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INTRODUCTION

All cash value insurance provides both insurance and investment. Federal income tax law allows individuals to defer paying tax on investment returns accruing inside such contracts (the "inside buildup") and to exclude from income life insurance death benefits.[1] Variable insurance contracts generate risk-related returns rather than the guaranteed, but low, returns of more traditional products.[2] Variable insurance contracts work well only for a fairly narrow range of individuals, and these contracts are susceptible to being marketed and sold to less affluent taxpayers for whom such contracts are unsuitable investments.[3] For more affluent taxpayers, variable insurance may make financial sense, but this group may not wish to settle for investing in standard variable contracts and may instead buy into

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1. See *infra* Part I.B for an overview of the tax rules applicable to life insurance and annuity contract owners.

2. *See* Charlene D. Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX. REV. 129, 135, 139 (2005).

3. *See* Joseph B. Treaster, *Insurers Want Their Say in Social Security Debate*, N.Y. TIMES, Aug. 2, 2005, at C3 (describing congressional objections to adding to the tax benefits already enjoyed by variable annuities); *see also infra* notes 75-84 and accompanying text (discussing high fees and aggressive marketing tactics connected with variable insurance).

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variable contracts characterized as wraparound tax shelters.[4]

As a method of addressing the investment suitability and tax shelter problems associated with variable insurance, I propose current taxation of variable contracts' risk-related returns but continued tax deferral for a deemed, risk-free return amount.[5] Preservation of tax deferral for a portion of the inside buildup may seem an unorthodox way of implementing insurance tax reform since such deferral represents a departure from the Haig-Simons income tax ideal.[6] Yet the likelihood of broader reform is low—in spite of the inadequate justifications supporting the tax deferral on inside buildup.[7] My proposal is offered as a reasonably politically-palatable approach to reform of a problematic insurance product.

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4. Through this technique, individuals convert a high tax rate to a lower one by wrapping income-producing assets in a variable contract. In the most recent iteration, individuals wrapped hedge fund interests, which tend to generate highly taxed ordinary income, in variable contracts. *See* Luke, *supra* note 2, at 174-83. The use of the term "tax shelter" is itself problematic as there is no general agreement on what types of transactions should be given this label. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 280 (3d ed. 2004) ("[T]here is no consensus on how to even define *tax shelter*."). I apply the term to the wraparound technique because the technique is used by sophisticated, wealthy individuals in order to obtain arbitrage and deferral tax benefits. *See id.* (describing tax arbitrage and deferral of taxes as frequent tax avoidance "principles"). This Article does not consider whether particular versions of the wraparound insurance shelter would be "reportable transactions" under Internal Revenue Code section 6011.

5. My proposal preserves other areas of favorable tax treatment for insurance contracts—including implicit deductibility of insurance costs, treatment of cash value withdrawals for life insurance, and the exclusion of life insurance death benefits. *See infra* Part I.B.

6. For a discussion of Haig-Simons literature, see *infra* note 197 and accompanying text. This Article does not address the normative question of whether we should have an income or a consumption tax. The current tax treatment of insurance products is clearly more readily justified under a consumption tax norm. *See* C. David Anderson, *Conventional Tax Theory and "Tax Expenditures": A Critical Analysis of the Life Insurance Example*, 57 TAX NOTES 1417, 1419-21 (1992) (describing the proper treatment of life insurance under a consumption tax and arguing that most long-term investment is currently taxed on consumption tax basis).

7. *See* Luke, *supra* note 2, at 140-42 (briefly critiquing policy justifications made to support the tax preferences granted life insurance and annuities); *infra* notes 18-21 and accompanying text. *But see* Anderson, *supra* note 6, at 1425-26 (arguing that life insurance taxation already largely complies with income tax norms given inflation and frequent policy cancellations).

First, implementation of my proposal should lead to increased transparency through forcing separate tax accounting of contract components, which should in turn improve consumers' ability to assess contracts and may also lead to lower fees by fostering competition.[8] Current taxation of risk-related returns should also make it more difficult for insurance sellers to tout variable contracts for their tax benefits to individuals for whom such tax benefits would be largely illusory. Finally, current taxation of risk-related returns removes an apparently key shelter incentive—the promise of a lower nominal tax rate on risky returns than that which is available outside variable insurance contracts. As a result, my proposal should make it possible to eliminate costs imposed as a result of the government's response to the wraparound shelter.

This last point—that the proposal removes a shelter incentive—requires, however, further elaboration in light of the literature on the taxation of risk. This literature (which I will refer to as "Domar-Musgrave" in reference to the authors of the formative article in this area, Evsey D. Domar and Richard A. Musgrave), posits that, given certain assumptions, taxpayers effectively do not pay tax on risk-related returns under a normative, flat-rate income tax.[9] The principal assumptions required for this result are that losses be fully deductible and refundable, gains and losses be taxed at the same rate, and taxpayers adjust their investment portfolios sufficiently to negate the effect of any nominal tax on risk.[10]

In the real world, numerous loss limitation rules apply, progressive rates may cause gains and losses to be taxed differently, and taxpayers may not make the necessary

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8. In term life, for example, greater access to pricing information has led to lower rates. *See* KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 77 (13th ed. 2000) ("[T]he term market [is] more price competitive than the market for cash-value policies.").

9. Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944).

10. *See* Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under A Progressive Income Tax*, 59 SMU L. REV. 879, 879 (2006). In addition, the Domar-Musgrave model also assumes indexation for inflation. *See* Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 22 (1996); Deborah H. Schenk, *Saving the Income Tax With a Wealth Tax*, 53 TAX L. REV. 423, 430 (2000).

portfolio adjustments because of transaction cost and informational hurdles. As a result, even though Domar-Musgrave results hold given the existence of various preconditions, at least some risk-related returns are taxed under our current income tax system.[11] Because of the problems associated with pinning down the real world implications of Domar-Musgrave, using it to inform incremental reform proposals remains unusual.[12] Yet, its theoretical correctness suggests that it should be taken into consideration—particularly in those situations where the necessary preconditions for its results are most likely to be met.

Tax shelter reform seems particularly ripe for examination in light of Domar-Musgrave since tax shelters are generally marketed to the group of taxpayers most likely to be able to satisfy the preconditions to the effective non-taxation of risk. That is, tax shelters are generally purchased by sophisticated, affluent taxpayers who are most able to avoid loss limitation rules, have income that puts them beyond the point where additional marginal rate changes may result in a different nominal rate for gains and losses, and are most able to make the necessary portfolio adjustments.[13] Indeed, perhaps many tax avoidance techniques, including the wraparound insurance shelter, can be explained in terms of enabling taxpayers to satisfy the necessary preconditions for Domar-Musgrave results (i.e., the non-taxation of risk).

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11. Professor Weisbach has recently stated that these precondition assumptions may not be as unrealistic as may first appear. David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 5 (2004).

12. *See* David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1891 (2004) (noting that "the theory has inspired little by way of concrete reform proposals"). For examples of proposals drawing on Domar-Musgrave, see Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX. L. REV. 731 (1995); Schizer, *supra*.

13. *See* Cunningham, *supra* note 10, at 38 ("[I]f a normative proportional income tax were in place, a sophisticated investor could reduce the impact of the tax on capital income so that only the risk-free rate of return (or her borrowing rate) on her net capital investment would be burdened by the tax."); Schenk, *supra* note 10, at 429 (describing how sophisticated investors and established firms are able to neutralize loss limitation rules); *id.* at 431-35 (discussing how the most sophisticated and affluent are also the most able to make the necessary portfolio adjustments).

Assuming tax shelter clients are in a good position to avoid paying tax on risk, the question then becomes whether incremental reform should make obtaining such a result more or less difficult. Though this Article does not take up an in-depth discussion of this preliminary normative question, the details of my proposal are guided by the view that, to the extent possible, incremental reform should adhere to a normative income tax, which (in theory) should have the effect of facilitating Domar-Musgrave results.[14] The details of my proposal also, however, reflect the uncertainty and controversy surrounding Domar-Musgrave's real world effects. That is, a proposal directly implementing Domar-Musgrave would likely impose fewer administrative costs than my proposal.[15] For example, as discussed by Professor Schizer, ensuring a zero tax rate for risk-related inside buildup would conform to Domar-Musgrave.[16]

My proposal is designed to accommodate a range of views on the real world effects of Domar-Musgrave. That is, if one assumes that risky returns are meaningfully taxed, my proposal removes a shelter incentive—the promise of a lower tax on risky returns than that which is available outside variable insurance contracts. If, on the other hand, one assumes that risky returns are untaxed, my proposal provides a politically feasible way of removing unnecessary anti-shelter provisions and should not substantially affect taxpayers' ability to make the portfolio adjustments necessary to reach Domar-Musgrave results with respect to variable insurance risky returns.[17]

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14. For discussion of some of the policy questions raised by Domar-Musgrave, see generally Cunningham, *supra* note 10, at 17; Schenk, *supra* note 10, at 428; Weisbach, *supra* note 11; Zelenak, *supra* note 10.

15. *Cf.* Weisbach, *supra* note 11, at 3 ("[I]f we are only going to tax the risk-free rate of return to capital, there are a variety of ways of doing so that might be much cheaper to administer than a Haig-Simons system.").

16. Schizer, *supra* note 12, at 1936 (explaining that a "provocative implication" of Domar-Musgrave analysis is that hedge fund life insurance "investments do not require special attention"). As will be described *infra* Part I.B, while a zero rate is a possibility under cash value life insurance, it is far from assured; annuities do not currently provide the potential for a zero rate.

17. A further implication of Domar-Musgrave is that a generous (and in some cases only available) tax preference for investment returns would be a benefit for risk-free returns. Thus, my proposal also provides an exploration of how a subsidy might be constructed consistently with Domar-Musgrave effects.

Part I of this Article provides an overview of insurance terms and contract owner taxation. Part I also analyzes prior variable and nonvariable insurance reforms, including those aimed at curtailing wraparound shelters. The details of my proposal are provided in Part II, which also explores some potential objections to it (other than those relating directly to Domar-Musgrave). Part III provides background on the Domar-Musgrave theory and discusses its application to incremental reform and to my proposal.

I. VARIABLE INSURANCE: TAX STRUCTURE AND POLICY

The congressional approach to hybrid insurance-investment products has been to preserve the core tax benefits long provided to mortality insurance products deferral of tax on investment buildup and exclusion of death benefits, for life insurance. Although these tax benefits are frequently criticized as introducing ineffectual economic distortion[18] and as skewing unfairly towards

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See infra text accompanying note 238. Whether such a subsidy is advisable in this setting is another matter. *See infra* notes 18-21 and accompanying text.

18. The tax treatment of life insurance and annuity contracts deviates from the Haig-Simon model in order to further the policy goal of encouraging taxpayer economic preparation. Yet, it is unclear whether the tax benefits granted to cash value insurance and annuities have had these intended effects. *See* BLACK & SKIPPER, *supra* note 8, at 16-17 (explaining that people "often avoid or purchase insufficient amounts of death, disability, and long-term care protection"); David F. Bradford, *The Case for a Personal Consumption Tax, in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 75, 90-91 (Joseph A. Pechman ed., 1980) (discussing taxation of cash value insurance as a complex income tax problem); Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership,* 47 TAX L. REV. 725, 798-99 (1992) (questioning current treatment of life insurance products); Kyle D. Logue, *The Current Life Insurance Crisis: How the Law Should Respond,* 32 CUMB. L. REV. 1, 26 (2001) ("[A]ll of the academic studies of life-insurance adequacy have concluded that life-insurance "inadequacy" is pervasive and in some cases severe."); Luke, *supra* note 2, at 141 (describing the inside buildup tax preference as "supported by flimsy justifications"); Andrew D. Pike, *Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance,* 43 TAX L. REV. 491, 528-32 (1988) (describing problems with the current treatment of life insurance); Tommy F. Thompson, *Nonqualified Deferred Variable Annuities: A Product in Search of a Coherent Theory,* 79 N.D. L. REV. 439, 461 (2003) (describing a study identifying factors that explain "the general reluctance of individuals to annuitize their retirement wealth"); William Vickrey, *Insurance Under the Federal Income Tax,* 52 YALE L.J. 554, 561 (1943) ("[T]he savings part of the life insurance contract should obviously be treated as any other form of savings . . . ."). *But see*

benefiting the wealthy,[19] the prospect of complete removal of these benefits is low.[20] The insurance lobby is strong,[21] as is congressional desire to aid (or to appear to aid) individuals in their economic preparations for retirement and death. Periodically, Congress has, however, acted to prevent insurance products from becoming overly investment oriented—or overly prone to use in tax shelters. The first two sections below describe basic distinctions among insurance products and basic tax treatment. These are followed by an examination and critique of congressional and administrative intervention in insurance contract taxation—with emphasis on measures aimed at variable insurance.[22]

Anderson, *supra* note 6, at 1418-19 (criticizing the conventional view on cash value life insurance). *See also* Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 385-86 (1992) (describing the complexity of determining the effect of tax on saving in "the real world"); Logue, *supra*, at 27 (explaining that it would be a "mistake" to conclude that studies on underinsurance are alone "sufficient to warrant a call for swift government intervention").

19. Term life insurance does not receive the benefit of deferral on inside buildup, since it does not generate inside buildup. *See infra* Part I.A. Term life insurance will be more affordable for young families than cash value insurance. In addition, cash value life insurance and annuity contract owners receive implicit, "above-the-line" deductions for various contract costs. *See infra* Part I.B. Such deductions are more valuable to those in higher rate brackets. Pike, *supra* note 18, at 532 ("[T]he tax incentives apply in an upside-down manner: The greatest benefits inure to the wealthiest taxpayers who have the least need for insurance protection; smaller, but still important, benefits flow to those whose insurance needs are modest; and those whose insurance needs are greatest receive no benefit at all.").

20. *See* Pike, *supra* note 18, at 578 ("[B]ecause the preferential tax treatment of cash value life insurance is based more on politics than on tax policy analysis," broad-based reform is unlikely.).

21. *See* Luke, *supra* note 2, at 142 & n.58 (describing the insurance lobby); Treaster, *supra* note 3, at C3 (noting that the main insurer trade association spent $9.1 million on lobbying in 2004, which was "up 54 percent from the previous year").

22. This Article addresses only individual, commercial products, not group or split-dollar arrangements or private annuities.

A. *Insurance Product Basics*

1. *Life Insurance.* Individuals are able to manage mortality uncertainty and enhance utility through the purchase of life insurance.[23] Traditionally, individuals receive a particular death benefit for a certain price (the premium)—a price which provides individuals with the ability to make current consumption decisions with less concern about untimely death.[24] Even with traditional contracts some uncertainty and risk will remain, for example, the credit risk associated with a particular insurance company. More modern insurance arrangements—in particular, variable insurance—shift all or part of the investment risk from the insurance company to the contract owners. Life insurance products thus may be viewed as falling along a continuum—ranging from pure insurance to products approaching pure investment.

Term life is at one end of this continuum. It provides coverage for a limited period of time, one year, for example,[25] and is often characterized as "pure" insurance. Generally, the premium pays only for the current term's mortality costs and other administrative expenses without any premium remaining to cover a future term's costs. Mortality costs depend on the statistical likelihood of a particular number of deaths occurring within a particular insurance classification.[26] The more precise a classification, the more precise can be the pricing—with the important caveat that a particular classification must yield a group large enough so that the actual number of deaths will not significantly differ from the statistically expected number.[27] While term insurance is often the most affordable for relatively young individuals, the cost of purchasing it

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23. *See* BLACK & SKIPPER, *supra* note 8, at 20-22 (summarizing research on insurance in the context of consumption theories).

24. *See id.* at 18-22 (summarizing various consumption models and their application to life insurance and annuities).

25. *See id.* at 77-87 (describing various aspects of term life insurance); Pike, *supra* note 18, at 497-98 (describing the same). This description applies only to single-payment, non-renewable term contracts. Guaranteed, renewable term or level-premium term contracts will have differing characteristics.

26. *See* BLACK & SKIPPER, *supra* note 8, at 26-27.

27. *See id.* at 28.

increases with age since the risk of death also increases with age.[28]

Traditional cash value insurance allows an individual to maintain a particular amount of insurance coverage as she ages without triggering premium increases. Such a contract requires the insured to pay larger premiums during her younger years than would be required for term insurance providing a comparable death benefit. The premium covers current mortality costs and contract expenses but is large enough so that even after payment of these costs an amount remains that is, in effect, invested with the insurance company. With the passage of time, the death benefit is covered by both a decreasing insurance component and an increasing savings portion—the cash value.[29] As a result, if the insured dies close to the contract maturity date, almost all of the death benefit will be paid out of the savings accumulation and not as a "pure" insurance payment.

In other words, cash value insurance contracts can be thought of as consisting of an increasing savings account and a decreasing term life insurance contract.[30] Thus, individuals can create the equivalent of a cash value insurance policy through a "buy-term-and-invest-the-rest" strategy.[31] The use of cash value insurance contract may, however, help individuals better meet their goals since it may serve as a savings commitment device.[32] In addition, the insurance company will be able to determine more

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28. *See id.* at 30-32.

29. *See id.* at 35.

30. *Id.* at 37. The same principles generally apply whether the cash value contract is whole life (a single- or level-premium contract) or universal life (flexible premium contract). This Article generally will not distinguish among types of nonvariable cash value contracts. *See id.* at 38-39 (explaining that traditional cash value and universal life policies share the same "fundamental nature").

31. *See* Tommy F. Thompson, *The Tax Advantaged Treatment of Life Insurance*, 4 TAX L.J. 27, 43-44 (1989). Direct comparisons between term and cash value insurance are made more difficult by various selection bias problems. For example, companies tend to have better mortality experience with buyers of cash value insurance than with term buyers.

32. *See* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1314 (1991) (describing precommitment mechanisms in retirement savings law).

easily than an individual the mix between insurance and savings that will provide the individual with her preferred death benefit coverage. That is, the insurance company guarantees that the premium will be sufficient to cover the mortality costs, and it bears the risk that the rate of return on the savings component of a traditional cash value policy will be adequate to ensure the death benefit level. In order to minimize its investment risk, an insurance company will typically guarantee only a conservative rate of return.[33]

Variable life insurance[34] is a more modern type of cash value insurance. It allows the contract holder to obtain risk-based returns on their premium investments. In a typical commercial variable contract, after payment of current contract expenses, the contract owner will allocate remaining premium (and accumulated inside buildup) among various funds, which are generally mutual fund equivalents.[35] Insurance companies do not have to create

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33. A book published in 2000, for example, put typical guaranteed rates for flexible-premium cash value contracts at between four and five percent and for flexible-premium deferred annuities at between three and 4.5 percent. BLACK & SKIPPER, *supra* note 8, at 122-23 ("Guaranteed rates [for universal life] of 4 to 5 percent are commonly found."); *id.* at 170 (Flexible premium deferred annuity "contracts typically guarantee a minimum interest rate, which is often within the 3.0 to 4.5 percent range . . . ."). In addition to the guaranteed rates, however, many nonvariable insurance products are available that offer interest-sensitive return adjustments in order to provide contract holders more protection against interest rate increases (and prevent flight from insurance contracts during such interest rate changes). *See id.* at 122-23 (describing mechanisms employed in universal life policies to adjust for changes in interest rates); *id.* at 97 (describing current assumption whole life as providing interest-sensitive coverage); *id.* at 170 (describing use of bonus rates used by some issuers of flexible-premium deferred annuity contracts). Participating insurance contracts serve a similar function. *See id.* at 39-40 (describing participating policies and current assumption policies, both of which "allow policy values to deviate from those illustrated at policy inception—both favorably and unfavorably"); Pike, *supra* note 18, at 514 (describing dividends available under participating cash value policies). Further, if the life insurance company issuing the policy is a mutual life insurance company the policyholders have an equity interest in the company in addition to their contractual interest. BLACK & SKIPPER, *supra* note 8, at 252.

34. As with traditional cash value life insurance, variable life insurance is offered through level premium policies and through flexible premiums. This Article will generally not distinguish between level premium and flexible premium plans.

35. Insurers routinely seek to expand the types of assets underlying contracts. *See* Kathy Chu, *Insurers Try to Simplify Annuities: Asset-Allocation*

and manage these funds, but rather may contract with independent investment advisors.[36] Such outside advisors have assumed much of the work of creating and monitoring the funds underlying variable contracts.

The contract's cash value will fluctuate based on the performance of these underlying funds.[37] In addition, the death benefit (or alternatively, the amount at risk[38]) will also vary depending on the performance of the funds.[39] Because the value of the contract is tied to underlying investments, the variable contract functions as a derivative—a financial instrument whose value is derived from some other asset.[40]

Except to the extent a contract holder purchases a minimum guarantee as to death benefit or cash value,[41] all of the investment risk is shifted from the life insurance company to the contract holder. Because of this shift in risk,

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Funds Make Way Into Investment Vehicle Criticized for Hefty Fees, Complex Structure, WALL ST. J., July 5, 2005, at R3.

36. 26 U.S.C. § 817(h)(5) (2000).

37. *See* BLACK & SKIPPER, *supra* note 8, at 102 (describing variance of cash value in fixed-premium variable life contracts); *id.* at 128 (describing cash value fluctuation in flexible premium variable life contracts).

38. The net amount at risk is the difference between the death benefit and the contract cash value. The larger the net amount at risk, the more expensive the mortality costs. *Id.* at 117-18 (describing the net amount at risk and its effect on the mortality charge amount).

39. *See id.* at 102 (explaining as to fixed-premium variable life contracts that the death benefit, except to the extent of a minimum guarantee, fluctuates with the performance of the funds underlying the contract); *id.* at 128 (explaining that with respect to flexible premium variable life contracts, the contract holder can choose whether the death benefit or the net amount at risk will fluctuate).

40. *See* Schizer, *supra* note 12, at 1935 (describing the relationship between derivatives and wraparound insurance contracts).

41. *See* BLACK & SKIPPER, *supra* note 8, at 102 (explaining that fixed-premium variable life contracts provide a guaranteed minimum death benefit and that some even provide a guaranteed minimum cash value); *id.* at 174 (explaining that although traditional deferred annuities typically guarantee a minimum return, "[m]ost variable annuities do not contain these interest guarantees"). Highly customized, private placement variable insurance contracts (such as those used in the wraparound hedge fund shelter) do not generally offer minimum guarantees. *See* Robert D. Colvin, *Private Placement Insurance Arrangements: Recent Developments Dictate a Fresh Look*, 3 J. TAX'N 34, 36 (2004) ("[C]arriers offer no minimum investment guarantees on PPLI [private placement life insurance] contracts.").

the underlying funds as well as the variable contract itself are subject to securities law regulation.[42] This provides contract owners with access to data on the investment to which they may allocate premiums. The insurance companies that sell variable insurance are generally treated as broker-dealers.[43] Thus, from a securities law perspective, variable insurance falls at the investment end of the insurance/investment continuum.

2. *Annuity Contracts.* Annuitization allows individuals to protect against outliving their assets through a systematic, actuarially determined liquidation of these assets.[44] Thus, the mortality risk associated with annuity contracts is that of prolonged life. In a traditional deferred annuity contract, individuals make premium payments during an accumulation phase.[45] During the accumulation phase, the contract is a savings vehicle and has little—if any—insurance component.[46] In a traditional contract, the insurance company guarantees a particular return on the investment during this phase (and during payout if that occurs). Mortality considerations come into play with the payout phase.

The accumulated fund may be paid out over a certain number of years or can be tied to one or more life contingencies.[47] In the case of annuitization tied to a life contingency, the insurance company assumes the risk that the contract owner will be long-lived. If the contract owner dies before the fund is paid out, the remaining money remains with the company unless the policy contains a minimum return or death payment rider. Most individuals choose not to enter a payout phase and instead withdraw

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42. *See* BLACK & SKIPPER, *supra* note 8, at 102-03 (explaining that the funds investing contract holder assets are subject to the Investment Company Act of 1940 and that a variable life insurance contract is a security under the Securities Act of 1933); *id.* at 177 (explaining that variable annuity contracts are subject to the same securities laws as variable life contracts).

43. *Id.* at 103 (describing broker-dealer registration requirement for distributors of variable insurance).

44. *See id.* at 162 (describing this purpose).

45. *See id.* An immediate annuity is one where the contract is fully funded when purchased and annuitization payments begin shortly thereafter.

46. *Id.* at 298.

47. *See id.*

their savings in a lump sum or in payments over a relatively short period of time at the conclusion of the accumulation phase (or earlier through contract surrender).[48]

Deferred variable annuity contracts function similarly to traditional deferred annuity contracts except that the investment return is not guaranteed by the insurance company. Rather, as with variable life insurance, the contract owner is able to allocate premiums among various investment funds, and the value of the contract's cash value fluctuates with the value of the underlying investment funds.[49] Like variable life insurance, variable annuities are subject to federal securities laws.[50]

B. *Tax Rules*

The investment return earned on the premiums paid for qualifying annuity contracts and cash value life insurance—called "inside buildup"—is not subject to taxation until withdrawal.[51] As a result, investment returns accumulate more quickly than would be the case if they were subject to current taxation, such as in garden-variety savings accounts.[52] Term life insurance does not receive the benefit of deferral on inside buildup since there is essentially no cash value to which the benefit could attach.[53] Death benefits paid on life insurance contracts are

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48. *See* Thompson, *supra* note 18, at 460 (describing the "extremely small" market for life annuities); *see also* Joseph B. Treaster, *Variable Annuity Guide: A Simple, Complex Idea*, N.Y. TIMES, April 13, 2004, at G9 ("[O]nly 2 percent to 3 percent make use of" the life annuity option; instead "most people take their money in a lump sum or in payments over . . . 5 or 10 years.").

49. *See* Luke, *supra* note 2, at 135-36.

50. *See id.* at 136-37.

51. Additional tax benefits applicable only to cash value life are discussed *infra* Part I.C.

52. For example, if $100 is placed in a savings account paying 3 percent, compounded annually, the $3 earned during the year will be subject to tax. If the tax were one-third of the amount, that would leave only $102 on which to earn interest in the subsequent year. If the $100 instead represented a net premium investment in an insurance product, the $3 would not be taxed currently and, thus, the subsequent year's return would be earned on all $103.

53. See *supra* Part I.A for a description of the differences between cash value life insurance and term insurance.

generally excluded from federal income tax.[54] Benefits paid on the death of an annuity contract owner do not qualify for this exclusion.[55]

Although variable life insurance offers the potential for a zero income tax rate, this result depends on the extent pre-death withdrawals exceed the contract holder's investment in the contract. Pre-death withdrawals are generally treated as coming first out of the nontaxable investment in the contract rather than from the inside buildup.[56] "Investment in the contract" is essentially equivalent to the concept of basis.[57] For example, for purposes of determining the treatment of withdrawals, the investment in the contract equals the consideration paid for the contract less any amounts already received that were excludable from income.[58] As a result of this rule for withdrawals, individuals are able to access cash value up to the amount of their investment in the contract without triggering tax. To the extent a withdrawal is subject to taxation, ordinary income tax rates apply.[59]

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54. *See* 26 U.S.C. § 101(a)(1) (2002 & Supp. 2006).

55. *See* 26 U.S.C. § 691(a). No step-up of basis to fair market value is allowed with respect to such survivor benefits. *See* 26 U.S.C. § 1014(c); DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 177 (3d ed. 2004) (describing the difference between life insurance proceeds and other survivor benefits).

56. *See* 26 U.S.C. § 72(e)(5)(A), (C); Pike, *supra* note 18, at 503 (discussing "stacking rule" applicable to life insurance contracts). If the life insurance contract is a "modified endowment contract" this rule does not apply. *See infra* Part I.C.1. The ability to take a pre-death withdrawal will depend on the terms of the insurance contract. *See* BLACK & SKIPPER, *supra* note 8, at 132 (partial surrenders are not permitted with fixed variable life, only with variable universal life).

57. For a discussion of problems with life insurance basis computation and differences in treatment between surrenders and sales, see Mitchell M. Gans & Jay A. Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, 7 FLA. TAX REV. 569, 571-72 (2006).

58. 26 U.S.C. § 72(e)(6) (2000).

59. In the case of policy sales, taxpayers have attempted to get capital gain treatment to little avail. *See* Gans & Soled, *supra* note 57, at 10-12. Insurers have recently lobbied to lower the tax rate to the same as that currently in effect for qualified dividends and long-term capital gains. *See* Treaster, *supra* note 3, at C3. Congress did not accede partly because so few individuals opt to receive a stream of payments rather than a lump sum once the annuity contract leaves the accumulation phase. *See id.*

Loans secured by the cash value of qualified life insurance contracts are not treated as withdrawals, and so do not affect the investment in the contract,[60] unless loans are outstanding at the time of contract surrender.[61] In addition, no penalty tax is assessed on early withdrawals from qualified life insurance contracts.[62] In contrast, a 10 percent penalty tax is typically assessed on withdrawals from other types of tax-preferred retirement vehicles, such as 401(k)s,[63] if made before the age of fifty-nine and one half.

The holders of deferred variable annuity contracts enjoy only current income tax deferral on inside buildup; there is no opportunity for permanent exclusion and the favorable rules for life insurance withdrawals do not apply. Most early withdrawals made during the accumulation phase of a deferred annuity contract are subject to a ten percent penalty.[64] Further, such withdrawals are deemed to come first out of the taxable inside buildup rather than the nontaxable investment in the contract.[65] Finally, loans tied to annuity contract cash value (even if only through the pledge of the cash value as collateral) are treated as withdrawals.[66] Regular annuity payouts made after the contract enters its payout phase are taxable under a formula that allocates part of the payment to investment in

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60. *See* 26 U.S.C. § 72(e)(5)(A), (C). These favorable rules do not apply if the life insurance contract is a modified endowment contract ("MEC"). In general terms, a MEC is a contract in which premium payments are excessively frontloaded. *See id.* § 7702A.

61. That is, outstanding loans at surrender are treated as previously excluded proceeds of the contract. *See* BLACK & SKIPPER, *supra* note 8, at 318-19.

62. If the life insurance contract is a "modified endowment contract" the penalty tax applies. *See infra* Part I.C.1.

63. *See* 26 U.S.C. § 72(t) (2000).

64. *See id.* § 72(q). The ability to make periodic cash value withdrawals will depend on the terms of the contract and any riders. For example, insurers may offer a minimum withdrawal benefit rider (at an additional cost) that allows generous withdrawals during the accumulation phase. *See* Kathy Chu, *New Way to Guarantee Annuity Income: Regular Stream of Funds Assured Despite Fluctuation of Market, But Feature Comes at a Price*, WALL ST. J., Apr. 4, 2005, at R3.

65. *See* 26 U.S.C. § 72(e)(2)-(3) (2000).

66. *See id.* § 72(e)(4)(A).

the contract and part to the inside buildup.[67] As with life insurance, the taxable portion of a withdrawal or regular annuity payment is taxed at ordinary income rates.[68]

Deferral of tax on inside buildup for both life insurance and annuities may be prolonged further through the tax-free exchange of contracts.[69] A life insurance contract may be exchanged tax free for another life insurance contract or for an annuity contract.[70] An annuity contract may only be exchanged for another annuity contract.[71] Although such exchanges are income tax free, insurance companies may charge fees for the exchange, and concerns about unnecessary replacements periodically surface.[72] In the case of variable insurance contracts, individuals are able to change their investment allocations without switching policy contracts. Such allocation changes are not taxable,[73] but they may trigger administrative costs that are passed on to the contract holder (though it is unlikely a direct transfer fee will be charged). An individual switching between mutual funds outside of a variable contract does not have the ability to avoid tax recognition.[74]

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67. *See id.* § 72(b). If the annuitant dies after regular annuity payments begin, a loss deduction is allowed on the final tax return of the decedent for the amount of the unrecovered investment in the contract. *See id.* § 72(b)(3).

68. *See* Thompson, *supra* note 18, at 449-52.

69. *See* 26 U.S.C. § 1035.

70. *See id.* § 1035(a)(1).

71. *Id.* § 1035(a)(3).

72. *See* BLACK & SKIPPER, *supra* note 8, at 305-08 (describing the debate over contract replacement). Some insurance companies may, however, provide incentives for making exchanges if the alternative is having the contract holder leave the insurance sector altogether. *See id.* at 112 (explaining that in order to facilitate policy exchanges, "[r]educed loadings may be offered on the new policy or increased policy face amounts may be offered"); Jeff D. Opdyke, *Annuity Sales Face Crackdown by Regulators: As Complaints Rise, New Laws Seek to Improve Risk Disclosure and Ease Withdrawal Penalties*, WALL ST. J., Aug. 4, 2005, at D1 (describing how seniors may be encouraged "to switch from one annuity to another, racking up big charges").

73. During the Clinton administration, changing this result was discussed. *See* Bridget O'Brian & Vanessa O'Connell, *Annuity Sales May Suffer in Clinton Plan to Tax an Exchange Between Accounts*, WALL ST. J., Feb. 4, 1998, at C1.

74. *See* Robert D. Hershey, Jr., *Mutual Funds Seem Simple, Until It's Time to Sell*, N.Y. TIMES, Feb. 12, 2006, at 24 (describing tax consequences of exchanging one fund for another).

Variable contracts are known for their high costs.[75] These costs can be divided into two categories: insurance costs (e.g., mortality charges) and investment related costs (e.g., investment management expenses).[76] Steep surrender charges for early withdrawals may apply in addition to any tax penalty.[77] A portion of these high costs—particularly of the investment-related costs—likely represents capture of the tax benefits by the insurance companies and thereby imposes an above-zero implicit rate of tax on investment income.[78] As a result of these high fees, variable contracts work well only for a narrow clientele.[79] Insurance companies may act to expand artificially the ownership of variable products through aggressive marketing[80] and lack of adequate suitability reviews. Certainly, such allegations have been made in the press and by contract owners— particularly by senior contract owners who do not have the long-term investment horizon necessary to benefit from these investments.[81]

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75. *See, e.g.,* Jonathan Clements, *Defending a Much-Maligned Investment: When Variable Annuities Make Sense,* WALL ST. J., Oct. 20, 2004, at D1 (describing the "sky-high fees" of variable annuities).

76. *See* BLACK & SKIPPER, *supra* note 8, at 128-29 (describing the mortality charges, back- and front-end loads, management costs, and costs for other guarantees associated with flexible-premium variable life policies); *id.* at 174 (describing back- and front-end loads for variable annuities).

77. *See* Treaster, *supra* note 48, at G9 (describing "penalties of up to 17 percent for early withdrawals").

78. *See* Lee Sheppard, *Rationalizing the Taxation of Financial Intermediaries,* 73 TAX NOTES 733, 735-36 (Nov. 11, 1996) (explaining that insurers "claw[] back a lot of the tax benefit through hefty fees"); *see also* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 118-20 (3d ed. 2005) (describing implicit taxes on tax-advantaged investments). A similar phenomenon occurs with respect to tax-exempt bonds. SCHOLES ET AL., *supra* note 78, at 121 (describing implicit taxes associated with tax-exempt bonds); Daniel N. Shaviro, *The Story of* Knetsch: *Judicial Doctrines Combating Tax Avoidance, in* TAX STORIES 318 (Paul L. Caron ed., 2003) (describing tax-exempt bonds as an exemption of "the tendency in some circumstances for market forces to eliminate through price changes any after-tax benefit").

79. *See* SCHOLES ET AL., *supra* note 78, at 130-32 (describing the formation of clienteles in connection with implicit taxes).

80. *See* Angela Pruitt, *NASD Rethinks Its Policy on Annuity Sales Practices,* WALL ST. J., Mar. 22, 2005, at D2 (describing the use of financial rewards and prizes to "encourage the sale of annuities").

81. *See* SEC & NASD, EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS (2004) (discussing concerns about the

Although some companies have voluntarily been moving toward lowering fees and simplifying their contracts,[82] state and federal regulators have been gradually implementing new rules on variable annuities.[83] For example, if the current set of National Association of Securities Dealers (NASD) proposed rules is finalized, sellers of deferred variable annuities will not be able to recommend the purchase or exchange of such contracts unless (in addition to other requirements) they have a reasonable basis to believe that "[t]he customer would benefit from the unique features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death

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marketing and sale of variable insurance products to those for whom the products would be unsuitable); Thompson, *supra* note 18, at 482 (discussing high fees and suitability concerns associated with deferred variable annuities); Gretchen Morgenson, *Who's Preying on Your Grandparents?*, N.Y. TIMES, May 15, 2005, § 3, at 1 ("[R]egulators . . . say they are fielding more and more complaints about aggressive sales practices by insurance companies that design annuity products and by the people who sell them."); Pruitt, *supra* note 80, at D2 (describing concern by state regulators that "seniors are often pushed to buy annuities that are unsuitable for their retirement needs"); Joseph B. Treaster, *S.E.C. to Increase Scrutiny of Some Annuity Sales*, N.Y. TIMES, June 15, 2004, at C2 ("Officials at NASD and at the S.E.C. say they have received thousands of complaints from people who say they did not understand how variable annuities worked when they were encouraged to invest in them."); Treaster, *supra* note 48, at G9 (explaining that even though variable annuities work best for the young and wealthy, according to a trade group, most variable annuity customers are in their fifties and sixties and earn less than $75,000 a year). As evidenced by declining inflows into variable annuities, the public may be learning to be "more skeptical" of variable contracts, and variable annuities in particular. *See* Jeff D. Opdyke, *Variable-Annuity Inflows Dropped 49% Last Year*, WALL ST. J., Mar. 9. 2006, at D2.

82. *See* Erin E. Arvedlund, *Variable-Annuity Charges Decline: Fidelity, Raymond James Aim to Lower Fees as Industry Faces Pressure About Sales Tactics*, WALL ST. J., Sept. 17, 2005, at B3; Diya Gullapalli, *Financial Makeover*, WALL ST. J., Jan. 16, 2006, at R7 ("[A] host of companies have begun selling variable annuities with lower costs."); Jeff D. Opdyke, *Annuities Lighten Up: New Entrants Add Flexibility, Slash Fees, Make it Simpler; Avoiding the 'Surrender' Fee*, WALL ST. J., May 13, 2006, at B1.

83. *See* Gullapalli, *supra* note 82, at R7 (describing consideration of new rules by SEC and state actions against "abusive sales tactics and onerous fees"); Opdyke, *supra* note 72, at D1 (describing state regulator actions); Jeff D. Opdyke, *Under Pressure, Insurers Push Rules on Annuity-Sales Tactics*, WALL ST. J., Aug. 11, 2005, at D2 (describing insurance industry support for model regulations "to eliminate the most flagrant practices").

benefit) . . . ."[84] While such efforts are likely to improve suitability discussions, the tax treatment of variable contracts may be an overlooked contributor to the problem.[85]

The tax treatment of contract costs does operate to lower their amount, particularly for individuals in higher tax brackets. Although personal insurance costs are not deductible if paid for with after-tax dollars,[86] payment of these expenses through a cash value insurance contract provides an implicit deduction. The insurance expenses reduce the contract's cash value but do not affect the investment in the contract (basis) for purposes of determining the amount of gain on withdrawals or contract surrender.[87] As a result, the cash value used to pay contract expenses is never taxed, and, since the taxpayer avoids paying current contract expenses with post-tax funds, she is receiving the equivalent of a current deduction for the expenses. This treatment results in further inequity between the tax treatment of term insurance and cash

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84. Securities & Exchange Commission, Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing Amendment No. 2 to Proposed Rule Relating to Sales Practice Standards and Supervisory Requirements for Transactions in Deferred Variable Annuities, 71 Fed. Reg. 36,840, at 36,840 (June 28, 2006). Additional requirements include that the sellers reasonably believe that "[t]he customer has been informed of the material features of a deferred variable annuity . . . ." *Id.* These features include the tax penalties and all charges and fees. The seller is also required to "make reasonable efforts to obtain" information about the customer, including income, investment objectives, investment experience, and investment time horizon. *Id.* In addition, supervisory review is required. *Id.* at 36,841. In response to the prior version of these rules, the SEC "received nearly 1500 comment letters"— most expressing opposition to the rules. *Id.* at 36,842.

85. *See infra* Part I.C.2.

86. 26 U.S.C. § 264 (2000); Treas. Reg. § 1.262-1(b)(1); *see also* BLACK & SKIPPER, *supra* note 8, at 311 (explaining that premiums for life insurance policies are treated as nondeductible personal expenses); Pike, *supra* note 18, at 505-06 (explaining the same).

87. BLACK & SKIPPER, *supra* note 8, at 127 ("expenses and mortality charges for the policy are paid with before-tax income"); Pike, *supra* note 18, at 505 (explaining that this effectively provides a deduction for the cost of current insurance protection). The possibility of deducting losses is considered *infra* notes 100-05 and accompanying text. In the case of life insurance policy sales, although the IRS has provided some indication that insurance protection costs should reduce basis, the general treatment has been that insurance protection costs do not reduce basis for purposes of determining gain. *See generally* Gans & Soled, *supra* note 57, at 580-82.

value insurance since term insurance premiums are paid for out-of-pocket.[88] Further, this tax treatment fails to reflect the general tax principles that maintenance expenses be excluded from basis and not produce deductions if personal in nature.[89]

Investment-related expenses, on the other hand, are generally deductible as expenses incurred in the production of income.[90] Such expenses are, however, rarely netted against income,[91] which is what occurs in the case of insurance contracts. Instead, investment expenses must generally be taken as miscellaneous itemized deductions subject to a two-percent-of-adjusted-gross-income floor and to recapture under the alternative minimum tax.[92] One exception allows publicly offered mutual funds to pass net investment income through to their shareholders.[93] Thus, to the extent a variable contract makes use of clones of publicly offered mutual funds,[94] the tax treatment of contract investment expenses is comparable to that for such

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88. In the case of withdrawals and policy surrenders, the statutory definition of "investment in the contract" supports this basis result. In the case of sales, the basis used by the IRS to compute gain and loss is not resolved. *See* Gans & Soled, *supra* note 57, at 578. The IRS has been moving towards reducing basis by insurance costs for purposes of measuring loss on sale of a contract. *Id.* at 580-82.

89. *See id.*

90. 26 U.S.C. § 212 (2000).

91. *See* Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OHIO ST. L.J. 1401, 1412-27 (2004) (detailing various tax provisions that limit the deduction of investment expenses).

92. *See* 26 U.S.C. § 56(b)(1)(A)(i) (2000) (disallowance of miscellaneous itemized deductions under alternative minimum tax); 26 U.S.C. § 67 (2000) (two percent floor on miscellaneous itemized deductions); Temp. Treas. Reg. § 1.67-1T(a)(1)(ii) (1988) (categorizing investment advisory expenses as miscellaneous itemized deductions).

93. 26 U.S.C. § 67(c) (2000). "Publicly offered" requires that the mutual fund's shares (1) be continuously offered pursuant to a public offering under securities law, (2) be regularly traded on an established securities market, or (3) be held by at least 500 persons. 26 U.S.C. § 67(c)(2)(B)(i) (2000).

94. As explained *infra*, in order for a variable contract to qualify for the tax preferences described in this section, the underlying variable contract investments funds may not actually be publicly offered. Clones of publicly offered mutual funds are, however, acceptable so long as all the interests are held only through variable contracts or by certain qualified persons. *See infra* Part I.C.2.

funds. As described in greater detail in the next section, the recent wraparound shelter utilized private placement hedge funds.[95] With respect to hedge fund expenses, the offset of expenses against variable insurance cash value would provide a better result than could be obtained for management expenses incurred outside such contracts.[96] My proposal, as a matter of political expediency, preserves the deductibility of all contract fees.

Because of the investment risk assumed by owners of variable contracts, the question of the tax treatment of contract losses is arguably more important than it is for traditional contracts. Variable contract investment losses incurred prior to withdrawal will reduce contract investment gains; thus, variable contract losses are in effect deductible to the extent of contract gains. The treatment of a net loss upon complete surrender or sale of a variable contract is less clear.[97] The Code provides that individuals may deduct "losses incurred in any transaction entered into for profit."[98] The extent to which this provision applies to variable insurance products has not been directly addressed. In the case of variable life insurance, support for taking a loss deduction on contract surrender is weak.[99] The

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95. Hedge funds are now, however, subject to some additional regulatory oversight under rules requiring hedge-funds to register as investment advisers; several exceptions apply to this rule. *See, e.g.,* Eleanor Laise & Rachel Emma Silverman, *Dissecting Hedge-Fund Secrets: Wealth-Managers Say SEC-Required Revelations Won't Replace Due Diligence,* WALL ST. J., Feb. 4, 2006, at B5 (describing these rules).

96. *See supra* note 92 and accompanying text.

97. Not only because it is unclear whether such losses pass the first hurdle of being related to profit, but also because the contract holder's basis for determining losses is not fully resolved. Gans & Soled, *supra* note 57, at 572. Resolution of this issue may become more urgent if the current "tiny secondary market" in annuity contracts grows. Opdyke, *supra* note 82, at B1.

98. 26 U.S.C. § 165(c)(2) (2000).

99. *See* BLACK & SKIPPER, *supra* note 8, at 318 ("Losses on surrender of a life insurance policy normally cannot be recognized for income tax purposes."). The reasoning is that "any loss is assumed to be composed, in whole or in part, of . . . mortality charges." *Id.; see also* Gans & Soled, *supra* note 57, at 574-76 (describing cases denying deductibility of losses for sold or surrendered life insurance contracts). A couple of older cases allowed deduction of losses on surrender of insurance contracts. *See, e.g.,* Cohen v. Comm'r, 44 B.T.A. 709 (1941); Fleming v. Comm'r, 4 T.C.M. (CCH) 316 (1945). In both cases the life insurance company through which the taxpayer originally purchased his life insurance policy had been taken over by another company on account of

subsequent discussion will assume that such deductions are not permissible—although it seems likely that contract holders who invested in hedge fund wrappers would also take an aggressive position on the deductibility of losses on surrender or sale of a variable life insurance contract.

A somewhat stronger case may be made for the deductibility of net loss on surrender of a variable annuity contract.[100] Again, the argument boils down to the assertion that such contracts are entered into for profit rather than for economic security[101]—which, of course, cuts against a commonly cited justification for the tax deferral benefit granted to annuities. The Code also provides that if an annuitant dies after regular annuity payments begin, a loss deduction is allowed on the decedent's final tax return in the amount of the unrecovered investment in the contract.[102]

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insolvency. The terms of the takeovers provided for a lien against the policy reserves, which reduced each taxpayer's amount received on surrender of the policy. In *Cohen*, the court held that the participating life insurance policy purchased by Cohen constituted a transaction for profit. *See Cohen* 44 B.T.A. at 714. The facts of these cases, however, are unique and do not provide broad support for a loss deduction on surrender of a variable life insurance contract. *But see* Colvin, *supra* note 41, at 37 (citing these cases and arguing that because of their investment orientation, losses on surrender of private placement variable contracts may be deductible).

100. *See* Colvin, *supra* note 41, at 37 ("A loss on surrender of an investment annuity is generally deductible as an ordinary . . . loss.").

101. Revenue Ruling 61-201, 1961-2 C.B. 46, provides some support for deductibility of losses. It held that an ordinary loss could be taken on surrender of a refund annuity. *See* Rev. Rul. 61-201, 1961-2 C.B. 46. It also held that the basis in the annuity contract was equal to the premiums paid less withdrawals that had not been taxed. *See id.* at 47. Thus, the contract basis was not reduced by any contract costs paid for with cash value. *See id.* This ruling warns: "[n]othing in this ruling should be construed as permitting a loss deduction on the surrender of any contract other than a refund annuity." *Id.; see also* Cohan v. Comm'r, 11 B.T.A. 743, 759 (1928) (allowing a loss deduction for forfeited premiums paid on an annuity contract determined to have been entered into "for profit").

102. *See* 26 U.S.C. § 72(b)(3) (2000). In the case of variable annuities, this Code provision may have limited application since variable annuities frequently provide a minimum death benefit equal to the greater of the cash value or the amount invested in the contract. *See* BLACK & SKIPPER, *supra* note 8, at 175 (describing use in variable annuities of such a contractual provision); Thompson, *supra* note 18, at 477-78 (describing the same). Before the enactment of this Code section, Revenue Ruling 72-193, 1972-1 C.B. 58, had held that loss treatment was not allowed on a decedent's return for a life annuity that had terminated because the decedent's "primary purpose in

　　　In addition to income tax consequences, the estate tax may also apply to variable insurance contract owners.[103] The gross estate includes life insurance death benefits either paid to the estate or the decedent possessed as "incidents of ownership at death."[104] The value of annuity payments are includible in the gross estate (to the extent the decedent paid for the contract) if survivor benefits are provided.[105] In addition to the specific Code provisions governing life insurance and annuities, inclusion may be required under other provisions—for example, the provision requiring inclusion of proceeds if life insurance was transferred within three years of death.[106] Whether the amount of estate tax owed may be tied to the value of life insurance or annuities included in the gross estate depends on the complex interaction of various deduction and credit provisions.[107]

　　　The tax treatment of the insurance companies will also affect contract owners, though an in-depth discussion of company tax consequences is beyond the scope of this Article. In the case of variable contracts, insurance companies are generally exempt from explicit tax on the returns generated by the investment funds underlying variable contracts.[108] Thus, the returns arising from these funds will likely be subject to, at most, only one nominal level of tax.

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entering into the contract was to provide security for himself, should he continue to live," rather than to receive a profit.

　　103. The estate tax applies only to the wealthiest. *See* SLEMROD & BAKIJA, *supra* note 4, at 52 (explaining that "the richest 2.3 percent of decedents" paid this tax in 1999 and the exemption levels have increased since that time).

　　104. 26 U.S.C. § 2042 (2000); *see* BLACK & SKIPPER, *supra* note 8, at 325-26.

　　105. *See* 26 U.S.C. § 2039 (2000); *see also* BLACK & SKIPPER, *supra* note 8, at 324.

　　106. *See* 26 U.S.C. § 2035 (2000); *see also* 26 U.S.C. § 2033 (inclusion of property to the extent of decedent's interest); 26 U.S.C. § 2038 (inclusion of property transferred but remaining subject to transferor control through various retained powers).

　　107. *See* BLACK & SKIPPER, *supra* note 8, at 326-32.

　　108. *See* 26 U.S.C. § 817(b) (2000); *see also* Richard W. Skillman, *The Impact of TEFRA and the 1984 Act on the "Inside Build-up" under Life Insurance Products*, 43 N.Y.U. INST. ON FED. TAX'N 40-1, 40-41 (1985) (discussing this provision).

The effect of the tax provisions summarized above will depend on the choices made by a variable contract holder and the fees charged by the insurance company. In the case of variable life insurance, for example, the result could be a nominal zero rate on both gains and losses if no withdrawals are made until death of the insured. For other taxpayers, however, the fees and penalty taxes may make variable contracts an altogether unsuitable investment. The complex interaction of the tax provisions and the difficulty of distinguishing the various tax components contribute to the problem consumers have in receiving and making adequate suitability determinations about these products.

C. *Sheltering Techniques*

The deferral of tax on the inside buildup of life insurance and annuity contracts has seemingly created incentives for individuals to lower their taxes by stuffing these contracts with income streams that would otherwise be taxed at higher rates. The primary focus of this Article is on variable insurance, but an understanding of the reforms introduced to curtail strategies focused on maximizing risk-free returns is important to the question whether my proposal could introduce new loopholes.

1. *Low or No-risk Return Techniques.* As described above, a traditional cash value life insurance contract guarantees a minimum interest rate payment actuarially designed to ensure adequate funding of the death benefit.[109] In the case of deferred annuities, the company will also guarantee a minimum return during the accumulation phase.[110] A simple technique to enhance the tax benefit derived from such minimum guarantees is to pay for a contract with a single premium. This allows for the maximum use of the inside buildup to fund the contract. That is, rather than using post-tax funds to pay premiums, through use of a single-premium contract, a taxpayer would

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109. Even in the case of nonvariable cash value contracts, certain contracts provide some risk-based return. *See supra* note 33.

110. *See* BLACK & SKIPPER, *supra* note 8, at 170-71 (describing typical guaranteed rates for deferred annuities).

be able to fund the contract with a greater amount of pre-tax accumulation.[111]

Two related techniques work only through life insurance contracts. Under an endowment contract, benefits are paid out not only on death but also if the insured survives the term of the contract.[112] Setting the endowment date earlier than the actuarially anticipated death date permits a more investment-oriented contract.[113] Another way to structure a more investment-oriented contract is to provide a disproportionately small death benefit. That is, the cash value could, under more reasonable actuarial assumptions, support a much larger death benefit than that provided for in the contract.

All three of these techniques have been dealt with to some extent by Congress. As to annuities, in 1982 Congress added the current rules on the tax treatment of loans and withdrawals (including the penalty tax), which were considered sufficient to deal with the problem of individuals stuffing risk-free returns into these contracts.[114]

Congress' approach to life insurance is more convoluted. In order to combat the problem of a disproportionately large cash value, the Code mandates a particular, actuarially defined relationship between a life insurance contract's cash value and its death benefit.[115] In order to test for this

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111. *See* Vickrey, *supra* note 18, at 564 n.20 ("Single premium policies . . . have proven a fertile field for tax avoidance . . . .").

112. *See* BLACK & SKIPPER, *supra* note 8, at 3 ("[E]ndowment insurance pays benefits if the insured dies during the policy term and also pays benefits if the insured survives the policy term.").

113. *Cf. id.* at 88 (stating that even before 1984 law changes restricted endowment insurance, "endowment insurance was having great difficulty competing against whole life and term insurance").

114. *See* Joel H. Goldberg & Thomas P. Lemke, *Disclosure of Variable Annuity Tax Contingencies: Revenue Ruling 81-225 and the Tax Equity and Fiscal Responsibility Act of 1982*, 15 CONN. L. REV. 433, 450 (1983).

115. One of two tests must be met in order for a contract to qualify as life insurance. I.R.C. § 7702 (2007). Several technical assumptions about interest rates and mortality charges apply to both tests. The cash value accumulation test was designed to accommodate traditional, level premium cash value policies. Under this test, the amount of the cash surrender value can not exceed the net single premium that would be required to fund future benefits under the contract. *Id.* § 7702(b)(1). The second test was designed to accommodate flexible premium contracts and consists of the guideline premium requirement and the cash value corridor requirement. Under the guideline premium requirement,

relationship, insurance companies must closely monitor cash value amounts. Part of this test includes the requirement that the contract endow no earlier than age ninety-five,[116] which effectively ended the early-date endowment contract technique.[117] Variable life insurance contracts must also satisfy the death benefit/cash value relationship requirements. Variable life insurance contracts must be tested any time the death benefits change under the contract but "not less frequently than once during each twelve-month period."[118]

If a life insurance contract fails to satisfy the death benefit/cash value relationship requirements, then the income on the contract—including amounts used to pay for insurance costs—is taxed at ordinary rates.[119] Prior years' contract income is also taxed, even for years during which the contract was in compliance.[120] Death benefits paid on contracts failing the death benefit/cash value relationship requirements are, however, excluded from income to the extent they exceed the net surrender value of the contract.[121]

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the premiums paid may not exceed the greater of the guideline single premium or the sum of the guideline level premiums. *Id.* § 7702(c). The guideline single premium is the single premium that would be needed to fund the contract under an assumed rate (greater of 6 percent or contractually guaranteed rate). The guideline level premium is the sum of the level premiums needed to fund the contract under minimum 4 percent interest rate. The cash value corridor specifies that the death benefit must equal at least to certain multiple of the cash value at a particular age. *Id.* §7702(d)(2); *see also* BLACK & SKIPPER, *supra* note 8, at 313 (describing these two tests); Luke, *supra* note 2, at 168 & n.180; Pike, *supra* note 18, at 509-17.

116. I.R.C. § 7702(e)(1)(B) (2007).

117. *See* Skillman, *supra* note 108, at 40-21.

118. I.R.C. § 7702(f)(9) (2007).

119. *Id.* § 7702(g)(1). The "income on the contract" means the excess of the sum of the increase in the net surrender value plus the cost of life insurance protection over the premiums paid. *Id.* § 7702(g)(1)(B). The cost of life insurance protection is the lesser of the actual stated mortality charges or the costs derived from Treasury regulations. *Id.* § 7702(g)(1)(D).

120. *Id.* § 7702(g)(1)(C). If failure occurs due to "reasonable error," the insurance company may seek a waiver from the Treasury. *Id.* § 7702(f)(8). If a waiver is granted, the company will be required to enter a closing agreement and pay a "toll." Notice 99-48, 199-2 C.B. 429 (describing computation of amounts to be paid under a closing agreement).

121. I.R.C. § 7702(g)(2) (2007).

Even when a life insurance contract satisfies the death benefit/cash value relationship requirements, if contract premiums are excessively frontloaded (e.g., a single premium contract), additional restrictions apply. Excessive frontloading is determined under the "seven-pay test."[122] If a contract fails this test, then the contract is termed a "modified endowment contract" (MEC), and contract payments and loans will be subject to essentially the same rules that apply to annuities (including imposition of a ten percent penalty for early withdrawals).[123] Distributions made in the two years prior to the year in which the contract fails the test are subject to these rules as well.[124]

The complexity of these provisions illustrates the lengths to which Congress has gone to preserve a tax preference for inside buildup. Although the preference is problematic, in the near future, Congress will doubtless continue to provide some preference for insurance inside buildup.

2. *Wraparound Variable Insurance Shelters.* By wrapping an income-producing investment asset inside the protective cloak of a variable insurance contract, contract owners hope to convert a higher tax rate to a lower one. This rate conversion technique was first used soon after individual, commercial variable insurance became available.[125] The earliest version of the shelter involved a simple transfer of income-generating assets—e.g., dividend-paying stock—inside an insurance contract.[126] Later, commercial mutual fund interests were wrapped inside variable contracts.[127]

In the most recently publicized wraparound tax shelter, individuals used variable insurance contracts to lower their

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122. The seven-pay test provides that the accumulated amount paid during the first seven contract years may not exceed the sum of the net level premiums that would have been paid had the contract been fully funded after the payment of seven level annual premiums. *Id.* § 7702(b). Various complex computational rules apply. *Id.* § 7702(c).

123. I.R.C. §§ 7702A, 72(e)(10), 72(v) (2007).

124. I.R.C. § 7702A(d) (2007).

125. *See* Luke, *supra* note 2, at 144-45.

126. *See id.* at 145-54.

127. *See id.* at 159-66.

tax rate on hedge fund interests.[128] The tax treatment of contract costs may also have contributed to the attractiveness of this wraparound iteration. As described in Part II.B, hedge fund management fees paid for through the contract cash value effectively receive "above-the-line" treatment, whereas if they had been paid outright they would have been subject to deductibility limitations.[129]

Whether a wraparound shelter (or a plain vanilla variable contract, for that matter) will be attractive to a particular individual depends on multiple factors, including the individual's marginal tax rate, the fees paid to the insurance company/accommodation party, and the tax rate on investments similar to those underlying the contract.[130] As will be described in Part III, the amount of tax savings derived from tax rate differences may depend largely on the rate applicable to the risk-free return component of the investments. The wraparound shelter's appeal will also depend on whether other tax shelters provide the same results more cheaply. During the 1990s, for example, individuals used derivatives to similar effect. Legislation enacted in 1999 made the use of derivatives more costly and, as a consequence, the use of variable contracts as substitutes more alluring.[131]

Congress and the tax agencies have responded in incremental fashion to the various iterations of this shelter.[132] The following sections provide additional details and analysis of these government reforms. The two primary government responses—the investor control doctrine and

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128. *See id.* at 174 (describing rise of hedge fund wrappers).

129. *See supra* notes 90-96 and accompanying text.

130. *See* Hershey, *supra* note 74 (explaining that low rate on dividends and capital gains makes variable annuities "even less attractive").

131. I.R.C. § 1260 (2007); *see also* David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1368 (2001) (describing use of variable insurance as a substitute for derivatives following enactment of § 1260).

132. For additional history and analysis of the investor control doctrine and the diversification requirement, see generally Luke, *supra* note 2. *See also* Carol V. Calhoun, *Tax Law and the Nonqualified Variable Annuity*, 41 TAX LAW. 765 (1988); Gair Petrie, *Eroding the Tax Benefits of Wrap-Around Annuities: An Analysis of Revenue Ruling 81-225*, 34 U. FLA. L. REV. 95 (1981); Steven S. Anreder, *Attractive 'Wrapper': The Investment Annuity Has Begun to Catch On*, BARRON'S, Nov. 17, 1975, at 3.

the diversification requirement—prohibit direct premium allocation to publicly available investments and attempt to make it more difficult to mimic such investments inside the contract. Although appearances may have been smoothed over by these reforms, even plain vanilla variable insurance contracts can be described as wraparound contracts.

    i. *Investor Control Doctrine.* The investor control doctrine developed through a series of revenue rulings—the first issued in 1977 and the most recent in 2003.[133] The doctrine, as it currently stands, operates principally by forbidding contract holders from allocating premiums directly to publicly available investments.[134] For example, a contract holder may not allocate premiums directly to Google shares—though it would be permissible to allocate premiums to an investment fund holding Google shares, so long as the interests in the fund were not publicly available. The hedge fund wraparound shelter relied in part, on the argument that the hedge fund interests were not publicly available, because they were offered only to wealthy, sophisticated investors and not publicly, as that term is used in securities law.[135] The tax agencies cut off this disingenuous argument relatively soon after reports of the wraparound hedge funds began to circulate.[136]

    In addition to the bright-line prohibition against allocating premiums directly to publicly available investments, the investor control doctrine also contains a substance-over-form standard. Investors are generally prohibited from having too much control over what goes on inside the funds underlying a variable insurance contract. This "smell test" aspect of the investor control doctrine has not been fully developed, although the idea of excessive control leading to retention of ownership has been explored in various trust and property cases.[137] Insurance companies typically take into account this aspect of investor control by

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133. *See* Luke, *supra* note 2, at 144-59, 174-83 (describing revenue ruling series).

134. *See id.* at 165 (describing this rule, which was first fully implemented in Rev. Rul. 81-225).

135. I.R.S. Priv. Ltr. Rul. 2002-44-001 (May 2, 2002).

136. First they issued a private letter ruling, followed by a revenue ruling and revised regulations. *See* Luke, *supra* note 2, at 176-79.

137. *See id.* at 190 (describing effect of this substance-over-form standard).

restricting the number of allocation changes that can be made in a particular year,[138] prohibiting contract owners from paying premiums in kind, providing investment choices that represent broad strategies,[139] and limiting communication between the company and the contract owner.[140]

ii. *Diversification.* Diversification is tested for on a quarterly basis.[141] Diversification is required of each investment choice on the contract holder's menu for premium allocations.[142] Under the commonly used regulatory test for diversification, any fund to which a contract holder may directly make premium allocations must hold at least five investments in the following percentages: no more than fifty-five percent of the value in any one investment, no more than seventy percent in two investments, no more than eighty percent in three investments, and no more than ninety percent in four investments.[143] Thus, this test does not mandate diversification as it is generally understood in the financial literature—i.e., the diversification away of nonmarket risk.[144] Rather, the requirement is intended to make it more difficult to mimic taxable cash flows inside the variable contract.

As a result of the diversification requirement, a contract owner may only choose from a menu of asset pools and not from a menu of individual investment assets. Since taxable investment pools (e.g., mutual funds) are now widely available, the regulations clarify that menu choices

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138. *See id.* at 163 & n.163.

139. *See id.* at 163-64, 180 n.234.

140. *See* Rachel Emma Silverman, *"Private Placement" Policies Draw More Wealthy Investors Despite Fees, Limited Control*, WALL ST. J., Oct. 18, 2006, at D1 (explaining that tax rules require investors "to give up a good deal of control and choice over . . . investments").

141. Treas. Reg. § 1.817-5(a)(1) (2004).

142. Each menu choice is more properly termed a "segregated asset account." *See* Luke, *supra* note 2, at 171 (describing segregated asset accounts).

143. Treas. Reg. § 1.817-5(b)(1)(i) (2004).

144. Although five investments should help diversify away at least some nonmarket risk. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 212 (6th ed. 2000). The type of risk that may be diversified away is generally referred to as unsystematic risk or unique risk. *See id.* at 167.

consisting of mutual funds, partnerships, and similar pass-through entities will be tested for diversification by looking through to their assets, but only so long as public access to the entity is available only through purchase of a variable contract.[145] For example, if one investment menu choice is to allocate premiums to a partnership, the partnership must be tested for diversification, and the test is performed by seeing if the partnership holds at least five investment assets in the required percentages. The partnership interests must, however, be available only through variable insurance contracts (or through certain other qualified means).[146] Thus, the diversification test is, in part, also a restatement of the investor control doctrine's prohibition on public investments.[147]

The diversification regulations amplify this restriction by providing that certain holders will be disregarded for purposes of testing whether an investment entity is insurance-only.[148] Trustees of qualified pension or retirement plans may hold interests, an exception which considerably expands the available pool of qualified holders.[149] Revenue Ruling 94-62 lists plans that qualify, and it provides that the IRS may expand the list through private letter ruling.[150] The IRS has done so by adding, for example, Roth IRAs, which were not yet created at the date of the revenue ruling.[151]

iii. *Discussion.* As the law currently stands, whether a particular product constitutes a "wraparound" tax shelter rather than a permissible contract depends primarily on the type of access taxpayers have to the underlying investment

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145. Treas. Reg. § 1.817-5(f) (2006).

146. And to certain other qualifying persons—for example, qualified retirement plans. *See infra* notes 148-51 and accompanying text.

147. Prior to a recent revision of this regulation, the "look-through" rule applied to both private placement partnerships in addition to partnerships whose interests were owned only through variable contracts (or by other qualifying persons). This loophole was one of the arguments relied on in the creation of the hedge fund wrapper. *See* Luke, *supra* note 2, at 172-73 (discussing this regulation and its use in the hedge fund wrapper).

148. *See* Treas. Reg. § 1.817-5(f)(3) (2006).

149. *See* Treas. Reg. § 1.817-5(f)(3)(iii) (2006).

150. Rev. Rul. 94-62, 1994-2 C.B. 164.

151. *See* I.R.S. Priv. Ltr. Rul. 2002-23-012 (June 5, 2002).

assets. If taxpayers are able to access the underlying investment only through a variable insurance contract (or through the handful of other qualified means), then the contract will not generally be considered a tax shelter.[152]

This requirement is, however, largely formalistic. For example, while it is not permissible to enclose a publicly available hedge fund interest inside a variable contract, the tax agencies have not attempted to use the investor control doctrine to go after clones of publicly available hedge funds. It is apparently permissible for an insurance company to offer through variable contracts a copy of a publicly available hedge fund interest. It just may not offer the original, publicly available interest.[153] The primary difficulty facing a taxpayer wishing to replicate taxable investments will be to find an accommodating insurance company, although the diversification requirement means that a contract owner will have to be willing to wrap a small pool of assets rather than a single asset.

After the government halts the use of a particular investment type in variable contracts, the trend has been for insurance companies to copy the investment, but restrict who may be an investor. For example, after the tax agencies prohibited the use of publicly available mutual fund interests in variable contracts, companies turned to creating mutual funds whose interests could only be purchased through variable contracts.[154] Thus, today most variable contracts are funded with insurance-only mutual funds. A similar repackaging of hedge fund interests is occurring.[155] It is, thus, difficult—perhaps impossible—to draw a principled distinction between an acceptable variable contract and a wraparound tax shelter.

Such repackaging efforts may have the unintended consequence of adding to the difficulty of providing adequate suitability counseling to consumers deciding

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152. *See supra* Part I.C.2.i (describing the substance-over-form aspect of the investor control test).

153. *See* Silverman, *supra* note 140, at D1 (describing such contracts).

154. *See* Luke, *supra* 2, at 160-67.

155. *See* Colvin, *supra* note 41, at 36 (explaining that following the most recent agency attack on hedge fund wraps, hedge funds have lost their reluctance to "fully embrace" the market for insurance dedicated funds); *see also* Silverman, *supra* note 140, at D1.

whether to invest in these products.[156] As described above, the investment funds underlying variable contracts must be available only through insurance companies and certain qualified retirement plans.[157] This may create an incentive to engage in aggressive marketing techniques in order to maximize the number and types of investment funds. A related problem has been the improper selling of variable insurance products by providing them as investment choices for retirement plans that are already receiving tax deferral benefits, such as IRAs.[158]

My proposal would remove the need for the prohibition on using taxable investments inside variable insurance contracts. The tax diversification specific to variable insurance contracts would not be required, although separate tax diversification rules applicable to mutual funds would apply.[159] Since contract cash value would be annually marked to market, protection against mimicking taxable investments inside the contract would no longer be necessary. The use of a broader array of underlying taxable investments may help address problems of suitability to the extent the current income tax system is allowing insurance companies to control artificially the market in variable contracts.

II. VARIABLE INSURANCE PROPOSAL

This section provides a detailed overview of my proposal to tax risky returns on variable insurance[160] and

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156. *See* Luke, *supra* note 2, at 190-91.

157. Two other narrower exceptions also apply. Treas. Reg. § 1.817-5(f)(3)(ii) (2006) (interests may be held by manager if it was acquired "in connection with the creation or management" of the fund); Treas. Reg. § 1.817-5(f)(3)(iv) (2006) (grandfather rule related to mutual fund wraparound contracts); *see also* Treas. Reg. § 1.817-5(f)(3)(i) (2006) (insurance company general account may hold interests but only if a segregated asset account also holds an interest and other requirements are met).

158. *See, e.g.*, Joseph B. Treaster, *S.E.C. Plans Warning on Annuities*, N.Y. TIMES, June 4, 2000, § 3, at 12 (describing lawsuits accusing annuity companies of "inappropriately selling variable annuities to IRA and 401(k) investors").

159. *See* I.R.C. § 851(b) (2007).

160. Dividing investment returns into risk-free and risky components has been utilized in incremental reform proposals aimed at alleviating the negative effects of the realization requirement. One such proposal (which also reflects a

Domar-Musgrave approach, *see infra* Part III) is the retrospective taxation method suggested by Professor Auerbach. Under retrospective taxation, realization remains the trigger for tax payments. The tax owed at realization is determined by taking the sales price at disposition and applying to it a formula based on the taxpayer's marginal rates and the risk-free return rates during the taxpayer's holding period. Auerbach, *supra* note 12, at 170-72. Because the tax amount is not dependent on the length of the taxpayer's holding period or on the asset's prior returns, Professor Auerbach's model is "holding-period neutral." *Id.* at 169.

Initial purchase price (i.e., basis) does not need to be known. Rather, the retrospective taxation model "treats investors as if they had arrived at their current position by investing at the risk-free rate." *Id.* at 172. That is, the process involves discounting the final sales price back using the risk-free rate rather than bringing the initial sales price forward through imputing interest. Tax is imposed on this gain, and the taxpayer is also required to pay interest on the gains that accrued in earlier periods. Because value is not measured during the holding period, use of the initial purchase price could fail to alleviate lock-in problems if the value of the asset grew faster than the risk-free rate. *Id.* at 173. This occurs because the rate of return would be calculated on too low a base. *Id.*

For example, suppose an investor purchases an asset for $100 at the beginning of Year 1. Assume that the imputed interest rate is a constant 5 percent but that the asset has increased in value to $110 at the end of Year 1. If interest is imputed based only on initial sales price and without reliance on any subsequent valuation, the base for Year 2's calculation would be $105 ($100 + $5 imputed interest) rather than $110. If the investor is trying to decide whether to hold or sell this asset at the end of Year 1, she will consider that if she sells for $110 and reinvests the $110 in a new asset, the risk-free return would be imputed on $110 for Year 2 rather than the lower $105 if she does not sell and reinvest.

Although Professor Auerbach's proposal applies to final sales price, it is not an *ex post* system. *Id.* at 176. The formula takes an *ex ante* approach by assuming that the asset earned the risk-free return during the taxpayer's holding period. Actual growth in value could differ significantly from the risk-free rate, raising fairness concerns. *See* Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and The Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 943-44 (1998) (critiquing Auerbach's approach). For example, disposition of an asset would be taxed the same whether the sales price accrued slowly over time or in one rapid burst. A similar criticism could, however, be made of *ex post* wealth taxes. Auerbach, *supra* note 12, at 176. In addition, the final sales price could result in a loss but the individual would still have to pay taxes at sale. *Id.* Thus, no *ex post* adjustment is made, and only the risk-free returns deemed earned are taxed. If application of the Domar-Musgrave theory is assumed, fairness concerns raised by this *ex ante* approach evaporate since the ideal, proportional income tax does not reach *ex post* risk-based returns. *See* Noël B. Cunningham, *Observations on Retrospective Taxation*, 53 TAX L. REV. 489, 491 (2000) ("[T]he tax burden imposed under the Auerbach approach is precisely the same as that of a conventional normative income tax.").

Professors Cunningham and Schenk have also suggested a proposal making use of a deemed risk-free return (it is not as closely tied to Domar-Musgrave because of the way *ex post* adjustments are carried out, *see infra* Part III.A).

discusses potential objections to the proposal—other than those directly related to Domar-Musgrave.[161]

A. *Proposal Details*

Under my proposal, the risk-free rate is applied to the beginning-of-period cash value.[162] At the end of each tax period, the insurance contract cash value is marked to

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Professors Cunningham and Schenk have recommended that commercial investments yielding low or no current tax be deemed to earn a minimum return equal to the rate on Treasury securities. Cunningham & Schenk, *supra* note 18, at 727, 735. The minimum return is applied to basis each year, and basis is increased by the amount included in income. *Id.* at 735-36. Applying the minimum return to basis eliminates the need for regular valuations. When the investment is sold, gain or loss is calculated according to the basis that has been adjusted for the minimum return income inclusions. *Id.* at 736. Thus, although tax is imposed each year based on expected returns, reconciliation of actual and expected returns occurs on the sale of the asset. *Id.* at 736.

Professors Cunningham and Schenk assert that this expected value approach moves the taxation of investments closer to the result under Haig-Simons without the burdensome valuations required by a full mark-to-market system. *Id.* at 748. By taxing a deemed minimum return, arbitrage caused by realization rule deferral loses some of its attractiveness. *Id.* at 749.

For a critique of the Cunningham-Schenk proposal, see Zelinsky, *supra*, note 60 at 927-31. He argues that the Cunningham-Schenk proposal "does not eliminate distortions but merely trades realization-generated distortions for a different set of inefficiencies." *Id.* at 930.

161. See *infra* Part III.C for discussion regarding the use of Domar-Musgrave in crafting incremental reform.

162. Adjustment for changes in the risk-free rate during the tax period could be made. As described *infra* notes 179-82 and accompanying text, I propose using the rate on short-term Treasury debt as the risk-free rate.

Applying the risk-free rate to opening cash value contrasts with Professor Auerbach's method of discounting back. *See supra* note 160. I assume that Congress (and taxpayers) would want the minimum return deduction to be as large as possible. If cash value has increased during the year, the preference would be to use Professor Auerbach's discounting system. On the other hand, if cash value has declined during the year, the preference would be to use opening cash value. Some imprecision is inevitable, and use of opening cash value was chosen because it is likely the more intuitive approach for taxpayers.

My proposal also shares similarities with the Cunningham-Schenk proposal in which the risk-free rate is applied to basis and carried forward. *See id.* All of the investment returns are eventually taxed under my proposal (unless no withdrawals are made under a life insurance contract prior to death). Because of this aspect of my proposal, investment in the contract must be tracked, just as basis was required to be maintained under the Cunningham-Schenk proposal. *See id.*

market, and it is assumed that the resulting net economic gain or loss is composed of both the deemed risk-free return and a risk-based return. That is, if there is a gain, a portion of the gain is characterized as the risk-free return; the remainder of the gain is deemed the risk-based return. If the mark-to-market procedure yields a loss, it is assumed that but for the deemed risk-free return earned on the beginning cash value, the loss would have been greater.[163] As a result, the deemed risk-based loss will be larger than the net economic loss.

The deemed risk-free return is offset by a deduction, which I term the "minimum return deduction." In order to provide a result similar to that of nonvariable cash value contracts, this deduction should result in deferral of tax on the accumulated risk-free returns. Permanent exclusion should result only if withdrawal from a life insurance contract is not made until death of the insured. Thus, adjustments are made to the investment in the contract to ensure that withdrawals will trigger proper tax treatment.[164] In order to preserve the benefits of tax deferral, interest is not charged on the risk-free returns deemed accumulated during tax periods prior to a taxable withdrawal from the variable contract.

1. *Examples.* The following examples assume a year-long tax period, no contract expenses and a constant risk-free rate of return of five percent

Year 1: At the beginning of Year 1, Judy invests $100 in a variable life insurance contract. At the end of the year, the cash value increased to $120. The contract is marked to market, yielding a $20 economic gain. Five dollars of this gain will be deemed to be the risk-free return on the original $100 investment.[165] The $15 remainder is deemed the risk-based gain for the year. Judy receives a minimum

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163. *See* Auerbach, *supra* note 12, at 172 (describing how it is possible for a person to lose money but still be deemed to have earned the risk-free rate); Weisbach, *supra* note 11, at 13-14 (illustrating that in loss year the economic amount reflects netting of risk-based loss with risk-free return).

164. A related question is whether the current beneficial treatment of withdrawals from life insurance should be maintained. *See supra* Part I.B. This Article will assume that the current system of taxing withdrawals remains in place.

165. $100 x .05%.

return deduction in the amount of $5, which will offset the risk-free return inclusion. Judy's investment in the contract increases from $100 to $115 to reflect her net tax consequences.[166] This adjustment ensures that tax on the risk-free return is deferred, rather than excluded. For example, if she were to terminate the contract at the beginning of Year 2 and withdraw the $120 cash value, she would be taxed on $5.

Year 2: At the end of Year 2, the cash value declines to $110. When her contract is marked to market, Judy has a $10 economic loss, but she also is deemed to have earned a $6 risk-free return on her $120 beginning-of-year cash value. In order to arrive at a $10 economic loss, Judy is deemed to have experienced a $16 risk-based loss. She will recognize this $16 risk-based loss for the tax year. Judy will also receive a $6 minimum return deduction, offsetting the deemed $6 of risk-free return. Judy's investment in the contract will be $99.[167] Once again, this preserves the potential for tax on the risk-free return. If Judy terminates the contract at the beginning of Year 3 and withdraws the $110 value, she would be taxed on $11, the sum of the minimum return deductions from Years 1 and 2.

Year 3: At the end of Year 3, the cash value has declined to $10. When her contract is marked to market, Judy has a $100 economic loss, but she also is deemed to have earned a $5.50 risk-free return on her $110 beginning-of-year cash value. In order to arrive at a $100 economic loss, Judy is deemed to have experienced a $105.50 risk-based loss. She will recognize this risk-based loss for the tax year. Judy will also receive a $5.50 minimum return deduction, which will offset the deemed $5.50 of risk-free return. Judy's investment in the contract will be a negative $6.50.[168] The use of a negative investment in the contract preserves the potential for tax on the risk-free return. If Judy were to terminate the contract at the beginning of Year 4 and withdraw the $10 value, she would be taxed on

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166. $100 original investment, plus $15 risk-based gain, plus $5 risk-free return, minus $5 minimum return deduction.

167. $115 Year 1 investment in the contract, minus $16 risk-based loss, plus $6 riskless rate of return, minus $6 minimum return deduction.

168. $99 Year 2 investment in the contract, minus $105.50 risk-based loss, plus $5.50 riskless rate of return, minus $5.50 minimum return deduction.

$16.50, which is equal to the sum of the minimum return deductions from Years 1, 2, and 3.

The use of negative investment in the contract is unorthodox and creates a lock-in effect. Although encouraging individuals to stay invested in cash value insurance is at the heart of the tax incentive, at some point individuals—assuming an accommodating insurance company—could hold onto worthless contracts in order to avoid the tax. As a result, it may be necessary to create a deemed realization event if the cash value of a contract falls to a worthless or near-worthless level.

2. *Effect of Insurance Costs.* The above examples did not incorporate insurance contract costs and fees. In order to provide parity with the current tax treatment of cash value insurance contracts, a cost payment would need to carry with it a current deduction if paid for from the variable contract cash value.[169] The most straightforward way of carrying this out is to provide a current deduction for such costs.

The timing of the reduction of cash value for payment of fees will affect the base used for calculating risk-free return. While it would be possible to calculate the risk-free return to track precisely change in the base caused by contract cost payment, an administratively simpler solution is to deem all contract costs paid at the same time. For example, the costs would reduce cash value from the beginning of the tax period regardless of when cash value was actually reduced during the tax period. Alternatively, the contract costs could all be deemed paid after both the risk-free and risk-related returns are determined for the current tax period, leading to a larger base for purposes of calculating the risk-free return.

I propose calculating the return components before taking into account the costs. Premiums are priced to take into account the returns they will generate. For example, a term life insurance premium is likely discounted to reflect the income that will accrue during the year on the premium even though term life is generally referred to as having no

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169. *See supra* notes 90-96 and accompanying text.

cash value.[170] Thus, returning to the Year 1 example above, if there had been $1 of insurance costs paid in Year 1 from the cash value, the amount of the risk-related return ($15) and the risk-free return ($5) would remain unchanged. Judy would also receive a $1 deduction for her insurance costs. Her investment in the contract would be reduced from $115 to $114, and in Year 2, the five percent assumed riskless rate of return would be applied to a $119 cash value rather than $120. This method would preserve deferral rather than exclusion of the minimum return deduction. If Judy were to withdraw all her cash value at the beginning of Year 2, she would be taxed on $5, which equals the amount of her Year 1 minimum return deduction.[171]

Under current law, to the extent cash value withdrawals are taxable, they are taxed at ordinary income rates.[172] Returns derived from the types of funds underlying a variable contract would, however, frequently be treated as capital gains or losses, which may be short-term or long-term, and subject to netting requirements and loss

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170. *See* Pike, *supra* note 18, at 497-98 (describing how term insurance pricing likely reflects an interest component).

171. The provision of a current deduction for expenses paid from cash value may, however, appear unseemly even though it is essentially what is already offered under cash value insurance contracts. In addition, as discussed in Part I.B, to the extent the expenses relate to investment management, they would be deductible as miscellaneous itemized deductions (or netted from investment return in the case of publicly-offered mutual funds). It may, however, be politically desirable to make the deduction less transparent, in which case a similar (though not identical) result could be obtained by providing no expense deduction but by increasing the investment in the contract by the amount of the expenses paid from cash value. Ultimately, this would allow the taxpayer to offset future gains on withdrawal, but the timing would be less advantageous than with a simple current deduction.

A better result would be for Congress to revisit the issue of paying mortality expenses with cash value. If out-of-pocket mortality charge payments are not deductible, then no implicit deduction should be available if payment is made with the cash value. A relatively simple way to deny even an implicit deduction for mortality charges is to treat charges paid through cash value as a deemed withdrawal of cash from the contract followed by the use of that cash to pay the expenses. Whether the deemed withdrawal were taxable would depend on application of I.R.C. § 72.

172. Regular annuity payments are also treated as ordinary income to the extent they are taxable under an exclusion ratio. I.R.C. § 72(b) (2007).

limitation rules.[173] Such restrictions are departures from a
normative income tax.[174] In a mark-to-market system, loss
limitation rules are unnecessary since they are required to
prevent taxpayers from engaging in selective realization to
take losses when most beneficial for tax purposes (i.e.,
"cherry-picking").[175] The possibility of a loss-stuffing shelter
is, however, considered in the next section.

B. *Potential Objections*

Use of a mark-to-market system brings with it concerns
about valuation and liquidity. There may also be questions
raised about whether my proposal creates new distortions
between the treatment of variable insurance and
nonvariable cash value or between variable insurance and
other taxable investments. New sheltering possibilities
must also be considered.

1. *Valuation and Liquidity*. Valuation and liquidity are
two well-recognized obstacles to a mark-to-market tax
system.[176] Regular valuation of contract cash value should
not, however, present a problem since insurance companies
must be able to provide information to contract owners
about available cash value. In the case of life insurance,
tracking cash value is already mandatory under the
Code.[177] While the Code does not directly mandate
calculation of annuity cash values, they must be calculated
for purposes of determining tax owed on withdrawals. In

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173. Net short-term gains are taxed at the same rates as ordinary income,
while net capital gain is taxed a special rate. I.R.C. § 1(h) (2007). For
individuals, capital losses are deductible only to the extent of capital gains plus
a modest $3000 per year additional deduction. *Id.* § 1211(b).

174. And thus also hamper Domar-Musgrave effects. *See infra* Part III.

175. *See* SLEMROD & BAKIJA, *supra* note 4, at 287 (explaining that "full
deductibility of capital losses is not feasible" given the realization requirement
"because investors with diversified portfolios could 'cherry-pick' their assets").

In order to facilitate Domar-Musgrave effects, losses arising out of a variable
contract should not only be currently deductible but should be refundable. *See
infra* Part III.

176. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual
Taxation*, 134 U. PA. L. REV. 1111, 1118 (1986) (describing the "two major
obstacles to accrual taxation" as valuation and liquidity problems).

177. I.R.C. § 7702 (2007).

addition, for both types of contracts, contractual loan limits and surrender charges may be tied to cash value.

While valuation should not present a problem if the types of assets underlying variable contracts remain as they are now, the mark-to-market system I propose does raise the possibility that individuals will attempt to understate the cash value amount (although this would affect the minimum return deduction amount). In addition, if difficult-to-value assets are placed inside variable contracts, valuation would be more costly. Accommodation for these types of assets should not be made, and valuation would be required. The problem seems unlikely to arise since variable insurance would seem to be an odd vehicle for holding artwork, for example, since the realization rule would already provide deferral.

Several factors should alleviate concerns about taxpayer liquidity. The individuals investing in variable insurance are likely to be relatively well off (although for many such contracts may still not be suitable). Further, the minimum return deduction will help lower the amount of gains that are taxable in a particular year. In the case of cash value life insurance loans are easily obtained and have no tax consequences. While loans taken against annuity cash values do not provide this same opportunity, if concerns about liquidity are substantial the penalty tax could be abated for withdrawals used to pay taxes.

2. *Fairness Concerns.* Since under my proposal cash value is marked-to-market annually, imprecision relating to the size of the base for imputation of the risk-free return is fairly minimal.[178] Critics might, however, assert that my proposal does not provide adequate parity of treatment between nonvariable, cash value insurance contracts, and variable contracts. Short-term Treasury debt would be used to calculate a tax period's risk-free return. This rate will be greater than mere passage-of-time return, estimated to be

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178. The mark-to-market period could be shortened to less than one year. Administrative costs would be increased but would remain comparable to similar rate resets already undertaken by insurance companies. For example, some interest-sensitive, nonvariable insurance contracts provide rate resets as frequently as monthly. *See* BLACK & SKIPPER, *supra* note 8, at 117 (describing policy periods as lasting "often a month" with interest credited "usually at new-money rates").

only .7% between 1926 and 2004.[179] The remainder of the return on short-term Treasury debt reflects inflationary expectations.[180] Thus, even though the tax system as a whole is not adjusted for inflation, using short-term Treasury debt for the risk-free rate provides some protection against being taxed on inflationary gains.[181] Inflationary returns should not be taxed since they do not represent real income.[182]

Under nonvariable cash value contracts, the insurance company, and not the contract holders, bears the investment risk. As a result, the rate guaranteed by the company will be conservative and will generally reflect the rate available on no- or low-risk investments.[183] While the guaranteed rates may be low, more modern, nonvariable contracts may provide for the possibility of larger, contingent returns. For example, rates may be ratcheted up or down (though not below the floor of the guaranteed rate) based on a specific index, including some contracts that are keyed to short-term T-bills.[184]

Insurance companies are well aware that they may lose business during periods of higher interest rates,[185] and

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179. *See* Zelenak, *supra* note 10, at 880; *see also* Bankman & Griffith, *supra* note 18, at 387 (explaining that study methodology was to compare the return on short-term treasury bills with period inflation rates and averaging the results). However, "the current risk-free rate of return is clearly higher than the near-zero level indicated by much of the historical data," and may be less trivial than it is perceived by many experts. *See* Zelenak, *supra* note 10, at 889-90.

180. *See* BLACK & SKIPPER, *supra* note 8, at 64 ("[I]nflation expectations drive interest rates"). Thus, use of short-term Treasury debt as the appropriate risk-free return benchmark assumes that its returns do not reflect a significant risky component.

181. Auerbach, *supra* note 12, at 169 n.2 ("If the tax system is not indexed for inflation, then this rate [the risk-free interest rate] should be viewed as a nominal interest rate."); Cunningham & Schenk, *supra* note 18, at 735 (using Treasury bill rate as the risk-free return).

182. *See* Bankman & Griffith, *supra* note 18, at 391 ("Virtually all scholars on both sides of the income and consumption tax debate believe that return attributable to inflation should not be taxed."); Weisbach, *supra* note 11, at 30-32.

183. *See supra* note 33.

184. *See id.*

185. *See* BLACK & SKIPPER, *supra* note 8, at 64 (describing how contract holders exit traditional life insurance during periods of high interest rates).

contract innovation is driven in part by such concerns.[186] Even if a contract does not offer rate adjustments, contract holders have the option to exchange, tax-free, their old contracts for new contracts offering competitive rates.[187] Thus, the proposed risk-free rate (short-term Treasury debt) will be lower than the rate offered by some contracts, and it will be higher than that offered by others.[188] While it would be possible to use a deemed return tied to actual contract returns, such a system would be more costly to administer. In addition, some compromises would still have to be made given the wide variety of nonvariable insurance contracts.[189]

In addition to concern about the similarity of tax treatment between variable and nonvariable insurance products, my proposal may elicit the contention that contract owners would be taxed more heavily than they would be if they held the underlying investments directly and purchased nonvariable cash value insurance. It would be possible to use a pass-through system rather than the proposed mark-to-market approach. That is, the contract owner's current taxation could be based on a share of the tax items generated by the various investment units underlying the variable contract cash value.

Although tax information for such investments should be available in most cases (since underlying investment funds are generally treated as separate tax entities), the process for passing through the various tax components to the contract holders would introduce significant administrative complexity. In addition, some of the underlying investments would already be providing some deferral of tax on the risk-free return through operation of the realization requirement. Thus, it would be problematic to provide a minimum return deduction based on cash value

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186. For example, variable contracts were created in order to provide an insurance product that would keep pace with general market trends. *See* Luke, *supra* note 2, at 134-35.

187. *See supra* notes 69-74 and accompanying text.

188. Actual interest credited does not need to match the assumed rates used under § 7702 in the cash value accumulation test or guideline premium test assumed rates. *See* Pike, *supra* note 18, at 511-14.

189. Further, given the implications of Domar-Musgrave, deferral of tax on the risk-free component of both variable and nonvariable contracts may provide parity of treatment between the two types of contracts. *See infra* Part III.

while taxing other contract returns based on a pass-through regime.[190]

3. *New Tax Shelters.* New tax sheltering opportunities frequently arise from the ashes of an old shelter. Provision of a specific minimum return deduction could induce individuals to artificially maximize the base on which this deduction is calculated. The threat should not, however, be greater than that already posed by existing cash value contracts, which are governed by Code sections designed to prevent this technique.[191] While these provisions could be fine-tuned, the larger question is whether the tax deferral for inside buildup should continue at all. The answer is likely that it should not,[192] but as discussed throughout, the tax treatment for inside buildup is so firmly-entrenched that reform efforts must work around it.

Because my proposal allows for current deduction of risk-related losses, taxpayers may attempt to increase these losses artificially. Losses on investments owned outside the variable contract are generally subject to deductibility limitations, whereas under a mark-to-market system losses are generally fully allowed and at ordinary tax rates. If a taxpayer knows that an investment will produce a loss, the taxpayer would prefer a high tax rate. Thus, taxpayers would have some incentive to shift investments inside variable contracts once it was certain they would produce a loss that would otherwise be subject to limitations.[193] The more subjective standard of the investor control doctrine could be retained in order to prevent this type of ex post manipulation of tax rates.[194]

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190. The Domar-Musgrave theory suggests that contract owners will be better off under a mark-to-market system because it would allow them to make portfolio adjustments more efficiently. *See infra* Part III.C.

191. *See supra* Part I.B (describing provisions mandating a particular relationship between cash value and death benefit, providing for early withdrawal penalties, and restricting excessive front-loading).

192. *See supra* notes 18-21 and accompanying text.

193. *See* Schizer, *supra* note 12, at 1911 (describing problem of "ex post reclassification" by taxpayers wishing to "pretend" a different transaction occurred once results are known).

194. *See supra* Part I.C.2.i.

In addition to the incentive to shift bona fide investments once it is known that they will produce losses, taxpayers may also have some incentive to craft underlying assets that are virtually certain to produce losses. One hallmark, however, of a loss generator shelter is that the economic risk of loss is essentially nonexistent.[195] Keying the amount of loss to the actual decline in value of a contract's cash value should help minimize this type of shelter. While an especially accommodating insurance company might be willing to tolerate negative cash value in the interest of enlarging the current loss deductions of a wealthy client, negative cash value could easily be prohibited and, as described above, a persistent low or zero cash value would also trigger taxation of the deferred risk-free returns.[196]

III. DOMAR-MUSGRAVE CONSIDERATIONS

Numerous reform proposals have addressed the questions of whether and how to replicate, with its accompanying current taxation of net gains and deduction of net losses, the annual asset valuation required by the Haig-Simons income norm.[197] A possible, though

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195. *See* Marvin A. Chirelstein & Lawrence A. Zelenak, 105 COLUM. L. REV. 1939, 1939 (2005) (describing tax shelters whose aim "is to create a tax benefit in the form of a loss . . . that has no economic corollary but is simply the consequence, or the hoped-for consequence, of rule manipulation").

196. *See supra* Part II.A.

197. Under the Haig-Simons income ideal, assets would be valued at the end of each tax period so that the net increase (or decrease) in wealth could be measured accurately and subjected to current taxation—a mark-to-market approach. The realization requirement interferes with the accomplishment of this ideal since the tax consequences of holding an asset are put off until its disposition (or other realization event). *See generally* Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004) (evaluating consensus views on realization requirement, including discussion of valuation, liquidity, and accrual taxation). The principal negative consequences of this deviation from an ideal income tax are lock-in effects and tax-avoidance transactions. *See* SLEMROD & BAKIJA, *supra* note 4, at 286 (3d ed. 2004) (describing these two effects); Auerbach, *supra* note 12, at 167-68 (same); *see also* David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1552 (1998) (article exploring whether realization can be justified as a "subsidy for private savings and investment"); Zelinsky, *supra* note 160, at 862 (1997) (concluding that "choosing de novo, we should elect realization, not accretionism, as a fundamental premise upon which to construct an income tax").

controversial, implication of the taxation-and-risk literature is that, with respect to risk-related returns, these questions may be largely beside the point.[198] Below is a brief synopsis of Domar-Musgrave, followed by an overview of its application given the current tax system. This Part concludes with a short discussion of the question as to how Domar-Musgrave should be taken into account in designing incremental tax reform and how it applies with respect to my variable insurance reform proposal.

A. *Overview*

The taxation and risk literature theorizes that under an ideal, single-rate income tax a taxpayer can and will achieve the same risk position in the after-tax world as in the no-tax world by making portfolio adjustments, assuming that (1) increasing the size of an investment is costless (including no change to price and yield)[199] and (2) gains and losses from an asset are taxed at the same rate (including a refundability feature to ensure full deductibility of losses).[200]

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198. For examples of or discussions about this literature, see Bankman & Griffith, *supra* note 18, at 392-403; Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. 239, 242-43 (2003) (applying Domar-Musgrave analysis to the corporate double tax); Cunningham, *supra* note 10; Domar & Musgrave, *supra* note 9, at 390; Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789 (Dec. 1994); Lederman, *supra* note 91, at 1435-43 (using Domar-Musgrave to analyze the tax burden on entrepreneurs); Jan Mossin, *Taxation and Risk-Taking: An Expected Utility Approach*, 35 ECONOMICA 74 (1968); Schizer, *supra* note 12; J.E. Stiglitz, *The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking*, 83 Q. J. ECON. 263 (1969); Weisbach, *supra* note 11.

199. *See* Schizer, *supra* note 12, at 1903-04 (explaining that increased demand could increase costs, which "could prevent taxpayers from completely canceling out the tax").

200. Domar & Musgrave, *supra* note 9, at 422 (explaining that different rates for gains and losses caused by a progressive tax system would alter their conclusions); *see also* Schizer, *supra* note 12, at 1891. Schizer describes the two principal assumptions as: "First, the government's share of gains must match its share of losses. Second, taxpayers must be able to adjust the size of their risky bets costlessly." *Id.*

Additional assumptions must be made. These relate to market conditions, investor expectations and wealth. *See* Domar & Musgrave, *supra* note 9, at 393, 421-22.

That a normative income tax does not reach risky returns follows from the insight that tax rates affect not only investment yield but also the riskiness of an investment.[201] If losses are deductible at the same rate at which income is taxed and are refundable, then the tax system affects yield and risk by the same amount such that "the return per unit of risk-taking remains unchanged."[202] As a result, a taxpayer can increase the size of his investment to attain the risk-based returns he would have had in the absence of taxes. If it costs nothing to increase his position, the taxpayer will rationally make adjustments.[203]

To take a simple example, taxpayer Trevor wishes to make a bet on the flip of a $1 coin, which he owns. If he wins, he receives back his $1 coin and wins an additional $1. If he loses, he forfeits his coin. In the no-tax world, Trevor would have a $1 gain if he wins and a $1 loss if not. If a fifty percent tax rate applied equally to gains and losses—without any limitation on loss deductibility—Trevor would have $ .50 after-taxes if he won and would lose $ .50 after taxes if not. By doubling the bet, Trevor could get back to the same position he would have had in the no-tax world, and he borrows $1 to make this adjustment. After paying back the loan, he will have a net gain of $1 if he wins and a net loss of $1 if not, which matches the returns available in the no-tax world.

Thus, if the tax system provides full loss offsets, the government will have no additional tax revenue from nominally taxing risk-based returns.[204] Instead, the government is using the tax system to take an indirect position in the risk-based returns market[205] and will share

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201. *See* Domar & Musgrave, *supra* note 9, at 389.

202. *Id.*

203. *See* Weisbach, *supra* note 11, at 8 (explaining that individuals "can and will adjust their portfolios" to offset the effect of the tax imposed on risk-based returns). An individual's precise response will be "a function of her utility schedule." Bankman & Griffith, *supra* note 18, at 395. The adjustment, however, should tend toward increasing the riskiness of the portfolio. *Id.* at 395.

204. *See* Weisbach, *supra* note 11, at 10 ("No tax revenue is collected and no risk is shifted. The tax is a complete nullity.").

205. While the government's share of any positive expected return may look like tax, it is not. Instead, the share represents the government's share of the risk premium and has a zero value. *See* Schizer, *supra* note 12, at 1932-33

in the taxpayer's investment gains and losses.[206] Like the taxpayer, the government can adjust its portfolio in order to arrive at its desired risk position.[207]

B. *Real World Domar-Musgrave*

Two controversial questions are, first, to what extent do Domar-Musgrave effects occur in the real world under the current tax system, and second, how, if at all, should Domar-Musgrave be used to inform tax reform.[208] Though empirical evidence remains unclear,[209] the current tax system likely reaches some risky returns, though in a manner that may be arbitrary and even regressive.[210] First, the income tax imposes various loss limitation rules. Under

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(explaining why the government's share of the risk premium has zero value and looks "a lot like a direct government investment in a portfolio"); Weisbach, *supra* note 11, at 12.

206. *See* Domar & Musgrave, *supra* note 9, at 390 (noting that "the Treasury assumes part of the risk . . . [i]f losses can be [fully] offset").

207. *See* Weisbach, *supra* note 11, at 9-10; Zelenak, *supra* note 10, at 884 n.18.

208. *See* Bankman & Griffith, *supra* note 18, at 405 ("It is unclear whether an income tax without full loss offsets will increase or decrease the amount of risky assets."); Lederman, *supra* note 91, at 1444 (arguing that given the loss deductibility restrictions on investments, "it is unrealistic to think that individuals functionally can eliminate the tax burden on investment capital through portfolio shifts"); Schenk, *supra* note 197, at 390-91 (explaining reasons for believing that the Domar-Musgrave model may not apply to the current income tax); Zelenak, *supra* note 10, at 891-96 (discussing the extent to which risky returns may be taxed under the current system).

Relatively few proposals have been made that explicitly take into account Domar-Musgrave effects—largely owing to this controversy over its application in the real world. One key proposal that is consistent with the Domar-Musgrave framework is the retrospective taxation method described by Professor Auerbach. *See* Auerbach, *supra* note 160; *see also* Bradford, *supra* note 12, at 738 (describing a similar method and stating the "Auerbach method is a special case of the alternative approach"); Weisbach, *supra* note 11, at 12-15 (decomposing the returns on stock investment into a risk-based and riskless portion in order to illustrate the taxation-and-risk model).

209. *See* Weisbach, *supra* note 11, at 45 ("The empirical evidence is insufficient to sway us one way or another.").

210. *See* Cunningham, *supra* note 10, at 21-22 (discussing how a normative income tax is "probably somewhat regressive" and also burdens the unsophisticated); Schenk, *supra* note 10, at 424 ("It [an income tax] is only able to tax the return to risk realized by poor and unsophisticated taxpayers or by varying a normative income tax in arbitrary and unacceptable ways.").

Domar-Musgrave, if losses may never be deducted but income is still taxed, then the tax system changes the investment yield but not the riskiness of an asset.[211] As a result, if a taxpayer wants to regain her pre-tax income position, she would have to increase her investment and thereby take more risk.[212] But because the tax system will also cause a reduction in the return per unit of risk, there is less inducement to take risk. The taxpayer may instead reduce her level of investment in order to reduce risk.[213]

Tax reality, of course, falls between the position of full loss deductibility and no loss deductibility.[214] For certain privileged taxpayers, however, the tax system looks more like a full loss offset system than it does for other taxpayer groups. Carryforward provisions apply to unused capital losses, for example.[215] Further, the realization rule provides taxpayers—particularly sophisticated ones—the ability to time recognition of gains and losses so as to minimize any impact from loss limitation rules. That is, loss deductibility restrictions may actually serve to equalize tax rates on gains and losses because of the deferral benefits afforded gains.[216] Wealthy individuals are likely in the best position to use this "timing option."[217]

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211. *See* Domar & Musgrave, *supra* note 9, at 389.

212. *See id.* at 390. This is an income effect analogous to the idea that an increase in the tax rate on wages puts pressure on workers to increase labor in order to stay at the same level of income they enjoyed prior to the tax change.

213. *See id.* Again, by analogy to the labor market, an increase in the tax rate on wages may induce workers to substitute leisure for labor since the return on labor has been diminished by the tax. *See id.* at 405-06 (analogizing the substitution and income effects at work to those also present in the labor market).

214. *See* Weisbach, *supra* note 11, at 33-34 (discussing various distortions in the income tax system); Zelenak, *supra* note 10, at 892-93 (discussing various limitations on loss offsets in the current tax system).

215. Domar & Musgrave, *supra* note 9, at 391 (describing "limited provisions for loss offset in the tax law").

216. David A. Weisbach, *Taxation and Risk-Taking with Multiple Tax Rates*, 57 NAT'L TAX J. 229, 241 (2004).

217. *See* Schizer, *supra* note 12, at 1909-10 (describing the timing option); *see also* Domar & Musgrave, *supra* note 9, at 391 ("A large corporation or a large-scale financial investor may undertake a risky investment as a side line, and know that possible losses are covered by other income which is reasonably certain to be derived from the main line of business.").

In addition to restrictions on loss deductibility, which may affect whether gains and losses from the same asset type are taxed at the same rate, the current income tax system provides for different rates on different asset types. Professor Weisbach argues that differential tax rates across asset types do not affect risk-taxing.[218] Instead, the benefit or detriment resulting from selecting among investments to which different tax rates apply would arise solely from the risk-free return component.[219] As a result, this tax benefit or detriment would likely be small, with the result that deadweight loss estimates calculated on the assumption that the income tax reaches full investment returns will be far too large.[220] To the extent the wraparound insurance shelter is driven by the low tax rate on the risk-free rate of return, my proposal would not affect that incentive.[221] Domar-Musgrave analysis thus provides additional nuance to arguments against deferral of tax on inside buildup.[222]

Not only does the current tax system impose different rates on different assets, progressive tax rates may cause gains and losses to be taxed differently on the same assets. Professor Zelenak recently suggested that if a progressive Haig-Simons income tax is the societal preference, then the patchwork of risk-related returns triggered by progressivity "is likely to be appropriate."[223] That is, assuming progressivity is desirable, it may follow that taxation of risk triggered by such progressivity is also desirable. Even if one accepts this proposition, the pattern produced by our current rate bracket structure is not likely to subject the most affluent to different rates on gains than on losses.[224]

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218. *See* Weisbach, *supra* note 216, at 229-30.

219. *Id.* at 230.

220. *Id.* at 239-40.

221. Indeed, my proposal may increase the attractiveness of the benefit for the risk-free return if the increase in the nominal rate of tax on the risky returns triggers a reduction in any implicit taxes (i.e., contract fees). *See infra* notes 235-36 and accompanying text.

222. *See supra* notes 18-21 and accompanying text.

223. Zelenak, *supra* note 10, at 900.

224. *See id.* at 901 (noting that the $336,550 top rate bracket is "modest" and that "taxpayers with significant wealth" will not face loss tax rates that differ from their gain tax rates); *see also* Weisbach, *supra* note 11, at 39 (explaining that the current rate structure "does not do very much" of causing gains to be taxed at a higher rate than losses).

As explained by Professor Zelenak, "[f]or the sometimes-taxation of risk premium under a graduated rate income tax to be attractive it would have to affect the wealthy as well as the merely affluent, and it would do so only if rate graduation extended throughout the income distribution."[225]

Of these tax rules interfering with Domar-Musgrave preconditions, none—with the exception of progressivity (which is really a separate normative issue)—are part of a normative income tax. The various loss limitation rules, for example, operate to limit the sheltering opportunities resulting from the realization requirement. Differential taxation of economically similar products and transactions contributes to tax sheltering and also increases the costs associated with tax planning even in transactions that do not rise to the level of tax shelters.[226]

In addition to the effect tax rules have on Domar-Musgrave effects, portfolio adjustments in the real world are likely to be complex and will not be costless—both conditions that will likely negatively affect the ability of the unsophisticated and less wealthy to avoid a tax on risk.[227] With respect to complexity, it is difficult to imagine taxpayers consciously engaging in the calculations seemingly required for real world Domar-Musgrave effects. Professor Weisbach argues that "[t]axpayers living within the systems . . . merely need to make investment decisions based on after-tax prices. . . . [T]axpayers could be completely unaware of the types of adjustments discussed in the models while conforming to the predicted behavior."[228] Notwithstanding this possibility, in the case of complex investments, such as variable insurance, after-tax

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225. Zelenak, *supra* note 10, at 901.

226. *See* Schizer, *supra* note 131, at 1314 (describing how inconsistency in the taxation of similar transactions leads to "wasteful tax planning").

As described in *supra* notes 218-21 and accompanying text, these costs may be tied most closely to the rate at which the risk-free return is taxed—and thus, may not trigger deadweight losses as large as usually estimated.

227. In addition, risk aversion may cause taxpayers to make adjustments that, while maximizing utility, do not result in the complete elimination of the taxation on risk. *See* Zelenak, *supra* note 10, at 895 (describing Ethan Yale's work on this point).

228. Weisbach, *supra* note 216, at 241.

prices may not be readily apparent. Less sophisticated individuals, in particular, may have a difficult time understanding the various factors, including fees, affecting the product's after-tax price and may be susceptible to aggressive marketing tactics.

Transaction costs also interfere with taxpayers' ability to make Domar-Musgrave portfolio adjustments. To return to Trevor taxpayer and his $1 wager,[229] taking out a loan to double his initial wager is unlikely to be costless in the real world. Only if loan expenses (e.g., interest and amortizable origination fees) are fully deductible and his bet pays a risk-free return matching loan expense payments as to amount and timing will doubling his bet be costless.[230] If loan costs exceed the risk-free rate, then the tax burden depends not on the risk-free rate but on the loan interest rate.[231] Since borrowing costs are tied not only to various administrative tasks performed by the lender but also to the

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229. *See supra* notes 203-04 and accompanying text.

230. The risk-free return earned on the non-borrowed investment will, of course, not be eliminated by doubling the bet. To illustrate, assume that the coin flip does not take place immediately after Trevor puts up his $1 so that there is a risk-free return associated with the bet. Assume that this return will be paid regardless of bet outcome and that this return equals six cents per $1 wagered. Assume also that Trevor is able to borrow at the rate of six cents of loan expenses (all deductible) per $1 borrowed. The timing of the receipt of the risk-free return from the bet and the payment of the loan expenses coincide; the payment of the tax and the receipt of any tax deduction coincide.

In the no-tax world, Trevor would not have to borrow and would have six cents of risk-free return at the conclusion of the investment. In a 50 percent tax world, Trevor borrows $1 to double the bet in order to eliminate the tax on the risky return. The $2 invested earns twelve cents of risk-free return. Trevor must pay six cents of tax on this amount—three cents attributable to his original $1 and three cents to the borrowed $1. Trevor had the remaining six cents to pay loan expenses, and will get a three cent deduction as a result. Thus, he is able to generate the money to pay the loan expenses because the risk-free rate and loan expense rate is the same. He is able to cancel out the risk-free return associated with the borrowed $1 because of the loan expense deduction, but he is not able to cancel out the three cent tax attributable to his original $1.

231. *See* Cunningham, *supra* note 10, at 39 ("To the extent than an investor's borrowing rate is higher than the risk-free rate and she uses borrowed funds to adjust her portfolio, the burden of the normative income tax on capital income is equivalent to a tax on the investor's wealth equal to the product of the investor's borrowing rate and the nominal tax rate.").

creditworthiness of the borrower, wealthier borrowers will generally enjoy lower borrowing costs.[232]

Transaction costs for wealthier taxpayers may also be lower as a result of more subtle interactions. The current income tax system offers various low tax-rate opportunities. Variable insurance provides one such opportunity. If the rate of tax is zero on policy inside buildup (which, though unrealistic,[233] makes for easier illustration), taxpayer Trevor would only have to wager $1 through a variable insurance contract in order to achieve his no-tax world risk level.[234] The zero tax rate would, however, be anomalous when viewed from the perspective of the entire tax system, which exacts higher nominal tax rates for comparable returns existing outside variable insurance. A portion of variable contract fees likely reflects insurance companies taking advantage of this tax rate differential.

While this phenomenon is generally referred to in terms of tax capture or implicit taxation, such fees may also be analogized to borrowing costs.[235] Just as more favorable terms are generally available to wealthier borrowers, contract fees vary with the affluence of the purchaser. That is, the ability to take what is, in effect, a full deduction for all costs—including mortality costs—paid out of cash value creates variance in these fees in a way that favors the affluent since the value of a deduction increases with rate bracket increases. Lack of wealth and sophistication may also lead to an increase in policy cancellations and other forms of early withdrawal, which will increase contract fees and may trigger tax penalties.[236]

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232. *See id.* at 39; *see also* Schizer, *supra* note 12, at 1905-06 (noting that the wealthy "can borrow at low cost, if not at quite the risk-free rate").

233. *See supra* Part I.B.

234. This also provides an illustration of the way after-tax price can substitute for a more complex portfolio adjustment. *See supra* note 228 and accompanying text.

235. *See supra* notes 78-79 and accompanying text. To the extent transaction costs are characterized as implicit taxes, they may be analyzed as contributing to tax rate differentials on the risk-free return. *See supra* notes 218-21 and accompanying text.

236. *See supra* notes 75-84 and accompanying text.

C. *Tax Shelter Reform and Domar-Musgrave*

Considerable overlap may exist between the taxpayers best able to avoid tax on risk and those who make use of tax shelters. This suggests that Domar-Musgrave implications should be examined when dealing with incremental reform aimed at tax shelters. Such an analysis may provide additional insight into the mechanisms of the shelter and help evaluate the likely effects of the proposed reform. A more difficult question is the extent to which Domar-Musgrave should be used normatively. The possibility that incremental reform should be implemented to facilitate, when possible, the non-taxation of risk may seem counterintuitive given that the wealthy and sophisticated are already in the best position to obtain this result. If, however, one assumes Haig-Simons as the normative goal, then most methods of taxing risk through an income tax system require departure from that goal.[237] The implication is that in order to implement reform that facilitates the non-taxation of risk, one need not aim for Domar-Musgrave results—aiming for Haig-Simons is sufficient.[238]

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237. Of course, departures from Haig-Simons are relatively commonplace in the current income tax system, and they occur largely because of various obstacles to removing the realization requirement. *See supra* Part III.B.

238. *See* Weisbach, *supra* note 11, at 36 (describing interaction of Domar-Musgrave and Haig-Simons).

As indicated in the introduction, this Article does not address whether risk should be taxed—it addresses only whether it is taxed under Haig-Simons and the current system. It seems safe to assume, however, that if it were decided that risky returns should not be taxed and a system were designed to accommodate that goal, Congress would wish to provide investment incentives. The potential targets for congressional largesse in such a system are clear. As described *supra* Part III.A, taxpayers are not able to use portfolio adjustments to eliminate the income tax on risk-free returns. In addition they cannot use such adjustments as to wages or inframarginal returns. Thus, with respect to investment assets, the clear candidate for which to provide subsidy treatment is the risk-free return component of such assets. *See* Schizer, *supra* note 12, at 1900-01 (describing the difficulties individuals have in adjusting wage income since they would "presumably have to do more work"); Weisbach, *supra* note 11, at 19-20 (explaining that to the extent inframarginal returns do occur, portfolio adjustment cannot be used to "eliminate the tax" on them). My proposal thus also provides a limited exploration of how a subsidy could be constructed in such a system.

Another method for implementing a preference for risk-free returns would be to provide for a zero tax rate on all the returns of the investment asset. *See* Schizer, *supra* note 12, at 1924 (describing the use of zero rate for risk-based

Haig-Simons does not mandate a particular rate structure, and the most efficient way to implement directly Domar-Musgrave might be to impose a zero tax rate on risk-related returns.[239] Professor Schizer suggests, for example, that variable life insurance reform (as to the risk-based returns) may not be necessary—assuming a zero rate applies to both risk-based gains and losses under these contracts.[240] As a general matter, zero rates may be difficult to legislate. Even in the case of variable insurance, several legislative adjustments would be required since a zero rate will not be a typical result for many variable life insurance contracts, and a potential zero tax rate does not apply to variable annuity contracts.[241] Drawing the risk-related returns out of the contracts and marking them to market should allow for Domar-Musgrave results comparable to those afforded by a zero rate while still allowing for progressivity.[242]

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returns as being "[i]n some ways . . . the simplest and most radical approach"). Professor Auerbach's method suggests another relatively simple approach to providing a deferral benefit to holders of insurance contracts. *See* Auerbach, *supra* note 160. At contract surrender, tax could be assessed using the final cash value to determine the risk-free returns, but an interest charge would not be assessed. The absence of the interest charge would provide the contract holders with the benefit of deferral. Tracking investment in the contract and marking cash value to market would not be required. In order to tax correctly a contract on which partial withdrawal of cash value had occurred prior to the final withdrawal date, additional calculations would, however, be required. Professor Auerbach describes an approach to dealing with distributions occurring prior to realization. *See* Auerbach, *supra* note 12, at 173.

239. The retrospective method provides for such a result. *See supra* note 160.

240. Schizer, *supra* note 12, at 1936 ("A provocative implication of this analysis is that these investments do not require special attention [because of the] zero rate applicable to insurance . . . .").

241. *See supra* Part I.B.

242. This assumes that the suitable clientele for variable insurance products does not differ substantially as between a zero-rate approach and my proposal. *See* Schizer, *supra* note 12, at 1892 (explaining that a zero-rate system "does not allow policymakers to apply progressive rates to risk-based returns"). In order to allow for taxation of risk arising as a result of income tax progressivity, the gains and losses should be classified as ordinary and taxed according to the individual's rate bracket. As discussed in Part III.B, because the rate brackets are fairly wide, it is possible that most risky gains and losses on variable insurance would be taxed at the same rate even after application of the rate brackets. If one wished to enhance further Domar-Musgrave effects, an explicit, uniform rate could be used to tax both gains and losses. *See* Schizer, *supra* note

In addition to risk taxed because of the structure of the current tax rules, risk may also be taxed because of failures to make portfolio adjustments. It perhaps goes without saying that minimizing such failures is desirable—particularly since such failures are likely to be most common among the less sophisticated and wealthy.[243] While necessarily speculative, my proposal may enhance taxpayer ability to make adjustments through lowering transaction costs. Implementation of my proposal will allow for removal of the current anti-shelter devices,[244] which impose monitoring costs and artificially restrict underlying contract investments to insurance-only funds. Nominally taxing risk may also lower transaction costs to the extent such costs represent tax benefit capture on the part of insurance companies.[245] Further, the requirement of separately stating contract elements—including fees—will increase contract transparency and thus should help foster competition.

CONCLUSION

Variable life insurance and annuities are complicated, problematic financial products. My proposal preserves most of the current tax treatment of these products, but imposes taxation of the risky returns, thereby allowing for relaxation of the current anti-tax shelter rules and potentially enhancing taxpayer ability to understand these products. Additional effects of this separation of risk-free and risky returns depend on the extent to which nominal taxation of risk is avoided through taxpayer portfolio adjustments. My proposal takes Domar-Musgrave considerations into account to some extent, but by imposing nominal taxation, it is also responsive to the view that risk-related returns are meaningfully taxed by the current, progressive income tax system.

12, at 1908-09 (describing uniform treatment of returns from the same instrument as necessary to achieving Domar-Musgrave balance). If differences between the nominal tax rate on risky returns on economically similar assets affect transaction costs, selecting a rate between the highest individual rate and the highest capital gains rate may help neutralize such effects.

243. *See supra* Part III.B.

244. *See supra* Part I.C.2.

245. *See supra* notes 78-79 and accompanying text.