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Western New England Law Review

Volume 11 *11 (1989)*
Issue 1

Article 5

1-1-1989

TAX LAW—THE DEVELOPMENT OF AND DIGRESSION FROM SECTION 105(c) OF THE INTERNAL REVENUE CODE

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Brendan M. Fox, *TAX LAW—THE DEVELOPMENT OF AND DIGRESSION FROM SECTION 105(c) OF THE INTERNAL REVENUE CODE*, 11 W. New Eng. L. Rev. 179 (1989), http://digitalcommons.law.wne.edu/lawreview/vol11/iss1/5

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NOTE

TAX LAW—THE DEVELOPMENT OF AND DIGRESSION FROM SECTION 105(C) OF THE INTERNAL REVENUE CODE

I. INTRODUCTION

Health insurance and the benefits that it provides are extremely important to many people,[1] a fact that Congress has long recognized. The first Revenue Act, enacted in 1918, contained a provision allowing benefits received as compensation for injuries or sickness to be excluded from gross income.[2] Although there have been major revisions to the Internal Revenue Code since 1918,[3] this exclusion still exists, as does the purpose that motivated the original enactment, to provide some form of relief to those who must endure the misfortune of pain and suffering.[4]

In response to problems concerning whether the source of the payments was a factor in qualifying for exclusion,[5] Congress replaced section 22(b)(5)[6] with section 105(c) in 1954.[7] Thus, although the exclusion privilege remains, the present exclusion statute, section

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1. D. BICKELHAUPT, GENERAL INSURANCE 345 (1974). As of 1974, more than 180 million Americans (nearly nine out of ten) possessed some form of accident or health insurance.

2. 26 U.S.C. § 213(b)(6) (1918). See *infra* note 11 for the text of this statute.

3. "[T]he Internal Revenue Code mirrors the major economic, political, and social institutions dominating American life today." J. CHOMMIE, FEDERAL INCOME TAXATION 7 (1968). Therefore, in an ever-changing society, the Internal Revenue Code must change in order to fulfill society's changing needs and expectations.

4. For an analysis of Congress' intent underlying § 105(c), the current exclusion provision, see *infra* notes 15-24, 56-67, and accompanying text.

5. During the 1940's and early 1950's, the exclusion's requirement that the payment had to come from an insured plan proved to be the source of a great deal of confusion. At one point, the IRS maintained that an "insured plan" was a plan underwritten by an outside insurance carrier, while at other times, it maintained that it was not necessary for the plan to be underwritten to qualify under the statute. For a detailed discussion of this controversy, see *infra* notes 25-45 and accompanying text.

6. Section 22(b)(5) was not the first exclusion statute. Congress enacted the first exclusion statute, § 213(b)(6), in 1918. However, in 1939, the Internal Revenue Code was recodified and § 22(b)(5) replaced § 213(b)(6), although the language of the statute essentially remained the same. *See infra* notes 11-14 and accompanying text.

7. 26 U.S.C. § 105(c) (1982).

105(c),[8] is distinguishable from its predecessors.[9] Under section 105(c), it is not sufficient simply to receive the benefits because of a permanent disability; instead, a number of requirements first must be satisfied in order to exclude disability benefits from gross income. While section 105(c) has solved the problems which existed prior to its enactment, new problems have developed. In certain cases, the Internal Revenue Service (IRS) and the courts may be misconstruing the statute and disserving Congress' intent.

This comment traces the development of this exclusion privilege from 1918 to the present, discussing in Section II the history of the statutes and their specific provisions, and in Section III and IV, discussing IRS and judicial interpretations of these statutes. Section IV also presents a recent case involving a claim for exclusion under section 105(c) in which the United States Court of Appeals for the Ninth Circuit applied an overly restrictive test and denied what this comment argues was a legitimate exclusion.[10]

II. The Purpose and History of the Exclusion Statute

A. *Pre-1954 Developments*

From 1918 to 1954, section 213(b)(6) of the Revenue Act of 1918[11] and then section 22(b)(5) of the Internal Revenue Code of 1939[12] governed the excludibility of accident and health benefits from

8. *Id.*

9. *See supra* note 6. See *infra* notes 11-14 and accompanying text for the text and discussion of the exclusion provisions which preceded § 105(c).

10. Beisler v. Commissioner, 814 F.2d 1304 (9th Cir. 1987). *See infra* notes 137-70 and accompanying text.

11. 26 U.S.C. § 213(b)(6) (1918) stated:

> That for the purposes of this title (except as otherwise provided in section 233) the term "gross income" —
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * *
>
> (6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

Id.

12. 26 U.S.C. § 22(b)(5) (1939), *amended by* 26 U.S.C. § 105 (1982). The statute provided:

> SEC. 22 GROSS INCOME
>
> (b) EXCLUSIONS FROM GROSS INCOME — The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> * * *
>
> (5) COMPENSATION FOR INJURIES OR SICKNESS — Amounts received,

the taxpayer's gross income. Using identical language,[13] the statutes provided that payments from an accident or health insurance plan that compensated for personal injuries or sickness would be excluded from the taxpayer's gross income.[14]

The legislative purpose underlying the statute has remained constant: to provide some measure of relief to those who must endure the misfortune of pain and suffering. The exclusion is necessary because the Internal Revenue Code's definition of gross income is extremely broad.[15] Although insurance benefits are not enumerated as income in

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> through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

Id.

13. *Compare* 26 U.S.C. § 22(b)(5) (1939), *amended by* 26 U.S.C. § 105 (1982) *with* 26 U.S.C. § 213(b)(6) (1918). *See supra* notes 11-12.

14. Unfortunately, the requirement that the payments come from an insured plan proved to be the source of much controversy, prompting the enactment of § 105. *See infra* notes 25-45 and accompanying text.

15. 26 U.S.C. § 61(a) (1982) provides:

GROSS INCOME DEFINED.

(a) General Definition. — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gross income derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

See also Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively."); Helvering v. Clifford, 309 U.S. 331, 334 (1940) (citation omitted) ("The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. Hence [the Supreme Court's] construction of the statute should be consonant with that purpose."); Blassie v. Commissioner, 394 F.2d 628, 630 (8th Cir. 1968) (citing *Clifford*, 309 U.S. at 334) ("In our view the language of Section 61(a) defining 'gross income' in broadest terms manifests Congress' intention to exert the full measure of its taxing power over all realized gains."); Heard v. Commissioner, 326 F.2d 962, 966 (8th Cir. 1964) ("Gross income is defined very broadly by § 22(a) of the 1939 Code and by § 61(a) of the 1954 Code, and includes all income from whatever source derived."), *cert. denied*, 377 U.S. 978 (1964)

section 61(a), the receipt of benefits from an accident or health insurance plan arguably is an accession to wealth over which the disabled taxpayer has complete dominion and control and thus is income.[16] Unless excluded by section 105(c), the taxpayer would have to include these benefits as gross income.

Two factors motivated Congress to enact this exclusion: a feeling of pity and sorrow for the suffering taxpayer,[17] and a belief that compensation for an injury essentially is a "return of capital" to the taxpayer, which Congress traditionally has not taxed.[18] With respect to the first element, the disabled taxpayer receives a payment only as a result of suffering a permanent, disabling injury. The purpose of the payment is to compensate the taxpayer for any pain and aggravation that he or she likely will be forced to endure for the duration of his or her life. Congress therefore chooses to exempt these payments from taxation "to avoid adding insult to injury."[19] As the Court of Appeals for the Seventh Circuit in *Epmeier v. United States*[20] stated, "The provisions . . . undoubtedly were intended to relieve a taxpayer who has the misfortune to become ill or injured, of the necessity of paying income tax upon insurance benefits received to combat the ravages of

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(citations omitted); Haberman Farms, Inc. v. United States, 305 F.2d 787, 790 (8th Cir. 1962) (citing *Clifford*, 309 U.S. at 334) ("Gross income is broadly defined by § 22(a) of the 1939 Code and by § 61(a) of the 1954 Code. . . . These and their corresponding predecessor statutes have been said to indicate the purpose of Congress to use 'the full measure of its taxing power.' "); Schoenberg v. Commissioner, 302 F.2d 416, 418 (8th Cir. 1962) ("The definition of income in the revenue statutes is very broad."); J. SNEED, THE CONFIGURATION OF GROSS INCOME 3 (1967) ("[T]he meaning of 'gross income,' while eluding precise definition, has been said to be as broad as the word 'income' in the sixteenth amendment."); *see generally* R. DAILEY, ITEMS OF GROSS INCOME (1967).

16. In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), the Supreme Court stated that "[i]nstances of undeniable accessions to wealth, clearly realized, and over which the taxpayer [has] complete dominion" are to be included in the taxpayer's gross income. *Id.* at 431. *See also* Moore v. United States, 412 F.2d 974, 978 (5th Cir. 1969) ("An economic gain is includable in gross income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it.").

17. *See generally* Caplin v. United States, 718 F.2d 544 (2d Cir. 1983); Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549, 550-52 (1954).

18. *See* Doyle v. Mitchell, 247 U.S. 179 (1918). The Court stated that "[i]n order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." *Id.* at 185. *See also* Commissioner v. Pennroad Corp., 228 F.2d 329 (3d Cir. 1955). Citing *Doyle*, the court held that petitioner receipt of a $15,000,000.00 settlement was tax-exempt because it represented a partial return of the $66,380,000.00 that petitioner was forced to expend due to defendant's fraud. *Id.* at 331-32.

19. Caplin v. United States, 718 F.2d 544, 548 (2d Cir. 1983); *see also* Schlenger, *supra* note 17, at 552.

20. 199 F.2d 508 (7th Cir. 1952).

disease or accident."[21]

The second factor which motivated Congress to enact the exclusion is the notion that this type of compensation is a "return of capital" and thus not subject to taxation.[22] Courts first applied this exclusionary theory to tort recoveries that were intended to make the plaintiff whole.[23] Disability benefits are similar to tort recoveries; both seek to restore to the taxpayer something which has been taken away. Congress treated them in the same way, excluding both from gross income.[24] From the statute's enactment in 1918 to its amendment in 1954, courts and the IRS struggled to define the term "insurance or health plan."[25] Congress never defined explicitly what would qualify

21. *Id.* at 511. This view is supported by Bertram Harnett's analysis of the purpose behind the privilege. He states: "The answer seems to lie . . . in the fundamental notion that the human body is not really property or capital [which] links with the feeling that the taxation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed." Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 627 (1952).

22. *See supra* note 18.

23. *See* Hawkins v. Commissioner, 6 B.T.A. 1023, 1025 (1927). Plaintiff received $112,000.00 in damages for defamation. The court ruled that the payment was not taxable because this type of compensation added nothing to the individual but simply attempted to put him in the same position that he was in before suffering the injury. *Id.*

24. Income Tax—Proceeds of Accident Insurance Policy, 31 Op. Att'y Gen. 304 (1918).

> [T]he proceeds of an accident insurance policy are not "gains or profits and income" as these terms are defined by the Supreme Court. Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident.

Id. at 308. *See* T.D. 2457, 20 Treas. Dec. Int. Rev. 457 (1918) which agreed with the Attorney General's opinion and added that the amount of any damages received from a lawsuit or settlement also should be excluded from gross income. *See generally* Note, *The Taxability of Punitive Damages*, 101 U. PA. L. REV. 1052, 1055-64 (1953).

See also H.R. REP. NO. 767, 65th Cong., 2d Sess. 9 (1918).

> Under present law, it is doubtful whether amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.

Id.

25. 26 U.S.C. § 22(b)(5) (1939), *amended by* 26 U.S.C. § 105 (1982), stated:

SEC. 22 GROSS INCOME

(b) EXCLUSIONS FROM GROSS INCOME—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * *

(5) COMPENSATION FOR INJURIES OR SICKNESS—Amounts received through *accident or health insurance* or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

as "insurance," and a conflict arose as to what would satisfy the "insurance" requirement of the exclusion provision.[26] The basis of the conflict was whether the "insurance or health plan" had to be underwritten by an outside insurance carrier.[27] This insurance issue became a major source of confusion in the late 1930's and early 1940's, when large-scale employers began instituting their own "in-house" health plans.[28] Instead of paying large premiums to outside insurance carriers for employee-disability coverage, companies would generate the necessary disability payments from their own resources, a practice which proved to be more economically efficient from the employers' viewpoint.[29]

These new in-house plans posed a problem for the IRS: did the statutory definition of "insurance" require an outside insurance carrier's financial support? The IRS vacillated for an entire decade, at one point holding that it did not,[30] at other times holding that it did.[31] In 1943, the IRS stated that it would determine what constituted an insurance plan[32] by examining various criteria on a case-by-case basis.[33] Thus, an employer-insured plan that included the appropriate

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Id. (emphasis added).

26. *See* Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952); I.T. 4107, 1952-2 C.B. 73; I.T. 4000, 1950-1 C.B. 21; *accord* I.T. 4015, 1950-1 C.B. 23; I.T. 4060, 1951-2 C.B. 11; Bureau of Internal Revenue News Release IR-53-047 (March 26, 1953), *reprinted in* [1953] 5 Stand. Fed. Tax Rep. (CCH) ¶ 6136.

27. *See* I.T. 4107, 1952-2 C.B. 73; I.T. 4000, 1950-1 C.B. 21; *accord* I.T. 4015, 1950-1 C.B. 23; I.T. 4060, 1951-2 C.B. 11; Bureau of Internal Revenue News Release IR-53-047 (March 26, 1953), *reprinted in* [1953] 5 Stand. Fed. Tax Rep. (CCH) ¶ 6136. *See also* Seligman, *1954 Code resolves many practical problems in taxation of sickness, accident benefits*, 3 J. TAX'N 322, 330-31 (1955).

28. *See generally Forty Topics Pertaining to the General Revision of the Internal Revenue Code, 1953: Hearings on H.R. 8300 Before the House of Representatives Committee on Ways and Means*, 83d Cong., 1st Sess. 364-73 (1953), *reprinted in* 3 INTERNAL REVENUE ACTS OF THE UNITED STATES: THE REVENUE ACT OF 1954 WITH LEGISLATIVE HISTORIES AND CONGRESSIONAL DOCUMENTS 364-73 (1982) (statement of Clifton W. Phelan, President, Michigan Bell Telephone Co.). Mr. Phelan stated that "in-house" plans were more attractive to large employers from a cost-benefit standpoint. He expressed dissatisfaction with the discrimination in favor of insured plans, which further discriminate against those employees receiving benefits. To force companies with self-insured disability plans to buy commercial insurance would increase costs thereby increasing prices, creating an overall negative effect on the economy. *Id.*

29. *Id.*

30. I.T. 4000, 1950-1 C.B. 21; *accord* I.T. 4015, 1950-1 C.B. 23; I.T. 4060, 1951-2 C.B. 11.

31. I.T. 4107, 1952-2 C.B. 73. *See also* B.I.R. Release (March 26, 1953) 53-5 (CCH) Fed. Tax Serv., ¶ 6136.

32. Gen. Couns. Mem. 23,511, C.B. 1943-1, 86.

33. *Id.* In its ruling, the IRS suggested that determinative factors in its analysis would include employee contributions to the "plan" in question, enforceable rights and obligations of the employees, determinable benefits based on the degree of disability rather

elements would qualify as an "insured plan." After reaffirming its 1943 interpretation in 1950 and 1951,[34] the IRS ruled, in 1952, that an employer's self-insured plan could *not* qualify as "insurance" under section 22(b)(5) if the plan was not established under a contract with an insurance carrier.[35] Benefits received under such a plan could not be excluded under section 22(b)(5).[36]

In the face of this confusion, the Seventh Circuit Court of Appeals, in 1952, issued the first judicial interpretation of the statutory term "insurance." In *Epmeier v. United States*,[37] the court ruled that, even though there was no formal contract of insurance, payments made by an employer to an employee for disabilities would be eligible for exclusion.[38] The court reasoned that the insurance requirement is satisfied if one party has assumed the duty and risk of compensating another should that other party suffer a loss,[39] and that the statute does not require a formal, written insurance agreement.[40] The *Epmeier* court stated that its decision was consistent with what Congress envisioned when it enacted this exclusion statute.[41]

In 1953, confusion and uncertainty remained as to what would qualify as insurance under section 22(b)(5) of the 1939 Code. There were conflicting revenue rulings and an appeals court case holding that the insurance requirement could be satisfied when the employer did not have a written contract with an insurance carrier.[42] In an

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than on the length of service and amount of salary and whether a separate fund earmarked for such benefits existed. *Id.* at 88.

34. I.T. 4000, 1950-1 C.B. 21; *accord* I.T. 4015, 1950-1 C.B. 23; I.T. 4060, 1951-2 C.B. 11.

35. I.T. 4107, 1952-2 C.B. 73, 74.

36. *Id.*

37. 199 F.2d 508 (7th Cir. 1952).

38. *Epmeier*, 199 F.2d at 511. This view ultimately was endorsed by the Supreme Court in Haynes v. United States, 353 U.S. 81 (1957). The Court observed that "[b]roadly speaking, health insurance is an undertaking by one person for reasons satisfactory to him to indemnify another for losses caused by illness." *Id.* at 83.

39. *Epmeier*, 199 F.2d at 510. *See also* Herbkersman v. United States, 133 F. Supp. 495 (S.D. Ohio 1955) (under a disability plan, risk of loss of income is transferred to the employer during periods of disability which makes in itself a contract of insurance); Haynes v. United States, 139 F. Supp. 671, 674 (N.D. Ga. 1955) (employer becomes the insurer and benefits are paid only when the employee is ill), *rev'd*, 233 F.2d 413 (5th Cir. 1956), *rev'd*, 353 U.S. 81 (1957).

40. *Epmeier*, 199 F.2d at 510.

41. *Id.* at 511. The court stated that "[t]he provisions of Section 22(b)(5) undoubtedly were intended to relieve a taxpayer who has the misfortune to become ill or injured, of the necessity of paying income tax upon insurance benefits received to combat the ravages of disease or accident." *Id. See supra* text accompanying note 17.

42. *See supra* notes 30-41 and accompanying text.

early example of non-acquiescence,[43] the Commissioner of the IRS refused to accept the Seventh Circuit Court of Appeals' decision as binding on the Service outside of the Seventh Circuit's jurisdiction.[44] The prognosis was for continued inconsistent rulings and increased confusion.[45]

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43. Nonacquiescence by the Commissioner of the Internal Revenue Service dates back to the Revenue Act of 1924 which created the Board of Tax Appeals. This Board was the predecessor to the Tax Court. Dwan, *Administrative Review of Judicial Decisions: Treasury Practice*, 46 COLUM. L. REV. 581, 593 (1946). Although the Commissioner is bound by rulings of the United States Supreme Court, he or she must follow lower tax court rulings only with respect to the party involved in the particular suit and can disregard these rulings as precedent. Divine v. Commissioner, 59 T.C. 152, 159 (1972). Thus, the Commissioner's nonacquiescence does not signal an appeal by the government; instead, it simply indicates that the IRS will maintain its original position on the issue, despite Tax Court and courts of appeals' rulings to the contrary. Carter, *Commissioner's Nonacquiescence; A Case for a National Court of Tax Appeals*, 59 TEMP. L.Q. 879, 882 (1986). As a result of recent litigation, the Commissioner must release to the public internal documents used by the IRS to explain to IRS personnel its position on district court, United States Claims Court, United States Court of Appeals and Tax Court Memorandum decisions. Taxation with Representation Fund v. IRS, 646 F.2d 666 (D.C. Cir. 1981). These internal documents are called Action on Decisions. *See* Carter, *supra*, at 883 n.20.

Some commentators have attacked the policy of nonacquiescence by the Commissioner on the grounds that it is an encroachment upon the judiciary by the executive branch and, as such, violates the concept of separation of powers established in Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803). Note, *Administrative Agency Intracircuit Nonacquiescence*, 85 COLUM. L. REV. 582, 595-604 (1985). *See also* Herzberg, *Blueprint of a Fair Tax Administration*, 41 TAXES 161 (1963). Others have argued that the policy is violative of the principles of equity, *see* Rodgers, *The Commissioner "Does Not Acquiesce"*, 59 NEB. L. REV. 1001, 1030-31 (1980), uniformity, *see* Comment, *The Commissioner's Nonacquiescence*, 40 S. CAL. L. REV. 550, 553 (1967), and certainty, *id.* at 559. While commentators generally disapprove of nonacquiescence, it may be an appropriate response to certain problems, such as uncertainty of venue, Note, *Administrative Agency Intracircuit Nonacquiescence*, 85 COLUM. L. REV. 582, 604 (1985), subsequent intercircuit conflict, *id.* at 605, and a pending review by the Supreme Court, *id.* at 606. *See also The Commissioner's nonacquiescences: their effect upon tax planning*, 28 J. TAX'N 57 (1968); Note, *Administrative Law—Jurisdiction, Class Action, Injunctive Relief and Nonacquiescence—Lopez v. Heckler, 104 S. Ct. 221 (1984)*, 7 W. NEW ENG. L. REV. 277 (1984) (providing an analysis of the Ninth Circuit Court of Appeals' condemnation of Social Security Administration nonacquiescence).

44. *See* Bureau of Internal Revenue News Release IR-53-047 (March 26, 1953), *reprinted in* [1953] 5 Stand. Fed. Tax Rep. (CCH) ¶ 6136. The IRS argued that when Congress enacted § 22(b)(5) in 1939, provision for compensation of permanent injuries was made by individuals purchasing policies from insurance companies with after-tax dollars. However, since 1939, employers have provided their own plans for employees. Therefore, "the Bureau deem[ed] that it was the intention of Congress that only payments which are truly 'insurance' payments should be excluded . . . under section 22(b)(5) of the Code." *Id.* See *supra* note 43 for a discussion of the Commissioner's nonacquiescence.

45. Seligman, *supra* note 27, at 332. The IRS' refusal to accept the *Epmeier* decision might have been justified if the IRS had a definitive policy which contradicted the decision. However, it did not. This is evidenced by the fact that Treasury Regulations 111 and 118, the official regulations that have interpreted the Code since 1942, contain no reference to § 22(b)(5). *Id.*

In 1954, therefore, during the major recodification of the Internal Revenue Code, the time was right for Congress to resolve the conflict surrounding the meaning of insurance under section 22(b)(5).

B. *Enactment of Section 105—Post-1954 Developments*

Congress' original purpose in enacting section 105, in 1954, was to remedy the confusion surrounding the interpretation of the insurance requirement contained in section 22(b)(5) of the 1939 Code.[46] However, Congress also added additional provisions in order to achieve another goal: to limit the exclusion privilege to the truly needy, disabled taxpayer who receives compensation because of injury or disease.[47]

Section 105 states:

> AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS
>
> (A) AMOUNTS ATTRIBUTABLE TO EMPLOYER CONTRIBUTIONS.— Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.
>
> * * *
>
> (C) PAYMENTS UNRELATED TO ABSENCE FROM WORK.— Gross income does not include amounts referred to in subsection (a) 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, his spouse, or a dependent (as defined in section 152), and
>
> (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.[48]

Congress solved the "insurance" problem in a deceptively simple manner—by agreement and not by amendment. The language which proved to be the source of the pre-1954 confusion, "accident or health insurance" plan, remained unchanged. However, both the House[49]

46. 26 U.S.C. § 22(b)(5) (1939), *amended by* 26 U.S.C. § 105 (1982).

47. *See supra* notes 18-24 and accompanying text.

48. 26 U.S.C. § 105 (1982). Section (a) of the statute, therefore, states the rule that benefits received through an accident or health plan shall be included in the employee's gross income. Section (c) then provides the exception to this general rule, excluding permanent disability payments that meet the requirements of subsections (c)(1) and (c)(2). This comment concentrates specifically on section (c) of § 105.

49. H.R. REP. No. 1337, 83d Cong., 2d Sess. 105, *reprinted in* 1954 U.S. CODE

and the Senate[50] Committee Reports clearly reveal a congressional intent that taxpayers should be able to exclude from their income, disability benefits financed by employers whether paid from insured or uninsured plans. In corresponding Treasury Regulation section 1.105-5(a), the Treasury Department defined "accident or health insurance plan" in a manner similar to the definition expressed by the *Epmeier* court.[51] Therefore, in order to satisfy the section 105(a) "accident or health insurance" requirement, the taxpayer now must prove only that the employer has agreed to accept responsibility for certain employee expenses and has compensated the disabled employee for a permanent disability.

In addition to resolving the insurance controversy, Congress added several new requirements to section 105.[52] For instance, the taxpayer must prove that the payment is "for the permanent loss or loss of use of a member or function of the body,"[53] and that the payment is "computed with reference to the nature of the injury" and not with reference to lost wages or salary.[54] These additional requirements further the legitimate legislative purpose of preventing taxpayers from abusing the exclusion privilege and escaping taxation through an available loophole.[55] In the floor debate over section 105, Senator Morse

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CONG. & ADMIN. NEWS 4017, 4039 ("[The House] committee's bill grants equal tax treatment to sickness and accident benefits financed by employers whether paid under insured or noninsured plans. Such benefits are . . . excluded from tax if received as compensation for personal injury or sickness."). *Id.*

50. S. REP. NO. 1622, 83d Cong., 2d Sess. 105, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4645 ("[The Senate] committee approves in principle of the general objective of the House provision in equalizing the tax treatment of the insured and noninsured sickness and accident benefits."). *See also* Comment, *The Legal Benchmarks of a Plan for Employees: A Navigational Framework Under Section 105*, 8 LOY. L.A.L. REV. 363, 365 (1975).

51. Treas. Reg. § 1.105-5(a) (1987) provides:

> In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries. . . . An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable.

Id.

The Treasury seems to have adopted the reasoning of the court in Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952). The *Epmeier* court stated that "[i]nsurance, of ancient origin, involves a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils." *Id.* at 509-10. *See supra* notes 37-41 and accompanying text.

52. *See* Morris v. Commissioner, 52 T.C.M. (CCH) 1304, 1306 (1987) ("[P]etitioners have failed to place themselves within the statute because their payments were for services, not for anything else, including the loss of use of a member or function of the body.").

53. 26 U.S.C. § 105(c)(1) (1982).

54. 26 U.S.C. § 105(c)(2) (1982).

55. A "loophole" to escape taxation would be available if taxpayers simply catego-

made the point sharply: "Limitations are wise because it is my understanding that in the past, corporation executives and other high-salaried employees have been able to draw the amounts of their regular salaries as tax-exempt 'disability' benefits from special plans while on extended vacations taken on 'doctor's orders.' "[56]

Added by the Senate Finance Committee[57] and accepted by the House,[58] these new requirements are codified in section 105(c).[59] The first requirement specifies that the amount received must constitute payment for a permanent disability.[60] According to Treasury Regulation section 1.105-3, the Treasury defines "permanent" as that which "may reasonably be expected to continue for the life of the individual."[61]

Disability is defined by statute as "loss or loss of use of a member or function of the body."[62] While the Treasury gives examples of what constitutes a "loss or loss of use of a member or function of the body" in Treasury Regulation section 1.105-3,[63] this regulation is general and open-ended.[64] Because of this, the meaning of "loss of use of a member or function of the body" is still litigated, as a later section of this note documents.[65]

The second major restriction, added in 1954, requires the payments to be "computed with reference to the nature of the injury without regard to the period that the employee has been absent from work."[66] This requirement prevents the taxpayer from doing what

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rized pension plan funds or sick-day credits as disability payments upon receipt. However, such a "loophole" is eliminated by the various requirements imposed by Congress through § 105(c), the courts, and the IRS.

56. 100 CONG. REC. 9,323 (June 30, 1954) (statement of Sen. Morse).

57. S. REP. No. 1622, 83d Cong., 2d Sess. 105, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4623.

58. H.R. REP. No. 2543, 83d Cong., 2d Sess. 105, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 5280, 5284.

59. For the language of section 105(c), see *supra* text accompanying note 48.

60. 26 U.S.C. § 105(c)(1) (1982).

61. *See* Treas. Reg. § 1.105-3 (1987).

62. 26 U.S.C. § 105(c)(1) (1982). *See also* Treas. Reg. § 1.105-3 (1987) which states:

> For purposes of section 105(c), loss or loss of use of a member or function of the body *includes* the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears.

Id. (emphasis added).

63. *Id.*

64. By the use of the word "include" in Treasury Regulation § 1.105-3, the IRS intended the examples provided to be illustrative rather than all-inclusive.

65. *See infra* notes 102-30 and accompanying text.

66. 26 U.S.C. § 105(c)(2) (1982).

Senator Morse feared: disguising wages or deferred compensation as disability benefits and, undeservedly, obtaining the exclusion privilege of section 105.[67]

Thus, the difficulty and uncertainty surrounding section 22(b)(5) of the 1939 Code was eliminated, not by altering the language which was the source of the confusion, but by means of the legislative history in which Congress expressed its wish to have uniform treatment of accident and health insurance plans.

In addition, Congress, through section 105(c), included certain requirements which the taxpayer must meet in order to exclude benefits from gross income. These requirements express Congress' desire that only those who suffer permanent disabilities should be able to use the exclusion. Since 1954, the courts and the IRS, at times, have interpreted these requirements to legitimately effectuate Congress' intent. However, there have been instances where the courts and the IRS overstepped the boundaries which Congress created in 1954.

III. JUDICIAL AND IRS INTERPRETATIONS OF SECTION 105—STANDARD APPLICATIONS

While the statute has remained unchanged since its enactment in 1954, its interpretation by the IRS and the courts has been ever-changing. The following subsections review IRS and judicial applications of section 105(c)'s plan and permanent loss requirements. The cases presented in this section exemplify proper and legitimate interpretations of the congressional intent underlying section 105(c). However, as illustrated by *Hines v. Commissioner*,[68] there still exists the danger of applying an approach which exceeds the bounds of judicial discretion defined by Congress when it enacted section 105(c). Section IV of this note presents a recent Ninth Circuit case in which the court of appeals applied the statutory requirements in an overly restrictive manner.[69]

A. Caplin v. United States—*"A Plan"*

In *Caplin v. United States*,[70] the United States Court of Appeals for the Second Circuit developed an approach for determining when an accident or health insurance plan exists for purposes of section

67. *See supra* text accompanying note 56.

68. 72 T.C. 715 (1979). *See infra* notes 102-30 and accompanying text.

69. Beisler v. Commissioner, 814 F.2d 1304 (9th Cir. 1987). For a detailed discussion of this case, see *infra* notes 137-70 and accompanying text.

70. 718 F.2d 544 (2d Cir. 1983).

105(c). In *Caplin*, a person employed by the same company for thirty-eight years[71] was forced to retire due to severe neurofibroma—"a neurological impairment causing the loss of use of the limbs."[72] At the time of his forced retirement, petitioner received $305,815.97, the total amount in his account in his employer's profit-sharing plan.[73] Petitioner reported the payment as income on his return and then filed a claim for a refund which the IRS denied.[74] On appeal, the petitioner contended that his employer's profit-sharing plan served a "dual-purpose" of a profit-sharing plan and an accident or health insurance plan.[75]

The *Caplin* court noted that there is a significant difference between a profit-sharing plan and an accident or health insurance plan.[76] The court stated that simply "changing the labels attached to the payments at the time the payments are made" was not enough to fulfill the requirements for the exclusion of income under section 105(c).[77] Profit-sharing plans are to reward employees, and the amount in each account depends solely on the financial success of the company and the individual employee's position within the company. Alternatively, accident and health plans protect employees and their beneficiaries[78] from accident and health risks.[79] Regardless of the fortunes of the company or the employee's "rank" within the company, benefits for disability compensation always will be available.[80]

Referring to the structure of section 105, the *Caplin* court noted that the threshold question, prior to addressing any section 105(c) issues, is whether a "plan" exists.[81] Acknowledging that Treasury Regulation section 1.105-5 is general and allows virtually everything to

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71. *Id.* at 545.
72. *Id.*
73. *Id.*
74. *Id.* at 547.
75. *Id.*
76. *Id.* at 548.
77. *Id.*
78. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 203 (3d ed. 1976) defines "beneficiary" as "the person named (as in an insurance or annuity policy) as the one who is to receive proceeds or benefits accruing." *Id.*
79. *Caplin*, 718 F.2d at 548.
80. Presumably in recognition of these and other differences, Congress has enacted an entirely different section pertaining to profit-sharing plans. *See* 26 U.S.C. § 402 (1982).
81. *Caplin*, 718 F.2d at 547. 26 U.S.C. § 105(a) (1982) states:

> Except as otherwise provided in this section, amounts received by an employee through an accident or health insurance plan for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

qualify as an accident or health plan,[82] the court decided to formulate its own guidelines to determine whether a plan actually is an accident or health plan for purposes of section 105.[83]

In searching for the plan's true purpose,[84] the *Caplin* court looked for the following general indicia: (1) a preamble to the plan which states that its purpose is to qualify as an accident or health plan;[85] (2) an announcement that the benefits payable under the plan are eligible for tax exclusion;[86] (3) a statement that the plan will reimburse the employee for certain medical expenses incurred;[87] and (4) a schedule listing pre-determined amounts of compensation for specific injuries incurred, such as loss of a leg or an arm.[88] While the court emphasized that including these provisions in a plan does not guarantee that it qualifies as an accident or health plan, their absence "plainly militates" against finding that the plan in question serves as an accident or health plan.[89] In *Caplin*, the court held that the benefits received by the petitioner were not eligible for exclusion under section 105(c) because the indicia were not present, and, therefore, the plan failed to qualify as an accident or health insurance plan.[90] Instead, the plan resembled a profit-sharing plan for employees of the company.[91]

Both the holding and the reasoning of the *Caplin* court faithfully serve the intent of Congress in enacting section 105.[92] Its judicial

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Id. See also American Foundry v. Commissioner, 536 F.2d 289 (9th Cir. 1976); Larkin v. Commissioner, 394 F.2d 494 (1st Cir. 1968); Kaufman v. Commissioner, 300 F.2d 128 (6th Cir. 1962); Priv. Ltr. Rul. 8,728,031 (Apr. 13, 1987); Comment, *Taxation of Employee Accident and Health Plans Before and Under the 1954 Code*, 64 YALE L.J. 222, 231 (1954) ("[I]f an arrangement fails to constitute a 'plan for employees,' the exemptions granted by . . . [Section] 105 will be lost unless the arrangement independently qualifies as 'insurance.' ") *Id.* (citation omitted).

82. *Caplin*, 718 F.2d at 549. *See also American Foundry*, 536 F.2d at 293.

83. *Caplin*, 718 F.2d at 549. *See infra* notes 85-101 and accompanying text.

84. *Caplin*, 718 F.2d at 549. *See also* Sidman v. United States, 336 F. Supp. 474 (S.D.N.Y. 1971). The court stated that, "[a]t the least, a 'plan' must contain the general indicia of insurance — that is, a contract by which one party undertakes to indemnify another against loss arising from an unknown or contingent event." *Id.* at 476 (citation omitted).

85. *Caplin*, 718 F.2d at 549.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. The *Caplin* court is not the only court to faithfully adhere to the congressional intent underlying § 105 and question whether the plan which generated the payments is truly an accident or health insurance plan. *See* American Foundry v. Commissioner, 536 F.2d 289 (9th Cir. 1976); Larkin v. Commissioner, 394 F.2d 494 (1st Cir. 1968); Kaufman

skepticism reflects well-grounded congressional concerns. Many plans are not accident or health plans but suddenly transform into such when the taxpayer attempts to exclude payments under section 105(c).[93] To "rubber-stamp" all payments made after a disability would open the door to substantial abuse of the privilege. Significant dividends or deferred compensation could be transferred tax-free in the form of putative health or disability benefits,[94] which Congress did not intend when it enacted section 105(c).[95]

The *Caplin* decision created what appropriately is known as the "*Caplin* analysis," which courts and the IRS now employ in determining what qualifies as an accident or health plan.[96] This analysis is

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v. Commissioner, 300 F.2d 128 (6th Cir. 1962); Bogene, Inc. v. Commissioner, 27 T.C.M. (CCH) 730 (1968); Priv. Ltr. Rul. 8,728,031 (Apr. 13, 1987).

93. *Caplin*, 718 F.2d at 548.

94. *American Foundry*, 536 F.2d at 293.

95. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 15, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4645; *see also* Hines v. Commissioner, 72 T.C. 715, 718-19 (1979) ("The intent was to provide a tax benefit to one who receives a severe physical injury which permanently and significantly lessens the quality of life which he had enjoyed prior to the injury.").

Treas. Reg. § 1.105-5(a) (1987) states that the plan does not have to be transcribed but also can be oral. With this in mind, and the fact that the "*Caplin* analysis" and its examination of various indicia can be applied only to written plans, there also are requirements for the informal, unwritten plan. Essentially, courts will search for an established practice or custom within the business which has the effect of a plan. For instance, the court may examine whether it is stated in the corporate minutes, Bogene, Inc. v. Commissioner, 27 T.C.M. (CCH) 730, 733 (1968), whether the employee knew of the plan's existence before payments were made, Greer v. Commissioner, 70 T.C. 294 (1978), or whether it has been the employer's practice in the past to pay employees who incur serious injuries or disabilities, Estate of Kaufman v. Commissioner, 35 T.C. 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962); *see also Greer*, 70 T.C. at 301 (because the use of corporate aircraft for medical reasons was available to all employees of the corporation and requests for such use never had been denied, "a 'policy or custom' existed which had the effect of [a] plan.") *Id.* Absent such instances, the courts are extremely reluctant to find that there is a plan. *See* Larkin v. Commissioner, 394 F.2d 494 (1st Cir. 1968).

96. *See supra* note 95. *See* Rosen v. United States, 646 F. Supp. 97 (W.D. Va. 1986), *rev'd*, 829 F.2d 506 (4th Cir. 1987). In *Rosen*, the petitioner was employed as an executive for Warner Communications, Inc. Shortly after commencing work with Warner, the taxpayer suffered a horse-riding accident, resulting in serious physical and neurological damage that prevented him from ever returning to work. *Id.* at 508. His employment contract with Warner contained a specific provision outlining the terms of benefits that the petitioner would receive in the circumstance of permanent injuries and inability to function in an executive capacity with the company. *Id.* Due to the severity of his injuries, the petitioner qualified for payments under the provision and received payments of $282,550.00 in 1977 and $183,691.44 in 1978. *Rosen*, 646 F. Supp. at 98. The petitioner paid taxes on these amounts and then filed a claim for a refund, maintaining that the payments were excludible under § 105(c). The IRS denied the refund claim and the taxpayer brought suit in district court. *Rosen*, 829 F.2d at 508. The district court ruled that the compensation received by the petitioner qualified for exclusion under § 105, stating that the § 105 determination rests upon the actual disability incurred and not upon the terms of the underlying

fairly simple for the IRS to apply and for the taxpayer and employer to satisfy. The plan must state that it serves as an accident and health plan,[97] that the benefits are excludible from gross income,[98] that medical expenses related to the injury are covered by the plan,[99] and that an accompanying schedule relates payments to the nature of the injury.[100] These "indicators" are clear, easy to follow, and faithful to the congressional purpose.[101]

B. Hines v. Commissioner—*"Function of the Body"*

Section 105 (c)(1) requires that the payment from a qualified plan must be for the "permanent loss or loss of use of a member or function of the body."[102] Although the "permanent loss or loss of use of a

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plan. *Rosen*, 646 F. Supp. at 99. In the view of the district court, where the triggering event leading to the distribution of benefits is a permanent disability, the entire distribution is eligible for exclusion under § 105, regardless of the terms of the underlying plan. *Id.* at 100.

The Fourth Circuit Court of Appeals reversed, stating that the lower court's analysis "generally ignored the significance of the governing agreement in determining whether payments were excludible under section 105(c)." *Rosen*, 829 F.2d at 509. While admitting that the permanency of the disability must be considered, the court emphasized that this was not the determinative factor. Instead, reaffirming *Caplin*, the court held that the plan requirement that the payment come from an accident or health insurance plan first must be satisfied. *Id.* The court of appeals concluded that the petitioner's plan failed to satisfy this requirement in several ways. First, the contract provided benefits only if the employee was absent from work for a six-month period. *Id.* at 510. It contained no requisite that the injury be permanent, and it failed to contain a schedule of payments which would reflect the nature of the injury. *Id.* Thus, although the payments were for the permanent injuries suffered by the petitioner, they were not excludible under § 105(c) because they did not come from an accident or health plan.

See also Gordon v. Commissioner, 88 T.C. 630 (1987). Relying upon the analysis established in *Caplin*, the Tax Court denied the petitioner's claim because the profit-sharing plan in question failed to include any of the indicia qualifying it as a dual-purpose plan. *Id.* at 638-40. *See also* Priv. Ltr. Rul. 8,728,031 (Apr. 13, 1987). Applying the "*Caplin* analysis," the IRS refused to allow a § 105(c) exclusion of benefits because the plan failed to state a goal to provide health care and security for employees and failed to provide specific compensation for certain injuries. Further, the employee's absence from work also was a requisite to receiving payments. Therefore, the IRS determined that the plan was not a dual-purpose plan, and the benefits generated from it could not be excluded from gross income. *Id.*

97. *Caplin*, 718 F.2d at 549.

98. *Id.*

99. *Id.*

100. *Id.*

101. As stated in *Caplin*, inclusion of these various indicia by no means automatically qualifies the plan's benefits for exclusion. However, the absence of these indicia is a clear signal to the court that an appropriate plan does not in fact exist. *Id.*

102. 26 U.S.C. § 105(c)(1) (1982); *see* Laverty v. Commissioner, 61 T.C. 160 (1973). The " 'loss or loss of use of a member or function of the body' must be the cause of the payment." *Id.* at 167 (quoting 26 U.S.C. § 105 (c)(1) (1982)).

member" is well understood,[103] the meaning of loss of use of a "function of the body" is less clear. Given the lack of a statutory definition,[104] an unhelpful legislative history,[105] and an inadequate Treasury Regulation,[106] the IRS and the courts have defined "loss of function" on a case-by-case basis.[107] The test which has evolved from these decisions is questionable, leading one to inquire whether there can be a viable definition for "loss of body function."

In Revenue Ruling 63-181,[108] petitioner, terminally ill with cancer, was forced to retire and received disability benefits.[109] Relying on competent medical authority, the IRS permitted him to exclude these benefits because his disease resulted in the complete loss of all bodily functions.[110] The IRS noted that when determining whether payments qualify for exclusion, all of the facts and circumstances of each case must be considered.[111] As later court decisions show, however, expert medical opinion proving loss of body function is, in and of itself, insufficient to satisfy section 105(c)(1).[112] The taxpayer also must prove that the lost "function" was a significant one, upon which he or she heavily relied. In *Hines v. Commissioner*,[113] a commercial airline pilot suffered a heart attack and consequently his commercial pilot's

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103. BLACK'S LAW DICTIONARY 887 (5th ed. 1979) defines "member" as "[a] part or organ of the body; especially a limb or other separate part." *Id. See* California Casualty Indem. Exch. v. Industrial Accident Comm. of Cal., 13 Cal. 2d 529, 531-33, 90 P.2d 289, 290-91 (1939) (court held that eye-glasses were not artificial "members" of the body and, therefore, injury to them is not compensable under workmen's compensation acts).

104. *See* 26 U.S.C. § 105(c)(1) (1982).

105. *See supra* notes 49-50, 56-58 and accompanying text.

106. Treas. Reg. § 1.105-3 (1987) states:

> For purposes of section 105(c), loss or loss of use of a member or function of the body *includes* the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears.

Id. (emphasis added).

107. *See* Watts v. United States, 703 F.2d 346, 350 (9th Cir. 1983) ("[W]hether the section 105(c) exemption applies to payments received by an employee depends upon all the facts and circumstances in each case."). *Id.* (citing Rev. Rul. 63-181, 1963-2 C.B. 74, 75).

108. Rev. Rul. 63-181, 1963-2 C.B. 74.

109. *Id.*

110. *Id.* The medical expert consulted in this particular case stated that petitioner's cancer gave him a life expectancy of only a few months and was so acute that it rendered him totally disabled. *Id.* at 74-76.

111. *Id.* at 75.

112. *See* Watts v. United States, 703 F.2d 346 (9th Cir. 1983). In *Watts*, the petitioner submitted an affidavit of his personal physician stating that his "loss" constituted a loss of body function. The court ruled this was insufficient and that petitioner must establish a permanent loss of body function. *Id.* at 352-53. *See also* Hines v. Commissioner, 72 T.C. 715 (1979). *See infra* notes 117-34.

113. 72 T.C. 715 (1979).

license was revoked.[114] The petitioner received benefits from his employer's disability plan[115] which he attempted to exclude from his gross income under section 105(c).[116] To show that the payment was for the "permanent loss . . . of a function of the body," petitioner presented expert medical opinion that his heart attack destroyed muscle tissue and that part of the heart's function was lost permanently.[117] The Tax Court denied his claim stating that Hines' liberal (and literal) interpretation of the word "function" would "circumvent the purpose of the statute,"[118] which is to provide some form of relief to the person who suffers a serious physical injury which significantly affects the quality of life enjoyed prior to the injury.[119]

In adopting a restrictive definition of "loss of body function," the IRS and the courts distinguish between loss of body function and loss of work function. It is not enough for the taxpayer to establish a permanent loss of body function. Instead, he or she also must show an inability to perform in the same capacity as prior to the injury, *and* that it is an injury which is serious enough to affect his or her lifestyle adversely.[120] As one court stated, "[i]t is quite possible for one to lose the capacity to function in a particular work setting without one's body losing the capacity to function in some manner."[121] The *Hines* court emphasized the fact that the petitioner continued to live a normal life,[122] and simply because he could not continue as a commercial airline pilot did not mean that he could not engage in other gainful activity.[123]

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114. *Id.* at 716. "[Federal Aviation Administration] regulations permanently disqualify an individual for the position of pilot if he has a history of heart attack, irrespective of the degree of recovery and subsequent freedom from symptoms." *Id.*

115. *Id.* To be eligible for benefits under the employer's disability plan, a pilot member must be incapacitated for fourteen consecutive months. An incapacitated member was defined in the plan as having a physical or mental disability or condition such that he was unable to hold an FAA medical certificate needed to serve in the capacity and status in which he was serving at the time of the incapacity. *Id.*

116. *Id.* at 716.

117. *Id.* Petitioner's personal physician also stated that petitioner was highly susceptible to another, more severely disabling heart attack. *Id.*

118. *Id.* at 719.

119. *Id.* at 718-19.

120. *Id.* at 719. *See infra* notes 123-28 and accompanying text.

121. Watts v. United States, 703 F.2d 346, 352 (9th Cir. 1983).

122. *Hines*, 72 T.C. at 719.

123. *Id.* at 720. *See also* Watts v. United States, 703 F.2d 346 (9th Cir. 1983), in which the petitioner was forced to retire from his job due to high blood pressure and excessive hypertension, and then attempted to exclude the benefits that he received at his retirement. The court rejected his claim stating that he may have lost that particular work function but he still was able to engage in other work where the pressure would not be so great and the petitioner's symptoms would not be aggravated. *Id.* at 351-52.

In an attempt to formulate a test to determine what qualifies as a "function of the body," judicial and IRS decisions[124] are consistent with the congressional intent underlying section 105; all have a restrictive interpretation which prevents those suffering a minor injury from benefiting from a privilege reserved for those suffering serious physical injuries.[125] However, this analysis is inconsistent with Congress' intent when it enacted the original exclusion statute, section 213(b)(6) in 1918,[126] to provide some form of relief to those who experience pain and suffering as a result of sustaining permanent injuries.[127] The result is that this particular "function" test is unpredictable and, at times, may be violative of congressional intent.

The "function" test established by the Tax Court in *Hines* is proper in that it will preclude the taxpayer with the very minor injury from escaping taxation through a loophole. For example, a person who loses her small toe in an accident is still capable of walking and running and is not hindered in any significant way. Section 105(c) was not intended to provide for her. However, the test disserves the original purpose of the statute by preventing a taxpayer with a more significant injury from excluding disability benefits from gross income. In *Hines*, the court denied the petitioner's claim because the loss of muscle tissue did not adversely affect his lifestyle, and he still possessed the ability to pursue gainful employment in some other area.[128] Granted, Hines is able to pursue other employment, but the additional requirement that the loss must "adversely affect" the taxpayer's lifestyle is inconsistent with the interpretative scheme which Congress envisioned when it enacted the first exclusion statute in 1918. Congress added these requirements in 1954 to restrict the use of section 105 for purposes of preserving it. Yet, to interpret these new requirements to mean that the injured taxpayer's lifestyle must be adversely affected in order to exclude disability benefits from gross income restricts the use of section 105 far beyond what Congress had intended. If the *Hines* court was somehow fearful of potential abuse of the exclusion privi-

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124. *See* Watts v. United States, 703 F.2d 346 (9th Cir. 1983); Hines v. Commissioner, 72 T.C. 715 (1979); Berner v. United States, 81-2 U.S. Tax Cas. (CCH) § 88,468; Rev. Rul. 63-181, 1963-2 C.B. 74.

125. *See supra* notes 52-67 and accompanying text.

126. *See supra* notes 17-24 and accompanying text.

127. *See supra* notes 17-21 and accompanying text.

128. *Hines*, 72 T.C. at 719-20; *see also Watts*, 703 F.2d at 352. ("It is quite possible for one to lose the capacity to function in a particular setting without one's body losing the capacity to function in some manner. The terms 'work' and 'body' simply are not synonymous—they have different definitions.").

lege, the requirements added by Congress in 1954 ensure that taxpayers cannot take unfair advantage of section 105(c).

In *Hines*, subsequent to his attack, the petitioner was no longer eligible to be licensed as a commercial airline pilot.[129] The Tax Court stated that the petitioner's loss was minor and that he could continue to live a normal life and pursue other means of employment, concluding that the loss would not have an adverse effect upon his lifestyle.[130] Yet, in a profession such as his, there is a significant chance that such a loss would have an adverse effect upon his lifestyle. For purposes of showing the approach's fallibility, assume that Hines' annual salary as an airline pilot was $120,000.00. Unable to pilot again, he is now required to search for new employment. Based on his previous work experience, he might be qualified for the position of cargo dispatcher which may pay an annual salary of $30,000.00. Undoubtedly, to be forced into such a position would have a serious effect upon the lifestyle which the taxpayer previously enjoyed, forcing him to adapt to an entirely new lifestyle due to a significant decrease in income.

As another example, consider the case of a surgeon specializing in a field requiring a significant amount of training and expertise. If the surgeon suffered some type of permanent nerve damage to her hands, depriving her of only a slight degree of manual dexterity, she likely would be forced to retire from surgery. Under the *Hines* approach, she could not exclude the disability benefits received under an accident or health plan because the injury would be deemed comparatively minor and the physician would be able to operate a diagnostic medical practice. From the physician's standpoint, however, the relatively minor loss of nerve function is absolutely devastating, signifying the loss of a skill which took years to acquire and master, forcing retirement from one's chosen work, and causing a significant loss of future income. Therefore, injuries which may appear minor to a court applying the *Hines* test may be major injuries to the taxpayer, the person section 105 is intended to serve.

The inequitable consequences which may result from applying the *Hines* approach exemplify the difficulties of formulating an approach which consistently can be true to both the general purpose of the exclusion privilege, to provide for those who suffer a permanent disability, and the specific purpose of section 105(c), to restrict the use of the exclusion and to preserve it for those whom it was intended to serve. The *Hines* approach will be true to the specific purpose in every

129. *Hines*, 72 T.C. at 716.
130. *Id.* at 719-20.

instance because it will effectively weed out fraudulent claims. However, in certain instances, the *Hines* court's myopic view of what constitutes an injury adverse to one's lifestyle may prevent the fair application of section 105(c) to disability benefits. Hence, the courts may violate the general purpose by preventing a taxpayer who is experiencing pain and suffering from excluding from gross income any disability benefits that he or she receives.

Although the holding in *Hines* may be incorrect, the approach which the *Hines* court formulated is a step in the right direction. The goal is to build from this approach and to formulate an analysis which can serve both purposes of section 105 in every instance. Considering the individual factors involved in each case, it appears that a uniform "function of the body" test would be impossible to effectuate, because it would discriminate against some claimants with legitimate injuries. Thus, the solution to the problem is to analyze each of these individual factors carefully, a solution that will consume both time and money but which is necessary to administer section 105 properly.

C. *Section 105(c)(2)—"Computed With Reference to the Nature of the Injury"*

Subsection (c)(2) of section 105 presents the final requirements which the taxpayer must satisfy in order to exclude disability benefits from gross income. This subsection requires that the payments made to the disabled taxpayer must be computed: (1) "with reference to the nature of the injury," and (2) "without regard to the period the employee is absent from work."[131] The purpose of these two requirements is to prevent the taxpayer from excluding those payments which actually are compensation for lost wages and not compensation for permanent disabilities. Thus, subsection(c)(2) plays an important role in properly restricting the use of the exclusion to those who receive compensation as a result of a permanent disability.

The second requirement of section 105(c)(2), that "payments must not be computed with regard to the employee's absence from work,"[132] means that payment of the benefits cannot be conditional upon the employee's not returning to work.[133] A plan that pays bene-

131. 26 U.S.C. § 105(c)(2) (1982).

132. *Hines*, 72 T.C. at 720.

133. *See In re* Maller, 53 Tax Ct. Mem. Dec. (P-H) § 84,614, at 84-2497 (1984); Christensen v. United States, 86-1 U.S. Tax Cas. ¶ 9254 (D. Minn. 1986); *see also* Rev. Rul. 74-603, 1974-2 C.B. 35. In *Christensen*, the petitioner, who was 50 years old, was forced to retire because of total blindness. Under his employer's accident and health plan, he was offered a lump-sum payment in lieu of the remaining payments he was to receive until he

fits *only* if the employee stays out of work fails this test because the payments are contingent upon the employee's period of absence from work.[134]

Section 105(c)(2) also requires that the benefits must vary according to the type of injury received.[135] To satisfy this subsection, the accident or health plan must use different benefit scales to determine the amount of benefits available for differing injuries.[136]

Section 105(c)(2) prohibits the taxpayer from excluding benefits which may, in reality, be compensation for lost wages or a payment from a profit-sharing plan. Thus, this part of the statute is integral in achieving Congress' desire that the taxpayer only be allowed to exclude benefits received because of a permanent disability. However, strict judicial and IRS interpretations of this section of the statute present some difficulties.

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reached the age of 65. The petitioner accepted the payment. The IRS held that the payment was not excludible because it was computed with reference to the period taxpayer would be absent from work. *Id.* at 36. *Accord* Gen. Couns. Mem. 35,970 (Aug. 29, 1974). The IRS stated that this case is distinguishable from Rev. Rul. 63-181, 1963-2 C.B. 74 because in Rev. Rul. 63-181 the payment to petitioner was computed with reference to the nature of the injury and not with respect to the petitioner's absence from work as was done here. Gen. Couns. Mem. 35,970 (Aug. 29, 1974).

134. Gen. Couns. Mem. 38,477 (Aug. 15, 1980). Because one of the provisions of petitioner's plan called for the termination of disability benefits if petitioner returned to work, the IRS concluded that the benefits were computed with regard to employee's absence from work and denied his § 105(c) claim. *Id.* *See also* Tech. Adv. Mem. 8,430,003 (Mar. 28, 1984). Due to his multiple sclerosis, the petitioner lost the use of his legs and received payments under his employer's commercial insurance policy. In ruling that the benefits were excludible under § 105(c), the IRS stated that the payments satisfied the requirement of "unrelated to absence from work" because the petitioner continued to work while receiving the payments. *Id.*

135. The *Hines* court decided the petitioner's claim on the issue of whether his loss met the requirements of § 105(c)(1). Hines v. Commissioner, 72 T.C. 715, 719 (1979). *See supra* notes 113-30 and accompanying text. However, in dicta, the court noted that the petitioner's plan also failed to satisfy the requirements of § 105(c)(2) because of its failure to vary benefits according to the type of injury received (i.e., a pilot who suffers a heart attack and a pilot who loses a limb both collect the same amount of benefits). *Id.* at 720.

136. For example, if the plan states that an employee suffering a career-ending heart attack receives "X" amount of dollars and an employee who loses a leg receives "Y" amount of dollars, the plan satisfies this requirement. The Senate Committee Report offered an example of a hypothetical plan which would satisfy the requirements of § 105(c):

> The following examples will illustrate the kind of payments excludible from gross income under [§ 105(c)]. Assume that under the plan of an employer payments equal to 25 percent of annual compensation are made to employees for loss of a leg. The $10,000 employee would therefore receive a payment of $2,500 and the $4,000 employee would receive a payment of $1,000. These amounts would be excludible from gross income if, under the plan, they are payable regardless of the period that the employee is absent from work.

S. REP. NO. 1622, 83d Cong., 2d Sess. 105, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4820.

IV. INTERPRETATION OF SECTION 105(C)(2)—BEYOND CONGRESSIONAL INTENT

A. Beisler v. Commissioner

While the courts and the IRS generally are justified in interpreting section 105 in a restrictive fashion, they occasionally apply an overly-restrictive test and overstep the boundaries which Congress has defined. A recent decision of the Ninth Circuit Court of Appeals, *Beisler v. Commissioner*,[137] is such a case.

In *Beisler*, the en banc court affirmed the Tax Court and panel denial of a section 105 exclusion claim.[138] The petitioner Randall Beisler played professional football from 1966 to 1975.[139] In 1975, while playing for the Kansas City Chiefs, Beisler suffered an injury that caused him to lose sixty to seventy-nine percent of the use of his neck.[140] His doctors advised him to stop playing football and to avoid strenuous labor for the remainder of his life.[141]

The National Football League (NFL) provides for injured players through the Bert Bell National Football League Retirement Plan (NFL Plan) which compensates players who incur a "substantial disablement" while playing in an NFL game.[142] Under the NFL Plan, a player who incurs a "substantial disablement" may receive, for up to sixty months, a monthly "line-of-duty" disability benefit calculated with respect to the player's accumulated benefit credits.[143] Following the approval of his application for "line-of-duty" disability benefits, Beisler received a total of $47,475.00 in payments from the NFL Plan

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137. 814 F.2d 1304 (9th Cir. 1987).

138. Beisler v. Commissioner, 49 T.C.M. (CCH) 534 (1985), *aff'd*, 787 F.2d 1325 (9th Cir. 1986).

139. *Beisler*, 814 F.2d at 1305.

140. *Id.*

141. *Id.*

142. *Id.* at 1305-06. A "substantial disablement" is defined by the NFL Plan as a permanent disability which:

> (A) Results in a partial bodily disability of 50% or more, or the loss of 50% or more of speech or sight; or 50% or more loss of use of the neck or back; or
> (B) Results in 60% or more loss of use of the hearing or an arm, shoulder, leg, or hip; or
> (C) Results in 80% or more loss of use of a hand, wrist, elbow, foot, ankle or knee; or
> (D) Is the primary or contributory cause of the surgical removal or major functional impairment of a vital bodily organ or part of the central nervous system.

Id. at 1306 n.1.

143. *Id.* at 1305-06. The following table, derived from Article 4.1 of the NFL Plan, shows the amount of Benefit Credits accrued by an eligible player for each credited season from 1966 to 1975.

in 1979, $10,552.00 of which he reported as pension income for that year.[144] The Commissioner of the IRS assessed a deficiency in Beisler's income tax in 1979 in the amount of $9,291.18 and an additional tax of $478.06 under section 6653(a) of the Internal Revenue Code.[145] Beisler paid the tax and appealed to the Tax Court for a refund, alleging that the NFL payments were eligible for exclusion under section 105(c). The Tax Court ruled that the entire amount constituted income for tax purposes and denied the refund.[146] On appeal, in both its panel and en banc decisions, the Ninth Circuit Court of Appeals affirmed the Tax Court decision and denied Beisler's claim for exclusion.[147]

In its en banc decision, the *Beisler* court acknowledged, but did not apply, the standard three-part test which a taxpayer must satisfy in order to exclude disability benefits under section 105(c):[148] (1) that the amount received was paid through an accident or health insurance plan;[149] (2) that the amount "constitute[s] payment for the permanent loss or loss of use of a member or function of the body;"[150] and (3) that the amount is "computed with reference to the nature of the injury without regard to the period the employee is absent from work."[151] Relying on dicta in the earlier Tax Court decision of *Hines v. Commissioner*,[152] the court denied Beisler's exclusion because the

Credited Season	Benefit Credit
1966	$ 65
1967	65
1968	85
1969	85
1970	100
1971	105
1972	110
1973	110
1974	110
1975	110

Beisler, 49 T.C.M. (CCH) at 536 n.4.

144. *Beisler*, 49 T.C.M. (CCH) at 536.

145. *Id.* at 535.

146. *Id.* at 534.

147. *See* Beisler v. Commissioner, 787 F.2d 1325 (9th Cir. 1986), *aff'd on reh'g*, 814 F.2d 1304 (9th Cir. 1987).

148. *Beisler*, 814 F.2d at 1306.

149. *Id. See* 26 U.S.C. § 105(a) (1982).

150. *Id. See* 26 U.S.C. § 105(c)(1) (1982).

151. *Id. See* 26 U.S.C. § 105(c)(2) (1982).

152. 72 T.C. 715 (1979). Although the *Hines* court made its determination based on § 105(c)(1), it did comment on what was necessary to qualify under § 105(c)(2). *See Hines*, 72 T.C. at 720-21; *see supra* notes 113-30 and accompanying text.

NFL Plan failed to vary benefits according to the type *and* severity of the injury.[153]

The court emphasized that only when its expanded "nature of the injury" requirement is satisfied do the payments properly reflect an exclusively compensatory purpose, and only then may the benefits be excluded under section 105.[154] Although the NFL Plan contained a threshold disability definition that was based on the nature of the injury,[155] it failed the *Beisler* test, because it computed benefits for eligible beneficiaries solely on the basis of the number of seasons the player had been in the NFL.[156] Under the NFL Plan, the ten-year veteran player who has lost the total use of his leg and the ten-year veteran who has lost eighty percent use of his ankle would both receive the same amount of benefits, even though one injury is much more severe than the other. For this reason, the court held that Beisler could not exclude the benefits he received from the NFL Plan.[157]

From a purely textual standpoint, the *Beisler* court's ruling seems persuasive. Section 105(c)(2) explicitly states that the benefits paid from an accident or health insurance plan must be computed "with reference to the nature of the injury."[158] When the player satisfies the NFL Plan's eligibility requirement, the benefits he receives, in fact, are computed with reference to the number of the games he has played rather than with reference to the nature of the injury that he has incurred. Thus, the NFL Plan fails to comply with the literal meaning of section 105(c)(2).

The *Beisler* court, however, did not pursue this line of reasoning when it denied Beisler's exclusion. The court ignored the legislative intent to provide some form of relief to those who are injured permanently,[159] and added "severity" to the requirement that benefits be computed with reference to the nature of the injury. However, a "se-

153. *Beisler*, 814 F.2d at 1307. Because the court decided the issue solely on this point, it refused to offer an opinion on whether the NFL Plan satisfied the traditional three-part test. *Id.*

154. *Id.* at 1308.

155. *See supra* note 142. In order to qualify for benefits, the player must experience a specified percentage loss or loss of use of the injured area. For instance, a player suffering a leg injury must lose at least sixty percent of the leg's use in order to be eligible. Thus, the player who loses his leg, a one-hundred percent or total loss, and a player who retains forty percent use of his leg are both within the same category.

156. *Beisler*, 814 F.2d at 1309.

157. *Id.*

158. *See* 26 U.S.C. § 105(c)(2) (1982).

159. The purpose of the original exclusion statute, § 213(b)(6), a purpose which Congress has retained, was to provide some form of relief to those who suffer from pain associated with a permanent injury. *See supra* notes 17-21 and accompanying text.

verity" requirement is not based upon legislative history or statutory language, but upon the court's belief that the NFL Plan payments were inherently unfair and favored those players who incurred less severe injuries. The court did not question the NFL Plan's threshold eligibility requirement. It denied the exclusion because, under the payment system established by the NFL Plan, a player who becomes a quadriplegic as a result of an injury and a player who loses eighty percent of the use of his hand could both receive the same amount of benefits. Yet, the NFL Plan does not compensate for every single injury that occurs; only those persons with injuries that satisfy the definition of "substantial disablement" will be compensated.[160]

As stated above, subsection (c)(2) requires, in part, that disability payments be "computed with reference to the nature of the injury."[161] In total, subsection (c)(2) is intended to preserve the exclusion only for permanent disability benefits. This requirement therefore prevents a taxpayer from excluding compensation for lost wages under section 105(c).[162] Prior to *Beisler*, this requirement was interpreted to mean that the payments must vary according to the type of injury received,[163] an interpretation that was more than adequate in achieving Congress' desire that the use of the exclusion privilege be restricted to those who suffer permanent disabilities.

The *Beisler* court, however, has unnecessarily added a further requirement to this test. According to the court, the payments now must be computed with reference to the *severity* of the injury as well as with reference to the nature of the injury.

The "*Beisler* test" of severity cannot be justified.[164] The word "severity" never is mentioned in the statute,[165] the corresponding

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160. *See supra* note 142.

161. 26 U.S.C. § 105(c)(2) (1982).

162. *See supra* notes 52-67 and accompanying text.

163. *See supra* notes 131-36 and accompanying text.

164. In his dissenting opinion, Judge Noonan stated that the majority's line of reasoning would be proper if § 105(c) stated that payments are excludible "if computed only in proportion to the severity of the injury and without regard to the number of years of service." *Beisler*, 814 F.2d at 1309 (Noonan, J., dissenting). However, § 105(c)(2) does not contain this language.

In addition to this, Judge Noonan supported his argument with the fact that payments from the NFL Plan would be reduced accordingly if workers' compensation payments were made to the player. Since workers' compensation statutes normally vary their benefits based on the degree of loss of bodily functions, payments under the NFL Plan would vary with the nature of the injury. *Id.* at 1310. Finally, Judge Noonan argued that to tax such payments is inconsistent with and contrary to the supporting legislative history. *Id.*

165. See *supra* text accompanying note 48 for the language of § 105(c).

Treasury Regulation,[166] or the legislative history accompanying section 105.[167] It is an addition which is unwarranted in light of the suitability of the test which it modified. The addition of "severity" by the *Beisler* court serves no other purpose than to unduly restrict the exclusion privilege far beyond what Congress intended.

One way to demonstrate the difficulties with the *Beisler* approach is to ask what more the NFL Plan could have done to satisfy the court and the IRS. The *Beisler* court indicated that a plan must have a schedule that tailors benefits to each specific injury.[168] Would *Beisler* have been decided differently if the NFL Plan provided a benefit scale which stated that a player who loses the total use of his legs and arms receives $10,010.00 and a player who loses seventy percent use of his neck receives $10,000.00? According to the *Beisler* court's reasoning, payments under such a benefit scale would qualify for exclusion. However, the number of differing disabilities resulting from a contact sport like football are far too numerous to "itemize" within a disability plan. Instead of cataloging every possible injury that a football player could incur, the drafters of the NFL Plan sensibly created four categories of permanent injuries. In order for the player to be eligible for benefits, the player's injury must fall within one of these categories, thus satisfying a threshold requirement. In this way, the NFL Plan met the section 105(c)(2) requirement that benefits be "computed with reference to the nature of the injury."[169]

The *Beisler* court's requirement that the payments be computed with reference to the "severity" of the injury is indicative of its displeasure with the NFL Plan only because of the chance that a severely injured player could receive less than a player who incurs injuries which are less severe.[170] To judge a section 105 claim in such a way not only is an injustice to the disabled taxpayer but also is inconsistent with Congress' intent when it enacted section 105. Congress does desire to have a restrictive interpretation of section 105. However,

166. *See* Treas. Reg. § 1.105-3 (1988).

167. *See supra* notes 49-50, 56-58 and accompanying text.

168. *Beisler*, 814 F.2d at 1308.

169. The dissent in *Beisler* argued that the use of the threshold requirement test in the NFL Plan satisfied the "computed with reference to the nature of the injury" requirement of § 105(c)(2) because it "relates the specific nature of the injuries to the payment of benefits." *Id.* at 1309-10 (Noonan, J., dissenting).

170. For example, a three year veteran player in the NFL who becomes a quadriplegic as a result of an injury suffered in an NFL game and a 10 year veteran who loses the use of 80% of his left hand would both qualify to receive benefits from the NFL Plan. However, under the NFL Plan, the player who lost 80% of the use of his hand would receive more disability compensation than the quadriplegic because the 10 year veteran has accumulated more benefit credits over the 10 year period. *See supra* notes 142-43.

before *Beisler*, such an interpretation had been established and served that purpose.

The effect of the *Beisler* decision is to restrict section 105's use unduly and, as a result, stifle Congress' intent that some form of relief be provided to those who suffer because of serious injury or disease. Randall Beisler is left with only twenty percent of the use of his neck, and all of his benefits are subject to taxation.

It is the judiciary's duty to interpret and apply the statutes and the laws which Congress enacts, but that duty is restricted by the will of Congress as expressed in the statute. Thus, it is the *Beisler* court's duty to ensure that the benefits are generated from an accident or health plan, that the payment represents compensation for a permanent loss, and that the payment is computed with reference to the nature of the injury. Prior to *Beisler*, satisfaction of these requirements was ensured through application of a series of tests. The *Beisler* court's addition of "severity" does nothing more than question the fairness of the payment, an inquiry which undoubtedly is outside the judicial prerogative established by Congress when it enacted section 105 in 1954.

V. CONCLUSION

Since the enactment of the original statute in 1918, Congress has retained the original purpose of the exclusion statute: to offer some form of relief to those who must endure the pain and suffering associated with permanent disabilities. Throughout the years, the statute has served that purpose well, but it also has experienced change in the wake of an additional congressional desire to preserve and protect this privilege. This additional purpose is served by section 105, which Congress enacted in 1954. In section 105, Congress included precise conditions which disability payments must satisfy before taxpayers can exclude such payments from their income. Since the enactment of section 105(c), Congress has not altered its language in any way. The judiciary and the IRS, however, have formulated and applied a series of tests, molded from their restrictive interpretation of the statutory language and the accompanying legislative history of section 105. The judicial creation of tests is not necessarily wrong nor violative of legislative intent. Indeed, some of the tests ensure the proper application of section 105, such as the test which the Court of Appeals for the Second Circuit created in *Caplin v. United States*.[171]

171. 718 F.2d 544 (2d Cir. 1983).

The *Caplin* court formulated an analysis which is restrictive and therefore protects section 105 from taxpayer abuse, thereby complying with the congressional intent of section 105.[172] Yet, the "*Caplin* analysis" still remains faithful to the purpose underlying the original exclusion statute, section 213(b)(6), to provide relief to those who are permanently disabled.

At other times, the IRS has formulated an approach which is of questionable validity but is not directly violative of congressional intent. For example, the approach which the Ninth Circuit Court of Appeals endorsed in *Hines v. Commissioner*[173] is consistent with the congressional intent underlying section 105(c). However, there are instances when the application of this approach may deny a legitimate claim by a disabled taxpayer because the loss of body function may not satisfy the IRS' standards or expectations. Despite these instances, both of the preceding approaches essentially are consistent with the statutory language and the legislative history of the statute.

However, the Ninth Circuit Court of Appeals in *Beisler v. Commissioner*[174] recently formulated a test which undoubtedly violates the very foundation section 105 evolved from.[175] The *Beisler* court created and applied a test which unnecessarily restricts the use of section 105, and, as a result, people who are permanently disabled and therefore within the class that Congress intended to provide for in 1918 are denied the right to exclude their disability benefits from gross income.

Prior to 1954, judicial and IRS applications of the exclusion statute, section 22(b)(5), were inconsistent and unpredictable. The IRS contradicted themselves numerous times with regard to what qualified as insurance.[176] This resulted in an untold amount of confusion and uncertainty. In 1954, Congress, out of necessity, intervened in order to squelch this uncertainty and confusion. The present pattern of quality of interpretation and tests, from good to questionable to bad, indicates that Congress should once again intervene and affirmatively act. Congress again should remind courts of the original purpose of the exclusion statute before they deny more legitimate section 105 claims.

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172. For a detailed discussion of the "*Caplin* analysis," see *supra* notes 84-101 and accompanying text.

173. 72 T.C. 715 (1979). *See supra* notes 113-30 and accompanying text.

174. 814 F.2d 1304 (9th Cir. 1987). *See supra* notes 137-70 and accompanying text.

175. *See supra* notes 17-24 and accompanying text.

176. *See supra* notes 25-45 and accompanying text.