding that the taxpayer's basis was equal to the policy's cash surrender value (which, in these cases, equaled the selling price of the policies). Echoed in many of these decisions is the following simple principle: "The part of the premiums which represents annual insurance protection has been earned and used." [FN26] As such, it could not be embedded in the policy's tax basis.

Court cases that involved the surrender, rather than the sale, of a policy have also denied loss deductions to taxpayers who attempted to invoke the aggregate premium approach. In the context of a policy surrender, the Code directs taxpayers to use the aggregate premiums paid as their tax basis for gain purposes; [FN27] in contrast, the Code is silent about how to compute tax basis for loss purposes. Thus, in the surrender cases as in the sales cases, the courts were required to compute tax basis using conventional principles in determining the amount of the *576 taxpayer's loss. In London Shoe Co. v. Comm'r [FN28] and Early v. Atkinson, [FN29] taxpayers surrendered life insurance policies for their cash value, which, as in the sales cases, was far less than the aggregate premiums paid. In both cases, the taxpayers sought to deduct the difference between the (higher) premiums paid and the (lower) amount received on surrender. The courts denied the loss deduction, adopting the same reasoning as in the sales cases, concluding that the portion of the premium attributable to the cost-of-insurance protection should not be included in basis.

It is worth emphasizing that in each set of the cases, whether involving a sale or surrender, the denial of the loss deduction served an important policy function. Had the taxpayers been successful, they would have effectively subverted the rule denying deductions for the payment of life insurance premiums. [FN30]

2. Analysis of Cases in Which Taxpayers Experienced Gains

In the context of computing gains, [FN31] however, courts have taken a divergent track: they have uniformly assumed that it is appropriate to use the aggregate premium approach. [FN32] Indeed, in cases involving the taxability of gains, the IRS did not even suggest the availability of an alternative to the aggregate premium approach.

By way of background, in endeavors to minimize their tax liabilities, taxpayers who have experienced gains on the dispositions of their life insurance policies have sought to secure capital gain treatment. [FN33] These taxpayers were anxious to secure the preferential capital gain rates. [FN34] But, as will later be discussed, [FN35] in order to qualify as capital gains these taxpayers had to cast their *577 disposition in the form of a sale or exchange, [FN36] and, second, they had to overcome the so-called substitution doctrine, under which capital treatment is denied in instances when taxpayers experience gains that are in essence a substitute for ordinary income. [FN37]

Phillips v. Comm'r [FN38] illustrates the difficulties of taxpayers' endeavors to secure capital gain treatment. In Phillips, the taxpayer owned an endowment policy. [FN39] The aggregate premiums of this policy totaled $21,360.49, and it had a cash surrender value of $26,973.78. [FN40] The taxpayer sold the policy for $26,750 to two of his partners, twelve days before its maturity value of $27,000. [FN41] The issue before the court was the character of the $5,389.51 gain (i.e., $26,750 less $21,360.49) the taxpayer had recognized (not whether the taxpayer's basis in the policy was $21,360.49 or some lesser number to reflect mortality charges). [FN42] The taxpayer argued that long-term capital gain treatment was appropriate because the policy was a capital asset, it was sold, and it was held for the requisite holding period. [FN43]

The Fourth Circuit had an entirely different perspective. Relying on several Supreme Court precedents, [FN44] it asserted that a “taxpayer may not convert such income into capital gain by a bona fide sale of the contract which is the means of producing such ordinary income.” [FN45] Several other courts reached the identical conclusion on the character-of-gain issue, [FN46] largely premised on the Fourth Circuit Court's same line of reasoning.

While Phillips and the other cases involved character-of-income issues, [FN47] all of these courts assumed the taxpayer's basis was equal to the aggregate premiums the taxpayers had paid for the policies in question (e.g., $21,360.49 in the Phillips decision). In none of these cases did the IRS argue (or even suggest) that amounts paid for the insurance protection feature caused the taxpayer's reported basis to be less, nor did any of the courts unilaterally raise this issue. [FN48]

In the end, one might fairly characterize the decided cases on the issue of tax basis as falling into one of two camps: the loss cases, where the courts applied *578 the policy investment approach; and the gain cases, where the courts assumed the application of the aggregate premium approach.

What accounts for this confusion? First, the government itself bears responsibility. The 1920 Office Decision, together with its restatement in Reverend Rulling 70-38, has made no small contribution in terms of shaping the tax basis issue. Remaining faithful to its position in these rulings, the IRS has apparently not argued in court that the principle established in the loss cases should be applied in gain cases. Second, in permitting taxpayers to use the aggregate premium approach in determining gain on the surrender of a policy, [FN49] the Code itself fosters the impression that gain on a sale should likewise be determined under this methodology. And, third, while, as suggested, there is a strong policy undercurrent driving the result in the loss cases, [FN50] the gain cases which have a very different complexion, [FN51] have not grappled with this difference.

B. Survey of the Aggregate Premium Theory

There are, in essence, three lines of reasoning that support the aggregate premium theory. [FN52] First, the most compelling argument that can be made on behalf of the aggregate premium approach is that the IRS itself has embraced it. As indicated, in Reverend Ruling 70-38, which restates Office Decision 724, the IRS concludes that a sale of a policy for less than the amount of aggregate premiums produces neither gain nor loss. [FN53] While the revenue ruling assumes that the sales price is equal to the policy's cash value, it cannot reasonably be read as implying that gain would be recognized if the price were greater than the cash value but still less than the amount of aggregate premiums. [FN54] The ruling merely restates the Office Decision under current law, and, in the Office Decision, no mention is made of the policy's cash surrender value; it simply hypothesizes a sale at a price that is less than the aggregate premium amount. [FN55] Moreover, a sale of a policy for a price equal to its cash surrender value should, in most instances, under a correct *579 application of the policy investment approach, produce gain. More specifically, to the extent that the cash value grows as a result of an earnings buildup in the policy's reserve value, gain should be recognized in the case of a sale for a price equal to the policy's cash value under the policy investment theory, even if the price is less than aggregate premiums. [FN56] In concluding that gain is not recognized on the facts of the ruling, the IRS implicitly disavowed the policy investment approach. The IRS's position is, moreover, reflected in its failure to object to the taxpayer's use of the aggregate premium approach in the gain cases where the character of income was at issue. [FN57] As a result, whatever merit the policy investment theory holds, taxpayers ought to be able to rely on its apparent rejection by the IRS, at least until its own rulings are withdrawn. [FN58]

The second line of argument supporting the aggregate premium approach is predicated on the treatment of a policy surrender. In the case of a policy surrender, as suggested, the Code explicitly permits taxpayers to use the aggregate premium approach for purposes of computing gain. [FN59] Thus, the Code does lend some indirect support to the proponents of the aggregate premium approach. Indeed, there is no other provision in the Code directing that a different approach be taken in computing basis in the context of a sale. Given this silence in the face of the Code's explicit adoption of the aggregate premium payment approach in Code section 72, and given the inequity that necessarily results from treating a taxpayer who surrenders a policy differently from one who sells it to a third party, [FN60] the argument in favor of applying the aggregate premium approach in both contexts is not entirely unappealing.

A final line of argument, made by some of the aggregate premium proponents, is that a life insurance policy is a unitary asset with two integrated components: an investment component in the form of cash reserves and a personal-consumption component in the form of insurance protection. One might analogize life insurance to other personal-use assets, like a home, which also have an *580 investment and a personal-consumption component. [FN61] As the argument goes, the owner of a home is not required to reduce basis on account of usage. [FN62] So why, the proponents of the aggregate premium approach ask, should life insurance be treated differently? They accordingly maintain that the mortality charges for the cost of life insurance should not result in a tax basis reduction.

C. Survey of the Policy Investment Theory

Notwithstanding the formal position it adopted in Office Decision 724 and Reverend Ruling 70-38, the IRS has begun to flirt with the policy investment theory. It first deviated from its published position in Private Letter Ruling 94-43-020. [FN63] This ruling discussed the tax implications where a taxpayer afflicted with AIDS sold an insurance policy on his life to a viatical settlement company.

The first issue addressed in this ruling was whether the sale of the policy constituted a taxable event; the second issue was how to compute the taxable amount if this event were taxable. The IRS ruled that the proceeds from this sale *581 were taxable to the taxpayer under Code section 61, noting that the shelter of Code section 101(a), which excludes policy proceeds from income, only applies in circumstances when the insured has died. [FN64]

Next, the IRS sought to compute the amount of the taxable gain resulting from the sale. To do so, it needed to determine the taxpayer's basis in his life insurance policy. The IRS first indicated that the governing Code sections were 1011, 1012, and 1016 and then added that the relevant case law included Century Wood and London Shoe. On the basis of these authorities, the IRS declared that the taxpayer's basis in his life insurance policy was equal “to the premiums paid less the sum of (i) the cost-of-insurance protection provided through the date of sale and (ii) any amounts (e.g., dividends) received under the contract that have not been included in gross income.” [FN65]

The controversial part of the IRS's ruling was its insistence that, contrary to Office Decision 724 and Reverend Ruling 70-38, the policy's tax basis be reduced by the insurance protection portion of the premium (invoking, in effect, the policy investment theory). [FN66] Since issuing Private Letter Ruling 94-43-020 and other private letter rulings, the IRS has continued to argue in favor of the policy investment theory. [FN67]

*582 For example, in Chief Counsel Advisory Opinion 2005-04-001, the IRS discussed the tax consequences for a taxpayer who owned a life insurance policy on the life of her ex-spouse. [FN68] After five years of owning the policy and paying premiums, the taxpayer was fraudulently enticed by the insurance company underwriting the policy to convert it into a new policy on the life of her ex-husband. A court found that the insurance company had misled the taxpayer and granted her a cash award. The portion of the award that related to interest was admittedly taxable. The remaining portion of the award, the taxpayer argued, was a tax-free recovery of the premiums and costs the taxpayer had paid with respect to the policy on her ex-spouse. The IRS did not agree: consistent with Private Letter Ruling 94-43-020, the IRS argued that the insurance protection portion of the policy had already benefitted the taxpayer. That being the case, this portion of the premium payment could not constitute tax basis in the policy and thereby be used to shelter any of the taxpayer's recovery.

III. The Theoretical Superiority of the Policy Investment Approach

The aggregate premium theory and the policy investment theory are at direct odds; each offers a different outcome insofar as tax basis determinations are concerned. The question to which we turn is whether the policy investment approach or the aggregate premium approach is preferable.

But before we answer this question, we explore the nature of life insurance and how, from a property perspective, it should be classified. Like other personal-use assets having personal-consumption and investment-type components, life insurance policies engender two different kinds of cost that must be distinguished *583 for tax purposes: the cost of acquisition and the cost of upkeep. Taxpayers can include the former, [FN69] but not the latter, [FN70] in the tax basis of their personal-use assets.

Distinguishing between acquisition and upkeep costs is thus very important. Yet, making this distinction is sometimes challenging, particularly for life insurance policies. In Section A we explore the different nature of these expenditures, enabling us from a better vantage point in Section B to analyze the correct tax treatment of life insurance policies.

A. Distinguishing Between Acquisition and Upkeep Costs

As indicated, [FN71] when taxpayers make expenditures, the Code attaches importance to how these expenditures are classified: the cost of acquisition is embedded in an asset's tax basis, whereas the cost of upkeep is extinguished and does not become part of an asset's tax basis.

To illustrate this point, consider two examples that entail acquisition and upkeep expenses. The first involves the purchase of a single use asset that for tax purposes is treated as a unitary whole. The second involves the purchase of a dual use asset that for tax purposes is treated as two separate and distinct assets.

Example 1: Single Use Asset. Suppose a husband and wife purchase a home for personal enjoyment and secondarily as a form of investment. Consider the tax consequences associated with this purchase. The Code permits acquisition costs (including items such as title searches and attorney fees) to be included in the tax basis the taxpayers have in their home; [FN72] by including such costs in basis, at the time of subsequent sale, they can be recouped tax-free as a return of capital. On the other hand, the expenses associated with the cost of upkeep (including items such as painting and plumbing repairs) cannot be added to tax basis because these expenses represent nondeductible personal-consumption; [FN73] by excluding such expenses from basis, they cannot be recouped tax-free at the time of subsequent sale. [FN74]

*584 As a theoretical matter, taxpayers who use their assets for personal purposes should be required to reduce their basis to reflect the economic decline attributable to such use. [FN75] Because the Code does not mandate these downward basis adjustments, however, taxpayers are in effect permitted to create tax deductions from their personal-consumption expenditures - an incongruous result given the Code's general commitment to a denial of deductions for such expenditures. [FN76]

To illustrate, suppose a husband and wife purchase a home for $500,000 (with $400,000 of the value attributable to the house and $100,000 attributable to the land). Suppose further that they inhabit the home for many years and that, through wear and tear, its value is reduced to $0. (Of course, no depreciation deductions are actually allowed because the home is not used in the taxpayers' trade or business.) [FN77] Upon the taxpayers' subsequent sale of their home for $1,100,000 (enjoying a profit attributable to the increase in the value of the underlying land), [FN78] in computing their gain, the taxpayers are able to utilize $500,000 as the appropriate tax basis, rather than the $100,000 basis that, as a matter of theory, would be appropriate. [FN79]

In permitting the taxpayers a $500,000 basis, the Code enables taxpayers to ignore the personal-consumption element of their home use. More specifically, the taxpayers are able to shift the personal-consumption element of their home into the investment component rooted in the land. This shift in basis from the personal to the investment component effects a conversion of consumption-type expenditure *585 into a tax deduction (a basis offset) and is therefore difficult to justify theoretically. Nonetheless, adherents of the aggregate premium theory build upon this example: [FN80] they declare, in the name of parity with these homeowners, that the tax basis taxpayers have in their insurance policies should not be reduced by any personal-consumption on their part, but rather shifted to the investment component of their policies. [FN81]

Example 2: Dual Use Asset. Suppose a husband and wife instead purchased a two-family home and rented one of the two units. In this example, based a long line of cases [FN82] and Treasury regulations, [FN83] the two-*586 family home would be treated as two separate assets: a personal home and a rental unit. [FN84] As to the personal-home component, the analysis set forth in the first example would apply. In contrast, as to the rental-unit component, a different tax treatment results. The rental unit would be classified as “property used in the taxpayer's trade or business.” [FN85] As such, its value would thus be depreciated and *587 the costs associated with its upkeep would be deductible [FN86] or capitalized, [FN87] as the case may be. When the taxpayers subsequently sold the two-family home, the Code would treat the sale as if it consisted of two components. [FN88] An allocation of the sales price would therefore have to be made, and two independent tax analyses would have to be conducted. [FN89]

To illustrate, suppose taxpayers purchased a two-family home for $500,000, with $375,000 of the value allocable to the personal-home component and $125,000 of the value allocable to the rental-unit component of the property. Suppose further that the taxpayers were permitted $100,000 of depreciation deductions with respect to the rental-unit component. Consider the tax consequences were the two-family home sold for $1.1 million. [FN90] The allocation would be as follows:

	Home	Rental Property
Cost Basis	$375,000	$125,000
Depreciation	($ 0)	($100,000)
Adjusted Basis	$375,000	$ 25,000
Amount Realized on Sale	$825,000	$275,000
Adjusted Basis	($375,000)	($ 25,000)
Gain	$450,000	$250,000

What Example 2 illustrates is that tax basis cannot be shifted or "shared" between the personal-use property (i.e., the personal-use component) and the rental-unit component. Each component retains its own share of basis. [FN91]

Like a home, nonterm insurance is typcally acquired for investment and noninvestment reasons. More specifically, they acquire life insurance as a mode of consumption (i.e., a mechanism to alleviate emotional concerns and family turmoil in the event of an untimely death) and also as an investment vehicle (i.e., a ready reserve of assets that the policy owner can borrow from or withdraw against). Notwithstanding taxpayers' different motives in acquiring such life insurance, there is no need to decide whether a life insurance policy is a unitary asset (which permits a shift in basis from the personal-use component to the investment component) or a dual use asset (which does not permit a shift in basis). In either case, the cost-of-insurance protection cannot be appropriately viewed as a cost of acquisition; it is instead a cost of upkeep. And, as we elaborate, under either the unitary or dual use model, it cannot be included in basis.

*588 B. The Nature of Life Insurance

Having decided that classifying life insurance as a unitary or dual use asset is irrelevant to the basis question, the critical issue thus is to distinguish between the acquisition and upkeep costs as they pertain to life insurance. We believe that the portion of the premium allocated to investment, including any commissions incurred in acquiring the investment, should be included in the policy's tax basis. In contrast, the mortality charges associated with the maintenance of the policy should be excluded.

Adherents to the aggregate premium theory are misguided when they claim that the portion of the premium allocable to the cost of maintaining the insurance can be added to the policy's tax basis. The critical flaw in their argument is that they treat all premium expenses as acquisition costs. Yet, this proposition cannot possibly be true: just as a home needs annual repairs to keep it in good working order, a life insurance policy generally needs an annual cash infusion to keep it intact.

Indeed, where the courts have considered the basis question in the context of a sale at a loss, they have uniformly treated the premium portion allocable to the carrying costs of the policy as an annual upkeep expense. [FN92] As such they have excluded the cost-of-insurance protection from basis and denied the claimed loss deduction. [FN93] And although the IRS in both Office Decision 724 and Reverend Ruling 70-38 concluded that the cost-of-insurance protection may be included in basis in the context of computing gain, it failed to provide a theory that would justify such a departure from conventional tax-basis principles.

In the end, the aggregate premium theory cannot be justified on policy grounds. It rests on the fallacious assumption that premium payments related to the mortality charge must be added to the basis of the investment component. There is, in short, no justification for attributing the cost-of-insurance protection to the investment component.

IV. Computing Tax Basis Under the Policy Investment Theory

Having established the superiority of the policy investment theory, we consider its application. Insurance companies do not ordinarily provide the insured with a statement allocating a portion of the premium to the cost-of-insurance protection. Nevertheless, there are actuarial tables readily available that could fulfill this function (i.e., indicating how much insurance companies would hypothetically charge for term insurance for a comparable insured). The difference between the aggregate premium payments the taxpayer makes and the hypothetical term insurance figures located on these tables should represent the taxpayer's investment *589 (tax basis) in the insurance policy. Hereinafter, we refer to this methedology for determining basis as the hypothetical term method. [FN94]

A. Mechanism to Determine the Investment Portion of an Insurance Policy

When a taxpayer makes premium payments, insurance companies often internally separate these premium payments into different “baskets.” That is, they place one portion of the premium into the “basket” that houses the taxpayer's investment (i.e., the policy's reserve account), if any, and they place the other portion of the premium into the “basket” used to pay life insurance. Since this is how, for internal bookkeeping purposes, insurance companies handle the receipt of premium payments or contract charges, it seems rather obvious that the identification of tax basis should follow suit.

Consider, for example, Estate of Wong Wing Non v. Comm'r, [FN95] a case in which a taxpayer purchased a twenty-year endowment life insurance policy that included, in the case of disability, a waiver-of-premium feature. Approximately halfway through the contract's term, the taxpayer became disabled and was no longer obligated to make premium payments. When the policy ultimately matured, the taxpayer received the face amount of the policy along with accumulated mutual insurance dividends and interest. The taxpayer claimed that he was not taxable on the latter portion because the aggregate premiums paid included those that were paid on his behalf when he became disabled. The court disagreed, holding instead that, for tax basis purposes, the premium payments were separable: the premium portion that related to the investment feature of the contract counted towards tax basis; in contrast, the premium portion directed towards disability protection (that was annually exhausted) did not constitute part of the policy's aggregate basis. [FN96]

To illustrate the point the Wing Non court made in the life insurance context and application of the hypothetical term method, consider a forty-year-old male who obtains a $1 million whole life insurance policy with annual premiums of $10,000. Suppose further that the annual premium payments for a $1 million term life insurance policy would be $4,000. Given the premium cost and the hypothetical cost of term insurance supplied by actuarial tables, the taxpayer's basis under the hypothetical term method would be $60,000 after ten years ($100,000 aggregate premium payments less the aggregate term cost of $40,000). [FN97]

*590 At least as expressed in its private letter ruling stance, the IRS has a somewhat different approach to identify the tax basis of life insurance policy. [FN98] The basic formula is the same: tax basis is equal to the aggregate premiums paid less the cost-of-insurance. As one possibility to determine the cost-of-insurance, the IRS instructs taxpayers to subtract the cash surrender value of their policies from the aggregate premiums paid. In effect, under this approach a policy's tax basis will equal the policy's cash surrender value. The IRS does, however, anticipate that this formula will not always produce the correct answer, and it reserves the right to compute basis in a different fashion. To illustrate, consider the prior example of the person who purchased a $1 million whole life insurance policy with annual premiums of $10,000 and an initial annual insurance cost of $4,000. As previously indicated, at the end of ten years, the taxpayer's investment in the policy should equal $60,000. Yet, depending upon the policy's terms and conditions, the cash surrender value of the policy could be much larger, say $90,000, attributable to unrealized gains, interest, and dividends that the underwriting company may be obligated to credit to the policyholder's account. In this case, the IRS would presumably not permit the taxpayer a $90,000 basis (the cash surrender value); for if it did, the accretion would escape tax.

B. The Appropriate Tax Treatment of Insurance Commissions

How would the cost of commissions and similar expenses incurred in the course of originating the policy be treated under the hypothetical term method? Superficially, these expenditures appear to be extinguished at the moment of their outlay. Yet not all of these costs can be attributed solely to the cost-of-insurance protection component. In other words, a portion of these costs is attributable to the policy's investment component, and, as such, should be embedded in the policy's tax basis. [FN99]

The hypothetical term method would properly account for these costs. The term factor supplied by the tables would necessarily include the cost of origination ordinarily incurred in acquiring a term policy. For example, in the prior illustration, the term factor according to the tables was $4,000; this figure would represent the *591 premium for a comparable term policy and would therefore include the cost of originating such a policy. Any amount paid in excess of the term factor would be attributable to the policy's investment component. Thus, if the actual premium were $10,000, the $6,000 excess would represent the cost of acquiring the investment component and should therefore constitute the taxpayer's basis in the policy. [FN100] In the context of so-called split-dollar insurance, the government recently adopted a similar method for differentiating between the costs of these two components. [FN101]

One might question whether the suggested approach tends to improperly inflate the policy's tax basis. This line of reasoning does not, however, take into account the fact that an insured agrees to incur the additional origination costs permanent (nonterm) insurance entails in order to acquire the investment component, not the insurance protection component of the policy. Indeed, were it not for the advantages the investment component makes available, the insured would instead presumably have purchased a term policy. Thus, to the extent that the permanent insurance costs more to originate than term insurance, the excess costs are properly attributed to the investment component of the policy and should accordingly be reflected in the policy's tax basis.

What is evident from this analysis is that the hypothetical term method should be applied to all taxpayers who dispose of a policy, whether by sale to a third party or by predeath surrender to the issuing insurance company. This is appropriate not only because it produces the correct basis, but also because it eliminates the inequity of treating taxpayers who sell their policies differently from taxpayers who surrender their policies. Under current law, Code section 72 mandates the use of the aggregate premium method in the case of a policy surrender. At the same time, in private letter rulings the IRS maintains, despite its *592 published guidance, that the policy investment theory should apply in the case of a policy sale. Given the failings of the aggregate premium theory and the inequity under current law of discriminating between sales and surrenders, Congress should amend Code section 72 to incorporate the hypothetical term method and make it applicable to all predeath policy dispositions.

If Code section 72 is not amended, and taxpayers who surrender their policies are therefore permitted to continue using the aggregate premium approach in computing gain, instituting the policy investment theory will be problematic. It will result not only in inequity but also in distortion. Under the policy investment theory, taxpayers who sell their policies would be required to reduce basis on account of the cost-of-insurance protection. Yet taxpayers who surrender their policies to the insurance company would enjoy a higher basis under the aggregate premium approach (which is sanctioned under Code section 72(e)). As a result, similarly situated taxpayers would be treated differently.

Yet, the decision to sell or surrender, in short, should not lead to different tax outcomes. Moreover, given this difference in treatment, taxpayers might well feel compelled to surrender a policy even if a sale might command a higher price. This is tantamount to telling the purchaser of an automobile that the government will provide her with a tax advantage if, at the time of disposition, she elects to do a trade-in with the original dealer rather than selling it to a third party. There is no policy justification for giving the dealer such an advantage. Likewise, there is no policy justification for taxing a surrender more favorably than a sale and for the resulting advantage to inure to the underwriting insurance company.

Until Congress resolves the current inequity, the IRS should consider the second-best strategy outlined in the next section for moving towards universal application of the hypothetical term method. [FN102]

V. Implementing the Hypolthetical Term Method Deference

Having explained why the policy investment theory is superior to the aggregate premium theory, we now consider the strategies available to the IRS for implementing the hypothetical term method. Specifically, we focus on how the courts might respond to the IRS instituting the hypothetical term method given the IRS's long-standing contrary position.

By way of background, when a government agency administering a statute issues an interpretation, the courts are required to assess its validity under one of *593 two standards. [FN103] The more deferential standard, announced by the Supreme Court in Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., [FN104] governs in cases where Congress intended to give the agency authority to issue what the Supreme Court has called "force-of-law" interpretations and the agency does so in the appropriate manner. [FN105] Under the so-called Chevron standard, an interpretation will be upheld if two conditions are met: (1) the statute is ambiguous, and (2) the agency reasonably resolves the ambiguity. [FN106] If both of these conditions are met, a court must defer under this standard even if it is not persuaded that the agency's interpretation is the best reading of the statute. [FN107]

Where the Chevron standard does not apply, the validity of the agency's interpretation is analyzed under the less deferential standard announced by the Supreme Court in Skidmore v. Swift & Co. [FN108] Under the so-called Skidmore standard, an agency interpretation will only be upheld if the court is persuaded that the agency has correctly read the statute. In determining whether an interpretation is persuasive, the courts are required under Skidmore to consider a number of subsidiary factors. For example, if the interpretation is inconsistent with an interpretation previously adopted by the agency, the court will be less inclined to find it persuasive. [FN109] Similarly, an interpretation issued long after the enactment of the statute will be viewed as less persuasive than a promptly issued one. [FN110]

Under the Chevron standard, the factors enumerated under the Skidmore standard are largely irrelevant. As long as the agency has not been arbitrary or capricious, its interpretation will not be invalidated merely because it has been inconsistent; indeed, Chevron contemplates that agencies will adjust to evolving circumstances and will therefore be permitted to change position where appropriate; furthermore, under Chevron, an agency's delay in issuing an interpretation will not count against its validity. [FN111]

The Tax Court refuses to endorse the Chevron-Skidmore dichotomy, under which the validity of all agency interpretations are evaluated under one of these *594 two standards. In Swallows Holding v. Comm'r, [FN112] the Tax Court indicated that a third deference standard may be appropriate in the tax context. Similar to Skidmore in substance, this standard provides less deference than the Chevron standard. It, in effect, permits courts to consider Skidmore's subsidiary factors. As such, it could render vulnerable a myriad of treasury regulations (as well as revoking Revnue Ruling 70-38).

Should the government seek to implement the hypothetical term method, it will need to navigate the deference question. Whether the method would be deemed valid may well depend on the deference standard the courts invoke given the IRS's long-standing commitment to a different approach; the lack of contemporaneousness; and Congress's reenactment of the underlying Code section without disapproving of the IRS's rulings. With each of these factors having different significance under the different standards, the IRS will have to consider its options, which include (A) revoking Reverend Ruling 70-38 or (B) promulgating a new regulation. (as well as revoking Revenue Ruling 70-38).

A. Revoke Revenue Ruling 70-38

As an initial step, the IRS should revoke Reverend Ruling 70-38. For, as long as the ruling remains outstanding, taxpayers will argue that the IRS is precluded from disavowing it. In a trilogy of recent cases, the Tax Court has held that the IRS must respect a taxpayer-friendly ruling and may not deviate from it without first revoking the ruling in question. [FN113] While it remains to be seen whether other courts will take a similar position, [FN114] it does seem fundamentally unfair, not *595 to mention inefficient, to permit the IRS to disregard a ruling after having invited taxpayer reliance. Thus, even though, as evidenced by the publication of several private letter rulings, the IRS has largely ignored Reverend Ruling 70-38, [FN115] it would seem unlikely that the Tax Court (or other courts) would be receptive to the hypothetical term method as long as Reverend Ruling 70-38 remains intact.

Although none of the decisions in the trilogy alludes to it, there is a narrow context in which a taxpayer-friendly ruling cannot bind the IRS. As the Supreme Court has indicated, where a ruling is contrary to an unambiguous Code provision, the ruling must yield; [FN116] otherwise, constitutional questions might arise. Put differently, where Congress clearly expresses itself, neither the judicial nor executive branch can effect an override. [FN117] It is unlikely that the IRS could, under this exception, disavow Reverend Ruling 70-38, for it seems very doubtful that a court could read the Code as unambiguously setting forth a methodology for computing a life insurance policy's tax basis. Thus, if the IRS should decide to implement the hypothetical term method, a revocation of Reverend Ruling 70-38 would seem to be an indispensable first step.

A revocation of the ruling would not in itself enable the IRS to claim deference for its new position. Thus, if such a claim is to be made, published guidance that affirmatively adopts the hypothetical term method must be issued. If the IRS were to adopt the method in a new ruling, the courts would likely analyze it under the Skidmore standard. Although the Supreme Court has not yet clarified whether Chevron or Skidmore applies to revenue rulings, it is very likely that the courts will apply Skidmore rather than Chevron in this context. [FN118] And, under Skidmore, the courts might well be skeptical about deferring to such a ruling given the IRS's long-standing contrary position.

*596 B. Promulgate a New Regulation

The IRS should consider instituting the hypothetical term method by promulgating a new regulation. [FN119] In all likelihood, such a regulation would be entitled to deference under the Chevron standard and would, as a result, be upheld in any taxpayer challenge to its validity. Although the Tax Court contemplates the possibility of a third deference standard, close examination shows that the Tax Court's approach is not likely to be sustained.

1. Probable Application of the Chevron Standard

A new regulation employing the hypothetical term method should easily satisfy Chevron's two-part test. First, the Code does not address, let alone unambiguously resolve, the basis-computation question. Second, the hypothetical term method would appear to effect a reasonable resolution in that it simply creates an administrable model built on the principle developed by the courts in the context of computing losses that the cost-of-insurance protection is not to be reflected in basis. [FN120]

The application of Chevron to a hypothetical term regulation would be consistent with the Supreme Court's foundational decision delineating the scope of the Chevron and Skidmore standards in United States v. Mead. [FN121] In Mead, the Court clarified that it had intended in Chevron to create a dichotomy, requiring all deference claims to be analyzed under one of these two standards. [FN122] The Court indicated that an interpretation that is subject to Chevron and that passes muster under this standard is entitled to force-of-law effect. [FN123] In other words, it is treated as if Congress itself had explicitly authorized it. The force-of-law nomenclature is *597 apparently inapt in the Skidmore context because if the interpretation is upheld under this standard, it is only because the court finds it persuasive, not because the agency's interpretation is analogous to a mandate from Congress.

2. Possible Application of a Different Deference Standard in Tax Cases

Mead cannot be easily read as contemplating the application of different deference standards in different areas of specialty. To the contrary, it is a comprehensive decision that seeks to impose the Chevron-Skidmore dichotomy across all areas of law involving agency-administered statutes. [FN124] Nonetheless, based on the Supreme Court's failure to cite Chevron with consistency in the tax context, some commentators have suggested that the Court may have contemplated the use of a third standard in tax cases. [FN125] Under this view, neither Chevron nor Skidmore would apply in the case of interpretive tax regulations (i.e., a regulation issued under the general authority of Code section 7805, as opposed to a regulation issued under a specific grant of authority contained in the Code section to which it relates). Rather, regulations would be analyzed under the standard the Supreme Court announced in National Muffler v. Comm'r, [FN126] in which the ultimate question in determining the validity of an interpretive tax regulation is whether it *598 "harmonizes with the plain language of the statute, its origin, and its purpose." [FN127] In National Muffler, the Court listed various factors that are to be considered in answering this question: whether the regulation was issued contemporaneously with the enactment of the statute, whether the regulation is long-standing, whether there has been taxpayer reliance on the regulation, whether the IRS has been consistent in its view of the statute, and whether the regulation has been scrutinized by Congress in any postregulation reenactment of the statute. [FN128]

The National Muffler standard is substantially similar, if not identical, to the Skidmore standard. The only difference between the two is that under National Muffler, the ultimate question is whether there is sufficient harmony between the regulation and the Code, whereas under Skidmore the ultimate question is whether the court finds the regulation persuasive. [FN129] In terms of the various subsidiary factors that are to be considered in answering the ultimate question, it is difficult to discern any significant difference between the two standards. [FN130] The similarity is not surprising. After all, as the Court indicated in Mead, Chevron introduced a new standard that was designed to displace in certain contexts the Skidmore-type analysis it had implicitly utilized in many of its prior cases. [FN131] National Muffler is therefore best understood as an iteration of Skidmore.

Despite the Chevron-Skidmore dichotomy articulated in Mead, the Tax Court in dicta in Swallows Holding, Ltd. v. Comm'r, [FN132] a nonunanimous court-reviewed decision, has indicated that the National Muffler standard may remain viable. It then invalidated a regulation on the ground that it could not be sustained under either the Chevron or National Muffler standards.

a. The Tax Court's Questionable Analysis

A critical difficulty with the Tax Court's analysis is that, in the course of maintaining that the regulation would be invalid under either standard, it lost sight of the fundamental differences between Chevron and the Skidmore-like National Muffler standard. For example, it emphasized the IRS's lack of consistency and the *599 fact that the regulation was issued long after the enactment of the section. [FN133] While such failings would have been unquestionably relevant under National Muffler, and would remain relevant were Skidmore the standard, the Supreme Court has made clear that they play no role under the Chevron standard. [FN134] Thus, the court not only reopened the National Muffler question, but also misapplied Chevron in forcing the conclusion that the outcome would have been the same irrespective of the deference standard. [FN135]

The Tax Court's analysis is troubling at an even more fundamental level given its failure to grapple with the Supreme Court's most recent decision on the applicability of Chevron in the tax context. Inexplicably, the majority, as well as the dissenting opinions, fails to cite the Supreme Court's decision in Central Laborers' Pension Fund v. Heinz, [FN136] where the Court attributed force-of-law effect to an interpretive tax regulation. [FN137] While the Central Laborers' Pension Fund decision does not cite Chevron, or any other deference standard, the Court nonetheless implicitly invoked it. [FN138] For, as Mead makes clear, force-of-law effect is only granted under the Chevron standard. Central Laborers' Pension Fund, moreover, dismissed as irrelevant the IRS's inconsistency, further indicating that the Court implicity applied Chevron in that an agency interpretation entitled to force-of-law effect is not weakened by the agency's inconsistency. [FN139] Thus, given the Court's grant of force-of-law effect to an interpretive tax regulation in Central *600 Laborers' Pension Fund, [FN140] it would appear that the court in Swallows Holding erred in refusing to abandon the National Muffler standard and the Skidmore-like analysis it produces. [FN141]

b. The Tax Court's Failure to Appreciate Chevron's Breadth

The Swallows Holding court also fails to address properly two important developments that stem from Chevron: agencies are to be given more latitude to change their interpretations even if Congress has reenacted the underlying statute, and, second, unless the statute is unambiguous, agencies are at liberty to overrule court decisions.

First, the court failed to recognize that the Chevron decision had a subtle, yet important, impact on the reenactment doctrine. Under the doctrine, where an agency has issued an interpretation or the courts have reached a consensus about the meaning of a statute, Congress's reenactment may be viewed as a ratification of the earlier construction. [FN142] The Swallows Holding court ultimately rested its decision on this doctrine, concluding that the statute's reenactment in effect ratified the pre-reenactment decisions. [FN143] As a result, according to the court, the Code section was rendered sufficiently unambiguous so as to make a regulation adopting a different approach invalid.

This analysis ignores, however, a critical aspect of Chevron's meaning: while the reenactment doctrine may be used to validate (ratify) an agency interpretation or court decision, it may not be used to undermine Chevron's policy *601 favoring agency flexibility. [FN144] Under Chevron, in other words, reenactment can expand an agency's ability to claim deference for interpretation while not necessarily contracting its ability to change position: (1) An agency can invoke the reenactment doctrine in instances when Congress reenacts a statute after an agency or court has construed it, based on the inference that Congress approved of the construction; and (2) an agency can only be precluded from changing its position under the doctrine if it can be determined that Congress unambiguously indicated an intent in reenacting the section to freeze in place the outstanding interpretation. [FN145] Had the court in Swallows Holding applied Chevron, rather than denying the differences between the Chevron and pre-Chevron standards, it presumably would have reached a different conclusion about the validity of the regulation after first focusing on the correct issue: whether, in reenacting the section, Congress had unambiguously expressed an intent to make the existing precedent unalterable. [FN146]

Second, as recently embellished, Chevron permits an agency to overrule judicial precedent. In National Cable & Telecommunications Ass'n v. Brand X Internet Services, [FN147] the Supreme Court held that an agency interpretation issued under Chevron may overrule a court decision, even including a Supreme Court decision, provided that the court did not hold the statute to be unambiguous. [FN148] Thus, under the National Cable framework, unless a statute is held unambiguous, [FN149] the government can convert its defeat in court into victory by *602 regulation and thereby render a court nothing more than a provisional decision maker. Presumably concerned about its new role, the Tax Court struggled, not surprisingly, to adopt a reading of National Cable that would preclude it from applying in tax cases. [FN150]

How did Swallows Holding support this reading? Building on its premise that interpretive tax regulations may not be subject to the Chevron standard, the Swallows Holding court questioned whether National Cable could ever be applied to such regulations, given that National Cable involved a Chevron interpretation. [FN151] Furthermore, the Swallows Holding court implicitly used a collateral-estoppel type analysis in its attempt to limit the application of National Cable, maintaining that an agency can only overturn a court decision if it was not a party in the prior litigation. [FN152] More specifically, in National Cable, the agency had not been a party in the prior litigation; in contrast, when it comes to tax litigation, the IRS will always be a party.

As a consequence, under Swallows Holding, the IRS will always be precluded from administratively overturning an unfavorable decision.

In advancing these arguments, the Tax Court misreads the Supreme Court. It is difficult to assert that the Supreme Court contemplated the application of a third, unique deference standard in tax cases. It is likewise difficult to find even the hint of a suggestion in National Cable that tax regulations are to be excluded from *603 its framework. Absent some indication from Congress that the IRS should be singled out in this fashion, the Supreme Court should not be lightly understood as having intended to create unstated, tax-specific exceptions to the administrative law framework it has established. In short, there is no basis in any of the Supreme Court's recent decisions to justify such an exception. [FN153]

*604 This is not to suggest that, as a matter of policy, such an exception would be inappropriate. Indeed, given the IRS's interest in vindicating itself after sustaining a defeat in court, one might question whether it would be salutary to permit the government to convert its losses into victory by regulation. [FN154] However, unless Congress decides to create a special regime for tax interpretations, the National Cable framework appears to apply to all agencies issuing interpretations under the Chevron standard.

The IRS must, at the very least, revoke Reverend Ruling 70-38. It might then adopt the hypothetical term method in a new ruling. However, given the low level of deference such a ruling would receive, the IRS should incorporate the hypothetical term method in a new regulation. Under a proper application of Chevron, the regulation would be virtually invulnerable to challenge. As the Supreme Court recently reiterated in National Cable, Chevron contemplates that, over time, agencies be permitted the flexibility to change position. Thus, the IRS's long-standing commitment should not preclude it from changing course. Nor should Congress's reenactment of the underlying sections be viewed as a ratification that freezes the IRS's prior rulings in place. Unless Congress has unambiguously directed that an interpretation not be changed, a court operating under the Chevron standard must respect the new interpretation. Given the need for guidance prompted by the recent marketing of life insurance products creating the potential for gain [FN155] and given the low standard that agencies must meet when changing position (i.e., not arbitrary or capricious), the regulation should be easily upheld.

If, on the other hand, the Tax Court persists in applying a Skidmore-like standard in considering interpretive regulations, the proposed regulation would obviously face a more difficult challenge, at least in the Tax Court: Under such a standard, the IRS's long-standing position, maintained both before and after the amendment of the underlying Code sections, would cut strongly against the validity of a newly issued regulation. Should other courts decide to follow Swallows Holding, a raft of treasury regulations would become similarly vulnerable. [FN156]

*605 In the end, the more likely outcome is that the Supreme Court's Chevron mandate will eventually come to be seen as having universal application. In short, Swallows Holding is less likely to survive than the regulation it invalidated.

VI. Dispositions of Life Insurance Policies

As a matter of policy, Congress has historically promoted the purchase of life insurance. This proinsurance bias is reflected in the tax-favored treatment given to life insurance policies and proceeds. [FN157]

In general, taxpayers who own life insurance policies may hold them to maturity, let them lapse, or dispose of them. Consistent with its policy objectives of promoting life insurance ownership, Congress offers very favorable tax treatment to taxpayers who hold their life insurance policies to maturity: when it *606 comes to the receipt of policy distributions, [FN158] loans, [FN159] and withdrawals, [FN160] Congress specifically allows taxpayers to use the aggregate premiums they have paid to shelter these proceeds from tax.

Taxpayers who no longer need or can afford to maintain their life insurance polices and allow them to lapse usually face one of two consequences. On the one hand, if the policy has no outstanding loans, the lapsing event will engender no income tax repercussions. On the other hand, if the policy is subject to outstanding loans, allowing the policy to lapse will be treated as a disposition event. [FN161]

Congress's magnanimous spirit towards the tax treatment of life insurance extends to policy surrenders. For reasons unexplained, the surrender of a life insurance policy enjoys extraordinarily favorable (and, as a matter of policy, undeserved) tax treatment. [FN162] Taxpayers who surrender their policies do not recognize income as long as the amount received does not exceed the aggregate *607 premiums each of these taxpayers paid. [FN163] (If, however, the cash surrender value exceeds the aggregate premiums paid, such excess is taxable.) [FN164]

The same favorable tax treatment does not extend to other life insurance policy dispositions. This is when proper basis identification is most critical. Today, there are several reasons why the disposition of life insurance policies has become increasingly popular. One reason is the emergence of life settlement companies, and another is that a new premium financing technique has arisen that makes the sale of life insurance policies much more attractive.

A. The Emergence of the Life Settlement Companies

Over the past decade the sale of life insurance policies has surged. There are several reasons for this trend.

One reason is that an increasingly greater percentage of the nation's population is over sixty-five. [FN165] People in this demographic often attempt to supplement their incomes and maximize economic returns on whatever assets they own. Life insurance policies with an investment component that are performance laggards are thus potential targets for taxpayers in this demographic to sell.

Another reason taxpayers may seek to sell their life insurance policies is that their insurance needs have become obviated. This may occur due to family changes or business transitions. More specifically, in the family context, taxpayers often purchase life insurance to help fund college educations or to provide for the financial needs of their family. At a certain point, however, the taxpayers' children may have completed their formal educations and taxpayers may have accumulated sufficient assets to meet their present and anticipated future financial obligations, thereby negating their insurance needs. In the business context, key employees upon whom the employer held policies may quit, be terminated, or retire. Any of the foregoing events may result in taxpayers owning life insurance policies that no longer serve any utility.

A final reason that taxpayers may deem retention of their life insurance policies unnecessary is that Congress has greatly alleviated the federal estate tax burden that used to haunt many taxpayers. In prior decades, a leading reason for the purchase of life insurance was to offset an anticipated federal estate tax burden. In the Economic Growth and Tax Relief Reconciliation Act of 2001, [FN166] however, Congress dramatically increased the applicable exclusion amount, [FN167] i.e., the amount taxpayers can shelter from the federal estate tax. Currently, this amount is *608 $2 million, but it is scheduled to increase to $3.5 million in 2009. [FN168] (In 2010, the federal estate is scheduled to be suspended, and in 2011 the applicable exclusion amount is scheduled to be reduced to $1 million. [FN169] However, most commentators doubt that either the full repeal of the estate tax or a reduction of the applicable exclusion amount will ever actually occur.) [FN170] In addition, as part of the same legislation, the federal estate tax rate is scheduled to decrease in the coming years from the prior 55 percent maximum tax rate to a maximum tax rate of 45 percent. [FN171] The combination of a significantly higher exclusion amount and a much lower tax rate alleviates much of the potential federal estate tax burden that many taxpayers once faced, mooting their need to maintain life insurance policies as a means of offsetting this perceived erstwhile burden.

In the past, when taxpayers owned life insurance policies that they no longer needed, they were essentially presented with an either/or choice: they could either let the policy lapse, or they could surrender the policy for its cash surrender value. The AIDS epidemic, however, had a profound effect on this either/or choice, opening up a third option: taxpayers now have the opportunity to sell their life insurance policies to the company offering the highest bid.

At the start of the AIDS epidemic in the early 1980s, the medical industry was scrambling to learn about the disease and its treatment. Medical treatment and care were scarce and costly; taxpayers who suffered from AIDS were anxious for both and sought to sell their life insurance policies as a means to cover such expenses. This financial need was the catalyst behind the advent of viatical companies. [FN172]

*609 The “problem” that arose in the viatical company industry is that new AIDS treatments prolonged life, making investments in insurance policies on the lives of AIDS patients far less economically attractive than when the epidemic first began. [FN173] To survive economically, viatical companies gradually changed their business model, transforming themselves into so-called life settlement companies. The business model of life settlement companies shares many of the same attributes of viatical companies. There is, however, one essential difference between the two kinds of companies: whereas viatical companies purchase life insurance policies when death is imminent, life settlement companies do not. In the case of life settlement companies, the insured ordinarily has a health ailment (e.g., cancer) that materially decreases the insured's life expectancy. This condition usually makes the value of the life insurance policy on the insured's life worth far in excess of the policy's cash surrender value.

Over the last ten years, the life settlement industry has evolved and has become more respected in the business community. Such respect has further contributed to the dramatic increase in the number of life insurance policies sold annually. The life settlement industry projects rapid growth, anticipating a tremendous rise in its revenues over the next decade. [FN174]

B. Premium Financing Technique

The emergence of the life settlement industry has fostered the establishment of several new estate planning techniques. One popular technique involves premium financing, in which the insured acquires a new policy with funds advanced by an investor. [FN175] Albeit somewhat oversimplified, here are the *610 technique's salient attributes: an investor seeks a healthy elderly participant who has significant wealth and can secure a large life insurance policy, say in the $5 million range. To entice the participant to partake in this arrangement, the investor promises to pay the policy's premiums for a period of two years. In return, the participant issues a nonrecourse note to the investor secured by the policy. If the participant dies during the first two years of the arrangement, the amount of the advance is repaid to the investor with interest; the participant's beneficiaries retain the proceeds to the extent such proceeds exceed the amount of the debt. Alternatively, if the participant is still alive at the end of the two-year term, the participant must decide whether (i) to retain the policy and repay the debt or (ii) to forfeit the policy to the investor in satisfaction of the debt.

From an economic perspective, the arrangement is attractive to both the participant and the investor. In terms of the participant, should death occur within the two-year period, her beneficiaries enjoy a windfall. And even if the participant is fortunate enough to still be alive at the end of the two-year period, the participant has no downside economic risk insofar as premium financing was conducted on a nonrecourse basis. In terms of the investor, the transaction is also profitable: if the participant's death occurs during the two-year inception period, the investor recoups the amount invested together with the interest provided for in the note; at the end of the two-year inception period, the investor may be repaid or acquire the policy, the latter of which is apparently a valuable investment in the life settlement industry because of the underwriting insurance company's failure to price the policy appropriately. [FN176]

From a tax perspective, however, the participant does have a downside risk both in terms of the amount of gain the taxpayer recognizes as well as its character.

1. Determining the Amount of the Taxable Gain

If the participant survives the two-year inception period and chooses to forfeit the policy to the investor rather than repaying the debt, the participant must recognize gain equal to the difference between the amount of the debt and the participant's basis in the policy. [FN177] Depending on the computation of the policy's tax basis, the potential tax liability on this gain could, in many cases, dissuade the participant from entering into the arrangement.

If the methodology used by the IRS in its private letter rulings were applied in this context, the participant's basis would likely be very low at the two-year point - indeed, near zero - since most of the premium is typically devoted to acquisition costs during the policy's early years and would be viewed by the IRS *611 as a cost-of-insurance. [FN178] If, on the other hand, the hypothetical term method were applied, the basis in the policy would be somewhat greater and the gain correspondingly reduced. In contrast, under the aggregate premium approach, the policy's tax basis would likely be sufficient to eliminate all of the participant's gain. Thus, the attractiveness, if not the feasibility, of the premium financing technique may well depend on the basis-computation question. [FN179]

2. The Character of the Gain

A transfer of the policy to the investor in discharge of the nonrecourse note should result in gain, not ordinary cancellation-of-debt (COD) income. In anticipation of the Supreme Court's decision in Comm'r v. Tufts, [FN180] regulations were adopted that make a distinction between recourse and nonrecourse debt. [FN181] In the case of recourse debt (which is not typically used in the premium financing arrangement), an allocation between COD income and gain must be made based on the value of the asset at the time of surrender: [FN182] to the extent that the amount of the recourse note exceeds the asset's value, COD income is generated, with the balance constituting gain. [FN183] In contrast, in the case of nonrecourse debt, the entire difference between the amount of the debt and the taxpayer's basis is gain. [FN184] Thus, a taxpayer who engages in a premium financing transaction via a nonrecourse note will not recognize COD income on account of a transfer of the policy in discharge of the note.

We turn now to the question of characterizing the gain. On first examination, one might be inclined to view the gain resulting from the taxpayer's satisfaction of the nonrecourse note as capital in nature. After all, the Code does not specifically exclude life insurance policies from the definition of capital assets, [FN185] *612 thus suggesting that they qualify as a capital asset. [FN186] In terms of the sale-or-exchange requirement, which is another precondition of capital gain treatment, a transfer of the policy to the investor in discharge of the note will suffice. [FN187] Parenthetically, even a surrender of the policy to the insurance company would be treated as a sale, [FN188] for the Code now deems contract terminations a sale for capital gain purposes. [FN189]

Nonetheless, upon closer examination, capital gain treatment appears to be inappropriate. Under an inveterate line of Supreme Court decisions, capital gain treatment is denied where the amount received is a substitute for ordinary income. [FN190] In the face of questions about the continuing viability of the so-called substitution of income doctrine in light of intervening developments, [FN191] the lower courts have been resolute in continuing to apply the doctrine. [FN192] To be sure, questions do remain as to doctrine's exact boundaries. Nonetheless, the Supreme *613 Court has identified a critical criterion that focuses on whether the asset has appreciated over time. [FN193] In instances where the taxpayer's profit is not attributable to such appreciation, the substitution doctrine is applied and ordinary income results. [FN194] This limitation on the capital gain concept makes sense not only as a matter of Congress's intent but also as a matter of policy; it reserves the preferential rate on gains for taxpayers who might otherwise be deterred from making a sale in order to ameliorate the lock-in effect that the realization requirement creates. [FN195]

Recently, disagreement in the Circuit Courts has erupted concerning the importance of the appreciation-over-time criterion and the foundational role it plays in the substitution doctrine. In United States v. Maginnis, [FN196] the Ninth Circuit held that a taxpayer who had won a lottery had ordinary income when he sold his right to receive the proceeds. [FN197] In invoking the substitution doctrine, the court emphasized that the taxpayer did not satisfy the appreciation-over-time criterion. [FN198] The court reasoned that the difference between the cost of the lottery ticket and the sales price for the right to receive the proceeds could not be viewed as the requisite appreciation. [FN199]

Analyzing a very similar fact pattern involving the sale of future lottery proceeds, in Lattera v. Comm'r, [FN200] the Third Circuit took a different approach. [FN201] It deduced a framework from the Supreme Court's cases that excludes the appreciation-over-time criterion as a relevant variable in the substitution doctrine. [FN202] It pointed out that the Supreme Court had applied the substitution *614 doctrine in two cases notwithstanding the fact, from the Third Circuit's perspective, that the taxpayer's profit could be viewed as attributable to appreciation accruing during the taxpayer's ownership of the asset. [FN203] Based on these cases, the court concluded that the appreciation-over-time criterion could not entirely explain the outcome of the Supreme Court's cases, thus justifying its decision to exclude the criterion from its framework. [FN204] Ultimately, applying its own framework, the Third Circuit nevertheless reached the same outcome as the Ninth Circuit in Maginnis: the sale of the right to receive lottery proceeds produces ordinary income under the substitution doctrine. [FN205]

The Third Circuit's failure to incorporate the appreciation-over-time criterion into its framework reflects a misreading of the Supreme Court's substitution cases. Surprisingly, the Third Circuit does not acknowledge that the *615 Supreme Court, in some of its decisions, explicitly references the appreciation-over-time criterion when it invokes the substitution doctrine. [FN206] Indeed, inexplicably, the Third Circuit relies upon one of these cases, Comm'r v. P.G.Lake, [FN207] in its attempt to demonstrate the Supreme Court's failure to apply the appreciation-over-time criterion [FN208] - seemingly oblivious to the fact that the P.G. Lake decision explicitly alludes to the criterion in explicating the policy rationale underlying the capital gain concept. [FN209]

What accounts for the Third Circuit's resistance to the appreciation-over-time criterion? This illustration should provide some insight: Suppose a taxpayer purchases stock at a cost of $10,000 and then one year later, when its value has increased to $15,000, sells the right to receive dividends on the stock for a period of, say, three years. Under Supreme Court precedent, the sale is clearly subject to the substitution doctrine and therefore produces ordinary income. [FN210] Yet, in what was presumably the Third Circuit's perception, some of the sales proceeds could be conceivably viewed as attributable to the appreciation accruing during the year of ownership (if, for example, the company prospers and the increase in the value of the stock corresponds with an increased dividend, some portion of the sale proceeds could be seen as related to the appreciation). One can surmise that the Third Circuit may have been concerned that, if it included the criterion in its framework, capital gain treatment would become available in this example - a result that is palpably wrong.

Contrary to this thinking, however, there is no tension between the appreciation-over-time criterion and ordinary income treatment for such a dividend sale transaction, for the taxpayer in this example would not be able to establish that the entire income (or gain) generated by the sale was attributable to appreciation. At best, the taxpayer might be able to show that a portion of the profit could be so attributed. This can be contrasted with a typical case in which capital gain treatment is appropriate: where the entire gain is clearly the product of appreciation in the investment. Thus, the Third Circuit could have embraced the appreciation-over-time criterion without permitting capital gain treatment in the dividend sale example. It could have done so by making the substitution doctrine operative where, as in the example, a taxpayer cannot establish that the entire gain is attributable to appreciation over time. Simply put, the Third Circuit's reading of the *616 Supreme Court's substitution cases is not a faithful one. A more accurate reading of the cases is as follows: unless a taxpayer is able to establish that the entire gain is attributable to appreciation over time, the substitution doctrine is to be applied and ordinary income results.

In the lottery cases, as the Ninth Circuit in Maginnis concluded, the substitution doctrine is properly applied because the appreciation-over-time criterion, as conceived by the Supreme Court, is not satisfied. Concededly, it is arguable that a taxpayer who buys a lottery ticket and holds it until the drawing is in a somewhat similar position to a typical stock investor who hopes that the company in which he invests will be awarded an important government contract. In both cases, the appreciation accrues at the moment of the favorable event (the drawing or the contract award). Yet the substitution doctrine applies in the case of the lottery but not the stock investment.

So how does the appreciation-over-time criterion permit a distinction to be made between these two cases? In formulating the appreciation-over-time criterion, the Supreme Court did not intend that it would be applied so that capital gain treatment could be obtained in a case like the lottery. As the Court has indicated, the criterion is designed so that capital gain treatment is targeted at taxpayers who might otherwise be deterred from selling their investment; [FN211] the stock investor might well be inclined to continue holding the stock after the favorable contract is awarded to the company in order to avoid paying the tax on the stock's appreciation. In the case of the lottery, in contrast, there is no such deterrent effect. Once the taxpayer is chosen as the winner, unlike the stock investor, he or she has no option by which to defer the income. Given the absence of any deterrent effect in the case of the lottery winner, a conclusion that the appreciation-over-time criterion is satisfied in this context and that capital gain treatment should therefore be appropriate would be inconsistent with the Supreme Court's purpose in establishing it. The taxpayers in the lottery cases are therefore appropriately subject to the substitution doctrine. [FN212]

The Lattera framework fails to capture not only the Supreme Court's cases but also a widely accepted Second Circuit decision. By the Third Circuit's own concession, its framework cannot account for the outcome in McAllister v. Comm'r [FN213] a pro taxpayer decision that even the IRS has embraced. [FN214] It explains away this difficulty by concluding that McAllister was wrongly decided. [FN215] The *617 problem, however, is not with McAllister but rather with the Lattera court's framework.

In McAllister, the taxpayer sold an income interest that she held under a testamentary trust. [FN216] The Second Circuit rejected the IRS's substitution doctrine argument, holding that the taxpayer should be treated as having sold a capital asset. [FN217] At an impressionistic level, the Third Circuit's criticism of McAllister appears to be well-founded, for if the taxpayer had retained the interest instead of selling it, the income received from the trust would have been ordinary in character. Thus, based on this view, the sale accelerated the receipt of income and should be taxed no differently than the income itself.

More properly viewed, however, the sale of a term interest should, as the court in McAllister held, qualify for capital gain treatment. To illustrate, consider a testamentary trust that is required to pay income to A for life and the remainder to B. Assume that at the testator's death the value of the asset bequeathed in trust is $100,000 and that, based on A's life expectancy, the actuarial tables reflect that the value of A's interest and B's interest in the trust is equal to, respectively, 40 percent and 60 percent of the corpus. On these assumptions, A's basis in the income interest would be $40,000, and B's basis in the remainder interest would be $60,000. [FN218] If, shortly after the testator's death, the value of the trust's assets increased to $200,000 and A and B simultaneously sold their interests in the trust for an aggregate price of $200,000 (with A receiving 40 percent, or $80,000, and B receiving 60 percent, or $120,000), [FN219] A would recognize a capital gain of $40,000 on the sale; (A's amount realized of $80,000 minus a basis of $40,000). B would recognize a capital gain of $60,000 (B's amount realized of $120,000 minus a basis of $60,000).

Contrary to Lattera, as well as the critique it references, [FN220] this is the correct result. Had the testator instead made an outright bequest to A and B with A receiving a 40 percent interest and B receiving a 60 percent interest as tenants in common, a simultaneous sale of the two interests at an aggregate price of $200,000 would produce the same amount of capital gain for A and B (A's gain would be $40,000, and B's would be $60,000). There is no justification for treating the simultaneous sale of an income and remainder interest any differently from a sale by tenants in common.

*618 Treating the simultaneous sale of the income and remainder interest in this fashion is consistent with the appreciation-over-time criterion. A's and B's gain, an aggregate of $100,000, would be exactly equal to the $100,000 increase in the value of the trust's asset after the testator's death. Their gain, in other words, would be entirely attributable to appreciation accruing during their period of ownership as beneficiaries. While, as the Lattera court indicates, there may be cases in which extenuating circumstances call for the substitution doctrine to apply where the gain accrues during the taxpayer's ownership, no such circumstances are present in this example. [FN221] Thus, A (as well as B) should receive capital gain treatment on the sale. In short, the Lattera court's difficulty with the outcome in McAllister is directly related to its failure to include the appreciation-over-time criterion in its framework. [FN222]

Taxpayers who participate in the premium financing arrangement and transfer the policy to the investor at the time the note matures cannot maintain that their benefit represents appreciation in an asset accruing over time. Under a proper application of the substitution doctrine, therefore, ordinary gain should result at the time of transfer. As a matter of substance, such a taxpayer receives in effect free life insurance during the term of the note as compensation for agreeing to acquire the policy; the note being nonrecourse, the taxpayer is under no obligation to repay *619 the note or to otherwise pay for the insurance provided. From the investor's perspective, at the maturity of the note, the policy is a valuable investment, which could not have been acquired without compensating the taxpayer for agreeing to participate. In somewhat analogous contexts, the courts have held that compensation of this kind constitutes ordinary income. [FN223]

The compensatory character of the arrangement cannot be altered by “dressing up” the transaction to look like the sale of an asset. [FN224] The taxpayer's amount realized on the transfer of the policy to the investor would be equal to the *620 amount of the note, [FN225] which would in turn equal the value of the free insurance received by the taxpayer. [FN226] The critical point is that, if at maturity, the taxpayer transfers the policy to the investor, no part of the gain represents appreciation accruing to the taxpayer over time. Rather, it represents the value of the free life insurance provided by the investor in order to induce the taxpayer to participate in the transaction. Put differently, with the right to the free insurance conferred at the outset, the taxpayer's benefit cannot be attributed to ownership of an appreciating asset. Thus, under a proper application of the substitution doctrine, the gain should be ordinary in character.

If, on the other hand, the taxpayer decided to retain the policy - perhaps because of a decline in health and a concomitant increase in the policy's value - there would be no taxable event unless the taxpayer subsequently sold the policy or surrendered it to the insurance company. [FN227] In the event of such a sale or surrender, the gain should be bifurcated; under the substitution doctrine, the portion equal to the amount of free insurance should be ordinary gain, and the balance, attributable to the appreciation in the policy's value, should be capital gain. [FN228]

VII. Conclusion

Historically, taxpayers who chose to dispose of their life insurance policies during their lives would surrender them to the issuing company. However, there is now a marketplace in which investors are willing to buy policies that a taxpayer no longer needs or wishes to retain. In addition, a new premium financing method is emerging, which grants taxpayers an option to sell their policies within the first few years after acquiring them. The sale of policies has thus become increasingly prevalent. As a result of this shift, the tax community has begun to focus on the computation of gain, raising questions about the determination of basis.

*621 While the Code mandates the use of the aggregate premium approach in determining gain on a policy surrender, it is silent about the appropriate methodology for determining basis in the case of a sale. In its published guidance on the consequences of a sale, the IRS has applied an aggregate premium approach. But, in private letter rulings, the IRS has instead applied a policy investment approach, under which a policy's basis is reduced by the cost-of-insurance protection.

We argue in favor of the policy investment theory and sketch out a new model (i.e., the hypothetical term method) for its implementation. We call for legislation that would incorporate this theory, making it uniformly applicable to insurance policy surrenders as well as to their sales. Short of such legislation, we suggest a second-best strategy for the IRS: revocation of its published guidance and promulgation of a new regulation. Recognizing that our model deviates from the IRS's long-standing commitment to a contrary approach, we consider whether the courts would uphold such a regulation. After examining the Supreme Court's deference jurisprudence and critiquing the Tax Court's recent invalidation of a regulation, we conclude that the regulation we propose should withstand taxpayer challenge.

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[FN1]. IRC § 1001(a). For a detailed discussion of IRC § 1001, see Louis A. Del Cotto, Sales and Other Dispositions of Property Under § 1001: The Taxable Event, Amount Realized and Related Problems of Basis, 26 Buff. L. Rev. 219 (1977). For an exhaustive discussion of tax basis rules, see James Edward Maule, Income Tax Basis: Overview and Conceptual Aspects, 560-2d Tax Management Portfolios.

[FN2]. When life insurance policies were first introduced to the marketplace, they had a singular purpose: to protect against the risk of premature death. Adam F. Scales, Man, God and the Serbonian Bog: The Evolution of Accidental Death Insurance, 86 Iowa L. Rev. 173, 185-90 (2000). See generally J. Owen Stalson, Marketing Life Insurance: Its History in America (Harvard Univ. Press 1942); S.S. Huebner & Kenneth Black Jr., Life Insurance (7th ed. 1969).

[FN3]. See The Life Insurance Fact Book 85 (2004) ("In 2003, direct purchases of permanent life constituted 53% of U.S. individual policies issued and 30% of the total face amount issued."). See generally, Viviana A. Rotman Zelizer, Morals and Markets: The Development of Life Insurance in the United States (1979); Ben G. Baldwin & William G. Droms, The Life Insurance Investment Advisor: A Guide to Understanding and Selecting Today's Insurance Products (1988).

[FN4]. See infra Part VI. In addition, because of a confluence of factors, a novel premium-financing technique has developed. The economic viability of this technique may well depend upon how the insured computes the basis in the policy. See infra notes 168-70 and accompanying text.

[FN5]. IRC § 1001(a).

[FN6]. IRC § 1012.

[FN7]. See generally, Joseph M. Dodge & Jay A. Soled, Debunking the Basis Myth Under the Income Tax, 81 Ind. L.J. 539 (2006).

[FN8]. Id. at 547-56.

[FN9]. Actuarially, regarding insurance contracts with fixed-death benefits, the life insurance protection portion of a premium will decrease with each passing year as the cash reserve increases. To make our illustration easier to follow, however, we nevertheless assume the life insurance protection portion of the premium remains constant, disregarding the increase in cash reserve attributable to the earnings buildup within the policy.

[FN10]. See infra Part II.B.

[FN11]. See infra Part II.A.

[FN12]. See infra Part II.C.

[FN13]. C.B. 3,244 (1920). In its entirety, the ruling reads as follows:

A corporation which carried insurance policies on the lives of its officers under which it was named as the beneficiary sold the policies for a sum less than the total premiums paid and not deducted from gross income. No part of the amount received for the policies is taxable.

[FN14]. 1970-1 C.B. 11. See also Chief Couns. Adv. 2005-04-001 (dated Oct. 12, 2004) (in characterizing Rev. Rul. 70-38, it states that the corporation discussed in the ruling was "not required to include in its gross income the amount received from the sale of the insurance policies").

[FN15]. A sale at a price equal to cash value could certainly produce a taxable gain in that cash value increases over time as earnings accrue. Yet, under the ruling, no gain is produced if the price is less than the amount of aggregate premiums. Thus, Rev. Rul. 70-38 perpetuates the government's endorsement of the aggregate premium approach in the Office Decision Indeed, it would be difficult to read the ruling differently inasmuch as it explicitly acknowledges that it is designed to do nothing more than restate (rather than overrule) the government's initial position.

[FN16]. See IRC § 264 (denying a deduction for the payment of life insurance premiums). For example, if the taxpayer had paid $10,000 in premiums, sold the policy for $6,000, and then sought to deduct $4,000 as a loss, IRC § 264 strongly suggests that this would be an inappropriate outcome.

[FN17]. 6 B.T.A. 980, 982 (1927).

[FN18]. Id.

[FN19]. Id.

[FN20]. Id.

[FN21]. Id. at 984.

[FN22]. See Forbes Lithograph Mfg. Co. v. White, 42 F.2d 287, 288 (D. Mass. 1930). The facts of Forbes were virtually identical to those of Standard Brewing Co.: A corporation owned life insurance policies on the lives of its officers. When the company surrendered these policies, it sought to take a loss on the difference between the cash value it received and the premiums it had paid. The Federal District Court of Massachusetts held in the taxpayer's favor, ruling that the taxpayer's basis in a life insurance contract was equal to the amount of aggregate premiums it had paid, not the policy's cash surrender value. In reaching this holding, the court relied almost exclusively on Lucas v. Alexander, 279 U.S. 573 (1929), a United States Supreme Court decision. While the Alexander case addressed the issue of tax basis, its primary focus was the value of certain endowment policies owned on March 1, 1913 (the inception date of the income tax).

[FN23]. 26 B.T.A. 1210 (1932).

[FN24]. 69 F.2d 967 (3rd Cir. 1934).

[FN25]. B.T.A.M. (P.H.) 35100 (1935).

[FN26]. Id. In Century Wood Preserving, the court did not establish a per se rule that basis is equal to cash value. It held instead that basis must be reduced by the cost-of-insurance protection and that, given the taxpayer's failure of proof, basis should not exceed cash value. See 69 F.2d at 968; see also Priv. Ltr. Rul. 94-43-020 (Jul. 22, 1994) (adopting this analysis).

[FN27]. See IRC § 72(e).

[FN28]. 80 F.2d 230 (2nd Cir. 1935).

[FN29]. 175 F.2d 118 (4th Cir. 1949).

[FN30]. See IRC § 264. When formulating its approach in the Office Decision it issued in 1920 and when restating its position under current law in Rev. Rul. 70-38, the government may have inadvertently overlooked this concern, failing to appreciate that its tacit endorsement of the aggregate premium approach would eventually be cited by taxpayers who experienced gains on the sale of their policies.

[FN31]. For a discussion of loss cases, see supra notes 16-27.

[FN32]. See infra notes 35, 38.

[FN33]. See David F. Shores, Reexamining the Relationship Between Capital Gain and the Assignment of Income, 13 Ind. L. Rev. 463 (1980); Charles S. Lyon & James S. Eustice, Assignment of Income: Fruit and Tree As Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 293 (1961-62); Note, Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are Sold, 69 Harv. L. Rev. 737 (1955-56); Note, The P.G. Lake Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies, 14 Stan. L. Rev. 551 (1961-62) (explaining the P.G. Lake and its implications).

[FN34]. See Gregg A. Esenwein, CRS Reviews Legislative History of Capital Gains Income Tax, 2005 TNT 123-17 (June 28, 2005) (report indicates that capital gain tax rates have historically been much lower than ordinary income tax rates).

[FN35]. See infra Part VI.B.

[FN36]. See IRC § 1222 (requiring a “sale or exchange”).

[FN37]. See infra Part VI.B.2.

[FN38]. 275 F.2d 33 (4th Cir. 1960).

[FN39]. Id. at 33.

[FN40]. Id.

[FN41]. Id. at 34.

[FN42]. Id.

[FN43]. Phillips, 275 F.2d at 36.

[FN44]. E.g., Hort v. Comm'r, 313 U.S. 28 (1941); Comm'r v. P.G. Lake, Inc., 356 U.S. 260 (1958).

[FN45]. Phillips, 275 F.2d at 35.

[FN46]. Estate of Croker v. Comm'r, 37 T.C. 605 (1962); Neese v. Comm'r, 23 T.C.M. 1748 (1964); Avery v. Comm'r, 111 F.2d 19 (9th Cir. 1940); Gallun v. Comm'r, 327 F.2d 809 (7th Cir. 1964).

[FN47]. See supra notes 28-38.

[FN48]. See supra notes 35 and 38 and accompanying text.

[FN49]. See IRC § 72(e)(6).

[FN50]. See supra note 16.

[FN51]. See supra notes 28-38.

[FN52]. For a discussion of these arguments, see, generally, Michael J. Frankel, Life Settlements: Sale of Life Insurance Policies in the Open Market, in 39th Annual Heckerling Institute on Estate Planning (2005); Burgess J.W. Raby & William L. Raby, The Tax Treatment of Life Insurance Settlements, 19 Ins. Tax Rev. 385 (2000); see also Sherwin P. Simmons, Life-Settlements, Senior Settlements, and Other Variations on Viatical Sales, SK020 ALI-ABA 163 (2004) (mentioning an opinion letter issued by the accounting firm KPMG to Viaticus, Inc., that endorses this position).

[FN53]. See supra note 14 and accompanying text.

[FN54]. See Priv. Ltr. Rul. 80-50-045 (Sept. 17, 1980) (describing Rev. Rul. 70-38 as authority for the proposition that taxpayers are not required “to include in [their] gross income the amount received from the sale of the insurance policies").

[FN55]. Id.

[FN56]. To illustrate, assume that, after paying a premium of $10,000, the cash value at the end of one year is equal to $6,300 or the sum of (i) $6,000 (the residual after accounting for the insurance protection charge) plus (ii) the earnings buildup accruing during the year, here assumed to be $300. A sale of the policy for its cash surrender value, $6,300, would produce $300 of gain under the policy investment approach (see supra Part IV), but produces no gain under the aggregate premium approach.

[FN57]. See supra notes 28-38 and accompanying text.

[FN58]. See infra Part V.

[FN59]. IRC § 72(e)(5) provides that "the amount received on the surrender of a life insurance contract is included in gross income to the extent it exceeds the 'investment in the contract."' The Code amplifies the meaning of investment in a contract with the following definition: it is the "aggregate premiums paid less amounts received under the contract before the surrender that were not included in gross income." IRC § 72(e)(6).

[FN60]. See London Shoe Co. v. Comm'r, 80 F.2d 230 (2nd Cir. 1935) (acknowledging the lack of parallelism between the predecessor of Code § 72 and the provisions in the Code that determine basis in the policy).

[FN61]. Cf. Moseley v. Comm'r, 72 T.C. 183 (1979). In Moseley, the taxpayer purchased a $5,000 twenty-payment life insurance policy. The policy required annual premium payments of $192.40. The policy also contained a special provision establishing that the insurance company would credit to a special reserve account $96.20 of the annual premiums paid from the second to the fifth year of the policy. At the end of the policy's tenth or twentieth year, assuming the policy owner were still living, the policy owner would have the right to receive a dividend distribution essentially equal to the then-value of the special reserve account.

Twenty years after the policy's inception, the taxpayer exercised his right to receive a dividend distribution and was sent a check equal to $3,561.95. The taxpayer took the position that this amount was not taxable because his aggregate premiums totaled $3,848 and Code § 72(e)(1)(B) shielded from tax any amounts received up to this threshold (i.e., the dividend distribution did not exceed the aggregate premium payments). The IRS disputed this position: it argued that the special reserve account should be treated separately and apart from the insurance protection part of the policy. Therefore, because the taxpayer received a dividend payment in excess of the premium payments allocated to the special reserve account, the taxpayer experienced a taxable event on the difference between the proceeds he received ($3,561.95) and the amount he invested ($384.80, i.e., 4 x $96.20).

The underlying premise of the IRS's approach was that there were "two distinct and economically independent policies" at work, and thus a bifurcated analysis of each component of the policy was appropriate. Id. at 186. The Tax Court did not see it this way, however. The court pointed out that the two components of the contract were interrelated and, furthermore, that neither of these components could be separately purchased. That being the case, the court held that the phrase aggregate premiums as used in the Code applied to the whole contract. Id. at 187. In the court's view, "the special reserve provisions [were] inseparable from the insurance provisions of the policy," so the court ruled in the taxpayer's favor. Id.

[FN62]. See infra notes 66-67 and accompanying text.

[FN63]. Dated Jul. 22, 1994.

[FN64]. Id. This private letter ruling predates the passage of Code § 101(g) (a Code section that now excludes the receipt of viatical settlements from income). See also IRC § 101(a).

[FN65]. Priv. Ltr. Rul. 94-43-020 (Jul. 22, 1994).

[FN66]. Id. To determine the actual amount of the reduction, the IRS offered the following guidance: "[T]he cost-of-insurance protection may be approximated using the difference between (i) the aggregate amount of premiums paid and (ii) the cash value of the contract with regard to surrender charges." Id. at n.4 (citing Century Wood Preserving Co. v. Comm'r, 69 F.2d. 967 (3rd Cir. 1934)). Applying the IRS formula to our hypothetical, where the annual premiums are $10,000 but the annual cash surrender value grows by only $6,000, the annual insurance protection cost is $4,000.

[FN67]. See Field Serv. Adv. Mem. 1999-832, Vaugn # 242 (undated), in which the taxpayer in question was a shareholder in an S corporation. The S corporation experienced losses that the taxpayer wished to deduct. The Code, however, limits allowable losses to the amount of tax basis shareholders have in their S corporation shares (IRC § 1366(d)(1)); all losses in excess of such basis are suspended (IRC § 1366(d)(2)). The IRS was charged with the duty of determining the taxpayer's basis in his S corporation stock, which, in turn, would determine the amount of the taxpayer's allowable losses.

By way of background, a shareholder's basis in an S corporation is generally equal to the shareholder's initial capital investment subject to several annual adjustments. These adjustments are detailed in Code § 1367, including one that provides a reduction for "any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account." IRC § 1367(a)(2)(D). This downward basis adjustment was critically relevant to the question at hand because the S corporation made premium payments to fund several insurance policies on the lives of its key employees. More specifically, the S corporation paid annual premiums of $10,000 (the actual number was redacted from the text), of which $6,000 (again, the actual number was redacted from the text) was attributable to the cash surrender value of the policies and was reflected as an asset on the company's books, while the remaining $4,000 (this number represents an extrapolation of the prior two figures) was treated as a nondeductible company expense.

Code § 264 explicitly states that the premiums paid by a taxpayer for life insurance constitute a nondeductible expense. Accordingly, Code § 1367 (which, as just indicated, mandates a downward basis adjustment for any nondeductible expense) required that the shareholders reduce the tax basis they had in their shares by the premium payment. But by what number - the full amount of the premium paid ($10,000) or the insurance protection portion of the premium ($4,000)?

Ruling in the taxpayer's favor, the IRS limited the taxpayer's downward basis adjustment to $4,000. The IRS stated that "the premium payments by [the taxpayer] reduce shareholders' basis to the extent those premiums are truly made in return for life insurance." The other portion of the premium, related to the policy's cash surrender value, "results in the corporation receiving a valuable proprietary right" and therefore has no effect on the shareholder's basis in his S corporation stock. From the IRS's perspective, this bifurcated approach towards life insurance policy analysis was the one that best corresponded with economic reality.

[FN68]. Dated Oct. 12, 2004.

[FN69]. IRC § 1012.

[FN70]. See IRC § 1016(a) (does not specify any adjustments that pertain to upkeep or maintenance expenses).

[FN71]. See supra notes 60 and 61 and accompanying text.

[FN72]. IRC § 1016(a).

[FN73]. IRC § 262. See Prop. Treas. Reg. § 1.263(a)-3(d)(5)(ii) 71 Fed. Reg. 48590-01 (Aug. 2006) (indicating that, as a general rule, repairs to a residence may not be included in basis unless incurred in the context of a remodeling or restoration).

[FN74]. To permit these expenses to be embedded into the tax basis of the home would effectively allow taxpayers to transform these expenditures into (deferred) deductible expenses. Consider another kind of personal-use asset, namely an automobile. Assume a taxpayer purchases a $20,000 automobile, producing a tax basis in the automobile of an equivalent amount (i.e., $20,000). Assume further that the taxpayer incurred maintenance costs of $2,000 and then sold the automobile four years later for $12,000. The taxpayer's basis in the automobile would remain $20,000, with the cost of maintenance viewed as a consumption-type expenditure that could not be included in basis; the resulting $8,000 loss would not be deductible because it in effect represents consumption. See IRC §165(c). This loss disallowance rule makes the basis computation academic, though it would have practical significance in terms of computing gain were the automobile to appreciate for some reason above its tax basis of $20,000.

[FN75]. See Richard A. Epstein, The Consumption and Loss of Personal Property Under the Internal Revenue Code, 23 Stan. L. Rev. 454, 461 (1971) (argues that taxpayers should have to reduce the basis they have in their personal-use assets to reflect their consumption of such items); Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 81-85 (1990) (indicating that tax on imputed income from consumer durables is appropriate and suggesting that depreciation deductions would be required under such an approach).

[FN76]. Notwithstanding the sound theoretical justification for these basis reductions, for reasons of administrative convenience, the Code does not mandate basis adjustments such as those proposed.

[FN77]. See IRC § 168.

[FN78]. Edward L. Glaeser & Joseph Gyourko, The Impact of Building Restrictions on Housing Affordability, 9 Econ. Pol. Rev. 21-39 (June 2003) (presenting a study that indicates how zoning laws are a major contributor to higher land values).

[FN79]. Of course, the taxpayers could seek to exclude a portion of this gain under IRC § 121.

[FN80]. See supra notes 52-53 and accompanying text.

[FN81]. Id.

[FN82]. There is a long history of cases that state it is appropriate for an asset to have two separate tax bases when a particular set of circumstances exist, e.g., mixed business-and personal-use property, and where inequities would arise were the asset deemed to have a singular tax basis. For a complete analysis of instances when courts have invoked a bifurcated basis approach, see James Maule, Income Tax Basis: Overview and Conceptual Aspects, 560 Tax Mgm't Portfolios (BNA) A102-A104 (2000).

One case that amply illustrates this point is Sharp v. United States, 199 F. Supp. 743 (Dist. of Del. 1961), aff'd, 303 F.3rd 783 (3rd Cir. 1962). In Sharp, taxpayers purchased an airplane for $47,000 (to facilitate comprehension, we have generally rounded the numbers enumerated in the decision), made capital expenditures to it of $8,000 (making the airplane's overall tax basis $55,000), and used it for both business and leisure (roughly 24% for business and 76% for leisure). With respect to the business portion of the airplane, over the ensuing years, the taxpayer took depreciation deductions totaling approximately $14,000 and subsequently sold the airplane for $35,380. Id. at 744.

For tax computation purposes, the taxpayers claimed that the plane's tax basis was approximately $41,000 (i.e., $55,000 initial cost basis less the $14,000 of claimed depreciation deductions). Id. The taxpayers therefore claimed that they had experienced an economic loss of approximately $6,000 (i.e., the amount realized of $35,380 less the airplane's adjusted basis of $41,000). Id.

The IRS had a much different perspective. In light of the fact that the airplane was used 24% for business and 76% for leisure, it treated the airplane as if it were two separate planes, one used exclusively for business and the other exclusively for leisure, and accordingly made the following computations:

	Business Plane	Leisure Plane
Cost Basis	$14,300	$40,700
Depreciation	($14,000)	($ 0)
Adjusted Basis	$ 300	$40,700
Amount Realized on Sale	$ 9,321	$26,058
Adjusted Basis	($ 300)	($40,700)
Gain/Loss	$ 9,021	$14,642

The IRS claimed that the taxpayers must recognize the gain related to the "business airplane" but denied allowance of the loss due to the fact that it was neither a loss incurred in a trade or business nor a loss incurred in a transaction entered into for profit. Sharp, 199 F. Supp. at 745. See IRC § 165(c).

The issue before the Sharp court was whether the IRS was correct in treating the airplane in question as two airplanes. From the outset of its analysis, the court made clear that the "taxpayers are clearly in error if it is their contention that courts will not regard a thing, normally accepted as an entity, as divisible for tax purposes." Sharp, 199 F. Supp. at 745. The court offered a myriad of examples when predecessor courts treated a unitary item as two distinct parts. Id. The taxpayers nevertheless attempted to distinguish their fact pattern from the cases the court cited. Id. The crux of the taxpayers' position was that all of these cases involved two distinct assets. Their own case, however, involved one asset. As averred by the taxpayers, an

airplane is not capable of separation into business and personal-uses in the same way that a hotel is separable from the land on which it stands, or in the same way that unharvested crop may be separated from the trees of the grove, or the accounts receivable from the other partnership assets. Id. at 746.

The taxpayers added that "[t]here were not two airplanes, . . . - a business airplane and a personal airplane - there was one airplane. There were not two sales; there was but one sale, one adjusted basis and one selling price." Id.

Although having superficial attraction, the taxpayers' position was dismissed by the court. Id. It held that if the taxpayers' theory were to prevail, a lack of uniformity would beset similarly situated taxpayers. Id. at 747. In support of its position, the court offered an example of a hypothetical taxpayer who purchased property, used it exclusively for business, depreciated it, and then sold it for a gain. Sharp, 199 F. Supp. at 747. It then compared the plight of the first hypothetical taxpayer to a different hypothetical taxpayer who purchased a piece of property fourfold the size and cost and used one-fourth of the property for business and three-fourths for personal-use. Id. The court posited that under a uniform rule, the same tax consequences should befall the first and second hypothetical taxpayers upon the sale of the business-use property. Id. Under the taxpayers' approach, however, the first and second hypothetical taxpayers would each experience a different tax outcome, making the result inherently inequitable. Id. The court also pointed out that the taxpayers' methodology of calculating their depreciation deduction (24% of the airplane rather than the whole) suggested the taxpayers' tacit endorsement that the airplane was really two separate and distinct pieces of property "trapped" in one body.

[FN83]. Regs. § 1.121-1(e).

[FN84]. See supra note 73.

[FN85]. IRC § 1231(b).

[FN86]. IRC § 168(a).

[FN87]. IRC § 263.

[FN88]. See supra note 73.

[FN89]. Id.

[FN90]. See supra note 69.

[FN91]. See supra note 73.

[FN92]. See supra notes 16-27 and accompanying text.

[FN93]. Id.

[FN94]. In the context of split-dollar policies, the IRS already has instituted this procedure. See IRS Notice 2002-8, 2002-1 C.B. 398 (permitting an approach similar to the one advocated here).

[FN95]. 18 T.C. 205 (1952).

[FN96]. Estate of Wong Wing Non, 18 T.C. at 209-10; see Rev. Rul. 55-349, 1955-1 C.B. 232 (premiums paid that are attributed to other benefits, such as disability, are not includible in computing total premiums paid for an endowment contract).

[FN97]. See supra note 9, which points out that as a practical reality, each year, as the internal reserve amount grows in value, the amount of insurance coverage will correspondingly decline. That being the case, each year this method will produce a smaller insurance charge.

[FN98]. See Priv. Ltr. Rul. 94-43-020, at n.4 (July 22, 1994).

[FN99]. Consider, for the example, the purchase of a $20,000 automobile along with a $2,000 maintenance contract. It would be inappropriate to attribute a 10% commission paid on the purchase price of the automobile exclusively to the maintenance contract. Instead, the automobile should be viewed as having a cost basis of $22,000 ($20,000 purchase price plus 10% commission of $2,000), and the maintenance contract as having a cost basis of $2,200 ($2,000 cost plus $200 commission). Similarly, in the case of an insurance policy, the origination costs attributable to the investment component, as opposed to the costs attributable to the protection component, should be reflected in basis for purposes of computing gain. But see Chief Couns. Adv. Mem. 2005-04-001 (dated Oct. 12, 2004) (concluding that origination costs may not be included in the basis of a policy).

[FN100]. In Priv. Ltr. Rul. 94-43-020, invoking Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3rd Cir. 1934) for the principle that basis should be reduced by the cost-of-insurance protection, the IRS in effect allocated the entire acquisition cost to the insurance-protection component. See also Chief Couns. Adv. Mem. 2005-04-001 (adopting the same approach). The difficulty with the IRS approach - aside from its failure to account for its deviation from its published rulings - is that it ignores the reality that acquisition costs are properly allocable to the policy's investment component as well as its insurance-protection component.

[FN101]. See Regs. § 1.61-22(d)(3); see also IRS Notice 2002-8, 2002-1 C.B. 398 (permitting taxpayers to value the cost-of-insurance protection based on the table contained in the Notice or the amount charged by the insurance company for term insurance). In fact, the regulations go on to provide that, as a general rule, a person paying for the cost-of-insurance protection under a split-dollar arrangement where the so-called economic benefit regime is applicable may not reflect such payment in calculating the amount invested in the contract for purposes of Code § 72. See Regs. § 1.61-22(g)(4)(iii). Although the regulation does not address the basis question in the case of a sale, as distinguished from a surrender, the implication is that payments for insurance protection should similarly be disregarded in this context.

[FN102]. In the absence of an amendment to IRC § 72, the IRS has a difficult choice. By regulation it can require taxpayers who sell their policies to reduce basis to account for mortality charges while permitting taxpayers who surrender their policies to use the aggregate premium approach. Alternatively, it can level the playing field by permitting selling taxpayers to use the aggregate premium approach. Neither alternative is ideal, but unless Congress amends IRC § 72, the IRS must choose between one of these second-best alternatives.

[FN103]. See United States v. Mead Corp, 533 U.S. 218 (2001) (summarizing how much deference courts should afford administrative agencies).

[FN104]. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., et al., 467 U.S. 837

(1984).

[FN105]. Mead, 533 U.S. at 226-27. For example, assuming for the moment that the IRS were to have the authority to issue interpretations having the force of law, it could not secure this effect by issuing a private letter ruling. See IRC § 6110.

[FN106]. Chevron, 467 U.S. at 843-45.

[FN107]. Id. at 843 n.11.

[FN108]. Skidmore v. Swift & Co., 323 U.S. 134 (1944).

[FN109]. Id. at 140.

[FN110]. See, e.g., Cathedral Candle Co. v. U.S. Int'l Trade Comm'n, 400 F.3d 1352, 1367 (Fed. Cir. 2005) (importance was given to the agency's contemporaneous issuance of ruling).

[FN111]. See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Serv., 545 U.S. 967 (2005); see also Smiley v. Citibank (S.D.) N.A., 517 U.S. 735, 742 (1996).

[FN112]. Swallows Holding, Ltd. v. Comm'r, 126 T.C. 96 (2006).

[FN113]. Rauenhorst v. Comm'r, 119 T.C. 157 (2002), Baker v. Comm'r, 122 T.C. 143 (2004); Dover Corp. & Subsidiaries v. Comm'r, 122 T.C. 324 (2004). In each of the three cases, the Tax Court emphasized that the IRS adhered to the position in question, evidenced by private letter rulings where the suspect rulings were referenced. Nevertheless, the Tax Court framed its analysis in terms of the published rulings, citing the private letter rulings only to support its reading of the published revenue rulings.

[FN114]. Indeed, some courts have suggested that the IRS is not bound by concessions made in a revenue ruling. See Black & Decker Corp. v. United States, 436 F.3d 431, 440 (4th Cir. 2006) (intimating a willingness to permit the IRS to disavow a taxpayer-friendly ruling); Vons Cos., Inc. v. United States, 55 Fed. Cl. 709, 718 (2003) (in dicta, indicating that the IRS cannot be stopped by a revenue ruling). It should be noted that, if the IRS were to revoke retroactively a taxpayer-friendly revenue ruling after the transaction was consummated but before the issue reached the courts, a different question would be presented. In these circumstances, assuming the revocation was not an abuse of discretion, the courts might well be inclined to permit the IRS to disavow the ruling. See Dixon v. United States, 381 U.S. 68, 72-73 (1965) (permitting the IRS to disregard a ruling in these circumstances after finding that its revocation was not an abuse of discretion); but see Estate of McLendon v. Comm'r, 135 F.3d 1017, 1024 n.15 (5th Cir. 1998) (questioning the viability of this aspect of Dixon given the fact that the IRS is more unequivocal in inviting taxpayer reliance on revenue rulings and distinguishing it on the ground that Dixon involved a ruling that was contrary to an unambiguous Code section).

[FN115]. See, e.g., IRS Priv. Ltr. Rul. 94-43-020 (July 22, 1994); and Chief Couns. Adv. 2005 04 001 (dated Oct. 12, 2004).

[FN116]. Schleier v. Comm'r, 515 U.S. 323, n.9 (1995).

[FN117]. See United States v. Burke, 504 U.S. 229, 246 (1992) (Scalia, J., concurring) ("[T]he Secretary of the Treasury would effectively be empowered to repeal taxes that the Congress enacts" if a taxpayer-friendly interpretation were upheld, even if contrary to the Code.); see also Mitchell M. Gans, Deference and the End of Tax Practice, 36 Real Prop. Prob. & Tr. J. 731, 797-98 (2002).

[FN118]. The Mead decision can be read as strongly implying that revenue rulings are to be analyzed under the Skidmore framework. See United States v. Mead Corp., 533 U.S. 218, 229 (2001) (discussing the fact that, under the Chevron decision, the Court of Federal Claims had not been giving any deference to revenue rulings). See also John Coverdale, Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead, 55 Admin. L. Rev. 39, 89-90 (2003) (indicating that, under the Mead decision, revenue rulings are reviewed under the Skidmore standard); Irving Salem et al., Report of the Task Force on Judicial Deference, 57 Tax Law. 717 (2004) [hereinafter ABA Task Force].

[FN119]. See generally Philip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax Law. 413 (2003) (regulations are the collaborative product of the Treasury Department and the IRS).

[FN120]. In addition, a new regulation should not be viewed as effecting an arbitrary or capricious change in position. In the context of the recent marketing of new life insurance products that have substantial potential to result in gain, the IRS must be given an opportunity to take a fresh look at the question of basis. Indeed, in issuing its earlier rulings decades ago, the IRS's focus was on the computation of loss as it was concerned about taxpayers converting nondeductible premiums into a deductible loss. See supra notes 16-27 and accompanying text. It certainly did not, and could not, foresee the basis issue in the gain context that it must now confront. See infra § VI.

[FN121]. See Mead, 533 U.S. at 218.

[FN122]. See also Gonzales v. Oregon, 126 S.Ct. 904, 914-15 (2006). The Court provides a circular test for determining which standard is to be applied, focusing principally on whether Congress intended the agency to have the authority to issue a Chevron-type interpretation. It is circular in the sense that while it nominally makes the issue turn on Congress's intent, the Court itself must ultimately decide whether Congress intended to grant such authority in the case of any given agency.

[FN123]. Mead, 533 U.S. at 218; see also Gonzales, 126 S.Ct. at 914-15.

[FN124]. See Kristin E. Hickman, Need for Mead, 90 Minn. L. Rev. 1537 (2006) (arguing that the Chevron-Skidmore dichotomy applies to interpretive tax regulations). But see Irving Salem, Supreme Court should clarify its Deference Standard, 112 Tax Notes 1063 (Sept. 18, 2006) (arguing for a different standard in fee tax context). See also Mitchell Gans, supra note 117 at 749-50; Jonathan Blattmacher, Mitchell Gans, and Damien Rios, The Circular 230 Desk Book, Ch. 1 (2006).

[FN125]. See, e.g., Thomas W. Merrill & Kathryn Tongue Watts, Agency Rules with the Force of Law: The Original Convention, 116 Harv. L. Rev. 467 (2002) (indicating that the Skidmore standard may apply in the case of interpretive tax regulations); Coverdale, supra note 118, at 83; (arguing that the Skidmore standard applies in this context); ABA Task Force, supra note 118 (arguing in favor of using factors enunciated in Nat'l Muffler v. Comm'r (infra note 126) in assessing the validity of interpretive tax regulations); Ellen P. Aprill, The Interpretive Voice, 38 Loy. L.A. L. Rev. 2081 (2005) (same); Noel Cunningham & James Repetti, Textualism and Tax Shelters, 24 Va. Tax Rev. 1 (2004) (summarizing the dispute); Gregg D. Polsky, Can Treasury Overrule the Supreme Court?, 84 B.U. L. Rev. 185 (2004) (noting the dispute); see also Gen. Elec. Co. v. Comm'r, 245 F.3d 149, 154 n.8 (2001) (noting the uncertainty); Bankers Life & Casualty Co. v. United States, 142 F.3d 973, 982 (7th Cir. 1998) (discussing the issue); E.I. du Pont de Nemours & Co. v. Comm'r, 41 F.3d 130, 135-36 n.23 (3rd Cir. 1994) (indicating less deference than the Chevron standard would require is appropriate); Snowa v. Comm'r, 123 F.3d 190, 197 (4th Cir. 1997) (applying the factors enunciated in Nat'l Muffler v. Comm'r (infra note 126)); Nalle v. Comm'r, 997 F.2d 1134, 1139 (5th Cir. 1993) (same); In re Craddock, 149 F.3d 1249, 1258 (10th Cir. 1998) (same); Schuler Indus. Inc. v. United States, 109 F.3d 753, 755 (Fed. Cir. 1997) (same).

[FN126]. Nat'l Muffler v. Comm'r., 440 U.S. 472, 477 (1979).

[FN127]. Id. at 476-77.

[FN128]. Id.

[FN129]. Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).

[FN130]. See id. (referencing as relevant factors whether the agency was deliberative and engaged in a formal process, whether it was thorough, whether its reasoning was valid, and whether the agency has been consistent - as well as all other factors that bear on the question of persuasiveness).

[FN131]. United States v. Mead Corp., 533 U.S. 218, 229 (2001).

[FN132]. Swallows Holding, Ltd. v. Comm'r, 126 T.C. 96 (2006). Much, if not all, of the Court's deference analysis in Swallows Holding is dicta. For once the Court concluded that the Code was unambiguous, the regulation could not be sustained. Irrespective of the applicable deference standard, the meaning of an unambiguous statute cannot be altered by regulation. See General Dynamics Land Systems, Inc. v. Cline, 540 U.S. 581, 599 (2004).

[FN133]. Id. at 137.

[FN134]. See Smiley v. Citibank (S.D.) N.A., 517 U.S. 735 (1996) (under the Chevron standard, upholding the validity of a regulation issued 100 years after the enactment of the underlying statute despite the fact that the agency had maintained inconsistent positions about the meaning of the statute); see also Gans supra note 117, at 754-55.

[FN135]. The court's misunderstanding of how the Chevron standard applies is also evident when it implies that less deference is appropriate when an agency construes statutory language that is not grounded in that agency's technical expertise. See Swallows Holding, 126 T.C. 96, at 144 (making this distinction and referring to constructions that are not based on expertise as "perfunctory"). The court fails to recognize that the Chevron decision effected a critical shift. Prior to Chevron, a critical justification for deference was agency expertise. Under the Chevron decision, however, agencies are entitled to deference for an entirely separate reason: the executive branch, unlike the judicial branch, is politically accountable, making it the more appropriate forum for resolving doubts about the meaning of statutes. See generally Gans, supra note 117. Thus, in suggesting that agency interpretations not based on technical expertise are deserving of less deference, the court misunderstands Chevron's meaning.

[FN136]. Central Laborers' Pension Fund v. Heinz, 541 U.S. 739 (2004).

[FN137]. Id. at 748.

[FN138]. See United States v. Mead Corp., 533 U.S. 218 (2001).

[FN139]. Central Laborers' Pension Fund, 541 U.S. at 748. This, of course, further confirms the Court's application of Chevron in that the IRS's inconsistency could not have been so dismissed under National Muffler (or Skidmore).

[FN140]. The interpretive regulation before the Court in Central Laborers' Pension Fund related to a section of ERISA (Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of Title 26 and 29 of the Code)) as the dispute involved a nontax, pension issue. Nonetheless, as the Court indicated, the same provision appears in the Code verbatim, and, according to the Court, the regulation is to be applied for tax, as well as pension, purposes. See Central Laborers' Pension Fund, 541 U.S. at 748 n.4. Indeed, in granting force-of-law effect to the regulation, the Court indicates that when issuing an interpretive regulation under IRC § 7805, the IRS speaks in its "most authoritative voice," see Central Laborers' Pension Fund, 541 U.S. at 748, further confirming that such regulations are to be reviewed under the Chevron standard.

[FN141]. Indeed, in the Mead decision itself, the Court cited Atl. Mut. Ins. Co. v. Comm'r, 523 U.S. 382 (1998), as an example of an earlier case in which the Chevron standard had been properly applied. Since Atlantic Mutual involved an interpretive tax regulation, the Mead decision leaves little doubt that the Court contemplates the application of the Chevron standard in this context. See Mead, 533 U.S. at 230. See also United States v. Haggar Apparel Co., 526 U.S. 380 (1999) (indicating that the Chevron standard is applicable when a question concerning the Code arises in the Tax Court).

[FN142]. See William N. Eskridge, Jr., Interpreting Legislative Inaction, 87 Mich. L. Rev. 67 (1988) (discussing the reenactment doctrine); Gans, supra note 117, at 764-75; Robert C. Brown, Regulations, Reenactment, and the Revenue Acts, 54 Harv. L. Rev. 377 (1941) (critiquing the doctrine).

[FN143]. See Swallows Holding v. Comm'r, 126 T.C. 96 (2006).

[FN144]. Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 125 S. Ct. 2688, 2708 (2005).

[FN145]. Id.

[FN146]. Lest there be any confusion, the court's attempt in Swallows Holding to make National Cable inapplicable in the tax context is not directly relevant to the validity of a proposed regulation adopting the hypothetical term method. Unlike the interpretation in National Cable (or Swallows Holding), the proposed regulation would not overturn a court decision; it would merely overturn the IRS's own ruling. The court's analysis of National Cable is nonetheless indirectly relevant in it that it reflects the Tax Court's unwillingness to embrace Chevron and all of its implications.

[FN147]. National Cable, 125 S. Ct. at 2688. See Lee A. Sheppard, Tax Court Flunks the Brand X Test, 110 Tax Notes 585 (Feb. 6, 2006) (pointing out that the Tax Court overlooked the importance of the National Cable decision). See also Stan R. Johnson, Swallows as it Might Have Been: Regulations Reversing Case Law, 112 Tax Notes 773 (Aug. 28, 2006) (critiquing Swallows Holding on the grounds that it fails to follow National Cable). But see Richard M. Lipton, A Divided Tax Court Rejects a Regulation and Struggles with Administrative Law - In Swallows Holding, 104 J. Tax'n 260 (2006) (arguing that the Swallows Holding court reached the correct result).

[FN148]. See National Cable, 125 S. Ct. at 2700 ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.").

[FN149]. For a discussion of National Cable, see Note, Implementing Brand X: What Counts as a Step One Holding? 119 Harv. L. Rev. 1532 (2006).

[FN150]. See Gans (exploring mindset of Tax Court Judges), supra note 117, at 780. See also Aprill (exploring mindset of Tax Court Judges), supra note 125 at 2111-12.

[FN151]. Swallows Holding v. Comm'r, 126 T.C. 96 (2006).

[FN152]. Id. at 144-45. It should be noted that there may be limits on an agency's ability under National Cable to trump the courts. In General Dynamics Land Systems, Inc. v. Cline 540 U.S. 581 (2004), the Court relied on a lower-court consensus in reaching the conclusion that the statute was unambiguous (indicating as well that Congress' failure to overturn the consensus view could be read as acquiescence). See id. at 593-94. See also Smiley v. Citibank (South Dakota) N.A., 517 U.S. 735 (1996) (indicating that disagreement in the lower courts suggested that the statute was ambiguous). Thus, assuming that a widely shared consensus develops, the agency may, as a practical matter, forfeit its ability to take a different approach by regulation. Whether the lower-court consensus in Swallows Holding, consisting of the Fourth Circuit's agreement with the Board of Tax Appeals, is sufficient to satisfy the widely-shared-consensus criterion remains questionable in that, in General Dynamics, the Court relied on a series of uniform decisions in two circuits courts and numerous district courts as well as an analysis in its own earlier decisions. See id. Surprisingly, the Tax Court in Swallows Holding fails to cite General Dynamics. Questions also remain about General Dynamics itself. Consider, for example, a statute that is construed in a similar fashion by different courts, with each successive decision adopting the reasoning of the first decision as a matter of stare decisis. Does the agreement among the courts suggest that the statute is unambiguous or, rather, that courts may, at least in close cases, tend to agree with each other? Finally, it is noteworthy that General Dynamics gives agencies an odd incentive: to overturn an unfavorable court decision quickly in order to avoid the risk that a consensus might develop, rather than taking time to reflect on the issue before promulgating a regulation.

[FN153]. The Swallows Holding court also emphasized, in seeking to limit National Cable, the fact that the IRS had not consistently maintained the position taken in the new regulation. Swallows Holding, 126 T.C. No. 6 at 144. But the majority failed to acknowledge that the Court in National Cable also indicated that Chevron contemplates that agencies can freely change their position as circumstances warrant and that, unless they are arbitrary or capricious, the inconsistency does not undermine the validity of the new interpretation. See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 125 S. Ct. 2688, 2699-2700 (2005).

As suggesterd in text, many regulations promulgated for the purpose of overturning court decisions will become vulnerable if the Tax Court's failure to embrace National Cable is sustained. The most recent example is a proposed regulation that would substantially alter the income tax treatment of private annuities. See Prop Treas. Reg. § 1.72-6 and § 1.1001-1, 71 Fed Reg. 61441-01 (Oct. 18, 2006). In the preamble, the Treasury explains that the approach taken in a 1933 Board of Tax Appeals decision that was based on Burnet v. Logan, 283 U.S. 404 (1931), as well as the approach taken in Rev. Rul 69-74, 1969-1 C.B. 43, cannot be followed if taxpayer abuse is to be prevented. See id. Whereas this proposal would, in all likelihood, be invalidated if the Swallows Holding analysis were applied, it would unquestionably be sustained under National Cable inasmuch as the neither IRC § 1001 nor § 72 unambiguously resolves the issues addressed in the proposal.

Note, however, that in Estate of Gerson v. Comm'r, 127 T.C. No 11 (2006), decided just before publication of this article, the court sustained a generation skipping tax regulation designed to overturn circuit court precedent. Adhering to its decision in Swallows Holding, the court applied the National Muffler standard rather than Chevron, indicating, as it did in Swallows Holding, that the result would be the same under either standard and that there was therefore no need to compare the two standards. In terms of National Cable, without acknowledging its shift, the court deviated from Swallows Holding. It concluded that, under the National Cable framework, where the courts are in conflict about the meaning of a Code section, an interpretive regulation can resolve the conflict. Thus, unlike Swallows Holding, Gerson contemplates that National Cable can apply to interpretive tax regulations. Unfortunately, however, Gerson fails to recognize that only a Chevron-type interpretation can overturn a court decision. See National Cable, 125 S. Ct. at 2701 (indicating that "the court's prior ruling remains binding law" in the case of an "agency interpretation to which Chevron is inapplicable"). Thus, it would seem that the court erred not only in failing to apply the National Cable framework in Swallows Holding, but also in failing to appreciate in Gerson that a non-Chevron (National Muffler) regulation cannot be used to overturn a court decision. Unless the Tax Court embraces Chevron, it will eventually have to confront the reality that, under National Cable, a non-Chevron regulation cannot interfere with precedent. In short, the Tax Court must choose between two inconsistent propositions that it advances in Gerson: that Chevron may not apply to interpretive tax regulations and that interpretive tax regulations can overturn precedent. For a discussion of the deference issues with regard to the generation skipping tax regulation sustained by the court in Gerson, see Gans supra note 117.

[FN154]. Timothy K Armstrong, Chevron Deference and Agency Self-Interest, 13 Cornell J. Law & Pub. Pol'y 203 (2004) (arguing that self-interested agencies should not receive Chevron deference). But see Hickman, supra note 124 (arguing that deference should be afforded to the IRS).

[FN155]. See infra Part VI.

[FN156]. See, e.g., Regs. § 1.61-22. The split-dollar regulations also replaced a contrary revenue ruling. In Rev. Rul. 64-328, 1964-2 C.B. 11, made obsolete by Rev. Rul. 2003-105, the IRS made no distinction between the so-called collateral assignment and endorsement methods. In the split-dollar regulations that replaced this ruling, however, two different regimes apply depending on which method is used. See Regs. §§ 1.61-22 & 1.7872-15.

[FN157]. Examples of such favoritism are reflected in the fact that the internal buildup of the cash value of a life insurance policy is not taxed (see, e.g., Cohen v. Comm'r, 39 T.C. 1055 (1963), acq., 1964-1 C.B. 4 (cash value of policy was deemed not constructively received by taxpayer because to receive such value, the taxpayer would have to surrender the policy)), and life insurance policy proceeds are entirely exempt from income tax. IRC § 101(a). These benefits do not come without a price, however; put in terms of dollars, this so-called "tax expenditure" costs the country's coffers billions annually. See, e.g., GAO Report, Governmental Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined, GAO-05-690, tbl. 2 at 34 (Sept. 2005) (shows a revenue loss estimate of $20.1 billion for fiscal year 2004 associated with the income tax exclusion on interest with respect to life insurance savings). From a public policy perspective, query whether a portion of this expenditure was ever intended to benefit those taxpayers who, at some point, seek to sell (or even surrender) their coverage.

[FN158]. All dividends paid or credited before the maturity or surrender of a contract are deemed a tax-free return of basis. IRC § 72(e)(5). The Code mandates that for these purposes, the term basis means aggregate basis and includes all premium payments. IRC § 72(e)(6).

As a corollary to this tax-free treatment reserved for dividends (assuming the dividends received do not exceed aggregate premium payments), the taxpayer must reduce the tax basis in the policy that generated such dividends. Regs. § 1.72-6. If, instead, these dividends are used to pay policy premiums, or, alternatively, they are used to purchase additional insurance, such payments will have no net effect upon the policy's tax basis.

[FN159]. Ordinarily a loan taken on a policy does not generate taxable income. See generally, Woodsom Assocs., Inc. v. Comm'r, 198 F.2d 357 (2d Cir. 1952) (holding that the act of borrowing does not constitute a recognition event). A policy loan thus has no bearing upon the tax basis taxpayers have in their insurance policies. The issue of consequence will be if the loan in question is still outstanding at the time the policy is surrendered or sold; in either case, the taxpayer is treated as if the borrowed (and still unpaid) sums were received. Atwood v. Comm'r, T.C. Memo. 1999-61.

[FN160]. For tax purposes, a policy withdrawal is treated as a cash distribution and is generally protected from tax until the aggregate amount withdrawn exceeds the aggregate premiums paid by a taxpayer. IRC § 72(e)(6). However, amounts withdrawn correspondingly decrease a taxpayer's tax basis in the policy. Regs. § 1.72-6. This general rule does not apply, for example, if the benefits under a life insurance contract are reduced during the fifteen-year period beginning on the issue date of the contract, and a cash distribution is made to the policyholder as a result of the reduction in benefits. See IRC § 7702(f)(7).

[FN161]. See Regs. § 1.1001-2(a) (the amount of the loan is considered an amount received on the transfer); IRS Priv. Ltr. Rul. 89-51-056 (Sept. 27, 1989) (same).

[FN162]. To provide an incentive for taxpayers to maintain their policies, Congress should consider eliminating any favorable tax treatment associated with policy surrenders and, in particular, repealing IRC § 72(e)(6). Indeed, it might even consider going a step further and instituting an excise tax in instances of policy surrenders to capture some of the income tax deferral the taxpayers are able to capitalize upon.

[FN163]. See supra note 27 and accompanying text.

[FN164]. IRC § 61.

[FN165]. Statistical Abstract of the United States: 2006, tbl. 34 at 38 (2006).

[FN166]. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

[FN167]. Id. at 71.

[FN168]. Id. See generally Dennis L. Belcher & Mary Louise Fellows, Report on Reform of Federal Wealth Transfer Taxes Task Force on Federal Wealth Transfer Taxes, 58 Tax Law. 93 (2004) (describing in exhaustive detail that if facets of the Economic Growth and Tax Relief Reconciliation Act of 2001 are made permanent, it will dramatically decrease the percentage of estates subject to federal estate tax).

[FN169]. See Pub. L. No. 107-16, supra note 137, at § 901, 115 Stat. 150 (prescribing "sunset" provisions for estate tax repeal).

[FN170]. See, e.g., Edward McCaffery, A Look Into the Future of Estate Tax Reform, 105 Tax Notes 997 (Nov. 15, 2004) (arguing that politicians use the prospect of estate tax repeal to generate campaign contributions); Edward McCaffery & Linda Cohen, Shakedown at Gucci Gulch: A Tale of Death, Money and Taxes, in USC CLEO Research Paper No. 04-14 (2004), at http:// ssrn.com/abstract=581084 (same).

[FN171]. See Pub. L. No. 107-16, supra note 133, § 511(a)-(c), 115 Stat. 38, 70-71.

[FN172]. The business model of viatical companies was fairly simple. These companies would buy life insurance policies at a discounted value from patients stricken with AIDS, who were deemed to have exceedingly short life spans; maintain the policy until the death of the insured; and give company investors a healthy return on their investments. Commentators estimate that "between $1.8 billion and $4.0 billion worth of policies were viaticated in 2001, up from $50 million in 1990 and $1.0 billion as recently as 1999." N.A. Doherty & H.J. Singer, The Benefit of a Secondary Market for Life Insurance Policies, 38 Real Prop. Prob. & Tr. J. 449, 451 (2003) (citing Erich W. Sippel & Alan H. Buerger, A Free Market for Life Insurance, Contingencies 17 (Mar.-Apr. 2002); Carrie Coolidge, Death Wish Investors in Insurance Policies for the Terminally Ill Are Watching Their Capital Get Annihilated, Forbes 206 (Mar. 19, 2001)).

[FN173]. D.W. Dunlap, AIDS Drugs Alter an Industry's Math, N.Y. Times, July 30, 1995, at D1; Coolidge, supra note 172.

[FN174]. See Jim Connolly, Institutions Reshape Life Settlement Market, National Underwriter 14 (Sept. 20, 2004) (estimating that the volume of life settlements will increase to $15 billion annually by the year 2010); M. Bryan Freeman, Life Settlements Enter the Mainstream, Nat'l Underwriter 20 (Sept. 19, 2005) (declaring that the life settlement market has come of age). But see Rachel Emma Silverman, Recognizing Life Insurance's Value: Study Says Keeping Policy May Mean Bigger Payoff Than Selling to an Investor, Wall St. J., May 31, 2005, at D2.

[FN175]. Some states have questioned the legality of this technique. See, e.g., Op. Off. Gen. Counsel, 05-12-15 (Dec. 19, 2005) (holding that the owner of the policy did not have a valid insurable interest). Insurance companies, too, have expressed misgivings regarding the premium financing technique because they apparently price policies based upon an assumption that a number of the policies will lapse before the insured dies. Those who invest in this type of transaction seek to exploit this assumption, acquiring the policy at a reduced cost because of the assumption and then holding it until the insured's death without lapse.

[FN176]. See R. Marshall, Stephen R. Leimberg, and Lawrence J. Rybka, 'Free' Life Insuarnce: Risks and Costs or Non-Recourse Providing Financing, 33 Est. Plan. 3 (2006); Stephan R. Leimberg, Stranger-Owned Life Insurance: Killing the Goose That Lays the Golden Eggs! 49 Exempt Org. Tax Rev. 93 (2005); Rachel Emma Silverman, Letting an Investor Bet on When You'll Die, Wall St. J., May 26, 2005, at D1.

[FN177]. See Regs. § 1.1001-2.

[FN178]. See supra notes 90-93 and accompanying text.

[FN179]. This is not to suggest merely because the hypothetical term method produces less gain that it is theoretically superior. Instead, its theoretical superiority stems from the more realistic allocation of origination costs. In short, the point of examining this new arrangement is not to praise the comparative virtues of any basis-computation method, but simply to explore the practical implications of the different alternatives.

[FN180]. 456 U.S. 960 (1982).

[FN181]. See Regs. § 1.1001-2(c), exs. 7, 8. See also Deborah A Geier, Tufts and the Evolution of Debt Discharge Theory, 1 Fla. Tax Rev. 115 (1992) (critiquing this distinction).

[FN182]. Assume a taxpayer's basis is zero and that it is encumbered by a recourse debt in the amount of $7,500. If, at a time when the asset's value is $6,000, the taxpayer surrenders it to the lender in discharge of the entire debt of $7,500, the taxpayer would have gain of $6,000 and COD income of $1,500. See Regs. § 1.1001-2(c), ex. 8. (using a similar example).

[FN183]. See Regs. § 1.1001-2(c), ex. 7.

[FN184]. See Regs. § 1.1001-2(c), ex. 7.

[FN185]. See IRC § 1221.

[FN186]. See Comm'r v. Phillips, 275 F.2d 33, 36 n.3 (4th Cir. 1960) (in dicta, indicating that a policy may be characterized as a capital asset); see also Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (same).

[FN187]. See Regs. § 1.1001-2.

[FN188]. Whereas, traditionally, capital gain treatment could only be secured if the asset were sold, the Code now permits such treatment even where the asset is surrendered on termination of a contract. See IRC § 1234A. Thus, it would seem that if the insured were to surrender a policy to the insurance company, capital gain treatment might be available. See Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (indicating that capital gain treatment might be appropriate on surrender of a policy).

[FN189]. See IRC 1234A. Even if the sale or exchange is satisfied, to the extent the sale proceeds are attributable to the accretion of earnings within the policy, ordinary income treatment is the result under the substitution doctrine. See, e.g., Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (indicating that the substitution doctrine requires that the accretion be treated as ordinary income).

[FN190]. See United States v. Midland-Ross Corp., 381 U.S. 54 (1965); Comm'r v. Gillette Motor Transp., Inc., 364 U.S. 130 (1960); Comm'r v. P.G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Comm'r, 313 U.S. 28 (1941).

[FN191]. See, e.g., Edward J. Roche, Jr., Lease Cancellation Payments Are Capital Gain? Yes! The TRA '97 Change to 1234A Overturned Hort, 102 J. Tax'n 364 (2005) (suggesting that Congress overruled the substitution doctrine in enacting Code § 1234A); see also Lattera v. Comm'r, 437 F.3d 399, 403 (3rd Cir. 2006) (rejecting the taxpayer's argument that the Supreme Court's decision in Ark. Best Corp. v. Comm'r, 485 United States 212 (1988), overruled the doctrine); United States v. Maginnis, 356 F.3d 1179, 1185 (9th Cir. 2004) (same).

[FN192]. See, e.g., Maginnis, 356 F.3d at 1185 (rejecting the taxpayer's argument that the Supreme Court in Arkansas Best overruled the substitution doctrine); Lattera, 437 F.3d at 403; Watkins v. Comm'r, 447 F.3d 1269, 1272 (10th Cir. 2006) (applying the substitution doctrine without discussing Arkansas Best); Wolman v. Comm'r, No. 05-9001, 2006 WL 1376899 (10th Cir. 2006) (applying Watkins to reach a similar outcome based upon a similar set of facts); see also Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (applying the substitution doctrine after the enactment of Code § 1234A and after the Supreme Court's decision in Arkansas Best).

[FN193]. Midland-Ross Corp., 381 U.S. at 57 (1965); see Gillette Motor Transp., Inc., 364 U.S. at 134; P.G. Lake, Inc., 356 U.S. at 265.

[FN194]. See supra note 180.

[FN195]. See, e.g., Daniel Halperin, Saving the Income Tax: An Agenda for Research, 24 Ohio N.U. L. Rev. 493 (1998) (indicating that the preferential capital gain rate is designed in part to address the lock-in effect, under which taxpayers are dissuaded from selling assets because of the potential tax liability); see also Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (explaining that Congress was concerned about the deterrent effect on taxpayers inclined to make a sale absent the preferential rate).

[FN196]. 356 F.3d 1179 (9th Cir. 2004).

[FN197]. Id. at 1186-87.

[FN198]. Id. at 1184.

[FN199]. Id.

[FN200]. 437 F.3d 399 (3rd Cir. 2006).

[FN201]. In disagreeing with Maginnis, the Third Circuit embraced a critique of the decision. Id. at 404-06. See generally Matthew S. Levine, Comment, Lottery Winnings as Capital Gains, 114 Yale L.J. 195, 197-202 (2004) (critiquing Maginnis); Thomas G. Sinclair, Comment, Limiting the Substitute-for-Ordinary Income Doctrine: An Analysis Through its Most Recent Application Involving the Sale of Future Lottery Rights, 56 S.C. L. Rev. 387, 421-22 (2004).

[FN202]. Under the Third Circuit framework - which, parenthetically, is dicta - there is a threshold inquiry as to whether the arrangement more closely resembles a substitution or capital gain type of transaction. Lattera, 437 F.3d at 405-06. If the issue is not resolved under this test, it becomes necessary to determine whether, in the court's terminology, the taxpayer has disposed of a vertical slice (i.e., where the taxpayer sells a complete undivided property interest) or a horizontal slice (i.e., where the taxpayer disposes of a part of his property interest and also retains a portion, too). Id. at 406-07. Where there is a disposition of a horizontal slice, the substitution doctrine is to be applied. Id. at 407. On the other hand, in the case of a vertical slice, a further determination must be made: whether the taxpayer disposes of the right to receive income that has already been earned, Id. at 407-09, or, instead, the right to receive income to be earned. The doctrine is to be applied in the former but not the latter case. See id. at 409.

[FN203]. See id. at 405 (indicating that the Supreme Court had invoked the substitution doctrine, even though the taxpayers held investment assets capable of appreciation, in Comm'r v. P.G. Lake, Inc., 356 U.S. 260 (1958), and Hort v. Comm'r, 313 U.S. 28 (1941)). It is certainly plausible that, in P.G. Lake, the amount received by the taxpayer was attributable in part to appreciation in the taxpayer's investment (i.e., the price the taxpayer received for selling the oil payment right may well have stemmed in part from the appreciation in the underlying investment that had accrued during the time of the taxpayer's ownership). In Hort, on the other hand, contrary to the Third Circuit's characterization, the amount the taxpayer/lessor received from the lessee as consideration for canceling the lease does not appear to reflect appreciation in the underlying investment.

[FN204]. Lattera, 437 F.3d at 405. In supporting its argument against the use of the appreciation-over-time criterion, the court uses a car as an example. Id. at 405. Since, the court says, cars tend to decline in value, use of the appreciation-over-time criterion would create an anomalous result in this context: the substitution doctrine would always preclude capital gain treatment on the sale of a car. See id. This is a faulty analysis that is predicated on a lack of understanding of the appreciation-over-time criterion and the substitution doctrine itself. The criterion - as well as the doctrine - can only have relevance where the transaction produces a profit. The doctrine can have no application where, as in the car example, loss occurs. As properly applied, the substitution doctrine converts profit that would otherwise qualify for capital gain treatment into ordinary gain. Thus, in the car example, should it for some reason be sold at a profit, capital gain would result - the profit having accrued over the period of the taxpayer's ownership.

[FN205]. Id. at 405-10.

[FN206]. See United States v Midland-Ross Corp., 381 U.S. 54, 57 (1965); Comm'r v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960).

[FN207]. See Lattera, 437 F.3d at 405 (referencing the Supreme Court decision in P.G. Lake).

[FN208]. The court also referenced the Supreme Court's decision in Hort, 313 U.S. at 28. See Lattera, 437 F.3d at 405.

[FN209]. See P.G. Lake, 356 U.S. at 265.

[FN210]. See Comm'r v. P.G. Lake, 356 U.S. 260 (1958) (involving similar facts concerning the sale of an oil payment right where the taxpayer retained the underlying asset); see also Estate of Frank D. Stranahan v. Comm'r, 472 F.2d 867 (6th Cir. 1973) (applying P.G. Lake in the context of such a dividend sale).

[FN211]. P.G. Lake, 356 U.S. at 265.

[FN212]. In also holding that the sale of the right to receive the lottery proceeds results in ordinary income under the substitution doctrine, the 10th Circuit found it unnecessary to engage in the dispute. See Watkins v. Comm'r, 447 F.3d 1269 (10th Cir. 2006).

[FN213]. 157 F.2d 235 (2nd Cir. 1946); see Lattera v. Comm'r, 437 F.3d 399, 409 n.5 (3rd Cir. 2006).

[FN214]. See Rev. Rul. 72-243, 1972-1 C.B. 233 (embracing McAllister).

[FN215]. See Lattera, 437 F.3d at 409 n.5.

[FN216]. Id. at 236-37.

[FN217]. McAllister, 157 F.2d at 235.

[FN218]. See Regs. § 1.1014-5(a).

[FN219]. In reality, A's interest, and therefore A's basis, would be somewhat less than 40% at the point of sale given that, over time, the income beneficiary's interest in the trust is deemed to be reduced and the remainderman's is deemed to increase concomitantly. See Regs. § 1.1014-5(a). In the example, since the sale occurs so shortly after the testator's death, no attempt is made to compute A's reduced interest.

[FN220]. See Lattera, 437 F.3d at 409 n.5 (referencing Marvin A. Chirelstein, Federal Income Taxation at 373, at ¶17.03, (9th ed. 2002), for the proposition that McAllister was wrongly decided).

[FN221]. In Comm'r v. P.G. Lake, 356 U.S. 260 (1958), see id. at 262, 265, in contrast, where the taxpayer sold a carved-out right and retained the balance of its interest in the investment, the taxpayer could not have established that the entire profit was attributable to appreciation that had accrued during the taxpayer's ownership. While some portion of the profit might have been the result of appreciation in the underlying asset, the taxpayer could not have established that the entire profit was so attributable.

[FN222]. The outcome in the trust examples would be different if A and B did not sell their interests simultaneously. In the case of a nonsimultaneous sale, the income beneficiary is not permitted to offset any basis against the amount realized on the sale. See IRC § 1001(e). Thus, A would be required to recognize as capital gain the entire amount realized on the sale if B did not simultaneously sell the remainder interest. This denial of a basis offset to A is entirely unrelated to the substitution doctrine and its concern about taxpayers converting what is essentially ordinary income to capital gain. Rather, it stems from a concern about trust beneficiaries manipulating the basis provisions to manufacture an overstated basis. Prior to 1969, it was possible for a trust beneficiary to sell the income interest and claim a basis offset based on the actuarial percentage of the interest at the time of sale and the date-of-death value of the trust's assets. See Regs. § 1.1001-5(a). The problem arose if the remainderman subsequently sold the remainder interest. If, for example, the sale were made at approximately the time the income interest terminated, the remainderman could claim as a basis the entire date-of-death value of the trust's assets. See id. This would, of course, permit an income beneficiary and remainderman to enjoy, in the aggregate, a basis offset in excess of 100% of the asset's date-of-death value. To prevent taxpayers from exploiting the basis rules in this fashion, Congress added Code § 1001(e) in the Tax Reform Act of 1969. Tax Reform Act of 1969, See Pub L. No. 91-172, § 516(a) 83 Stat. 487, 649 (1969). See also Marvin A. Chirelstein, Federal Income Taxation, 387-89, at ¶ 17.03 (10th ed. 2005) (explaining this rationale for the 1969 amendment).

[FN223]. See Sutter v. Comm'r, 76 T.C. Memo (CCH) 59, T.C. Memo (RIA) 98,250 (1998); Haderlie v. Comm'r, 74 T.C. Memo (CCH) 1254, T.C. Memo (RIA) 97,525

(1997). In Sutter and Haderlie, as part of a prearrangement, the taxpayers borrowed money on a nonrecourse basis from an entity controlled by an insurance agent. Sutter, 76 T.C. Memo (CCH) at 59-60, T.C. Memo (RIA) at 98-1449 to 98-1450; Haderlie, 74 T. C. Memo (CCH) at 1255, T.C. Memo (RIA) at 97-3500 to 97-3501. The borrowed moneys were then used by the taxpayer to pay premiums on policies sold by the insurance agent. Sutter, 76 T.C. Memo (CCH) at 60, T.C. Memo (RIA) at 98-1499; Haderlie, 74 T.C. Memo (CCH) at 1255, T.C. Memo (RIA) at 97-3501. Finding the nonrecourse note was illusory, both the Sutter and Haderlie courts held that the entire amount of the premium advanced to the taxpayer/insured represented compensation for agreeing to acquire the policy (in Haderlie, the court held that the entire premium constituted gross income, whereas in Sutter the taxpayer conceded that Haderlie was correct as to this point). Sutter, 76 T.C. Memo (CCH) at 61-62, T.C. Memo (RIA) at 98-1451 to 98-1453; Haderlie, 74 T.C. Memo (CCH) at 1255-57, T.C. Memo (RIA) at 97-3501 to 97-3503. It should be emphasized that, in these cases, the parties did not treat the nonrecourse note as if it had legal significance, thus permitting each court to find that it was illusory. In Sutter, the court relied on its decision in Comm'r v. Wentz, 105 T.C. 1 (1995), where it had held that the entire premium (not simply the cost of comparable term insurance) rebated to the insured must be included in the participating taxpayer's gross income. Sutter, 76 T.C. Memo (CCH) at 61, T.C. Memo (RIA) at 98-1451 to 98-1452; Wentz, 105 T.C. at 11-12. For a discussion of the contexts in which nonrecourse notes may be disregarded, see, generally, Mitchell M. Gans, Re-Examining the Sham Doctrine: When Should an Overpayment Be Reflected in Basis?, 30 Buff. L. Rev. 95 (1981).

[FN224]. In some cases, the investor may loan an amount to the taxpayer that is greater than the premiums due during the term of the arrangement. In effect, the taxpayer receives this cash-in-the-pocket inducement, which will not have to be repaid if the policy is transferred to the investor in discharge of the nonrecourse note, in order to equalize the values. In other words, in the judgment of the parties, the life insurance policy is expected to have a value at the maturity of the note that is greater than the amount necessary to pay the premiums during the arrangement - thus requiring the investor to provide an additional inducement. The presence of such an additional inducement would not alter the tax consequences. The amount of the taxpayer's ordinary income would now include the amount of the inducement, as well as the amount of the premiums supplied by the investor. Both the free-insurance and the cash-in-the-pocket inducements represent, in substance, compensation to the taxpayer for agreeing to acquire the policy and should be treated as such. See IRC § 61.

[FN225]. See Regs. § 1.1001-2.

[FN226]. The amount realized would also include the amount of any accrued interest. See, e.g., Catalano, 79 T.C. Memo (CCH) 1632, T. C. Memo (RIA) 2000-082 (2000), overruled on other grounds by Catalano v. Comm'r, 279 F.3d (9th Cir. 2002) (holding that the amount realized on the surrender of an asset in discharge of a nonrecourse note includes accrued interest). The taxpayer would be deemed to pay the interest at the time of the discharge, see id., but no deduction would be available for the deemed payment. See IRC § 264.

[FN227]. If retained until death, the proceeds would not be taxable. See IRC §101.

[FN228]. For a similar bifurcation of gain in an analogous context, see, e.g., Bolnick v. Comm'r, 44 T.C. 245, 253-57 (1965), acq., 1980-2 C.B. 1 (applying the Supreme Court's decision in Midland-Ross and concluding that, on redemption of a bond, the portion of the proceeds attributable to earned original interest was ordinary income under the substitution doctrine and that any additional gain on the redemption constituted capital gain); see also Rev. Rul. 80-143, 1980-1 C.B. 19 (embracing the reasoning found in Bolnick).

With respect to capital gain treatment of the surrender of a policy, see supra note 177.