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## TAXING PERSONAL INSURANCE: THE CASE OF TAX AUDIT INSURANCE

William D. Popkin\*

A recent brochure explaining tax audit insurance<sup>1</sup> to tax practitioners warns that “[e]ven the most meticulously prepared returns are subject to questions about the adequacy or propriety of the documentation and substantiation which the client has accumulated and maintained” and that there is “added uncertainty as to how courts will decide complicated provisions.”<sup>2</sup> Thus warned, taxpayers are expected to find tax audit insurance, which reimburses policyholders for tax deficiencies and, in some cases, professional fees, attractive. From the insurance company’s viewpoint, tax audit insurance is economically feasible because the company can aggregate the statistical probabilities that particular taxpayers will be audited and spread the costs over a large number of insured taxpayers.<sup>3</sup>

Before acquiring this new type of insurance, taxpayers must pay careful attention to how the proceeds and premiums will be taxed. The taxation of any type of personal insurance is difficult to determine,<sup>4</sup> and tax audit insurance raises special problems.<sup>5</sup> Addition-

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<sup>1</sup> Currently, tax audit insurance is only offered to individuals. See *infra* note 2. Consequently, this article is limited to treatment of that insurance as it applies to individuals.

<sup>2</sup> Victor O. Schinnerer & Co., *The CPA/Tax Attorney Guide to Taxright Tax Audit Insurance 2* (1983) (Tax Notes Doc. No. 83-4555) [hereinafter cited as *Audit Insurance Guide*].

<sup>3</sup> Most tax returns are selected for audit from returns identified by statistical formula for their revenue potential. See Comptroller Gen. of the U.S., *Report to the Joint Committee on Internal Revenue Taxation, How the Internal Revenue Service Selects Individual Income Tax Returns for Audit 12-27* (1976). But because of the uncertainties contained in the selection process, chance remains a major factor. Different categories of risk are, of course, compatible with insurance, and translate into varying premiums depending upon the category of audit risk. For example, Exhibit III of the *Audit Insurance Guide*, *supra* note 2, specifies different premiums for twelve categories of taxpayers filing Schedule E and four categories of taxpayers who do not file Schedule E but who itemize deductions. See *id.* at 21.

<sup>4</sup> See Popkin, *Defining Taxable Consumption: A Comment on Personal Insurance Premiums*, 54 Ind. L.J. 389 (1979).

<sup>5</sup> A recent New York State Bar Report argued that the insurance proceeds covering tax deficiencies and professional fees would be taxable, but that the amount spent on professional fees would be deductible. See *Comm. on Unreported Income and Compliance*, N.Y. State Bar Ass’n Tax Section, *A Report on Tax Audit Insurance*, reprinted in 22 Tax Notes 53, 55 (1984). According to the Report, the policy premium, with two exceptions, would not

ally, widespread use of tax audit insurance has special policy implications.

Insurance reduces the taxpayer's financial burden of an additional assessment after audit and, therefore, might encourage him to be more aggressive in asserting questionable positions in his tax return. The insurance contract, however, has been structured to reduce the taxpayer's incentive to play the tax lottery.<sup>6</sup> Professional fees are covered only if the insurance company decides to contest an issue.<sup>7</sup> Tax deficiencies are covered up to \$100,000 per return, but coverage is not provided for penalties and interest, amounts arising from acts which could result in penalties, amounts arising from tax avoidance transactions or transactions without economic substance, amounts arising from omissions of gross income (unless the omission was in good faith), and amounts arising out of mathematical and clerical errors.<sup>8</sup> A taxpayer is eligible for insurance only if his return is prepared by a certified public accountant or an attorney engaged in federal tax practice who is not suspended from practice before the Internal Revenue Service (Service).<sup>9</sup>

Moreover, the insurance company suggests that the Government may even benefit from tax audit insurance. Funds would be readily available to pay the tax deficiencies,<sup>10</sup> and tax advisors might be less aggressive since questionable positions could affect insurability and the amount of premiums charged.<sup>11</sup> Additionally, a requirement that the purchase of a tax audit insurance policy be revealed on the return may reduce, rather than increase, the incentive to play the tax lottery.<sup>12</sup>

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be deductible. The premiums allocable to professional fees would be deductible since the fees would be deductible, and the premiums allocable to tax deficiencies would be deductible from any taxable proceeds which the insured collected. *See id.* The author of this article agrees with some, but not all, of these conclusions. The author agrees that insurance proceeds are taxable but argues that the premiums should never be deductible, not even to reduce taxable proceeds and not even if the expenditure covered by the insurance is itself deductible. *See infra* notes 102-12 and accompanying text.

<sup>6</sup> *See* Audit Insurance Guide, *supra* note 2, at 6 (policy terms have been discussed with Internal Revenue Service officials).

<sup>7</sup> However, the insured is immediately entitled to \$1,000 to reduce the initial impact of a tax audit. *See id.* at 2.

<sup>8</sup> *See id.* at 3, 23.

<sup>9</sup> *See id.* at 4.

<sup>10</sup> *See id.* at 6.

<sup>11</sup> *See Novel Plan Will Insure Against Loss Due to Tax Audits*, 19 Tax Notes 759 (1983).

<sup>12</sup> *See A Report on Tax Audit Insurance*, *supra* note 5, at 55.

Nonetheless, the advantages to the Government of tax audit insurance are speculative, while the dangers of encouraging taxpayers to play the tax lottery are obvious.<sup>13</sup> Many of the risks covered by the insurance policy are items on which an aggressive taxpayer might gamble, such as omitting noncash fringe benefits, distinguishing debt from equity, deducting hobby losses, calculating the basis of inherited property, distinguishing ordinary from capital asset property, deducting educational travel expenses, and valuing charitable contributions.<sup>14</sup> The potential effect of tax audit insurance on taxpayer compliance highlights the importance of determining how tax audit insurance should be taxed.

Section I of this article will explain the various ways the tax law might treat personal insurance, i.e., insurance protecting against risks arising from personal, rather than income-producing activities.<sup>15</sup> This article considers five theories for taxing personal insurance and then examines current law to determine whether any of these theories have been adopted in the Internal Revenue Code (Code). It deals first with insurance replacing lost income, such as life and disability insurance, then considers insurance replacing personal losses, such as medical insurance, and finally, it discusses casualty insurance. Section II then applies this analysis to tax audit insurance.

## I. TAXING PERSONAL INSURANCE

### A. Introduction

The taxation of personal insurance premiums and proceeds does not fit easily into the conventional patterns of thought defining taxable income. The premiums paid may eventually result in the production of income as the result of an occurrence covered by the policy, but the injured taxpayers do not really want the income to be produced, and would prefer that the loss not occur. The premiums, therefore, are usually characterized as personal, rather than business, expenses.<sup>16</sup> It is also true, however, that insurance premi-

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<sup>13</sup> The risk covered by tax audit insurance is one of economic hardship only, as opposed to the risk of bodily injury, which carries its own disincentives.

<sup>14</sup> See *Audit Insurance Guide*, *supra* note 2, at 14-19.

<sup>15</sup> Analysis of personal insurance is instructive because of its relationship to insurance covering federal income taxes, which is a nondeductible expense.

<sup>16</sup> See *infra* note 18.

ums are not typical personal consumption. Taxable personal consumption usually provides the taxpayer with an immediate benefit, such as food, travel, or clothing, rather than an opportunity to receive a large return on an investment. This distinction lends plausibility to analyzing the premiums as an investment to produce proceeds, despite the fact that it is an investment the taxpayer does not want to realize. The tension between defining income from personal insurance proceeds and conventional views of defining taxable income helps to explain the number of theories that can justify how personal insurance should be taxed.

This article distinguishes between two types of personal insurance. The first type replaces lost income.<sup>17</sup> Typical examples are life and disability insurance, which are personal insurance when they cover risks arising from personal activity.<sup>18</sup> The proceeds of such insurance might be tax-exempt, perhaps out of sympathy for the insured and his family, but the taxpayer unquestionably has income as a result of the insurance coverage. The second type of

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<sup>17</sup> This income, had it been earned, would have been taxable when received.

<sup>18</sup> Disability insurance which covers only occupational hazards is not personal insurance, but almost all other disability insurance, other than workmen's compensation, is personal because it covers only personal risks or both business and personal risks. This view of disability insurance is taken by the Service in a number of rulings concerning nonoccupational disability insurance. If money is withheld from an employee's wages for contribution to a *private* disability plan, the amount withheld is a nondeductible personal expense. If money is withheld for contribution to a *state-imposed* fund, however, the amount is deductible as state taxes pursuant to § 164. See Rev. Rul. 81-194, 1981-2 C.B. 54; Rev. Rul. 81-193, 1981-2 C.B. 52; Rev. Rul. 81-192, 1981-2 C.B. 50; Rev. Rul. 81-191, 1981-2 C.B. 49. Premiums for voluntarily purchased disability insurance are similarly considered nondeductible personal expenses. See Rev. Rul. 70-394, 1970-2 C.B. 34 (insurance called "occupational" but coverage not limited to occupational hazards); Rev. Rul. 58-480, 1958-2 C.B. 62; Rev. Rul. 55-331, 1955-1 C.B. 271.

Insurance purchased by an employee to protect against unemployment due to an economic recession would be an example of business, not personal, insurance. Cf. Rev. Rul. 75-156, 1975-1 C.B. 66 (tax withheld for state unemployment compensation fund is deductible as a business tax where fund pays wages lost due to business contingencies). An early ruling dealing with disability insurance purchased as an adjunct to an unemployment insurance program characterized the premiums as a business expense. See I.T. 3607, 1943 C.B. 110. The ruling does not explicitly state that the insured risks included nonoccupational hazards, but they probably did. It is therefore inconsistent with the above Revenue Rulings, which characterize nonoccupational disability insurance premiums as personal expenses. Two other rulings characterize an employee's payments to an unemployment insurance fund as a business expense, without explaining what the insurance covered. See I.T. 3096, 1937-2 C.B. 81; I.T. 3085, 1937-1 C.B. 64. This characterization is also inconsistent with the more recent rulings. For purposes of this discussion, it is assumed that the life and disability insurance covers only losses from personal activity.

personal insurance replaces a personal loss. The typical example is medical insurance, which, in the conventional view,<sup>19</sup> only compensates for a personal loss, and, therefore, does not produce income.<sup>20</sup>

## B. Replacing Lost Income—Life and Disability Insurance

### 1. Theories of Taxing Life and Disability Insurance

#### a. Expenses to produce income

The first way to conceptualize personal insurance is that the premiums purchase future income, in the form of insurance proceeds. This view of insurance seems correct for life and disability insurance, a primary purpose of which is to replace the insured's lost earnings. If life and disability insurance premiums are analyzed for tax purposes as the cost of acquiring the income produced by the insurance, the correct treatment of the premiums depends on how the proceeds are taxed. If the statute excludes the income from the tax base, the premiums are not deductible because they are expenses of producing tax-exempt income.<sup>21</sup> If the

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<sup>19</sup> If, contrary to this view, reimbursement of medical costs is considered income, then medical insurance should be treated like life and disability insurance. See *supra* notes 17-18 and accompanying text.

<sup>20</sup> Compare Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309 (1972) with Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 Stan. L. Rev. 831 (1979). The contrast between insurance which replaces income and insurance which compensates for a personal loss is illustrated by the following example. Assume the taxpayer has \$100 cash income if no loss occurs. Insurance proceeds, if a loss occurs, would be \$24. If the insured recovers insurance proceeds of \$24, he has \$124 cash. However, his income under the two types of insurance is very different. Disability or life insurance produces an additional \$24 gain, minus the premium, and his total income is increased by that gain. The tax law might not tax that gain for various reasons, but the proceeds are clearly income since they replace lost income.

By contrast, medical insurance, in the conventional view, does not replace lost income and does not produce a gain. The medical costs are a personal loss, and their replacement is not income. Although the insured has \$124 cash receipts, his income is still only \$100. The premiums are, therefore, not an investment which can produce a gain, but are a maintenance expense to preserve the taxpayer's standard of living against the hazards covered by the insurance.

An example of personal insurance which produces taxable proceeds is casualty insurance which reimburses normal living expenses. See *infra* text accompanying notes 76-77. It is also possible to view life and disability insurance like medical insurance, as replacing a personal loss. If that view prevailed, life and disability insurance would be analyzed the same way as personal insurance replacing a personal loss.

<sup>21</sup> See I.R.C. § 265(1). Disallowing the deduction of expenses to produce tax-exempt in-

proceeds are taxable, the premiums are deductible income-producing expenses.

*b. Social wealth redistribution*

The second way to view personal insurance is in accordance with its social function of redistributing wealth. The effect of insurance is to shift wealth from those who pay premiums and do not suffer a loss to those who pay premiums and do suffer a loss. From society's perspective, there is no income; the premiums paid are a debit in the social balance sheet, which offset the credit enjoyed by those who collect insurance proceeds.<sup>22</sup> If the insurance proceeds are tax-exempt, for whatever reason, the premiums would not be deductible.<sup>23</sup> This assures that the net result to society will be zero,<sup>24</sup> which reflects the wealth redistribution feature of the insurance. If the insurance proceeds were taxable, a zero balance in social wealth would be reflected in the tax law by permitting a deduction for the premiums.

The social wealth approach to taxation runs counter to the usual treatment of each individual as a separate taxpayer, entitled to be taxed in accordance with how his expenses and receipts fit the ba-

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come is a questionable result when applied to the net losses from the activity. The reason for disallowing deductions when the related income is exempt is that otherwise the taxpayer could shelter taxable income from other sources with the expenses while excluding the expense-produced income. *Cf.* Rev. Rul. 83-3, 1983-1 C.B. 72 (no deduction allowed when tax-free reimbursements are received for business expenses because the purpose of the exemption is to assure tax-free enjoyment of the reimbursement whether or not the expense is a deductible business expense, not to permit the expense to shelter other income). If the expenses produce a net loss from the activity, deduction of only the net loss does not permit expenses equal to tax-exempt income to shelter taxable income. However, as long as the tax law disallows a deduction for expenses to produce tax-exempt income, whether or not there is a net loss, there is no special reason to make an exception for insurance premiums which produce a net loss because there are no proceeds to be collected.

<sup>22</sup> This disregards the income retained by the insurance company.

<sup>23</sup> The taxpayer is "taxed" on these premiums in the sense that he is not allowed a deduction for the amount paid. Accordingly, this term will be used to describe the situation where the premiums are nondeductible.

<sup>24</sup> The net societal effect is zero so long as one and only one of the two groups of transactions is taxed. For example, assume 10 taxpayers each paid \$10 premiums, and one of the 10 received proceeds of \$100 for a deficiency on his tax return. If the \$100 proceeds are taxed, and the \$100 premiums are also taxed (not deductible), the group as a whole must pay taxes on more income than they would have had they not purchased insurance. A similar gain would result if neither the proceeds nor the premiums were taxed, because the group has effectively deducted \$100 of their cumulative tax liability.

sic definition of income. However, some areas of the Code can be explained using this theory. One such area is intrafamily gifts, where the payor (donor) does not deduct a gift to a donee, and the donee is not taxed on the gift,<sup>25</sup> even though it might make sense to tax the donee rather than the donor. Another example is section 274,<sup>26</sup> which deals with entertainment expenses and disallows the employer's deduction as a proxy for taxing employees on income which the employees are unlikely to report. Finally, in certain circumstances, an accrual basis taxpayer may not accelerate deductions for obligations which the payees do not have to report until the cash is received.<sup>27</sup> Denying a payor's deduction for insurance premiums cannot, however, be justified on these grounds since there are no administrative problems in taxing the payee, and there is no opportunity to manipulate the relationship between the payor and payee.

*c. Premiums as current value of proceeds*

Another theory of personal insurance views the premiums as the current value of the insurance proceeds. This perspective on premiums is an application of the broader principle that any investment, considered before realization of the income, equals the future income discounted for risk and passage of time. Thus, if there is a one in one hundred chance of recovering \$100,000 tomorrow, the investment would be \$1,000, which is the present value of \$100,000 discounted by the probability of recovery. The same computations equate the tax on the premiums to the tax on the proceeds, assuming the premiums and proceeds would be taxed at the same rate. Thus, a 50% tax on \$100,000 equals \$50,000, the present value of which, discounted by a one in one hundred chance of recovery, is \$500, which equals 50% of the \$1,000 premium.

A theory of taxing insurance which builds on this relationship would tax the premiums as the equivalent of taxing the proceeds. Thus, if the proceeds from life and disability insurance were not taxed, nondeductibility of the premiums would be a proxy for taxing the proceeds. If the proceeds were taxed, the premiums would

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<sup>25</sup> See I.R.C. § 102(a).

<sup>26</sup> See *id.* § 274(a), (e)(4).

<sup>27</sup> See *id.* § 267(a)(2), (b).



be deductible.<sup>28</sup>

Equating premiums and proceeds for tax purposes is as problematical as the social wealth redistribution approach to taxing insurance. Neither approach taxes individuals on the basis of their unique experiences, but rather, both theories are based on the relationship between the premiums and the proceeds. In the "social wealth redistribution" theory,<sup>29</sup> the relationship is established by the social balance sheet, even though one taxpayer's premiums fund another taxpayer's proceeds. In the "premiums equal proceeds" theory, the relationship is established by the before-the-fact equality between an investment and investment proceeds. In either case, an explanation is required to justify incorporating the relationship into the tax law when it runs counter to the common intuition that the income tax is an individual tax.<sup>30</sup>

#### d. *Personal origin*

The fourth theory of taxing insurance, like the first, looks at premiums from the perspective of each individual's experience, but it differs from the first theory because it does not analyze the premiums as the cost of producing the benefits. In fact, the fourth theory is not a theory about taxing proceeds at all, but, instead, analyzes the premiums and proceeds separately. Premiums are nondeductible personal expenses or deductible business expenses depending on whether the insured activity is personal or business in nature. This theory is generally associated with *United States v. Gilmore*,<sup>31</sup> where the Supreme Court used the personal origin of the taxpayer's marital dispute to characterize litigation costs as nondeductible personal expenses, regardless of the fact that their purpose was to retain the taxpayer's income-producing wealth. The expense was personal because the litigation arose out of the taxpayer's marital situation, which was a personal concern. Under this

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<sup>28</sup> This is the approach suggested by the Treasury Department. See U.S. Dep't of the Treasury, *Blueprints for Basic Tax Reform* 59-61 (1977), reprinted in 1 A. Krage & J. McNulty, *Federal Income Taxation* 568-69 (3d ed. 1979).

<sup>29</sup> See *supra* notes 22-27 and accompanying text.

<sup>30</sup> Compare Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113 (1974) with Warren, *Would a Consumption Tax be Fairer Than an Income Tax?*, 89 Yale L.J. 1081 (1980). See generally Kelman, *Time Preference and Tax Equity*, 35 Stan. L. Rev. 649 (1983).

<sup>31</sup> 372 U.S. 39, 48 (1963).

theory, the premiums which purchase insurance to protect against personal risks are not deductible, whether the proceeds are taxable income, exempt income, or not income at all, because denial of the deduction depends on their origin, not their relation to the proceeds.

One objection to taxing premiums without regard to the taxability of the proceeds is that personal insurance provides security to the individual, which is too ephemeral to be taxable income. Although all personal consumption is psychic, regardless of what the taxpayer actually purchases, insurance seems different because taxing the premiums is arguably double taxation of the same flow of funds which produces the proceeds. However, this argument against taxing the premiums assumes that the taxation of premiums should depend on how the insurance proceeds are taxed. It is an echo of the social wealth redistribution theory,<sup>32</sup> which requires that the premiums and proceeds be considered together, even though different taxpayers pay premiums and recover proceeds. There is no *a priori* reason why the same flow of money cannot produce two taxes for two separate individuals, as in fact occurs when a taxpayer purchases household services with after-tax income.

#### *e. Policy implications*

The fifth theory for taxing personal insurance is not a theory defining income, but is concerned with the policy implications of taxing premiums and uninsured losses.<sup>33</sup> Although the first four theories also embody policy considerations, they are considerations concerning the fairness of the basic tax structure. The fifth theory rests on policies concerning taxpayer behavior.

An important policy consideration is tax neutrality between purchasing insurance and self-insuring. For example, if uninsured losses do not reduce taxes, a deduction for premiums would favor purchasing insurance over not purchasing insurance, but if an uninsured loss lowers taxes, disallowing a deduction for the premiums favors self-insurance. Proponents of tax neutrality would argue for

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<sup>32</sup> See *supra* notes 22-27 and accompanying text.

<sup>33</sup> Cf. Popkin, *Household Services and Child Care in the Income Tax and Social Security Laws*, 50 Ind. L.J. 238 (1975) (child care deductions should be defended because they promote tax neutrality, not because they accurately define income).

similar treatment of insurance and self-insurance. They would permit the deduction of premiums if losses are deductible, but deny a deduction for premiums if uninsured losses do not reduce taxes.<sup>34</sup>

Tax neutrality is, however, just one policy which might be advanced. In addition, the overall societal effect of taxing these premiums and proceeds should be considered. The social effects of encouraging either insurance or self-insurance might be more favorable than tax neutrality. The *Gilmore* case<sup>35</sup> itself is a good example of how tax policy and income definition issues become intertwined. The Court not only noted that the origin of the litigation was a personal activity, but also suggested that it would be undesirable to favor the litigation efforts of taxpayers with income-producing assets by permitting the deduction of litigation expenses.<sup>36</sup>

## 2. Current Law

Current law offers little guidance as to which theory of taxing insurance the Code adopts. Life and disability insurance premiums are not deductible,<sup>37</sup> but the proceeds are tax-exempt.<sup>38</sup> Nondeductibility of the premiums is, therefore, consistent with all of the theories discussed above.<sup>39</sup> If the premiums are a cost of producing the proceeds, the exemption of the proceeds justifies disallowing

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<sup>34</sup> Section 1231(a) (last sentence) achieves tax neutrality between insuring and self-insuring by permitting an ordinary loss deduction for the self-insured's business losses in excess of insurance proceeds. The premiums are already deductible under § 162.

<sup>35</sup> 372 U.S. 39 (1963). See discussion at *supra* note 31 and accompanying text.

<sup>36</sup> See 372 U.S. at 48-49.

<sup>37</sup> See Treas. Reg. § 1.262-1(b)(1) (life insurance); *supra* note 18 (disability insurance).

<sup>38</sup> See I.R.C. §§ 101(a) (life insurance), 104(a)(3) (disability insurance).

<sup>39</sup> This article focuses on the individual's purchase of insurance as the prototype of how insurance is taxed. The tax law provides different rules if the taxpayer is an employee for whom the employer buys insurance. For life insurance, the premiums (and the proceeds received by the beneficiary, *see id.* § 101) are excluded from the insured's taxable income for up to \$50,000 of group term life insurance, if nondiscrimination rules are satisfied. *See id.* § 79. For disability insurance, the premiums are excluded, but the benefits are taxable, *see id.* §§ 105, 106, subject to a tax credit if the disability is severe and other income is not too high. *See id.* § 22(a), (b)(2), (c), (d). The exclusion of premiums when the insurance is financed by employers is not inconsistent, however, with the general rule that personal insurance premiums are taxed. The exclusion results from a policy of encouraging employer insurance plans and from the economic similarity between unfunded employer promises, on which a cash basis employee is not taxed, and employer-funded insurance. The rules governing employer-funded insurance are not applicable to the treatment of personal insurance generally.

the deduction. Exempting the proceeds also justifies disallowing a deduction for the premiums if the premiums are viewed as a redistribution of wealth or as the present value of the proceeds. Under either of these two theories, only one tax should be imposed, and exemption of the proceeds requires that the premiums be taxed. The personal origin of the risks also results in nondeductibility of the premiums. Finally, a deduction for premiums would be contrary to the tax neutrality policy because the uninsured taxpayer who experiences a loss enjoys no tax reduction, other than that incident to not receiving taxable income. There is no provision for downward income averaging to account for declining income after a loss occurs, and there is only a limited provision for a tax credit for a disabled taxpayer under such narrowly defined circumstances that it is unlikely to affect the choice between insurance and self-insurance.<sup>40</sup>

Occasionally, courts have recognized the uncertainty surrounding which theory justifies disallowing a deduction for insurance premiums.<sup>41</sup> If a taxpayer buys life insurance and it is unclear whether it serves a business or personal purpose, the taxpayer will argue that the business purpose is sufficiently dominant to justify a deduction. The court can avoid the issue, however, by relying either on the nondeductibility of personal insurance premiums or on the rules denying a deduction for life insurance premiums because the proceeds are tax exempt.<sup>42</sup>

The same equivocation is possible with disability insurance. When a taxpayer buys disability insurance, the deduction is usually disallowed because of the personal origin of the insurance, even though it protects against loss of income.<sup>43</sup> However, the fact

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<sup>40</sup> See I.R.C. § 22. The tax benefits are focused on low income taxpayers who are not likely to buy disability insurance in the first place. Moreover, to be eligible for the credit, the taxpayer must be permanently and totally disabled, which is more severe than many insurance policies require. See *id.* § 22(b).

<sup>41</sup> See, e.g., *Hills v. Commissioner*, 691 F.2d 997, 1005-06 (11th Cir. 1982).

<sup>42</sup> See *King v. Commissioner*, 22 T.C.M. (CCH) 1343 (1963) (premiums paid for life insurance to secure a loan constituted nondeductible personal expenses).

<sup>43</sup> See *supra* note 18; see also *Blaess v. Commissioner*, 28 T.C. 710, 714-17 (1957) (alternatively holding that the premiums were not deductible because they were not related either to business or to income production).

Rev. Rul. 55-264, 1955-1 C.B. 11, fits into this analysis only on tax neutrality grounds. It permits a business expense deduction for disability insurance premiums if the proceeds cover business overhead expenses, despite the personal origin of the risk. Because overhead expenses would be deductible expenses if the taxpayer did not own insurance, deducting the

that the proceeds are exempt also provides a justification for disallowing the deduction. Thus, when an employer buys disability insurance to protect against an employee's disability, the deduction of the premiums as a business expense is disallowed because the income is exempt.<sup>44</sup>

### C. Replacing Personal Loss—Medical Insurance

#### 1. Theories of Taxing Medical Insurance

The first theory for taxing personal insurance, which relates premiums to the production of proceeds,<sup>45</sup> cannot be applied to medical insurance in the same manner as to life and disability insurance because the proceeds, under the conventional view, are not income. The premiums, therefore, are not a cost of producing income. Under the first theory, the premiums are nonetheless related to the proceeds for tax purposes. As a result, they would be conceptualized as a cost of maintaining income free from the burden of medical costs. As maintenance expenses, they would be deductible as costs to preserve a level of risk-free taxable income.<sup>46</sup>

The second theory, which views insurance as social wealth redistribution,<sup>47</sup> would produce a different result than in the case of life or disability insurance, where the proceeds do not produce a net social loss. Under this theory, the proceeds are excludible because they merely replace a personal loss, and the premiums are deductible to reflect the net social loss.

The third theory, which analyzes premiums as an investment to produce income,<sup>48</sup> cannot be applied to medical insurance if the proceeds do not produce income. Since the proceeds are not income, this theory is irrelevant.

The fourth theory, which focuses on the origin of the expense,<sup>49</sup> would deny a deduction for premiums because the insurance covers a personal risk. The taxation of the proceeds is irrelevant under this theory, because the proceeds and premiums are not related for

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premium produces neutrality between insuring and self-insuring.

<sup>44</sup> See Rev. Rul. 66-262, 1966-2 C.B. 105; *supra* note 21.

<sup>45</sup> See *supra* note 21 and accompanying text.

<sup>46</sup> See I.R.C. § 212(2).

<sup>47</sup> See *supra* notes 22-27 and accompanying text.

<sup>48</sup> See *supra* notes 28-30 and accompanying text.

<sup>49</sup> See *supra* notes 31-32 and accompanying text.

tax purposes.

The fifth theory is concerned with the impact of tax rules on taxpayer behavior.<sup>50</sup> If tax neutrality between purchasing insurance and self-insuring was the favored policy, then medical insurance premiums would be deductible if medical expenses were deductible. Conversely, if medical expenses were not deductible, the premiums would not be deductible. If tax neutrality was less preferable than favoring or discouraging the purchase of insurance, then the taxation of premiums would not depend on how the expenses were taxed.

## 2. Current Law

Current law excludes medical insurance proceeds from income,<sup>51</sup> but still allows a deduction for medical insurance premiums.<sup>52</sup> This is in sharp contrast to the rules applicable to life and disability insurance, where the proceeds are not taxable, but the premiums are not deductible.<sup>53</sup>

The rules applicable to medical insurance might be interpreted as expressing a preference for the first or second theories, which permit deduction of premiums, either as a maintenance expense or because the redistribution of wealth produces a net social loss. However, the history of the deduction of medical insurance premiums belies this interpretation; instead, it suggests that, but for policy considerations, the premiums would be nondeductible personal expenses.<sup>54</sup> There is no explanation of why medical insurance premiums were included in the definition of deductible medical ex-

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<sup>50</sup> See *supra* notes 33-36 and accompanying text.

<sup>51</sup> See I.R.C. § 104(a)(3).

<sup>52</sup> See *id.* § 213(a), (d)(1)(C).

<sup>53</sup> See *supra* notes 18, 37-38.

<sup>54</sup> In *Green v. Commissioner*, 74 T.C. 1229, 1235-36 (1980), the taxpayer sold blood plasma as her primary source of income and deducted her medical insurance premiums. The court held that insuring against the costs of maintaining personal health was primarily a personal, not a business, concern and, therefore, the premiums were personal, rather than business expenses. See *id.* at 1235-36. There was no indication in the case that the insurance covered only medical problems arising from the business of selling plasma. If only business risks had been covered, the insurance premiums might have been deductible business expenses. Cf. *Denny v. Commissioner*, 33 B.T.A. 738, 743 (1935) (cost of replacing teeth lost while acting in a prize fight film held to be a business expense); Rev. Rul. 58-382, 1958-2 C.B. 59 (cost of physical examination required by employer for pilots held to be a business expense).

penses when the medical expense deduction was adopted in 1942,<sup>55</sup> but subsequent history indicates a tax neutrality objective. Before 1965, medical expenses, including insurance premiums, were deductible if they exceeded a percentage of adjusted gross income.<sup>56</sup> The floor discouraged the purchase of insurance,<sup>57</sup> however, so the law was changed in 1965 to permit a deduction for a portion of medical insurance premiums without regard to the percentage floor.<sup>58</sup> In 1982, this generous treatment of insurance premiums was repealed,<sup>59</sup> again for policy reasons unrelated to the definition of income.<sup>60</sup>

#### D. Casualty Insurance

##### 1. Theories of Taxing Casualty Insurance

The tax analysis of casualty insurance on personal assets is more complicated because the proceeds can be used either to replace the lost asset or for an entirely different purpose. In addition, the proceeds may serve only to allow the taxpayer to recover his investment in the asset without producing gain.

The first theory, which analyzes premiums as the cost of producing insurance proceeds,<sup>61</sup> would be applied in the following manner: if no loss occurred, the premiums would be viewed as an expense of maintaining the use value of the asset. If the asset were lost and the proceeds were used to replace the asset, it is still rea-

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<sup>55</sup> Revenue Act of 1942, Pub. L. No. 77-753, § 127, 56 Stat. 798, 825-26.

<sup>56</sup> See I.R.C. § 213(a) (1965).

<sup>57</sup> See H.R. Rep. No. 213, 89th Cong., 1st Sess. 137 (1965). The concern was that medical insurance spread medical costs over a long time period so that the annual insurance premiums were below the floor for medical expense deductions, while the uninsured taxpayer could deduct some of his expenses when a large medical expense was incurred. See also *Hills v. Commissioner*, 691 F.2d 997, 1005 (11th Cir. 1982) (interpreting the medical expense deduction for insurance premiums as a tax neutrality provision, equalizing insurance and self-insurance).

<sup>58</sup> See I.R.C. § 213(a)(2) (1966).

<sup>59</sup> Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 202(a), 96 Stat. 324, 421.

<sup>60</sup> The Joint Committee on Taxation stated that repeal would simplify tax returns, see Staff of the Joint Comm. on Tax'n, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 24 (Comm. Print 1982), but an additional reason was growing concern with the effect of tax deductions on skyrocketing medical costs. See *id.* (generous employer insurance plans lead to overuse of medical services).

<sup>61</sup> See *supra* note 21 and accompanying text.

sonable to analyze the premiums as an expense of maintaining the prior use value. In both of these cases, the premiums would or would not be deductible, depending on whether the use value was taxable. If the asset were lost and the proceeds were not reinvested in a similar asset, however, the taxpayer could realize gain on recovery of the proceeds; accordingly, the premiums might be analyzed as a cost of producing the proceeds, which would reduce the gain or increase the loss.<sup>62</sup> It might be more reasonable, however, to view the premiums as a cost of maintaining the old asset whether or not the lost property is replaced, because the insurance was probably acquired for maintenance purposes, even if the taxpayer changes his plans and does not replace the old asset after a loss occurs.

The second theory taxes either the premiums or the proceeds, but not both, on the assumption that there is a redistribution of wealth and that the tax law should reflect this fact.<sup>63</sup> The difficulty with applying this theory to casualty insurance is that the insured does not recognize income if the proceeds do not exceed the basis of the property at the time of the loss.<sup>64</sup> In that respect, the insurance is analogous to medical insurance, and, consequently, the premiums should be deductible to reflect the net social loss, even though the proceeds were not taxed. If the taxpayer realizes a gain, however, the premiums would or would not be deductible, depending on whether the proceeds were taxed, as in the case of life and disability insurance.

The third theory, equating the premiums with the net present value of the proceeds,<sup>65</sup> is also hard to apply to casualty insurance because there may not be a gain. This theory permits taxing premiums as a proxy for taxing proceeds, but is irrelevant if there is no gain to tax. To the extent of the gain, however, either the pre-

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<sup>62</sup> The proceeds might be broken down into two components. One component is noted in the text, i.e., the proceeds received on disposition of an investment. A second component is tax-exempt income, which arises because the tax law does not require a reduction of cost for personal assets equal to prior personal consumption. By permitting taxpayers to recover their entire costs against proceeds of a disposition, the tax law in effect permits a deduction for personal consumption. Consequently, the premiums allocable to the tax-exempt income should not be deductible.

<sup>63</sup> See *supra* notes 22-27 and accompanying text.

<sup>64</sup> To the extent of basis, proceeds equal wealth already taxed. Proceeds in excess of basis constitute taxable gain. See I.R.C. § 1001.

<sup>65</sup> See *supra* notes 28-30 and accompanying text.



miums or proceeds should be taxed, but not both.

The fourth theory, making taxation of the premiums dependent on the origin of the insured activity,<sup>66</sup> would deny a deduction if the risk had a personal origin, without regard to what happened to the asset or the insurance proceeds. The premiums are not analyzed for tax purposes as a cost of producing income but only in relation to the origin of the insured risk. If the risk relates to personal assets, the premiums are a nondeductible personal expense.

The fifth theory would permit a deduction for premiums if the taxpayer could deduct an uninsured loss, assuming that tax neutrality between purchasing insurance and self-insuring is desirable.<sup>67</sup>

## 2. Current Law

The taxation of casualty insurance proceeds reflects the different ways in which taxpayers use the proceeds. Reinvestment of proceeds in similar property results in tax deferral of the gain.<sup>68</sup> Any other use of the proceeds results in taxing the proceeds in excess of basis.<sup>69</sup>

With regard to the premiums, the regulations are unequivocal in treating them as nondeductible personal expenses.<sup>70</sup> There is little pressure to consider whether this is the correct rule, however, because in the usual case the property is either not lost or the taxpayer reinvests the proceeds in a similar asset. In such cases, all of the theories would deny a deduction for the premiums.

Under the first theory, the premiums would not be deductible as an income-producing expense because the income from using the asset is not taxed. The second and third theories would permit a deduction if the proceeds were taxable, but there is no practical way to decide at the time the premiums are paid whether the proceeds will be reinvested in a similar asset and tax thereby deferred. Therefore, a general rule is needed based on probable taxpayer behavior. The most reasonable rule would assume reinvestment of

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<sup>66</sup> See *supra* notes 31-32 and accompanying text.

<sup>67</sup> See *supra* notes 33-36 and accompanying text.

<sup>68</sup> See I.R.C. § 1033(a)(2).

<sup>69</sup> See *id.*

<sup>70</sup> See Treas. Reg. § 1.262-1(b)(2) (personal residence); see also *Paal v. Commissioner*, 37 T.C.M. (CCH) 252, 254 (1978), *aff'd on other grounds*, 450 F.2d 1108 (9th Cir. 1971).

the proceeds in a similar asset, which would result in both deferring taxation of the proceeds, and in denying a deduction for premiums. Under the fourth theory, no deduction would be allowed because the origin of the expense is personal. Finally, the fifth theory, which promotes tax neutrality between purchasing insurance and self-insuring, might permit a deduction for casualty insurance premiums because uninsured casualty losses are deductible.<sup>71</sup> There is no deduction, however, for the lost value of the asset in excess of cost,<sup>72</sup> and the deduction of cost is, under a recent amendment, limited to losses in excess of ten percent of adjusted gross income.<sup>73</sup> Since losses are not usually deductible, to achieve tax neutrality, a deduction for premiums must be disallowed.

In the unusual case of a taxpayer who collects casualty insurance proceeds on personal assets and does not reinvest them in a similar asset, the insurance proceeds can produce taxable gain. The taxpayer might, therefore, argue that the transaction is entered into for taxable profit, whether or not the proceeds exceed cost, and, therefore, the premiums are deductible under the first theory. In *York v. Commissioner*,<sup>74</sup> for example, the taxpayer recovered proceeds which were less than the amount of the loss and added the premiums to the deductible loss. The court, however, refused to include the premiums in the loss deduction. The court stated that the premiums were not related to the loss and could not be deducted.<sup>75</sup> This statement can be interpreted as adopting the fourth theory, i.e., that the premiums are personal expenses regardless of what happens to the asset. Alternatively, it could mean that the premiums are related to maintaining the tax-exempt use value of the lost asset, despite the fact that the proceeds are used for a new purpose. The case law is, therefore, equivocal about why premiums are not deductible.

### 3. Reimbursement of Living Expenses

Casualty insurance might also reimburse a taxpayer for living expenses incurred while the insured's home is being repaired or re-

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<sup>71</sup> See I.R.C. § 165(c)(3).

<sup>72</sup> See *id.* § 165(b).

<sup>73</sup> See *id.* § 165(h)(2)(A) (generally effective for tax years beginning after Dec. 31, 1983).

<sup>74</sup> 33 T.C.M. (CCH) 988 (1974).

<sup>75</sup> See *id.* at 990.

placed. After years of uncertainty in the case law as to whether the reimbursements were taxable income,<sup>76</sup> Congress exempted the insurance proceeds to the extent that they reimburse the taxpayer for the excess of expenses over normal living costs.<sup>77</sup> The rationale for exempting these reimbursements is closely related to that which exempts medical insurance proceeds, i.e., the expenses do not increase the taxpayer's standard of living and, therefore, are not taxable.

Because a portion of the casualty insurance proceeds may be taxable, it must be determined whether premiums for personal insurance are, for that reason, deductible. In *Arnold v. Commissioner*,<sup>78</sup> the taxpayer argued that the premiums should reduce taxable proceeds, in terms reflecting the first theory, which permits deductions if the expenses produce taxable proceeds.<sup>79</sup> The court's opinion does not reject this argument out of hand, noting only that the expenses could not in any event be deductible in the year the proceeds were collected because the taxpayer was a cash basis taxpayer, and the premiums had been paid in a prior year.<sup>80</sup> However, the court also stated that the insurance contract was entered into for personal protection, rather than for profit; apparently, the court also applied the personal origin theory in denying the deduction.<sup>81</sup> Once again, the case law is equivocal concerning the theoretical basis for denying the deduction.<sup>82</sup>

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<sup>76</sup> Compare *Millsap v. Commissioner*, 387 F.2d 420 (8th Cir. 1968) (taxable), *Cornelius v. Commissioner*, 56 T.C. 976 (1971) (taxable), and Rev. Rul. 59-360, 1959-2 C.B. 75 (taxable), with *Conner v. United States*, 439 F.2d 974 (5th Cir. 1971) (not taxable).

<sup>77</sup> See I.R.C. § 123.

<sup>78</sup> 289 F. Supp. 206 (E.D.N.Y. 1968).

<sup>79</sup> See *id.* at 209.

<sup>80</sup> See *id.*

<sup>81</sup> See *id.*

<sup>82</sup> One other straw in the wind concerns legal insurance. Under current law, both premiums and proceeds are tax-free if they are funded as part of a qualified group employer plan. See I.R.C. § 120. Without this provision, the proceeds would be taxable. It is unclear, however, what effect paying tax on legal insurance premiums would have on taxing the proceeds. There is a suggestion in the legislative history of the statute exempting legal insurance premiums and proceeds that, without the exemption, either the premiums or the proceeds would be taxed; however, the same source also states that taxable premiums might reduce the amount of taxable proceeds. See Staff of the Joint Comm. on Tax'n, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 668 (Comm. Print 1976). In rulings concerning nonqualified plans, the Service asserts that the proceeds would be taxable but does not state how the premiums would be taxed or what effect taxing the premiums would have on taxing the proceeds. See Pvt. Ltr. Rul. 8129095 (undated); Pvt. Ltr. Rul.

### E. Conclusions About Taxing Personal Insurance

Taxation of personal insurance proceeds depends on what the proceeds replace. Some proceeds replace personal losses and, therefore, do not constitute income at all; on the other hand, insurance proceeds which replace lost income conceptually should be taxable income. The more difficult question is how the premiums should be taxed.

The personal origin test<sup>83</sup> is the most attractive explanation of the disallowance of deductions for premiums. It has the advantage of being a theory about how the income tax should be applied to individuals, unlike the "social wealth redistribution"<sup>84</sup> or "premiums equal proceeds"<sup>85</sup> theories. Its main rival, which views the premiums as related to the production of the proceeds,<sup>86</sup> does not accurately depict taxpayers' views of personal insurance. Taxpayers do not want to collect proceeds. The insurance is a way of purchasing security in the conduct of personal life and should be viewed as a cost of that activity.<sup>87</sup>

The origin test has a deceptively certain ring to it which implies that an expense can be traced back to an originating cause in a more or less mechanical manner. In actuality, however, the test is more difficult to apply because tracing may lead to differing conclusions as to the personal or business nature of the source.<sup>88</sup> Consequently, the ultimate legal question is whether an apparently personal origin of an expense should characterize the expense as personal for tax purposes or whether other factors intervene to convert the expense to a cost of doing business.<sup>89</sup> But because

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8142136 (July 24, 1981).

<sup>83</sup> See *supra* notes 31-32 and accompanying text.

<sup>84</sup> See *supra* notes 22-27 and accompanying text.

<sup>85</sup> See *supra* notes 28-30 and accompanying text.

<sup>86</sup> See *supra* note 21 and accompanying text.

<sup>87</sup> See Popkin, *supra* note 4, at 404-05. This view is reflected by cases which state that premiums cannot be related to insurance proceeds. See, e.g., *York v. Commissioner*, 33 T.C.M. (CCH) 988, 990 (1974) (premiums not connected with loss). See also *Arnold v. United States*, 289 F. Supp. 206, 209 (E.D.N.Y. 1968) (transaction not "entered into for profit").

<sup>88</sup> Like many statements in the law regarding causation, the origin test is not merely a description of what happens; rather it is a judgment about the legal significance of events. Cf. *United States v. Generes*, 405 U.S. 93, 105 (1972) (rejecting tort law concepts of proximate relationship as the tax law test for distinguishing capital from ordinary losses).

<sup>89</sup> For example, litigation expenses to resist a court martial commenced on the ground that failure to pay alimony is conduct unbecoming an officer are business expenses, see

there is no litmus test for deciding when expenses originate in the personal or business spheres of activity, policy criteria, such as tax neutrality or other considerations, should play a role in deciding how the expenses should be taxed.

In the next section, this article considers how tax audit insurance would be taxed under the various theories that might apply to personal insurance and concludes that a combination of the origin test and the policy implications test should deny a deduction for the premiums, regardless of whether proceeds are collected, or whether the expenses covered by the insurance would be deducted.

## II. TAX AUDIT INSURANCE

Tax audit insurance covers both tax deficiencies and the cost of professional tax assistance. Each element of coverage raises different questions and each will be discussed in turn.

### A. Tax Deficiencies

#### 1. Insurance Proceeds

Insurance proceeds covering tax deficiencies should be taxed for the same two reasons that reimbursement of nondeductible personal expenses should be taxed—to enhance public acceptance of the rate structure and to permit differently-situated taxpayers to be taxed differently.

First, if income taxes or other personal expenses are deductible in computing taxable income, tax rates would have to be increased to achieve the required level of taxation. Even if all taxpayers in the same tax bracket have deductions which are an equal percentage of income, so that an increase in tax rates could compensate for the deduction of personal expenses without changing the tax burden, the increase in rates would damage public perception of the Government's objective.<sup>90</sup> Rates would appear high, even

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Howard v. Commissioner, 202 F.2d 28, 30-31 (9th Cir. 1953), despite their seemingly personal origin. *But cf.* United States v. Gilmore, 372 U.S. at 48 (because of the personal origin of taxpayer's marital dispute, the related litigation costs were characterized as nondeductible personal expenses, even though their purpose was to retain the taxpayer's income-producing wealth).

<sup>90</sup> Rate adjustments could also compensate for deductions if all taxpayers had the same dollar amount of deductions or had deductions which are the same percentage of income. These situations are special cases of the less restrictive requirement that taxpayers in the

though they would not result in a greater tax, taking into account the increased deduction.

Second, if different taxpayers incur personal expenses but only *some* of the taxpayers are reimbursed, exempting the reimbursed expenses from taxation contravenes income tax objectives by taxing differently-situated taxpayers equally; the taxpayers receiving the reimbursements have more income available for personal consumption than the unreimbursed taxpayers. Similarly, allowing tax audit insurance proceeds to escape taxation would effectively allow a deduction for federal income taxes since a third party would be paying the taxpayer's liability; the taxpayer would not suffer a decline in after-tax income. Under the well-established rule of *Old Colony Trust Co. v. Commissioner*,<sup>91</sup> the taxpayer receives taxable income when his personal income taxes are paid for him by a third party. Consistent with this precedent, tax audit insurance proceeds should constitute taxable income to the recipient.<sup>92</sup>

## 2. Insurance Premiums

In addition to the decision to tax personal insurance proceeds, a correlative decision must be made as to which theory of taxation should be applied to the premiums. As concluded above with regard to personal insurance,<sup>93</sup> the personal origin theory is conceptually the most sound. Under that theory, a deduction for premiums would be disallowed if the risk covered by the insurance is personal, even if the proceeds are taxable.<sup>94</sup> The question in apply-

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same bracket have deductions which are the same percentage of income.

<sup>91</sup> 279 U.S. 716 (1929).

<sup>92</sup> *Clark v. Commissioner*, 40 B.T.A. 333 (1939), is not to the contrary. In that case the taxpayer had to pay more tax than he originally thought he owed because of his tax advisor's mistake. The advisor paid the taxpayer's excess taxes. The reimbursement was not taxable because there was no gain, just as there is no gain when excess living costs are reimbursed by an insurance company. See also Rev. Rul. 57-47, 1957-1 C.B. 23 (agreeing with the *Clark* decision).

<sup>93</sup> See *supra* notes 83-89 and accompanying text.

<sup>94</sup> The fifth theory, which deals with tax neutrality and the policy implications of a deduction, is discussed below. See *infra* text accompanying notes 102-04. Additionally, under the first theory, which conceptualizes the premiums as a cost of generating the proceeds, the premiums would be a deductible expense to produce taxable income. Cf. *Arnold v. United States*, 289 F. Supp. 206 (E.D.N.Y. 1968) (premiums for insurance proceeds which reimburse taxable living expenses might be deductible). Under the second theory, which treats the insurance as a social wealth redistribution, the premiums would be deductible because there should be only one tax on the insurance transaction, and the proceeds are taxable. Similarly,

ing the origin test to tax audit insurance premiums, therefore, is whether the risk of a tax deficiency is a personal risk. The risk covered by tax audit insurance arises from both personal and income-producing activities.<sup>95</sup> Typically, the premiums cannot be fairly and accurately allocated between these activities. As a result, since the origin of the expense cannot be determined prospectively, the taxpayer would not be allowed to deduct any of the premiums.<sup>96</sup>

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under the third theory, which equates premiums with the present value of proceeds, there should be a tax on either the proceeds or premiums, but not both; since the proceeds are taxed, the premiums should be deducted.

<sup>95</sup> Although it might seem that an income tax must arise from income-producing activities, that is not an accurate description of our federal income tax system. The income tax is the result of both income-producing and personal activities, and insurance premiums to protect against the risk of additional income tax burdens arise from both sources.

The dual nature of the income tax is recognized in cases where a taxpayer claims that state income taxes are deductible business expenses and, therefore, includible in the computation of net operating losses, which are generally limited to business expenditures. The Service and courts have properly held that state income taxes are business expenses only if the tax burden can be traced explicitly to taxation of business income. *See* *Reise v. Commissioner*, 35 T.C. 571 (1961), *aff'd*, 299 F.2d 380 (7th Cir. 1962) (substantially all of the deficiency concerned whether business income should be reported on an accrual rather than on a cash basis); *Rev. Rul. 70-40*, 1970-1 C.B. 50 (state taxes on net income from business profits are trade or business expenses). The same result is reached for expenses related to state income tax deficiencies arising from business income determinations. *See* *Wood v. Commissioner*, 37 T.C. 70 (1961) (legal fees related to determining state income tax deficiency which was based, for all significant purposes, on adjustments to business income); *Polk v. Commissioner*, 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960) (interest on state income tax deficiency attributable to revaluation of business inventory). Tax determination fees related to federal income taxes are also included in net operating loss computations if the origin of the dispute was the taxation of business income. *See* *Wood*, 37 T.C. at 76-78.

The state income tax is not, however, deductible from gross income to arrive at adjusted gross income if the law imposes the tax on all income, rather than on business income alone, even if in a particular case the tax falls on business income. *See* *Tanner v. Commissioner*, 45 T.C. 145 (1965), *aff'd per curiam*, 363 F.2d 36 (4th Cir. 1966); *Rev. Rul. 70-40*, 1970-1 C.B. 50. This distinction is based on legislative history concerning the definition of adjusted gross income, which requires that business expenses which are deductible from gross income to determine adjusted gross income be "directly" related to income production. *See* S. Rep. No. 885, 78th Cong., 2d Sess. 24-25 (1944), *cited in* *Tanner v. Commissioner*, 45 T.C. at 147 n.2. In the usual case, there is no way to allocate income taxes between the personal and business origin of the expense.

The New York State Bar Committee Report cites six examples of items covered under a tax audit insurance policy, two of which involve personal activity. *See A Report on Tax Audit Insurance, supra* note 5, at 54. The two examples are a transfer of property in a divorce settlement and taxation of net gifts.

<sup>96</sup> *Cf. Professional Services v. Commissioner*, 79 T.C. 888, 919-20 (1982) (taxpayer did not provide any rational method to separate deductible tax planning expenses from nondeduct-

Another challenge to applying the personal origin test to tax audit insurance premiums is that the Code does not apply this test to tax determination expenses,<sup>97</sup> which are similar to the premiums in that they are intended to reduce the tax burden. The Supreme Court has held that tax determination expenses incurred by a trust were deductible expenses because they maintained income-producing property.<sup>98</sup> The Treasury, rather than limiting the holding to entities which had the preservation of property as their major objective, permitted income tax determination expenses incurred by individuals to be deductible maintenance expenses, without regard to whether the tax issues involved personal or income-producing activities.<sup>99</sup>

An additional reason for allowing the deduction of tax determination and litigation expenses is that tax determination expenses should not be considered taxable personal consumption since they arguably represent a major involuntary expenditure, essentially thrust upon the taxpayer, draining his resources available to purchase the basic necessities of food, clothing, and shelter.<sup>100</sup> In this respect, tax determination expenses are similar to medical expenses and reimbursement of excess living costs resulting from a casualty. Tax audit insurance premiums, however, are not analogous; they are voluntary rather than imposed by an outside source. They are actually similar to purchasing security, which generally is

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ible personal expenses); I.R.C. § 213(d)(6) (the premiums allocable to the medical insurance element of medical/disability insurance are deductible only if the policy explicitly identifies the medical insurance element); Treas. Reg. § 1.162-5(b)(1) (education expenses which are an inseparable aggregate of personal and capital expenses are not deductible). *But see* Merians v. Commissioner, 60 T.C. 187, 189-90 (1973) (attorney's testimony provided a method to allocate expenses to deductible tax advice). Additionally, the policy itself might allocate additional premiums to specific activities; if so, the premiums allocated to business or income-producing activities would be deductible. *See also supra* note 95 (third paragraph).

<sup>97</sup> *See* I.R.C. § 212(3).

<sup>98</sup> *See* Trust of Bingham v. Commissioner, 325 U.S. 365 (1945).

<sup>99</sup> *See* T.D. 5513, 1946-1 C.B. 61, amending Treas. Reg. 111, § 29.23(a)-15(b) (1946). This taxation of tax determination expenses is consistent with the first theory, permitting a deduction of maintenance expenses, even though the expenses have a personal origin. However, this theory was not consistently applied by the Government. Litigation expenses arising from personal activities were not deductible simply because they maintained income-producing assets. *See id.* Tax determination expenses related to gift taxes were an example of such nondeductible expenses. *See id.*; *see also* Lykes v. Commissioner, 343 U.S. 118 (1952).

<sup>100</sup> *See* M. Chirelstein, Federal Income Taxation ¶ 7.01, at 142 (3d ed. 1982).



a nondeductible personal activity.<sup>101</sup>

Another important policy furthered by allowing the deduction of tax determination expenses is to encourage taxpayers to get the "right answer" regarding the tax consequences of their activities. Again, the analogy of tax determination expenses to tax audit insurance premiums is absent, because tax audit insurance may arguably encourage taxpayers to take an overly aggressive position, rather than the position they believe is correct, by allowing them to deduct the cost of playing the "tax lottery."

This analysis reveals that the abandonment of the personal origin theory based on an analogy of tax audit insurance premiums to tax determination expenses is not justified. Accordingly, application of the personal origin theory indicates that tax audit insurance premiums generally should not be deductible.<sup>102</sup> Moreover, an examination of other policy implications reveals other strong bases for disallowing the deduction.

Because tax payments are not deductible, a deduction for insur-

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<sup>101</sup> See I.R.C. § 262. However, extension of § 212(3) to permit the deduction of tax planning expenses is a more direct challenge to applying the origin test to disallow a deduction for tax audit insurance premiums because tax planning expenses cannot be analogized to tax determination expenses. Tax planning expenses originating in personal activities, such as marital or family property arrangements, are more like nondeductible expenses to stay healthy than medical expenses incurred after getting sick. The Service has permitted tax planning expenses to be deducted under § 212(3), *see* Rev. Rul. 72-545, 1972-2 C.B. 179 (tax advice incident to divorce), but the Tax Court seems reluctant to accept this view. For example, in *Merians v. Commissioner*, 60 T.C. at 188, the court stated that it accepted without endorsing the Government's concession that estate tax planning expenses were deductible, and a majority of the judges expressed doubts or affirmatively denied that the expenses were deductible. *See id.* at 190-91 (Scott, J., concurring), 198 (Quealy, J., dissenting). *But see* *Carpenter v. United States*, 338 F.2d 366 (Ct. Cl. 1964) (section 212(3) permits deduction of tax planning expenses); *Merians v. Commissioner*, 60 T.C. at 191 (Fay, J., concurring) (tax planning expenses are deductible as § 212(2) maintenance expenses).

There could be policy reasons for permitting the deduction of tax planning expenses which would not apply to tax audit insurance premiums. Through tax planning, a taxpayer attempts to avoid incurring an obligation for more tax than is necessary, assuming the Government is fully aware of what the taxpayer has done. By contrast, a tax audit insurance policyholder tries to reduce the financial burdens of what he owes, if it is discovered. A policy which supports taxpayers in their efforts to avoid taxes legally by allowing a deduction for tax planning expenses would not support a deduction for an expense which permits taxpayers to avoid confronting their tax burdens and thereby encourages them to take risks by exploiting the tax lottery. *Cf.* *Luman v. Commissioner*, 79 T.C. 846 (1982) (expenses to rearrange personal property within a family are not deductible maintenance expenses); *Epp v. Commissioner*, 78 T.C. 801 (1982) (same).

<sup>102</sup> Premiums directly allocable to income-producing activities would still be deductible. *See supra* notes 95-96 and accompanying text.

ance premiums covering tax payments would provide an incentive for purchasing insurance. The effect of such favoritism might not be salutary. It is too early to know how tax audit insurance will influence taxpayer behavior, but it might encourage taxpayers to play the "tax lottery" by insulating them from the financial effect of tax deficiencies. Therefore, the premiums should not be deductible in the absence of an explicit congressional judgment permitting the deduction.

The New York Bar Association has proposed that premiums covering tax deficiencies should not be deducted but, rather, should reduce any taxable proceeds collected by the insured.<sup>103</sup> Reducing the taxable proceeds by the amount of the premium is, however, inconsistent with the personal origin theory, which denies the deduction because of both the personal origin of the risk and the policy implications of permitting a deduction. A deduction is a deduction whether it reduces proceeds or reduces other income when no proceeds are collected. The only virtue of the New York State Bar solution is that a deduction for premiums is limited to the situation where the taxpayer has received taxable proceeds, which is less serious than if premiums are deductible in all situations. Even so, the incentive to purchase insurance is increased by any deduction, and it would be better to disallow the deduction in all cases.<sup>104</sup>

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<sup>103</sup> See *A Report on Tax Audit Insurance*, *supra* note 5, at 55.

<sup>104</sup> The New York Bar approach seems to adopt the first theory, where the premiums are a cost of producing the proceeds. With regard to tax audit insurance, the better result is to treat the premiums as unrelated to the proceeds from the loss, as with casualty insurance. See *York v. Commissioner*, 33 T.C.M. (CCH) 988, 990 (1974). *But cf.* *Gilmore v. United States*, 245 F. Supp. 383 (N.D. Cal. 1965) (Mr. Gilmore persuaded the court to allow him to add his otherwise nondeductible personal litigation costs to the basis of the property he was trying to protect).

Another possible analogy, which would permit the premiums to reduce taxable proceeds but not other income, is § 183. That section generally permits expenses to be deducted against gross income, but prohibits net losses from being deducted. See I.R.C. § 183. Using this analogy, the premiums would reduce insurance proceeds but not permit a deduction for premiums if the proceeds did not materialize. The analogy should not apply to insurance, however, because § 183 is aimed at personal hobbies and tax shelters where the taxpayer is trying to produce gross income, even though the taxpayer does not care about net income. Permitting the expenses to reduce gross income is a compromise reflecting this modified income-producing motive. Personal insurance is not an activity which should be characterized for tax purposes as having even this modified income-producing purpose. If the risks are personal and the tax policy implications favor disallowing the deduction, the premiums should not be deductible, whether or not proceeds are collected.

*B. Tax Practitioners' Costs*

In addition to covering tax deficiencies, tax audit insurance also covers a limited amount of professional fees. These proceeds would be included in gross income,<sup>105</sup> but would also be deductible as tax determination expenses.<sup>106</sup> They should not be excluded from gross income initially because the expenses can only be deducted as itemized deductions, which reduce taxable income only if they exceed the zero bracket amount.<sup>107</sup> The deduction should not be more generously available when it is funded by insurance rather than by the taxpayer's own resources.<sup>108</sup>

With respect to premiums relating to coverage for professional fees, there is a stronger argument for not adopting the personal origin theory than exists for tax deficiencies. This is because the professional fees are in actuality tax determination expenses, which are always deductible.<sup>109</sup> Nevertheless, policy implications indicate that premiums related to professional services should not be deductible. As previously mentioned, the expenditure of funds for these premiums is purely voluntary;<sup>110</sup> allowing a deduction for the premiums may actually encourage taxpayers to play the "tax lottery" and, consequently, to be overly aggressive. The fact that the actual expenses are deductible should not alter that conclusion.<sup>111</sup>

The best argument for allowing deduction of the premiums is a tax neutrality argument, since self-insurance would be favored if the uninsured loss is deductible while the insurance premiums covering the same loss are not deductible. Notwithstanding that result, equal treatment of the self-insurer and the insurer is not necessarily desirable. The deduction of professional fees still confronts the taxpayer with a large after-tax cost. Premiums are small by comparison, and their deduction would present too great a risk of

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<sup>105</sup> See *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (taxpayer receives income when a third party pays the taxpayer's personal expenses).

<sup>106</sup> See I.R.C. § 212(3); Treas. Reg. § 1.212-1(l).

<sup>107</sup> See I.R.C. § 211.

<sup>108</sup> If the insurance company takes over the litigation for its own purposes, the litigation expenses would probably not be included in gross income because the company was incurring the expenses for its own business reasons.

<sup>109</sup> See I.R.C. § 212(3).

<sup>110</sup> See *supra* notes 100-01 and accompanying text.

<sup>111</sup> *But see A Report on Tax Audit Insurance, supra* note 5, at 55.

encouraging taxpayers to play the tax lottery.<sup>112</sup>

### III. CONCLUSION

The taxation of any personal insurance raises questions which have not received much attention because of the statutory exclusion of the proceeds from taxable income. Tax audit insurance proceeds should not be exempt, however, because the application of income definition principles requires taxation of proceeds. The more difficult question is how the premiums should be taxed. This question is difficult because it is not easy to characterize the purchase of personal insurance as a traditional income-producing activity or to dismiss it as having an obviously personal origin, devoid of any income-producing function. Nonetheless, the personal origin test requires that tax audit insurance premiums be included in taxable income (by disallowing the deduction).

Applying the personal origin test to expenses related to income taxes raises difficult questions since income taxes originate from both personal and business activities. Moreover, the deduction of tax determination expenses clouds the issue because it is not entirely clear why these expenses are deductible and whether the same rationale would justify deducting tax audit insurance premiums. This article has argued that the potential personal origin of some income tax disputes should characterize all tax audit insurance premiums as personal and that the deduction of tax determination expenses rests on considerations not applicable to tax audit insurance premiums.

In reaching these conclusions, the article also considered the policy implications of deducting the premiums. The rules for deducting personal insurance premiums and, more generally, the application of the origin test, should be influenced by the effect a deduction might have on taxpayer behavior. Because permitting a deduction for tax audit insurance premiums could encourage taxpayers to play the tax lottery, a deduction should not be allowed,

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<sup>112</sup> A countervailing policy consideration in the case of professional fees is the desirability of professional representation in disputes with the Government. *Cf. Tellier v. Commissioner*, 383 U.S. 687 (1966). If this consideration overcomes the reasons for disallowing the deduction, only that portion of the premiums allocable to professional fees should be deductible. That amount is likely to be very small and should, in any event, be deductible only if it is earmarked in the insurance policy and is reasonable in amount. *Cf. I.R.C. § 213(d)(6)* (medical insurance with a disability insurance feature).

either to offset collected proceeds or to reduce other taxable income if no loss occurs.

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