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Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill

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DEATH AND TAXES: THE TAXATION OF ACCELERATED DEATH BENEFITS FOR THE TERMINALLY ILL

Wayne M. Gazur*

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"Change demands that each of us prepare for, guide where possible, and adapt to the new order quickly.... Life insurance has been of great benefit in our history of change."1

"[W]e must have missed something because here we are again, faced with another life insurance product that just doesn’t look like life insurance."2

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2 Tax Treatment of Single-Premium Life Insurance: Hearing Before the Subcomm. on Tax’n and Debt Management of the Senate Comm. on Finance, 100th Cong., 2d Sess. 2 (Comm. Print 1988) [hereinafter 1988 Senate Hearing] (statement of Senator Max Baucus, Chairman). Senator Baucus' lament reflects the recurring challenge to Congress presented by the taxation of life insurance. The income tax benefits of life insurance are generally considered by Congress to be worthy of preservation, but only for those products which resemble, by some yardstick, "traditional" forms of life insurance protection. Recent struggles in determining the acceptable boundaries of life insurance income tax incentives are
I. INTRODUCTION

It is often stated that the income tax laws should be applied with reference to the substance of transactions rather than their form. Tax statutes nevertheless contain arbitrary distinctions which draw lines between similar transactions, producing very different results. The income tax treatment of life insurance proceeds presents an example of tax results which vary dramatically with one factor, the timing of receipt. If received as a result of the death of the insured, the proceeds are excluded completely from the recipient’s income. If, on the other hand, proceeds are received even one moment before the insured’s death, the exemption is generally limited to the policyowner’s investment in the life insurance contract comprised of the aggregate premiums previously paid.

In recent years Congress has addressed the income taxation of life insurance on several occasions, distinguishing between “traditional” life insurance and products with a more pronounced investment flavor. In a similar manner, Congress will probably be required at some point to reassess the significance of death as the line of demarcation in the income tax treatment of life insurance described at infra text accompanying notes 165-95.

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4 "There are times, however, when form alone determines the tax consequences of a transaction." Bittker & Lokken, supra note 3, ¶ 4.3.3, at 4-33. Cash or accrual methods of accounting, accelerated or straight-line depreciation, specific identification of shares sold from a block of stock and designated child support are examples of tax fictions with few nontax consequences. Id.

5 Section 101(a)(1) of the Internal Revenue Code excludes from income “amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.” The exclusion is limited, however, in situations in which life insurance policies have been transferred for a valuable consideration. See I.R.C. § 101(a)(2). See also infra note 268.

6 Subsections 72(e)(5)(A), (C) & (E) of the Internal Revenue Code, taken together, establish the rule that the insured includes in gross income, the amount received under a contract on its complete surrender, redemption, or maturity, to the extent it exceeds the “investment in the contract.” The phrase, “investment in the contract”, is defined for this purpose “as of any date as the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent such amount was excludable from gross income.” I.R.C. § 72(e)(6).

7 See infra text accompanying notes 165-95.
proceeds. The recent development of life insurance settlement options, which in general permit the lifetime payment of life insurance death benefits upon certain events such as the insured’s terminal illness or permanent confinement to a nursing home, may be a catalyst to such an appraisal.

This article examines the tax treatment of accelerated death benefits, assessing in particular a proposal to expand the existing income tax exclusion for death benefits to encompass these new insurance products. Arguably, an income tax exclusion for accelerated death benefits further exalts life insurance as a tax favored investment, ignoring income from the sales of other assets necessitated by terminal illness. Moreover, an exclusion, no matter how carefully fashioned, is inconsistent with, and potentially detracts from, the survivor-protection role of life insurance, thereby undermining the traditional rationale for its favored tax treatment. Although the terminally ill insured, family members caring for the insured, and other dependents, often share financial concerns as a unit and cannot be readily separated, a shift in primary focus from the needs of survivors to the care of the insured may ultimately blur the present distinction between the income taxation of life insurance, which traditionally emphasizes survivor protection, and the taxation of retirement, health, and long-term care requirements.

A brief discussion of the concerns which prompted the development of life insurance settlement options permitting the accelerated payment of death benefits is presented first. A description of the Prudential Life Insurance Company of America ("Prudential") “living needs benefit” plan follows in Part III, including a discussion of the apparent income tax treatment of such payments. Part IV examines the tax policy issues presented by an income tax exemption for accelerated death benefits, and Part V concludes the article with a critique of several legislative proposals.

II. CONVENTIONAL LIFETIME INSURANCE PAYMENT OPTIONS

As of 1989 there was $8.7 trillion of life insurance in force in the United States.9 The face value of life insurance payable upon the

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* For description of accelerated death benefit payment options see infra text accompanying notes 29-87.

* The precise amount of life insurance in force in 1989 was $8,694,015,000,000. American
death of the insured can represent an important asset for individuals of moderate wealth. However, under the terms of conventional whole life insurance policies, only limited amounts of the face value could be tapped prior to the death of the insured through insurance policy loans, loans from third party lenders,

Council of Life Insurance, 1990 Life Insurance Fact Book 5 [hereinafter 1990 Life Insurance Fact Book]. This total was in turn comprised of $4,939,964,000 in ordinary life insurance, $3,469,498,000,000 in group insurance, $24,446,000,000 in industrial insurance and $260,107,000,000 in credit insurance. Id.

In 1989, the average amount of life insurance in force in the United States per household was $93,600, and per insured household, $115,500. 1990 Life Insurance Fact Book, supra note 9, at 5. Life insurance was owned by 81% of American households, and approximately 70% of adult Americans owned some form of life insurance. Id. at 6. Despite these modest average amounts, life insurance may provide an attractive income and estate tax avoidance opportunity for wealthy individuals. See infra note 102.

The owner of a permanent life insurance policy can usually withdraw cash by borrowing against the cash surrender value under the terms of the policy. The practice of making a policy loan available to the individual policyowner, secured by the cash value of his policy, was started on a voluntary basis by life insurance companies themselves at a relatively early date. It proved so valuable that the laws of most states now require most cash value policies to include a policy loan provision. Janice E. Greider & William T. Beadles, Principles of Life Insurance 133 (rev. ed. 1972) [hereinafter Greider & Beadles]. See, e.g., N.J. Stat. Ann. § 17B:25-8 (West 1991); N.Y. Ins. Law § 3203(a)(8)(A) (McKinney 1885 & Supp. 1991). The value of this option would be limited during the early years of permanent policies because cash surrender values increase with the duration of the policy.

A policy loan would be unavailable under most policies of term insurance. First, a cash value, on which most policy loans are based, can usually arise only in term insurance policies of greater than 15-20 years duration, depending upon the policy and state law. "The Standard Nonforfeiture Law requires the cash surrender benefit . . . to be included in every whole life and endowment policy, as well as in level term contracts for periods longer than 15 years." Greider & Beadles, supra, at 144. See, e.g., N.Y. Ins. Law § 4220(a)(8) (McKinney 1985 & Supp. 1991) (cash surrender value requirements not applicable to term insurance of 20 years or less) and Cal. Ins. Code § 10165(e) (West 1972 & Supp. 1991) (no cash surrender value for certain types of insurance, including term insurance of 20 years or less, terminating prior to age 71). Second, even if a cash value accumulates under a term insurance policy, for purposes of the standard nonforfeiture provision, it does not necessarily follow that a policy loan for that amount is available. New York insurance law, for example, does not require policy loans for term policies. See N.Y. Ins. Law § 3203(a)(8) I (McKinney 1985 & Supp. 1991).

Life insurance policies have been commonly used as collateral for loans. "The life insurance contract, with its valuable prematurity rights and promise to pay a specified sum of money upon maturity, is an ideal form of collateral for credit transactions. Hence, it is not surprising that the assignment of life insurance policies as collateral security has reached large proportions." Dan M. McGill, Life Insurance 606 (rev. ed. 1967) [hereinafter McGill]. This assumes that a policy loan from the insurer is otherwise unavailable or insufficient in amount, because most policyholders would probably prefer the favorable interest rates and simplified loan procedures provided under the terms of policy loans. Some state laws pre-
policy surrenders, and endowment options. The life insurance


It is the author's impression that commercial lenders generally do not lend funds based solely on the pledge of a life insurance policy, although a pledge will be welcome or required as additional collateral if the bank is uncomfortable with the overall creditworthiness of the borrower or quality of other collateral. This was confirmed by an admittedly nonscientific, limited survey conducted by the author with several lenders. The lenders cited among other reasons, uneasiness with the ultimate maturity date of the loan (i.e., the insured's death) and the inability of an otherwise impecunious insured to make current interest and/or principal payments pending death. If that view is accurate, it would reduce the availability of such loans to a terminally ill person of moderate wealth and assets. Even if such loans were extended, to account for the increased risk presented by the uncertain date of death and resulting maturity of the policy, it might be made as only a modest percentage of the face value. If the lender was operating in an entrepreneurial fashion more closely resembling an outright purchase of the policy, however, a loan might be made to the terminally ill individual. Of the companies in the business of purchasing life insurance policies on the lives of terminally ill insureds surveyed by Messrs. McCormack & Petersen, only one, Life Benefits Corporation, would structure the transaction as a loan. "The mechanism designates a series of rising beneficiary percentages in favor of [the lender] to match the rising debt. If [the insured] dies before allowable interest can compound up to the face amount, a second beneficiary of the client's choice receives the balance of the policy payout." Thomas McCormack & David Petersen, 'Living Benefits' for the Insured, Terminally Ill Client: A Remarkable New Resource with Tax, SSI, and Medicaid Implications, 24 Clearinghouse Rev. 1348, 1350 (April 1991) [hereinafter McCormack & Petersen].

The owner of a policy can usually surrender it to the insurance company and receive an immediate cash payment, its cash surrender value. Like policy loans based on cash surrender values, this alternative is of limited benefit for newer permanent life policies with modest surrender values, and of little utility for pure term insurance which typically offers only a minimal cash value, if any. See supra note 11. Surrendering a traditional policy results in forfeiting the difference between the face value and the cash surrender value. This amount would be less significant in older policies which have accumulated a significant cash value, but many insureds die prematurely. Based on 1985 statistics, 19.2% of insureds under ordinary life policies die before age 44. In addition, 29.9% of all ordinary life policies mature when the policy duration is less than 5 years. 1990 Life Insurance Fact Book, supra note 9, at 47. In 1988, 65.6% of the deaths from AIDS, for example, were individuals under the age of 40. U.S. Centers for Disease Control, reprinted in United States Department of Commerce-Bureau of Census, Statistical Abstract of the United States, No. 119 (110th ed. 1990) [hereinafter 1990 Statistical Abstract].

In 1989, only .9% of ordinary life insurance in force and 2.9% of industrial life insurance in force was "endowment." Id. The so-called "endowment policy" has been in existence for a number of years and is an exception to the general rule of limited lifetime benefit options. The purpose of such a policy is to provide an investment fund which grows, maturing at a time certain.

Endowment life insurance policies are appropriate for any situation in which a fund needs to be accumulated, since they guarantee that the fund will be completed by the end of the specified period, whether the insured lives or dies. Such policies are most appropriate, however, where the need for life insurance is somewhat incidental —
death benefit consequently remained largely beyond the reach of insureds, including those facing death from protracted, costly terminal illnesses such as cancer and Acquired Immune Deficiency Syndrome ("AIDS"), or those requiring extended nursing home care.

As an alternative to the conventional options noted above, the owner of a policy can generally sell it to a third party. This transaction, that is, where the policyowner needs life insurance only to assure himself that his savings plan will be completed in the event of his death prior to the end of the specified period.

Greider & Beadles, supra note 11, at 37.

The endowment policy is therefore commonly sold for education or retirement needs. Id. at 42. Some would compare the endowment to whole life policies; it just takes whole life policies longer to reach scheduled maturity, at approximately age 100.

An endowment life insurance policy, in its basic makeup, is very similar to a whole life policy. In fact, if the whole life policy is viewed for the entire period contemplated by the mortality table — that is, for a period ending at the insured's age 100 — the policies are exactly alike; and the whole life policy is, in effect, an endowment at age 100.

Greider & Beadles, supra note 11, at 36.

Contributing to its position as a small percentage of total life insurance in force is the expensive death protection coverage under an endowment contract. In a common analysis, one treatise compares the life insurance protection of a $10,000, 18-year endowment policy to that of a whole life policy requiring the same annual premium. The whole life insurance death protection under those facts is $31,300, more than triple that of the endowment policy. Moreover, the cash value of the whole life policy 18 years later, is $7,019, more than 70% of the endowment's cash value. Greider & Beadles, supra note 11, at 42-43.

If the matured policy amount is received as a lump sum, the income tax treatment is essentially the same as that for a policy surrender as noted in supra note 6. However, if received as an annuity, an exclusion ratio is computed which is applied to each payment in determining the portion which is a return of investment, with the balance taxable income. See I.R.C. § 72(b). See also Treas. Reg. § 1.72-1(b) (defining amounts received as an annuity if payable at regular intervals over a period of more than one full year from the date on which they begin, provided the total amount payable or the payment period can be determined as of that date). The exclusion ratio is computed as the ratio of the investment in the contract (as of the annuity starting date) to the expected return under the contract, on the same date. Id. The investment in the contract is the aggregate amount of premiums or other consideration paid for the contract minus the aggregate amount received under the contract before such date to the extent such amount was excludable from gross income. See I.R.C. § 72(c)(1). The "expected return" for installment payments is simply the aggregate of the amounts receivable under the contract. See I.R.C. § 72(c)(3)(B). If instead the amounts payable under the contract depend in whole or in part on the life expectancy of one or more individuals, the expected return is determined with reference to actuarial tables. See I.R.C. § 72(c)(3)(A).

One insurance law reporter currently lists cases from five jurisdictions which require an assignee for value to have an insurable interest in the policy. 17 Crouch on Insurance 2d § 63A:17 (Rhodes ed. 1983 & Supp. 1990) (listing decisions from Alabama, Kansas, Kentucky, Texas, and Virginia). Alabama and Virginia have statutorily abolished this requirement. See
action would be taxed much like a policy surrender.\textsuperscript{16} The owner would be inclined to sell the policy, rather than borrow against the policy or surrender it to the life insurer, if a purchaser would offer a price, net of applicable transaction costs, in excess of the cash surrender value. A purchase price in excess of the policy's cash surrender value is calculated by reference to a maturing of the policy upon the approaching death of an insured, and in 1989 a number of articles appeared in the popular press discussing sales of life insurance policies by the terminally ill as a source of needed funds.\textsuperscript{17}

The emergence of investors willing to gamble\textsuperscript{18} on the immi-

ence of an insured's death by purchasing policies from the termi-

\textsuperscript{16} The transaction would be governed by I.R.C. § 1001, rather than I.R.C. § 72. If the proceeds received exceeded the policyholder's investment in the contract, and the contract was a capital asset in the policyowner's hands, the excess would seem eligible for treatment as a capital gain. However, there are judicially imposed limitations, principally the assignment of income doctrine, that "leave little room for capital gains treatment save for the sale of a policy at a gain attributable to the insured's supervening ill health." Bittker & Lokken, supra note 3, 12.4.4, at 12-45 (questioning whether the Tax Court's application of the assignment of income theory to require ordinary income treatment for an increase in value due to accumulated income, in Gallun v. Commissioner, 22 T.C.M. (CCH) 798 (1963), aff'd, 327 F.2d 809 (7th Cir. 1964), would also extend to an increase in value from other factors such as an impending maturity of the mortality gain). One would usually not sell for less than the cash surrender value because the policy could be surrendered to the insurer for the full cash surrender value.

\textsuperscript{17} See, e.g., Tamar Lewin, For AIDS Patients, a Special Insurance Plan, The N.Y. Times, Mar. 23, 1989, § A, at 27, col. 1; Mike Scotti, Living Benefits Policies Slowly Gaining Acceptance, 12 Orange County Bus. J., April 2, 1990, No. 45, § 1, at 7; Christine Woolsey, More insurers expected to offer 'living benefits', Bus. Ins., Mar. 12, 1990, at 1. A survey conducted by the American Council of Life Insurance noted that accelerated death benefits were being offered by some insurers as early as 1987. See infra note 30.

\textsuperscript{18} The price is in many respects a gamble, determined by a number of factors. Besides the question of disability waivers of premium, numerous variables determine offering prices for life policies, including the face amount payable, cash loans on the policy, future premium expenses, and the cost of financing. The offering prices will also be affected by the patient's diagnosis, prognosis and symptoms, months of life expectancy, the administrative costs of securing releases from former beneficiaries and other loved ones, medical and legal professional fees for each case review . . . . Since no actuarial tables of life expectancies by HIV symptom pattern have been developed, prices must be arrived at by painstaking and somewhat ad hoc judgments on each case.

McCormack & Petersen, supra note 12, at 1349.
nally ill, often afflicted with AIDS, demonstrated the need for policy terms under which terminally ill insureds could obtain more of the face value of their life insurance policies prior to death. The magnitude of the problem is unclear, and the reported evidence could be no more than anecdotal. Nevertheless, AIDS related deaths account for a large percentage of life insurance death benefits, and the percentage is increasing. Cancer remains a sig-

19 “Almost all policies purchased so far have been upon the lives of [persons with AIDS].” Id.

20 Living Benefits, Inc., based in Albuquerque, New Mexico, was one of the first private firms established in the United States for the purpose of purchasing life insurance policies from the terminally ill. Reportedly, the purchase price reflected a 20-45% discount from the face value of the policy. See Martha Groves, A Final Hope for the Dying, L.A. Times, July 2, 1990, § A, at 1, col. 1. For a critical review of this program see Joseph M. Belth, A System for the Exploitation of the Terminally Ill, 16 The Ins. F., Mar. 1989, at 11-14 (noting that the discount can be 25-40%, the terminally ill person and family members are under stress and may be vulnerable to exploitation, and suggesting an inquiry into whether this is a form of gambling or moneylending). A recent survey reported the existence of at least eight companies engaged in this business. See McCormack & Petersen supra note 12, at 1355. For a positive view of private brokers see id. at 1351 (rejecting the “vulture” comparison, noting the benefits of having an “unexpected source of desperately needed money,” and justifying the high discounts from face value in view of the high administrative costs of evaluating each case). See also supra note 18. The Prudential Insurance Company of America now offers high percentages of the face value under its living needs benefit plan, see infra text accompanying note 39. If such favorable insurance company options become common, the private brokers may become an avenue of last resort only for individuals for whom life insurance company accelerated death benefits are unavailable.

21 One article highlighted the situations of three individuals, a pharmacist, a gift salesman, and a doctor, all suffering from AIDS and needing cash for medical and living expenses. See Groves, supra note 20. The article reported that one purchaser of policies from the terminally ill, Living Benefits, Inc., had purchased or signed contracts to purchase 71 policies, with an additional 69 applications in process. Id. A recent article listed eight companies actively involved in the purchase of life insurance policies from the terminally ill, and reported the results of a January, 1991 telephone survey which placed at 472 the number of policies bought by all eight companies since inception of their programs. See McCormack & Petersen, supra note 12, at 1355. Robert P. Hill, Executive Vice President of the Prudential Insurance Company of America, testified on June 12, 1991, that “So far, more than 135 policyholders have received accelerated death benefits. Most have been victims of cancer or AIDS.” Hearing on Miscellaneous Tax Bills Before the Subcomm. on Tax’n of the Senate Comm. on Fin., 102nd Cong., 1st Sess. (1991) [hereinafter 1991 Senate Hearing].

22 It was estimated for 1988 that AIDS accounted for 6.6 deaths per 100,000 population and .75% of deaths from all causes. U.S. National Center for Health Statistics, Vital Statistics of the United States, reprinted in 1990 Statistical Abstract, supra note 13, No. 115. In 1988, there were 15,463 reported deaths due to AIDS. U.S. Centers for Disease Control, reprinted in 1990 Statistical Abstract of the United States. Id., No. 119. Another study reports that AIDS deaths accounted for 1% of all deaths in 1989. 1990 Life Insurance Fact Book, supra note 9, at 41. Based on a survey of 275 life insurance companies, identifiable 1989 AIDS death benefits were 1.7% of individual life benefits, 2.5% of group benefits, and
significant cause of death. With the aging of the general population, paying for long-term health care will assume even greater significance, a factor health insurers already recognize. These trends suggest that the adequacy of financial resources during the lifetime of the insured will be of increasing concern.

1.5% of credit life benefits. Id. These percentages had increased from their comparable figures for 1988 of 1.1%, 1.6%, and .9%, respectively. Id. A reported study by Professor Warren Greenberg of George Washington University, based on interviews of insurers, indicated that as of early 1989, the average cost for lifetime treatment of an AIDS patient ranged from $35,054 to $60,000. Kari Berman, AIDS not hurting group health costs: Study, Bus. Ins., Feb. 27, 1989, at 32. Since 1985 an increasing number of insurers require an HIV blood test before extending coverage, particularly for individual policies. This phenomenon would tend to limit life insurance benefits to AIDS victims, depending upon the timing of their HIV symptoms.

In 1988, it was estimated that malignancies accounted for 488,200 deaths, 22.5% of total deaths in the United States. U.S. National Center for Health Statistics, Vital Statistics of the United States, reprinted in 1990 Statistical Abstract, supra note 13, No. 115. A Prudential Insurance Company of America spokesman was reported in mid-1990 to have stated that most of the policyholders taking advantage of their living benefits program for the terminally ill were suffering from cancer, not AIDS. Groves, supra note 20.

It is estimated that the number of individuals 75 years old and over will increase by 26.2% in the period 1990-2000, that the increase then tapers off to a 10.1% increase for the years 2000-2010, and that there is a projected 46.0% increase in the number of individuals of age 45-54 years in the period 1990-2000. U.S. Bureau of the Census, Current Population Reports reprinted in 1990 Statistical Abstract, supra note 13, No. 18. The per capita federal outlay for Medicare is estimated at $349 for 1989, up from $142 in 1980, and $31 in 1970. U.S. Office of Management and Budget, Budget of the United States Government, reprinted in id. at No. 141. However, the private sector plays an important role in funding long-term care costs. For example, one author has stated that 50% of nursing home expenses are paid by personal expenditures, 41% by Medicaid, 4% by other government programs, 2% by Medicare, 2% by private insurance, and 1% from miscellaneous sources. Anthony J. Gajda, Long Term Care Insurance, 14 Employee Benefits J. 10, 11 (June 1989). He also asserts that 70% of single persons become impoverished within three months of their confinement in a nursing home, and when the patient has a spouse, 50% become impoverished within six months. Id., at 10. See generally Lawrence A. Frolik & Alison P. Barnes, An Aging Population: A Challenge to the Law, 42 Hastings L.J. 683 (1991) (addressing the scope of the problem of an aging population and the law's treatment of the elderly).

A new health insurance product is the long-term care contract or "LTC," which is designed to cover the expense of nursing home care. The promotion of accelerated death benefit plans by life insurers, which can in part provide for long-term care, has reportedly created new competition between the health care insurance industry and life insurers. See, e.g., Cliff Green, Riders In the Storm, Fin. Plan., May, 1990 at 62. See also Marshall B. Kapp, Options for Long-Term Care Financing: A Look to the Future, 42 Hastings L.J. 719, 746-49 (1991) (discussing, in part, the recent development of private long-term care health insurance); Lauren Chambliss, It's About Time, 169 Fin. World, Oct. 16, 1990, at 58 (discussing development of long-term care insurance with more liberal eligibility requirements); Pamela Sherrid, A Microscope on Nursing-Home Plans, 100 U.S. News & World Rep. 621, Aug. 13, 1990, at 62 (criticizing limitations imposed on benefits by many LTC plans).
The illiquidity of life insurance products has historically brought cash-poor insureds to the marketplace. In 19th century England, elderly insureds lacking resources to continue coverage offered their policies at auctions.

In London, [Elizur Wright] visited the insurance auctions at the Royal Exchange. There he saw old men standing on the life insurance auction block, their policies being offered to the highest bidder at a fraction of their actual worth. In one case a man had paid premiums for forty-four years and could meet the payments no longer. "This was done, I was told, because the companies made it a rule never to buy their own policies," wrote Mr. Wright.26

This grisly process prompted Elizur Wright to advocate reforms in the United States such as the cash surrender provisions now common in life insurance policies.27

The following section examines the response of the life insurance industry to the concerns of the terminally ill insured, sometimes referred to as "accelerated death benefits," "living benefits"28 or "living needs benefit" options.

III. ACCELERATED DEATH BENEFITS POLICY TERMS

A. Operation

Prudential followed the lead of several smaller life insurance companies in offering accelerated death benefits to the terminally ill.29 A number of life insurers now embrace the concept, and a

27 Wright's actions were apparently successful:
As a result of the activities of Elizur Wright, the Massachusetts legislature in 1861 enacted a law requiring insurance companies to continue a limited amount of insurance in force under a policy that lapsed after premiums had been paid for a specified number of years. Legislation enacted later required the company to pay a cash value under these same circumstances if the policyowner wished to surrender his policy. Greider & Beadles, supra note 11, at 71. See supra note 11 (discussing cash surrender provisions).
28 Although used in connection with the recent development of accelerated, lifetime payments of death benefits, the term "living benefits" or some variation of that term has been used for a number of years to describe policy terms which provide for lifetime payments to the insured. See Greider & Beadles, supra note 11, at 164-65. John C. Pyle, Jr., Taxation of Living and Death Benefits Under Life Insurance Policies, reprinted in The Beneficiary in Life Insurance 214 (Dan M. McGill ed. 1956).
29 The concept of lifetime death benefit payments to the terminally ill was reportedly first developed in Canada by Ron Barbaro, president of Canadian operations for Prudential.
majority of states now permit such plans. Accelerated death benefits are not limited to terminal illness and may be combined with other qualifying events. Some plans provide accelerated benefits upon the incidence of a "dread disease" such as cancer. Others, such as the Prudential plan, also provide for the payment of death benefits for long-term care to individuals permanently confined to a nursing home. To simplify discussion of a broad range of competing product variations still under development, and in view of


A survey commissioned by the American Council of Life Insurance, found that as of October, 1990, 70 companies offered some type of accelerated death benefit product. American Council of Life Insurance, Accelerated Death Benefit Products - Results of a Study 1 (Dec. 1990) [hereinafter ACLI Survey]. The preliminary results from a recent survey show that "more than 100 companies are now offering some variation of [accelerated death benefit plans]." 1991 Senate Hearing, supra note 21 (statement of Daniel A. Mica, Executive Vice President, American Council of Life Insurance). A recent article places the number of states permitting accelerated benefits by insurers at 44. See McCormack & Petersen, supra note 12, at 1351. For example, Colorado law provides that:

Any policy of life or endowment insurance or annuity contract or contract supplemental thereto may contain benefits providing for the acceleration of life or endowment or annuity benefits in advance of the time they would otherwise be payable for an insured . . . (a) who is diagnosed with a terminal case of AIDS, . . . or with any other terminal illness, for healthcare expenses or for long-term care which is certified or ordered by a physician; or . . . (b) upon the occurrence of a qualifying event, as defined by the policy or contract.


A contract offered by Jackson National Life Insurance Company, discussed at infra note 58, is an example of a dread disease policy. A survey sponsored by the American Council of Life Insurance reported that specific conditions covered by dread disease products include "heart attacks, strokes, life-threatening cancer, coronary-artery bypass surgery, and renal failure." ACLI Survey, supra note 30, at 5. Conditions covered less frequently are "major organ transplant, Alzheimer's disease, severe bodily injury, paraplegia, total permanent blindness, and loss of both arms or legs." Id.

As of October, 1990, 70 companies offered some type of accelerated death benefit. ACLI Survey, supra note 30, at 1. The Prudential plan appears to be one of the broadest. Competition may cause other insurers to expand their narrower policy terms. Commercial Bankers Life, for example, as of April 2, 1990 reportedly would pay only 50% of policy face value for a terminal illness, and Transamerica Life paid 25% of the death benefit and only for six "dread" illnesses, excluding AIDS. See Scotti, supra note 17. Competition apparently has already had its effect. "In early 1991, Connecticut Mutual Insurance Company an-
Prudential's position as the largest life insurer in the United States, the following discussion will focus on the Prudential "Living Needs Benefit" plan.\textsuperscript{33}

The Prudential plan generally provides lifetime payments of benefits, calculated as a percentage of face value, if the insured becomes terminally ill or is permanently confined to a nursing home. Prudential currently extends this benefit to new and existing policies for no additional premium.\textsuperscript{34} However, the options are available only on permanent policies (which would exclude term insurance)\textsuperscript{35} with face amounts of at least $25,000-$50,000.\textsuperscript{36}

1. Terminal Illness Option

The terminal illness option is available if it is demonstrated to Prudential that the insured has six months or less to live. Evidence of a terminal condition includes documentation from a qualified physician.\textsuperscript{37} Organ transplants also qualify for the benefit if pronounced a \ldots rider [similar to the Prudential plan] for all of its existing or new policies; other insurance firms are expected to add these benefits, too — probably with the life expectancy of six months or permanent nursing home confinement provisions. McCormack & Petersen, supra note 12, at 1348.

\textsuperscript{32} Except where otherwise indicated, the discussion is based on the author's examination of Prudential's Living Needs Benefits brochure ORD 87246 Ed. 10-90 [hereinafter Brochure ORD 87246 Ed. 10-90], and a specimen living needs benefit policy rider, ORD 87241-90 [hereinafter Rider ORD 87241-90].

\textsuperscript{34} "[M]ore than 900 thousand Prudential policyholders have a Living Needs Rider on their life insurance policies." 1991 Senate Hearing, supra note 21 (oral testimony of Robert P. Hill, Executive Vice President of the Prudential Insurance Company of America). A spokesman for the American Council of Life Insurance reported that industry-wide "more than 4 million individuals are now eligible for this benefit." 1991 Senate Hearing, supra note 21 (statement of Daniel A. Mica, Executive Vice President, American Council of Life Insurance).

\textsuperscript{36} There are, however, reported instances of the availability of living needs benefit terms in group term insurance plans offered by United of Omaha Life Insurance Co. and Travelers Insurance Co., with similar offerings being planned by other insurers. See Woolsey, supra note 17. In a survey commissioned by the American Council on Life Insurance, only 4 insurance products out of 62 (6%) offered accelerated death benefits in individual term life policies, and only 1 (2%) offered such benefits under group term life policies. ACLI Survey, supra note 30, at 5.

\textsuperscript{35} The Prudential brochure states only that "clients applying for new policies must meet certain face amount \ldots requirements." Brochure ORD 87246 Ed. 10-90, supra note 33. An early article indicated that the rider is available on existing policies with a death benefit of at least $25,000, plus most new policies with a death benefit of at least $50,000. Green, supra note 25, at 62.

\textsuperscript{37} "In most cases, documentation from a qualified physician will suffice. The Prudential reserves the right to investigate further and decide eligibility for payment." Brochure ORD
claimed before the transplant procedure is performed. The benefit is generally 90 to 95 percent of the applicable death benefit. The payments can be received as a lump sum or in six equal monthly installments. All or a portion of this benefit can be

87246 Ed. 10-90, supra note 33. The life insurance policy rider states "[T]o choose this option you must give us evidence that satisfies us that the Insured's life expectancy is 6 months or less; part of that evidence must be a certification by a licensed physician." Rider ORD 87241-90, supra note 33. A survey prepared by the American Council of Life Insurance states that "[s]ix months is the period most commonly specified, although several provide for longer periods — i.e. nine, twelve, or twenty-four months." ACLI Survey, supra note 30, at 5.

While Rider ORD 87241-90, supra note 33, does not expressly state this, the descriptive brochure states that "[i]n most instances under current claim procedures, this option can also advance funds if the Insured requires a vital organ transplant, including heart, heart-lung, liver and bone marrow." Brochure ORD 87246 Ed. 10-90, supra note 33.

The 90 to 95 percent figure is stated in the descriptive brochure. Brochure ORD 87246 Ed. 10-90, supra note 33. Robert P. Hill, Executive Vice President of Prudential, stated that it "generally works out to about 96 percent of the death benefit." 1991 Senate Hearing, supra note 21. The policy rider discusses the mechanics of the determination. The computation begins with "convertible proceeds," calculated as the death benefit, less contract debt and term insurance that comes from supplementary benefits (except level term insurance still in the conversion period and for which a premium is being charged). A "benefit base" is then computed, considering factors such as the insured's age and sex, expected future premiums, future dividends, continuation of any reduction in guaranteed charges, continuation of the current rate of any excess interest credited on contract values, and a processing charge of up to $150. The benefit base is at least as great as the net cash value of the contract multiplied by the percentage of the convertible proceeds placed under that option. Rider ORD 87241-90, supra note 33. The generous percentages of face value offered by Prudential need to be compared with those of non-insurance companies which buy policies. See supra note 20. The author has no evidence that Prudential is in effect operating the program as a "loss leader" to promote sales of new policies. However, Mr. Hill has testified that "The Prudential makes [a Living Needs Rider] available on both existing and new permanent life insurance policies — at no extra charge. We don't make money on this program. It's just the right thing to do." 1991 Senate Hearing, supra note 21. Although better financial resources may be a large factor in the disparity, the independent companies also purchase policies for individuals with more months, or years, to live, reducing the present value of the purchaser's investment. In addition, the purchaser must pay federal income taxes on the profit from the death benefit proceeds in excess of the purchase price. See infra note 268. However, life insurance companies are also subject to federal income taxation, and death benefits paid, juxtaposed against premiums received, would be components in the determination of taxable income. See I.R.C. §§ 801-847.

If the installment payout is elected, the unpaid sum is computed with reference to an annual interest rate factor of 5%. Rider ORD 87241-90, supra note 33. The implicit 5% rate will increase the aggregate of payments received over six months as compared with a lump sum. Section 101(d) of the Code, (dealing with interest on life insurance proceeds held on deposit with the life insurer after death and paid on a deferred basis) does not apply since it refers to the date of death of the insured. Section 483 of the Code does not apply because the sales price is not due more than 6 months after the date of the sale or exchange. See I.R.C. § 483(c)(1). The original issue discount provisions of I.R.C. § 1272 do not apply to
claimed, and unused benefits remain as a death benefit.

2. Nursing Home Option

If the insured has been confined to a nursing home for six months, and it is demonstrated to Prudential that the insured will remain in the nursing home for life, the insured can receive 70 to 80 percent of the death benefit in a lump sum or over a term of years. The likelihood of nursing home care for the remainder of the insured's life is evaluated under the same procedures as for a terminal illness.\(^4\)

\(^4\) The 70 to 80 percent figure is set forth in Brochure ORD 87246 Ed. 10-90, supra note 33. The benefit base is determined under the same criteria established for the terminal illness option. See infra note 39. The benefit base may be paid in one sum upon the insured's request. If a lump sum is not elected, payments will be made in equal monthly payments over a term of years set forth in the rider which declines with the insured's age. If the insured is 65-67, for example, the payment period is 8 years. If the insured is 74-77, for example, the period is 5 years. If the insured is 87 or older, the period is 2 years. Upon the agreement of Prudential and the insured, the payment period can be extended. The nursing home payments are determined with reference to a 5% interest rate factor, which can be increased at Prudential's discretion. Rider ORD 87241-90, supra note 33. Original issue discount might be a concern at first because of the payment period which extends beyond one year. See infra note 40. However, I.R.C. § 1275(a)(1)(B) excludes from the definition of the operative term "debt instrument," for purposes of I.R.C. §§ 483 and 1272, "any annuity contract to which section 72 applies" and which depends (in whole or in substantial part) on the life expectancy of one or more individuals or is issued by a life insurance company in a transaction in which there is no consideration other than cash or another annuity contract meeting the requirements of the passage. The Prudential payments are roughly tied to remaining life expectancy and most policies would have been issued for cash consideration. Payments received over a period exceeding one year would probably be considered an annuity contract under I.R.C. § 72. Even if not treated as interest or original issue discount, the interest element would be recognized as additional insurance proceeds under annuity taxation principles. See supra note 14. Compare I.R.C. § 72(j) which states that "if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income."

\(^4\) See supra note 37.
3. Benefit Adjustments

Under both the terminal illness and nursing home options, no recalculation of benefits is made if the insured lives longer than six months or leaves the nursing home. Similarly, if the insured dies before the six month period on which the calculation of payment is based, or the insured dies without living in the nursing home for a great length of time, no adjustment is made to the benefit amount. If the insured dies while being paid benefits on an installment basis, however, the present value of the remaining benefits is paid in a lump sum to the policy beneficiaries.43

B. Taxation

1. Terminal Illness Option

Life insurance benefits received "by reason of the death of the insured" are excluded from the gross income of the recipient.44 Because the terminal illness option is payable only upon impending death, the income tax exclusion does not apply.45 The transaction is essentially a policy surrender governed by settled tax principles.46 Consequently, the owner of the policy must report income

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43 This treatment applies to both the terminal illness and nursing home options. The Prudential rider otherwise permits living needs benefit payments only to the insured and to no other persons. Rider ORD 87241-90 supra note 33.

44 See supra note 5.

45 The exclusionary language was introduced to the Internal Revenue Code in 1913. See infra text accompanying notes 110-51. The living needs benefit was not foreseen at the time, but the congressional debate clearly focused on the distinction between lifetime surrenders and payments on account of the death of the insured. See infra text accompanying notes 145-46. A literal reading of the statute does not support an exclusion for the living needs benefit, and generally exclusions are narrowly construed. See Treas. Reg. § 1.1002-1(b) ("[E]xceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception."). Legislation is pending which would exempt living needs benefit payments from taxation. See infra text accompanying notes 260-63.

46 A taxpayer surrendering a policy will be required to report income for any surrender proceeds received in excess of aggregate premiums previously paid during the term of the policy. See I.R.C. § 72(e)(5)(A) & (E). A surrender to the insurer has been held not a “sale or exchange” producing capital gain income. See Hawkins v. Commissioner, 3 T.C.M. (CCH) 1135 (1944), rev’d on another issue, 152 F. 2d 221 (5th Cir. 1945). If, on the other hand, aggregate premiums exceed the surrender proceeds, the recognition of a loss is generally not permitted. See, e.g., London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935), cert. denied, 298 U.S. 663 (1936) (denying loss on surrender to insurer). However, “if the taxpayer receives less than the policy’s cash surrender value ... because of the insurer’s insolvency or for some other reason, the taxpayer should ordinarily be able to establish that it
to the extent proceeds received exceed the aggregate premiums paid.

2. Nursing Home Option

Like benefits paid for terminal illness, the nursing home benefits are paid for reasons other than the death of the insured, and a lump sum payment must be taxed accordingly. If payments are received in installments over a term of years, the benefits will be taxed as an annuity. However, a medical expense deduction may be allowable for a portion of the nursing home expenses.
3. Unanswered Taxation Questions

a. Loan Treatment

The Prudential plan is structured as a policy surrender. The benefit, although payable in installments at the election of the insured, is a final amount, not subject to adjustment based on the actual life span of the insured.\textsuperscript{50} It is unclear if the plan could be configured as a nontaxable policy loan, by placing a lien against the policy in the amount of any death benefits advanced to the insured.\textsuperscript{51} Unlike most policy loans which are limited to cash sur-

form of reimbursement, not only reimbursements excluded from income. See Litchfield v. Commissioner, 40 T.C. 967, 969 (1963), aff'd, 330 F.2d 509 (1st Cir. 1964) (deduction denied for payments by payor son for mother's medical expenses offset by reimbursements from siblings); McDermid v. Commissioner, 54 T.C. 1727, 1729-1730 (1970) (deduction allowed only for medical expenses paid with taxpayer's own funds; deduction denied for payments from aunt's pension income). It is unclear whether taxable accelerated death benefits would be considered as "insurance" for this purpose or an amount included under "otherwise." If the taxpayer had other available assets to which the payments of medical expenses could be traced, the potential impact of these precedents could be minimized. However, if the taxpayer is so needy that accelerated death benefits are a necessary option, other assets may be unavailable. If benefits paid under the nursing home option are includible in taxable income, then the 7.5\% adjusted gross income threshold to the medical care deduction is particularly inappropriate if it reflects adjusted gross income swollen by the insurance proceeds. See I.R.C. § 213(c). An incrementalist reform of a minor nature would exclude living needs benefits from adjusted gross income for this purpose and would expressly permit a medical expense deduction for expenses subject to taxable reimbursements.

\textsuperscript{50} See supra text accompanying note 43.

\textsuperscript{51} The receipt of insurance proceeds through a policy loan generally does not require the recognition of taxable income. At first blush, this result apparently is derived from the statute. Section 72(e)(1) deals with distributions under annuity and insurance contracts and applies to "any amount which ... is received under an annuity, endowment, or life insurance contract, and ... is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount." The rule of I.R.C. § 72(e)(5)(A) would apparently apply and "the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract." The investment in the contract is essentially aggregate premiums paid. See I.R.C. § 72(e)(6). The aggregate premiums will usually exceed the cash surrender value due to the portion of the premiums paid for pure death insurance protection, so most loans based on cash surrender values would not run afoul of this provision. However, the exemption is instead based on general tax principles that the borrowing of money is not a taxable event, and a loan does not even rise to the level of "any amount ... received under an annuity, endowment or life insurance contract." See Drake v. United States, 597 F. Supp. 1271 (D.C. N.C. 1984) and In Re: Robert and Mary Minnis, 71 T.C. 1049 (1979) applying this analysis to annuity contract loans under the law prior to the changes introduced by the Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.) ("TEFRA"). The TEFRA amendments added an express provision treating loans under an annuity contract as a taxable amount not received as an annuity, but excluded life insurance or endowment contracts
render values, the Prudential living benefits would often exceed that amount. No precedent exists to guide the appropriate taxation treatment of a loan from an insurer in excess of the cash surrender value.

from this treatment. See I.R.C. §§ 72(e)(4)(A), 72(e)(5)(A), & 72(e)(5)(C). This suggests that Congress considered it necessary to expressly treat certain loans as distributions, in contrast with the prevailing loan treatment. The 1982 Blue Book supports this conclusion:

The Act does not change the tax treatment of withdrawals from most life insurance and endowment contracts. However, the Secretary is authorized to issue regulatory guidelines as to when the amount at risk under these types of contracts is sufficiently minimal that the contract should be treated as an annuity for purposes of these provisions.


* State insurance law statutes generally limit policy loans to an amount no greater than the loan value, which is typically tied to cash surrender value. See supra note 11.

** If a loan were available and bona fide, the pledge of a life insurance policy generally would not be a disposition of the policy resulting in the recognition of taxable income. The pledge of certain annuity and modified endowment contracts could, however, produce a taxable distribution. See supra note 51. One of the companies that purchases policies from the terminally ill structures the transaction as a loan in an arrangement that closely resembles the common pledge of an insurance contract to a third party lender. See supra note 12. While that is a different situation than one in which the insurer is the lender, the rationale underlying the decisions cited in supra note 51 (holding that insurance policy loans do not give rise to the recognition of taxable income) is that the relationship of the insured and the insurer under the circumstances of a policy loan is that of a borrower and a lender, respectively. The cash surrender value would therefore seem irrelevant to that inquiry as a matter of tax law, and the relationship closely resembles a nonrecourse loan. However, to be even considered as a loan, the amount of the Prudential benefit would need to be left open for final determination with reference to the term of the loan, the insured’s actual life span; that would detract from the finality of the present arrangement.

A survey sponsored by the American Council of Life Insurance reported a number of differing approaches in reflecting the payment of accelerated benefits. In 46 of the 62 products surveyed (74%), the acceleration of benefits reduced the face amount by the amount of the payout. In 10 products, liens were placed on the policies in the amount of the payout. For the remaining six products, assignments in the amount of the accelerated benefits were made against the policies. ACLI Survey, supra note 30, at 10. The effect of acceleration on cash surrender values demonstrated broad variations. In 34 of the products, the cash value
b. Disability Exclusion

As noted above, medical expense deductions can offset taxable income from the nursing home benefit.\textsuperscript{54} This could also be true for terminal illness benefits paid on account of an organ transplant procedure. Other exclusions or deductions may also apply to the terminal illness option. For example, section 104(a)(3) of the Internal Revenue Code [hereinafter "Code"] excludes from income amounts received through health insurance for personal injuries or sickness if the premiums were paid by the insured. Although section 104(a)(3) states the exclusion broadly,\textsuperscript{55} the terminal illness option may not be paid strictly on account of sickness or disability; it is paid on account of impending death usually arising from illness and often involving disability. Prudential adopted this liberal eligibility standard, rather than one linked to specific dread diseases, for example, to benefit the insured:

Some policies also limit living benefits to specific illnesses, such as stroke, heart attack, cancer, coronary artery surgery or renal failure. . . . 'We think that is the wrong way to go,' says [Prudential was reduced proportionately to the reduction in face value. In three products, a reduction was made in the amount of the accelerated payout. In seven products, a lien attached to the policy, in an amount proportionate to the reduction in face value. In four products a lien attached in the amount of the accelerated payment. In three products, cash values were assigned in the amount of the accelerated benefit. Of the remaining products, six provided for no reduction, four provided no answer, and the question was not applicable to one because the insurance had no cash value. Id. In a loan scenario, the death benefit income tax exclusion would be available to the insured's estate which would in effect immediately pay a portion of the proceeds to the lender in satisfaction of the loan. The death benefit exclusion and other provisions of I.R.C. § 101 would generally not apply to the lender's receipt of the pledged policy proceeds. Treas. Reg. § 1.101-1(b)(4) (section 101 is inapplicable to any amounts received by the pledgee). See Landfield Finance v. United States, 418 F.2d 172, 175 (7th Cir. 1969) (exclusion denied to lender that received policy proceeds upon death of borrower insured), distinguishing Durr Drug Co. v. United States, 99 F.2d 757, 759 (5th Cir. 1938) (creditor deemed to be owner of the policy from the outset and eligible for the death benefit exclusion).

\textsuperscript{54} See supra note 49.

\textsuperscript{55} The "primary function of § 104(a)(3) is to exempt from taxation amounts received under ordinary accident and health insurance policies that pay medical expenses, lump-sum amounts for bodily injury, per diem amounts during hospitalization, amounts related to the taxpayer's wage level or length of incapacity during recuperation, and perhaps other benefits." Bittker & Lokken, supra note 3, ¶ 13.1.5, at 13-14. See, e.g., Rev. Rul. 73-155, 1973-1 C.B. 50 (excluding no-fault auto disability payments for loss of income); Rev. Rul. 58-90, 1958-1 C.B. 88 (excluding income replacement insurance payable if taxpayer is sick or disabled); Rev. Rul. 55-331, 1955-1 C.B. 271 (excluding disability insurance proceeds for disability due to a loss of a part of the body).
senior vice-president Robert] Hill. 'Why should someone be penalized because he got one disease and not another?'

However, the Treasury has favorably interpreted section 104(a)(3) as applying to combined policies of life and disability insurance. Other accelerated death benefits plans which link eligibility to specific physical maladies also enjoy exclusion under this section.

Section 105(c) provides an exclusion for disability payments, but it too may be inapplicable because the disability in question, such as cancer or AIDS, is generally not tied to "permanent loss or loss of use of a member or function of the body." In addition, the benefit, computed primarily as the net present value of the policy's face value, may not meet the statutory requirement of computa-

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66 Green, supra note 25, at 67.
67 In Rev. Rul. 63-181, 1963-2 C.B. 74, an insured was covered under a group, renewable term life or disability insurance policy. A benefit was payable upon death or permanent and total disability prior to age 65. The employee was found to be "permanently and totally disabled, with a life expectancy of a few months, on account of an acute cancerous condition." Id. at 74. The Internal Revenue Service ruled that the lump sum was excludable under I.R.C. § 104(a)(3) (and under I.R.C. § 105(c) discussed in the text which follows). In Estate of Wong Wing Non, 18 T.C. 205 (1952) the insured owned an endowment policy which contained a disability benefit. Upon the disability of the insured, future premiums were waived. However, the policy benefit was not paid until the endowment's maturity. The Tax Court found, because the government had already conceded the point, that the predecessor of I.R.C. § 104(a)(3) applied to exclude the endowment contract proceeds in excess of the cost of the contract.
68 The author reviewed a copy of a February 9, 1988 opinion letter issued by Peat Marwick Main & Company with respect to the tax status of Jackson National Life Insurance Company's "Life Line Ultimate" policy. The opinion concludes that a portion of the benefit, which is accelerated upon the occurrence of certain events designated with reference to medical conditions, is exempt as an accident and health insurance benefit under I.R.C. § 104(a)(3). The accelerated benefit is payable upon proof of the occurrence of heart attack, stroke, coronary artery surgery, life threatening cancer, and renal failure. Id. at 2. The Peat Marwick opinion is based largely on Rev. Rul. 63-181, supra note 57, and Estate of Wong Wing Non, supra note 57.
69 I.R.C. § 105(c). Section 105(c) of the Code provides:
Gross income does not include [amounts received by an employee for personal injuries or sickness] to the extent such amounts (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of the taxpayer . . . and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.
See, e.g., Watts v. United States, 703 F.2d 346, 352 (9th Cir. 1983) (hypertension resulting in permanent disability is not a permanent loss of bodily function. "The terms 'work' and 'body' simply are not synonymous.").
tion "with reference to the nature of the injury." See Gordon v. Commissioner, 88 T.C. 630, 640-41 (1987) (payment for arteriosclerotic heart condition was not calculated with regard to the severity or nature of the injury and therefore could not be excluded from income under I.R.C. § 105(c)); Hines v. Commissioner, 72 T.C. 715, 720 (1979) (benefits qualify for exclusion only if they vary according to the type of injury suffered by the taxpayer).

Rev. Rul. 63-181, supra note 57, held that a lump sum paid on account of disability due to a cancerous condition was also excludable under I.R.C. § 105(c). The Jackson National life plan described at supra note 58, for example, pays an accelerated benefit only upon the presence of specified medical conditions. Specificity is arguably illusory if one treats as a terminal illness, for example, "any medical condition reasonably certain to result in death within 6 months." On the other hand, Rev. Rul. 63-181, described a loose standard of "permanently and totally disabled, with a life expectancy of a few months, on account of an acute cancerous condition." See supra note 57.

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See Treas. Reg. § 1.451-2(a). The regulation provides:

Income . . . is constructively received . . . in the taxable year during which it is credited to [the taxpayer's] 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. . . ."

The requirements of proof of illness or nursing home care arguably pose a substantial restriction. With respect to annuities, the Internal Revenue Service has issued a private letter ruling concluding that the surrender of a policy as a condition to the payment of certain income was a substantial restriction. See Priv. Ltr. Rul. 80-42-036 (July 22, 1980). See also Cohen v. Commissioner, 39 T.C. 1055 (1963) (no constructive receipt of increment in cash surrender value because policy surrender required).
Accelerated Death Benefits

C. Issues of a Nontax Nature

The living needs benefit options present several nontax issues which are briefly introduced in the materials which follow.

1. Creditors of the Insured

If the owner of a life insurance policy files for bankruptcy protection, the policy is an asset of the bankruptcy estate. However, a bankrupt may choose between exemptions allowed under state law and federal statutes other than the Bankruptcy Code or those

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64 See I.R.C. § 1035 (stating that no gain or loss shall be recognized on the exchange of specified combinations of life insurance, endowment or annuity contracts). See also Treas. Reg. § 1.1035-1 ("but section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. . ."); Rev. Rul. 72-358, 1972-2 C.B. 473 (holding that I.R.C. § 1035 applies to exchange of policies issued by different insurers). See, e.g., Dorothy K. Dropick, Life Insurance Exchanges Under Section 1035: Think Twice Before You Surrender, 17 Conn. L. Rev. 525 (1985) (discussing the structure and potential pitfalls of policy exchanges). If the insured were terminally ill at the time of the proposed exchange, lack of insurability would be a potential obstacle in finding a substitute policy.

66 The Peat Marwick Main & Company opinion letter, supra note 58, raises the issue of whether an accelerated death benefit may alter the status of a policy under the income tax definition of life insurance under I.R.C. § 7702(f)(7) (dealing with subsequent changes in benefits). Priv. Ltr. Rul. 91-06-050 (Nov. 16, 1990) held that long-term care and home health care benefits provided under a life insurance contract rider were not a "qualified additional benefit" under I.R.C. § 7702(f)(5)(A). Pending legislation would add terminal illness benefits as a "qualified additional benefit" under this provision. Senate Bill 284, infra note 260, § 2(b). One implication would be treatment of charges for the terminal illness benefit as "future benefits." See I.R.C. § 7702(f)(5)(B). That in turn impacts the guideline premium tests, which are tied to the cost of premiums for future benefits under the contract, by increasing the amount of the limitation. See I.R.C. § 7702(c)(3). The pending legislation also amends I.R.C. § 818 (stating definitions applicable to provisions for the taxation of life insurance companies) with the addition of a new subsection (g) which expressly includes terminal illness riders in the definition of life insurance for the purposes of insurance company taxation. Senate Bill 284, infra note 260, § 2(a).

66 See 11 U.S.C. § 541(a)(1) (1988) (the estate is comprised of "... all legal or equitable interests of the debtor in property as of the commencement of the case.").
under the Bankruptcy Code. States can require that a bankrupt utilize only the state exemption statutes, barring the federal bankruptcy exemptions.

a. Federal Exemptions

Two federal bankruptcy exemptions address life insurance. One exempts "[a]ny unmatured life insurance contract owned by the debtor, other than a credit life insurance contract." The second exempts "[t]he debtor's aggregate interest, not to exceed $4,000 ... in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract owned by the debtor under which the insured is the debtor or an individual of whom the debtor is a dependent." The legislative history suggests that the two exemptions taken together prohibit the trustee from surrendering a life insurance policy. However, the trustee may exercise other rights under the contract, such as the right to borrow against the cash surrender value of all policies of the debtor, leaving the debtor with the policies encumbered by the loans (subject to the $4,000 exemption). Structured as a policy surrender, the living benefits option possibly falls within the first exemption which does not require a surrender of policies, provided that the "unmatured" policies language could not be applied to preclude an exemption for ripened living benefits. It is uncertain if the living benefits

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71 [T]he trustee may not surrender a life insurance contract, which remains property of the debtor if he chooses the Federal exemptions ... A trustee is authorized to collect the entire loan value on every life insurance policy owned by the debtor as property of the estate. First, however, the debtor will choose which policy or policies under which the loan value will be exempted.
72 In In Re O'Brien, 67 B.R. 317 (Bankr. N.D. Iowa 1986), the court addressed the issue of whether a single premium whole life policy was "unmatured" for purposes of an Iowa state exemption statute which exempted unmatured life insurance policies. The court noted the similar wording of the federal bankruptcy exemption, but could locate no state or federal law definition of the term. Drawing upon definitions of insurance in the Internal Revenue
option also skirts the second exemption which is couched in terms of traditional policy loan provisions.

The Prudential disclosures state: "[W]e do not believe that creditors, a trustee in bankruptcy, or a bankruptcy court could force you to exercise this option involuntarily." This conclusion draws force from a form of spendthrift clause which states, "If you are required by law to use this option to meet the claims of creditors, whether in bankruptcy or otherwise, you are not eligible for this benefit." It is uncertain, however, if the Prudential rider creates a spendthrift trust relationship that will prevent the living needs benefit from becoming property of the bankruptcy estate.

Code (I.R.C. § 7702(e)(1)(B) (stating that the maturity date for that purpose is no earlier than the day on which the insured reaches age 95, and no later than the day on which the insured reaches age 100)) and industry usage, the court concluded that the policy did not "mature", until the cash value equalled the death benefit. In most whole life policies this does not occur until age 95-100. See supra note 14. If one accepts this rough analysis, the living needs benefit, which is not greater than 95-96 percent of face value, is not matured for purposes of bankruptcy. See also In Re Buffinton, 100 B.R. 448 (Bankr. N.D. Iowa 1987) (applying In Re O'Brien).

If the ripened living benefit were property of the bankruptcy estate, then the effect of a debtor's relinquishment of the option prior to the filing of the petition would need to be considered. In that regard, the Prudential living needs benefit plan permits the insured's removal of the option at any time. See Rider ORD 87241-90, supra note 33. A concern is that the relinquishment of the property interest prior to the bankruptcy filing, for the benefit of the secondary beneficiary, would have the effect of a fraudulent transfer under 11 U.S.C. § 548 (1988). But see Hoecker v. United Bank of Boulder, 476 F.2d 838 (10th Cir. 1973) (disclaimer of an inheritance by an individual prior to filing a petition in bankruptcy was not a "transfer"). However, the result in Hoecker turned upon the court's construction of the disclaimer statute, which produced a passing of property directly from the decedent to the ultimate beneficiary, without any connection to the disclaimant. Otherwise, "[t]he term 'transfer' would include the disclaimer filed by the bankrupt if the effect of such disclaimer was to transfer from him to his children the property devised and bequeathed to him by the will." Id. at 840-41.

Brochure ORD 87246 Ed. 10-90, supra note 33.
Rider ORD 87241-90, supra note 33.

In bankruptcy, an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement "that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of . . . a custodian" of a debtor's property, unless the restriction is "on the transfer of a beneficial interest of the debtor in a trust that is enforceable under 'applicable nonbankruptcy law' . . . ." 11 U.S.C. §§ 541(c)(1)(B), (c)(2) (1988).

The first issue is whether the Prudential rider creates a trust relationship. The Restatement (Second) of Trusts § 2 (1959) [hereinafter the Second Restatement] defines a trust in part as: "a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." However, § 12 of the Second Restatement states that "[a] debt is not a trust." Comment k
b. State Exemptions

If the federal exemptions are not attractive, the debtor can take of that section states that when the insured or the beneficiary of a life insurance policy exercises an option to receive deferred payments, the insurer does not become a trustee unless it is under a duty to segregate the proceeds as a separate fund, and the insurer does so. Otherwise, it is only a debtor. See George G. Bogert, The Law of Trusts and Trustees § 240 (1977 and Supp. 1986) (discussing the repudiation by courts of a trust characterization for insurance company payment arrangements in the absence of a segregated fund, but citing a number of overriding state statutes which recognize a trust relationship and the enforceability of spendthrift clauses under such circumstances). See, e.g., In Re Brown, 86 B.R. 944, 948 (Bankr. N.D. Ind. 1988) (life insurance company annuity contract containing a nonalienation clause purchased by the Arizona Lottery Commission for the benefit of a lottery winner characterized as a contract rather than a trust); compare In Re Haddad, 9 B.R. 368 (Bankr. D. Nev. 1981), aff'd in part, rev'd in part on other grounds, 15 B.R. 903 (Bankr. 9th Cir. 1981) (applying California Insurance Code provisions recognizing the enforceability of spendthrift clauses in insurance policies).

Legislative history indicates that 11 U.S.C. § 541(c)(2) was directed at interests in spendthrift trusts. See H.R. Rep. No. 595, 95th Cong., 2d Sess. 369, reprinted in 1978 U.S.C.C.A.N. 5963, 6325. Even if the Prudential rider is held to create a trust, it is not clear that it would be considered the type of trust relationship excluded from the estate. Courts are split, for example, on the issue of whether interests under trusts that comply with The Employee Retirement Income Security Act of 1974 ("ERISA"), requiring inclusion of anti-alienation clauses, 29 U.S.C. § 1056(d)(1) (1988), are excluded from property of the estate under 11 U.S.C. § 541(c)(2) if the beneficiary is in bankruptcy. The liberal minority rule reasons that since ERISA spendthrift restrictions are enforceable against creditors outside of bankruptcy, they are also enforceable against the bankruptcy trustee. See, e.g., In Re Moore, 907 F.2d 1476 (4th Cir. 1990). The majority of courts, however, hold that the legislative history of 11 U.S.C. § 541(c)(2) indicates that Congress intended only to exclude traditional spendthrift trusts under state law. See, e.g., In Re Kerr, 65 B.R. 739 (Bankr. D. Utah 1986) (the spendthrift clause was not enforced against creditors because Utah law does not enforce such clauses if the trust is self-settled). A stated rationale is that if Congress intended to include ERISA anti-alienation provisions in 11 U.S.C. § 541(c)(2), thereby excluding all ERISA benefits from the estate, no function would be served by 11 U.S.C. § 522(d)(10)(E) which exempts certain ERISA benefits. See, e.g., In Re Starkey, 116 B.R. 259, 262 n.1 (Bankr. D. Colo. 1990). A similar argument could be made with respect to an unmatured life insurance contract as it is already exempted under 11 U.S.C. § 522(d)(7). However, whether living benefits would be included as unmatured life insurance is unclear. See supra note 72.

The final issue is whether a spendthrift provision in favor of the creator of the trust or other relationship is enforceable against the claims of creditors as a matter of state law. A typical test of enforceability under state law as a spendthrift trust includes a determination of: (a) whether spendthrift trusts are valid in the state; (b) whether the trust restrains the voluntary or involuntary transfer of the beneficiary's interest; and (c) whether the settlor is the beneficiary and has thereby created an invalid spendthrift trust. See In Re Matteson, 58 B.R. 909, 911 (Bankr. D. Colo. 1986). (A principal factor is the degree of dominion and control a beneficiary has over the trust corpus. The pension plan was held to be a valid spendthrift trust and excludable under 11 U.S.C. § 541(c)(2) because Matteson had limited access to the plan.). The Prudential clause is technically a forfeiture restraint which terminates the debtor's interest upon an attempted alienation. This type of clause is generally
advantage of state creditor exemption statutes which make life insurance “the most privileged capital asset in the United States.” An examination of such statutes and their application to the living benefit options is beyond the scope of this article. However, it

enforceable. See § 150 of the Second Restatement (a forfeiture restraint is valid as to income) and § 153 of the Second Restatement (a forfeiture restraint on principal is generally enforceable, subject, however, to sections 156 and 157). Section 157 of the Second Restatement deals with certain classes of claimants, such as a spouse or child claiming support, a supplier of necessaries, or a governmental claim, who are not barred by a spendthrift clause. Section 156 of the Second Restatement provides that where a person creates for his or her own benefit a trust with a spendthrift provision, creditors can reach his or her interest. Comment f to § 156 states that “it is not necessary that the beneficiary shall have himself conveyed the property held in trust. It is sufficient that he paid the purchase price for a conveyance upon a trust, of which he is the beneficiary or one of the beneficiaries.” It would seem that the insured who pays the life insurance premiums could be compared to the creator of a self-settled trust.

In bankruptcy cases, which typically involve retirement plans, the self-settled aspects of such plans often preclude an exemption. See, e.g., In Re Goff, 706 F.2d 574 (5th Cir. 1983) (self-settled aspects of plan, where only the debtor contributed to the plan, violated state law concerning spendthrift trusts); In Re Swanson, 79 B.R. 422 (D. Minn. 1987) (pension fund under Minnesota Teachers Retirement Act not an exempt spendthrift trust, in part because beneficiary was an indirect settlor of a self-settled trust to the extent of employee contributions, and in part because beneficiaries could withdraw funds at will upon termination of their employment); In Re Walker, 108 B.R. 769 (Bankr. N.D. Okl. 1989) (self-settled aspects of Individual Retirement Arrangement precluded recognition as valid spendthrift trust interest); In Re Boykin, 118 B.R. 716 (Bankr. W.D. Mo. 1990) (Wal-Mart Profit Sharing Plan interest found not excludable because debtor's control, including the right to receive benefits upon a termination of employment, was inconsistent with spendthrift trust law); In Re Lyons, 118 B.R. 634 (C.D. Ill. 1990) (debtor's interest in Illinois State Employees Retirement System not exempt because employee could reach assets by voluntarily terminating his employment).


See, e.g., Cal. Civ. Proc. Code § 704.100 (West 1987) (exempts $4,000 of loan value, but balance of loan value is subject to creditor claims; otherwise, unmatured life insurance policies are exempt, and benefits from matured policies (including endowment and annuity policies) are exempt to the extent reasonably necessary for the support of the judgment debtor and the spouse and dependents of the judgment debtor); Colo. Rev. Stat. § 13-54-102(1)(l) (Supp. 1990) (life insurance to the extent of $5,000 exempt from levy and sale); Fla. Stat. Ann. § 222.14 (West 1991) (cash surrender value and proceeds of annuity contracts are exempt); Ill. Ann. Stat. ch. 110, ¶ 12-1001(f) (Smith-Hurd 1991) (exempts all proceeds paid because of death of the insured and the aggregate net cash value of life insurance, endowment policies, and annuity contracts payable to a wife or husband of the insured, or to a child, parent, or other person dependent upon the insured); N.M. Stat. Ann. § 42-10-3 (Michie 1978) (broad exemption for most insurance proceeds); Tex. Prop. Code Ann. § 42.002(7) (West 1984) (exempts cash surrender value of any policy in force more than two years if a member of the insured's family or a dependent of a single person claiming the exemption is a beneficiary).
can be said that the common law, in tandem with state statutory exemptions, is very protective of the owners and beneficiaries of life insurance. A number of courts have found that in the absence of special circumstances, such as fraud, creditors are precluded from obtaining the cash surrender value of a life insurance policy by garnishment or other proceedings. The presence of the spendthrift clause is also of some force in frustrating creditor claims against available living needs benefits.

2. Public Assistance Eligibility

The receipt of living needs benefits may affect eligibility for future Medicaid or other public assistance benefits. A question to which an answer is less clear is whether a life insurance policy containing an exercisable living benefits option should be valued according to the available benefits, even if the option is not exercised.

The standard for determining Medicaid eligibility is "income and resources... as are available to the applicant or recipient." Limited authority previously held that only the cash surrender value of life insurance policies could be taken into account for this purpose. It is difficult to distinguish a cash surrender value from

78 In explaining why an insured cannot be compelled to request the cash surrender value of a policy, one commentary states, "[T]his distinction between an option right, available to but not exercised by the insured, and a fully matured and accrued liability or debt on the part of the insurer to the insured, is made apparent by many of the cases." 6 Couch on Insurance 2d, supra note 15, § 32.155, at 449. Another commentary states, "[t]he courts have considered that the purpose of life insurance is to provide for the maintenance of those surviving the insured and dependent upon him. Consequently, one of the most popular indoor sports among jurists is to find new reasons for this rule." 2A John A. Appleman, Insurance Law and Practice § 1341, at 567 (1966). For a thorough, although somewhat dated, exposition of the law in this area see Riesenfeld, supra note 76.

79 See supra text accompanying note 74. An objection to enforcement of the spendthrift clause is that it runs in favor of the insured, who would also generally be the policyowner and also the beneficiary. Moreover, the insured can terminate the rider, at his or her option, so the rider, and its spendthrift provision, is cancellable by the insured. A spendthrift clause in a trust for the settlor's own benefit is generally not given effect. See supra note 75.

80 The Prudential brochure disclosures state that "[y]ou may affect your ability to receive certain government benefits or entitlements." Brochure ORD 87246 Ed. 10-90, supra note 33. A reported administrative agreement supports this conclusion. See infra note 84.


82 See Wilczynski v. Harder, 323 F. Supp. 509 (D. Conn. 1971) (state Medicaid eligibility regulation requiring evaluation of life insurance policies at face value held invalid). The Prudential rider, for example, permits the relinquishment of the rider and its benefits. If
the living needs benefit option. The traditional distinction that the face amount, as compared to the cash surrender value, was not includible because it was not available appears inappropriate; for the living needs benefit is available to an insured, and the face value of traditional policies never was. The Social Security Administration and Health Care Financing Administration agreed, however, that potential living benefits are not an "available" resource.

A spendthrift provision in the Prudential rider also addresses this issue, stating that, "[i]f you are required by a government agency to use this option in order to apply for, obtain, or keep a government benefit or entitlement, you are not eligible for this benefit." Although not directly on point, state case law is divided on the issue of whether a spendthrift clause can make trust property unavailable to public agencies providing support to the beneficiary.

the option would otherwise be an asset to be considered for purposes of public assistance, would the relinquishment be an impermissible transfer of property to the beneficiary? In that regard, most public assistance statutes prohibit asset transfers within a specified period prior to an application for benefits by the transferor. See, e.g., 42 U.S.C.A. §§ 1396a(a)(51)(B), 1396p(c) (West Supp. 1991) (Medicaid standards for pre-application asset transfers); Abramson v. Welfare Commission, 31 Conn. Supp. 544, 330 A.2d 822 (1974) (addressing a transfer of assets prior to application for benefits).

The individual in Wilczynski v. Harder, supra note 82, was not terminally ill, so that the face value of the policy was not ripe. Moreover, this 1971 decision predates the recent development of sales by the terminally ill to independent brokers as an avenue in realizing a portion of the face value of policies. Life insurance company options aside, it would seem that the net realizable value of the policy that can be obtained from independent brokers could be the value of the policy for this purpose, like any other asset.

These two agencies have agreed that benefits when and as received are considered as resources; potential benefits are not. McCormack & Petersen, supra note 12, at 1352.

This again raises the issue discussed at length in supra note 75 of whether a life insurance company settlement option creates a trust relationship for state law purposes. Comment k to § 12 of the Second Restatement, supra note 75, states: "Thus, just as a restraint on the alienation of the interest of a beneficiary under a trust may be valid . . . so a restraint on the interest of the beneficiary of an insurance policy may be valid, since the policy permitting spendthrift trusts is equally applicable to life insurance contracts."

The leading case finding that a spendthrift trust clause can defeat the claims of a public agency for the support of a beneficiary is Zeoli v. Comm'r of Social Services, 179 Conn. 83, 425 A.2d 553 (1979) (the trustee's standard for distributions was absolute, uncontrolled discretion). See also Miller v. Ibarra, 746 F. Supp. 19 (D. Colo. 1990) (court-created trusts for incompetent nursing home residents were not available resources for Medicaid). Trusts have been tapped where the intent of the settlor was support of the beneficiary, and no prohibition was expressed on the use of trust funds for support which public agencies would otherwise provide. See, e.g., Department of Mental Health & Developmental Disabilities v. First
If the living benefits would be subject to offset if received or affect eligibility for assistance even if not exercised, the living benefits options would be less attractive to needy individuals who wish to leave a death benefit to survivors. Pending legislation would exempt unexercised living benefit options from available resources for public assistance eligibility.  

IV. CONSIDERING AN INCOME TAX EXCLUSION FOR ACCELERATED DEATH BENEFITS  

A. General Policy Questions  

The enactment of an income tax exclusion for terminal illness benefits could be based on humanitarian grounds. Simply stated, the tragedy surrounding a person who is about to die, and his or her family and loved ones, should not be exacerbated by the federal government collecting a tax. This rationale is partially reflected in exclusions for personal injury awards. Humanitarian appeals have their limits, however, and a more common legislative response is to fashion a need-based exclusion or deduction.

Another argument for excluding living benefits is that the tax collector should not receive a windfall from a taxpayer's misfortune. If the taxpayer could have waited a bit longer, all of the proceeds would be exempt from tax upon the insured's death. This same argument, however, could be leveled at almost any favorable provision, the attainment of which a taxpayer barely misses. The

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See infra note 278.

"The imposition of an income tax on compensation received by persons who have been seriously injured by accident would no doubt be regarded as heartless, unless recoveries from tortfeasors were correspondingly increased." Bittker & Lokken, supra note 3, ¶ 13.1.1., at 13-2.

One example is the 7.5% of adjusted gross income floor for medical expenses imposed by I.R.C. § 213(a). Other examples are the $100 floor and 10% of adjusted gross income limitations applicable to personal casualty losses, I.R.C. § 165(h), and the partial inclusion of social security benefits, I.R.C. § 86.

Some in the insurance industry have voiced this argument: "[An exclusion for accelerated death benefits] is simply the same treatment as if the benefits were paid a few months later, after death . . . . [A]ccelerated death benefits are just death benefits paid a few months early." 1991 Senate Hearing, supra note 21 (oral testimony of Robert P. Hill, Executive Vice President of the Prudential Insurance Company of America). There is, however, a
argument, however, has more force, if it is restated in terms of "substantial compliance;" that is, if proceeds are totally excluded upon the insured's death, doesn't the same policy justification apply to a lifetime payment shortly before death? The role of death as the determinative factor is addressed in section IV(B) below.

An exclusion for accelerated death benefits at first seems consistent with horizontal\(^{91}\) and vertical\(^{92}\) equity. An exclusion would, however, conflict with the principles of economic neutrality\(^{93}\) and

horizontal and vertical equity aspect to this argument which is discussed at infra text accompanying notes 91-103.

91 "As applied to income taxation, the horizontal equity principle is usually said to require that persons with equal [economic] incomes pay the same amount of taxes." Bittker & Lokken, supra note 3, ¶ 3.1.4, at 3-10. Taxing living benefits must fail the horizontal equity test if one compares, all other factors equal, the tax burden of a terminally ill person who receives a taxable living benefit, with that of a terminally ill person who defers receipt, such that his or her beneficiaries receive the benefits without the imposition of a tax. This doesn't prove much, because most tax exclusions, when viewed comparatively, operate in this fashion. Moreover, the comparison is not altogether accurate; the decedent received the living benefits while living, while in the latter case the beneficiaries received the benefits. The comparison is closer if one compares the family group, including the insured, before, and the family group survivors, after, the insured's death. This recognizes that the survivors are financially impacted by the care of the insured and their own support requirements prior to the insured's death, as well as their support after the insured's death. The taxation of the living as compared to the taxation of the heirs and the devisees of the once living also demonstrates skewed results arising from the use of death as a line of demarcation. For example, if the insured would sell shares of corporate stock before death, or would gift shares to a family member who ultimately sold them, any gain on the transaction would be determined with reference to the insured's adjusted basis. See I.R.C. § 1015. If the family member, however, received the stock upon the death of the insured, the adjusted basis of the stock would become the stock's fair market value at the insured's date of death (or alternate valuation date, if applicable). See I.R.C. § 1014. The analogy of an accelerated death benefits exclusion to I.R.C. § 1014 is discussed in the text which follows.

92 "[V]ertical equity as a principle mandates only that there be some differentiation between each group and the next higher and lower groups, and does not specify the amount of the differentiation." Bittker & Lokken, supra note 3, ¶ 3.1.4, at 3-12. This factor is discussed in the text which follows.

93 "Any tax has an efficiency cost because it alters the relative values of labor, capital and leisure, thereby affecting the allocation of resources. The goal is to choose a tax system, consistent with other objectives, that minimizes these efficiency costs." Stanley S. Surrey, Paul R. McDaniel, Hugh J. Ault, & Stanley A. Koppelman, Federal Income Taxation 46-47 (1986) [hereinafter Surrey & McDaniel]. The availability of living benefits could direct more investment into life insurance products. A recent article foreshadows the obvious marketing theme: "Life insurance is finally living up to its name. Instead of just protecting your near-est and dearest from financial burden after your death, some new policies free up the proceeds before you die. . . . The enthusiasm is understandable." Steven Findlay, Now, Benefits for the Living, 109 U.S. News & World Rep., Oct. 8, 1990, at 78. According to a study sponsored by the American Council of Life Insurance, of individuals interviewed, approximately 40% of "those without individually-purchased life insurance indicated that the avail-
simplicity. In this regard, the strongest traditional tax policy argument in support of an exclusion apparently rests on considerations of vertical equity. In the absence of a tax exemption for accelerated death benefits, a person with other financial resources could avoid the income tax on insurance benefits by using other assets rather than an accelerated payment of death benefits. This would seem to present the greatest negative impact on the middle to upper-middle class taxpayer with dependents; wealthy people would not need to utilize a lifetime benefit payment, or want to utilize it due to the obvious adverse income and estate taxation consequences, while a poor individual or individual without dependents may not be overly concerned about the tax aspects of

ability of accelerated death benefits increased the likelihood of their purchasing life insurance.” ACLI Survey, supra note 30, at 2. This additional incentive to life insurance acquisition is not necessarily desirable. In addressing a proposed exclusion for accelerated death benefits the staff of the Joint Committee on Taxation stated, “[t]he treatment of inside buildup under present law favors life insurance as an investment over other investment vehicles thereby distorting the flow of savings and investment in the economy. The bill would provide an additional incentive for individuals to purchase life insurance and would exacerbate the inefficiencies of present law.” Joint Comm. on Tax’n, Description of Tax Bills (S. 90, S. 150, S. 267, S. 284, S. 649, and S. 913) 23 (Comm. Print. 1991) [hereinafter Staff Explanation]. Some in the insurance industry apparently expect to sell, or keep in force, more life insurance. One industry spokesman has urged the adoption of an exclusion in part to “contribute to the stability of that sector of the financial services community represented by life insurers.” 1991 Senate Hearing, supra note 21 (statement of Denis F. Mullane, CEO and President, Connecticut Mutual Life Insurance Company).

“Simplicity . . . can be used to assess the way a statute is written and the ease with which taxpayers may comply with the system . . . [I]t can also refer to the extent to which taxation complicates everyday life for taxpayers by requiring that transactions be structured to take consequences into account. Or simplicity can relate to the ease with which a tax system is administered.” Surrey & McDaniel, supra note 93, at 47. A difficulty would arise in determining who is “terminally ill” for purposes of a statute. See infra text accompanying notes 276-77.

A wealthy person for whom estate taxation is an issue, would generally seek to avoid any “incidents of ownership” in the life insurance which would require inclusion in the taxable estate. See I.R.C. § 2042. An inter vivos payment to the insured would frustrate this tax avoidance plan by making the unexpended proceeds an asset of the estate under I.R.C. § 2033.

The distribution of life insurance ownership bears a relationship to household income such that an income tax on the average amount of insurance owned by a low income household could be negligible. See infra note 208. A single person, without dependents, might not claim the proceeds as income. If death is imminent, income taxes payable and an insolvent estate, even assuming the discrepancy is disclosed by a timely audit, may not be a practical concern. “Despite the current law, many policy sellers have decided not to pay taxes on their proceeds. Some acknowledged that is one reason they prefer not to give their full names.” Groves, supra note 20, at A 19. There currently is not a Form 1099 reporting re-
the transaction.

The current life insurance death benefit exclusion grants to the insured's estate or other beneficiary, an income tax basis in the policy equal to the death proceeds, in a fashion resembling the at death basis adjustment provided by section 1014.97 Placed in that light, the vertical equity objections advanced above are not limited to the treatment of accelerated death benefits, but apply to any assets (with an inherent gain) that must be sold prior to death. In speaking to the reasons for the elimination of section 1014 in favor of the stillborn section 1023,98 the Staff of the Joint Committee on Taxation noted:

Prior law resulted in an unwarranted discrimination against those persons who sell their property prior to death as compared with those whose property was not sold until after death. Where a person sells appreciated property before death, the resulting gain is subject to the income tax. However, if the sale of the property could be postponed until after the owner's death, all of the appreciation occurring before death would not be subject to the income

requirement for sales of policies to companies other than the insurer. Life insurance companies must report certain policy surrenders. See Temp. Treas. Reg. § 35.3405-1, F-18.

97 If the theme of I.R.C. § 1014 had not been followed, that of I.R.C. § 691, applicable to income in respect of a decedent, could have been adopted to tax the recipient on any insurance proceeds in excess of the decedent's basis in the contract; that result would resemble I.R.C. § 1015 carryover basis. A carryover basis treatment for life insurance was, however, rejected in the carryover basis rules of I.R.C. § 1023(b)(2)(B) introduced by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (as amended in scattered sections of 26 U.S.C.). This exclusion of life insurance met with some criticism. Michael Graetz proposed that "at a minimum, interest earned on life insurance policies should be subject to a death-time income tax." Michael Graetz, Taxation of Unrealized Gains at Death - An Evaluation of the Current Proposals, 59 Va. L. Rev. 830, 846 (1973). The § 101 exclusion has also been compared to the exclusion for gifts and inheritances provided by I.R.C. § 102. See infra text accompanying notes 134-37. The easiest analogy is to a testamentary transfer arranged through a contract between the insured decedent and an insurance company for the benefit of the insurance policy beneficiary. The analogy does not work well, however, when a third party procures insurance on the life of the insured decedent, who plays no part in the contract other than being the insured life. In that regard too, the I.R.C. § 101 exclusion is even broader than the I.R.C. § 1014 basis adjustment which applies only to the basis of property acquired or passing from a decedent.

On closer examination, an income tax exclusion for accelerated death benefits could be viewed as underinclusive, as elevating life insurance above other significant assets, such as homes and retirement savings, which also may need to be liquidated on account of terminal illness. An exclusion might also be viewed as a further expansion of an overexpanded principle: the death basis adjustment in section 1014 of the Code.\textsuperscript{100}

Without the special circumstances presented by payments to the terminally ill, the current death benefit exclusion apparently operates in an uneven fashion when considered from the standpoint of vertical equity. Life insurance ownership is a tax advantaged investment for the middle to upper-middle class,\textsuperscript{101} of mixed attrac-


\textsuperscript{101} Treasury estimates in 1983 of the distribution of life insurance demonstrated an increase in the percentage of families with cash-value life insurance that correlated with increases in family income.

<table>
<thead>
<tr>
<th>Family Economic Income</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 0 - 9,999</td>
<td>13</td>
</tr>
<tr>
<td>10,000 - 14,999</td>
<td>25</td>
</tr>
<tr>
<td>15,000 - 19,999</td>
<td>33</td>
</tr>
<tr>
<td>20,000 - 29,999</td>
<td>41</td>
</tr>
<tr>
<td>30,000 - 49,999</td>
<td>53</td>
</tr>
<tr>
<td>50,000 - 99,999</td>
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<tr>
<td>200,000 or more</td>
<td>70</td>
</tr>
<tr>
<td>All Families</td>
<td>42</td>
</tr>
</tbody>
</table>

Reprinted in Tax Reform for Fairness, Simplicity and Economic Growth: The Treasury Department Report, Vol. 2, 262 (Nov. 1984) (hereinafter Treasury I). Based on ordinary life insurance purchases, the greatest percentage of insurance purchased was by insureds in the $25,000-$49,999 income range, while 45% was purchased by insureds with incomes in excess of $50,000.
tiveness to the very wealthy,\textsuperscript{102} and most likely not tax driven at all for the very poor.\textsuperscript{103}

In considering an expansion of the current income tax exclusion for accelerated death benefits, the inquiry should consider why the exclusion applies only to payments received upon the death of the insured, and if broadening the exclusion would promote the policy objectives of Congress concerning life insurance reflected in its income tax treatment. Accordingly, the policy underlying the treatment of life insurance investment is considered in the next section.

<table>
<thead>
<tr>
<th>Income of Insured</th>
<th>% of Amount 1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $5,000</td>
<td>Less than .5%</td>
</tr>
<tr>
<td>$5,000 - 7,499</td>
<td>Less than .5%</td>
</tr>
<tr>
<td>7,500 - 9,999</td>
<td>1</td>
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<tr>
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<tr>
<td>50,000 - 99,999</td>
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</tr>
<tr>
<td>100,000 or more</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

1990 Life Insurance Fact Book, supra note 9, at 12. These statistics, however, do not indicate the percentage of total insurance in force owned by each income category. See infra note 208.

\textsuperscript{102} Because of the administrative "load" charged by insurance companies municipal bonds may provide a better tax shelter for very wealthy individuals. However, one commentator has noted that the after-tax return on life insurance could exceed the modest tax-free return on state and local obligations. See Graetz, supra note 3, at 189. Compare Mark Warschawsky, Life Insurance Savings and the After-Tax Life Insurance Rate of Return, 52 J. Risk & Ins. 585 (1985) (attributing a decline in life insurance as a percentage of household savings to a widening of the after-tax rate of return differential in comparison with alternative investments, due in part to the slow adjustment of returns from long-term corporate bond investments historically held by insurers in the face of high market interest rates).

Although historically life insurance was more attractive to taxpayers with mostly earned incomes, as compared to those with investment incomes, see Richard Goode, Policyholders' Interest Income From Life Insurance Under the Income Tax, 16 Vand. L. Rev. 33, 45 (1962), current planning literature praises insurance for the very wealthy:

With the advent of Sec. 2036(c) in Dec. 1987, as well as its successor, Chapter 14, owners of estates as large as in the nine digits are fast becoming life insurance believers. Planning professionals...are now aggressively advocating life insurance as a key ingredient in estate plans, including those with assets of $10 million and higher. A contributing factor to this change of attitude...is the product revolution in the life insurance industry over the past 15 years and the introduction of innovative new products.


\textsuperscript{103} Based on 1989 insurance company statistics, less than .5% of ordinary life insurance purchases were by people in the under $7,499 income range, and only 1% of total policy amounts was purchased by individuals in the $7,500-9,999 income range. 20%, however, was purchased by individuals in the $10,000-24,999 range. See supra note 101.
However, a brief comment about health and long-term care insurance is required.

As described in part III, many of the accelerated death benefit policies, including the Prudential plan, offer long-term care options as well as terminal illness options. As noted there, only portions of the long-term care or nursing home benefits may be eligible for an offsetting medical expense deduction in view of the predominant custodial care, as opposed to skilled nursing care, aspects of long-term care confinement. Proposed legislation excludes terminal illness benefits, but ignores long-term care benefits. An income tax exclusion for long-term care benefits is beyond the scope of this article, but is a related topic. For example, an exclusion for life insurance terminal illness benefits and long-term care benefits might not only be compared to a liberalization of the life insurance death benefit exclusion, but also to a broadening of the section 104(a)(3) exclusion for “amounts received through accident or health insurance for personal injuries or sickness.” An exclusion for long-term care, focusing on the preservation of life, more closely resembles the area addressed by an exclusion for health insurance than would an exclusion for terminal illness options which are directly related to the death of the insured. An in depth analysis of the policies underlying the health insurance exclusion, including its application to long-term care benefits, is therefore not attempted in this article. However, the

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104 See supra text accompanying notes 29-33.
105 See supra note 49.
106 See supra text accompanying notes 260-79 discussing legislative proposals for amendments to I.R.C. § 101 to exclude proceeds of terminal illness payments.
107 See supra text accompanying notes 54-62 for a discussion of possible exclusion of terminal illness benefits under I.R.C. § 104(a)(3). In hearings concerning an income tax exclusion for accelerated death benefits, one insurance industry spokesman urged a broader approach, that would clarify the treatment of death benefits accelerated for conditions other than terminal illness, and would extend health insurance treatment to long-term care insurance. 1991 Senate Hearing, supra note 21 (statement of Daniel A. Mica, Executive Vice President, American Council of Life Insurance).
108 The I.R.C. § 104(a)(3) exclusion is applied to exclude all health insurance receipts, irrespective of the actual amounts spent on health related expenses. See, e.g., Rev. Rul. 58-602, 1958-2 C.B. 109 (amounts under surgical expense indemnity were excluded although paid irrespective of actual expenses); Rev. Rul. 69-154, 1969-1 C.B. 46 (excess indemnification received from multiple insurance policies is excludable if from insured’s own contributions). However, a deduction for medical expenses is denied to the extent reimbursed by insurance, see I.R.C. § 213(a), and a subsequent year reimbursement of previously deducted expenses can give rise to income, see Treas. Reg. § 1.213-1(g). This broad exclusion was
long-term care, terminal illness overlay might also suggest a flaw in the approach of proposed legislation. Instead of broadening the income tax treatment of life insurance to accommodate accelerated death benefits, the discussion should be directed at a broader exclusion, along the lines of health insurance, for the care of the terminally ill and their dependents.\textsuperscript{109}

\textbf{B. The Significance of Death to the Exclusion}

As will be demonstrated by the following discussion, the justifications for the longstanding exclusion of life insurance death benefits are more clearly enunciated today than they were upon the provision's adoption almost 80 years ago. It is likely that the underlying policies have changed while the provision's language has remained relatively static.

introduced in 1918, prompted by doubts of whether such receipts were “income” in a constitutional sense, but has been retained on general policy reasons. See Bittker & Lokken, supra note 3, ¶ 13.1.1, at 13-2. It would seem that the I.R.C. § 104(a)(3) exclusion is appropriate because the taxpayer generally spends much, if not all, of the receipts for medical care. There is no net gain, instead the taxpayer subsists. Long-term care is somewhat different, however, because to the extent not spent on medical expenses, which are otherwise deductible, the proceeds may be spent on day-to-day care, a personal expense. These are the expenses shared by all taxpayers to varying degrees, but for which a deduction is denied under I.R.C. § 262. However, long-term care is more expensive than the day-to-day costs of independent living and is linked to disability. Compare I.R.C. § 123 which excludes from income, casualty insurance proceeds received for actual living expenses in excess of “normal living expenses.” This discussion arguably relies too much on concepts of what are deductible medical expenses. Such expenses are admittedly personal, it is just that Congress has permitted their deductibility. An exclusion for long-term care benefits would simply expand the classes of deductible personal expenditures. Properly circumscribed, the Treasury would not be subsidizing high living, but rather the extraordinary living expenses of individuals who cannot regularly dress, bathe, use the restroom, or eat without assistance.

\textsuperscript{109} The development by life insurance companies of accelerated death benefits, which have long-term care aspects, has reportedly created friction with traditional health insurance providers. See supra note 25. A focus on life insurance, rather than health or long-term care insurance, is arguably misdirected:

If the purpose of the bill is to encourage individuals to purchase insurance that covers the expenses of a terminal illness, the bill is inefficient because it requires the purchase of life insurance in order to obtain the favorable tax treatment. A more efficient approach would be to provide a tax subsidy for the purchase of terminal illness insurance.

Staff Explanation, supra note 93, at 23. Legislation has been introduced in Congress which would extend the existing health insurance benefits income tax exclusion to long-term care insurance benefits. See H.R. 1693, 102nd Cong., 1st Sess. (introduced April 10, 1991); S. 1021, 102nd Cong., 1st Sess. (introduced May 9, 1991).
1. Civil War and 1894 Tax Acts

During the Civil War era, income taxes were broadly cast and could have arguably encompassed life insurance proceeds payable upon the death of an insured. A series of Treasury rulings resolved this question in the taxpayer's favor by exempting life insurance proceeds and kindred receipts from taxation.

110 The Act of August 5, 1861 levied a 3% tax on all incomes in excess of $800. The tax base was “annual income . . . derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any source whatever . . . .” Special rates were provided for income from U.S. Treasury securities and income of citizens residing abroad. 37th Cong. 1st Sess., ch. 45, § 49, 12 Stat. 292, 309. The Act of August 5, 1861 was repealed by the Act of July 1, 1862. See 37th Cong., 2nd Sess., ch. 119, § 89, 12 Stat. 432, 473. The new statute defined the tax base as: “annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatsoever, except as hereinafter mentioned . . . .” See Id. § 90, 12 Stat. 473.


111 A letter dated April 23, 1866, signed by D.C. Whitman, Deputy Commissioner responded to the question of whether “a sum received by A. from a life insurance company, upon a policy taken out by B. for the benefit of A., [is] taxable in any form under the excise law?” The reply was “that by the ruling of this office, sums of money so paid by life insurance companies are subject to neither legacy nor income tax.” 3 Internal Revenue Rec. 140, col. 2 & 3. Another letter dated March 30, 1866, signed by E.A. Rollins, Commissioner, responded to the question of whether wrongful death damages paid to the guardian of minor children are “taxed as a legacy, or distributive shares.” The reply was that “the ruling of this Office has always regarded moneys received in satisfaction of damages as neither legacy nor income.” 3 Internal Revenue Rec. 118, col. 1.

The treatment of gifts, however, was mixed. In an April 17, 1866 letter signed by D.C. Whitman, Deputy Commissioner, two inter vivos gifts were treated as taxable income to the recipients. This was indicated to be a change in Treasury policy, said to have occurred on March 24, 1866. 3 Internal Revenue Rec. 140, col. 2. Another ruling dated April 17, 1866, also classified lifetime gifts as taxable income. 3 Internal Revenue Rec. 133, col. 2. The inquiry by an assessor in New York referred to an earlier ruling of Commissioner Lewis
The short-lived112 Act of 1894113 contained a broad catchall phrase that could have been construed to include life insurance death benefits.114 The statute also expressly included as income “money and the value of all personal property acquired by gift or inheritance . . . .”115 The ambiguous treatment of life insurance proceeds and the imposition of a tax on gifts, were accomplished in an environment sensitive to the issue of whether a tax on certain receipts was a direct tax in violation of the Constitution. One Civil War income tax had already withstood this attack.116 Concerns about the constitutionality of the income tax as applied to real estate rents, for example, spawned an amendment, which was ultimately rejected, to exclude “rents from real estate”.117 At this point, an express exclusion of life insurance proceeds, however, was not proposed. The setting would change for future legislation with the defeat of this statute on constitutional grounds and ratification of the Sixteenth Amendment.118

which excluded gifts from income. The inquiry suggested that gifts be taxed as a backstop to the inheritance tax (imposed by the Act of June 30, 1864, see supra note 110) which could otherwise be avoided by lifetime gifts. However, in instructions dated January 1, 1868, for the collection of taxes under the Act of March 2, 1867, gifts were excluded from income, as well as “[a]mounts received on life insurance policies and damages recovered in actions of tort.” 7 Internal Revenue Rec. 58, 59, col. 2.

112 The law was declared unconstitutional, as an unapportioned direct tax, in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). The Civil War Act of June 30, 1864 as amended by the Act of March 3, 1865, had been upheld against constitutional objections as a direct tax in Springer v. United States, 102 U.S. 586 (1880) (Court construed direct taxes as primarily head and real estate taxes; the tax in question was an excise or duty not requiring apportionment).


114 The Act of 1894, id., described the tax base in relevant part as “all other gains, profits, and income derived from any source whatever. . . .” Act of 1894, § 28, 28 Stat. 553.

115 Act of 1894, supra note 113, § 28, 28 Stat. 553. Opponents of this addition unsuccessfully tried to exempt inheritances of spouses and lineal descendants (26 Cong. Rec. 6778-79 (1894)) and unsuccessfully tried to exempt gifts altogether (26 Cong. Rec. 6823-25 (1894)).

116 The early Supreme Court precedent focused the direct tax inquiry on head taxes and taxes levied on real estate. See supra note 112.

117 The proponent of the amendment was Senator Hill. 26 Cong. Rec. 6826-27 (1894). The word “devise” (which refers to transfers of real property) was also stricken from the provision for the taxation of gifts, to ensure that gifts on bequests of real property were not taxed, because some feared this to be an impermissible direct tax. See 26 Cong. Rec. 6820-25 (1894).

118 With the 1913 Income Tax Act some have suggested that the doubtful constitutionality of taxing life insurance proceeds may have been a factor in the adoption of an express exclusion. Of course, the focus had shifted from direct tax constitutional questions to the
The imposition of an income tax on both gifts and inheritances suggests no philosophical deference toward amounts received of a testamentary nature, although congressional sentiment was bitterly divided on this point. Gifts which had been taxable income in several Civil War vintage administrative pronouncements were now expressly included. Personal injury awards and life insurance death benefits which had been expressly excluded in similar rulings were neither expressly included in nor excluded from income in the statute. One might speculate that the reasons for the prior administrative exclusion of life insurance death benefits were still considered appropriate.

2. 1913 Income Tax Act

The 1913 Income Tax Act contained the first statutory exclusion for life insurance proceeds. The language of the congressional debate suggests several bases for the exclusion.

meaning of "income" in a constitutional sense. See infra text accompanying notes 125-30.

119 Senator Hill strongly objected to taxing gifts and inheritances. 26 Cong. Rec. 6821-23 (1894). Senator Hoar first proposed an amendment which would exempt transfers from lineal ancestors and descendents or between spouses. See 26 Cong. Rec. 6778 (1894). After that amendment was rejected, he unsuccessfully proposed an amendment which would have created a $5,000 exemption for gifts and inheritances. See 26 Cong. Rec. 6779-6780 (1894).

120 The Civil War vintage pronouncements, with at least one exception, treated gifts as taxable income. See supra note 111. The Civil War period saw the imposition of an inheritance tax in the Act of June 30, 1864 (see supra note 110), repealed in 1870, and upheld in Schloley v. Rew, 90 U.S. 331 (1874), while a death tax was not again seen until 1898 (Act of June 13, 1898, §§ 29-30, 30 Stat. 448, 464-465), which was upheld in Knowlton v. Moore, 178 U.S. 41 (1900). Some have analogized the current exclusion for insurance proceeds to the exclusion of I.R.C. § 102 for gifts and inheritances. See infra text accompanying notes 134-37.

121 See supra note 111.

122 Regulations dated December 13, 1894, interpreting the Act of 1894, do not mention personal injury awards or life insurance proceeds. Regulations, Dec. 13, 1894, 46 pp., Sec. 7, No. 21, Treas. Dept. Doc. 1736, reprinted in Roger Foster & Everett Abbot, A Treatise on the Federal Income Tax Under the Act of 1894, at 475-502 (1895). This is to be contrasted with the instructions for the Civil War era Act of March 2, 1867, which expressly addressed gifts, life insurance, and personal injury awards. See supra note 111.


124 "Provided, [t]hat the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income." Act of 1913 § II(B), 38 Stat. 167.
Cordell Hull, the principal draftsman of the legislation, established a sharp distinction between taxable "income" and returns of "capital," stating that "[the statute] defines the net income of a taxable individual or person. Income as thus defined does not embrace capital or principal, but only such gains or profits as may be realized . . . ." Congressman Hull then proceeded to imply that insurance proceeds are nontaxable returns of capital, relying on prior judicial and administrative treatments:

The rulings of the Treasury Department and the decisions of the courts of this country with respect to similar provisions of the old income-tax laws, and also the English rules of construction . . . will make clear the distinction between taxable profits or income on the one hand and capital or principal on the other. The proceeds of life insurance policies paid on the death of the person insured are expressly exempted; likewise the return of any part of principal invested in insurance during life, as distinguished from the earnings upon same, would not be taxable.

Hull's reference to clear "rulings of the Treasury Department" must have been to those of the Civil War income tax period, which, in their cryptic fashion, did not specifically refer to returns of capital or any other principle as a basis of decision. Seven years later, the United States Supreme Court placed a constitutional gloss on concepts of income in its landmark decision rendered in *Eisner v. Macomber*, speaking of "gains" from capital. Later, the Court stopped short of clarifying the issue by broaching, but reserving judgment on, the constitutionality of a tax on life insurance death benefits. Several commentators have suggested that the

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115 50 Cong. Rec. 506 (1913) (statement of Congressman Hull).
116 Id.
117 See supra note 111.
118 252 U.S. 189 (1920). In its famous statement, the Court reaffirmed a definition of income expressed in two earlier cases involving the Corporation Tax Act of 1909 "as the gain derived from capital, from labor, or from both combined." Id. at 207.
119 See United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924). The Court noted that life insurance proceeds "are not usually classed as income," but did not decide whether "Congress could call the proceeds of such indemnity, income, and validly tax it as such." Id. at 195. The Court, in support of its view that insurance proceeds are not in the nature of income reasoned that death benefits have no periodicity. Id. The Court then made a replacement of capital argument, stating that "[i]t is a substitution of money value for something permanently lost either in a house, a ship, or a life." Id. One commentator has suggested that exclusions for personal injuries (see I.R.C. § 104) and disability proceeds (see I.R.C. § 105) could reflect notions of a nontaxable replacement of impaired human capital.
1913 statutory exclusion arose from doubts about the constitutionality of a tax on life insurance death benefits.130

Providing incentives for the protection of survivors, the prevailing justification today, was not expressly raised, but it was perhaps almost too obvious to mention in view of the strong survivor protection theme that had pervaded the life insurance sales campaigns. One writer, however, has asserted that the investment aspects of life insurance had become the primary selling point, with survivor protection assuming second place, by the end of the 19th Century.131 Congressman Hull responded to a question framed as "whether a widow will be required to pay an income tax on the money secured as the result of her husband's death, or whether

See Paul B. Stephan III, Federal Income Taxation and Human Capital, 70 Va. L. Rev. 1357 (1984). However, one cannot find any analogy by Professor Stephan to the life insurance death benefit exclusion. That is not surprising because unlike personal injury awards or disability payments which bear some relationship to an actual loss, the death benefit exclusion is limited only by the amount of insurance purchased. The constitutional limitations on taxable income have generated a number of scholarly discussions. See, e.g., Charles L. B. Lowndes, Current Conceptions of Taxable Income, 25 Ohio St. L.J. 151 (1964); Phillip Mullock, The Constitutional Problem of Taxing Gifts as Income, 53 Minn. L. Rev. 247 (1968); Phillip Mullock, Current Conceptions of Taxable Income - A Comment, 26 Ohio St. L.J. 43 (1965).

130 "This exclusion, in force since 1913, may have originally reflected doubts about the constitutional validity of taxing the proceeds of life insurance, but the exclusion is now based on a legislative policy judgment rather than on a perception of constitutional compulsion." Bittker & Lokken, supra note 3, ¶ 12.1.2, at 12-5. "Since life insurance proceeds payable on death have been excluded from gross income beginning with the 1913 Act, except in the case of certain transfers for value, it may be assumed that such proceeds were not considered to be within the constitutional concept of gross income." Leslie M. Rapp, Some Recent Developments in the Concept of Taxable Income, 11 Tax L. Rev. 329, 340 (1956). "The rationale behind the exclusion ... is unclear. However, it may be that the exclusion rests upon the same uncertainty that supports the exclusion of gifts and bequests, that is, that the recipient does not have 'income' within the meaning of the statute, the sixteenth amendment, or the Constitution." Thomas J. Gallagher, Jr., A Primer on Section 101 - Federal Income Taxation of Life Insurance Proceeds, 49 Temp. L.Q. 831 n.2 (1976).

131 Life insurance advertising after the 1870's reflected the new emphasis on investment by adopting an unemotional rational approach to its product. Traditional sales appeals were criticized: "What has thus far been urged of life insurance is an argument that it saves our homes from the claims of creditors, leaves a support for wives and children. But all these plans place enjoyment in the distance." There were better reasons to buy a policy ... Company publications briefly skimmed over the protective functions of a policy to concentrate on policyholder moneymaking ... By the end of the Century, interest in the investment features of life insurance overrode all other considerations.

that money will be considered as property?" He answered simply that "[i]t never was contemplated to tax the proceeds of life insurance policies."

Congressman Hull later observed that particularly where:

gifts, bequests, and devises are not made income, the return of insurance investments is held not to be taxable income. The proceeds of life insurance policies paid to some third person on the death of the insured is not considered taxable, and still less would any return of the investment to the person during lifetime be considered taxable income.

However, the exclusion of both gifts and life insurance proceeds had not been the United States experience during the Civil War years or in the 1894 legislation. Although gifts and inheritances were excluded from income in the Act of 1913, the stated reason was the proposal of a separate inheritance tax at highly graduated rates. The comparison made by Congressman Hull of life insurance proceeds received upon death to testamentary transfers nevertheless remains a persuasive argument in support of the exclusion's consistency with the income tax treatment of property received on account of an individual's death.

Congressman Hull offered an amendment, which was ultimately adopted, expressly addressing the treatment of lifetime transactions by the insured. He said that he did so because "it was de-

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182 The question was posed by Congressman Madden. 50 Cong. Rec. 508 (1913).
183 Id.
184 50 Cong. Rec. 1239 (1913).
185 See supra note 111 and supra text accompanying notes 112-22.
186 50 Cong. Rec. 506 (1913) (statement of Congressman Hull). In 1926, with a temporary hiatus in the gift tax regime, Senator Norris proposed the logical extension of Congressman Hull's earlier justification, that in the absence of a gift tax, gifts and bequests be included in taxable income. The provision was rejected after much debate. See 67 Cong. Rec. 3831-36, 3843-51 (1926).
187 "Economically, life insurance proceeds are nothing more than a bequest procured through the medium of an insurance company. Section 101(a) is the same as section 102." Joseph M. Dodge, The Logic of Tax 105 (1989). "Additionally, the exclusion is consistent with § 102, which excludes bequests from gross income, and with § 1014, which provides a step-up in basis for appreciated property acquired from a decedent." Sanford M. Guerin & Philip F. Postlewaite, Problems and Materials in Federal Income Taxation 139 (2d ed. 1988).
188 The exemption originally was stated as: "Provided, that the proceeds of life insurance policies paid upon the death of the person insured, shall not be included as income." The amendment made on the floor of the House added the following phrase after "insured": "or payments made by or credited to the insured, or life insurance, endowment, or annuity con-
sired by a number of gentlemen . . . ."139 It is unclear who the gentlemen were. The debate indicated that a number of Hull's colleagues in the House were quite confused about the legislation,140 but this is not to say that lobbyists were not active in the legislative process. Life insurance was already a major enterprise,141 and Congressman Hull noted in debate that life insurance companies had been encouraging complaints by their stockholders about the legislation.142 One commentator has made a passing observation that an insurance company lobbying effort was behind the enactment of the death benefit exclusion.143 Public support to this day for a life insurance tax exemption might be found in invested self-interest; according to 1989 insurance company statistics, 81% of American households owned some form of life insurance.144

The death benefit exclusion was conceded by Hull, so the taxation of insurance maturing or surrendered during the insured's lifetime occupied the debate. Some of the congressmen proposed, unsuccessfully, that all insurance proceeds be excluded from income.145 The debate produced an early structural distinction be-

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139 50 Cong. Rec. 1239 (1913).
140 See discussion at 50 Cong. Rec. 1239, 1257-59 (1913).
141 Life insurance in force in 1910 and 1915, was $14,908,000,000, and $21,029,000,000, respectively. 1990 Life Insurance Fact Book, supra note 9, at 16.
142 Congressman Hull stated:
Now, some of the companies have sent out alarming circulars to the stockholders, which are calculated to impress upon them that they are about to be outraged or in some other respect seriously injured by some of the provisions to be found somewhere in the pending measure. As a matter of fact, there is no tax, as I said, upon the proceeds of life insurance policies paid at the death of another. There is no tax imposed upon any individual with respect to the return of any sum or amount invested in insurance as a business proposition during his life.
50 Cong. Rec. 513 (1913).
144 1990 Life Insurance Fact Book, supra note 9, at 6.
145 Congressman Hinebaugh proposed an exclusion, stating "that the proceeds of life insurance policies shall not be included as incomes." 50 Cong. Rec. 1239 (1913). Congressman Stafford later pressed the point:
For instance, a man has a 20-year-payment policy, or a 20-year endowment, or any other period, and wishes to have it cancelled before the term. No provision has been made to exempt the amount that is paid to the assured, yet we have the principle as carried in the bill exempting the amount paid to the beneficiary on his death. Carrying out the logic of the bill, I think there is no reason why the amount that may be
between payments upon death and those made during the insured's life. An unlimited exclusion was extended to death benefits while payments to the insured during his or her lifetime were essentially treated as returns of capital to the extent of premiums paid, with income realized only for any excess proceeds.\textsuperscript{146} The other principal tax benefit of life insurance, the tax free inside buildup of value,\textsuperscript{147} was also established in the 1913 legislation. In the debate, an analogy in support of tax free inside buildup was made to a home which increases in value over the years, but the appreciation is not taxed until sale.\textsuperscript{148} Recent arguments in favor of retaining the treatment of inside buildup have also rallied behind the home analogy.\textsuperscript{149} Elimination of this tax benefit has been urged by many

\begin{quote}
paid upon cancellation before the time expires should be considered as the income of the assured or to whom it may be paid.
\end{quote}

50 Cong. Rec. 1257 (1913).

\textsuperscript{146} The language of the act survived attempts by Congressmen Stafford, Lenroot, and Martin to change the language to exclude even receipts from lifetime surrenders. See 50 Cong. Rec. 1258-60 (1913). Congressman Hull was solidly aligned with the principle of taxing lifetime receipts in excess of an investment in the contract. It is unclear whether the other congressmen were trying to clearly express that principle, or a broader one of total exclusion. It is frequently observed that treating all premiums previously paid as a return of capital overstates a policyowner's investment in the contract because a portion of the premium is paid for current death protection, term insurance, which expires and does not resemble a capital investment.

\textsuperscript{147} "The investment component of a life insurance premium is the portion of the premium not used to pay the pure insurance costs . . . . This amount, which is added to the cash value of the policy, may be considered comparable to an interest-bearing savings deposit. The cash value of the life insurance is credited with interest. This amount of interest is called the inside buildup, and under present law it is not taxed as current income of the policyholder." Staff of the Joint Comm. on Tax'n, Tax Reform Proposals: Taxation of Insurance Products and Companies 5 (Comm. Print 1985) [hereinafter 1985 Insurance Proposals].

\textsuperscript{148} Congressman Underwood stated:

Now, in the case of a life insurance policy, it is the same as an investment in a house. The [insurance company], instead of the insured person, will be taxed on its net profits during the period the insurance runs, and at the termination of the period the insured will not pay a tax on his capital, but will pay a tax on the return of his profits, just as the man would pay a tax by the increased value of his storehouse in the case I cited.

50 Cong. Rec. 1259 (1913).

\textsuperscript{149} Some may argue that analogizing life insurance to certificates of deposit or mutual funds fails to recognize the character and importance of permanent life insurance . . . . It is argued that the purchase of whole life insurance is similar to the purchase of a home or other capital asset. The appreciation in value of the home or other asset is not taxed until the asset is sold.

commentators and has been proposed in several recent tax reform measures.

3. Revenue Act of 1918

The Revenue Act of 1918 narrowed the death benefit exclusion to exempt only payments to individual beneficiaries or the estate of the insured. Congress was seeking to close an alleged loophole utilizing corporate-owned life insurance. In a companion provision, deductions for corporate key employee life insurance were prohibited.

4. Revenue Act of 1921

In the Revenue Act of 1921, Congress shifted course and reinstated the exemption for corporations and partnerships as an owner or beneficiary of life insurance. In view of the continuing prohibition on the deductibility of key employee insurance premiums, Congress apparently agreed with proponents of the amendment that "such insurance constitutes a reasonable and proper...

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150 "There is nothing in the institution of life insurance which displaces the condemnation of tax exempt interest that [Equity and Free Market Compatibility] always evoke." Joseph T. Sneed, The Configurations of Gross Income 192 (1967). "The income on life insurance savings could be taxed by including in adjusted gross income the portion of the annual increases in the cash surrender value of life insurance policies that reflects interest earned on past savings." Joseph A. Pechman, Tax Reform, The Rich and The Poor 67 (2d ed. 1989). See also, William Vickrey, Insurance Under the Federal Income Tax, 52 Yale L.J. 554, 562-63 (1943); Goode, supra note 102, (noting, however, serious practical difficulties in taxing the interest element).

151 Treasury I, supra note 101, at 258-61; The President's Tax Proposals to the Congress for Fairness, Growth & Simplicity 253-56 (May 1985) [hereinafter Treasury II]. The inside buildup of value is already a component of "adjusted current earnings" for the purposes of the corporate alternative minimum tax. See I.R.C. § 56(g)(4)(B)(ii).


153 The exclusion was amended to exclude "The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured . . . .

154 Congressmen Hull noted: "We found a number of large corporations, at the instance of big stockholders, had dropped into the habit of taking out policies for such individuals and paying the premiums in a way which would enable the individual to escape his proper income-tax liability and probably later on to escape his estate tax liability."

155 Revenue Act of 1918, ch. 18, § 215(d), 40 Stat. 1069.

156 Revenue Act of 1921, ch. 136, § 227 [hereinafter Revenue Act of 1921].

provision against actual losses which business enterprises sustain in the death of responsible officers and employees.” The general rule that precludes a deduction for life insurance premiums also provides some justification for the exclusion of the death benefits but such symmetry is not faithfully demonstrated in other areas of the tax law. The exemption might also be viewed as

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156 The formal legislative history does not include this language. See H.R. Rep. No. 350, 67th Cong. 1st Sess. (1921). The language was contained in “Notes on the Revenue Act of 1918” submitted on Nov. 3, 1919 by the Secretary of Treasury, without recommendation, to the Ways and Means Committee, reprinted in Seidman, supra note 138, at 818. Although life insurance proceeds are excluded from corporate taxable income, the amount of proceeds in excess of aggregate premiums paid by the corporation is included in earnings and profits. See Rev. Rul. 54-230, 1954-1 C.B. 114. Aside from the effect on characterization of corporate distributions, the inclusion in earnings and profits makes such proceeds a part of “adjusted current earnings” under the corporate alternative minimum tax. See I.R.C. § 56(g)(4)(B)(i)(I).

157 See, e.g., I.R.C. § 262 (denying a deduction for “personal, living, or family expenses”); I.R.C. § 264(a)(1) (denying a deduction for premiums of life insurance policies owned by a business); Treas. Reg. § 1.262-1(b)(1) (“Premiums paid for life insurance by the insured are not deductible.”). But see I.R.C. § 56(g)(4)(B)(ii) (permitting a deduction for the insurance protection portion of premium payments in computing “adjusted current earnings” for purposes of the corporate alternative minimum tax).

Professors Klein, Bankman, Bittker, and Stone state:

One alternative would be to treat premiums as nondeductible investment costs and at death tax any gain and allow a deduction for any loss. People who died before their life expectancy would tend to have gains, taxable at a time when the payment of the tax might seem unduly burdensome (though there would be cash in hand). Others would wind up with losses, deductible at a time when, because income is low, they might not do much good. In addition to these negative considerations there is the vexing question of whether to allow a deduction before death if insurance coverage is permanently (for how long?) terminated. The second alternative would be to allow a current deduction of all premium payments and treat all proceeds as income. Again, the problem would be a heavy tax burden at a difficult time, and this problem would be even more serious than with the first alternative because all the premiums would have been deducted so the entire amount of the proceeds would be taxable . . .


Another commentator has, however, distinguished between insurance payments to the insured and receipts by the beneficiaries upon the death of the insured.

The rule denying any deduction for the expense portion of the premiums is arguably wrong, since the aim of the premiums is to make a profit . . . [T]he fact that premiums are nondeductible . . . to other taxpayers would be deemed irrelevant . . . The “internal” logic of tax only requires that the same dollars not be taxed twice to the same taxpayer . . . Hence, § 101(a) . . . would be a prime candidate for repeal.

Dodge, supra note 137, at 105.

158 For instance, wagering losses are deductible only to the extent of wagering gains unless the gambler is in the trade or business of wagering. See I.R.C. § 165(d) and Commissioner v.
rough justice which in the aggregate operates to offset the mortality gains of some persons against the mortality losses of others.\textsuperscript{161}

5. Revenue Act of 1926

In the Revenue Act of 1926\textsuperscript{162} the modern language of the exclusion "by reason of the death of the insured"\textsuperscript{163} was substituted for "upon the death of the insured." The new language was considered necessary to ensure that installment payments of death benefits would be accorded tax exempt treatment along with lump sum settlements payable upon death.\textsuperscript{164} The basic exclusion for benefits paid by reason of the death of the insured was crystallized with the 1926 legislation.

6. Recent Developments

In recent years Congress has examined the taxation of life insurance products with increasing frequency. Its primary focus has been an attempt to preserve favorable income tax treatment for life insurance contracts with a long-term perspective, while re-

\textsuperscript{161} Professors Klein, Bankman, Bittker, and Stone write:

\begin{quote}
In individual cases, where death occurs, large gains will escape taxation. In the aggregate, however, the amounts paid out will equal the amounts paid in . . . . [S]ince the premiums are not deductible, the tax effect in the aggregate is roughly accurate: In the aggregate, the amount received is a recovery of capital and no gain escapes taxation (assuming that we disregard the value of the piece of mind acquired by the purchase of the policies).
\end{quote}

Klein et al., supra note 159, at 173. The quoted passage focuses only on the mortality gains or losses of pure insurance protection best exemplified by term insurance. The authors later discuss the broader aspects of the death benefit exclusion, which can exclude from income the proceeds derived from the inside buildup of value in life insurance, such as whole life policies, with an investment feature. See id. at 175-76. This latter facet of the exclusion cannot be supported on the basis of an aggregate netting of gains and losses.

\textsuperscript{162} Revenue Act of 1926, Pub. L. No. 69-20, 44 Stat. 9 [hereinafter Revenue Act of 1926].

\textsuperscript{163} Revenue Act of 1926 § 213(b)(1), 44 Stat. at 24.

\textsuperscript{164} "The House bill, in order to prevent any interpretation which would deny the exemption in the case of installment payments, amended this provision so that proceeds 'paid by reason of the death' of the insured would be exempt." H.R. Conf. Rep. No. 356, 69th Cong., 1st Sess., at 33 (1926). If we are to exalt literalism, recognize that any life insurance death benefit, lump sum or otherwise, must be paid at least a moment after the death of the insured.
stricting uses driven principally by income tax benefits. Congress has shown a tendency to place stringent restrictions on investments such as tax deferred annuities and retirement savings plans that do not have a life insurance component, while striving to preserve income tax benefits for those considered sufficiently “traditional.” An issue related to the taxation of accelerated death benefits is whether this congressional firewall construction is desirable and could be avoided by more closely aligning the income tax treatment of life insurance with that of investments that serve similar purposes.

a. Tax Equity and Fiscal Responsibility Act

In the Tax Equity and Fiscal Responsibility Act (“TEFRA”), Congress attempted to distinguish between retirement and tax shelter uses of tax deferred annuities: “The Committee believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal. However, the Committee believes that their use for short-term investment and income tax deferral should be discouraged.”

Tax deferred annuities were often sold by life insurance companies. At maturity, the annuity payments were in part a nontaxable return of capital and in part taxable income. However, the income tax treatment of interest and other returns during the accumulation phase and loans against the contract, strongly resembled life insurance, as described by the Staff of the Joint Committee on Taxation:

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165 This is not a recent lament. Randolph Paul wrote in 1940:
It may be noted in final conclusion that tax pressures are twisting out of shape the underlying social function of life insurance. The old-fashioned function of life insurance was to provide security for dependents . . . . It may still do so, but emphases have changed, and today life insurance and annuities are sold by the tax saving appeal . . . . Something is radically wrong in such a picture. The true function of life insurance can never have been to accomplish an inequitable distribution of the tax burden.


166 Alternatives for the overall taxation of life insurance receipts are briefly considered at infra text accompanying notes 238-59.


169 See supra note 14 for a brief description of annuity benefit income taxation.
The taxation of interest or other current earnings on a policyholder’s investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract, were first treated as a return of the policyholder’s capital and were taxable (as ordinary income) only after all of the policyholder’s investment in the contract had been recovered.

The TEFRA amendments retained the deferral of tax on investment accumulations, but withdrawals or other dispositions of the annuity contract were subject to new restrictions. To the extent that the cash value of the contract exceeded the investment in the contract, any partial surrenders or cash withdrawals prior to the annuity starting date were treated as income. Borrowing against, or the pledging of, an annuity contract was treated as a withdrawal. The legislation also imposed a 5% penalty on the withdrawal of amounts from the annuity prior to age 59 ½ unless accomplished in equal installments over a 60 month period.

On the life insurance front, Congress adopted measures limiting the tax deferral benefits of so-called “flexible premium life insurance contracts.” The concern was similar to that expressed for

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172 See I.R.C. § 72(e)(4).
173 The provision for a 60 month payout was found in § 265(b)(1) of TEFRA, codified at I.R.C. § 72(q)(2)(D). The TEFRA statute imposed the penalty only on amounts allocable to investments made during the 10-year period ending on the date of the withdrawal, determined on a first-in, first-out basis. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 222(a), 98 Stat. 494, 774, amended the provision to eliminate the 10-year provision, applying the penalty to any amount distributed. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 1123(b)(2), 100 Stat. 2085, 2474, amended the provision to read as it does today, requiring payments over the life of the taxpayer or the joint lives of the taxpayer and a beneficiary. See I.R.C. § 72(q)(2)(D). The 5% penalty on premature distributions was also increased to 10% by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1123(b)(1), 100 Stat. 2085, 2474.
174 The Code defines a flexible premium life insurance contract as a “life insurance contract . . . which provides for the payment of one or more premiums which are not fixed by the insurer as to both timing and amount.” I.R.C. § 101(f)(3)(A). In the life insurance industry a flexible premium policy is defined as “[a] life insurance policy . . . under which the policyholder . . . may vary the amounts or timing of premium payments.” 1990 Life Insurance Fact Book, supra note 9, at 135. A common form of this insurance is “universal life insurance” defined as a policy “under which the policyholder may change the death benefit from time to time . . . and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted.
Accelerated Death Benefits

The committee believes that flexible premium life insurance contracts should have the same tax treatment as traditional level-premium whole life insurance contracts if they are substantially comparable to traditional contracts. However, the committee is concerned by the fact that some flexible premium contracts can be overly investment oriented by allowing large cash value build-ups without requiring a continued reasonable amount of pure insurance protection.\textsuperscript{176}

TEFRA provided temporary statutory guidelines for use in determining whether flexible premium life insurance contracts qualified as "life insurance" for purposes of the death benefit exclusion.\textsuperscript{176} The purpose of the limitation was primarily to limit the death benefit exclusion to only traditional death protection. If the guidelines were violated, the contract was separated into term insurance, for which the death benefit exclusion was retained, and into an annuity or deposit fund.\textsuperscript{177}

\textbf{b. Deficit Reduction Act of 1984}

The Deficit Reduction Act of 1984 ("DEFRA")\textsuperscript{178} refined the TEFRA amendments, implementing a definition of life insurance contracts, applicable to all forms of insurance.\textsuperscript{179} If a life insurance

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\textsuperscript{178} This result is not obvious from an examination of the statute, but is confirmed by the opening paragraph of the Blue Book explanation, which should be consulted for explanation and examples of the provision. See 1982 Blue Book, supra note 51, at 367-76. For another explanation with examples see 1988 Single Premium Pamphlet, supra note 11, at 6-10.

\textsuperscript{179} See 1988 Single Premium Pamphlet, supra note 11, at 6-10 for a succinct explanation of these guidelines. For an in-depth discussion see Andrew D. Pike, Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insur-
contract does not meet the definition, the income on the contract for any taxable year will be treated as ordinary income received or accrued by the policyholder. However, even if a life insurance contract does not meet the definition, the excess of the death benefit over the net surrender value of the contract is still deemed to be paid under a life insurance contract for purposes of section 101 of the Code.

c. Tax Reform Act of 1986

The Tax Reform Act of 1986 produced only minor adjustments to the scheme of life insurance taxation. The $1,000 annual surviving spouse benefit was repealed. The legislation also placed additional restrictions on policy loans and deferred annuities owned by other than natural persons.

\[\text{I.R.C. § 7702(g)(1)(A). For this purpose, income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided during the taxable year exceeds the amount of premiums paid less any policyholder dividends paid. I.R.C. § 7702(g)(1)(B).}\\
\text{I.R.C. § 7702(g)(2). Generally there should still be no inclusion in income for any portion of the death benefit. The death benefit exclusion applies to the amount of proceeds in excess of the net surrender value. The net surrender value is the cash surrender value of the policy, determined with regard to surrender charges. I.R.C. § 7702(f)(2)(B). The aggregate premiums paid will usually exceed the cash surrender value, because the portion of the premiums paid for current death protection do not add to cash value. The policyowner should therefore have an adjusted basis in the contract at least equal to the net surrender value so that a receipt of the portion of the death benefit identified as such should be treated as a nontaxable return of capital. See also I.R.C. § 7702(g)(3) (stating that a life insurance contract which is a life insurance contract under “the applicable law” but does not meet the definition of I.R.C. § 7702(a), is otherwise still treated as an insurance contract for purposes of Title 26).}\\
\text{I.R.C. § 7702(a), is otherwise still treated as an insurance contract for purposes of Title 26).}\\
\text{Section 101(d) of the 1954 Internal Revenue Code, before its repeal by the Tax Reform Act of 1986, P.L. 99-514, § 1001, 100 Stat. at 2387, permitted a surviving spouse to exclude up to $1,000 annually of installment life insurance payments received in excess of the death benefit. The excess was, in effect, an interest equivalent on the installment payout.}\\
\text{The deductibility of interest on policy loans in connection with a policy on the life of an officer, employee, or other person financially interested in a business was limited if the aggregate debt exceeds $50,000 per insured. I.R.C. § 264(a)(4).}\\
\text{Congress was concerned that employers would avoid the nondiscrimination rules under qualified retirement plans through the purchase of deferred annuities by the employers which would be used to fund nonqualified deferred compensation arrangements. S. Rep. No. 313, 99th Cong., 2d Sess., 566-67 reprinted in, 1986 U.S.C.C.A.N. 1075, 4488-89. The}
d. Technical and Miscellaneous Revenue Act of 1988

In the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") Congress revisited investment oriented life insurance, focusing on single premium life contracts which were not effectively limited by the DEFRA insurance definitions. The single premium life contracts enjoyed the usual tax benefits of life insurance: tax deferred inside buildup of value; total exclusion from income if benefits are received upon death; and flexibility in withdrawing cash as a nontaxable loan or withdrawal not in excess of the investment in the contract. However, some single premium life insurance products were offered on terms which made them practically indistinguishable from a simple, lump sum tax deferred deposit arrangement.

The "modified endowment contract" was identified as the new villain. Essentially, the restrictive distribution and loan provisions applied to annuities by TEFRA were now extended to the modified endowment contract. Amounts received under the contract were first considered income, and then a recovery of basis. With two exceptions for funeral expenses and small contracts, loans under or against modified endowment contracts were generally treated as distributions. The legislation also extended the 10% penalty that had been previously imposed on early distributions from annuities, to most distributions from modified endowment contracts received prior to age 59 1/2.

e. Omnibus Budget Reconciliation Act of 1989

Congress revisited the modified endowment contract in the Om-

result was present I.R.C. § 72(u) which in general treats as ordinary income when earned, the accumulation in value of a deferred annuity owned by a person who is not a natural person.


187 For several examples of advertising emphasizing the tax shelter advantages of the single premium life insurance policy see 1988 Single Premium Pamphlet, supra note 11, at 23-24.

188 See I.R.C. § 7702A.

189 See I.R.C. §§ 72(e)(2)(B), 72(e)(10).

190 See I.R.C. §§ 72(e)(4)(A), 72(e)(10).

191 See supra text accompanying notes 171-73.

nibus Budget Reconciliation Act of 1989,\(^{193}\) with technical changes aimed at sweeping an outbreak of decreasing death benefit single premium contracts into the modified endowment contract limitations.\(^{194}\)

\(f.\) Summary and Overview

Congress has exhibited some pronounced patterns of behavior in recent years in its dealings with the taxation of life insurance and related products such as annuities. The goal of making annuities and modified endowment contracts more long-term in nature, and less tax driven, prompted the amendments to the treatment of such investments. Congress drew from retirement plan taxation concepts in limiting loans and penalizing early withdrawals. However, Congress remained committed to the search for a traditional insurance paradigm. In trying to define this in the TEFRA amendments, the penalty was a partial denial of the death benefit exclusion. If this prize were removed from contention for all insurance products, a degree of simplification and integration with the related annuity investments would be achieved. In DEFRA, Congress again tried to define traditional insurance, and the penalty to products failing to comply was current income recognition, a fate not even visited on the annuity products. Still, the definitional amendments to DEFRA were considered necessary to curb perceived abuses of life insurance because other established restrictions which could promote a long-term view, such as loan limitations and withdrawal penalties, were not considered appropriate for the “traditional insurance” tax shelter. It is likely that additional remedial legislation will be required so long as Congress remains committed to a “traditional insurance” model, with a death benefit exclusion, tax deferred inside buildup, and facile loan and withdrawal provisions. The protected incentives, including the death benefit exclusion, should be evaluated with regard to their effectiveness of furthering the societal goals in encouraging life in-


\(^{194}\) The single premium contracts were structured to comply with the “7-pay test” of I.R.C. § 7702A(a)(1)(B). However, the death benefit was decreased in the eighth year, reducing the mortality charge and creating a cash value that could be tapped through policy loans. The 1989 amendments take such a reduction into account at the outset and apply the 7-pay test to the reduced benefit. See I.R.C. § 7702A(c)(6).
C. Assessing the Success of the Regime

1. The Goal of the Incentives

In 1988 hearings, a representative of the Treasury spoke of the policy supporting tax incentives for life insurance:

The Treasury Department has in the past recognized and continues to recognize the social benefits of encouraging insurance protection. In the event of the death of a working spouse, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving the government of an obligation it otherwise would have to assume.\(^{198}\)

In a report prepared by the Staff of the Joint Committee on Taxation for use in 1985 hearings on life insurance, survivor protection policy was again at the forefront: "The traditional purpose of life insurance has been to protect the policyholder's beneficiaries (usually the policyholder's family) against a loss of income and costs arising from the death of the person whose life was insured."\(^{199}\)

2. Measuring Success

If one accepts the premise that the purchase of life insurance should be subsidized by the Treasury to encourage survivor protection in the event of the death of a provider, then the tax incentives should be judged by their success in encouraging such protection. Three criteria in judging the effectiveness of the tax incentives are: (1) Do the incentives promote the acquisition of insurance protection? (2) Do the incentives promote continuity of insurance protection? and (3) Do the subsidies flow to the parties that need protec--

\(^{198}\) 1988 Senate Hearing, supra note 2, at 118 (statement of Dennis E. Ross, Deputy Assistant Secretary (Tax Policy), Department of the Treasury).

\(^{199}\) 1985 Insurance Proposals, supra note 147, at 2. See also Bertram Harnett, Taxation of Life Insurance 147 (1957); Solomon S. Huebner, Life Insurance 13 (1950). Even Benjamin Franklin was an advocate, reportedly stating that "[a] policy of life insurance is the oldest and safest mode of making certain provision for one's family." Id.
tion most, and is the acquired insurance effective in keeping those individuals from "becoming dependent on governmental assistance"?

a. Promoting Acquisition

An empirical study isolating the effect of specific income tax incentives on the decision to purchase life insurance would aid assessment of the effectiveness of such incentives to fulfill the policy objectives of Congress. Such an analysis would need to judge the importance of each major tax incentive, tax deferred buildup, the death benefit exclusion and flexible loan provisions.

The tax deferred buildup incentive, even if a significant factor in the purchase decision, is highly skewed toward higher income households. The importance of the incentive to families of mod-

197 The Life Insurance Marketing and Research Association could not provide this information to the author and referred him to the American Council of Life Insurance. The American Council of Life Insurance was very cooperative in providing other information but did not produce specific information of this nature. Existing studies focus on a number of other factors. See, e.g., John M. Fitzgerald, The Taste for Bequests and Well-Being of Widows: A Model of Life Insurance Demand by Married Couples, 71 Rev. of Econ. & Stat. 206 (1989) (wealth of widow generally correlated to her age at time of husband's death); Ritchie A. Campbell, The Demand for Life Insurance: An Application of the Economics of Uncertainty, 35 J. Fin. 1155 (1980) (factors include current wealth, age, number of dependents, and sense of moral responsibility, education, and other traits); John Fitzgerald, The Effects of Social Security on Life Insurance Demand by Married Couples, 54 J. Risk & Ins. 86 (1987) (husband's future earnings increase demand for insurance on his life, Social Security survivor benefits decrease this demand, and Social Security retirement benefits increase the demand).

198 The Treasury produced estimates of the average inside buildup, based on 1983 statistics, for households with insurance.

<table>
<thead>
<tr>
<th>Family Economic Income</th>
<th>Average Annual Inside Buildup</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 9,999</td>
<td>$85</td>
</tr>
<tr>
<td>10,000 - 14,999</td>
<td>110</td>
</tr>
<tr>
<td>15,000 - 19,999</td>
<td>135</td>
</tr>
<tr>
<td>20,000 - 29,999</td>
<td>190</td>
</tr>
<tr>
<td>30,000 - 49,999</td>
<td>310</td>
</tr>
<tr>
<td>50,000 - 99,999</td>
<td>520</td>
</tr>
<tr>
<td>100,000 - 199,999</td>
<td>1,240</td>
</tr>
<tr>
<td>200,000 or more</td>
<td>3,050</td>
</tr>
<tr>
<td>All Families</td>
<td>355</td>
</tr>
</tbody>
</table>

Reprinted in Treasury I, supra note 101, at 262.

Anecdotal evidence that was presented in connection with the 1988 single premium life insurance debate indicated that for segments of the population, tax incentives for life insurance were important factors in the acquisition decision. The single premium policies were extremely tax driven and might not be a good example. Moreover, the testimony was mixed
erate means appears questionable; applying a 15% income tax rate, the subsidy to families earning up to $30,000 is only $13-29 annually.\footnote{199}

It has been anecdotally stated that the insurance sales presentation does not emphasize the depressing death benefit aspects,\footnote{200} let alone the income tax advantages of the death benefit exclusion. Even if this factor is an inducement to purchase, it might be more significant to wealthier, more tax sensitive clients.\footnote{201}

Policy loan provisions may indeed be an inducement to purchasers, particularly those of limited means, because they provide the current comfort of future liquidity.\footnote{202}

\footnote{199}{This applies a 15% income tax rate to the first four income ranges set forth in supra note 198. The subsidy is not without great cost to the Treasury. In 1989, the revenue loss from the exclusion of interest income on life insurance was estimated as $5.56 billion. See infra note 258.}

\footnote{200}{"One whole life insurance brochure ... does not mention insurance on either cover ... . The words 'death benefit' appear nowhere. Advertising life insurance as a savings plan is nothing new." 1988 Senate Hearing, supra note 2, at 105 (written statement of Gordon N. Oakes, Jr.). On the other hand, "Policyholders like the tax free growth in their insurance policies. But certainly just as vital to the sale is the death benefit that remains in effect for the insured's entire lifetime and is more than the conservative investor could ever achieve without the aid of life insurance." Id.}

\footnote{201}{The death benefit exclusion, of course, produces more after-tax cash from the life insurance investment and is a factor in the demand for insurance. Wilshinsky stated:

The financial benefits of using life insurance as a wealth replacement vehicle is determined by the ability of an insurance policy to generate an amount of death proceeds substantial enough to provide a meaningful after-income-tax yield on the life insurance premium dollars paid .... When viewing the viability of life insurance for wealth replacement, the amount of death benefits paid is the controlling factor.}

\footnotesize{Wilshinsky, supra note 102, at 12.}

\footnote{202}{"Not only is this characterization of a loan against life insurance sound in principle, it is necessary to the decision to buy an adequate amount of permanent insurance. People will not -- indeed often cannot — commit to years of premium payments without the knowledge that, should a financial emergency arise, they can borrow against their policies on a tax neutral basis." 1988 Senate Finance Hearings, supra note 2, at 10 (testimony of William V. Irons, CLU, Chairman and Fed'l Law and Leg. Comm., Nat'l Assoc. of Life Underwriters and State Senator from R.I.). "Sixty-eight percent of permanent life insurance is purchased}
b. Promoting Continuity

The deferral of income on the inside buildup has been fundamental to the treatment of cash value insurance such as whole life insurance. It is argued that, as a practical matter, whole life should be encouraged because it provides greater lifetime insurance protection by its nature as compared to term insurance which is more likely to be cancelled as the cost of pure insurance protection increases with the age of the insured.\textsuperscript{208} As discussed above, the

by individuals earning less than $30,000. These individuals may be less likely to purchase the insurance if their ability to borrow against the policy in the event of financial need is subject to tax and penalties.” Id. at 76, (written statement of Mark V. Heitz).

\textsuperscript{208} It is often asserted that whole life has a greater inherent permanence because much term insurance is group insurance through employment or is no longer renewable after age 65. Otherwise, this statement about cost of protection can be misleading. The annual premium for term insurance protection for a specified coverage is generally less than the annual premium for a whole life policy of equal amount, particularly when the insured is young. However, at some point, the cost of pure insurance protection, represented by the term insurance premium, will exceed the established whole life premium, the pure insurance risk portion of which is reduced by the cash value accumulated from past premiums in excess of pure insurance protection costs, plus investment earnings thereon. Nevertheless, it is common advice that one should “buy term and invest the difference,” creating a separate non-insurance investment fund which can be used to pay the increased term insurance premiums applicable during the advanced years of the insured. See, e.g., Greider & Beadles, supra note 11, at 43-45. This assumes that the insured can invest on an aftertax basis at a rate which equals or exceeds the implicit return in the whole life policy, and that the insured consistently adheres to this savings program. Id. The weaknesses of human nature in failing to save in this fashion underlie the common argument in favor of whole life insurance as opposed to term discussed in the following paragraphs.

There are two arguments in this regard. First, insurance is more automatic as a savings plan, which avoids the shortsighted aspects of human nature. People would not, so the argument goes, save without the incentive of avoiding loss of their insurance coverage. Second, insurance would still be needed to provide death indemnity. Term insurance can achieve this, but term becomes expensive or unavailable when the insured is older (and again, due to human failing, the insured failed to invest the premiums saved through a lifetime of purchasing term, rather than whole life insurance). The argument here is that the tax sheltered savings element of whole life, the proceeds of which are excluded on the insured’s death, encourages the acquisition of whole life insurance and, consequently, the maintenance of lifetime protection. Speaking to taxation of financial buildup during the insured’s lifetime, a facet of the issue of the taxation of death benefits, the Staff of the Joint Committee on Taxation stated:

In addition, some point out that the goal of having individuals maintain adequate death benefit protection should be encouraged through tax incentives. It is argued that, without the existing tax benefits, policyholders would switch from whole life insurance to term insurance coverage. Although policyholders could afford the term insurance premiums while they are young, the costs might not be affordable in later years. This argument assumes that the reduction in premiums resulting from the purchase of term rather than whole life insurance would not be saved to reduce the
value of the income deferral, however, varies with the economic circumstances of the insured, and may therefore be of greatest benefit to wealthier individuals who, in view of their other resources, need less protection.

Inasmuch as there are more funds paid out each year by life insurance companies as lifetime surrenders than as death benefits, the effect on behavior of the tax exemption for death benefits on continuation of coverage is uncertain, except perhaps for the terminally ill or elderly. Even the terminally ill or elderly might continue coverage more to preserve receipt of the full death benefit, rather than to take advantage of the death benefit exclusion.

The loan provisions are of mixed effect. On one hand, they may forestall a surrender of the policy. On the other hand, the loan proceeds may be dissipated while the outstanding loan amount reduces the death protection afforded by the policy.

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Joint Comm. on Tax’n, 1985 Insurance Proposals, supra note 147, at 8-9.

Conjecture plays a part in this inquiry. Do the tax benefits play such a role as to stop people from surrendering policies, or is taxation an issue but not the ultimate moving issue? More funds are paid out by insurance companies as lifetime surrenders than as death benefits. See infra note 204. Taxes aside, one frequently finds discussion of the “forced saving” benefits of insurance: See McGill, supra note 12, at 56. Opinions, of course, differ on this point. “If people want to save, they will; and real savers will reject life insurance as an unrewarding vehicle.” Ralph Hendershot, The Grim Truth About Life Insurance 45 (1957).

204 "In 1989 payments to policyholders totaled $27.6 billion, 54.2% of total life insurance benefit payments." 1990 Life Insurance Fact Book, supra note 9, at 48. Cash surrender values on policies terminated voluntarily accounted for $14.9 billion of that total, matured endowments $727 million, disability payments $554 million (of which $206 million were direct income payments and $348 million represented waived premiums) and dividends $11.4 billion. Id. An analysis of surrender values paid in September 1985 showed that 81.6% of the surrender values were paid to policyholders under age 65, and 96.7% of the surrender values were paid in a lump sum. Id. at 50. The overall voluntary termination rate of ordinary life insurance policies in 1989 was 8.8%. The rate for policies in force less than two years was 18.6% and for those in force for two years or longer it was 6.7%. Id. at 67.

205 However, policyowners apparently feel that they have a lesser stake in a loaned up policy. “Since there is a higher termination rate of policies on which loans are outstanding, companies urge that loans be used only in genuine financial emergencies, and that they be promptly repaid.” 1990 Life Insurance Fact Book, supra note 9, at 67. Compare Mark Warshawsky, Sensitivity to Market Incentives: The Case of Policy Loans, 69 Rev. Econ. & Stat. 286 (1987) (suggesting that due to self-control, a large group of policyowners resist borrowing against life insurance policies even when the proceeds could be reinvested at a higher market rate).
c. Incentives and Protection

A significant issue is whether the tax incentives, including the death benefit exclusion, function to keep individuals off the welfare rolls in a meaningful way, or whether they instead maintain or improve the comfort of households, the members of which would not become wards of the state in the absence of the incentives. The distribution of life insurance coverage appears to be skewed toward middle and upper income individuals, with less than 1% of insurance purchases made by individuals with income less than $10,000.\textsuperscript{206} In 1989 the average insurance per household was a modest $93,600, and the average amount per insured household was an equally modest $115,500.\textsuperscript{207} However, since insurance ownership is disproportionately weighted toward wealthier people, the ownership by poorer individuals is less than the average, and that for wealthier individuals is more.\textsuperscript{208} A narrower, need-based exclusion would seem more appropriate in implementing Congress' stated purpose of aiding the bereaved who are financially deprived by the death of a provider. In establishing a need based exclusion, Congress would need to determine the level of comfort, the maintenance of which requires an income tax subsidy. This would radically depart from the present system in which the insured determines the amount of the exclusion in choosing a level of insurance protection.

In considering a need-based exemption for life insurance death

\textsuperscript{206} See supra note 101.
\textsuperscript{207} See supra note 10.
\textsuperscript{208} Although the averages stated in the preceding text are modest, large face amount policies constituted a large percentage of 1989 ordinary life insurance purchases.

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<thead>
<tr>
<th>Size of Policy</th>
<th>% of Policies</th>
<th>% of Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $2,000</td>
<td>2</td>
<td>Less than .5%</td>
</tr>
<tr>
<td>$2,000 - 4,999</td>
<td>6</td>
<td>Less than .5%</td>
</tr>
<tr>
<td>5,000 - 9,999</td>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td>10,000 - 24,999</td>
<td>22</td>
<td>4</td>
</tr>
<tr>
<td>25,000 - 49,999</td>
<td>14</td>
<td>6</td>
</tr>
<tr>
<td>50,000 - 99,999</td>
<td>19</td>
<td>16</td>
</tr>
<tr>
<td>100,000 - 300,000</td>
<td>23</td>
<td>51</td>
</tr>
<tr>
<td>300,000 or more</td>
<td>3</td>
<td>22</td>
</tr>
</tbody>
</table>

\textsuperscript{208} Although the averages stated in the preceding text are modest, large face amount policies constituted a large percentage of 1989 ordinary life insurance purchases.

1990 Life Insurance Fact Book, supra note 9, at 12. A 1984 survey conducted on behalf of the American Council of Life Insurance reported the following average insurance coverages, separated by household income:

Id. at 38.
benefits, one must, however, acknowledge the entrenched regime for the income taxation of gifts and inheritances. Some forms of wealth, although passing from a decedent, are taxable in the hands of the recipient as income in respect of a decedent.\(^{209}\) However, the general rule is that income does not include property received by gift, bequest, devise, or inheritance.\(^{210}\) The taxation of gratuitous transfers of a decedent's wealth is left to the estate tax and gift taxes.\(^{211}\) The current life insurance death benefit exclusion could be seen as an extension of the gifts and inheritance income tax exclusion which is available to all recipients, irrespective of their level of income or wealth.\(^{212}\) Objections to the life insurance death benefit exclusion should perhaps not be advanced as a separate matter, but instead as part of revision of Internal Revenue Code section 102.\(^{213}\) However, resolving the broader confrontation is beyond the scope of this article.\(^{214}\)

Returning to an incrementalist reform\(^{215}\) of the death benefit exclusion, one could argue that the present exemption is overbroad. It applies to related beneficiaries and relative strangers\(^{216}\) alike. It

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\(^{209}\) See I.R.C. § 691 and Treas. Reg. § 1.691(a)-1(b) ("In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income ... under the method of accounting employed by the decedent.").

\(^{210}\) I.R.C. § 102.

\(^{211}\) See infra note 224.

\(^{212}\) See supra text accompanying notes 97-100 and 134-37.

\(^{213}\) Amending I.R.C. § 101 without addressing I.R.C. §§ 102 & 1014 might further validate Professors Bittker and Lokken's observation that:

Professors Bittker and Lokken's observation that:

Most tax reformers, however, have avoided a direct assault on § 102, preferring to push for peripheral changes in existing law (e.g., taxing unrealized appreciation when property is transferred by gift or at death) and for a separate system of taxing gratuitous receipts. As a result, few provisions of existing law resemble their 1913 antecedents as much as § 102.

Bittker & Lokken, supra note 3, ¶ 10.1, at 10-4.

\(^{214}\) Some commentators have urged the repeal of the I.R.C. § 102 exclusion which conflicts with the ideal of a comprehensive tax base. See, e.g., Joseph M. Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 Harv. L. Rev. 1177 (1978).

\(^{215}\) Incremental reforms may be the political reality.

Thus, at any point in time, decisions on tax policy fulfill most of the conditions of the incremental model. They lead to primarily marginal variations in existing structures, with little time spent in consideration of radical proposals; they are remedial in nature, responding to general or particular needs or problems . . .

Witte, supra note 143, at 247 (1985).

\(^{216}\) Life insurance is frequently obtained by employers and business associates on the lives of valuable individuals, subject to the state law insurance requirement that the purchaser of life insurance protection have an insurable interest in the life of the insured.
is neither tied to demonstrated need nor diminished at higher income levels. With respect to the first point, insurance industry statistics suggest that the majority of benefits are in fact paid to surviving spouses and children, but that does not establish that the familial recipients were financially dependent on the insured. The second point is more provocative. If the justification for the favorable income tax incentives rests on keeping survivors off public assistance and to maintain the standard of living of those who otherwise would suffer economically from the loss of a provider, should all survivors, even the well-heeled, be allowed the exemption automatically? A need-based formula could be fashioned utilizing, for example, an exemption which phases out at certain income levels, partial inclusion tied to an income base, inclusion in gross income with special averaging, or a graduated sepa-

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217 Based on a 1985 sample of benefit payments, 67.4% of ordinary life insurance benefits, 81.9% of group insurance benefits, and 75.5% of industrial benefits were paid to members of the insured's immediate family. 1990 Life Insurance Fact Book, supra note 9, at 47. If the exclusion were limited to family members and dependents, recognition of nontraditional households would be an issue. See, e.g., Joan B. Ellsworth, Prescribing TUM's: An Alternative to the Marital Deduction for Unmarried Cohabitanats, 11 Va. Tax Rev. 137 (1991).

218 Insurance is usually said to offer protection against "premature" death, death before the provider has lived long enough to accumulate capital. Based on statistics for ordinary life policies for September 1985, 64% of total death benefits were paid on account of insureds who died at over age 55. See 1990 Life Insurance Fact Book, supra note 9, at 47. In view of the percentage of death benefits paid when the insured dies at age 55 or older, one might speculate that many of the children beneficiaries are adults and independent, and the surviving spouse may be already provided for by other accumulated assets and sources of income, including Social Security benefits. See, e.g., Fitzgerald, supra note 197. In evaluating the burden of federal wealth transfer taxation Professor Bittker observed: "Solicitude for the orphaned babe in arms or young child should not blind us to the fact that the children of these estate tax decedents are less likely to be five or fifteen years old than thirty or forty." Boris I. Bittker, Federal Estate Tax Reform: Exemptions and Rates, 57 A.B.A. J. 236, 238 (1971).

219 See, e.g., I.R.C. § 32(b) (phaseout of earned income credit for higher income taxpayers); I.R.C. § 151(d)(3) (phaseout of 15% tax rate and personal exemptions at certain taxable income levels);

220 See, e.g., I.R.C. § 86(c) (inclusion of a portion of social security benefits for higher income recipients).

221 Prior to its repeal by the Revenue Act of 1964, Pub. L. No. 88-272, § 232(b), § 72(e)(3) of the 1954 Code provided a special averaging convention for the lifetime lump sum receipt of surrender values or endowment proceeds. The tax attributable to the inclusion of the sum could not exceed the aggregate of the taxes attributable to such part had it been included in the gross income of the taxpayer ratably over the taxable year of receipt and the preceding two taxable years. Id. The income averaging rules of §§ 1301-05 of the 1954 Code, repealed by the Tax Reform Act of 1986, supra note 182, provided more blunted relief. One writer has proposed spreading lump sum insurance proceeds over the "period corresponding to the
Still, in view of the modest wealth of many insureds and their survivors, an income tax on death benefits could potentially touch only a fraction of individuals. If death benefit in-

remaining productive period of the insured had he lived.” Vickrey, supra note 150, at 563. This follows from viewing the pure insurance proceeds as “a replacement of income lost through the death of the insured, rather than as compensation for loss of property . . . .” Id. at 562.

This could resemble an estate tax progression, since wealth is being measured, or some combination of the existing income tax rates and a flat tax rate. See, e.g., I.R.C. § 402(e) (taxing lump sum distributions from qualified employee plans with reference to 5-year averaging).

As of 1989, the average policy amount was only $93,600 and the average per insured household was only $115,500. See Life Insurance Fact Book, supra note 9 at 5. However, larger average amounts are reported for higher income households. See supra note 208. One witness during the 1988 single-premium life insurance hearings noted that “Seventy-two percent of our insureds have annual incomes of under $60,000 a year; 48 percent of the insureds have annual incomes of under $40,000 a year.” 1988 Senate Hearing, supra note 2, at 13 (testimony of Mark V. Heitz). Anecdotal evidence, coupled with the author’s own experience, suggest that there are very wealthy individuals who use life insurance as a significant income and estate tax avoidance tool. See, e.g., Wilshinsky, supra note 102 at 10. An exemption might be structured to impact those individuals, while leaving untouched the proceeds paid to others of modest wealth. The poverty level in 1988 for households with four persons, for example, was $12,092. U.S. Bureau of the Census, Current Population Reports, series P-60, No. 166, reprinted in 1990 Statistical Abstract, supra note 13, at 423. At an 8% simple return, for example, a principal sum of approximately $150,000 would generate this income stream without consuming principal.

If $150,000 were chosen as the amount of a flat exemption, should other assets be considered? Probably not, to simplify matters, because Congress would probably exclude illiquid assets or those which would frustrate other tax incentives, such as personal residences and retirement savings. Otherwise, an exemption would be stated as the lesser of the amount of life insurance proceeds received or $150,000 (or some level tied to other surviving household sizes) reduced by the value of other household assets. Only one fixed exemption per insured life would be available, lest insurance proceeds be spread among numerous parties, trusts, etc. to obtain multiple exemptions. If a fixed dollar exemption is used, it is easy to apply in the case of a widow or widower with minor children. It becomes more difficult to allocate the exemption (unless we tax the insured’s income tax estate) among beneficiaries, including trusts and other entities, for the benefit of family members or otherwise. Elective allocations by the insured might be permitted, with a default provision which allocates all of the exemption first to the spouse, then dependent children, parents, siblings, etc. An alternative would be a tax on the owner of the policy, permitting however, a deduction for amounts paid to qualified beneficiaries such as spouses and dependents, but precluding any deduction for payments to employers, business associates, etc. If the owner and beneficiary were not the same, this would require some mechanism whereby the owner of the policy could recoup from the beneficiary a portion of the income tax paid. See, e.g., I.R.C. § 2206.

The proposal assumes that Congress would not instead conclude that preservation of any existing standard of living, no matter how comfortable, or increasing an existing standard of living, is a worthy goal for insurance which should not be hindered by the taxation of life insurance proceeds. The unlimited transfer tax marital deduction, for example, permits a surviving spouse’s continued enjoyment of all of the marital unit’s wealth without the impo-
come taxation would affect only a relatively small number of taxpayers, an alternative to income taxation would be a strengthened estate taxation system for life insurance proceeds, a difficult task indeed.\textsuperscript{224}

Despite the shortcomings of the death benefit exclusion from a tax policy standpoint, Congress remains committed to retaining the exclusion and other income tax incentives to encourage survivor protection. It is against this measuring rod that proposals for the taxation of accelerated payments of death benefits must be assessed. However, if the exemption is not based on survivor protection, but is instead an extension of the gift and inheritance income exclusion,\textsuperscript{225} the discussion can be summarily concluded: a terminally ill insured individual cannot receive a gift or inheritance from himself or herself.\textsuperscript{226}

\textsuperscript{224} Congress is not totally benign, at least at face value, in its treatment of insurance proceeds. The insurance benefits which are nontaxable in an income tax sense, can be subjected to estate taxation. See I.R.C. § 2042. In view of the easy avenues of avoidance, the estate tax on insurance proceeds, like much of the estate tax, is one of appearances without substance. See generally George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum. L. Rev. 161, 187 (1977) ("The most significant item [for creating tax exempt wealth] is life insurance. This was frequently described by our interviewees as the single most important weapon in the planner's arsenal . . . ."). Establishing the fixed exemption discussed in supra note 223 is in part difficult because the one-time payment of life insurance proceeds resembles a transfer of wealth, arguably different in nature from periodic income receipts. This notion was reflected in the "capital" versus "income" distinctions of Congressman Hull in adopting the present death benefit exclusion. See supra text accompanying notes 125-26. If the wealth of the recipient from all sources is to be a factor, rather than that of the decedent insured, perhaps an accessions tax is a better answer. However, there has not been much interest in resuscitating, or exploring alternatives (such as an accessions tax) to, the wealth transfer taxation system. See, e.g., Joel C. Dobris, A Brief for the Abolition of All Transfer Taxes, 35 Syracuse L. Rev. 1215 (1984); Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L.J. 259 (1983) (a tongue-in-cheek appraisal of the ineffectiveness of the system); Thomas A. Robinson, The Federal Wealth Transfer Taxes—A Requiem? 1 Am. J. Tax Pol'y 25 (1982); American Bar Association, Section of Taxation, Task Force on Transfer Tax Restructuring, 41 Tax Law. 396 (1988) (a conservative appraisal of reform opportunities). Compare Gutman, supra note 100.

\textsuperscript{225} See supra text accompanying notes 209-14.

\textsuperscript{226} The inheritance characterization would not be valid for a lifetime transaction such as the accelerated payment of death benefits. A gift could occur if someone other than the policyowner paid a premium. See Treas. Reg. § 25.2511-1(h)(8). A situation resembling a gift of proceeds might also arise if the terminally ill individual were not also the policyowner. A gift would not occur if the terminally ill individual were merely designated as the beneficiary, but the policyowner retained the power to change the designation. Id. A gift from the
D. The Policy Goals of Insurance Incentives as Applied to an Exclusion for Lifetime Payments of Death Benefits

1. Congruence With Existing Policy

If encouragement of survivor protection is the real justification for the favorable income tax treatment of life insurance, an exemption for lifetime payments of death benefits may conflict with that goal. The accelerated death benefit shifts the focus from care of survivors to care of the insured. However, that distinction reflects a narrow view of survivor support because the survivors may need financial support during the prolonged illness of a provider. One possible concern is that family members will be reluctant to deny the hedonistic, or selfish, last wishes of the ill individual. Even if not spent on wasteful excess, the proceeds could be depleted by medical expenses and other obligations that might otherwise go unpaid or be assumed by public assistance. In that regard, state debtor exemption laws clearly reflect a public policy of sheltering insurance from the debts of the insured. Even then, however, an individual intent on using the insurance proceeds could borrow and spend the cash surrender value or sell the policy. Never-

owner of the policy to the terminally ill beneficiary could occur, however, when the beneficiary designation became final upon the death of the insured. See, e.g., Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946); Rev. Rul. 77-48, 1977-1 C.B. 292. In a similar fashion, the payment of the accelerated death benefit to the insured would also seem to be a completed gift.

It is commonly stated that prolonged disability of a provider is often a greater risk to a household's welfare than the provider's death. With respect to long-term care, for example, much of the burden reportedly falls on the individual and the family:

[A]nywhere from one-third to one-quarter of those 65 or older are likely to need long-term care at some point in their life. Since a good nursing home can cost up to $40,000 a year, it is easy to see how an unexpected illness requiring long-term care could easily wipe out savings. Today, of the $50 billion spent on long-term care, nearly half comes straight out of the pockets of patients or their families.

Chambless, supra note 25, at 58.

See supra text accompanying notes 80-87 for a discussion of the public assistance issues presented by accelerated death benefit options.

See supra text accompanying notes 76-79. "Statutory exemption provisions have been passed principally to prevent the widow and children of the insured from becoming public charges," Appleman, supra note 78, § 1342, at 577. "The role of insurance as a family 'nest egg' is normally reinforced by statutory provisions in the various states that afford exemption for life insurance policies and their proceeds from attachment by the decedent's creditors . . . ." Harnett, supra note 196, at 4.

See supra note 11.

See supra text accompanying notes 15-20.
theless, an income tax exemption could make a decision to surrender the policy easier because a tax toll charge would not be due, and an accelerated benefits option would make available a larger portion of the face value than afforded under a policy loan or surrender.

If Congress creates an exclusion it would be viewed as sanctioning the inter vivos use of insurance proceeds by the insured. The avenue would probably be further widened by life insurance companies who would respond to an exclusion with more liberal programs facilitating surrenders. The ultimate question is whether an exclusion should be denied for all in fear of what might be done by few insureds. The challenge is fashioning a rule that can balance survivor protection with the needs of the insured. This balancing effort is addressed in Section V below which examines proposed legislation. However, some consideration should be given to an exclusion’s place in the larger scheme of the taxation of life insurance products.

2. Moving the Line — Again

Death as the determinative factor in taxing life insurance proceeds clearly reflected a passing of the insured and a focus on the survivors, a “fresh start” in some sense. An exclusion for accelerated death benefit payments suggests deeper repercussions beyond

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332 A view of the insured as a spendthrift may be an exaggeration typical of most “parades of horribles.” Recently published research suggests that a significant motivation for total saving is a desire to leave bequests: the bequest motive. This motivation extends to life insurance purchases where the insured will forego lifetime consumption via an annuity and instead choose a vehicle with a death benefit. See B. Douglas Bernheim, How Strong Are Bequest Motives: Evidence Based on Estimates of the Demand for Life Insurance and Annuities, 99 J. Pol. Econ. 889 (1991).

The survivor protection argument has even less force if one is faced with the terminal illness of an individual without survivor support obligations. In that regard, the reports of sales of insurance policies to private brokers indicate that most of the sellers are suffering from AIDS. See supra note 19. On the other hand, a Prudential spokesman was quoted as saying that most of the individuals taking advantage of the living needs benefit are suffering from diseases other than AIDS, such as cancer. See supra note 23.

333 Section 1014 of the Code and its collateral effect on transactions involving other sections, including, I.R.C. §§ 306, 368, 1031, 1245, 1250, and 1254, reflects this fresh start focus on the living. The income tax exclusion for transfers at death, which has been previously compared to the insurance exclusion, also demonstrates this passing, except that the I.R.C. § 102 exclusion also applies to the receipt of lifetime gifts. See supra text accompanying notes 97-100 and 209-14.
survivor protection, in the fundamental shift of focus from survivors to the insured.\textsuperscript{234} If death recedes as a factor of distinction, then life insurance resembles programs for the preservation or enhancement of the living standards of the insured, such as retirement and health benefits.\textsuperscript{235} If six or twelve months, for example, is so close to death to support equal treatment with death benefits, can an exclusion for long-term care such as Prudential's nursing home option be denied? Such an exclusion would detract even less from the protection of the family because premature death of a wage earner would be of less concern with a retired person needing nursing home care.\textsuperscript{236} Even if the nursing home patient has a household, one could fashion a survivor protection argument based on the physical and financial burdens of survivors in caring for an afflicted individual.\textsuperscript{237}

3. Restoring Some Coherence to the System

If the focus of life insurance shifts to the insured's life and needs, traditional distinctions of life insurance as an indemnity as compared with other investments would require reexamination. As discussed earlier in this article, Congress has been aligning the taxation of certain lifetime benefits from annuities and modified endowment contracts with that of retirement savings.\textsuperscript{238} The regime for tax deferred annuities and retirement plans tends to be much more restrictive than that applied to life insurance.\textsuperscript{239} As discussed

\textsuperscript{234} Again, this is tempered somewhat by the reality that the onus of caring for the terminally ill individual, financially, physically, and emotionally, would often rest on the survivors. The accelerated death benefits could, in that respect, help lessen their burden in caring for the insured. See supra text accompanying note 227.

\textsuperscript{235} There is arguably a fallacy here, at least in a relative sense, because the Internal Revenue Code is so replete with special exclusions. The survivor protection rationale behind I.R.C. § 101(a) seeks to aid in the replacement of human capital through life insurance when a provider dies. See Guerin & Postlewaite, supra note 137 at 139. Section 104(a)(3) of the Code would exclude disability payments received upon the disability of an individual. Therefore, an exclusion could be consistent on that basis for lifetime payments of death benefits to a terminally ill wage earner, where an exclusion for retirement income would not.

\textsuperscript{236} Of course, not all nursing home residents would be admitted due to the infirmities of advanced age.

\textsuperscript{237} An exclusion for long-term care benefits is briefly discussed at supra text accompanying notes 104-09.

\textsuperscript{238} See supra text following note 194.

\textsuperscript{239} The staff of the Joint Committee on Taxation prepared a chart that compares the tax incentives for individual retirement arrangements (IRA's), 401(k) plans, qualified pension
earlier in this article, many of the difficulties in dealing with the taxation of life insurance arguably spring from Congress’ efforts to maintain a boundary around “traditional” life insurance which remains a target for those seeking to take advantage of its dearth of restrictions.\textsuperscript{240} A brief discussion of alternative treatments of life insurance follows.

\textbf{a. Consumption or Accretion Taxation?}

A vigorous tax policy debate has centered on whether a consumption or expenditure tax\textsuperscript{241} or an accretion-type tax\textsuperscript{242} is the appropriate model for the income tax system.

The retirement savings provisions, which in general permit a deduction for retirement savings contributions, deferral of tax on in-
vestment earnings, and full inclusion in income upon withdrawal reflect consumption tax principles. Tax deferred annuities outside of qualified retirement plans do not enjoy deductibility of contributions and only allow deferral of tax on accretions in value, departing somewhat from the classic consumption model. Both retirement savings and deferred annuities currently reject "accretion-type" treatment which would require the current taxation of increases in value. Assuming that Congress continues to draw from consumption tax principles for the taxation of retirement savings and deferred annuities, rather than current income recognition of accretions in value, a consistent treatment for life insurance, which bears some similarities, could incorporate consumption tax principles. Professor Andrews has proposed that

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Michael Graetz proposed a classic consumption tax treatment for annuities, with a deduction for purchases and inclusion in receipts as they are paid, rejecting "Yield Exemption" treatment under which no deduction would be allowed for purchases of annuities, but earnings and withdrawals of principal would be exempt from a consumption tax. Graetz, supra note 241, at 1613. The term "tax deferred annuity" as used in this article refers to those investments discussed at supra text accompanying notes 167-73 and not to annuities purchased in connection with a qualified retirement plan for which a deduction is permitted for contributions. See, e.g., I.R.C. § 403(b) (deduction for annuities purchased for tax exempt organizations and schools).

Several recent proposals have addressed different facets of the issue of taxing accretion. For example, President Bush's 1990 budget proposal included a "Family Savings Account" which would permit a person with an income of less than $80,000 to deposit up to $2,500 a year and pay no tax on the interest if the account were maintained at least seven years. A couple earning less than $120,000 could deposit up to $5,000. See Doubts Raised Over Bush's Tax Plan for Savings, N.Y. Times, Mar. 29, 1990, at D7. So-called "Super-IRA" legislation has been introduced which would expand the eligibility for IRA contributions and liberalize permissible early withdrawals without the imposition of penalties. Two IRA's would be created. One would be funded with deductible contributions and all earnings would be taxable upon withdrawal. The other account would be funded with non-deductible contributions, but earnings would not be taxed if held in the account for at least 5 years. The accounts could be tapped without penalty for first-time home purchases (including purchases by children or grandchildren), certain education expenses, and catastrophic medical costs (those in excess of the 7.5 percent of adjusted gross income limitation of I.R.C. § 213(a)). S. 612, 102d Cong., 1st Sess. (1991).

The purpose of qualified retirement plans is obviously to provide for retirement income needs. The tax deferred annuity is also a retirement savings vehicle. See supra text accompanying note 168. Cash value life insurance, particularly the flexible premium products, strongly resemble a tax deferred savings account plus death insurance protection. See supra note 174. The policyowner accumulates, through the cash surrender value, a fund which can be tapped for retirement or other needs. The endowment policy, which matures at a certain time before death, is very similar to a tax deferred annuity. See supra note 14. Pure term insurance, which has no investment element, however, does not share many similarities with retirement savings.
“Life insurance policies and annuity contracts would be treated under a consumption-type personal income tax just like any other investment: premium payments would be deductible and proceeds would be fully taxable.”

If something is to be learned from past experience with life insurance taxation, less stress will be placed on definitions of products qualifying for special tax incentives or subject to special restrictions, if investments which are comparable in economic terms are subject to comparable rules of taxation. Nevertheless, an application of either consumption or accretion principles to life insurance on an incremental basis, without broad changes in the taxation of comparable products, creates inconsistencies with other established regimes.

b. Adopting a Retirement Plan or Consumption Tax Model

A deduction for premiums paid would be consistent with the retirement plan analogy and consumption tax principles. However, in establishing more congruence with retirement plans, insurance policy loans would need to be restricted. No income tax exclusion would be provided for death benefits or other payments when received, although special averaging for death benefits might be

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246 Andrews I, supra note 241, at 1164. Professor Andrews suggests that the beneficiaries would bear the tax on the policy proceeds, but they could offset that inclusion by a deduction for investment, and “the net effect would be that proceeds would be taxable only if and when devoted to consumption.” Id.

247 The following countries reportedly permit tax deductions for personal life insurance premiums: Egypt, Fiji, Ghana, Luxembourg, Portugal, St. Lucia, Thailand, and Venezuela. Coopers & Lybrand, 1988 International Tax Summaries, at E-3, F-3, G-17, L-36, P-70, S-3, T-23 & V-7, respectively. Other countries permitting an income tax deduction are noted in J. Pechman, Comparative Tax Systems (1987): France, id. at 12, 155, 168; West Germany, id. at 17; Sweden, id. at 40; the Netherlands, id. at 101; and Japan, id. at 407. The United States tax system permits an income tax deduction are noted in J. Pechman, Comparative Tax Systems (1987): France, id. at 12, 155, 168; West Germany, id. at 17; Sweden, id. at 40; the Netherlands, id. at 101; and Japan, id. at 407. The United States tax system permits an income tax deduction to individuals only for health insurance premiums. See I.R.C. § 213(d)(1)(C). However, a “deduction” for life insurance protection is indirectly allowed to the extent an individual's employer maintains group term life insurance protection, the premiums for which are not included in the employee's taxable income. See, e.g., I.R.C. § 79 providing an exclusion for employer paid premiums for an amount not in excess of $50,000 of group-term life insurance. If an income tax deferral for inside buildup, or dividends used to pay mortality charges, were retained, a deduction would not be allowed for insurance protection purchased with such funds.

248 Under a pure consumption tax, any loans would be treated as taxable consumption. Retirement plans limit or completely preclude loans from the plan. See, e.g., I.R.C. § 72(p) (loans permitted from qualified retirement plans but limited in amount and term); I.R.C. § 408(e)(4) (pledge of an individual retirement account treated as a distribution).
considered. A penalty on lifetime surrenders could be reserved only for protection procured through a deductible premium, but a penalty for any withdrawal not meeting hardship criteria would be consistent with the existing treatment of other investments. Nevertheless, the retirement savings distribution rules would require some adjustments in an adaptation to the life insurance context.

As an alternative, one could continue the present prohibition on the deductibility of most life insurance premiums (like, for exam-

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249 House Bill 3441, introduced on October 7, 1987, by Congressmen Stark & Gradison in the 100th Congress proposed extending the deferred annuity taxation rules to all life insurance policies, including income recognition upon loan transactions, income recognition first (rather than return of capital) on withdrawals, and penalties for withdrawals prior to age 59 ½. H.R. 3441, 100th Cong., 1st Sess. (1987). See supra text accompanying notes 219-23 (discussing averaging and exemption alternatives). Liquidity concerns have been raised by some commentators with respect to taxing death benefits. See, e.g., Klein et al., supra note 159 ("a heavy tax burden at a difficult time"); Andrews I supra note 241, at 1164 ("might seem to compound the tragedy of death"). However, this assumes the absence of a need based exemption or special averaging. One must also ask if liquidity will ever not be a problem if it is one even when the recipients have recently received a lump sum, cash life insurance settlement.

250 Two of the leading articles proposing a consumption tax do not advocate penalties or other disincentives on premature withdrawals of retirement savings, beyond taxing them as current consumption. See Andrews I, supra note 241, nn. 143-44 (noting without comment the penalty taxes on premature retirement plan distributions). Graetz, supra note 241, at 1629-34 (noting, however, that adopting consumption tax incentives for some types of income may be required due to political expediency). Withdrawal restrictions might be required as a matter of retirement policy rather than tax policy. Presently tax deferred annuities and modified endowment contracts, for which there is no deduction on the purchase of the investment, bear retirement plan type premature withdrawal penalties. See supra notes 188-92. The premature distribution rules generally discourage withdrawals before age 59 ½. See I.R.C. § 72(t) (10% additional tax on early distribution from qualified retirement plans).

251 While 59 ½ approximates retirement age for many individuals, which justifies a relaxation of distribution restrictions, the mortality rate dramatically increases in the years thereafter. See supra note 218. Moreover, participants in qualified retirement plans are required to commence withdrawals no later than April 1 of the calendar year following the calendar year in which the employee attains age 70 ½. See I.R.C. § 401(a)(9) ("a plan shall not be qualified unless, in general, it requires distributions not later than the required beginning date tied to age 70 ½"). On the other hand, if life insurance is seen as an income replacement upon the death of a provider, a surviving provider would be approaching retirement age anyway and should have accumulated retirement assets to replace cash flow from employment. Social Security retirement benefits would be an important asset affecting the demand for life insurance. See, e.g., Fitzgerald, supra note 197. Dividends actually received by the policyholder, often an adjustment of premiums payable, would be included in income without the benefits of averaging or a recovery of basis. On the other hand, since insurance protection is not eroded by the receipt, a withdrawal penalty would be inappropriate.
ple, nondeductible IRA or tax deferred annuity contributions), while taxing all of the proceeds (in excess of aggregate premiums paid) upon ultimate receipt. The benefit of the arrangement to the insured would be the deferral of tax on inside buildup. However, the unique pure death protection aspects of insurance, which are not shared by the retirement plan models, could produce a "loss". A more refined response to this loss characterization would allow a current income tax deduction or credit for all or a portion of premiums paid for pure insurance protection. Upon the insured's death, the death benefit would be treated as a tax-free return of capital to the extent of premiums previously paid and not deducted, with inclusion in income of any excess, subject to any exemptions or averaging conventions. The deduction or credit could be limited to a certain level of insurance protection and could be phased out at certain income levels, producing an incentive for the acquisition of death protection without creating a new tax avoidance opportunity.

c. Adopting an Accretion Model

A possible solution rests upon implementing a longstanding rec-

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If an individual purchases a one year term insurance policy, for example, and it lapses one year later without the individual's death, this could be the proper point for recognition of a loss. See supra note 161 (asserting that the current death exclusion finds support in producing, in the aggregate, no overall gain or loss due to individual mortality gains and losses, but noting that this conclusion assumes that the peace of mind from current insurance protection was not of value). This assumes that an economic loss has occurred. The insured did receive protection for the one year period, much as the occupant of owner-occupied housing receives protection (from the elements). Neither enjoyed benefit requires inclusion in current income nor a deduction for the resources used to purchase the benefit (if one ignores the mortgage interest deduction).

Tax shelter opportunities would not be greater than those currently afforded by cash value insurance and deferred annuities, but if loan and withdrawal restrictions were more broadly applicable, it would seem that the desirability would be reduced for those principally seeking tax advantages. A deduction for the pure death protection premiums would resemble deductible gambling. A deduction for life insurance premiums would also run counter to the thrust of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, which generally sought to eliminate deductions for personal expenses not of a business or investment nature, although the taxation of death benefits would lend to a taxable investment characterization of life insurance. A solution which is simpler, but not symmetrical in result, would ignore the "loss" suffered by the owner of an expiring policy, permitting no loss recognition nor deduction for premiums paid. As under current law, aggregate premiums could be offset against amounts received under the policy.
ommendation, that inside buildup be taxed as accrued. However, a deduction for pure death insurance protection could be permitted on the terms described above in the retirement plan model, with inclusion of death benefits in income. A deduction for the balance of the premiums would not be allowed, and accretions in value would be taxed currently, producing a policyowner's adjusted basis in the life insurance contract consisting of aggregate nondeductible premiums paid plus accretions in value previously included in income. Under this regime, restrictions on withdrawals and loan provisions would not be critical, from an income tax standpoint, because there would be no income deferral.

A possible objection is that deferred taxation of inside buildup, a needed incentive for acquisition and continuity of protection, has been eliminated. A response is that the prior incentives flowed in large part to the wrong individuals, and a current deduction for a portion of premium payments could provide a more targeted incentive for the acquisition and maintenance of insurance protection.

A more fundamental objection to taxing accrued inside buildup is that it creates inconsistencies with comparable investments. Life insurance would be subjected to harsher treatment with respect to inside buildup than tax deferred annuities and retirement plans. On the other hand, qualified retirement plans have restrictions on loans, withdrawals, and the amount of contributions which limit the tax advantages associated with the deferral of inside buildup and which accomplish broader retirement policy objectives. The comparison, therefore, is not fair. The argument is more difficult with tax deferred annuities which, while subject to loan and withdrawal restrictions, are not subject to limitations on the amount of contributions one can make. The inconsistency could be removed if Congress reassesses the unlimited opportunity for investment in-

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254 See supra notes 150-51. The current recognition of investment income has already been incorporated in the taxation of annuities not owned by individuals, see supra note 185, and for life insurance not meeting the statutory taxation definition, see supra note 180. A continuing proposal has been treatment of inside buildup as an item of tax preference. See, e.g., 1988 Single Premium Pamphlet, supra note 11, at 38. Inside buildup is already a factor in the corporate alternative minimum tax. See supra note 151.

256 This approach was proposed by William Vickrey in his 1942 article. See Vickrey, supra note 150.

256 See supra text accompanying notes 198-99.

257 Id.
come deferral presented by the purchase of tax deferred annuities.

A degree of simplification and coordination of treatment of comparable investments would be achieved if no current deduction were allowed for insurance premiums or annuity purchases, inside buildup were currently taxable, and all proceeds were taxable, subject to a recovery of aggregate premiums paid plus any amounts previously included in income. A deduction for “losses” arising from cancelled insurance would be denied to provide an additional incentive for continuity of protection and in the interest of simplification. This modified accretion approach would be better suited to an incrementalist revision of the income tax system in lieu of a broad implementation of a consumption tax regime.

Under any system outlined above, accelerated benefits in general would be treated as taxable consumption or income upon receipt. However, any exemption or averaging convention extended to death benefits could be likewise extended to the receipt of accelerated death benefits.

d. Summary

Coordination of all tax incentives for health insurance, long-term care insurance, life insurance, and retirement benefits is beyond the scope of this article. There might also be a tendency to see this as only a tax matter, where “taxation is King,” but a discussion would also need to focus on broader aspects of national health insurance and social security.

An interim solution could address

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258 One of the best discussions of the problems and possible solutions in dealing with the taxation of life insurance and kindred products is the pamphlet produced by the staff of the Joint Committee on Taxation. See 1988 Single Premium Pamphlet supra note 11. The revenue effect of all of this is uncertain. The exclusion of interest on life insurance savings was a tax expenditure of $5.56 billion in 1989. U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, reprinted in 1990 Statistical Abstract supra note 13, No. 503, at 314. The revenue cost of the death benefit exclusion was not shown as a tax expenditure, although in view of the amount of death benefits paid annually (during 1989, $23.3 billion in death benefits was paid, 1990 Life Insurance Fact Book, supra note 9, at 44), the tax thereon would appear to exceed the $1 billion de minimis threshold for reporting.

259 See, e.g., Michael J. Graetz, The Troubled Marriage of Retirement Security and Tax Policies, 135 U. Pa. L. Rev. 851 (1987) (arguing that a national retirement policy must coordinate the coverage and incentives of at least three systems: the payroll tax, employer-provided pensions, and individual retirement savings). In enhancing incentives for life insurance, one must consider the effect on other sectors such as employer-provided retirement plans. Tax deferral of earnings under annuities owned by other than natural persons was
the taxation of accelerated insurance death benefits, but with some appreciation of the path broader reform might take. Some current proposals are considered in the following section.

V. INTERIM LEGISLATIVE SOLUTIONS FOR AN INCOME TAX EXCLUSION FOR ACCELERATED DEATH BENEFITS

A. Current Proposals

In recent years several bills have been introduced in Congress to liberalize the income tax treatment of accelerated death benefits.\textsuperscript{260} Senate Bill 284,\textsuperscript{281} for example, proposes the addition of a new Internal Revenue Code section 101(g) which would treat payments made with respect to terminally ill individuals as paid by reason of the death of the insured.\textsuperscript{282} A similar bill has been introduced in the House of Representatives.\textsuperscript{283} Neither bill would exempt other payments, such as those for long-term care, from taxation.

The proposed language of Senate Bill 284 permits an exclusion for “any amount paid to an individual under a life insurance con-
tract on the life of an insured who is a terminally ill individual . . . .”264 This suggests that payments to beneficiaries other than the insured would also qualify.265 The language of House Bill 134 limits the exemption to “any amount paid under a life insurance contract to an insured who is a terminally ill individual . . . .”266 The broader language of the Senate Bill might ensure that installment benefit payments remaining at the time of the insured’s death would receive exclusionary treatment in the hands of the beneficiary, but literally the deceased insured would not be someone who “is” a terminally ill individual.267 If the terms of accelerated benefit policies depart from the model established by the Prudential plan and permit the receipt of benefits by persons other than the terminally ill insured, the language of the Senate Bill would suggest that such payments would be eligible for the exclusion. This might be appropriate for dependent members of the insured’s household, as part of the insured’s economic unit, but it is not compelling for other beneficiaries. The Senate Bill language also raises the issue of whether an individual who purchased the policy of a terminally ill insured could utilize this exemption to exclude the proceeds from income. This result would conflict with other language of both bills, discussed next, which denies an exemption for payments from the purchasers of policies. It also would conflict with established tax law which limits the exclusion available to a purchaser of a life insurance policy to the purchase price plus premiums paid.268

264 Senate Bill 284, supra note 260, at § 1(a).
265 Under the Prudential living needs benefit rider, for example, the living needs benefits are paid only to the insured. Payments would be made to beneficiaries only if the insured died before an installment payment plan was completed. See supra text accompanying note 43.
266 House Bill 134, supra note 260, at § 1(a).
267 The sole reason the beneficiaries would receive the unpaid installments would be due to the death of the insured, and the death benefit exclusion would therefore appear applicable, or failing that, the exclusion for bequests and inheritances. As to the latter exclusion, the exception of Code § 691 pertaining to income in respect of a decedent should not apply because under the proposed legislation the decedent insured would not have been taxable upon the inter vivos receipt of the insurance proceeds.
268 Purchasers of life insurance policies would already be subject to I.R.C. § 101(a)(2), which requires that the purchaser recognize income to the extent the death benefit proceeds exceed the cost (to the purchaser) of the policy. This limitation was included in the 1954 enactment of the Internal Revenue Code because otherwise the death benefit exclusion could “result in abuse in encouraging speculation on the death of the insured . . . .” S. Rep.
Both bills state that the payments must be “under” the life insurance policy; proceeds from the sale of a policy would not be eligible for the exclusion. Since accelerated death benefits are in most cases available only on permanent life policies (as contrasted with term insurance policies), this leaves the seller of a term policy without an exemption. This concern will be alleviated as more group insurance plans and other term policies offer accelerated death benefits terms. Term insurance aside, the statute also places the owner of a permanent policy not containing a living benefits provision (or containing a provision on unfavorable terms) at a tax disadvantage in selling the policy to a third party. Nevertheless, the language of the exemption appears to channel all of the living benefits advantages back through life insurance companies.

A terminally ill individual under the Senate Bill is one “who has been certified by a licensed physician as having an illness or physical condition which can reasonably be expected to result in death in 12 months or less.” The House bill is similar but describes a

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The Prudential living needs benefit plan, for example, is available only on permanent life policies. See supra text accompanying note 35.

Some group term plans are already incorporating living benefits options. See supra note 35.

The insureds presently utilizing independent purchasers of policies reportedly include those with life expectancies of 18 to 24 months. At that point they would not qualify for the 6-month terminal illness requirement of the Prudential plan. McCormack & Petersen, supra note 12, at 1348. If legislation is enacted with the 12-month terminal illness requirement described in the following paragraphs of the text, the insurance companies would probably liberalize their terms accordingly. The owner of a permanent policy seeking enhanced accelerated death benefits could consider an exchange of policy contracts. See supra text accompanying note 64.

If sales of policies were also eligible for an exclusion, the exclusion should be limited to sales by only the insured. It seems inappropriate to permit policyowners, other than the insured, to sell a policy on the terminally ill individual’s life and be eligible for the exclusion. On the other hand, if the seller is the spouse of the insured, and the funds are needed to care for the insured and other family members, an exemption would not seem to be troublesome. A concern is that no traffickers in policies be permitted an exemption, although existing tax law would preclude such an exclusion. See supra note 268. In that regard, five of the companies purchasing life insurance policies from the terminally ill indicated in a January 1991 survey that they will purchase policies from a third party after a transfer from the insured, and the other three companies indicated that they will consider such a transaction. McCormack & Petersen, supra note 12, at 1355.

Senate Bill 284, supra note 280, at § 1(a). The 12-month period of the definition of terminal illness exceeds, for example, the 6-month requirement of the Prudential plan. See supra text accompanying notes 37-38.
licensed physician as "a physician, licensed under State law . . . ."\textsuperscript{274} The certification procedure understandably introduces uncertainty into this area and could invite abuse because the exclusion apparently is achieved if the insured receives the certification, without further inquiry. As an alternative, the burden of proving the existence of a terminal condition could remain with the taxpayer.\textsuperscript{275} If the certification route is retained, a physician might be subject to criminal fraud provisions of the Internal Revenue Code and general federal law if the certification were fraudulent or false.\textsuperscript{276} Congress could make this penalty clearer, at the risk of chilling the availability of the exemption to the terminally ill, if the physician were required to certify the insured's condition, "in writing, made under the penalties of perjury."\textsuperscript{277}

Senate Bill 284 also amends the Social Security Act to prohibit requirements that an accelerated benefit payment election be made to qualify for assistance.\textsuperscript{278} It would apparently not exempt

\textsuperscript{274} House Bill 134, supra note 260, at § 1(a).

\textsuperscript{275} Compare I.R.C. § 213(g)(3), repealed effective January 1, 1967, by Pub. L. No. 89-97, § 106(d), 79 Stat. 286, 337, which stated "An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary or his delegate may require." The regulation required for the first taxable year for which exclusion was claimed, "a doctor's statement as to the impairment of such individual upon which the taxpayer relies." Treas. Reg. § 1.213-2(d)(2). See also I.R.C. § 72(m)(7) (incorporating the same statutory test of disability as former I.R.C. § 213(g)(3)). A spokesman for the Treasury has testified that "a physician's certification . . . raises serious problems of administration. 'Audit' of such a certification would be difficult, to say the least. Yet if the standard is effectively unauditable, compliance concerns are certain to arise." 1991 Senate Hearing, supra note 21 (statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy) Department of the Treasury).


\textsuperscript{277} Under I.R.C. § 7206(1) it is a felony to make and subscribe "any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter . . . ." It is a misdemeanor under I.R.C. § 7207 to deliver to the Internal Revenue Service "any list, return, account, statement, or other document" known to be fraudulent or false in any material matter. A signature under penalties of perjury is not a necessary factor since delivery of the statement constitutes the crime. Physicians would usually not deliver the statement to the Internal Revenue Service in the absence of provisions requiring the delivery of information statements such as forms 1099.

\textsuperscript{278} Section 3 of Senate Bill 284, supra note 260, would add a new section to Title 42 of the United States Code:

Treatment of Accelerated Death Benefits Sec. 1143(a) In General - Notwithstanding
funds from inclusion in assets for public assistance eligibility if the election is, however, made.\textsuperscript{279}

\textbf{B. Assessing the Proposals}

As noted above, Senate Bill 284 and House Bill 134 appear to qualify only life insurance company payments. The proponents of the legislation were apparently shocked at the activities of investors such as Living Benefits, Inc.\textsuperscript{280} In response, the bill substitutes an income tax penalty on the terminally ill individual\textsuperscript{281} as a form of any other provision of law, no individual who is an applicant for or recipient of aid or assistance under a State plan approved under title IV, X, XIV, XVI, or XIX, of assistance funded by payments under title V or XX, or of benefits under the Supplemental Security Income program established by title XVI shall:

1. be required, as a condition of eligibility for (or of continuing to receive) such aid, assistance, or benefits, to make an election to receive an accelerated death benefit under a policy of life insurance, or
2. by reason of failure to make such an election, be denied (or suffer a reduction in the amount of) such aid, assistance, or benefits.

(b) Accelerated Death Benefit - For purposes of this section, the term "accelerated death benefit" means any payment made under the terms of a life insurance policy, while the insured individual is alive, as a result of a recalculation of the insured individual's life expectancy.

The exemption for public assistance eligibility raises issues of whether government funds should thereby be used, rather than the individual's, so that an inheritance is preserved. An inheritance for dependent family members is one matter and comports with family protection policies; preserving an inheritance for adult children or other beneficiaries, on the other hand, is quite another matter. For a discussion of these issues see Joel C. Dobris, Medicaid Asset Planning by the Elderly: A Policy View of Expectations, Entitlement and Inheritance, 24 Real Prop. Prob. & Tr. J., 1 (1989). For a discussion of mechanics see Louis A. Mezzullo, Advice on Planning for Medicaid Qualification, 130 Tr. & Est. 8, July, 1991, at 8.

\textsuperscript{279} The description of Senate Bill 284 prepared by the staff of the Joint Committee on Taxation, however, states as a "pro" of the bill that "The bill may reduce the amount that would otherwise be paid under Federal or State public assistance programs (such as Medicaid) by encouraging terminally ill individuals to elect to accelerate the receipt of death benefit payments." Staff Explanation, supra note 93, at 23. To the contrary, it would seem that if the unexercised option is not to be considered as "available" for assistance eligibility, but proceeds from the exercise of an election will be considered for eligibility, one would not exercise the option to obtain the proceeds tax-free if public assistance were otherwise a possibility.

\textsuperscript{280} See supra note 20.

\textsuperscript{281} The purchaser already pays a form of income tax penalty under existing law through the "transfer for valuable consideration" rules of I.R.C. § 101. See supra note 268. An explanation of Senate Bill 284, supra note 260, makes it clear that private purchasers were targeted. "Certain noninsurance companies currently purchase life insurance contracts from terminally ill policyholders. These companies may not pay policyholders the present value of the death benefit under the contract." Staff Explanation, supra note 93, at 23.
of insurance regulation. This may not be a significant issue if competition compels most life insurers to offer attractive surrender terms; companies like Living Benefits, Inc. would probably see shrinking business and profit margins.282

A greater concern is the potential unavailability of an accelerated death benefit option for many term policies, leaving sales to third parties as the only alternative.283 This implied rejection of all policy sales comes in the face of evidence that there were few reported abuses in the purchases of policies by independent brokers.284 If Congress wants to engage in insurance regulation,285 then the tax exclusion could initially encompass all receipts but be further conditioned upon the incorporation of consumer protection measures, prescribing, for example, minimum payout percentages and payment schedules and standards to be applied in determining terminal illness.286

282 For example, Living Benefits, Inc. would reportedly offer $66,000 for a $100,000 policy on the life of a terminally ill person with a life expectancy of one year; a discount of approximately 33%. See Belth, supra note 20, at 14. A January, 1991 survey of eight companies that purchase life insurance policies from the terminally ill, reported that the maximum purchase price ever paid as a percentage of face amount ranged from 50-80%. McCormack & Petersen, supra note 12, at 1355. The Prudential brochure claims that its plan pays out 90-95% of the policy's face value, and actual experience has been reported as 96% of face value. See supra note 39.

283 However, the living needs option is reportedly being extended to term policies, and if that trend continues, this problem will diminish. See supra note 35.

284 See supra note 20.

285 Senate Bill 284, supra note 260, clearly has a regulatory purpose: "The bill would encourage policyholders to elect to accelerate the death benefit payment from the issuing insurance company, which is subject to State regulation and, therefore, is more likely to pay the policyholder the present value of the death benefit under the contract." Staff Explanation, supra note 93, at 23. The McCarran-Ferguson Act, 15 U.S.C. §§ 1011, 1012 (1988) provides that the regulation of insurance is subject to state law, and no act of Congress shall be construed to impair or supersede state regulation unless the federal statute specifically relates to the business of insurance. However, the Sherman Act, Clayton Act, and Federal Trade Commission Act are applicable to the extent that such business is not regulated by state law. See Spencer L. Kimball & Barbara P. Heaney, Emasculation of the McCarran-Ferguson Act: A Study in Judicial Activism, 1985 Utah L. Rev. 1 (1985) (discussing the background of the law and federal legislative restraint, tempered, however, by expansive judicial pronouncements). Congress, of course, is not foreclosed from enacting legislation; the inquiry is often whether legislation specifically relates to the business of insurance. I.R.C. § 832, concerning the taxation of life insurance companies, was held to be specifically related to the business of life insurance in Hanover Insurance Co. v. Commissioner, 598 F.2d 1211 (1st Cir. 1979), cert. denied, 444 U.S. 915 (1979).

The absence of a limit on the exemption, in the proposed legislation, or any familial or means-tested basis for exemption, could be explained as a consistent extension of the broad exclusion presently contained in section 101 of the Code. However, protecting survivors from dissipation of the insurance proceeds by the insured is a new concern presented by accelerated benefits plans, and not by conventional death benefit payments. Survivor protection aside, one might also propose that living benefits should be approached as a narrow exception to the general death benefit rule, and any exemption should be more circumscribed than the death benefit exclusion. Although not answering objections raised by comparisons with the prevailing income tax treatment of lifetime sales of other assets, the exemption could be limited to receipts by the insured, his or her spouse, and dependents.

With survivor protection as a goal, one might propose a monetary cap, say $50,000-75,000. If the primary purpose of an exemption is to provide for the needs of the insured during the last 6-12 months of life, while discouraging profligate spending of the survivors' nest egg, this could promote that purpose. This, of course, assumes that the arbitrary monetary limit is a reasonable amount for the insured's needs. As of 1989, the average amount of insurance per insured household was only $115,500, very close to all but a very restrictive limitation. The statistics more directly applicable to accelerated death benefits are even more modest. The average size of an individual AIDS death claim in 1989 was $28,200, while the average group life claim identified with an AIDS death


287 See supra text accompanying notes 215-18.

288 If one grants a tax exemption to lifetime receipts of life insurance, one must grapple with tax breaks for lifetime sales of other assets when required by illness or other catastrophes. See supra text accompanying notes 97-100.

289 See supra note 10. The averages, however, are greater for wealthier households and less for poorer households. See supra note 208.
was $34,200. A survey commissioned by the American Council on Life Insurance found that the average face amounts for terminal illness, dread disease, and long-term care policies were $32,482, $66,311, and $78,680, respectively. Any arbitrary limitation is irrelevant, as a survivor protection goal, if the insured has no dependents. A limit, no matter how determined, also produces additional complexity because matters such as the allocation of the limitation among recipients and the effect of indirect beneficial interests through trusts, for example, arise. In view of such complexity, the limited exclusion could be applied only to proceeds received by the insured, or a trust for the benefit of solely the insured, and by no other persons.

An arbitrary exemption could be restated as, or supplemented by, a standard tied to the insured's uncovered medical care expenses. Medical expenses not paid by insurance are already determined for purposes of the medical expense itemized deduction and the exemption from premature retirement plan distribution penalties, so a familiar standard would be utilized. This would introduce to the system a need-based exclusion for insureds without dependents. For insureds with dependents, it would introduce a need-based standard and also further the congressional purpose of providing for survivors by not creating a tax incentive for excessive pre-death surrenders. However, reliance on the medical expense deduction definition of allowable expenses may be too restrictive in dealing with unapproved drugs and care which is custodial.

1990 Life Insurance Fact Book, supra note 9, at 41.
ACLI Survey, supra note 30, at 2. The study notes that there was "considerable variation in the averages . . . . Although several companies reported average face amounts of less than $10,000, others reported averages of $90,000 or more." Id. at 8.
See supra note 232.
See supra note 223.
See I.R.C. § 213. A more modest proposal would include benefits as income but exclude them from adjusted gross income for purposes of the 7.5% of adjusted gross income medical expense limitation. The so-called "Super IRA" proposals define distributions for catastrophic medical expenses with reference to expenses in excess of the 7.5% adjusted gross income limitation. See supra note 244. I.R.C. § 72(f)(2) similarly exempts from the 10 percent penalty tax on early distributions, retirement plan distributions for employee medical care deductions allowable under I.R.C. § 213.
Incorporation of the deductible medical expense definitions would undeniably place greater pressure on successful characterization under those provisions. For example, I.R.C. § 213(b) permits a deduction only for a drug which requires a prescription of a physician for its use. Drugs not approved for use by the Food and Drug Administration would present a
care, such as eating, bathing, dressing and walking, rather than medical. On one hand, such a standard would ignore simple living expenses of an individual too ill to support himself or herself and any dependents. On the other hand, if an exclusion is to be means-tested, inclusion of resources for living expenses in taxable income may be appropriate, subject to the income taxation system's other standard deductions, exemptions, and graduated rates. However, an averaging mechanism would be appropriate.

In spite of obvious shortcomings, a limitation linked to actual medical expenses and other expenses of care would be more desirable than a requirement of spousal or dependent consent. There is precedent for such a requirement under the Retirement Equity Act, and the independent purchasers of policies reportedly require such waivers as a matter of course. However, a consent or waivable requirement would only subject the household unit to difficult pressures in the insured's final days. An unyielding limit or need-based requirement is not as flexible, but it would preclude this controversy.

In summary, the broad exemption of the pending legislation could be amended to better protect survivors and to align the treatment with an ultimate elimination of the death benefit exclusion for all beneficiaries in favor of a need-based exemption. A

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problem in fulfilling this requirement. See, e.g., Sandra G. Boodman, Insurers Balk at 'Experimental Drugs,' Wash. Post, Mar. 28, 1989, at 27 (in part briefly discussing the licensing and experimentation aspects of the Food and Drug Administration approval process).

See supra note 49.

The payment of living expenses is traditionally handled by disability insurance proceeds which are excluded from income under I.R.C. § 104(a)(3). See supra text accompanying notes 54-62.

The insured would also be entitled to offset his or her investment in the insurance contract as under present law, consisting of aggregate premiums paid. See supra note 47. In addition, this treatment assumes an incremental modification to life insurance taxation in the absence of a broad-based exclusion for long-term care benefits. See supra text accompanying notes 104-09. This treatment is arguably inconsistent with the present treatment of disability insurance proceeds. See supra note 297.

See supra text accompanying notes 219-22.


See McCormack & Petersen, supra note 12, at 1349.
blanket terminal illness exclusion could be replaced by an arbitrary de minimis exclusion of $50,000, which could be supplemented by actual medical expenses not covered by insurance (to the extent not otherwise deducted in that year as a medical expense\(^3\)). Any additional receipts in excess of the taxpayer’s investment in the contract would be taxable income, subject to an averaging mechanism.

None of the technical problems with proposed legislation are insurmountable. However, in all candor, the author questions whether the complexity generated by an averaging convention or medical expense exclusion as outlined above for accelerated death benefits is the appropriate avenue to use in introducing broader insurance taxation reforms, irrespective of any theoretical inconsistencies generated by an outright exclusion. Although the income taxation of life insurance needs reform and coordination, the recipients of accelerated death benefits and their dependents may generally be poorer individuals, because if they were not poor, they would not resort to these surrenders. The numbers also seem to be too modest.\(^3\) The degree of potential abuses that are sought to be curtailed would need to be evaluated, or the risks of the experiment would fall on those in the worst circumstances: the poor and terminally ill.\(^3\)

**VI. Conclusion**

A clarification of the income tax treatment of accelerated death benefits is necessary. A narrow exclusion for benefits paid to the terminally ill can be fashioned, although such a provision is incon-

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\(^3\) To the extent that some of the uninsured expenses are deductible as an itemized deduction under I.R.C. § 213, increasing the exclusion by that amount would provide both an exclusion and a deduction for the amount. In any event, the 7.5% adjusted gross income limitation of § 213 of the Code would require an amendment to exclude insurance proceeds from gross income for purposes of that limitation, and § 213 should also be amended to clarify the deductibility of amounts defrayed by taxable reimbursements. See supra note 49.

\(^3\) See supra text accompanying notes 289-91.

\(^3\) The staff of the Joint Committee on Taxation suggests that an exclusion would benefit wealthier persons who can afford more insurance. “In addition, the bill would primarily benefit higher-income individuals who are able to afford greater amounts of life insurance. A more efficient and equitable tax subsidy could be developed if the goal is to assist the terminally ill.” Staff Explanation, supra note 93, at 23. Although life insurance is owned by wealthier individuals, see supra text accompanying notes 101-03, it is uncertain if truly “wealthy” individuals would need to resort to an accelerated death benefit.
sistent with, and could possibly detract from, the survivor financial protection function of life insurance. An exclusion would mix life insurance with care of the insured, a task for which long-term care or health insurance is more suited. From a broader perspective, an approach with some merit would be the adoption of a system incorporating features of that prescribed for retirement savings, but the retirement model is not altogether comparable and ensuing complexity aside, a number of inconsistencies would be generated. A drastic alternative would render many insurance taxation issues moot by removing, or limiting, many of the tax incentives now enjoyed by life insurance, primarily tax deferred buildup and the death benefit exclusion, reducing insurance to a more income tax neutral status.

As an interim measure, a restricted exclusion for accelerated death benefits, linked to an arbitrary amount plus uninsured, but otherwise nondeductible, medical expenses, with an averaging convention for the excess proceeds, could be appropriate. More far reaching reform of the taxation of all insurance proceeds, however, is needed. Even as an interim measure, an exclusion for terminal illness benefits is defective. It excludes from income the gain on the disposition of only one type of asset, life insurance, and does not exempt gains on the sales of other assets prompted by terminal illness. This area will need to be revisited, together with the exclusion for health insurance benefits, if and when an exclusion for long-term care benefits is considered. Pending a broad evaluation of the interrelationships of health and long-term care insurance, life insurance, and retirement savings, perhaps the best course of action with respect to accelerated death benefits is, sadly, to do nothing. However, if the evaluation is ever made, it should reconsider the overall role of life insurance, including the effect of reforms as a potential revenue source to support broader human welfare goals.\(^5\)

\(^5\) Any such expansion of section 101 will bring forward proponents of further expansions for similar needs — such as long-term care — or other worthy goals, such as education or housing. Such expansions and the potential adverse revenue consequences they entail would undoubtedly place section 101 under severe pressure. It is a journey we should not begin. 1991 Senate Hearing, supra note 21, (statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy) Department of the Treasury). However, limiting the tax free inside buildup of cash value life insurance and the death benefit exclusion could generate revenues to offset the revenue losses in accomplishing “other worthy goals.” See supra note 258.