Justifying the Exclusion of Insurance

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Casualty Insurance for Excess Living Expenses

A general rule is that a taxpayer has income when another person either reimburses or directly pays the taxpayer's personal expenses. However, there are exceptions, many of which involve insurance reimbursements or payments. One such exception appears in section 123, which was enacted in 1969 and exempts payments from an insurance company to reimburse a taxpayer for excess living expenses attributable to casualty damage that makes the taxpayer's home unusable.

In Rev. Rul. 59-630, the IRS held (before the enactment of section 123) that a taxpayer must include in gross income payments received from an insurance company to compensate for the taxpayer's excess living expenses. In the ruling the taxpayer's home was damaged by a fire and became uninhabitable. The taxpayer carried fire insurance on the property that provided reimbursement for "any increase in his family's living expenses resulting from loss of use and occupancy of the residence." The IRS stated:

The insurance proceeds which compensated the taxpayer for added living expenses constitute gross income to the taxpayer within the meaning of section 61 of the Code. The latter amounts were received to compensate the taxpayer for the loss of use and occupancy of his home. The value of the use and occupancy of a dwelling by the owner thereof does not constitute gross income to him. However, when transformed into cash, as where an owner rents his property to another, the amounts received constitute gross income. This is true even though the cash receipt is in the form of insurance proceeds. [Citations omitted.]

Before the enactment of section 123, the courts followed the conclusion of this ruling. In *Millsap v. Commissioner*, the taxpayer's home was destroyed by a fire. Both the Tax Court and the Eighth Circuit held that the taxpayer had income for the amounts received under an insurance contract for reimbursement of excess living expenses attributable to the loss of his house. Neither court provided much analysis of the issue, although they both cited Rev. Rul. 59-630 approvingly.

Section 123(a) provides that a taxpayer whose principal residence is damaged or destroyed by a casualty does not have income for amounts provided under an insurance contract to
"compensate or reimburse such individual for living expenses incurred for himself and members of his household resulting from the loss of use or occupancy of such residence." Thus, a taxpayer will not recognize income even though the insurance company is paying for the taxpayer's personal expenses.³

A limitation to the general rule appears in section 123(b), under which the exclusion from income applies only to the amounts received by taxpayers for living expenses that exceed their normal or regular living expenses.⁴ Reg. section 1.123-1(b)(1) further clarifies that "the excludable amount represents such excess expenses . . . for renting suitable housing and for extraordinary expenses for transportation, food, utilities, and miscellaneous services during the period of repair or replacement of the damaged principal residence."

One other case involving insurance payments for excess living expenses is worthy of note. In McCabe v. Commissioner,⁵ the taxpayers lost the use of their home because of a fire in 1965. The Tax Court rendered its opinion in the case in 1970, after the enactment of section 123, but the law was not applied retroactively so it did not apply to the tax year at issue. The taxpayers contended that the "adverse legislative response" to Millsap required a reversal of the holding in that case. The taxpayers also argued that economically they were no better off and thus "it would be unfair to tax them merely because the nontaxable use and occupancy of their house was temporarily and involuntarily converted to cash." The Tax Court disagreed and held that the insurance payments must be included in income. The Tax Court noted that "the involuntary conversion of property into cash may result in a gain, even though the taxpayer is economically no better off."

Thus, the courts generally held that insurance payments for excess living expenses were includable in the taxpayer's income. Although Congress altered that result by enacting section 123, the limitation in the provision implies that insurance payments for normal or regular living expenses will not be excluded from income.⁶ That conclusion conforms to the general rule that a taxpayer has income when another person pays for that taxpayer's personal expenses. Two questions are raised and discussed in this article. First, were the courts and the IRS correct in determining that excess living insurance payments should be treated as income? (Or put another way, is section 123 truly required to reach the nontaxable result?) Second, should the general rule of taxability apply to normal or regular living expenses or is there justification for excluding all such insurance reimbursements or payments?

**Tax Treatment of Liability Insurance**⁷

To better understand the tax treatment of insurance payments for excess living expenses, let us consider the tax treatment of a more familiar insurance product -- liability insurance. A taxpayer buys liability insurance by paying the insurance company a premium. Assume an insured taxpayer causes an accident and, under the insurance contract, the insurer is required to pay a third party for the damage caused by the taxpayer. Currently, the taxpayer does not recognize income even though the insurance company is paying the taxpayer's personal liability. Commentators have noted this seemingly inconsistent result:

Yet another, more perplexing exception to the *Old Colony* rule is the universally accepted
exclusion by a taxpayer-tortfeasor of liability insurance proceeds paid to a claimant plaintiff by the insurance company on the taxpayer's behalf. This treatment is sanctioned by practice, even though there is no statutory provision or administrative or judicial authority on point.  

One reason for the exclusion may be unrelated to tax policy -- Congress wanted to encourage people to buy insurance (or at least not have the tax system discourage it). While that may be true, there is also another principled justification for the current exclusion treatment. To understand it, consider the well-established doctrine of anticipation of income. If an individual sells for a fair price the right to dividends (but not the underlying stock) for the next five years, that individual will have ordinary income for the amount received. The dividends paid will be taxed to the buyer rather than the seller, but the buyer is allowed a deduction for the amortization of the amount the buyer paid for the right to the dividend. The right to the dividend income passes from the seller to the buyer, and the seller is no longer subject to tax on that income. In effect, the seller is taxed on the present value of the assigned income as reflected by the amount paid to the seller for the right to that income, and the amount received by the buyer in excess of that present value is taxed to the buyer. The seller is thereby able to shift to the buyer the incidence of the tax on the amount of assigned income that accrues in the buyer's hands.

What significance does the anticipation of income doctrine have for the proper treatment of insurance proceeds? When a person purchases insurance coverage, he pays the insurer to assume a risk that otherwise is borne by the insured. The premium paid reflects the current dollar value of the risk that is insured plus a fee for the services provided by the insurer. If the loss that was insured takes place, the amount of that loss in excess of the value of the risk at the time that the premium was paid reflects the increase in the value of the risk while in the hands of the insurer. As a consequence of that contract, the insurer (rather than the insured) is the person primarily responsible for any losses that are covered by the insurance contract. The transfer of the risk to the insurer is comparable to the transfer of the right to income in an anticipation of income transaction.

It is true that the insured party is also liable to the injured parties for the damage, but the ultimate liability for those damages lies with the insurer who had agreed to accept that risk. It is irrelevant to the tax treatment of those payments that the insured is secondarily liable for those damage payments should the insurer fail to fulfill the contract. The fact that the insured could be required to pay the victims of his actions does not make the insured the primary obligor because the insured would be entitled to reimbursement from the insurer if he pays. For tax purposes, the primary obligor should be deemed to be the person who ultimately bears the loss.

Is Section 123 Necessary?

Based on the above analysis, Millsap and McCabe were wrongly decided and section 123 is an unnecessary provision. When a taxpayer pays an insurance premium and thereby purchases insurance for excess living expenses attributable to the loss of the taxpayer's home, the taxpayer has shifted the risk of loss to the insurance company for those excess expenses. The insurance company is the primary obligor if those expenses become due, and thus the
insurance company’s payment or reimbursement of those expenses should not cause the insured taxpayer to have income in that amount. However, perhaps section 123 is required not because it is needed to exclude the insurance payments from the taxpayer's income, but rather to override this analysis for insurance reimbursements for regular living expenses. That is, under this analysis of risk-shifting, shouldn’t the taxpayer also be able to exclude insurance payments for regular expenses? If the insured has paid a premium for the insurance company to be liable for regular expenses as well as excess living expenses, does the above analysis suggest none of the insurance payments should be income?

Section 123 is not required to avoid this result. Insurance must involve a true shifting of risk. The Supreme Court has held that “historically and commonly insurance involves risk-shifting and risk-distributing.”14 While there is risk involved in the section 123 insurance transaction -- that is, there is a risk that the taxpayer's home may become uninhabitable because of a casualty and the insured may then incur excess expenses because of that consequence -- there is no risk concerning the taxpayer's regular living expenses which, by definition, are the same when a casualty occurs as they would be if no casualty had occurred. It is impossible to shift the risk of incurring regular living expenses because there is no possibility that they will not be incurred. Nor would the occurrence of injury to the taxpayer's home have any adverse effect on the taxpayer's ability to pay those expenses. Therefore, those expense reimbursements should not qualify for the same tax treatment as those reimbursements that are the product of true risk-shifting.

Conclusion

It is unlikely that Congress will repeal section 123. The purpose of this article is to explore the tax policy justification behind the insurance exclusion on all types of insurance payments, not just those covered by section 123. Although the exclusion has been accepted by the IRS and courts, there has been no attempt to justify the exclusion as a matter of policy. By presenting this article, the author hopes that the IRS and courts looking at this issue in other contexts will be better able to analyze the situation and reach the correct tax result.

by Jeffrey H. Kahn

Jeffrey H. Kahn is a professor of law at Washington and Lee University School of Law. Using section 123 (exclusion for casualty insurance proceeds for excess living expenses) as an example, this article provides a tax policy justification for the general exclusion of insurance proceeds for the insured party.

FOOTNOTES
1 See, e.g., Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (when an employer pays the income tax owed by an employee, the employee has income).


3 Note that this provision offers better tax treatment to the insured taxpayer than is available to the uninsured taxpayer. An uninsured taxpayer is not afforded a deduction for the living expenses incurred on account of a casualty loss to the principal residence even though an insured taxpayer gets an exclusion (which can be viewed as an implicit deduction) for the amounts paid by the insurance company. This is one of many examples in the code of nonparallel treatment for reimbursed and unreimbursed taxpayers. See Jeffrey H. Kahn, "The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity," 57 Hastings L.J. 645 (2006).

4 For purposes of determining the limitation amount, the excess expenses incurred by the taxpayer are offset by the taxpayer's savings in reducing or eliminating expenses that would have been incurred if the taxpayer had used the primary residence. Reg. section 1.123-1(b)(4), Example 1.


6 Reg. section 1.123-1(a)(5).

7 Much of this section and its analysis derives from the author's article, "Hedging the IRS -- A Policy Justification for Excluding Liability and Insurance Proceeds," 26 Yale J. on Reg. 1 (2009).

8 Boris I. Bittker, Martin J. McMahon Jr., and Lawrence A. Zelenak, Federal Income Taxation of Individuals, para. 3.08[1][c] (3d ed.).


10 There is no term to refer to the dollar amount that a risk represents. I use the term "value" to refer to that dollar amount, but I recognize that it is an awkward choice. I will use the term "value" in this manner throughout the article.

11 The portion of the premium that represents a payment for the service performed by the insurer does not represent the present value of any part of the risk borne by the insured.

12 Cf. reg. section 1.752-2(b)(1), (b)(3), and (f), Example 4. Also consider the analogous circumstance in which an employee's negligence causes harm to a third party who recovers damages from the employer. Even though the employee also was liable for the injury, the employer's payment is not income to the employee.

13 Prof. Joseph M. Dodge has also argued that Millsap was wrongly decided. Dodge, "The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress From Disallowing Such Costs," 27 Va. Tax Rev. 297, at 342 n.181. Dodge was on the right track, but his explanation for his position is inadequate. Dodge states:
The real problem with *Millsap* is that the taxpayer already paid for the reimbursed personal consumption in the form of the nondeductible premium payments. The premium is full payment for the right to reimbursement, and therefore it is full payment for the consumption. That market transaction is the equivalent of paying an 'average price' for future services whose value is contingent and unknown. In sum, the result of *Millsap* was to effectively tax the same consumption twice.

While reaching a correct result, this argument fails to explain why the payment of a nondeductible premium excludes the insurance payment from taxation and why a contrary result would constitute double taxation of consumption. For example, X purchases gasoline for his automobile, which he used for personal purposes. The station at which X purchased the gasoline has a promotional program under which the 10,000th person to purchase gasoline there will be reimbursed by the station for all their gasoline expenses for that car for the next six months. X happens to be the 10,000th customer and is awarded the right to reimbursement for gasoline expenses. X's payment for the gasoline was a nondeductible payment for personal consumption. The resulting right to reimbursement was a product of X's having made that purchase. The purchase included the obtaining of a chance to win the right to reimbursements for six months. When X receives a reimbursement for the gasoline purchases he later makes, those reimbursements will be included in his gross income. The expenditures for subsequent purchases of gasoline are separate consumptions from the purchase of gasoline in the first instance. There is no double tax of a single consumption. Dodge's use of a comparison of insurance proceeds to the purchase of an undetermined amount of future services (examples of this are HMOs and auto club memberships) as a reason for excluding insurance proceeds is a circular argument. The purchase of future services includes a kind of insurance contract. In addition to paying for services, the purchaser is buying insurance that the purchaser's costs for future services will not exceed a fixed amount (i.e., the amount paid upfront to the service provider). The purchaser shifts to the service provider the risk that the amount of services needed will exceed the amount paid to the service provider. There is no doubt that the IRS will not seek to tax the purchaser if the value of the services actually received exceeds the amount paid, and that is equally true when the liability insurance proceeds exceed the amount of premiums paid. But, the question is not whether those payments are excluded from income (we know that they are), but rather why are those payments excluded. In this article, I have offered a policy justification as to why the exclusion exists.

14 Helvering v. Le Gierse, 312 U.S. 531 (1940) (the Court determined no actual risk had been shifted from the decedent to the insurer and thus the insurance payment on the decedent's death did not qualify as insurance proceeds). See also Donald A. Winslow, "Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies," 40 *Case W. Res. L. Rev.* 79, 96 (1990). ("The courts have followed this analysis and found the absence of insurance where the company in question did not assume an underwriting or economic risk. In addition, the risk must be substantial.")

END OF FOOTNOTES