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# YALE LAW & POLICY REVIEW

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## Using Insurance Law and Policy To Interpret the Tax Code's Loss and Medical Expense Provisions

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## INTRODUCTION

Nancy and Robert Madsen co-owned and operated the Pit Stop Bar & Grill in Cushing, Wisconsin from 1979 until 1982, when Robert intentionally set the tavern ablaze, destroying the establishment.<sup>1</sup> Nancy had no prior knowledge of her husband's plans, nor any involvement with the arson. On their joint income tax return, she deducted one-half of the loss resulting from the fire as a loss under Tax Code § 165,<sup>2</sup> reasoning that she owned one half of the property destroyed.<sup>3</sup> The Tax Court, however, could find no tax case law or IRS regulations on point, and instead disallowed the deduction on other grounds.<sup>4</sup>

Several years after *Madsen*, Louis Kaplow published an article recognizing that Tax Code § 165, which allows a deduction for losses, including losses from fire, and § 213, which authorizes deduction of medical expenses, constitute a free partial insurance scheme.<sup>5</sup> The taxpayer's co-pay amounts

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1. *Madsen v. Comm'r*, 57 T.C.M. (CCH) 1307 (1989).
  2. I.R.C. § 165(a) (2000) ("There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.").
  3. The parties agreed that Robert could not deduct his half. *Madsen*, 57 T.C.M. (CCH) at 1308.
  4. These grounds—that Madsen had a "reasonable prospect" of recovery against their insurer at the Wisconsin Supreme Court, and hence that the loss might be "compensated for by insurance or otherwise"—turned out to be an empty hope. See *Madsen v. Threshermen's Mut.*, 443 N.W.2d 311 (Wis. 1989) (denying review). The case law says nothing more about the history of Nancy and Robert Madsen, but there are indications that Nancy might have eventually gotten some recovery from the insurance company. See *Madsen v. Threshermen's Mut. Ins. Co.*, 439 N.W. 2d 607, 613-14 (Wis. 1989).
  5. Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991) (first recognizing that §§ 165 and 213 are a type of insurance and arguing for their abolition) [hereinafter Kaplow, *Deductions*]; see

to 100% minus the marginal tax rate, with deductibles (in the insurance sense of the word) applying to individual taxpayers in some situations.<sup>6</sup> This important insight provides a potential solution for cases such as *Madsen*, where no tax cases or regulations help resolve the issue. In these cases, the IRS and federal courts could draw upon the rich and well-developed insurance case law and scholarship.<sup>7</sup> In insurance law terms, Nancy Madsen faced the problems of an “innocent co-insured,” which have been addressed by multiple courts and commentators.<sup>8</sup> LexisNexis even has a subject header dealing with innocent co-insureds.<sup>9</sup>

Substantial sums of money can hang in the balance. Combined federal, state, and local marginal tax rates easily reach 50% for many individuals and corporations.<sup>10</sup> Without having paid any “premium,” taxpayers get this

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*also* Louis Kaplow, *Income Tax Deductions for Losses as Insurance*, 82 AM. ECON. REV. 1013 (1992) [hereinafter Kaplow, *Insurance*].

6. I.R.C. § 56(b)(1)(B) (2000) (Alternative Minimum Tax requires medical losses reach 10% of Adjusted Gross Income); *id.* § 165(h)(1) (\$100 limitation per casualty for individuals); *id.* § 165(h)(2) (individuals must exceed 10% of Adjusted Gross Income before deducting casualty losses); *id.* § 213(a) (individuals must exceed 7.5% of Adjusted Gross Income before deducting medical losses). The thresholds in § 165 do *not* apply for corporations or individuals engaged in trade, business, or for-profit transactions; viewed from a different perspective, the deductions are \$0. *Id.* § 165(c)(1)-(2).
7. For example, there have been treatises on insurance law since the nineteenth century. *E.g.*, ROBERT C. CUMMING & FRANK B. GILBERT, *THE INSURANCE LAWS OF THE STATE OF NEW YORK* (1899); CHARLES FRANCIS MORRELL, *INSURANCE: A MANUAL OF PRACTICAL LAW* (Adam Black & Charles Black eds., 1892).
8. *See, e.g.*, *Williams v. Auto Club Group Ins. Co.*, 569 N.W.2d 403 (Mich. Ct. App. 1997); *Watson v. United Servs. Auto. Ass’n*, 566 N.W.2d 683 (Minn. 1997); *Allstate Ins. Co. v. LaRandeau*, 622 N.W.2d 646 (Neb. 2001); Michael Vincent Laurato, Sr., *A Return to Innocence: One Good Reason (Along with Several Other Arguments) Why the Extension of Florida’s Innocent Co-Insured Doctrine Makes Good Public Policy Sense*, 7 FLA. COASTAL L. REV. 59 (2005); C.T. Newsum, *Haynes v. Hanover Insurance Co.: Good News for the Innocent Co-Insured*, 19 CREIGHTON L. REV. 1076 (1986); Leane English Cerven, Note, *The Problem of the Innocent Co-Insured Spouse: Three Theories on Recovery*, 17 VAL. U. L. REV. 849 (1983).
9. “Insurance Law > Property Insurance > Innocent Insured Parties.” Westlaw provides extensive coverage of innocent coinsured law via Key Number 217k2166 (acts of insureds).
10. I.R.C. § 11(b)(1) (West Supp. 2006) (top corporate tax rate is 35%); *id.* § 1(a) (top individual rate is 39.6%, with Bush’s tax cuts temporarily lowering this to 35%). State income taxes often add nearly 10% to this top marginal tax rate. *See* FED’N OF TAX ADM’RS, *STATE INDIVIDUAL INCOME TAXES* (Jan. 1, 2007),

insurance for free, with a “co-pay” as low as 50% applying.<sup>11</sup> Kaplow develops models showing how this free insurance discourages many from buying private insurance and creates a moral hazard.<sup>12</sup> While Kaplow suggests abolishing §§ 165 and 213,<sup>13</sup> this Note accepts the continued political vitality of these provisions and argues for using the law developed around private insurance to mitigate these problems and improve the functioning of this free insurance.

Part I of this Note gives a brief overview of §§ 165 and 213. Part II looks at a number of actual and hypothetical tax issues arising under these sections and shows how the application of insurance law principles leads to an equitable and efficient result. While this approach has great promise, it also has limitations. Part III examines three limitations of applying insurance principles in the tax context and explores what they reveal about the nature of §§ 165 and 213. Part IV considers the details of implementing this Note’s proposals, including its interaction with state law and its statutory basis. In light of Congress’s current push for additional tax revenues, Part V proposes a novel method for the IRS to increase revenues, using a legal tool often employed by private insurers: subrogation.

## I. BRIEF OVERVIEW OF SECTIONS 165 AND 213

### A. Section 165 Losses

The general rule of § 165 allows corporations and individuals to take “as a deduction any loss sustained during the taxable year and not compensated for by *insurance* or otherwise.”<sup>14</sup> This broad language encompasses a wide

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[http://www.taxadmin.org/fta/rate/ind\\_inc.html](http://www.taxadmin.org/fta/rate/ind_inc.html) (highest being California at 10.3%); FED’N OF TAX ADM’RS, RANGE OF STATE CORPORATE INCOME TAX RATES (Jan. 1, 2007), [http://www.taxadmin.org/fta/rate/corp\\_inc.html](http://www.taxadmin.org/fta/rate/corp_inc.html) (highest being Iowa at 12%).

11. For a taste of the philosophical justifications behind these deductions, see Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989). Note that the overall limitation on individuals’ itemized deductions in § 68 does not apply to the two sections covered in this Note. I.R.C. § 68(c) (2000).
12. See Kaplow, *Insurance*, *supra* note 5; see also Robert K. Lu, Note, *Gross Negligence and the Medical Expense Deduction*, 71 S. CAL. L. REV. 845 (1998) (showing how barring § 213 medical expenses deductions due to the taxpayer’s gross negligence would increase social well-being). Some have argued that the entire income tax acts as a form of consumption insurance. See Thomas J. Kniesner & James P. Ziliak, *Explicit Versus Implicit Income Insurance*, 25 J. RISK & UNCERTAINTY 5 (2002).
13. See Kaplow, *Deductions*, *supra* note 5, at 1509-10.
14. I.R.C. § 165(a) (2000) (emphasis added).

range of possible losses, and courts have filled in the residual meaning of “loss,” defining it as an “unintentional parting with something of value”<sup>15</sup> and “some specific, identifiable loss of assets.”<sup>16</sup> Although § 165 covers some losses for which one cannot traditionally buy insurance,<sup>17</sup> it explicitly covers many losses against which one can insure, including: theft,<sup>18</sup> disaster losses,<sup>19</sup> deposits at insolvent banks,<sup>20</sup> fire, storm, shipwrecks, and other casualties.<sup>21</sup> This Note addresses the jurisprudence around these areas where § 165 partially replaces private insurance.

This free insurance kicks in after the first dollar of loss for corporations, partnerships, and individuals engaged in a trade, business, or for-profit transaction.<sup>22</sup> In many circumstances, it prevents the capitalization<sup>23</sup> over many years of a current outlay that does not qualify as an “ordinary and necessary” expense.<sup>24</sup> Avoiding capitalization can result in substantial tax savings to business taxpayers due to the time value of money.

Section 165 has more limited benefits for individuals when involving property not connected with a trade, business, or for-profit transaction. First, taxpayers can only deduct losses beyond certain thresholds<sup>25</sup>: 10% of Adjusted Gross Income (AGI)<sup>26</sup> and \$100 “per casualty.”<sup>27</sup> Second, in order

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15. McDonald v. Comm’r, 139 F.2d 400, 402 (3d Cir. 1943); see also J.G. Boswell Co. v. Comm’r, 34 T.C. 539, 545 (1960) (“[P]etitioner must have suffered a ‘loss’ in the economic sense. Bookkeeping entries and paper losses are not sufficient.”).
  16. B & L Farms Co. v. United States, 238 F. Supp 407, 411 (S.D. Fla. 1965).
  17. See, e.g., I.R.C. § 165(f) (2000) (capital losses); *id.* § 165(g) (worthless securities); *id.* § 165(j) (losses on unregistered bonds); *id.* § 165(d) (gambling losses).
  18. *Id.* § 165(e).
  19. *Id.* § 165(i).
  20. *Id.* § 165(l). This can be viewed as supplementing FDIC insurance.
  21. *Id.* § 165(c)(3) (which applies to individual taxpayers not engaged in a trade, business, or for-profit transaction).
  22. *Id.* § 165(c)(1)-(2).
  23. *Id.* § 263.
  24. *Id.* § 162. Cf. David G. Coolidge, Note, *A Square Hole for a Square Peg: Section 165 and Environmental Cleanup Costs*, 14 VA. TAX REV. 779 (1995) (arguing for the use of § 165 to avoid capitalization of remediation expenses).
  25. These are effectively deductibles (in the insurance sense), but this Note avoids the term because of its distinct meaning in tax law.
  26. I.R.C. § 165(h)(2) (2000). Note that AGI is a taxpayer’s gross income minus certain adjustments to income, such as student loan interest, moving expenses, health savings accounts, and IRA contributions.

to qualify, losses must arise from “fire, storm, shipwreck, or other casualty, or from theft.”<sup>28</sup> Courts have interpreted the catch-all “other casualty” under the *ejusdem generis*<sup>29</sup> canon of statutory interpretation. For example, an early Second Circuit case reasoned that a negligent automobile crash bore sufficient similarity to shipwreck to qualify as an “other casualty.”<sup>30</sup> In general, courts will only allow an individual to deduct a loss not related to a trade, business, or for-profit transaction if it is “due to some sudden, unexpected, or unusual cause.”<sup>31</sup> Between this restriction, the 10% of AGI threshold, and \$100 “per casualty” minimum—all of which apply only to individuals outside the trade, business, and for-profit context—it is clear why § 165 has the largest benefit for business taxpayers. Since § 165 acts as a form of insurance for all taxpayers, however, the proposal in this Note would improve the jurisprudence applying to all.

### B. Section 213 Medical Deductions

Section 213’s deduction for medical expenses—not to be confused with the favorable tax treatment of employer-provided health insurance<sup>32</sup>—bears many similarities to the § 165 deduction. Like § 165, it excludes deduction of expenses “compensated for by insurance or otherwise.” While § 165 applies to both businesses and individuals, § 213 applies only to individuals, as corporations and partnerships do not themselves require medical or dental care.

Just as § 165 only allows deductions of losses beyond 10% of AGI outside the trade, business, or for-profit context, § 213 only allows deductions beyond 7.5% of AGI.<sup>33</sup> Commentators have noted that this free health insur-

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27. *Id.* § 165(h)(1). The opportunity cost of not taking the standard deduction, *id.* § 63(c), can add another threshold in some cases. As a separate matter, another threshold is *not* added the itemized deduction phaseout, *id.* § 68, which explicitly does not apply to § 165(c)(2)-(3). *Id.* § 68(c)(3).
  28. *Id.* § 165(c)(3).
  29. Latin for “of the same kind or class.” See BLACK’S LAW DICTIONARY 556 (8th ed. 2004) (“A canon of construction that when a general word or phrase follows a list of specifics, the general word or phrase will be interpreted to include only items of the same type as those listed.”).
  30. *Shearer v. Anderson*, 17 F.2d 995 (2d Cir. 1927).
  31. *Matheson v. Comm’r*, 54 F.2d 537, 539 (2d Cir. 1931).
  32. I.R.C. § 106(a) (2000) (“Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.”); see also *id.* § 105 (excluding from gross income amount received under health plans).
  33. *Id.* § 213(a) (2000). Under the Alternative Minimum Tax, the threshold is actually the same for both medical expenses and § 165 losses. *Id.* § 56(b)(1)(B)

ance might explain why many affluent taxpayers choose not to buy health insurance.<sup>34</sup> Even with its hefty co-pay and 7.5% threshold, this partial national health insurance program will cost the federal government approximately \$55 billion between 2006 and 2010.<sup>35</sup>

## II. EXAMPLES OF HOW INSURANCE LAW COULD HELP INTERPRET SECTIONS 165 AND 213

Many court decisions and internal IRS documents endeavor to properly apply §§ 165 and 213 in the numerous different situations where taxpayers use them to claim deductions. This Part considers a number of actual and hypothetical tax issues arising under these sections. It demonstrates how application of insurance law principles leads to equitable and efficient results more effectively than tax law could reach alone.

### A. Public Policy Reasoning

Courts have long recognized a “public policy” exception to the deductibility of a loss under § 165.<sup>36</sup> While Congress has acted affirmatively to curb judicial public policy discretion in other areas of tax law,<sup>37</sup> it seems quite

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(AMT requires reaching 10% of Adjusted Gross Income for medical losses). As with § 165, the opportunity to simply take the standard deduction, *id.* § 63(c), can impose an additional threshold on some taxpayers. As a separate matter, § 68, which phases out most itemized deductions for individuals, explicitly does *not* apply to § 213. *Id.* § 68(c)(1).

34. See Kaplow, *Deductions*, *supra* note 5; Kaplow, *Insurance*, *supra* note 5; see also Paul Fronstin, Employee Benefit Research Institute, Issue Brief, *Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 2006 Current Population Survey* (Oct. 2006), available at [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_10a-20061.pdf](http://www.ebri.org/pdf/briefspdf/EBRI_IB_10a-20061.pdf). Note that 5.4% of workers ages 16-64 who earn over \$100,000 have no health insurance. *Id.* at fig.20. There are undoubtedly other factors contributing to this surprising number, including free-lancers, risk-takers, and those with chronic medical conditions.
35. OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES ON THE BUDGET OF THE UNITED STATES GOVERNMENT 318 (2005) (tax expenditure item 110). Note that the tax expenditures budget reflects only the very limited expenditures for § 165(c)(3), *not* for all of § 165, since most losses are presumably seen as part of the baseline of normal income against which tax expenditures are measured. *Id.* at 319 (tax expenditure item 134).
36. See, e.g., *Hopka v. United States*, 195 F. Supp. 474 (N.D. Iowa 1961) (confiscated slot machines).
37. I.R.C. § 162 (2000), which covers “ordinary and necessary” business expenses used to be subject to a judicially-crafted public policy exception. See, e.g., *Tank Truck Rentals v. Comm’r*, 356 U.S. 30 (1958). Congress codified and limited judicial discretion over § 162 in 1969. Tax Reform Act of 1969, Pub. L. 91-172, 83 STAT. 549 (amending I.R.C. § 162(c) and adding §§ 162(f) and (g)).

content to let judges determine whether a § 165 deduction would frustrate public policy. The IRS, not surprisingly, has proclaimed its intent to take advantage of this leeway to maximize revenues.<sup>38</sup> Insurance case law also rests heavily on public policy reasoning, providing the IRS and federal courts with a great source of precedent and insight.

The Tax Court could have explicitly borrowed from insurance case law to justify its holding in *Blackman v. Commissioner*.<sup>39</sup> The taxpayer in that case returned from business in North Carolina and discovered that his wife had invited another man to move into their house in Baltimore. Outraged, he set his wife's clothes on fire on the kitchen stove, then doused the embers and headed out. Apparently having failed to douse the clothes properly, the fire spread to the rest of the house, destroying it.<sup>40</sup> Although the Tax Court found the taxpayer only had a *mens rea* of "grossly negligent,"<sup>41</sup> it nonetheless denied the deduction, referring vaguely to "the articulated public policy of Maryland against arson and burning."<sup>42</sup> The Tax Court nonetheless admitted that it was well-settled that "mere negligence" of the taxpayer should not bar a casualty loss deduction.<sup>43</sup>

Why does public policy require drawing the line at gross negligence, rather than at willful acts? Certainly nothing in the Tax Code suggests the result reached by the Tax Court, nor does Maryland's arson statute.<sup>44</sup> Insurance cases have long recognized the rule, grounded in public policy, that gross negligence provides an insurance company a defense against paying a claim.<sup>45</sup> The Tax Court could have simply reasoned that since the federal government acts as an insurer through § 165, it should also have this defense.

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38. Rev. Rul. 77-126, 1977-1 C.B. 47 (disallowing deduction for seized slot machines based on this legislative history).

39. 88 T.C. 677 (1987).

40. The taxpayer pled out to probation and got no jail time. *Id.* at 679.

41. *Id.* at 682.

42. *Id.*

43. *Id.* at 681 (citing *Anderson v. Comm'r*, 81 F.2d 457, 460 (10th Cir. 1936), and *Shearer v. Anderson*, 16 F.2d 995, 997 (2d Cir. 1927)).

44. Maryland's arson statute says nothing of gross negligence or a comparable *mens rea*. Rather it requires willfulness or malice. See MD. CODE ANN., CRIM. LAW §§ 6-101, 6-103 (LexisNexis 2006).

45. See, e.g., *Chandler v. Worcester Mut. Fire Ins. Co.*, 57 Mass. 328 (1849); *Hynds v. Schenectady County Mut. Ins. Co.*, 16 Barb. 119 (N.Y. Gen. Term 1852); see also *Orient Ins. Co. v. Cox*, 238 S.W.2d 757, 759 (Ark. 1951); *Dynasty, Inc. v. Princeton Ins. Co.*, 754 A.2d 1137 (N.J. 2000).



The IRS and courts have denied deductions under § 165 for all manner of forfeitures and other losses based on public policy considerations.<sup>46</sup> Denying a deduction is not troubling as long as the losses result from criminal activity. An extensive gray area remains, full of potential losses which did not arise from criminal behavior, but from circumstances that courts find repugnant. Here, the tax law can look for guidance from the case law around both types of insurance: first-party and third-party.

First-party insurance covers policyholders against losses to their own property. Tax law could draw from cases determining whether a first-party insurance contract covering the relevant loss would be unenforceable as against public policy.<sup>47</sup> Third-party insurance, such as automobile liability insurance or commercial general liability (CGL) insurance, covers payments that the policyholder must make to injured third parties. An extensive case law has developed to determine whether third-party insurance payments resulting from various actions would defeat public policy. For example, courts have long grappled with whether third-party insurance can and should cover behavior that merits punitive damages.<sup>48</sup> Tax law could benefit from the public policy-based reasoning expressed in these cases.

#### B. ISO Forms

Virtually all property and liability insurers offer the same contract language, which the Insurance Services Office (ISO)<sup>49</sup> creates and sells to insur-

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46. See, e.g., *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989) (“sharply defined national policy against the possession and sale of marijuana”); *Wood v. United States*, No. 02-21320-CIV-Huck/Turnoff, 2002 U.S. Dist. LEXIS 25361 (S.D. Fla. Dec. 17, 2002) (“smuggling freon and evading the excise taxes on it, not a perfectly legal business”); *Mazzei v. Comm’r*, 61 T.C. 497 (1974) (taxpayer swindled out of counterfeited currency); *Richey v. Comm’r*, 33 T.C. 272 (1959) (same).
47. E.g., *Gossett v. Farmers Ins. Co.*, 948 P.2d 1264, 1271 (Wash. 1997) (refusing to enforce contract for lack of insurable interest).
48. Compare *First Bank-Billings v. Transamerica Ins. Co.*, 679 P.2d 1217 (Mont. 1984), with *Hartford Cas. Ins. Co. v. Powell*, 19 F. Supp. 2d 678 (N.D. Tex. 1998). The issue of punitive damages and public policy should not be confused with the deductibility of punitive damages as business expenses under § 162. On that matter, see Rev. Rul. 80-211, 1980-2 C.B. 57.
49. ISO is a private company that serves virtually the entire property and casualty insurance industry, providing data, risk-management, legal, regulatory, and underwriting services. See Insurance Services Office, <http://www.iso.com> (last visited Dec. 12, 2007).

ers.<sup>50</sup> Commentators have noted that insurance contracts are not only contracts of adhesion, but also contracts of “*super-adhesion*.”<sup>51</sup> Not only do insurers offer contracts to consumers on a “take-it-or-leave-it” basis, but every insurance company also offers the same contract language, with small tweaks at most.

This coordination has many social benefits, especially reducing transaction costs, facilitating easy price comparisons, enabling standardized data collection, and leading to predictable case law.<sup>52</sup> These benefits explain why Congress exempted the insurance industry from most of the antitrust laws.<sup>53</sup> Indeed, even large corporations, which have the bargaining power and sophistication to demand custom language, rarely deviate from the standard ISO forms.<sup>54</sup>

The process of ISO form creation more closely resembles legislation than any traditional notion of contract formation.<sup>55</sup> The ISO has committees and subcommittees, and the form contracts go through multiple draft revisions with extensive input and commentary from consumer groups, industry players, and state regulators.<sup>56</sup> Ultimately, the standardized forms must be approved by fifty state insurance regulatory bodies. After issuance, they inevitably receive extensive scrutiny by legions of lawyers and judges.

Because of this process, ISO forms embody many practical insights into sound public policy and practice that could help in interpreting § 165. Consider the case of Samuel Greenbaum, who moved out of his house one summer, without yet having found a buyer.<sup>57</sup> The house remained unoccupied in December, when a water pipe in the cellar froze and burst, thereby

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50. JEFFREY W. STEMPEL, *LAW OF INSURANCE CONTRACTS* § 4.06 (3d ed. 2006); see also Insurance Services Office, *ISO's Policy Language and Rules*, <http://www.iso.com/products/0000/prod0104.html> (last visited Dec. 12, 2007).

51. STEMPEL, *supra* note 50, § 4.06[B] (emphasis added).

52. See *id.* § 4.06[C] (listing the many benefits to both consumers and insurers of these industry-standard contracts).

53. McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-1015 (2000). The extent of the antitrust exception has been heavily litigated. See, e.g., *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993); *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119 (1982); *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531 (1978). Of course, the lobbying might of the insurance industry also helps explain this treatment.

54. STEMPEL, *supra* note 50, § 4.06[B].

55. *Id.* § 4.05[A]. This description applies to the property and liability insurance contracts, and less so to the health and life insurance contracts.

56. *Id.*

57. *Greenbaum v. Comm'r*, 8 B.T.A. 75 (1927).

flooding the basement. The court denied his casualty deduction under the predecessor to § 165 on the questionable grounds that it was a personal expense.<sup>58</sup>

The ISO Homeowners Broad Form handles just this sort of situation, denying coverage for “Accidental Discharge or Overflow of Water or Steam”<sup>59</sup> “if the dwelling has been vacant for more than 60 consecutive days immediately before the loss”<sup>60</sup> or if “caused by or resulting from *freezing*.”<sup>61</sup> ISO’s data on hundreds of millions of homeowners’ policies and years of experience made it recognize that serious water damage often occurs when the homeowner neglects commonsense precautions, allowing the house to freeze or leaving it vacant for a very long time. In the future, courts and the IRS could look to this collective wisdom to provide a more sound basis for the denial of a deduction like Mr. Greenbaum’s or one of the myriad other situations addressed by the ISO forms.<sup>62</sup>

### C. Preventive Costs

If an insurer will pay for a particular expense or casualty, then it intuitively makes sense for the insurer also to pay for *preventing* an impending expense or casualty when doing so would cost less. This approach also appeals to a sense of fairness and symmetry: if gross negligence can bar recovery from insurance, then prudent preventative expenses should be covered.<sup>63</sup> The IRS and Tax Court, however, have consistently denied deductions for such items under § 165.<sup>64</sup>

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58. *Id.* at 75-76. *Greenbaum* was based on the discredited theory that a casualty loss is personal (and not deductible) unless it is a total loss. See M.L. Cross, Annotation, *What Constitutes “Casualty” Within Provisions of Internal Revenue Code Concerning Deduction of Losses Arising from Fires, Storms, Shipwrecks, or Other Casualty*, 41 A.L.R.2d 691, 713 (1955).

59. INS. SERV. OFFICE, HOMEOWNERS 2 BROAD FORM HO 00 02 05 06, “Section I: Perils Insured Against” § 12 (2006) [hereinafter “ISO FORM”].

60. *Id.* § 12(b)(1) (“On the ‘residence premises’, if the dwelling has been vacant for more than 60 consecutive days immediately before the loss. A dwelling being constructed is not considered vacant.”).

61. *Id.* § 12(b)(3) (emphasis added).

62. Compare *id.* § 12(b) (“does not include loss . . . [t]o the system or appliance from which the water or steam escaped . . .”), with Internal Revenue Serv., General Counsel Memorandum 34,229 (Nov. 28, 1969) (denying deduction for broken water heater).

63. The taxpayer unsuccessfully made this argument in *Austin v. Comm’r*, 74 T.C. 1334, 1337 (1980).

64. The issue is generally mooted in § 213 because it defines “medical care” to include “amounts paid . . . for the diagnosis, cure, mitigation, treatment, or

In *Austin v. Commissioner*,<sup>65</sup> the taxpayer's trees were inexorably overtaking power lines. After considering several alternatives and half-measures, all the trees were cut down. The *Austin* court denied the taxpayer's deduction for the trees' value on the grounds that "other casualty" did not cover such slow-moving casualties. It glossed over the fact that the removal likely prevented a fire,<sup>66</sup> which the plain language of § 165(c)(3) covers.

This denial could have found much stronger footing in cases considering insurance claims in similar situations. For example, *Rosen v. State Farm General Insurance Co.*<sup>67</sup> dealt with a homeowner Rosen, whose contractor informed him that his decks were in imminent danger of collapse.<sup>68</sup> Rosen fixed the decks and sought reimbursement from his insurer, who denied coverage since the plain language of the policy defined collapse as "actually fallen down or fallen to pieces."<sup>69</sup>

The trial court and appellate court found for Rosen, reasoning that public policy overrode the clear language of the contract, lest it "encourage property owners to place lives in danger in order to allow insurance carriers to delay payment of claims until the structure actually collapses."<sup>70</sup> The California Supreme Court reversed, noting that "[a]pplying the same logic, with the same lack of restraint, courts could convert life insurance into health insurance."<sup>71</sup> The court recognized that expanding coverage to prevention would create serious line-drawing problems.<sup>72</sup> This same reasoning

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prevention of disease." I.R.C. § 213(d)(1)(A) (2000) (emphasis added). The line-drawing issues around preventative medical expenses typically involve § 262, which disallows deductions for personal expenses. See, e.g., Rev. Rul. 2002-19, 2002-1 C.B. 778 (allowing deduction for weight-loss counseling, but not for diet food). Many commercial property insurance policies include a "sue and labor" clause that does cover imminent loss that would be covered if the loss were permitted to occur. Cf. *GTE Corp. v. Allendale Mut. Ins. Co.*, 372 F.3d 598 (3d Cir. 2004). This comports with the facts business or trade taxpayers could likely deduct fixing in advance, as an "ordinary and necessary" expense under § 162.

65. 74 T.C. 1334 (1980).

66. See CAL. DEP'T OF FORESTRY AND FIRE PROTECTION, TREES + POWER LINES = DISASTER (2007), available at [http://www.fire.ca.gov/about\\_content/downloads/powerlines.pdf](http://www.fire.ca.gov/about_content/downloads/powerlines.pdf).

67. 70 P.3d 351 (Cal. 2003).

68. *Id.* at 353.

69. *Id.*

70. *Id.* (quotations omitted).

71. *Id.* at 355.

72. *Id.*

would justify the Tax Court's denial in *Austin*, as the contrary result would have created difficult line-drawing problems and turned § 165(c)(3) into a deduction for grounds-keeping expenses.<sup>73</sup>

#### D. The Principle of Indemnity

One of insurance law's most fundamental principles is the principle of indemnity, that "net gain to an insured through the receipt of insurance proceeds exceeding a loss should be regarded as inimical to the public interest."<sup>74</sup> If an insured could receive a net gain as the result of an insured event, that would create perverse incentives. For example, if a homeowner could recover \$300,000 from insurance to rebuild a fire-ravaged house that only costs \$200,000 to rebuild, then the homeowner would have a \$100,000 incentive either to start a fire or to forego precautions.

A closely related corollary is the doctrine of insurable interest, which allows parties to insure only property in which they have an interest, thereby removing incentives for socially destructive activities such as arson.<sup>75</sup> The doctrine of insurable interest would lead to the same result as current tax case law in many circumstances. For example, courts have long denied § 165 deductions to purchasers who have not yet received title, even though the purchaser paid for insurance and storage.<sup>76</sup> The Tax Court has also denied deductions to holders of purchase options<sup>77</sup> and to those having mere possession.<sup>78</sup>

Similarly, § 213 and the associated regulations<sup>79</sup> effectively adhere to the principle of indemnity by limiting the deduction to amounts actually paid for medical care, which is given a carefully circumscribed definition. For example, medical care does not include transportation costs whenever they

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73. Interestingly, "usual and ordinary" repairs to a dwelling *were* deductible under the 1867 code. Revenue Act of 1867, ch. 169, § 13, 14 Stat. 478. The draftsmen of the 1867 Act apparently recognized the serious line drawing problems that might emerge: "no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments, made to increase the value of any property or estate." *Id.*

74. *Gossett v. Farmers Ins. Co.*, 948 P.2d 1264, 1271 (Wash. 1997) (quoting ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES, PRACTITIONER'S EDITION* § 3.1(a) at 135 (1988)).

75. *See id.* at 1271-72.

76. *Haas Bros. v. McLaughlin*, 39 F.2d 381 (9th Cir. 1930).

77. *Dankos v. Comm'r*, 52 T.C.M. (CCH) 722 (1986).

78. *Corcoran v. Comm'r*, 35 T.C.M. (CCH) 972 (1976).

79. *Treas. Reg.* § 1.213-1 (2006).

contain a significant element of personal pleasure or lodging costs over \$50 per night.<sup>80</sup> The IRS regulations allow a deduction for adding a medically necessary elevator or exercise pool to one's house, but only to the extent that it does not increase the value of the property.<sup>81</sup>

These sections, however, take the principle of indemnity beyond where insurance law does, perhaps reflecting the unique rigidity of tax law.<sup>82</sup> In doing so, tax law often results in unjust or economically inefficient results. To see the potential injustice, consider two taxpayers *A* and *B* with identical incomes and with houses worth \$100,000 in Mississippi. *A* bought her house thirty years ago and has an adjusted basis of \$20,000, while *B* bought her house one year ago and has an adjusted basis of \$100,000. Both *A* and *B* thought they did not need flood insurance, and both saw their houses destroyed by unexpected—and uninsured<sup>83</sup>—flood waters in Hurricane Katrina. Both face identical huge costs to return to their pre-Katrina way of life, yet *A* gets almost no tax break reflecting these hardships: her deduction is capped by the \$20,000 basis,<sup>84</sup> minus 10% of her adjusted gross income. *A*'s § 165 deduction might not even exceed the standard deduction that she could get if she didn't itemize her deductions.<sup>85</sup>

Some of the IRS regulations implementing § 165 also can result in economic inefficiency. Consider a hypothetical lumberyard in Louisiana seri-

80. I.R.C. § 213(d)(2)(B) (2000).

81. Treas. Reg. § 1.213-1(e)(1)(iii) (2006). Of course, the extent to which it does increase the value of the property would be added to the adjusted basis. Even if this adjustment in basis provided any benefit to the taxpayer, it would be only upon selling the property. Several provisions make it unlikely that it will ever produce any benefit. I.R.C. § 1014 (2000) (basis reset to fair market value when passed on at death); *id.* § 121(b)(1) (sheltering most capital gains from a house anyhow).

82. See *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542-43 (1979) (emphasizing the difference between the purposes of the tax laws and financial accounting).

83. This hypothetical is hardly speculative for many homeowners. See *Leonard v. Nationwide Mut. Ins. Co.*, 438 F. Supp. 2d 684 (S.D. Miss. 2006) (finding for insurer on Katrina damage caused mostly by flood, against which the homeowner had not insured on advice of Nationwide's agent).

84. I.R.C. § 165(b) (2000); Treas. Reg. § 1.165-1 (2006).

85. The standard deduction is available to taxpayers who choose not to itemize deductions, such as the mortgage interest deduction and the deductions provided by §§ 165 and 213. In 2006, the standard deduction was \$5150 for single filers and \$10,300 for married filing jointly. See I.R.S. Form 1040 (2006), available at <http://www.irs.gov/pub/irs-pdf/f1040.pdf>.

ously damaged by uninsured flooding in Katrina.<sup>86</sup> Given that reconstruction will result in a much greater demand for its services, it would make sense to allow it to repair in such a way as to increase its capacity. Doing so would deny it a current deduction under the existing regulations, as it would fail the test as to whether “the repairs are necessary to restore the property to its condition immediately before the casualty.”<sup>87</sup>

Insurance money generally comes without these sorts of restrictions and hence does not create similar economic inefficiencies. It does so without violating the principle of indemnity. Some of the severity of the regulations around §§ 165 and 213 might stem from the fact that when adopted, the top marginal tax rate was 91%.<sup>88</sup> As a result, the danger of violating the indemnity principle with overly generous deductions was quite high, as allowing a deduction inflated by as little as one-tenth could lead to taxpayers receiving benefits greater than their losses.<sup>89</sup> As rates have significantly decreased, so has the risk of violating the principle of indemnity with §§ 165 and 213. This

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86. The same economic inefficiency could also apply to personal expenditures. Consider a growing family thinking of adding two new bedrooms above its garage. Katrina then severely damages the garage. This seems like a perfect opportunity to address the needs of the growing family, but doing so would cost the family its casualty loss deduction.
87. Treas. Reg. § 1.165-7(a)(2)(ii) (2006). Nor would the lumberyard likely get any relief from the alternate method of valuing loss, appraised fair market value, governed by *id.* § 1.165-7(a)(2)(i). Katrina almost certainly led to a severe “general market decline.” *See id.* As a result, rather than a current deduction, the lumberyard would likely have to capitalize the improvements.
88. Internal Revenue Code of 1954, Pub. L. No. 591, section 1(a), 68A Stat. 5 (Aug. 16, 1954). The 91% bracket applied to any income over \$200,000. The IRS adopted both Treasury Regulations §§ 1.165-7 and 1.213-1 in 1960.
89. For example, say that a taxpayer in the 91% bracket suffered a loss of \$1000, but was able to deduct one-tenth more (i.e., \$1100) due to lax tax regulations. That would save the taxpayer 91% times \$1100 = \$1001, thereby allowing the taxpayer a net profit of \$1. Of course, if the taxpayer could deduct even more than \$1100, the net profits to the taxpayer increase proportionally.

The potential injustices and economic inefficiencies from restrictions on the medical expense deduction are less clear, but still present. For example, § 213(d)(2)(B) denies deductibility for travel expenses that have any “significant element of personal pleasure, recreation, or vacation.” Consider a child with terminal cancer. The parents are deciding between two specialists, one in Florida and one in Minnesota, equally good in all respects except for location. If they choose the one in Florida so that their child can visit Disneyworld once, they will be denied the deduction for travel expenses. The utility gained from vacation-like experiences near the end of a life can be particularly high, yet the tax code discourages such utility-maximizing behavior.

considerable drop in rates argues for a reassessment of the economic inefficiencies and inequities such restrictions create.

#### E. One Casualty or Two?

Due to wet weather, in 1993 the Mississippi River basin suffered extensive flooding, with two main episodes, one from April to May, and again from June through October.<sup>90</sup> The total damage fell between \$10 billion and \$15 billion in 1993 dollars.<sup>91</sup> Due to a combination of cost concerns and a false sense of security, a substantial number of the affected homeowners had no flood insurance.<sup>92</sup>

As a result, significant sums of money depended upon whether the two episodes of Mississippi flooding were one casualty or two for the purposes of § 165. Subsection 165(i) allows the taxpayer to elect to carry the loss from a federally recognized disaster back to the previous year. If the two episodes of flooding were indeed two casualties, then taxpayers would benefit immensely by carrying back part of their losses to the previous year, and keeping the remainder of the deduction for the current year. Doing this would erase their highest marginal rate income for two years, rather than for one.<sup>93</sup>

The IRS found no precedent on point and ultimately ruled in favor of two casualties on the questionable basis of vague congressional intent to bring tax relief to devastated areas via § 165(i).<sup>94</sup> The IRS simply ignored the fact that Congress passed § 165(i) in 1962 in response to a single devastating hurricane, giving no indication whatsoever of when a series of events would count as multiple disasters. If the IRS had ruled in favor of one casualty,

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90. Internal Revenue Serv., Technical Assistance in Determining if Losses Resulting from Multiple Floods Constitute a Single Casualty, I.R.S. Field Serv. Adv. Mem. (Apr. 1, 1994).

91. *Id.*

92. Albert R. Karr, *False Sense of Security and Cost Concerns Keep Many on Flood Plains from Buying Insurance*, WALL. ST. J., Aug. 31, 1993, at A12.

93. Due to the progressive tax system and inability of individual taxpayers to carry over non-business casualty losses, I.R.C. § 172(d)(4) (2000), this would be a huge tax boon. The same issue—how many casualties occurred—was also relevant to whether the \$100 threshold on the deduction for individual taxpayers had to be met once or twice. *Id.* § 165(h)(1) (“Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds \$ 100.”). Although much less important here, this limitation to “each casualty” might become much more important in some circumstances, such as where many casualties occurred.

94. Internal Revenue Serv., *supra* note 90, at \*13-14. Since this ruling was overwhelmingly favorable to taxpayers, it is not surprising that no litigation challenged this IRS determination.



§ 165(i) would have still granted substantial tax relief to taxpayers. Nothing in the legislative history mandated that the IRS *maximize* this relief.

Insurance law, however, has many cases addressing whether a particular loss constitutes one or more “occurrences,” upon which the IRS could have drawn instead. For example, the IRS could have adopted the approach of the Connecticut Supreme Court in *Metropolitan Life Insurance Co. v. Aetna Casualty & Surety Co.*,<sup>95</sup> which interpreted “occurrence” to cover only losses occurring in the same time and at the same place.<sup>96</sup> Since there were two temporally separate periods of flooding that affected each property, the IRS could have found two separate occurrences, regardless of common causation by underlying weather patterns.

#### F. “Other Insurance” Clauses

Many insurance policies come with so-called “other insurance” clauses that specify how the policy interacts with other insurance covering the same loss. There are three types of “other insurance” clauses: *pro-rata*, sharing coverage equally with other applicable insurance; *escape*, seeking to avoid any coverage; and *excess*, providing insurance only after the exhaustion of all other applicable coverage.<sup>97</sup>

Many interesting issues come up when two insurance policies covering a loss have conflicting “other insurance” clauses. For example, if a policyholder has two policies each with an excess clause, then neither policy kicks in until the other one is exhausted. But, neither policy will be exhausted if neither ever kicks in. This presents a “chicken and egg”<sup>98</sup> problem for courts, which have developed rules to resolve such situations.<sup>99</sup>

95. 765 A.2d 891 (Conn. 2001).

96. *Id.* at 900. Of course, there is conflicting insurance case law, so if the IRS had reached the opposite conclusion and had wanted to defend against the onslaught of taxpayer suits, they could have looked to the underlying cause. *See, e.g.,* *Appalachian Ins. Co. v. Liberty Mut. Ins. Co.*, 676 F.2d 56, 61 (3d Cir. 1982). Note that while the World Trade Center insurance case centered on the meaning of “occurrence,” the Second Circuit simply punted that hot multi-billion-dollar issue to a jury, based on the intentions of the parties. *See* *World Trade Ctr. Props., L.L.C. v. Hartford Fire Ins. Co.*, 345 F.3d 154, 190 (2d Cir. 2003). On the inutility of insurance cases decided on such contract law principles for the purpose of tax law, see Section III.C.

97. *Carriers Ins. Co. v. Am. Policyholders’ Ins. Co.*, 404 A.2d 216, 218 (Me. 1979).

98. *State Farm Mut. Auto. Ins. Co. v. Travelers Ins. Co.*, 184 So. 2d 750, 753-54 (La. Ct. App. 1966) (Tate, J., concurring) (“[T]he primary and (attempted) secondary liability of each policy chase the other through infinity, something like trying to answer the question: Which came first, *the chicken or the egg?*” (emphasis added)).

99. *Carriers*, 404 A.2d at 219.

Sections 165 and 213 both contain “other insurance clauses,” with the exact same statutory text: “not compensated for by insurance or otherwise.”<sup>100</sup> These are “excess” clauses, providing the free partial insurance only in excess of any other applicable coverage or source of recovery. The same issues that come up with private “other insurance” clauses also can arise with respect to these clauses. Of course, in the unlikely situation where a private insurer dared write a clause that would conflict with the other insurance clause in §§ 165 or 213, a court would obviously find for the IRS.<sup>101</sup>

However, consider the possibility that the other form of excess compensation comes from another government to which the United States owes comity, be it one of the states or a foreign government. For example, say a foreign multinational suffered a loss to property in the United States due to an uninsured catastrophe, and the multinational’s home country offered a casualty deduction provision similar to § 165.<sup>102</sup> The IRS might attempt to deny the deduction to the extent that the other country’s deduction compensated it; meanwhile, the other country could make the reverse claim. When facing such a conflict, the IRS and Tax Court could apply the clear majority rule for handling similar conflicts between private insurers: disregard the other insurance clauses and simply prorate the deductions.<sup>103</sup>

#### G. Inherent Defects

Rock-A-Bye Lady won numerous championships and ribbons in amateur horse shows from 1967 to 1972.<sup>104</sup> She became tragically ill from the intestinal disease colic one day in 1972 and died the next day, aged just eight years,<sup>105</sup> compared to a horse’s typical life expectancy of twenty to twenty-five years.<sup>106</sup> Her owners attempted to take a deduction under § 165 for her

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100. I.R.C. §§ 165(a), 213(a) (2000).

101. Many bases exist for such a decision, including: congressional intent, public policy, *see supra* Section II.A, federal law’s supremacy over state insurance law, and the broad grant of the Sixteenth Amendment.

102. Or, even more compellingly, the company’s home country could offer a tax *credit* covering the losses.

103. *See Carriers*, 404 A.2d at 220. The method of proration, *see id.* at 221-22, is generally not relevant, since § 165 has no limit on coverage. The only possible issue would be whether the pro-ration should be done giving half the deduction in one country, half in another. Alternatively, it could be done based on the multinational’s marginal tax rates in the two countries, so that each country bears half the loss in tax revenues.

104. *Daugette v. Comm’r*, 36 T.C.M. (CCH) 252, 253 (1977).

105. *Id.*

106. *See Horses and Horsemanship*, in 20 THE NEW ENCYCLOPEDIA BRITANNICA MACROPAEDIA 646, 648 (15th ed. 2002).

considerable value. The Tax Court denied the deduction based on extensive precedent requiring that a casualty result from a “sudden or destructive force,”<sup>107</sup> by applying the canon of *ejusdem generis*<sup>108</sup> to the statutory list “fire, storm, shipwreck, or other casualty.”<sup>109</sup>

The Tax Court could have much better justified its decision on basic insurance principles. Insurance companies and courts do not permit insurance coverage for guaranteed events, as no socially beneficial risk transfer occurs, and society actually loses the administrative costs involved in issuing the policy and handling the claim.<sup>110</sup> So, a loss that is intrinsically guaranteed to happen should be uninsurable, and a horse is intrinsically guaranteed to die.<sup>111</sup>

In an illustrative early insurance case on point, a policyholder sued for reimbursement for a rare specimen of opal that had developed a crack entirely on its own.<sup>112</sup> This type of opal has an inherent tendency to develop fissures over time, without the application of external force.<sup>113</sup> The court

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107. *Daugette*, 36 T.C.M. (CCH) at 254 (citing *Appleman v. United States*, 338 F.2d 729 (7th Cir. 1964)).

108. *See supra* note 29 and accompanying text.

109. I.R.C. § 165(c)(3) (2000).

110. The Tax Court had an intuitive understanding of intrinsic loss, noting that “[t]he veterinarian who attended Rock-A-Bye Lady during her colic attack stated that the horse’s death was due to her own inherent physical weakness.” *Daugette*, 36 T.C.M. (CCH) at 254. *See generally* STEMPPEL, *supra* note 50, § 1.03[A] (explaining risk and what risks are insurable).

111. Human term life insurance insures only against death before a certain point, not against death itself. *See id.* Of course, an insurance company could issue a similar life insurance policy on the life of a horse, and Rock-A-Bye Lady was indeed insured, although only for \$10,000 despite being the “best living Tennessee Walking Horse mare.” *Daugette*, 36 T.C.M. (CCH) at 254. The key distinction is that § 165 is a type of casualty insurance, not a type of life insurance. The Tax Court has made clear that § 165’s “other casualty” does not include the losses from the death of a human. *See Procter v. Comm’r*, 19 T.C. 387, 395 (1952).

112. *Chute v. North River Ins. Co.*, 214 N.W. 473 (Minn. 1927); *see also* *British & Foreign Marine Ins. Co. v. Gaunt*, [1921] 2 A.C. 41, 57 (H.L.) (“For wool to get wet in the rain is a casualty, though not a grave one; it is not a thing intended but is accidental; it is something which injures the wool from without; it does not develop from within.”). *See generally* Kenneth S. Abraham, *Peril and Fortuity in Property and Liability Insurance*, 36 TORT & INS. L. J. 777 (2001) (discussing the intrinsic-loss issue and fortuity).

113. *Chute*, 214 N.W. at 473.

held that the public policy against covering guaranteed events overrode plain contract language favorable to the insured.<sup>114</sup>

#### H. Cosmetic Surgery

Prior to 1990, the Tax Court and IRS allowed taxpayers to take § 213 deductions for cosmetic surgery, ranging from hair transplants for baldness,<sup>115</sup> to electrolysis,<sup>116</sup> to full facelifts.<sup>117</sup> In 1990, Congress overruled these decisions, adding § 213(d)(9), which explicitly disallows deductions for cosmetic surgery unless necessitated by “congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.”<sup>118</sup> The IRS and Tax Court could have reached the same result and avoided Congress’ rebuke by simply recognizing that § 213 acts as insurance.

It makes no sense to insure against non-probabilistic events.<sup>119</sup> This observation explains why insurance does not cover intentional acts by the insured<sup>120</sup> or inevitable decay.<sup>121</sup> Insurance against a non-probabilistic expense, such as elective cosmetic surgery, would simply cost its present value, plus administrative fees and a profit for the insurer. The exceptions to § 213’s cosmetic surgery exclusion cover precisely those situations where cosmetic surgery *does* result from probabilistic events: personal injury, disfiguring disease, and birth defects. The IRS could have used insurance law

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114. *Id.* at 474. On *contra proferentem*, see BLACK’S LAW DICTIONARY 352 (8th ed. 2004) (“The doctrine that, in interpreting documents, ambiguities are to be construed unfavorably to the drafter.”).

115. *Mattes v. Comm’r*, 77 T.C. 650 (1981).

116. Rev. Rul. 82-111, 1982-1 C.B. 48.

117. Rev. Rul. 76-332, 1976-2 C.B. 81.

118. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11342(a), 104 Stat. 1388 (codified at I.R.C. § 213(d)(9) (2000)). For a recent application, see Int. Legal Mem. 200603025 (Oct. 14, 2005), reprinted in 2006 TAX NOTES TODAY 4-12 (sex changes not deductible).

119. Health insurance often pays for basic preventative care and check-ups to reduce the probability of larger future losses, so that is itself a form of insurance. *Cf.* I.R.C. § 213(d)(1)(A) (2000) (covering “prevention of disease”). One possible exception is the ill-designed government requirement from the 1980s that asbestos-removal contractors have long-term coverage for the health problems that were sure to emerge. At the time, it was clear that certain health problems would emerge. This could perhaps be thought of more as a type of mandated pre-payment.

120. See discussion *supra* Section II.A; *supra* note 45.

121. See discussion *supra* Section II.G; see also Abraham, *supra* note 112. Cosmetic surgery such as facelifts or hair transplants simply fix inherent defects in human beings, who inevitably age and suffer from wrinkled skin and less hair.

reasoning to issue regulations identical to the change that Congress ultimately made.

Moreover, Congress itself could have much better justified adding § 213(d)(9) on insurance grounds. Instead, the legislative history explained this change on the tax law principle that personal expenditures should not be deductible:<sup>122</sup> “Expenses for purely cosmetic procedures that are not medically necessary are, in essence, *voluntary personal expenses*, which like other personal expenditures (e.g., food and clothing) generally should not be deductible.”<sup>123</sup> This rationale does nothing to explain why it carved out an exception for surgery to correct “congenital abnormalities,” which is a clearly “voluntary personal expense.” Congress had the correct intuition but failed to articulate proper reasoning.

### I. Efficient Proximate Causation

A combination of two (or more) causes often leads to a policyholder’s loss, with one cause covered by the policy, and the other not covered. For example, in one case, a homeowner lived on a mountain, and a power company negligently clear-cut the forest uphill, causing a mudslide that destroyed the house.<sup>124</sup> While the policy did cover destruction due to the negligence of others, it did not cover mudslides. To untangle such problems, courts have developed and widely adopted<sup>125</sup> the “efficient proximate cause” rule, which looks to whether the *predominant* cause was covered.<sup>126</sup>

The same combination of causes also comes up in § 165 casualty cases. In one case, a taxpayer’s house suffered severe damage at the hands of its plumbers.<sup>127</sup> First, the plumbing company negligently installed an underground pipe without any protection.<sup>128</sup> Then, when inspecting the plumbing later, an employee accidentally stepped on the unprotected pipe, causing a release of water that severely damaged the house’s foundations.

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122. I.R.C. § 262 (2000).

123. 136 CONG. REC. 30,570 (1990) (emphasis added).

124. *State Farm Fire & Cas. Co. v. Bongen*, 925 P.2d 1042 (Alaska 1996). See generally Mark D. Wuerfel & Mark Koop, *Efficient Proximate Causation in the Context of Property Insurance Claims*, 65 DEF. COUNS. J. 400 (1998).

125. 5 J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 3083, at 309-11 (1970).

126. See *Garvey v. State Farm Fire & Cas. Co.*, 770 P.2d 704, 706-09 (Cal. 1989).

127. *Hayutin v. Comm’r*, 31 T.C.M. (CCH) 509, 537-39, 560-61 (1972).

128. The negligent construction was found by a state trial court. *Id.* at 537-39.

Tax case law does not allow deductions for faulty construction<sup>129</sup> but does for sudden accidents. The Tax Court employed the efficient proximate cause rule without even recognizing it as such, finding the accidental stepping on the pipe to be the “primary cause” and hence allowing the deduction.<sup>130</sup> Simply employing the efficient proximate cause rule would have avoided duplicating the underlying reasoning and would have ushered in a large body of insurance precedent to handle future cases.

Using the efficient proximate cause rule would also help decide borderline § 213 medical expense controversies. Consider the venerable case of *Ochs v. Commissioner*,<sup>131</sup> involving a taxpayer whose wife was convalescing from throat cancer. Her doctor strictly instructed the couple to send their children away to boarding school until she had recovered, lest the stresses of maternal responsibility lead to a fatal recurrence. The Second Circuit disallowed deduction of boarding school expenses, fretting that if courts allowed this expense, then some taxpayers would attempt to deduct expenses for nannies or a cook.<sup>132</sup> The scathing dissent decried the “scant” statutory or legislative history in favor of denying the deduction<sup>133</sup> and noted that courts regularly draw lines.<sup>134</sup>

The rule of efficient proximate causation would provide an excellent line-drawing tool in an area of tax law where lines remain hard to draw.<sup>135</sup> The IRS and Tax Court could allow for a deduction whenever a covered disease is the efficient proximate cause of the expense.<sup>136</sup> In the case of *Ochs*,

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129. See *Rountree v. Comm’r*, 27 T.C.M. (CCH) 810 (1968); cf. *F & H Constr. v. ITT Hartford Ins. Co. of the Midwest*, 12 Cal. Rptr. 3d 896 (Cal. Ct. App. 2004) (insurance should not act as a construction bond).

130. *Hayutin*, 31 T.C.M. (CCH) at 561. This is the variation of the efficient proximate cause rule favored by the dissent in *State Farm Fire & Cas. Co. v. Bongen*, 925 P.2d 1042, 1048 (Alaska 1996).

131. 195 F.2d 692 (2d Cir. 1952) (Augustus Noble Hand, J.). The majority opinion’s author was the cousin of Judge Learned Hand.

132. *Id.* at 694.

133. *Id.* at 695 (Frank, J., dissenting) (“[M]y colleagues[] are certain Congress did not intend relief for a man in this grave plight. The truth is, of course, no one knows what Congress would have said if it had been faced with these facts.”).

134. *Id.* at 698.

135. The IRS seems to have softened its stance on such matters since *Ochs*. See, e.g., Rev. Rul. 75-318, 1975-2 C.B. 88 (braille books deductible); Rev. Rul. 64-173, 1964-1 C.B. (pt. 1) 121 (hiring guide for blind child deductible).

136. Indeed, the dissent’s reasoning at times suggested an intuition that efficient proximate cause would make a good line-drawing tool. “Congress required only that medical expenses be ‘primarily’ for the patient’s recovery. The evidence here, moreover, establishes (and the Tax Court so found) that the effect

the disease predated the boarding school expenses, and the taxpayers sent their children away only while the wife was under strict doctor's orders. A court would easily find her illness the efficient proximate cause. By comparison, hiring a cook would have had an efficient proximate cause of the human need to eat, which predated the illness and which drives behavior in the absence of disease. Hiring a cook would hence fall on the other side of the line.

J. Reconsidering "Reasonable Expectations of the Taxpayer"

In 1971, Professor Robert Keeton distilled a principle from insurance case law that he called honoring the reasonable expectations of the insured.<sup>137</sup> The complexity of insurance contracts means few consumers actually read their policies, so courts will often extend coverage to cases not covered by the contract when it comports with reasonable expectations of coverage.<sup>138</sup> Some jurisdictions have explicitly adopted this principle; some appear to have implicitly endorsed it, while others disregard it.<sup>139</sup>

Interestingly, just three years earlier in 1968, a Note in the *Chicago Law Review* had argued for honoring the reasonable expectations of *taxpayers* in interpreting § 165(c)(3).<sup>140</sup> While this goes to exemplify the similarities between § 165's free insurance and private insurance, the reasonable expectations of taxpayers has received significantly less traction with judges.<sup>141</sup> Given the viability and acceptance of reasonable expectations of the insured, perhaps this idea deserves renewed consideration.

III. LIMITATIONS ON USING INSURANCE LAW TO INTERPRET SECTIONS 165 AND 213

While insurance case law and practice has a great deal to contribute to § 165 and § 213 jurisprudence, this approach has limits. This Part details

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on the wife's health was the *sole consideration* inducing her husband's action even if it was not the sole result." *Ochs*, 195 F.2d at 696 (emphasis added); see also *id.* ("direct or proximate therapeutic relation") (emphasis added).

137. ROBERT E. KEETON, *INSURANCE LAW: BASIC TEXT* 350-57 (1971).

138. See, e.g., *Atwood v. Hartford Accident & Indem. Co.*, 365 A.2d 744 (N.H. 1976).

139. For a summary of the state of acceptance, see Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990); and see generally *Symposium on the Insurance Law Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 1 (1998).

140. Note, *The Casualty Loss Deduction and Consumer Expectation: Section 165(c)(3) of the Internal Revenue Code*, 36 U. CHI. L. REV. 220 (1968).

141. The only reported decisions citing to it do so for its excellent discussion of the history of § 165(c)(3) and its predecessors.

three of these limitations and considers what they reveal about the difference between private insurance and this free partial government insurance.

#### A. Partial Interests in Property

Gertrude Becker had a life estate in her house, yet she paid the same homeowners insurance premiums that would have applied were she owner of the house in fee simple.<sup>142</sup> Her house caught fire, and she died approximately nineteen minutes into the conflagration.<sup>143</sup> The insurer denied the claim of her executor, arguing that since the life estate ended with her life, she had lost nothing.<sup>144</sup>

The highest court of Maryland found against the insurer, holding that liability attached when the fire started.<sup>145</sup> The insurer had received the same premiums from the deceased as if it had been covering a fee simple and could not escape full recompense. Although the remaindermen were not parties to that suit, in a similar case the Oregon Supreme Court awarded all the insurance proceeds to the life tenant who had paid the premiums, with none for the remainderman.<sup>146</sup>

This just and sensible result cannot be extended into the realm of § 165 jurisprudence, for the simple fact that the insurance provided by § 165 is free. The IRS favors an apportionment of casualty losses between a life tenant and a remainderman.<sup>147</sup> While the life tenant can almost certainly deduct the cost of debris removal, other losses must be apportioned based on evidence, with the default coming from actuarial tables reflecting life expectancies. This approach comports with justice and efficiency in the absence of one party's payment of premiums.

#### B. Highly Correlated Risks

Just as it makes no sense to insure against eventualities that are certain—such as intentional acts or inherent flaws<sup>148</sup>—it also makes no sense to

142. *Home Ins. Co. v. Adler*, 309 A.2d 751, 753 n.2 (Md. 1973). *But see* *Beekman v. Fulton & Montgomery Counties Farmers' Mut. Fire Ins. Ass'n*, 73 N.Y.S. 110 (N.Y. App. Div. 1901).

143. *Home Ins. Co.*, 309 A.2d at 751.

144. Except for personal property. *Id.*

145. *Id.* at 754.

146. *Morris v. Morris*, 544 P.2d 1034 (Or. 1976) (giving full proceeds to still-alive life tenant over remainderman's challenge).

147. I.R.S. Gen. Couns. Mem. 37,236 (Aug. 26, 1977). This memo indicates that in situations such as *Bliss v. Commissioner*, 256 F.2d 533 (2d Cir. 1958), where the remaindermen do not also attempt to deduct a portion of the loss, the life tenant may have the entire deduction.

148. See discussion *supra* Sections II.A and II.G.



insure against highly correlated risks. At one extreme, automobile accidents tend to be highly *uncorrelated* with each other, making them ideal subjects of insurance. At the other extreme, all-out nuclear war results in massive, completely-correlated property losses.

Many other types of insurance fall between these two extremes.<sup>149</sup> For example, while property losses due to nor'easters in New England are highly correlated with each other, they are uncorrelated with losses due to thunderstorms in Oregon or tornados in Nebraska. Hence, homeowners policies offer protection against weather damage. By contrast, war results in sufficiently correlated losses that the vast majority of insurance contracts exclude coverage.<sup>150</sup> Nuclear incidents also have the potential to create such highly correlated losses that policies exclude coverage, even if the discharge is entirely accidental.<sup>151</sup>

In contrast, taxpayers can deduct losses due to war, terrorist acts, and nuclear accident under § 165.<sup>152</sup> Four differences in function justify this divergence. First, the United States government acts on a much larger scale than any private insurer possibly could, giving it the ability to absorb large, correlated losses. Second, the government is not subject to many of the market imperfections that discourage private insurers from taking on such catastrophic risks.<sup>153</sup> Third, unlike private insurers, the federal government

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149. Other factors also can discourage private insurance of certain types of risks. See Dwight M. Jaffee & Thomas Russell, *Catastrophe Insurance, Capital Markets, and Uninsurable Risks*, 64 J. RISK & INS. 205 (1997) (arguing that institutional factors such as tax, accounting, and takeover risk result in private insurers not providing insurance against earthquakes, hurricanes, and floods, although financial markets have been innovating around these problems).

150. ISO FORM, *supra* note 59, at "Section I Exclusions" § 6. Incidentally, insurers made a wise public-relations move after 9/11 not to invoke the war exclusion, despite talk of a "War on Terror." See Christopher Oster, *Insurers Pledge Act of War Won't Block Claims*, WALL ST. J., Sept. 17, 2001, at A3.

151. ISO FORM, *supra* note 59, at "Section I Exclusions" § 6 ("Discharge of a nuclear weapon will be deemed a warlike act [and hence excluded] even if accidental."). See generally STEMPER, *supra* note 50, § 1.03[B][2].

152. *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955) (loss due to enemy bombardment); *Popa v. Comm'r*, 73 T.C. 130 (1979) (loss of personal property due to fall of South Vietnam). Without prodding from any case law, the IRS openly proclaims that terrorist attacks are deductible. I.R.S. Pub. 547, at 2 (2006). See generally Terrence Chorvat & Elizabeth Chorvat, *Income Tax as Implicit Insurance Against Losses from Terrorism*, 36 IND. L. REV. 425, 438-43 (2003).

153. See Chorvat & Chorvat, *supra* note 152, at 438-43 (showing how unfavorable rules on tax carryovers and carrybacks discourage private insurers from taking on huge risks); Jaffee & Russell, *supra* note 149.

has non-pecuniary concerns such as macroeconomic stability and taxpayer solvency. Indeed, Congress has explicitly indicated that it views § 165 as a form of disaster relief, and used it as such.<sup>154</sup>

Finally, the federal government, with its war powers, vast intelligence community, and regulatory agencies, is the least-cost avoider of these catastrophic losses.<sup>155</sup> Democracy unfortunately seems to fail in providing incentives to federal officials to actually avoid them. For example, federal officials often see *improvements* in their popularity ratings after terrorist attacks and the inception of wars.<sup>156</sup> Section 165 counters this moral hazard by forcing government decision makers to face a substantial fiscal impact from such government failures.

### C. Insurance Law Based on Inapplicable Contract Reasoning

Insurance policies are contracts, albeit highly regulated and standardized contracts with a specialized body of case law and practice behind them. In many insurance cases, as with many garden-variety contracts cases, the result comes from public policy reasoning.<sup>157</sup> Not all of the contract law principles that courts use to decide insurance cases translate properly into tax law.

For example, an insurance case relying on the “intent of the parties”<sup>158</sup> has little to contribute to tax law, as Congress and individual taxpayers never have anything like a meeting of the minds. In the same vein, courts generally employ *contra proferentem* to construe insurance contracts against the drafter, as courts often do with contracts of adhesion.<sup>159</sup> Taxpayers, however, never contracted with the federal government and never paid a

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154. 108 CONG. REC. 34 (1962) (enacting § 165(i)'s carryback provision as a form of immediate disaster assistance).

155. *Cf.* Chorvat & Chorvat, *supra* note 152, at 443-45 (talking about terrorist attacks).

156. *See, e.g.*, Graphic, *President Bush's Approval Ratings*, WASH. POST, Oct. 30, 2005 (showing huge spikes in popularity after the September 11, 2001 attacks and again after the commencement of the Iraq war), available at <http://www.washingtonpost.com/wp-dyn/content/graphic/2005/04/25/GR2005042500945.html>; *see also* HISTORICAL BUSH APPROVAL RATINGS (Oct. 23, 2007), <http://www.hist.umn.edu/~rug-gles/Approval.htm>.

157. *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 178-199 (1981) (detailing the interaction between public policy and contract law).

158. *E.g.*, *World Trade Ctr. Props., L.L.C. v. Hartford Fire Ins. Co.*, 345 F.3d 154, 184 (2d Cir. 2003).

159. *See generally* STEMPER, *supra* note 50, §§ 4.08[F], 4.11[F][11].

premium<sup>160</sup> for the insurance they receive under §§ 165 and 213. Insurance cases decided via pure contract language interpretation<sup>161</sup> also have little to add to tax law, as courts already have access to well-developed canons of statutory interpretation that serve similar goals.<sup>162</sup>

Finally, insurance cases sometimes involve overruling an insurance contract term as being void for public policy. Since Congress proclaims public policy via the Tax Code, courts obviously cannot and should not overrule terms on this basis.<sup>163</sup> Similarly, the deference courts show to IRS regulations makes it inappropriate to interpret them this way.<sup>164</sup>

Tax law should look to the underlying reasoning in insurance cases decided on public policy considerations. A case that explicitly overrules or upholds policy language based on public policy or economic efficiency grounds has much to add to tax law.<sup>165</sup> Similarly, when a court or insurance practice provides contract terms—either default or mandatory—based on policy or efficiency grounds,<sup>166</sup> tax law should pay particular heed.

#### IV. IMPLEMENTATION

As discussed in Part II, insurance law, policy, and practice have a great deal to add to the jurisprudence around §§ 165 and 213. Practicality alone, however, does not empower the courts and IRS to make this shift. As this Part will show, the text, history, and structure of these statutes also provide ample justification for courts to cite to insurance law or for the IRS to use its interpretive power to encourage courts to do so. Finally, this Part observes that federal tax law respects and incorporates many elements of various areas of state law, and therefore doing so with insurance law, which is mostly state law, would not present any challenges.

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160. One's prior year taxes cannot be considered a premium, since the casualty loss deduction is available to recent immigrants, newborns, and other new taxpayers.

161. *E.g.*, *Vargas v. Ins. Co. of N. Am.*, 651 F.2d 838 (2d Cir. 1981).

162. *See generally* WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, *LEGISLATION AND STATUTORY INTERPRETATION* (2d ed. 2006).

163. Indeed, tax legislation even carries a very strong presumption of constitutionality. *See* *Regan v. Taxation With Representation of Wash.*, 461 U.S. 540, 547 (1983); *Black v. Comm'r*, 69 T.C. 505, 510 (1977).

164. *See* discussion *infra* Section IV.D.

165. *E.g.*, *Rosen v. State Farm Gen. Ins. Co.*, 70 P.3d 351 (Cal. 2003) (upholding contract language based on public policy considerations); *Strickland v. Gulf Life Ins. Co.*, 242 S.E.2d 148 (Ga. 1978) (striking down based on public policy of discouraging unnecessary amputations).

166. *E.g.*, *Home Ins. Co. v. Adler*, 309 A.2d 751 (Md. 1973).

### A. Text

Most importantly, both sections contemplate an insurance-like role, as subsection (a) of both disallows the deduction when “compensated for by *insurance* or otherwise.”<sup>167</sup> Section 213 explicitly refers to various other types of insurance, including private medical insurance and long-term care insurance.<sup>168</sup> Additionally, both use words with strong insurance implications, as with § 165’s reference to “casualty.”<sup>169</sup>

### B. History

Section 165 has an ancient lineage, with its predecessor first appearing in the income tax provisions of the Revenue Act of 1867.<sup>170</sup> Later, the Revenue Act of 1894 added the still-present requirement that the loss not be “compensated for by insurance or otherwise.”<sup>171</sup> As a result of its early origins, we have very little substantive history surrounding its original enactment. Subsequent Congresses have acted consistently to ensure that § 165 provides a form of insurance against disaster losses. For example, Congress enacted § 165(i), which allows individuals to carry certain casualty losses back one year, in 1962 as a result of the “Ash Wednesday storm” that had just devastated the mid-Atlantic states.<sup>172</sup>

We do have legislative history around the passage of § 213’s predecessor.<sup>173</sup> Notably, Congress enacted it during World War II, which also marked the rise of mass employer-provided health insurance.<sup>174</sup> The cost of war led to extremely high marginal tax rates, running as high as 88%, leaving only a 12% “co-pay.”<sup>175</sup> Indeed, the legislative history reads as if Con-

167. I.R.C. §§ 165(a), 213(a) (2000) (emphasis added).

168. *Id.* § 213(d)(1).

169. *Id.* § 165(c)(3).

170. Revenue Act of 1867, ch. 169, § 13, 14 Stat. 478.

171. Revenue Act of 1894, ch. 349, § 28, 28 Stat. 553, *invalidated by* Pollock v. Farmer’s Loan & Trust Co., 157 U.S. 429 (1895). Similar language was used in the first act passed after the ratification of the Sixteenth Amendment. Revenue Act of 1913, ch. 16, § IIB, 38 Stat. 167.

172. See 108 CONG. REC. 4146 (1962); see also Pub. L. No. 108-311, §§ 408(a)(7)(A), (B), 118 Stat. 1166 (2004) (amending § 165(i)); Pub. L. No. 105-34, § 912(a), 111 Stat. 788 (1997) (amending § 165(i)); Internal Revenue Serv., *supra* note 90, at \*12-14 (discussing the legislative history of § 165(i)).

173. 26 U.S.C. § 23(x) (1946).

174. See Randall R. Bovbjerg et al., *U.S. Health Care Coverage and Costs: Historical Development and Choices for the 1990s*, 21 J.L. MED. & ETHICS 141 (1993).

175. Internal Revenue Serv., SOI Bulletin, tbl. A, at 187-88 (Winter 2007), available at <http://www.irs.gov/pub/irs-soi/07winbul.pdf>.

gress had just created universal health insurance: “This allowance is recommended . . . [to] maintain[] the present high level of public health and morale.”<sup>176</sup>

### C. Structure

Much of this Note has addressed the broad structural similarities of § 165 to property insurance and of § 213 to medical insurance.<sup>177</sup> The structure of the sections themselves provides further support. For example, § 165’s enumeration of covered perils, “fire, storm, shipwreck, or . . . theft,” resembles the named perils in most property policies.<sup>178</sup>

Section 213 similarly covers many of the same topics as a health insurance policy,<sup>179</sup> dealing with the physicians it covers,<sup>180</sup> expenses after death,<sup>181</sup> and prescription drug coverage.<sup>182</sup> Like most employer-provided health plans, it covers dependents and spouses.<sup>183</sup> The section also has a number of coordinating references with Medicare, the nation’s largest health insurer.<sup>184</sup>

### D. Courts or the IRS Can Implement Use of Tax Law

Insurance law, policy, and practice could be used to interpret §§ 165 and 213 via two methods. First, federal courts hearing tax matters<sup>185</sup> could simply start using them to help decide cases. For example, either counsel for the IRS or a taxpayer could cite to insurance law in their briefs, and the court could use these citations in support of its decision. Given the text, history, and structure already noted, courts would have ample justification for doing so.

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176. *Id.* at 6.

177. *See also* Kaplow, *Deductions*, *supra* note 5.

178. *Cf.* ISO FORM, *supra* note 59, at “Section I Perils Insured Against” (enumerating perils, including “Fire,” “Lightning,” “Windstorm,” and “Theft,” among others).

179. Indeed, it even includes premiums paid for health insurance in the definition of deductible medical expenses. I.R.C. § 213(d)(1)(D) (2000).

180. *Id.* § 213(d)(4).

181. *Id.* § 213(c).

182. *Id.* § 213(b).

183. *Id.* § 213(a).

184. *See id.* §§ 213(d)(1)(D), (d)(4), (d)(7).

185. Tax matters can come before any federal district court, the federal court of claims, the tax court, any circuit court of appeals, and the Supreme Court. I.R.C. §§ 6213, 7422, 7441, 7482(b) (2000); 28 U.S.C. §§ 1295, 1346(a)(1), 1402(a)(1), 1491 (2000).

Second, the IRS itself could use its regulatory powers to bring insurance law to bear on §§ 165 and 213, preferably by issuing regulations in 26 C.F.R. §§ 1-165, 1-213 under its general rulemaking authority,<sup>186</sup> or, alternatively, by using insurance law to solve an issue presented in a Revenue Ruling.

The degree of deference given to such regulatory decisions remains unclear. For example, the lower courts and scholars continue to debate whether general-authority Treasury regulations receive deference under the *Chevron*<sup>187</sup> standard, or the earlier and less-deferential *National Muffler*<sup>188</sup> standard.<sup>189</sup> The Seventh Circuit aptly noted, “This seemingly simple inquiry leads us into a free-fire zone of judicial debate over the proper level of judicial deference to various IRS interpretations of the revenue laws.”<sup>190</sup>

Treasury regulations prescribing the use of insurance case law and practice should merit deference regardless of which standard courts apply. For example, under the less-deferential *National Muffler* standard, a court will look to see if the “regulation harmonizes with the plain language of the statute, its origin, and its purpose.”<sup>191</sup> The previous Sections of this Note, as well as Part II above, have provided evidence addressing just these factors.<sup>192</sup>

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186. I.R.C. § 7805(a) (2000) (“the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title”). Note that unlike a few Tax Code provisions, such as *id.* §§ 163(i)(5) and 357(d)(3), the two sections addressed by this Note do not have clauses specifically authorizing the issuance of Treasury regulations.
187. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (dealing with deference to EPA regulations).
188. *Nat’l Muffler Dealers Ass’n v. United States*, 440 U.S. 472 (1979) (dealing specifically with deference to Treasury regulations).
189. *See Swallows Holding, Ltd. v. Comm’r*, 126 T.C. 96 (2006) (en banc) (showing how divided the Tax Court remains on this issue). *Compare Hosp. Corp. of Am. & Subsidiaries v. Comm’r*, 348 F.3d 136, 140-41 (6th Cir. 2003) with *Snowa v. Comm’r*, 123 F.3d 190, 197 (4th Cir. 1997). *See generally* Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537 (2006) (thoroughly reviewing the debate over which standard to apply and concluding *Chevron* to be appropriate).
190. *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 977 (7th Cir. 1998).
191. *Nat’l Muffler*, 440 U.S. at 477.
192. Since the regulations proposed by this Note have obviously not been promulgated, many of the related *National Muffler* factors, such as the regulation’s longevity, reliance, consistency, and congressional scrutiny, cannot be predicted. *See id.* A court could also apply the quite similar standard from *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), which is also less deferential than *Chevron*, and which had its continuing vitality reaffirmed by *United States v. Mead Corp.*, 533 U.S. 218 (2001). *Skidmore* focuses on persuasiveness, and the arguments in this Note should help persuade. *See Skidmore*, 323 U.S. at 140.

Under the *Chevron* analysis, since nothing in the Code argues against interpreting §§ 165 and 213 using insurance law, the inquiry moves on to whether the agency's interpretation of the statute is a reasonable construction of the statute.<sup>193</sup> Again, the factors of text, history, and structure, addressed above, all weigh strongly in favor of such a regulation being a reasonable construction, and hence valid.<sup>194</sup>

#### E. Interaction with State Law

State regulators oversee private insurance, and insurance law is the province of state law. Some might object to federal income tax law taking cues from state law. Deferring to the insurance law of the taxpayer's state might also result in better or worse treatment than a similarly situated taxpayer in a state with different insurance case law, providing additional grounds for objection.

Federal tax law, however, has long deferred in many respects to state law. For example, the Supreme Court has held that courts should disallow a tax deduction "if allowance of the deduction would frustrate sharply defined national or *state* policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."<sup>195</sup> The proclamations of a state's courts and insurance commissioners certainly merit consideration as "governmental declarations." Similarly, in the landmark case *Poe v. Seaborn*,<sup>196</sup> the Supreme Court deferred to Washington state's community property law to allow a husband and wife to reduce their tax bill by splitting their income,<sup>197</sup> despite case law's generally strong tilt against income splitting.<sup>198</sup>

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193. *Chevron*, 467 U.S. at 842-45.

194. *Cf. id.* at 848-51 (looking at statutory language, legislative history, and policy to determine reasonableness).

195. *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 33-34 (1958) (emphasis added) (disallowing deduction of overweight truck fines under § 162, even though paying the fines was viewed as ordinary to the trucking business in that state); *see also* *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 n.17, 607 n.1 (1983) (denying tax-exempt status to otherwise clearly exempt educational institution based on "national policy to discourage racial discrimination in education").

196. 282 U.S. 101 (1930). *But see* I.R.C. § 1(a) (2000) (allowing for joint returns, effectively extending the benefit of *Seaborn* to married couples in non-community-property states).

197. Income splitting can provide huge benefits if the recipient is in a lower tax bracket.

198. *See, e.g., Helvering v. Horst*, 311 U.S. 112 (1937); *Lucas v. Earl*, 281 U.S. 111 (1930) (decided concurrently with *Seaborn*).

Of course, most principles of insurance law have wide acceptance, and many factors work to make insurance practice mostly uniform between the states.<sup>199</sup> When jurisdictions split on a point, the IRS or the Tax Court could simply accept the rule supported by the strongest reasoning. And, even if acceptance of a particular insurance principle would benefit some taxpayers relative to similarly situated taxpayers in other states, the Supreme Court long ago ruled that fully permissible in *Seaborn*.<sup>200</sup>

## V. SUBROGATION: A NOVEL SOURCE OF FEDERAL REVENUE

We live in a time of budgetary constraints, with Congress and the Administration pressing the IRS to collect more revenue but hesitant to raise tax rates.<sup>201</sup> This pressure has come along with record budgets for the Service.<sup>202</sup> This Part proposes that the IRS boost revenue by borrowing an approach long used by private insurers: subrogation.<sup>203</sup> While Parts II, III, and IV discussed drawing upon insurance law as precedent for interpreting tax law, this proposal goes a step further, showing how viewing these provisions as insurance can lead to novel policy proposals.

### A. Subrogation Basics

Subrogation allows insurers to stand in the shoes of the insured to recover monies paid out to the insured in those situations where a third-party<sup>204</sup> tortfeasor caused the loss.<sup>205</sup> For example, if *A* runs her car into *B*,

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199. For example, the ISO strongly promotes national uniformity in a variety of ways. See *supra* notes 50-62 and accompanying text.

200. *Seaborn* encouraged several states to move to community property, until Congress simply extended the benefits of *Seaborn* to married couples in common-law states in 1948 with the introduction of the joint return. See *supra* note 196.

201. See Tom Herman, *How to Avoid Getting Audited—IRS Ramps Up Scrutiny of High-Income Groups; Red-Flag Deductions*, WALL ST. J., Apr. 7, 2007, at B1 (“Pressured by Congress to collect more money, the Internal Revenue Service has been busy boosting its audits.”); Tom Herman, *Pressure Mounts to Crack Down on Those Not Filing Tax Returns*, WALL ST. J., Apr. 25, 2007, at D3.

202. Tom Herman, *Congress Set To Eliminate Loophole on Some Long-Term Capital Gains*, WALL ST. J., Feb. 14, 2007, at D2 (Bush administration proposes record \$11.1 billion budget for IRS to increase revenues).

203. Subrogation is not limited to insurance law, playing a role in general debtor-creditor law. “Subrogation extends to every instance in which one party is required to pay a debt for which another is primarily answerable.” *Nw. Farm Bureau Ins. Co. v. Althaus*, 750 P.2d 1166, 1167 (1988) (quotations omitted).

204. A fundamental principle of insurance subrogation is that the insurer has no subrogation rights against the insured. Otherwise, insurance would serve little value: paying premiums, then litigating to get them back. For example, this



resulting in massive hospital bills, then *B*'s health insurer would have subrogation rights against *A* for the hospital bills.<sup>206</sup> Similarly, if *X* negligently kills 18,000 of *Y*'s chickens, and *Y*'s property insurer compensates *Y* for her loss, the insurer can then sue *X* in tort.<sup>207</sup> The insurer can typically bring suit in the name of the insured,<sup>208</sup> and can often invoke the collateral source rule<sup>209</sup> to keep jurors from knowing that insurance has already compensated the loss.<sup>210</sup>

Property insurers have long pursued their subrogation rights,<sup>211</sup> and health insurers have also become particularly aggressive in this area with the inexorable increases in medical costs.<sup>212</sup> This trend towards increasing use of

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would render insurance provisions covering damage due to the negligence of the taxpayer nugatory. Courts have extended this principle to "implied co-insured" such as tenants. *See, e.g., Alaska Ins. Co. v. RCA Alaska Comm'ns*, 623 P.2d 1216 (Alaska 1981).

205. Note that if an insured were herself to initiate a suit against the tortfeasor, then the insurer would have an action against the insured. In this way, subrogation vindicates the principle of indemnity, *see* Section II.D *supra*, by preventing the injured party from recovering twice: once from her insurer and again by suing the tortfeasor. The Code already guards against this type of subrogation problem by disallowing the deduction if "compensated for by insurance or otherwise." I.R.C. §§ 165(a), 213(a) (2000) (emphasis added). The IRS explicitly states that "or otherwise" includes recovery by lawsuit. *Treas. Reg. § 1.165-1(d)(2)(ii)* (2006).
206. Most courts find health insurers have subrogation rights. *See, e.g., Int'l Underwriters, Inc. v. Blue Cross & Blue Shield, Inc.*, 449 A.2d 197 (Del. 1982); *Canfora v. Coast Hotels & Casinos, Inc.*, 121 P.3d 599 (Nev. 2005).
207. Facts directly from *Insurance Co. of N. America v. Cease Electric, Inc.*, 688 N.W.2d 462 (Wis. 2004).
208. Jurisdictions vary on this. *See generally* STEMPER, *supra* note 50, § 11.04 (discussing party naming rules and subrogation structuring).
209. RESTATEMENT (SECOND) OF TORTS § 920A(2) (1979).
210. Many tort reform advocates have pushed for reforming the collateral source rule. *See* NAT'L ASS'N OF MUT. INS. COS., COLLATERAL SOURCE RULE REFORM, <http://www.namic.org/reports/tortReform/CollateralSourceRule.asp> (last visited Dec. 12, 2007) (listing the progress of reform).
211. *See, e.g., Mason v. Sainsbury* (1782), 99 Eng. Rep. 538 (K.B.).
212. *See, e.g., BLUECROSS BLUESHIELD OF SOUTH CAROLINA, UNDERSTANDING YOUR BENEFITS AND CONTROLLING HEALTHCARE COSTS*, [http://www.southcaroliablues.com/bcbs/bcbs\\_img.nsf/\(WebFiles\)/benefit\\_coordination\\_broch.pdf/\\$FILE/benefit\\_coordination\\_broch.pdf](http://www.southcaroliablues.com/bcbs/bcbs_img.nsf/(WebFiles)/benefit_coordination_broch.pdf/$FILE/benefit_coordination_broch.pdf) (last visited Dec. 12, 2007) ("BlueCross uses workers' compensation and subrogation to ensure your healthcare bills for an injury or illness caused by someone else are paid correctly. Our efforts help contain healthcare costs by reducing premium dollars

subrogation applies even to government-run full insurance programs such as Medicaid.<sup>213</sup> Since the IRS provides partial insurance through §§ 165 and 213, it could also pursue subrogation rights against tortfeasors who cause deductible losses or medical expenses. Specifically, it could aim to recover the amount of tax revenue lost directly because of the deduction taken by the tort victim.

### B. Benefits of Allowing the IRS To Pursue Subrogation

This proposal would most obviously allow the federal government to raise additional revenue directly from tortfeasors. In doing so, it would also further the tort law goals of deterrence and accountability, much as private insurers' subrogation does.<sup>214</sup> The IRS has substantial experience practicing before various courts on matters not directly related to tax law, suggesting it could competently take advantage of the opportunity to pursue subrogation.<sup>215</sup> Moreover, it has extremely effective collection tools not available to private parties.<sup>216</sup>

Other economic considerations often lead tort victims not to pursue their possible causes of action. For example, a business will often not pursue a lawsuit when injured by the negligence of an important customer, supplier, or partner. In such circumstances, the parties may reach an informal agreement, and shove much of the loss onto the federal government via § 165. Giving the IRS subrogation rights would discourage such agreements. In the extreme, two taxpayers might even collude to get a loss deduction, a form of moral hazard combated by subrogation.<sup>217</sup>

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paid by you and/or your employer.”); *see also* Theo Francis, *House Bill Provision May Help Insurers Recover Medical Costs*, WALL ST. J., June 8, 2006, at D2; *cf.* *Sereboff v. Mid Atl. Med. Servs.*, 547 U.S. 356 (2006) (allowing subrogation under ERISA).

213. *Cf.* *Arkansas Dept. of Health & Human Svcs. v. Ahlborn*, 547 U.S. 268 (2006) (limiting Medicaid subrogation rights to amount of medical damages).
214. *See* STEMPEL, *supra* note 50, § 11.03 (listing rationales for subrogation).
215. For example, the IRS is a regular litigant in bankruptcy courts. *E.g.*, *Begier v. IRS*, 496 U.S. 53 (1990) (examining bankruptcy liquidation of airline, with result turning on issues of trust law).
216. *E.g.*, I.R.C. §§ 6320-27 (2000) (tax liens). The IRS naturally has extensive experience enforcing these liens and dealing with competing liens. *Cf. In re Walter*, 45 F.3d 1023 (6th Cir. 1995).
217. Michael Sean Quinn, *Subrogation, Restitution, and Indemnity: The Law of Subrogation*, 74 TEX. L. REV. 1361, 1372 (1996) (reviewing CHARLES MITCHELL, *SUBROGATION, RESTITUTION, AND INDEMNITY: THE LAW OF SUBROGATION* (1994)) (“[S]ound public policy requires that there be subrogation in the law of insurance . . . . The absence of subrogation would create a powerful moral

### C. Implementation of IRS Subrogation

When taking § 165 deductions, taxpayers currently must fill out a form<sup>218</sup> listing each property damaged, along with insurance information, date acquired, and fair market values. It would not be difficult to require brief information about the cause of the loss. This information would allow the IRS to perform a quick cost-benefit analysis and decide whether to pursue its subrogation rights. The IRS could similarly require basic itemization with § 213 deductions.

A thornier problem arises with statutory authorization. In the absence of explicit authorizing legislation, the IRS could pursue subrogation supported by two theories. First, it could issue regulations giving itself the power to pursue subrogation rights and hope that courts find these regulations worthy of the relevant level of deference.<sup>219</sup> Second, the IRS could simply claim equitable subrogation rights. There are two types of subrogation: equitable and contractual.<sup>220</sup> Most insurance policies have explicit subrogation clauses, so most insurance subrogation is contractual.<sup>221</sup> Even in the absence of such terms, courts typically give the insurer equitable subrogation rights, based solely in equity, rather than contractual terms or a statute.<sup>222</sup> The IRS could similarly seek equitable subrogation for its losses due to § 165.

Regardless of which of the two approaches the IRS took, courts would likely hesitate to find a subrogation right in a reasonable interpretation of the statute<sup>223</sup> or to find the equities pointing towards subrogation. In effect, the IRS would be attempting to create a new cause of action for itself. Realistically, subrogation would probably require congressional authorization,

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hazard . . . . In the absence of subrogation, people would be tempted to conspire to perform actions which appear to be torts.”).

218. I.R.S. Form 4684 (2007), available at <http://www.irs.gov/pub/irspdf/f4684.pdf>.

219. See discussion *supra* Section IV.D.

220. See STEMPER, *supra* note 50, § 11.02.

221. These can often detail particular aspects of the subrogation relationship, such as the duty to do certain paperwork and cooperate. *E.g.*, ISO FORM, *supra* note 59, at “Sections I and II Conditions” § F.

222. *E.g.*, Hartford Accident & Indem. Co. v. Pac. Indem. Co., 57 Cal. Rptr. 492 (Cal. App. 2d 1967); First Nat’l Bank of Columbus v. Hansen, 267 N.W.2d 367 (Wis. 1978).

223. Courts’ *Chevron* decisions are unpredictable and often based on ideological policy preferences. See Thomas J. Miles & Cass R. Sunstein, *Do Judges Make Regulatory Policy? An Empirical Investigation of Chevron*, 73 U. CHI. L. REV. 823 (2006).

which could also address procedural details such as venue, notice, available defenses, the effect of contractual waivers,<sup>224</sup> and the deductibility of a tortfeasor's payments to a prevailing IRS.<sup>225</sup> The budgetary constraints of modern governing and the Treasury's influence over the lawmaking process put congressional action well within the realm of possibility.

Once the IRS sues a tortfeasor to recover lost revenue, the victim will probably often join the lawsuit to vindicate her full rights.<sup>226</sup> At this point, the IRS could simply leave the suit. Should the victim recover, the taxpayer would lose the deduction, thereby restoring the Treasury to the same position as if it had won on its own.<sup>227</sup> Indeed, the IRS's filing suit could provide a reluctant plaintiff with "cover" to pursue the tortfeasor; alternatively, the taxpayer might avoid taking the deduction at all to avoid having the IRS file suit against a key supplier or customer. Either way, the Treasury and the average taxpayer benefit.

#### CONCLUSION

Insurance law and policy have developed over centuries at the hands of innumerable judges, legislators, and regulators. The practices of the insurance industry have emerged from the input of these government actors, as well as from scholars, consumer groups, and data on literally hundreds of millions of policies. Insurance case law provides well-reasoned, policy-oriented resolutions to a wide variety of situations and problems in the tax context. In interpreting and implementing the partial insurance programs of §§ 165 and 213, the IRS and the federal courts have much to gain from looking to insurance law for precedent and guidance.

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224. *Cf.* *Great N. Oil Co. v. St. Paul Fire & Marine Ins. Co.*, 189 N.W.2d 404 (Minn. 1971) (honoring exculpatory waiver by insured, thereby defeating the insurer's subrogation rights).

225. Allowing the tortfeasor to deduct the amounts collected by the IRS would blunt the value of the subrogation rights to the Treasury, as the recovery would be measured in after-tax dollars.

226. In much the same way, disallowing deductions for insured losses for which the taxpayer does not submit a claim has encouraged taxpayers to seek compensation from insurance. *Cf.* I.R.C. § 165(h)(4)(E) (2000).

227. The tax code, via marginal tax rates and deduction rules, already determines the portion of the victim's recovery that the IRS can collect. As a result, neither the IRS nor Congress needs to consider which subrogator-subrogee allocation method to use. *Cf.* STEMPER, *supra* note 50, § 11.04 (listing the three most prevalent allocation formulas).