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Some Income Tax Aspects of Variable Life Insurance Policies

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Introduction

This article will discuss some of the income tax aspects of what are called "variable" life insurance contracts. Some provisions are straight forward. However, others are not just complicated but finding the correct result is like walking through a maze. Fortunately, all but one of them can be negotiated with a relatively certain end result. Nonetheless, one rule the Internal Revenue Service ("IRS" or "Service") has attempted to create, called the "investor control" doctrine, is uncertain in scope and effect.

Life Insurance: Why It Seems Mysterious but Isn't

Many people have strong views about life insurance[1] but a reasonable observation seems to be that it is probably the least understood financial product that is widely held. The peculiar structures of so-called "cash value" policies (more fully described below) that combine both a risk of death payment component and an investment component are especially confusing to many.

All investments involve some type of gambling—that a purchased stock or parcel of land will go up in value or that a bond will make the regular interest payments and will be paid in full upon maturity. In some senses, pure life insurance (sometimes, called "term insurance" but known in the insurance industry as the "net amount at risk"[2]) is a gamble as to when the insured will die and the death benefit paid. Obviously, the longer the insured lives, the lower the return on the premiums paid will be.[3] In any event, all forms of insurance, including life insurance, typically involve risk shifting and risk distribution.

> *"Not only is life insurance a unique form of financial product, it is also treated uniquely or at least in a different manner than other such products are for certain legal or regulatory purposes."*

However, unlike virtually all other types of insurance, life products, as indicated above, commonly have an additional feature or component: an investment component, commonly called the "cash value" account.[4] This additional feature is critical, for many life products, to maintain the payment of coverage at death at advanced ages. The reason is that the cost of the pure

1 Frequently, individuals will claim they do not "believe" in life insurance, presumably meaning they do not think it is wise from a financial or investment perspective to acquire such a policy.

2 However, in some contexts, net amount at risk is the amount that would have to be paid if death occurred above the amount the insurer has in a reserve account for the payment. See, generally, http://rmtf.soa.org/net_amount.pdf.

3 See, generally, J. Blattmachr & M. Pasquale, "Buying Life Insurance to Fund Estate Taxes (A Counterintuitive Approach)," 151 Trusts & Estates 27 (July 2012).

4 Although called the "cash value" account, its value is not maintained as cash. Rather, the "cash" is invested in one of potentially several ways.

life insurance component (the net amount at risk) increases every year with the insured's increasing age, becoming extremely great at advanced ages. By coupling the pure risk component (which typically declines at least at certain ages by design of the product or by choice of the owner if the owner is looking to maximize the cash value) with the cash value account (anticipated to grow in value), the death benefit may be maintained at a fixed or at least at a minimum level. Many products are designed so the net amount at risk declines, dollar for dollar, for increases in the investment component (commonly call the "cash value" account) and the death benefit, which will consist of the remaining "net amount at risk" and the investment (cash value) component, will remain constant.[5] With a variable (universal) policy, "the cash value can be invested in a wide variety of separate accounts, similar to mutual funds, and the choice of which of the available separate accounts to use is entirely up to the contract owner. The 'variable' component in the name refers to this ability to invest in separate accounts whose values vary—they vary because they are invested in stock and/or bond markets. The 'universal' component in the name refers to the flexibility the owner has in making premium payments."[6]

Unique Treatment under the Law

Not only is life insurance a unique form of financial product, it is also treated uniquely or at least in a different manner than other such products are for certain legal or regulatory purposes. For example, the regulation of pure term policies is governed almost exclusively by state rather than Federal law.[7] If the cash value component of the life policy varies with investment experience, then that component is regulated under Federal law by the Securities & Exchange Commission.

> *"Under the law of most states, an owner's interest in a policy of life insurance (including the cash value component) may be exempted from claims of the owner's creditors."*

Under the law of most states, an owner's interest in a policy of life insurance (including the cash value component) may be exempted from claims of the owner's creditors.[8] Also, usually, the death benefit paid is not subject to the claims of creditors of the insured or his or her estate (unless paid to the insured's estate).[9]

Life insurance products and insurance companies are uniquely treated, to a significant degree, under the Internal Revenue Code. The taxation of insurers is under Subchapter L of the Code (entitled "Insurance Companies" with Part I dealing specifically with "Life Insurance Companies").

The inclusion of life insurance proceeds in the gross estate of the insured for Federal estate tax purposes is dealt with under Section 2042 (which applies to no other asset).[10] Even the allowance of an annual exclusion for the payment of premiums on

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5 So-called "whole life" products usually are structured so a fixed premium is paid each year for life and provides a fixed death benefit regardless of when the insured dies. Some insurers vary those elements to try to differentiate their products from a standard whole life one—e.g., permit a single premium to be paid when the policy is acquired rather than having premium paid each year until the insured dies.

6 https://en.wikipedia.org/wiki/Variable_universal_life_insurance. The amount of death benefit may vary, compared to a standard "whole life" policy, if it is a universal life policy whether or not it is a variable one, because the cash value will be dependent upon the amount credited to cash value by the insurance company if it is a universal one (but not variable) or upon the investment experience of the assets (e.g., mutual funds) held inside the policy if it is a variable universal one. One difference between variable policies, compared to non-variable but universal policies as well as compared to traditional whole life ones, is that, with a variable policy, the assets the policy owns in the cash value are held in a "segregated" account, meaning they are not subject to the claims of the insurance company's creditors.

7 Cf., *Paul v. Virginia,* 75 U.S. 168 (1868). See, also, Staff Report to the Securities and Exchange Commission (dated June 22, 2010), recommending that the SEC recommend to Congress a change in the definition of securities to include life settlements.

8 See, e.g., NY Insurance Law § 3212; NJSA § 17B:24-6; *But cf.* Cal Code Civ Proc § 704.100(b). There is even a limited exemption directly in the United States Bankruptcy Code. See G. Rothschild & D. Rubin, "Creditor Protection for Life Insurance and Annuities," 4 Journal of Asset Protection 38 (May 1999) ("The federal bankruptcy exemptions for life insurance policies owned by the debtor are found at 11 U.S.C. sections 522(d)(7) and (8), where their relative importance to the average person is, perhaps, evidenced by their placement between the exemptions for the debtor's professional books and tools of the trade and the debtor's professionally prescribed health aids."). Go to https://www.mosessinger.com/site/files/CreditorProtectionLifeInsuranceAnnuities.pdf for a chart (not updated) for a summary of state law creditor protection exemptions.

9 Note that life insurance proceeds may be subject, in effect, to claims of the Federal government for estate taxes if the proceeds are included in the insured's gross estate for Federal estate tax purposes even if not paid to the insured's estate. See Sections 2042 and 2206 of the Internal Revenue Code of 1986 as amended ("Code"). Throughout this article, unless otherwise noted, the term "Section" means a section of the Code.

10 The proceeds payable at death may be includible in the insured's gross estate for Federal estate tax purposes if the insured holds at (or by the application of Section 2035 within three years of) death any "incident of ownership" under the policy. However, "incident of ownership" is not fully defined in the tax law. (As will be discussed later in the text, the IRS has referred to "incidents of ownership" for purposes of its investor control doctrine, but it is not at all certain if it is intended to have the same meaning as it does under Section 2042). Although annuities are taxed, in some cases, in the same manner as life insurance products are, Section 2042 applies only to proceeds of insurance with respect to the estate of the insured and not to an annuity contract (the estate taxation of which is governed by Section 2039).

a life policy owned by a trust has been specially developed.[11]

Special Treatment for Income Tax Purposes

Except to the extent the Code has a specific rule to the contrary (as it does for interests in certain retirement plans and accounts, grantor trusts and zero coupon bonds[12]) and except where the income has been actually received, the determination of when a taxpayer must report an item in gross income turns on the doctrine of "constructive receipt."

Treas. Reg. 1.451-2(a) sets forth the doctrine as follows:

> *"Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."*

In fact, the timing of taxation of the growth in cash value in or receipt of income by a policy of life insurance apparently is based upon the doctrine. In what may be viewed as a seminal case, *Cohen v. Commissioner,* 39 TC 1055 (1963), to which the Commissioner has acquiesced[13], the United States Tax Court stated, in part and in conclusion, "[W]e hold that the petitioner's right to receive the cash surrender value including periodic increments thereof was subject to such 'substantial restrictions' as to make inapplicable the doctrine of constructive receipt. Petitioner would have been required to surrender his entire investment in the policies in order to realize that income."

Hence, the investment (or cash value) component in the life policy would grow tax free and the receipt of that component at death as a death benefit was (and is) excludible as a general rule from gross income.[14]

Moreover, until the adoption in 1988 of Section 7702A (and amendments to Section 72) relating to modified endowment contracts ("MECs"), discussed below, the owner of the policy could make a partial surrender of a life policy or borrow from the policy's cash value without being treated as having received any gross income, even if the cash value exceeded the sum of premiums paid (investment in the contract).

Meaning of Life Insurance for Tax Purposes

Until the enactment of the Deficit Reduction Act of 1984 ("1984 Act"), the Code did not have a definition of life insurance although it had many specific rules dealing with tax matters relating to life insurance, such as the exclusion from gross income of the receipt of proceeds payable by reason of the death of the insured.[15] In order to obtain the benefits of income tax free growth in the cash (or investment) value of a policy and to receive that growth income tax free at death, all the contract had to be was life insurance under applicable law. As a consequence, many policies were sold to provide those tax benefits with minimal shifting of risk attributable to the death of the insured.

However, the 1984 Act added Section 7702(a) to the Code to provide a definition which a life policy had to meet so that the growth on or income earned on the investment or cash value component of the policy (such growth or income commonly called the "inside buildup") would not be subject to income tax when earned "inside" the policy. Under that definition, a contract is a life insurance policy so the growth or income on its cash value is not subject to income tax when earned only if it is a life insurance contract under applicable law[16] and it meets either (1) a certain cash (investment) value accumulation test or

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11 See, generally, Slade, "Personal Life Insurance Trusts," BNA Tax Mgt. Portfolio No. 807-2d.

12 Although a taxpayer may have, under traditional notions of constructive receipt, income in a retirement plan described in Section 401 of the Code or an individual retirement account (IRA) under Section 408 or 408A, the Code does not require the taxpayer to report such constructively received income into gross income as earned. See, generally, N. Choate, Life and Death Planning for Retirement Benefits (7th Ed.,Ataxplan). Subpart E of Part 1 of Subchapter J of Chapter 1 of the Code contains the grantor trust rules under which the income of a trust may be attributed directly to the trust's grantor (or another) without regard to the general constructive receipt of income doctrine. Section 1272 provides explicit rules for the taxation of original issue discount obligations (such a zero coupon bonds).

13 1964-1 CB 4.

14 See Section 101(a)(1).

15 There are exceptions such as under the so-called "transfer for value" rule under Section 101(a)(2), to which there are, in turn, exceptions, meaning the proceeds nonetheless may be excluded from gross income. See, generally, D. Zeydel, "The Transfer for Value Rule: Developments and Clarifications," 134 *Trusts & Estates 75* (April 1995).

16 It is apparent that "applicable law" is the applicable local law. Cf. Reg. 1.817-5(a)(1)(fourth sentence) ("If a variable contract which is a life insurance

(2) a guideline premium test and falls within a certain cash value corridor, all as set forth in Section 7702(a).

Consequence If the Contract Does Meet the Definition

Section 7702(g) specifies the tax consequences if the contract is a life insurance policy under applicable law but does not meet either the cash value accumulation or the guideline premium test under Section 7702(a).[17] Section 7702(g) provides that, in such a case, the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year. However, essentially, the amount of income is limited to the increase in the *net* (cash) surrender value[18] of the contract during the taxable year[19] plus the cost of pure life insurance protection (the net amount at risk) provided under the contract during the taxable year over the premiums paid under the contract during the taxable year. This seems to mean that the owner of the contract must include in gross income the increase in net surrender value and the cost of any term component essentially paid by the cash value component of the policy. Income taxation under Section 7702(g) does not turn on any borrowing or withdrawal—it is based solely on the annual increase in net surrender value (and the annual cost of the premiums paid by the policy's cash value), over premiums paid for the year, and does not seem to be based upon any notion of constructive receipt. [20]

> *"The amount of income is limited to the increase in the net (cash) surrender value of the contract during the taxable year plus the cost of pure life insurance protection (the net amount at risk) provided under the contract during the taxable year over the premiums paid under the contract during the taxable year."*

Section 7702(g) goes on to provide that, with respect to any contract, which is a life insurance contract under the applicable law but does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by reason of the death of the insured over the net surrender value of the contract is deemed to be paid under a life insurance contract for purposes of Section 101[21] (meaning, as a general rule, that the proceeds are not includible in gross income) and, essentially, will be treated as insurance for estate and gift tax purposes.[22]

Therefore, if a contract is a policy of life insurance under applicable law but does not meet the definition of a life insurance policy under Section 7702(a) but never had an increase in net surrender value[23], no growth in cash value (even if gross cash surrender value has increased) will be subject to income tax during the lifetime of the insured or at his or her death (although,

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or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance or endowment contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with section 7702 (g) and (h).")

17 Section 7702 does not specify the consequences if the contract is not life insurance under applicable law. Presumably, it will simply be treated as an investment account, the earnings on which would be taxed to its owner as earned.

18 For a variety of reasons, typically including the recoupment of the costs incurred by the insurer in issuing a policy (e.g., sales commissions), the policy owner may be restricted in amount of cash value that may be withdrawn from the policy upon surrender (cancellation) or borrowing. The amount of cash value that may be withdrawn at any time is called the "net" (cash) surrender value as opposed to simply the surrender value (sometimes called the "account value"). Typically, the percentage of cash value that may not be withdrawn diminishes over time and may vanish after a few years. Section 7702(f)(2)(B) provides, "The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan."

19 The Section uses the phrasing, "the increase in the net surrender value of the contract during the taxable year." According to one commentator, the gross income, at least with respect to a so-called "frozen cash value" policy, for the year is limited to the cost of insurance protection (as defined in Section 7702(g)(1)(D)) for the year plus "the lesser of: (1) the cash value, or (2) the sum of all premiums paid under the policy, computed without regard to any surrender charges and policy loans...." G. Nowotny, "Frozen Cash Value Life Insurance," 151 Trusts & Estates 33, 34 (July 2012).

20 For example, assume that the owner has paid $20,000 in premiums in the first year but no additional premium, that the policy failed to meet AT LEAST one of the two tests of Section 7702(a), that gross cash (or account) value in the first year is $18,000 and that the net surrender value that year is only $15,000. Assume the gross cash value increases to $19,000 in the second year and the net surrender value increases to $16,500. Literally, under Section 7702(g), the owner would have to include in gross income the $1,500 increase in net surrender value occurring in the second year (plus the cost of insurance for the year). Although G. Nowotny may suggest there would be no such inclusion because the cash value would be below total premiums paid, there does not seem currently to be any announcement by the IRS or other authority that directly supports such a conclusion. Nonetheless, if net surrender value were defined under the policy to be the lesser of premiums paid or lowest surrender value for any year during the life of the policy, then there would seem to be no income imputed for any increase in net surrender value pursuant to Section 7702(g).

21 Section 7702(g)(2).

22 Section 7702(g)(3).

23 Policies that never have the net cash surrender value exceed premiums paid are called "frozen cash value policies." See, generally, G. Nowotny.

to the extent the cash value is used annually to pay term premiums inside the policy it will be included in gross income for such year[24]).

Modified Endowment Contract Rules

Despite the enactment of a statutory definition of life insurance, life insurance policies that met the definition could produce significant income tax benefits by avoiding taxation of growth in the cash value component of a policy and permitting that income to be accessed, in certain ways, such as by a partial surrender or by borrowing, income tax free.

Those benefits are discussed in the legislative history ("TAMRA Conference Report"[25]) to the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") that states, in part, that "the undistributed investment income (sometimes called the 'inside buildup') earned on premiums credited under a contract that satisfied *a statutory definition of life insurance* is not subject to current taxation to the owner of the contract. *** Amounts received under a life insurance contract prior to the death of the insured generally are not includible in gross income to the extent that the amount received does not exceed the taxpayer's investment in the contract. *Amounts borrowed under a life insurance contract generally are not treated as received and, consequently, are not includible in gross income.*"[26] (Emphasis added.)

To curb some of these benefits for policies that met the definition of life insurance under Section 7702(a), TAMRA added a new rule for life insurance policies that the Act defined as "modified endowment contracts," under new Section 7702A, which is any contract that "satisfies *the present-law definition of a life insurance contract* but fails to satisfy a 7-pay test."[27] (Emphasis added.) Under that new law enacted as part of the Act, "amounts received under modified endowment contracts are treated first as income and then as recovered basis. In addition, loans under modified endowment contracts and loans secured by modified endowment contracts are treated as amounts received under the contract."[28]

Therefore, the increase in the investment component (the inside buildup) of a policy that meets the definition of a life insurance policy under Section 7702(a) (that is, one that is a life policy under applicable law and meets either (1) a certain cash value accumulation test or (2) a guideline premium test and falls within a certain cash value corridor) is not currently taxed but, if the premiums are withdrawn (such as by a partial surrender) or borrowing against the cash value occurs, the inside build up is taxed, to the extent of the surrender or borrowing, under Section 72 if the policy is a modified endowment contract (a "MEC").

Technically, this occurred by changes made to the Code by TAMRA Section 5012(c), which added Section 7702A which provides a definition of a modified endowment contract and made amendments to Section 72(e) to cause partial surrenders of a MEC or borrowing against the cash value of a MEC to be included in gross income. (Partial surrenders or borrowing against cash value of a policy that is not a MEC continue to be income tax free.)

More on the Definition and Treatment of a Modified Endowment Contract

Section 7702A, as indicated, contains the definition of a modified endowment contract as "any contract meeting the *requirements* of section 7702…which…fails to meet the 7-pay test of subsection (b)." (Emphasis added.) Quite apparently, this means a contract meeting the definition of a life insurance contract under Section 7702(a) that fails to meet the 7-pay test as suggested by the emphasized portions of the Conference Report quoted above. Although no regulation has been issued discussing the definition of modified endowment contracts, it seems quite certain, for the reasons set forth immediately below, that it includes only contracts that meet the definition of a life policy under Section 7702(a) and not one dealt with under Section 7702(g), which would be one that does not meet that definition.

First, as noted, the TAMRA Conference Report certainly must be referring only to insurance policies defined in Section 7702(a) by referring to "the present-law definition of a life insurance contract." Indeed, there is no other definition of a life insurance contract in the Code other than in Section 7702(a).

24 Section 7702(g)(1)(B)(i)(II).

25 H.R. 4333.

26 H.R. 4333 at p. 96.

27 Id. at p. 97.

28 Id.

Second, Section 7702A refers only to a contract that meets the "requirements" of Section 7702 and only Section 7702(a) has requirements. Section 7702(g) does not contain requirements. It deals with the "Treatment of [a contract] which…[is a] life insurance contract under the applicable law [but] does not meet the definition of life insurance contract under subsection (a)." Hence, all that Section 7702(g) does is provide the income tax treatment of a contract that does not meet the tax definition of life insurance under Section 7702(a); Section 7702(g) provides no "requirements" at all.

Third, as described above, Section 7702(g) eliminates the income tax free buildup in investment value and provides that such buildup is taxed to the policy owner each year but it limits the amount of gross income to the annual increase in the *net* surrender value (and the cost of term insurance essentially paid by the cash value). Because the owner of a policy that does not meet the Section 7702(a) definition is taxed currently on increases to the net surrender value and cannot withdraw or borrow the account value to the extent it exceeds the net surrender value, there would seem to be no need to have a contract that does not meet the definition of life insurance under Section 7702(a) fall under the tax treatment of modified endowment contracts under Section 7702A and Section 72. Section 72 essentially provides that any withdrawal of premium or borrowing of cash value from a MEC is first treated as income earned on the cash value before being treated as a tax free return of premium (investment).

The definition of a modified endowment contract, as stated, is under Section 7702A and its taxation is governed by Section 72(e). TAMRA added the definition of a MEC and provided for partial surrenders and borrowings against the cash value of a MEC to be included in gross income. Prior to the TAMRA changes, Section 72(e) essentially provided that partial surrenders and borrowings against the cash value of a life policy were not included in gross income. However, under TAMRA, beginning in 1988, such surrenders and borrowing are included in gross income if the policy is a MEC. The reason is that Section 72 provides rules with respect to amounts received as an annuity under an annuity or life insurance contract and to amounts not received as an annuity.[29] Section 72(e)(2)(B) essentially provides that any amount received before the annuity starting date of the contract is included in gross income to the extent it is deemed to consist of income earned in the contract but not to the extent it exceeds the investment in the contract—and the amount received before the annuity starting date is deemed to consist of the income earned through that time. Section 72(e)(3) essentially provides that this profit is the amount by which the cash value (*determined without regard to any surrender charge*) exceeds the investment in the contract (essentially premiums paid). Section 72(e)(4)(A) basically provides that amounts received as a loan under a policy fall under the income inclusion rule of Section 72(e)(2)(B). So, up to this point, there is an indication that any amount received under any policy to the extent of gross cash value over premiums paid is included in gross income.

However, Section 72(e)(5)(A) and (C) basically together provide that Section 72(e)(2)(B) and Section 72(e)(4)(A), which in essence cause partial surrenders and borrowings (up to gross cash value above premiums paid) to be included in gross income, do *not* apply to non-annuity payments under a life policy with the exception, added by TAMRA, for modified endowment contracts. In other words, these rather complexly weaved provisions of Section 72 provide that partial surrenders or borrowings from a life insurance policy are included in gross income only if the policy is a MEC.

Comparison of Taxation under Section 7702(g) and Taxation of MECs

It will be noted that the treatment of a modified endowment contract generally is more beneficial under Sections 7702A and 72 than the treatment prescribed for policies the taxation of which is governed by Section 7702(g): the owner can avoid any taxation of the inside buildup for a modified endowment contract merely by not surrendering or borrowing; but the taxation of the inside buildup of a policy that is not described in Section 7702(a) and, therefore, whose treatment is prescribed by Section 7702(g), cannot be avoided, except that it is limited to "the increase in the *net* surrender value of the contract during the taxable year, and the cost of life insurance protection provided under the contract during the taxable year" over premiums paid that year. (Emphasis added.) Hence, it seems there would be no reason for the definition of a modified endowment contract to include one that is not described in Section 7702(a).[30] This is borne out by the words of Section 7702A and the legislative history of the TAMRA by which that section was added to the Code.

However, there may be one circumstance in which a policy not meeting the definition of life insurance under Section 7702(a)

29 Section 72(e)(1).

30 In other words, with a policy whose taxation is governed by Section 7702(g), the owner is taxed on accessible increases in cash value even if there is no surrender or borrowing.

may fare better than a modified endowment contract. That is the case where the amount borrowed from a MEC is included in gross income is greater than the total increases in net surrender value of a policy the income taxation of which is determined under Section 7702(g) whether borrowing from the latter policy occurs or not (which borrowing, of course, could never exceed net surrender value). As mentioned above, a modified endowment contract is taxed under Section 72.[31] Section 72(e)(2)(B) provides, in effect, that distributions under the contract shall be included in gross income to the extent allocable to income on the contract, and shall not be included in gross income to the extent allocable to the investment in the contract. Section 72(e)(2)(C) provides that the amount allocable to income is limited to the "cash value of the contract (*determined without regard to any surrender charge*) immediately before the amount is received, over … the investment in the contract at such time." (Emphasis added.) Hence, an increase in cash value of a modified endowment contract will be included in gross income (to the extent of a withdrawal or borrowing) even to the extent there is a cash surrender charge (by which cash surrender value is reduced to net surrender value).[32] For a policy not described in Section 7702(a), the inside buildup is taxed (annually without regard to any surrender or withdrawal) only to the extent there is no surrender charge. See, in particular, Section 72(e)(5) which retains prior law treatment of distributions (presumably, including borrowings) that are not annuity payments from a policy except for modified endowment contracts.

It seems relatively certain that borrowing against a policy that is not described in Section 7702(a) (that is, one that is not a modified endowment contract) does not result in income tax inclusion although any increase in net surrender value each year would.

A Little More on Surrender Value

As noted above, Section 7702(g) expressly provides that, if the policy does not fall under the definition under Section 7702(a), the annual increase in the *net surrender* value is included in the owner's gross income. It seems reasonably certain that net surrender value is the gross cash surrender value reduced by what would be the actual surrender charges imposed upon the surrender of the policy. However, as noted, Section 72(e)(2)(C) provides that the amount allocable to income is limited to the "cash value of the contract (*determined without regard to any surrender charge*) immediately before the amount is received, over … the investment in the contract at such time." (Emphasis added.)

These two provisions are not inconsistent. They simply fall under different rules. The latter (Section 72(e)(2)(C)) deals only with a modified endowment contract, which as explained is one that meets the definition of a life insurance policy under Section 7702(a) and does not comply with the so-called seven pay test set forth in Section 7702A. Hence, any owner of a modified endowment contract who borrows cash from the policy or does a partial surrender of the policy for cash must include the cash in gross income to the extent of gross cash value (but only to the extent it exceeds premiums paid). In contrast, Section 7702(g), dealing with policies that do not meet the definition of a life insurance policy under Section 7702(a), limits the amount the owner must include in gross income to annual increases in value—and this increase must be included in gross income even if not withdrawn or borrowed. As recited in the TAMRA Conference Report, borrowing against the cash value of a policy does not result in gross income (except for a modified endowment contract which by its definition cannot include a policy the income taxation of which is governed by Section 7702(g)).

Section 817 and Section 7702(a)

As mentioned above, there are specific Code provisions that provide for the taxation of life insurance companies.[33] Section 817 provides a special rule in determining that tax relating to variable contracts. Section 817(h) provides that, in order to be considered a variable contract for purposes of Subchapter L, which, as stated above, governs the taxation of insurance companies, as well as for purposes of Section 7702(a), so the contract is a life insurance policy, the investment component of the contract, among other things, must at least be adequately diversified as provided in Section 817(h) and the regulations

31 See Section 72(e)(10) which provides that Sections 72(e)(2)(B) and 72(e)(4)(A) apply to a modified endowment contract.

32 For example, assume, at the time of borrowing $30,000 from the cash value of a MEC, the premiums paid are $100,000, gross cash value is $125,000 but surrender charges are $15,000, making the net cash surrender value $110,000. The owner/borrower would have to include $25,000 in gross income (the amount by which the gross cash value of $125,000 exceeds premiums paid even though the owner can access only $10,000 of the $25,000 increase in gross cash value); the $5,000 balance of the borrower would not be included in gross income but would be treated as a return of investment.

33 See Section 801 et. seq.

promulgated thereunder.[34] Hence, if the contract is not adequately diversified, then it seems that it is not treated as a life insurance policy for purposes of Section 7702(a) apparently even if it otherwise meets the definition of life insurance (because it is insurance under applicable (local) law and meets either the cash value accumulation or the guideline premium test). And the regulations indicate the tax treatment of a variable contract the investments in which are not adequately diversified is the same as a contract that does not meet at least one of the two tests under Section 7702(a) or, in other words, the annual increase in the *net surrender* value must be currently included in the gross income of the owner of the contract. Indeed, the regulations provide, in part:

"[F]or purposes of…section 7702(a), a variable contract…shall not be treated as…[a] life insurance contract…for which the investments of any such account are not adequately diversified.***If a variable contract which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance… contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with section 7702 (g) and (h)."[35]

Hence, just as current income taxation of the investment (cash value) component of a life insurance contract that fails to meet AT LEAST one of the two actuarial tests under Section 7702(a) occurs to the extent of the annual increase in the net surrender value so too is the income taxation of the investment component of a variable contract that fails to meet the diversification requirements of Section 817(h)—that is, only to the extent of the annual increase in the net surrender value (plus cost of insurance for the year).

No Income from Borrowing from Non-Section 7702(a) Policies

As discussed above, until 1988, borrowing from the cash value (investment) account of any life policy did not result in the owner having any gross income even if the cash value account exceeded premiums paid at the time of the borrowing. TAMRA made changes causing the owner of a MEC to include any borrowing from the cash value account in gross income to the extent the value (without regard to any surrender value) of the account exceeds premiums paid. And, as explained, an owner who borrows against the investment (cash) value of a contract that fails to meet AT LEAST one of the two actuarial tests of Section 7702(a) does not have to include any portion of the borrowing in gross income because any increase in net (cash) surrender value is annually taxed to the owner even if not borrowed or otherwise withdrawn. The same seems true for a policy that fails to meet the diversification requirements of Section 817(h) and, in that sense, is preferable to a Section 7702(a) "compliant" contract that is a MEC.

Nonetheless, to avoid having to include increases in cash value in a contract that is not Section 7702(a) compliant and a contract that fails to meet the Section 817(h) diversification requirements, the net surrender value cannot exceed premiums paid. That means the owner of such contracts can borrow or make a partial surrender of the policy only up to the amount of premiums paid but no more—the owner (or the owner's beneficiary) can receive more only upon the death of the insured. Hence, the owner is "locked" into the contract until it matures (by the death of the insured or the insureds). Therefore, a taxpayer should acquire such a frozen cash value only if the owner is certain that there will be no need to access from the policy more than the premiums paid.

Investor Control Doctrine

As mentioned earlier in this article, despite the fact the a taxpayer must report, as a general rule, only income actually or constructively received unless there is a statutory provision requiring inclusion without constructive receipt, the IRS has attempted to engraft an additional doctrine that could cause the owner of a variable life policy to include in gross income earnings "inside" the policy and without any statutory provision such as for MECs and for contracts that do not meet the definition of life insurance under Section 7702(a). And it seems to have tried to develop this "theory" despite the fact that the Commissioner has acquiesced, as noted above, in *Cohen* in which the Tax Court ruled there was no such constructive receipt with respect to earnings in the life insurance policy saying, as quoted above, "the petitioner's right to receive the cash surrender value including periodic increments thereof was subject to such 'substantial restrictions' *as to make inapplicable the doctrine of constructive receipt*. Petitioner would have been required to surrender his entire investment in the policies in order to realize that

34 Reg. 1.817-5(b).

35 Reg. 1.817-5(a). Section 7702(h) deals with certain endowment contracts.

income." (Emphasis added.) The IRS calls this new theory of income taxation of life insurance policies (AND annuity contracts) the "investor control" doctrine.

> *"Even indirect communication with the insurance company or its advisor with respect to investments inside the policy by its owner alone could trigger the doctrine, causing the owner to be taxed on income earned inside the policy."*

The Service began its quest to establish that doctrine in Rev. Rul. 77-85.[36] It has continued to issue several additional revenue and private letter rulings dealing with the doctrine.[37] It was not until 2003, by the issuance of Rev. Rul. 2003-91[38] and Rev. Rul. 2003-93,[39]that the Service, without explanation or proffered rationale, attempted to extend this alleged doctrine from variable annuity contracts to variable life insurance policies.[40] In any event, the IRS has not established the parameters of the doctrine[41], although it has indicated that having a variable contract offer investments through a so-called "insurance dedicated fund" or ("IDF")[42]will not implicate the investor control issues provided, among other things, "no Private Placement Variable Annuity (PPVA) or Private Placement Variable Universal Life (PPVUL) Investment Account owner can directly or indirectly influence the IDF manager with respect to the selection of funds or securities to fulfill the IDF's investment mandate."[43] Nonetheless, it may have suggested that even indirect communication with the insurance company or its advisor with respect to investments inside the policy by its owner alone could trigger the doctrine, causing the owner to be taxed on income earned inside the policy.[44]

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36 1977-1 CB 12.

37 See, e.g., Rev. Rul. 80-274, 1980-2 CB 27; Rev. Rul. 81-225, 1985-2 CB 12; Rev. Rul. 82-54, 1982-1 CB 11; PLR 201417007 (not precedent); PLR 201323002 (not precedent).

38 2003-2 CB 347.

39 2003-2 CB 350.

40 The Service seems consistently to look at the owner (often referred to as the "Holder") of the policy suggesting, perhaps, that if someone, other than the policy owner, holds sufficient control over investments that the doctrine which would apply if the control were held by owner, does not apply to such other person. In other words, if someone other than the owner holds investment control (e.g., the spouse of the owner or a trust that does not cause the owner to be treated as its income tax owner under Section 671), the doctrine, at least as the IRS has apparently attempted to apply it, would not apply. See, e.g., Rev. Rul. 2003-91, 2003- 2 CB 347. "There is no arrangement, plan, contract, or agreement between *Holder* and [Insurance Company] or between *Holder* and [Investment] Advisor regarding the availability of a particular Sub-account, the investment strategy of any Sub-account, or the assets to be held by a particular sub-account." (Emphasis added.) See also Chief Counsel Advice 200840043 (not precedent). There is apparently no constructive ownership rule under the doctrine, even assuming the doctrine exists. Cf. *Minahan v. Commissioner*, 88 TC 472 (1987), in which the Tax Court imposed sanctions against the IRS for continuing to attempt to apply a constructive ownership or aggregation rule for certain wealth transfer valuation purposes where no statutory constructive ownership rule existed and stated, in part, "It has been noted that the Congress has explicitly directed that family attribution or unity of ownership principles be applied in certain aspects of Federal taxation, and in the absence of legislative directives, judicial forums should not extend such principles beyond those areas specifically designated by Congress. Furthermore, the subjective inquiry into feelings, attitudes, and anticipated behavior might well be boundless." (Citation omitted.)

41 For example, under the doctrine, if the investments in the annuity contract are available to the general public, the owner will be taxed on the income. See, e.g., Rev. Rul. 82-54. And, it is at least arguable, that the IRS in attempting to perpetuate the doctrine, has ignored treasury regulations promulgated under Section 817(h). See, e.g., PLR 200244001[10002] (not precedent)

42 An insurance dedicated fund has been defined as being "similar in many ways to [a] private investment fund. It may be established directly by either an insurer, a mutual or hedge fund or by a qualified high-net worth investor. Its defining characteristic is that it is only available for use in a tax-compliant, private placement…Annuity or Private Placement Life Insurance policy." http://www.swiss-annuity.com/php/what_we_do/international_investment_strategies/what_we_do_international_insurance.php.

43 M. Liebeskind, "IRS Clarifies the Structuring of Insurance-Dedicated Funds," (June 16, 2014), discussing PLR 201417007 (not precedent) at http://wealthmanagement.com/insurance/irs-clarifies-structuring-insurance-dedicated-funds.

44 "Moreover, Holder cannot communicate directly or indirectly with any investment officer of [Insurance Company] or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account." Rev. Rul. 2003-91, 2003-2 CB 347. Although it seems extraordinary that merely having communications with the insurer or its advisor about investment but without any legally enforceable right to control investments in any way could result in income earned on the investment being attributed to the owner/communicator, the IRS from time to time has indicated that adverse tax results will occur even if the taxpayer merely holds an expectation of investment activity. See, e.g., PLR 7737071 (not precedent), although arising in another context of whether gain recognized on appreciated assets contributed to a charitable remainder trust, described in Section 664, should be included in the gross income of the trust's grantor. But it does not seem the IRS has taken such an extreme position in court. Cf. *Palmer v. Commissioner,* 62 TC 684, aff'd on another issue, 523 F. 2d 1308 (8th Cir. 1975), to which the IRS acquiesced in 1978-1 CB 2, where the court held that gain recognized by the liquidation of a corporation with respect to shares given to charity before the liquidation plan was adopted would not be attributed back to the donor, saying, in part, "Although we recognize that the vote [to liquidate] was anticipated,…that expectation

The only authority upon which the IRS has relied in its revenue rulings is *Christoffersen v. United States*.[45] However, reliance on *Christoffersen,* as approving the doctrine or establishing it, may be misplaced. First, that case involves an "annuity" contract, not life insurance. These are, of course, substantially different financial products[46] and by and large are treated in quite different ways for tax purposes. As explained earlier, Sections 7702(a) and 7702A apply only to life policies, not annuities. [47] As indicated above, the legislative history to those sections is filled with references exclusively to life insurance contracts, not both life insurance and annuity products.[48]

Second, as the United States Court of Appeals in *Christoffersen* points out, the taxpayers did not even claim the product had been "annuitized"—that is, had actually become an annuity contract.[49] The court does go on to discuss that, under the arrangement in place during the tax years in question, the taxpayers "surrendered few of the rights of ownership or control over the assets of the sub-account" and that "the possibility that the assets [would] be converted into an annuity in 2021 [did] not significantly impair the Christoffersens' ownership since all, or any portion, of the assets [could] be withdrawn before that time."[50] Perhaps, most important, in contrast to adopting any new doctrine of "investor control," the court found, citing to Treas. Reg. § 1.451-2(a), quoted above and that sets forth the constructive receipt doctrine, that "[u]nder the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the plaintiffs in the year earned, not at some later time when the Christoffersens choose to receive it. This is the essence of Rev. Rul. 81-225, which we find persuasive."[51]

The arrangement in *Christoffersen* seems entirely different than the life policy dealt with in *Cohen:* a policy of life insurance involves substantial shifting of risk at death that an annuity contract may not or at least does not in the same way a life policy does. And, as the Tax Court indicated in *Cohen*, this risk shifting would be forfeited by surrendering the policy and obtaining the underlying assets in the cash value account. This would seem to fall clearly under that part of Treas. Reg. 1.451-2(a), the constructive receipt of income regulation, which provides, in part, that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." And the restriction appears to be there regardless of the underlying investments in the policy or the identity of the person who controls the investments.

Perhaps, therefore, in light of the Service's acquiescence in *Cohen,* the only viable hope for the IRS of some sort of judicial acceptance of an investor control doctrine with respect to variable life policies, other than constructive receipt, would be on the principles of income taxation enunciated in *Helvering v. Clifford*[52], regarded by some as the seminal case of charging the grantor with a trust's income prior to the adoption of the so-called *Clifford* regulations. Indeed, the IRS in *Christoffersen* rolled out such an argument, in addition to constructive receipt, to the Court of Appeals. [53] The court, in comparing the Christoffersens' interests in the "annuity" contract to those of the grantor in the trust in *Clifford*, stated, "Upon examination of the Contract as a whole, we must conclude that the Christoffersens, and not [the annuity company], own the assets of the sub-account." But later in its opinion, the court stated, "Under the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the plaintiffs in the year earned, not at some later time when the Christoffersens choose to receive it. *This is the essence of Rev. Rul. 81-225*, which we find persuasive." (footnote omitted; emphasis added.)

Consequently, it seems that it is uncertain how the court in *Christoffersen* reached its conclusion. It does not seem that *Clifford*

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was not enough." 62 TC at 693. But cf. *Ferguson v. Commissioner,* 174 F.3d 997 (9th Cir. 1999).

45 749 F.2d 513 (8th Cir. 1984), rehearing and rehearing en banc denied (1985).

46 Unlike an annuity product, a life insurance policy involves a significant risk shifting from the "owner" and the beneficiaries who will succeed to the death benefit, on the one side, to the insurance company, on the other. See *Helvering v Le Gierse,* 312 US 531 (1941).

47 Although Section 72 deals with certain income taxation aspects of both annuity and life insurance contracts, the taxation is not the same. See, e.g., Section 72(e)(5)(C), which states, "Except as provided in paragraph (10) [relating to MECs] and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.")

48 See, e.g., H.R. 4333 at pp. 96-97.

49 The Court of Appeals framed the issue on appeal as "whether the…Contract, purchased by the taxpayers…, is an annuity…and qualified to deferred tax treatment…" and stated, in part, "The Christoffersens do not argue that the monies received by the Trust are funds received under an annuity. The annuity does not start until the year 2021 and then only if taxpayer elects to exercise his contract at that time" and concluded that "[b]ecause the dividends were not received under an annuity, [the deferral of taxation allowed for annuity contracts under] Section 72(e) is not applicable [and] [t]he dividends must be included in gross income…." 749 F.2d at 516.

50 Id. at 515, 516.

51 Id. at 516.

52 309 US 331 (1940).

53 See Brief of Appellant, *Christoffersen v. United States*, 84-1420-NI (8th Cir.) (filed June 6, 1984), at I, 4-5, 7-17 for the government's other theories raised with the court.

is based upon the constructive receipt doctrine.[54] The Supreme Court does not mention it in its opinion. It was observed long ago, in discussing *Clifford* and *Douglas v. Willcuts,*[55] the latter case holding the grantor of a trust he created in connection with his divorce was to substitute for his alimony obligations and therefore the trust's income was taxable to him:

> The cases stemming from the [*Douglas v.*] *Willcuts* case emphasize the settlor's support obligation, whereas one of the greatest avenues of expansion of the *Clifford* doctrine has developed on the settlor's control. Nonetheless, *these two approaches are so intertwined in the constructive receipt concept as to be almost inextricable*. Often it is hard to tell just what the basis of the commissioner's argument is....[56] (emphasis added.)

So, although it is not certain, it may be that there are two doctrines that could possibly be applied: constructive receipt under Treas. Reg. 1.451-2(a) and deemed ownership of the assets under the *Clifford* principles. And, if either applies, the taxpayer will have to include the earnings in gross income. *Cohen* seemed to foreclose taxation under the constructive receipt doctrine with respect to a life insurance policy.[57] If *Clifford* represents a doctrine separate from and in addition to constructive receipt, deciding whether the owner of a life policy is taxed on its earnings seems more complicated and, in many situations, uncertain.

As pointed out by many commentators, as well as the Treasury, *Clifford* turned on whether the taxpayer held a sufficient number of the "bundle of rights"[58] of property ownership (and benefit) meaning its application had to be determined on a case by case basis. "Recognizing that the application of this principle 'to varying and diversified factual situations' has led to considerable uncertainty, the Treasury has now set down specific norms by which in its judgment the doctrine is to be applied,"[59] by the promulgation of the *Clifford* regulations under Section 22 of the Internal Revenue Code of 1939 (which were adopted with virtually no change as the "grantor trust" rules under Subpart E of Part 1 of Subchapter J of Chapter 1 of the Internal Revenue Code of 1954).

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54 The doctrine of constructive receipt goes back to at least 1918. See Article 53 of Regulations 45 under the Revenue Act of 1918. So the Court must have been aware of it. However, the decision of the Court of Appeals in *Christoffersen* may read as concluding that *Clifford* is based upon the doctrine of constructive receipt.

55 296 US 1 (1935).

56 Note, "The Federal Estate Tax and Discretionary Powers to Invade Trust Corpus or Accumulate Income," 97 U. of Penn Law R. 221 (1948), n. 82. See, also, A. Guterman, "The Federal Income Tax and Trusts for Support—The Stuart Case and Its Aftermath," 57 Harv. L. Rev. 479, 487 (1944), where, in discussing income taxation of trust income to the settlor on account of an obligation of support, the author states, in part, "It is not impossible that some general doctrine compounded of the *Douglas* and *Clifford* cases may be adduced to hurdle this difficulty. But it would certainly require a straining of the present doctrine of constructive receipt based on Section 22(a) [(the section of the Internal Revenue Code of 1939 that defines gross income)] to impose a tax on a grantor by reason of the possibility of use of unrestricted income by the dependent to discharge the grantor's legal obligations without the benefit of the specific terms of a statutory provision such as Section 167 [of the Internal Revenue Code of 1939 and which section is the predecessor to Section 677 of the Internal Revenue Codes of 1954 and 1986]."

57 As long as the contract is a life insurance policy under local law, it is treated as such for all tax purposes ("If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title"—Section 7702(g)(3)), except for the income tax treatment specified in the Code such as (1) under Section 7702(g)(1)(A) ("If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year"), (2) under Section 72(e) for MECs, and (3) under Section 7702(g)(1)(A) for policies that do not meet the diversification requirements of Section 817(h). The Code does not provide it will not be treated as a life policy in any circumstance where it is one under applicable (local) law. The specific treatment and definition of life insurance (which appears to be determined exclusively by applicable law) under the Code seems to foreclose a finding that the owner of the policy "owns" assets within the contract. Although the Court of Appeals in *Christoffersen* may have found them to be owned by the contract owners, the contract was not a policy of life insurance which, as stated, is determined (except for the prescribed special income tax treatment) by applicable (local) law. The Court of Appeals found the contract not even to be an annuity contract. It does not seem it could have found a contract not to be a policy of life insurance if it was one under local law. Nonetheless, the IRS might argue that, although the contract is a policy of insurance and entitled to the tax treatment specified in the Code, its assets are "owned" for income tax purposes by the policy owner, although that would seem inconsistent with the specific treatment under the Code for such contracts.

58 "A 'bundle of sticks'-- in which each stick represents an individual right - is a common analogy made for the bundle of rights."http://en.wikipedia.org/wiki/Bundle_of_rights. See *Frank Lyons Company v. US*, 536 F.2d 746, mod'd on denial of reh. and reh. denied (1976), rev'd, 435 US 565 (1978) ("We examine the issue of ownership by examining the respective rights held by the parties. In the common law sense, property rights can be analogized to a bundle of sticks. Each stick represents an interest in the underlying res which is the object of property")

59 J. Lynch, "The Treasury Interprets the Clifford Case," 15 Fordham L. Rev. 161, 161 (Nov. 1946). See, also, M. Ascher, "The Grantor Trust Rules Should Be Repealed," 96 Iowa L. Rev. 885 (2011) ("fine-grained legal analysis…[*Clifford*] most certainly was not. *** Predictably, the floodgates of litigation opened wide." (footnote omitted.)) To avoid further disputes on whether a grantor (or another) could be taxed on the income earned by a trust, Section 671 states, in part, "No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart."

In *Clifford*, the taxpayer held many rights[60] and the court certainly did not indicate that investment control alone would be sufficient.[61] "Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue."[62]

It is at least arguable that Congress was sufficiently concerned about the vagaries of the alleged investor control doctrine that it adopted Section 817(h) to provide a definite set of rules about it. "Because [Section] 817(h) and the associated regulations were enacted after the investor control authorities, and because they address some of the same issues as those authorities, many in the insurance industry concluded that [Section] 817(h) superseded the investor control doctrine."[63]

At least part of the legislative history to the enactment of Section 817(h) supports that conclusion. "The [Deficit Reduction Act of 1984] adopts a provision that grants the Secretary of the Treasury regulatory authority to prescribe diversification standards***In authorizing the Treasury to prescribe diversification standards, the Congress intended that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment will be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (e.g., stocks, bonds, or certificates of deposit of a single issuers); (2) that invest in one or a relatively small number of publicly available mutual funds; (3) that invest in one or a relatively small number of specific properties (whether real or personal); or (4) that invest in a nondiversified pool of mortgage-type investments.***If the segregated account does not meet the prescribed diversification standards, then a variable contract based on the account will not be treated as an annuity, endowment, or life insurance contract for purposes of subchapter L (relating to taxation of insurance companies), section 72 and section 7702(a) (relating to the definition of a life insurance contract)."[64]

Although certain regulations, as noted above, have been promulgated by the Treasury under Section 817(h), none appears to deal with the four areas quoted above specifically or "investments which are made, in effect, at the direction of the investor."[65] This seems to have been acknowledged by the IRS. For example, in Rev. Rul. 2003-91, the Service stated:

> *Approximately two years after enactment of § 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of § 817(d). The preamble to the regulations stated as follows:*
>
> *The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the defini-*

60 "The settlor had created an irrevocable trust for a five-year term for the benefit of his wife and had retained for himself a reversionary interest in the entire trust corpus. As trustee, he had also retained a number of other controls over the trust property, the most significant of which seems to have been the power to determine how much, if any, of the trust income his wife would actually receive in any given year.***As trustee, the settlor had 'full power' to vote the stock held in trust; to 'sell, exchange, mortgage, or pledge' any of the trust assets on 'such terms and for such consideration' as he in his 'absolute discretion [deemed] fitting'; to invest the trust assets 'without restriction'; to collect the trust income; to compromise any claims held in trust; and to hold the trust property in his own or, an assessment of the settlor's powers, a provision that supplemented the applicable principal and income rules, an exculpatory clause, and a provision that conferred spendthrift protections on the wife's income interest. [*Helvering v. Clifford*, 309 US] at 333." M. Ascher, *supra*, at 890. (footnotes omitted.)

61 Although arising in the context of potential inclusion of trust property in a settlor's gross estate, the Supreme Court in *United States v. Byrum*, 408 US 125 (1972), seems to conclude that mere management and control over investment in a trust are insufficient to cause the property to be included in the settlor's gross estate and appears to cite with approval, *Estate of King v. Commissioner*, 37 T C 973 (1962), which, according to the Supreme Court, held that where, "a settlor reserved the power to direct the trustee in the management and investment of trust assets," there is no estate tax inclusion. 408 US at 133.

62 *Helvering v. Clifford*, 309 US at 336.

63 Giordani & Chesner, "Private Placement Life Insurance and Annuities," 870 T.M., at A-20.

64 General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R., 4170, 98th Congress; Public Law 98-369), prepared by the Staff of the Joint Committee on Taxation (December 31, 1984) ("General Explanation"), pp. 607-609.

65 This reinforces the notion that, as mentioned in note 5, if someone other than the owner chooses the investments (e.g., the spouse of the policy owner) then a regulatory investor control rule should not apply.

tion of variable contracts.

T.D. 8101, 1986-2 C.B. 97 [51 FR 32633] (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. *See* LR-295-84, 1986-2 C.B. 801 [51 FR 32664] (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

As foreshadowed in T.D. 8101 (quoted immediately above), the IRS has issued revenue rulings[66], but no regulations (proposed, temporary or final), dealing with investor control. However, unlike regulations, revenue rulings are not entitled to a high level of deference by the Federal courts.[67] Essentially, revenue rulings seem to merely state the official position of the Service and are not binding upon taxpayers or courts as regulations may be.

In any event, it seems appropriate to mention that Section 817(h) and the definition of life insurance under Section 7702(a) were both enacted as part of the Deficit Reduction Act of 1984. And the legislative history seems to make clear that the failure of a contract that is life insurance under applicable state law but fails to meet at least one of the two tests of Section 7702(a) or any diversification standard promulgated by regulation under Section 817(h) would mean the treatment of the contract would be as prescribed under Section 7702(g) which limits the current taxation of gain or income experienced inside the policy to annual increases in net surrender value only.[68]This would seem to mean that the policy's owner who has investor control would be taxed pursuant to Section 7702(g), which is the result of "flunking" the diversification requirements of Section 817(h), if the investor control doctrine is embodied somehow within the latter section.

But the IRS has indicated, at least in private letter rulings, that the investor control doctrine falls under the uncertain principles of *Clifford,* not Section 817(h).[69] Although the Supreme Court in *Clifford* did mention that the taxpayer, to whom the trust income was attributed, held investment control over the assets, this "right" was only one of the several he held. Hence, it seems unlikely that the court would find under an application of *Clifford* to variable life insurance policies that controlling, much less merely communications about, investments would be sufficient to cause the income earned inside the policy to be attributed to the policy owner.[70]

In fact, it seems relatively certain that investor control over assets alone cannot under the *Clifford* principles cause the income from those assets to be taxed to the taxpayer holding that control even if the taxpayer paid the premiums on the life policy in which those assets are held. Less than two months after deciding *Clifford,* the Supreme Court decided *Helvering v. Fuller*.[71] In that case, the taxpayer (Mr. Fuller of the famous Fuller Brush Company) created a trust, in connection with his divorce, for his

66 See, e.g., Rev. Rul. 2003-91; Rev. Rul. 2003-92.

67 "'Deference to Revenue Rulings' 'A "Revenue Ruling" is an official interpretation by the Service that has been published in the Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned." Statement of Procedural Rules. 'We are not bound by revenue rulings, and, applying the standard enunciated by the Supreme Court in *Skidmore v. *209 Swift & Co.,* 323 U.S. 134, 140, 65 S.Ct. 161, 89 L.Ed. 124 (1944), the weight (if any) that we afford them depends upon their persuasiveness and the consistency of the Commissioner's position over time. See *PSB Holdings, Inc. v. Commissioner*, 129 T.C. 131, 142, 2007 WL 3225191 (2007)("[W]e evaluate the revenue ruling under the less deferential standard enunciated in *Skidmore v. Swift & Co.*, 323 U.S. 134, 65 S.Ct. 161, 89 L.Ed. 124 (1944)").[16] The Statement of Procedural Rules acknowledges the meaningful distinction to be drawn between regulations and revenue rulings. See sec. 601.601(d)(2)(v)(d), statement of procedural rules ("revenue rulings published in the Bulletin do not have the force and effect of Treasury Department Regulations (including Treasury *210 decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose.").'" *Taproot Admin. Servs. v Commissioner*, 133 TC 202 (2014), aff'd, 679 F 3d. 1109 (9th Cir. 2012).

68 Any regulation that deals with these matters should be prospective only. "The Congress anticipated that any regulations prescribing diversification standards changing current practice will have a prospective effective date." General Explanation, p. 607.

69 Citing to *Clifford,* the IRS has stated, "In its revenue rulings, the Service takes the position that, if the holders of a variable life insurance policy or variable annuity contract possess sufficient incidents of ownership over the assets supporting the policy or contract, they are considered the owners of the underlying assets for federal income tax purposes. Although the rulings apply only to variable insurance products, they cite and adopt the language of the general tax ownership cases and conclude that contract holders who possess control over the investment of the separate account assets (*in addition to the other benefits and burdens of contract ownership*) are the owners of separate account assets for federal income tax purposes even if the insurance company retains possession of, and legal title to, those assets." (footnotes omitted; emphasis added.) PLR 201417007 (not precedent).

70 Although private letter rulings ("PLRs") may not, under Section 6110(k)(3), be cited or used as precedent, the IRS has indicated that there must be sufficient "incidents of ownership" to cause the owner to be taxed on income earned inside a variable insurance or annuity contract. ("the Service takes the position that, if the holders of a variable life insurance policy or variable annuity contract possess sufficient incidents of ownership over the assets supporting the policy or contract, they are considered the owners of the underlying assets for federal income tax purposes.") PLR 201417007 (not precedent). But the Service has not, as mentioned in the text, ever spelled out the parameters of such a test.

71 310 US 69 (1940).

wife. According to the dissent (by Justice Reed) "the settlement agreement shows that the husband retained voting power over the stock placed in trust. 60,380 shares of Class A Common Stock of the Fuller Brush Company, the only class of voting stock, was placed in the trust. An equal amount was retained by the taxpayer. The aggregate was a majority of the total of voting stock outstanding."[72] Yet it is certain that the Court, in holding the husband was not taxable on the dividends received by the trust, rejected both the application of the *Clifford* principles and the constructive receipt doctrine. In fact, although the Court was aware Mr. Fuller had the voting power, it stated, in part, "If the debtor retained no right or interest in and to the property, he would cease to be the owner for purposes of the federal revenue acts. See Helvering v. Clifford, 309 U.S. 331…"[73] Hence, this voting power alone was not sufficient to cause the taxpayer to be taxed on the trust's income. It seems, therefore, that control over investments alone is not sufficient to cause taxation either under the *Clifford* principles or constructive receipt. In fact, the IRS seems to have acknowledged that at least unofficially.[74]

> *"The consequence of the doctrine applying may be viewed as sufficiently adverse (no income tax avoidance) that most taxpayers likely will try to ensure that the structure of their life policies falls on the safe side of the doctrine."*

In any event, for the constructive receipt doctrine to be applied, the taxpayer must have had some entitlement to the income with which the taxpayer is charged. As mentioned above, if a contract of life insurance is a frozen cash value policy, no one can receive any income,[75]and certainly not in the year it was earned. Such a policy is designed to maximize the death benefit, not to provide any access to the increase in cash value. Section 7702(g), which provides the income taxation of policies that fail to meet AT LEAST ONE OF the actuarial tests of Section 7702(a) or the diversification tests of Section 817(h), causes no current taxation of income except to the extent of an increase in net surrender value for the year (something that cannot occur under a frozen cash value policy).[76] Hence, it would seem relatively certain that any investor control doctrine should not be applied, at least in the absence of further developments in the law (by legislation or, perhaps, regulation), to such a policy even if the doctrine has some viability in other contexts.[77] It seems even more certain that the investor control doctrine should not apply if the owner is the insured under the frozen cash value policy as the insured could never access or benefit from the increase in the account value as it could never be accessed by anyone during the insured's lifetime—in other words, it is difficult to discern what other "incidents of ownership," in addition to controlling investments, the insured owner could have when no one during the insured's lifetime could benefit from the "inside buildup" within the policy.[78]

Nonetheless, the consequence of the doctrine applying may be viewed as sufficiently adverse (no income tax avoidance) that most taxpayers likely will try to ensure that the structure of their life policies falls on the safe side of the doctrine, such as set forth, by example, in Rev. Rul. 2003-91.

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72 Id. at 79.

73 Id. at 74.

74 As noted above, in PLR 201417007 (not precedent), the Service in describing its investor control revenue rulings states that the revenue rulings "conclude that contract holders who possess control over the investment of the separate account assets (*in addition to the other benefits and burdens of contract ownership*) are the owners of separate account assets for federal income tax purposes even if the insurance company retains possession of, and legal title to, those assets." (footnote omitted; emphasis added.)

75 Although one may contend that the owner (or the owner's beneficiaries) would receive the income upon the death of the insured, Section 101(a)(1) explicitly provides, subject to exceptions, that the death benefit (including increases in cash value) is not included in gross income.

76 It may be noted that, in *Clifford*, the taxpayer could not receive the income for five years because it was payable for that period to his wife. The Supreme Court noted that the close family relationship meant that the taxpayer, as a practical matter, would benefit from the income currently as paid to his wife. However, with a frozen cash value policy, no one can receive any benefit from the income until the insured dies, other than its use to pay the cost of the net amount at risk which, as mentioned above, is currently taxed to the policy's owner.

77 As noted above, in PLR 201417007 (not precedent), the Service seems to acknowledge that control over investments alone is not sufficient for the income inside the contract to be taxed to the owner because the IRS revenue rulings "conclude that contract holders who possess control over the investment of the separate account assets (*in addition to the other benefits and burdens of contract ownership*) are the owners of separate account assets for federal income tax purposes even if the insurance company retains possession of, and legal title to, those assets." (footnote omitted; emphasis added.)

78 In a similar vein, it seems that if the policy is owned by a non-grantor trust, the investor control doctrine, applied under the *Clifford* principles, should not apply merely because the grantor controls investments. Virtually, by definition, neither the grantor nor the grantor's spouse would have any beneficial interest and investment control does not trigger grantor trust status except in the limited circumstance as to stock as described in Section 675. Although the IRS might contend the grantor should be treated as owning the policy (and under some other doctrine the policy's underlying assets) if the trust were a grantor trust (see Rev. Rul. 85-13, 1985-1 CB 184), there is no such imputed ownership if it is not a grantor trust.

Summary and Conclusions

Earnings inside a contract that constitutes life insurance under applicable (local) law that is not withdrawn is not subject to income taxation as earned except to the extent of the annual increase in net surrender value if the contract fails to meet AT LEAST one of the two tests set forth in Section 7702(a) or the diversification rules of Section 817(h) and its regulations. Moreover, neither the receipt of any amount by a partial surrender of the policy nor any amount received by a borrowing against cash value is included in gross income unless the policy is a MEC and then such an amount is included in income to the extent of the increase in cash value (determined without regard to any surrender charge). However, according to the Service's investor control doctrine, a policy owner of a variable life policy will be taxed on the income earned inside the contract where the owner has an undefined level of control over the investments and, perhaps, has certain other undefined "incidents of ownership," although, as mentioned, perhaps limited to annual increases in net surrender value if the doctrine falls under the purview of Section 817(h). Although, despite the contention of the IRS to the contrary, it does not seem that any court has adopted an independent investor control rule. Nonetheless, general tax principles developed by the Supreme Court, as reflected in the *Clifford* case might cause the owner of a variable contract to be taxed on the earnings in some cases. Hence, it seems prudent to attempt to ensure structuring the policy to avoid that result.

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