Taxing the Disabled: the IRS, the Insurance Industry, and the Disability Waiver of Premium Rider

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Introduction

This Comment discusses the current tax methods being applied to the disability waiver of premium rider, an optional addition to life insurance policies that waives subsequent annual premiums in the event the policyholder becomes disabled. This Comment will show that the seminal case regarding the taxation of disability waiver of premium riders, Estate of Wong Wing Non v. Commissioner, has been misconstrued by both the IRS and the insurance industry. This has allowed for the existence of two scenarios where a disabled policyholder is subjected to an unexpected tax liability he would have avoided but for the onset of disability.

Finally, the correct holding from Wong Wing Non will be analyzed and constructed: waived premiums constitute a constructively received disability benefit that should be excluded from taxation under § 104 of the Code. Model legislation will also be proposed as an alternative to a subsequent judicial challenge to Wong Wing Non.

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1 See Compensation Planning, 386-3rd Tax Management Portfolio (BNA) II-B(2)(c)(8) (2006) [hereinafter Compensation Planning] (discussing the function of the disability waiver of premium rider); KENNETH BLACK, JR. & HAROLD SKIPPER, JR., LIFE INSURANCE 53 (11th ed. 1987) (explaining that the majority of individual life insurance policies sold in the United States provide that if the insured becomes totally disabled, the insurer will waive premium payments during the period of disability due to a provision either automatically included within the policy or, more commonly, offered as an additional benefit for a specified additional charge); WILLIAM F. MEYER, LIFE AND HEALTH INSURANCE LAW § 12:14 (Bancroft-Whitney Co. & The Lawyers Co-Operative Publ’g Co. 1972 & Supp. 1996) (1964) (“The waiver of premium benefit is also commonly written in connection with a life policy.”).
2 See Compensation Planning, supra note 1; MURIEL L. CRAWFORD, LAW AND THE LIFE INSURANCE CONTRACT 206 (Amy Lund ed., Irwin 7th ed. 1994) (1960) (discussing the operation of the disability waiver of premium rider and how insurers sell the waiver of premium disability benefit as part of life insurance policies more extensively than a separate disability income benefit); MEYER, supra note 1.
3 18 T.C. 205 (1952) [hereinafter Wong Wing Non].
I. THE FUNCTION OF THE DISABILITY WAIVER OF PREMIUM RIDER

Insurance riders have long been used to modify insurance policies to fit the unique needs of particular insureds and insurers. One rider in particular, the disability waiver of premium rider, is usually an optional addition to life insurance policies. Policyholders can purchase the rider for a nominal charge which is then added to the life insurance premium. In the event that the insured becomes disabled, a benefit is received whereby the policyholder no longer is required to pay the premiums due on the policy for the duration of the disability. In certain scenarios however, the self-insured’s receipt of the waiver of premium benefit can lead to unexpected tax liabilities.

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4 See WILLIAM R. VANCE, HANDBOOK ON THE LAW OF INSURANCE 278 (Jesse H. Chopper et al. ed., West Pub’g Co. 3d ed. 1951) (1904) (West Pub’g Co. Hornbook Series) (discussing that in the conduct of insurance business, insurance riders solve the dilemma of the often necessary task of adding a new term to a policy, or modifying or waiving an existing term); CRAWFORD, supra note 2 (discussing how insurers first offered disability benefits in life insurance contracts before the turn of the 20th century via disability waiver of premium riders).

5 See Compensation Planning, supra note 1 (analyzing the disability waiver of premium rider as a cost-effective option in a life insurance policy where cash values can be used to provide income to the insured during times of disability); KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 113 (commenting on the pricing of disability waiver of premium riders as either being included in the regular premium price or more likely being added to the life insurance contract for a small extra premium).

6 See supra note 1. The exact definition of “disability” is policy specific but the customary wording of the clause declares the policyholder to be entitled to the benefits promised when the insured’s illness or injury results in his or her total and permanent disability. See KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 113; LEE R. RUSS ET AL., COUCH ON INSURANCE §§ 146:3-147:1 (3d ed. 1998) (analyzing how general disability, or non-occupational, policies defines disability). Note also that the Internal Revenue Code defines disability. See I.R.C. § 22(e)(3) (2000) (defining disability for the application of a tax credit benefiting qualified elderly and permanently and totally disabled taxpayers) (“An individual is permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.”); Holcomb v. Prudential Ins. Co., 673 F.2d 102 (5th Cir. 1982) (held a provision which stated that a period of total disability which commenced more than sixty days after the disabling injury was sustained was deemed to be a disability due to sickness, was held applicable only when initial disability commenced more than 60 days from the date of injury). After the onset of this disability, the policyholder is relieved of paying the premiums. See Compensation Planning, supra note 1; MEYER, supra note 1. Insurance experts recommend the disability waiver of premium rider as an essential protective measure for those seeking insurance coverage. See MEYER, supra note 1 (commenting on how the waiver feature not only keeps the policy in force, but it adds to the cash values as well).

7 Separate tax treatment may apply to the policyholder if the policy was provided by an employer. The tax treatment of employer provided insurance is beyond the scope of this Comment. See I.R.C. §§ 104(a)(3), 105, 106 (2000); Rev. Rul. 2004-55, 2004-1 C.B. 1081. See also STEPHAN R. LEIMBERG ET AL., STANLEY & KILCULLEN’S FEDERAL
Background

II. INSURANCE POLICIES AND THE INTERNAL REVENUE CODE

The Internal Revenue Code ("the Code")\(^9\) delimits the taxation of insurance policies and several sections need to be understood before an analysis concerning the taxation of the disability waiver of premium can be made.

In 1984, Congress enacted § 7702, a comprehensive statutory definition of life insurance.\(^{10}\) Life insurance policies enjoy certain favorable tax benefits\(^{11}\) and § 7702 serves to exclude certain other insurance and investment vehicles from this treatment.\(^{12}\) Essentially, § 7702 provides that, for a contract to qualify as a life insurance contract for Federal income tax

\(^{11}\) See I.R.C. § 101(a) (2000) ("Except as otherwise provided in paragraph (2), subsection (d), and subsection (f), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured."); MEYER, supra note 1, at § 25:1 (discussing the exclusion of death proceeds from gross income as a general rule); Pike, supra note 10, at 502 (analyzing the favorable tax treatment afforded to life insurance policies as investments) ("The increase in the cash value of a life insurance contract consists, in part, of interest or other investment returns that the life insurance company credits to the policy's cash value. The tax treatment of this interest credited differs from the tax treatment of other forms of interest in three significant respects. First, taxation of the interest is deferred. Second, the income measurement rules cause a portion of the interest credited to escape taxation. Third, § 101(a) generally excludes the remaining interest from gross income if the policy remains in force until the death of the insured.").
\(^{12}\) See Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1315 (11th Cir. 2001) (summarizing special tax treatment afforded to life insurance policies that meet the requirements of § 7702 in a case involving sham loans made by a corporate taxpayer against insurance policies held on its employees); KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 223 (commenting on how § 7702 limits the Code's favorable life insurance tax treatment to policies whose savings element do not predominate over the protection aspect); MEYER, supra note 1, at § 25:1 ("For purposes of the I.R.C, to be considered a life insurance contract, a contract issued after 1984 must qualify as such a contract under applicable state or foreign law and must meet either a cash value accumulation test or a guideline premium and cash value corridor test."); Pike, supra note 10, at 507 (explaining the impact of § 7702) ("This definition eliminated uncertainty as to the tax status of various life insurance products while denying life insurance status to some that were considered overly investment oriented.").
purposes, the contract must be a life insurance contract under the applicable law and must either (1) satisfy the cash value accumulation test of § 7702(b), or (2) meet the guideline premium requirements of § 7702(e), and fall within the cash value corridor of § 7702(d).\(^{13}\)

Section 72 of the Code sets out the rules for the taxation of the proceeds of life insurance policies paid by reason other than the death of the insured.\(^{14}\) Most applicable to this Comment are §§ 72(b) and 72(e) which govern the tax treatment of dividends and surrenders of life insurance policies.\(^{15}\) A life insurance payout (brought by policy surrender, redemption, or maturity) is taxed in reference to the policyholder’s investment in the contract.\(^{16}\) The

\(^{13}\) I.R.C. §§ 7702(b)-(d) (2000). These tests serve to limit how much money may be paid into a policy and how quickly. See Rev. Rul. 2005-6, 2005-1 C.B. 471 (illustrating how a contract meets the requirements of § 7702 in a dispute over whether the contract was a valid policy and whether charges for qualified additional benefits should be taken into account under the mortality charge rule of § 7702(c)(3)(B)(i) or the expense charge rule of § 7702(c)(3)(B)(ii) (“A contract meets the guideline premium requirements of § 7702(c) if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of that time. The guideline premium limitation as of any date is the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to that date. . . . A contract meets the cash value accumulation test of § 7702(b) if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future benefits under the contract.”).

\(^{14}\) I.R.C. § 72 (2000); STEPHAN R. LEIMBERG ET AL., supra note 8, at 3-29. Although the statutory language of § 72 deals mainly with contracts containing an annuity feature, courts have assumed that taxation of gain realized on surrender or exchange of life insurance or endowment policies lacking such a feature is governed by § 72(e). See Gallun v. Comm’r, 327 F.2d 809, 810 (7th Cir. 1964); Barrett v. Comm’r, 42 T.C. 993, 998 (1964), aff’d, 348 F.2d 916 (1st Cir. 1965).

\(^{15}\) I.R.C. §§ 72(b), 72(e)(5)(E) (2000) (“(b)(1) Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). . . . (e)(5)(E) This paragraph shall apply to—(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and (ii) any amount received under a contract on its complete surrender, redemption, or maturity.”). Generally, if dividends are received under a life insurance policy to which § 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity (whichever is later) such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Simply stated, dividends received by the policy owner are not included in his or her gross income until the amount of dividends exceeds the amount of premiums and other consideration he or she has paid for the policy. This same principle of return on investment also applies to policy surrenders. See Treas. Reg. § 1.72-11(b)(1) (2006) (analyzing the tax treatment of amounts not received as annuity payments); LOUIS A. MEZZULLO, AN ESTATE PLANNER’S GUIDE TO LIFE INSURANCE 21 (Roger D. Winston et al. ed., ABA Publishing 2000) (commenting on the taxability of insurance policy dividends); Pike, supra note 10, at 493 n.1 (discussing the history of § 72(e) and its treatment of policy surrenders).

\(^{16}\) I.R.C. § 72(e)(5)(A) (2000). The general rule for taxation of lump-sum cash value payments made on life insurance policy surrenders is the cost recovery rule. Under this rule, the amount included in the policyholder’s
policyholder’s investment in the contract at any given time is the aggregate amount of premiums or other consideration paid for the contract to date, minus the aggregate amount received under the contract to date.\textsuperscript{17} Section 72(e) also works in conjunction with § 7702(f)(1)(A) in defining “premiums paid” as premiums paid under the contract less amounts to which § 72(e) applies. This Comment will illustrate that the interpretation of these definitions directly affects the disabled insured taxpayer.

Finally, § 104(a)(3) generally excludes from gross income amounts received through accident or health insurance for personal injuries or sickness.\textsuperscript{18} This Comment will show that the disability waiver of premium benefit can be construed as a disability benefit which would then exclude it from taxation.\textsuperscript{19}

\textsuperscript{17} I.R.C. § 72(e)(6) (2000). The cost basis of a life insurance contract normally is the sum of the premiums paid less the sum of any dividends received in cash or credited against the premiums. See KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 225. This cost basis is also referred to as the policyholder’s investment in the contract. For example, if total premiums paid were $10,000, but excludable amounts not received as an annuity (e.g., distributions or loans) totaled $500, the investment in the contract would be $9,500. See STEPHAN R. LEIMBERG ET AL., supra note 8, at 3-30 (discussing the computation of investment in the contract).

\textsuperscript{18} I.R.C. § 104(a)(3) (2000). This section applies only to an individual who purchases the policy out of his or her own funds. Special provisions apply for amounts received by an employee. See Treas. Reg. § 1.104-1(d) (2006); supra note 8. See generally O’Gilvie v. United States, 66 F.3d 1550, 1558 (10th Cir. 1995) (discussing the general applicability of § 104) (“All of the subsections of § 104 address replacement for losses resulting from injury or sickness, and thus are compensatory in nature.”).

\textsuperscript{19} Generally, disability benefits are treated as amounts received through accident or health insurance. See Rev. Rul. 2004-55, 2004-1 C.B. 1081; Rev. Rul. 75-499, 1975-2 C.B. 43 (discussing the exclusion of payments an employee receives as non-occupational disability benefits); Rev. Rul. 75-479, 1975-2 C.B. 44 (“Benefits received by an unemployed individual under the Temporary Disability Insurance Law of Hawaii, as a result of temporary disability
III. WONG WING NON v. COMMISSIONER: AN INTRODUCTION

The seminal case regarding the taxation of the disability waiver of premium benefit is an unappealed 1952 case: Wong Wing Non v. Commissioner. In 1925, California resident Wong Wing Non entered into an endowment life insurance policy with New York Life Insurance Company ("the Company"). The policy provided that if he was still alive twenty one years later, in June 1945, the Company would pay him $10,000 in consideration for twenty annual premiums of $568.60. This annual premium included a charge of $10 for a double indemnity benefit and another charge of $18 for a disability benefit that included a disability waiver of premium provision.

In June 1935, after paying ten years of premiums, Wong Wing Non became wholly and permanently disabled and thereafter his annual premiums of $586.60 were waived as provided by

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due to non-occupational sickness or accident, are in the nature of unemployment compensation and excludable from the recipient's gross income and benefits received by an employee under provisions of the Law are amounts paid pursuant to a wage continuation plan and are excludable from gross income to the extent provided under sections 104(a)(3) and 105(d) of the Code.

18 T.C. 205 (1952). See Joseph M. Belth, Prudential, the Internal Revenue Service, and the Taxation of Waiver-of-Premium Disability Benefits, THE INSURANCE FORUM, Dec. 2005, at 330 (discussing a conversation with an insurance company regarding the company's refusal to include waved premiums in a policyholder's investment in the contract) ("The Prudential spokesman told me the company’s 1099 calculations are ‘based on our understanding of tax law.’ He cited a 1952 U.S. Tax Court case (Estate of Wong Wing Non v. Commissioner), Revenue Ruling 55-349 (1955), and Private Letter Ruling 9106050"). Premiums waived under the disability waiver rider do not affect the Taxpayer’s ‘investment in the contract’ under section 72(e)(6) of the code or ‘premiums paid’ under section 7702(f)(5)(B) for the Contract. You may refer to Estate of Wong Wing Non v. Comm’r, 18 T.C. 205 (1952)").

Id. at 206. Endowment policies provide not only for the payment of the face of the policy on the death of the insured during a fixed term of years, but also the payment of the full face amount at the end of the term if the insured is living. See supra note 1, at 59.

22 Id. at 207.

23 The court and the insurance policy referred to the rider as "certain Disability Benefits under the terms of the policy." Id. This language was used because the rider not only waived the premiums but also provided a monthly $100 disability benefit. Id. ("The annual premium of $568.60 included . . . an annual premium of $18 for certain 'Disability Benefits' under the terms of the policy. . . . [P]arts of the total premium of $568.60 were shown in the Annual Statement as follows: $540.60 as premiums for 'Life', $18.00 as premiums for 'Disability Benefits', $10.00 as premiums for 'Additional Accidental Death Benefits.' The endowment life insurance policy also provided that if the insured should become wholly and presumably permanently disabled during the term of the policy, the Company would then and in that event pay him $100 per month during the endowment period and would waive the payment of premiums thereafter.").
the policy.\textsuperscript{24} Ten years later, the policy matured and Wong Wing Non received the $10,000 face amount and also $1,648.19 in accumulated mutual insurance dividends and interest.\textsuperscript{25} A dispute then arose between the Internal Revenue Service ("IRS") and Wong Wing Non as to how much of this $11,648.19 should be included as income.

Before the court began to analyze the facts of the case, it stated that the IRS conceded that the $10,000 proceeds of the $11,648.19 received was excludible from gross income pursuant to § 22(b)(5) of the 1939 Code.\textsuperscript{26} The court then declared that the only remaining issue was whether the $1,648.19 in dividends and interest should be taxed.\textsuperscript{27} This concession by the IRS, that the $10,000 represented an excludable disability benefit, embodies the conclusion of this Comment.

Petitioners Chinn Shee Wong (Wong Wing Non’s widow) and Bank of America National Trust and Savings Association (Wong Wing Non’s trustee), went beyond the IRS’s concession and argued that $10,812 of the $11,648.19 received was excludable from gross income.\textsuperscript{28} They reasoned that half of this amount, $5,406, should be excluded because it represented a return of capital based on ten annual premiums that were actually paid.\textsuperscript{29} They further argued that the remaining $5,406 should also be excluded because it represented a disability benefit constructively received via the waived premiums.\textsuperscript{30} If the court sided with the petitioners and

\textsuperscript{24} Id.
\textsuperscript{25} Id. at 208. The $1,648.19 received in dividends and interest was intrinsic to the life insurance policy and would have been received even if Wong Wing Non had not become disabled.
\textsuperscript{26} Id. at 206. I.R.C. § 22(b)(5) (1939) has subsequently been incorporated in I.R.C. § 104(a)(3) (2000). \textit{See infra} note 96.
\textsuperscript{27} Id.
\textsuperscript{28} Id. at 209.
\textsuperscript{29} Id.
\textsuperscript{30} Id.
excluded $10,812, it would be excluding $812 of income beyond the $10,000 face amount of the policy, which would essentially represent an exclusion of $812 in dividends and interest.\footnote{Section VI of this Comment further discusses the petitioners’ argument.}

As previously mentioned, the IRS conceded that the $10,000 received as the face value of the policy was excludible from gross income. The IRS further argued however that the $1,648.19 amount received as dividends and interest was taxable:

\[\text{Petitioners are entitled under section 22(b)(5) of the Internal Revenue Code to exclude from gross income the portion of the insurance proceeds attributable to the operation of the disability provision of the policy. It is considered that the amount to be so excluded should be the difference between the amount actually paid by the decedent for the endowment life feature of the policy, $5,406, and the face amount of the policy, $10,000. This difference, amounting to $4,594, represents the benefit received which is attributable to the disability provision of the policy. Petitioners are also entitled under section 22(b)(2)(A) to exclude the premiums actually paid by the decedent since to that extent the amount received in 1945 represents a return of capital. The balance of the amount received under the insurance contract, consisting of $1,648.19 in accumulated dividends and interest, is neither a return of capital nor a disability benefit but represents earnings on the fund while held by the insurance company and as such is properly includible in gross income.}\footnote{\textit{Wong Wing Non}, 18 T.C. at 209 n.2.}

Thus the IRS argued not one but two reasons why the payment of $10,000 to Wong Wing Non should be excluded from gross income. First, the waived premiums represented a disability benefit. Second, the amount Wong Wing Non received would only be includable in gross income if it was in excess of his investment in the contract.\footnote{Section VI of this Comment further discusses the concessions made by the IRS.} Putting these two arguments together, petitioners were entitled to exclude income, but only up to the $10,000 face amount of the policy. According to the IRS, the only taxable piece was the $1,648.19 in accumulated dividends and interest.\footnote{\textit{Wong Wing Non}, 18 T.C. at 209 n.2.}
The court agreed with the Government, and held that although the petitioners could exclude $10,000 from gross income, the amount of $1,648.19 representing dividends and interest was taxable.\footnote{Id. at 209.} Judge Van Fossan explained the court’s holding in two brief paragraphs:

Petitioners argue that the total amount of premiums paid ($5,406), plus the total amount of premiums waived ($5,406), or $10,812, should be excluded from gross income, and contend that such waived premiums were constructively received by petitioners as disability benefits.

We are unable to follow petitioners to this conclusion. It is our opinion that petitioners have not established that the $1,648.19 constituted anything other than the “accumulated mutual insurance dividends and interest,” as labeled by the parties in the stipulation filed herein. While “dividends” may be excluded from income as a reduction of premium, at the time of the periodic payment of premiums, they, nonetheless, become a taxable income item when the amount paid for the policy has been fully recovered. Consequently, we hold that the sum of $10,000, constituting the face amount of the policy paid by the company in 1945, is excludible and the remainder, or $1,648.19, is taxable as ordinary income.\footnote{Id.}

While the rationale is not clear, taken broadly this brief opinion seems to hold that insurance proceeds payable for reasons other than death are excludable from income even when premiums have been waived via a disability waiver of premium rider. Construed narrowly, the holding may simply indicate that an insurance payout due to the maturation of an endowment policy, paid for by a combination of actual premiums and waived premiums from a disability waiver of premium rider, is excludable from income up to the face amount of the policy.

The interpretation of this holding is discussed further in section VI of this Comment. Also discussed are insurance company correspondence and an IRS private letter ruling which demonstrate that the IRS and the insurance industry have illogically taken this holding to mean...
the opposite of both the narrow and broad constructions: that the disability waiver of premium benefit is completely taxable.\(^{37}\)

**Analysis**

**IV. THE “CURRENT METHOD”**

For purely social policy reasons, it would not appear logical to preserve tax mechanisms that levy additional tax liabilities on taxpayers who have become totally disabled. As illustrated below, however, two scenarios exist where the owner of an insurance policy with a disability waiver of premium rider is burdened with a tax liability that he would have otherwise avoided had he not become disabled as defined by the policy.\(^{38}\) The root of these tax liabilities involves the treatment of the waived premiums with respect to the policyholder’s investment in the contract.\(^{39}\) In the two scenarios below, it is assumed that the policyholder is insured under a whole life insurance policy\(^{40}\) that meets the requirements of § 7702.\(^{41}\) the annual premiums are

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\(^{37}\) The IRS refuses to acknowledge that disability waiver of premium benefits are nontaxable despite the court in Wong Wing Non holding they represented a nontaxable benefit. See FEDERAL INCOME GIFT AND ESTATE TAXATION § 63.04 (MB) (2006) (“But, if the premium waiver has taken effect by reason of disability, the premiums are constructively received as exempt income under I.R.C. § 104. Apparently recognizing this principle, the Tax Court has nevertheless inconsistently refused to treat the entire amount of the waived premiums as the taxpayer's cost of the policy. Such cost has been held limited to the face amount of the policy, so that additional proceeds denominated ‘accumulated dividends and interest’ are taxable gain.”); Wayne M. Gazur, Death and Taxes: the Taxation of Accelerated Death Benefits for the Terminally Ill, 11 VA. TAX REV. 263, 283 n.57 (1991) (“In Estate of Wong Wing Non, 18 T.C. 205 (1952) the insured owned an endowment policy which contained a disability benefit. Upon the disability of the insured, future premiums were waived. However, the policy benefit was not paid until the endowment’s maturity. The Tax Court found, because the government had already conceded the point, that the predecessor of I.R.C. § 104(a)(3) applied to exclude the endowment contract proceeds in excess of the cost of the contract.”).

\(^{38}\) It is assumed that the insured is also the policyholder, meaning the individual who is receiving the insurance coverage also owns the policy. Generally, the same tax consequences are realized regardless of whether the policyholder is also the insured as long as the insured is the individual who becomes disabled, not the policyholder. \(^{39}\) See supra note 17.

\(^{40}\) The most traditional type of permanent insurance is whole life insurance. This type of insurance, also known as straight life insurance, is insurance with premiums payable until death, or until some advanced age such as 100, if
not tax deductible, the policy contains a disability waiver of premium rider, and dividends are paid annually in cash.

the insured is still living at that age. An attractive feature of whole life insurance is the ability to build a cash reserve. Because the premiums paid in the early years are substantially higher than the actuarial risk to the insurance company, the balance is credited in a reserve account on the insurance company's books. The cash value of the policy, which is related to but not exactly equal to the reserve account, is available as collateral for loans and will be paid to the insurer if the policy is surrendered. In some types of policies, the cash value may actually be withdrawn by the insured. Whole life, and other permanent insurance types, are preferable to term when the need is known to last for more than 5 to 10 years because the premium doesn't increase with advancing age. See Crawford, supra note 2, at 175 n.4 (commenting on the general attributes of whole life insurance); Mezzullo, supra note 15, at 8 (discussing the ability to accrue cash value in a whole life insurance policy); Richard A. Schwartz & Catherine R. Turner, Life Insurance Due Care Carriers, Products, and Illustrations 189 (Alan J. Robin et al. ed., ABA 2nd ed. 1994) (1989) (contrasting the advantages of whole life insurance against term life insurance).

Whether premiums paid for insurance are deductible from income depends largely on who paid the premiums and the type of insurance at issue, with property and liability insurance premiums generally deductible only if the payor can establish that the insurance coverage is an ordinary and necessary expense of carrying on any trade or business. See I.R.C. § 162 (2000) (allowing a deduction for all the ordinary and necessary expenses paid or incurred during the table year in carrying on any trade or business). Other types of insurance premiums are generally deductible by the policyholder only if they fall within the purview of a special deduction provision of the code, such as those for medical expenses, or for a percentage of the health insurance costs of the self-employed. See I.R.C. §§ 162(i), 213 (2000).

Dividends may be issued on many different types of life insurance policies, but the type of company issuing the policy plays an essential role in determining whether they can be issued. A mutual insurance company is a company that is owned by its policyholders. The policyholder is in effect, a shareholder. An owner of a life insurance policy issued by a mutual insurance company will usually receive dividends on an annual basis based on the profitability of the life insurance company. Higher profits will obviously yield higher dividends. A stock life insurance company is also owned by shareholders but merely purchasing an insurance policy will not entitle the policyholder to an ownership interest. A stock life insurance company may provide a similar benefit however, through a reduction in premiums or providing additional benefits under the policy based on the profitability of the company. See Mezzullo, supra note 15, at 6. Although uncommon, in some policies the policyholder's right to receive dividends is postponed until the death of the insured. See Lee R. Russ et al., supra note 8, at § 80:57.

The scenarios in this Comment have been adapted from the hypotheticals and analysis illustrated by Joseph M. Belth in Belth, supra note 32, at 326 (“The manner in which the Prudential/IRS view results in partial taxation of waiver-of-premium benefits may be illustrated with a hypothetical policy. . . . Other policy details [besides annual premium, cash value, and dividend amounts] such as issue age, death benefit, and policy type are not needed for this analysis.”). Although Belth states that policy type need not be designated, Scenario 2 of this Comment discusses a type of tax liability that can only be generated via an insurance policy that has accrued a cash value or has a maturing endowment feature. Whole life insurance policies are commonly used policies that accrue a cash value and therefore have been selected for use in these scenarios. See supra note 40 and accompanying text.
A. Scenario 1: Disability = Taxable Dividends

The current tax treatment of the disability waiver of premium rider can lead to partial dividend taxation.\textsuperscript{45} Consider the hypothetical policy shown in fig. 1 which has an annual premium of $1,025, of which $1,000 is for the underlying policy and $25 is for the disability waiver of premium rider.\textsuperscript{46} Suppose the policyholder pays all premiums until year five, at which time he becomes disabled and premiums are therefore waived in years five through twelve.\textsuperscript{47}

\begin{table}[h]
\centering
\caption{Hypothetical Policy}
\begin{tabular}{|c|c|c|c|}
\hline
Year & Premium & Cash Value & Dividend \\
\hline
1 & $1,025 & $700 & $70 \\
2 & $1,025 & $1,400 & $140 \\
3 & $1,025 & $2,100 & $210 \\
4 & $1,025 & $2,800 & $280 \\
5 & $1,025 & $3,500 & $350 \\
6 & $1,025 & $4,200 & $420 \\
7 & $1,025 & $4,900 & $490 \\
8 & $1,025 & $5,600 & $560 \\
9 & $1,025 & $6,300 & $630 \\
10 & $1,025 & $7,000 & $700 \\
11 & $1,025 & $7,700 & $770 \\
12 & $1,025 & $8,400 & $840 \\
\hline
\end{tabular}
\footnotesize{\textsuperscript{*} = Premium waived due to disability.}
\end{table}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{fig1.png}
\caption{Hypothetical Policy}
\end{figure}

\textsuperscript{45} Belth, supra note 32.
\textsuperscript{46} It is assumed the annual premium of $1,025 does not change year over year. This is common in straight life insurance policies as opposed to flexible premium life insurance. See supra note 40. The disability waiver of premium rider generally costs much less than the underlying premium. See supra note 6 and accompanying text.
\textsuperscript{47} It is assumed the policyholder becomes disabled within the definition of the policy. This usually means permanent and total disability. See supra note 23ε3note.
Under § 72, any taxable gain resulting from the dividends received is deferred until the policyholder surrenders the policy, or until the sum of the dividends received exceeds the sum of the total premiums paid.\(^{48}\) Imagine two separate accounts maintained by the insurance company: Total Premiums Paid and Total Dividends. Each, respectively, represents the sum of all premiums paid or dividends received to date.\(^{49}\) In order to avoid taxation, the Total Premiums Paid account must be greater than the Total Dividends account.\(^{50}\) An issue then arises when the insured becomes disabled and the annual premium is waived: does the Total Premiums Paid account increase with each waived premium or does it remain constant, merely the sum of actual premiums paid? In other words, does a waived premium contribute to the policyholder’s investment in the contract?\(^{51}\)

\(^{48}\) See supra note 15. Generally, taxation of dividends is deferred until the amount of dividends received exceeds the amount of premiums paid, or if the policy is surrendered. In the first instance, if the total amount of dividends received equals the total amount premiums that have been paid, all dividends subsequently received (in excess of premiums paid) will be treated as ordinary income. See Kenneth Black, Jr. & Harold Skipper, Jr., supra note 1, at 225 (commenting on general taxation principles regarding insurance policy dividends); Belth, supra note 32 (discussing scenarios which annul the favorable tax treatment applied to insurance policy dividends). Dividends can also be susceptible to adverse tax treatment under certain high cash value life insurance and endowment policies where the policy is actually treated as an annuity. These types of insurance/investment vehicles are outside the scope of this Comment.

\(^{49}\) Note that Total Premiums Paid only includes premiums paid for the underlying policy and does not include the $25/year charge for the disability waiver of premium rider. Thus the annual payment by the policyholder of $1,025 would lead to an increase of Total Premiums Paid by $1,000. See Kenneth Black, Jr. & Harold Skipper, Jr., supra note 1, at 226 ("Premiums paid for supplementary benefits such as premium waiver and accidental death benefit features are not a part of the basis.")

\(^{50}\) See supra note 48.

\(^{51}\) See supra note 17 and accompanying text.
Under the current method being applied by the IRS and several insurance companies, the answer is "no." As shown in fig. 2, waived premiums are not included in Total Premiums Paid.

Even though the accounting is as if the insured sends a premium payment and the company sends a disability benefit, the insurance company here chooses not to include the waived premiums in their calculation of Total Premiums Paid. This leads to Total Premiums Paid amounting to only $4,000 in our example, which is less than Total Dividends of $5,460. As such, it must now be determined when the Total Dividends eclipse the Total Premiums Paid. As shown in fig. 3, in year eleven, the Total Dividends were $620 greater than the Total Premiums Paid ($4,620 v. $4,000), generating a taxable gain of $620. Because the annual dividend eclipsed the total premiums paid in year eleven, the entire dividend in year twelve, or $840, is also now taxable. The disabled policyholder has a total taxable gain of $1,460. Assuming the policyholder continued making timely premium payments, had the policyholder not become

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52 Belth, supra note 32, at 325 (“Recently I learned that The Prudential Insurance Company of America and the Internal Revenue Service (IRS) hold a different view of the waiver-of-premium benefit. The Prudential/IRS view results in partial taxation – and in some situations full taxation – of waiver-of-premium benefits. In my opinion, the Prudential/IRS view is illogical and incorrect.”). Belth also conducted a survey of fifty life insurance companies and questioned their methods of calculating Total Premiums Paid. Of the fifty companies eight companies responded with answers of which four stated they included waived premiums in Total Premiums Paid (the cost basis) and four stated they did not. See Id. at 330. The term “Current Method” is a construction by the author of this Comment.
53 Belth, supra note 32, at 325.
54 See supra note 48.
55 Id.
56 Id.
57 This total taxable gain would normally be spread out between years eleven and twelve: a taxable gain of $620 in year eleven and a taxable gain of $840 in year twelve.
disabled Total Dividends would not have eclipsed Total Premiums Paid and the policyholder would not be subject to a taxable gain.\textsuperscript{58}

B. Scenario 2: The Cash Out Penalty

Another scenario in which the disabled policyholder incurs an unexpected tax liability is when the policyholder surrenders the policy.\textsuperscript{59} Using the same hypothetical policy from above (fig. 1), suppose now the disabled policyholder decides to surrender the policy in year twelve and receive the cash value.\textsuperscript{60} As shown in fig. 1, the cash value of the policy in year twelve is $8,400\textsuperscript{61} and the payout is taxable only to the extent that the amount received exceeds the policyholder’s cost basis in the policy.\textsuperscript{62} The cost basis, or investment in the contract, is equal to the Total Premiums Paid minus any dividends received on the policy.\textsuperscript{63}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Year} & \textbf{Cost Basis/ Investment in the Contract} \\
\hline
1 & $930 \\
2 & $1,790 \\
3 & $2,580 \\
4 & $3,300 \\
5 & $2,950 \\
6 & $2,530 \\
7 & $2,040 \\
8 & $1,480 \\
9 & $850 \\
10 & $150 \\
11 & $0 \\
12 & $0 \\
\hline
\end{tabular}
\caption{Current Method}
\end{table}

\textsuperscript{58} This scenario assumes that the non-disabled insured would continue to pay the annual premiums and is explained in more detail in section V(A) of this Comment.

\textsuperscript{59} The phrase “cashing out the policy” is sometimes used to refer to a policyholder surrendering the policy to receive the accrued cash value. Here, the same tax consequences will develop if instead of cashing out a whole life policy in year twelve, the policyholder holds an endowment policy that matures in year twelve. See supra note 16.

\textsuperscript{60} Id.

\textsuperscript{61} See supra note 40.

\textsuperscript{62} See supra note 16.

\textsuperscript{63} See supra note 17.
Again, under the “Current Method” being applied by the IRS and several insurance companies, waived premiums are not included in Total Premiums Paid. As shown in fig. 4, the policyholder’s cost basis increases every year until year five when he becomes disabled. At this point, the waived premiums are not recognized as Total Premiums Paid and the dividends essentially erode the cost basis until it reaches $0 in year eleven. As fig. 5 shows, this leads to a taxable gain of $9,860. Had the policyholder not become disabled, the cost basis would not have eroded and the tax liability generated would have only been $1,860. Alternatively, had the insured simply died instead of surrendering the policy, the death benefit would incur no taxation.

V. THE “CORRECT METHOD”

To lessen (or avoid) the tax liabilities illustrated in Scenarios 1 and 2, waived premiums could simply be included in Total Premiums Paid. This “Correct Method” has been deemed to be the correct view of the waiver of premium benefit by Joseph Belth, Professor Emeritus of

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64 See supra note 52.
65 Because the policy dividends are increasing each year and Total Premiums Paid remains constant after year four, the policyholder’s investment in the contract diminishes at an accelerating rate starting in year five. See supra note 17.
66 This scenario assumes that the non-disabled insured would continue to pay the annual premiums and is explained in more detail in section V(B) of this Comment.
67 See supra note 11.
insurance at Indiana University’s Kelley School of Business. Harold Skipper, retired professor of risk management and insurance, and the late Kenneth Black, previous Regent’s Professor of insurance, both from Georgia State University, agreed that premiums waived under the premium waiver feature, logically, should be included in the basis of the policy. Using the same hypothetical policy in fig. 1, a comparative analysis can be made between the “Correct Method” of including waived premiums in Total Premiums Paid and the “Current Method” of disregarding waived premiums.

A. Scenario 1: Disability ≠ Taxable Dividends

With regard to dividend taxation, fig. 6 shows that under the “Correct Method”, Total Premiums Paid consists of all premiums either paid by the policyholder or waived by the insurance company. As illustrated, the Total Dividend amount of $5,460 is less than the Total Premiums Paid amount of $12,000.

<table>
<thead>
<tr>
<th>Correct Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Premiums Paid = Actual Premiums Paid + Premiums Waived</td>
</tr>
<tr>
<td>$12,000 = $4,000 + $8,000</td>
</tr>
<tr>
<td>Therefore...</td>
</tr>
<tr>
<td>Total Dividends ≪ Total Premiums Paid</td>
</tr>
<tr>
<td>$5,460 ≪ $12,000</td>
</tr>
</tbody>
</table>

Result: Any taxable gain from dividends is deferred.

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68 The term “Correct Method” is a construction by the author of this Comment, however see Belth, supra note 32 (“Under what I consider the correct view of the waiver-of-premium benefit, the sum of the premiums paid by the insured includes the sum of the waived premiums.”).

69 KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 226 (noting that the tax court did not follow this logic in Wong Wing Non). As further discussed in section VI of this Comment, the court in Wong Wing Non held that although disability waiver of premium benefits are not included in a policyholder’s investment in the contract, they are still nontaxable because they are a disability benefit. The experts mentioned in section V of this Comment agree that the benefits should be nontaxable; but because they contribute to a policyholder’s investment in the contract.
and thus the policyholder is not subject to taxable gain.\footnote{See supra note 15.} Under the “Correct Method”, the policyholder avoids the $1,460 taxable gain from the “Current Method” and is taxed the same as if he had not become disabled.\footnote{This assumes the policyholder made timely and complete annual premium payments.}

### B. Scenario 2: No Cash Out Penalty

When cashing out the policy under the “Correct Method,” the policyholder is again taxed as if he had not become disabled. As illustrated in fig. 7, the policyholder’s cost basis does not decrease. Even though Total Dividends increases each year, Total Premiums Paid also increases and since Total Dividends never eclipse Total Premiums Paid, the cost basis never decreases.\footnote{See supra note 17. In this scenario the Total Dividends increase at a faster rate than Total Premiums Paid (fig. 1) leading to a cost basis that increases at a diminishing rate. If this scenario were expanded, the policyholder’s cost basis would start to decrease in year fifteen and would reach $0 in year twenty eight.} In year twelve, instead of a cost basis of $0 under the “Current Method”, the “Correct Method” yields a cost basis of $6,540.\footnote{See supra note 17.}

Assuming a constant tax rate, the “Current Method’s” disregard of waived premiums leads the tax system to increase the disabled policyholder’s tax liability by

\footnotesize

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12 & $6,540 \\
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\caption{Correct Method}
\end{table}

\footnotesize

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Correct Method} & \\
\hline
Total Premiums Paid = Actual Premiums Paid + Premiums Waived \\
$12,000 = $4,000 + $8,000 \\
Therefore... \\
Taxable Income = Cash Value + Sum of Dividends Received - Total Premiums Paid \\
Taxable Income = $8,400 + $5,460 - $12,000 \\
Result: \\
Taxable Income of $1,860 \\
\hline
\end{tabular}
\caption{Correct Method}
\end{table}

\footnotesize
roughly 530% relative to the non-disabled policyholder. Although the disabled policyholder receives the benefit of not having to pay annual premiums, the benefit is severely reduced by the imposition of this tax liability.

VI. Wong Wing Non v. Commissioner: Analysis

A. Constructing a Holding

The court’s opinion is brief and gives little expressed rationale. An analysis of what arguments the court accepted and rejected will shed light on the court’s holding. As previously mentioned, the IRS offered two arguments why some or all of the petitioners’ $10,000 income should be excluded: (1) a disability benefit argument, and (2) an investment in the contract argument.

The result of the IRS’s disability benefit argument is that the difference between the face amount of the policy ($10,000) and the premiums actually paid ($5,406) should be excluded from Wong Wing Non’s 1945 taxes. According to the IRS, this represented a disability benefit of $4,594 which was excludable under I.R.C. § 22(b)(5) (1939).

Regarding the investment in the contract argument, the IRS stated that Wong Wing Non should be able to exclude an amount equal to his “premiums actually paid.” With the use of the word “actually,” it can be inferred that the IRS did not wish to have waived premiums included

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74 Ignoring the “Findings of Fact” and footnotes, the opinion in Wong Wing Non is only one page in length.
75 See supra note 32 and accompanying text.
76 See Wong Wing Non, 18 T.C. at 209 n.2.
77 Id. For background on I.R.C. § 22(b)(5) (1939) see infra note 96.
78 Id.
when determining the total premiums paid. According to the IRS, having paid ten years of premiums, Wong Wing Non would be able to exclude $5,406 as a return of capital under I.R.C. § 22(b)(2)(A) (1939).

These two arguments complimented each other such that if the court agreed with both the disability benefit and the investment in the contract arguments, then the entire $10,000 face amount of the policy would be excluded. Although the court neither expressly affirmed nor rejected either of these arguments, the court did exclude the face amount of the policy and the language it used gives insight into its reasoning.

A quick read of the first few sentences of the court’s holding may lead one to believe that the court ruled out the disability benefit argument:

Petitioners argue that the total amount of premiums paid ($5,406), plus the total amount of premiums waived ($5,406), or $10,812, should be excluded from gross income, and contend that such waived premiums were constructively received by petitioners as disability benefits. We are unable to follow the petitioners to this conclusion.

Broadly construed, the sentence “We are unable to follow petitioners to this conclusion,” may indicate that the court does not agree with the disability benefit argument as a matter of law. The court may simply think that premiums waived under a disability waiver of premium rider do not constitute compensation for injuries or sickness or amounts received through accident or health insurance benefits, and are therefore not excludable under I.R.C. §

79 The IRS used the word “actually” as opposed to “actually or constructively” to indicate their desire to only include those payments physically received from, or on the behalf of, the policyholder. But see Penn Mut. Life Ins. Co. v. Norcross, 163 Ind. 379 (Ind. 1904) (“The requirement of ‘actual payment’ in the policy does not exclude all other methods of payment which are not made in cash. The premium may be paid by the credit of the assured, if so accepted.”). For more detail on this statutory construction see supra note 126.

80 The insurance policy, not including the disability waiver of premium or double indemnity benefit riders, had an annual premium of $540.60. Wong Wing Non made ten annual payments before becoming disabled. Any portion of the annual premium which is attributable to other charges, such as a disability income rider, is not to be included as a part of the total premium paid. See Rev. Rul. 55-349, 1955-1 C.B. 232. For more background information on I.R.C. § 22(b)(2)(A) (1939) see infra note 97.

81 Wong Wing Non, 18 T.C. at 209.

82 Id.
Given the one page opinion, it is doubtful that the court would have intended such a broad holding without expressly stating it. The real meaning is much simpler.

Looking at the sentence’s plain meaning in conjunction with the specific numbers involved, it is clear the court was articulating its disagreement with the petitioners’ math. The amounts of premiums paid and premiums waived were both $5,406, but when added together, the total amount of $10,812 was greater than the $10,000 face amount of the policy. If the court followed the petitioners’ argument and excluded the full $10,812, $812 of dividends and interest would also be excluded. This would go against the only seemingly clear part of the holding.

After the court stated that the petitioners’ mathematical conclusion is wrong, the court proceeded to analyze the taxation of the dividends but strangely the court did not mention the IRS’s investment in the contract argument. The court briefly touched the issue of taxing returns in excess of an individual’s cost basis: “While ‘dividends’ may be excluded from income as a reduction of premium, at the time of the periodic payment of premiums, they, nonetheless, become a taxable income item when the amount paid for the policy has been fully recovered.” This would have been a logical place for the court to mention whether or not waived premiums are included in the taxpayer’s investment in the contract but it declined. If the $10,000 face amount was excludable from income, the reasoning must come from somewhere else.

Surprisingly, it concludes their terse holding with the following sentence: “Consequently, we hold that the sum of $10,000, constituting the face amount of the policy paid by the company

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83 See infra note 96 and accompanying text.
84 Id.
85 Id. For a discussion of the court’s holding regarding dividends and interest, see infra note 86 and accompanying text.
86 This is basic investment and return taxation theory following that an investor’s basis will increase for every dollar he invests, and decrease for every dollar he receives. When his basis reaches zero, subsequent amounts he receives will be taxed. See supra note 17.
87 If the court had expressly stated that waived premiums increase a policyholder’s investment in the contract, then it would have left no doubt why the $10,000 face amount of the policy was excludable. It would have been simply a return of invested capital. See supra note 17.
in 1945, is excludible and the remainder, or $1,648.19, is taxable as ordinary income.”

Though beneficial to the taxpayer, the court does not expressly state why the $10,000 face amount is excludible from income.

In its analysis of the dividends and interest, the court was silent as to whether waived premiums should be included in the policyholder’s investment in the contract. If the court thought the $10,000 was excludible because waived premiums increased Wong Wing Non’s invested amount, it would have expressly stated as such. This begs the question of whether the court believed the waived premiums represented an excludable disability benefit. Again, in this last section of the opinion, the court does not expressly state if it has indeed sided with the IRS’s disability benefit argument. But it didn’t have to. The court already ruled on this issue at the start of the opinion. Before the court examined the findings of fact, it stated:

In making his determination of deficiency, respondent included in petitioners’ taxable income the excess of the amount received by them under a maturing endowment insurance policy over the aggregate of premiums paid on such policy. Respondent now concedes that a portion of the amount so received under the policy is excludible from gross income pursuant to section 22(b)(5), Internal Revenue Code. The sole issue remaining for our consideration is whether that portion of such amount as represents accumulated dividends and interest upon the policy fund should be taxed to petitioners. 89

Right from the beginning, the court highlighted the IRS’s disability argument that waived premiums represent a disability benefit that is constructively received by the insured. 90 The court did not need to analyze or discuss the IRS’s conclusion that pursuant to I.R.C. § 22(b)(5) (1939), disability waiver of premium riders provide a nontaxable benefit. The only remaining issue for

88 Wong Wing Non, 18 T.C. at 209.
89 Id. at 206. I.R.C. § 22(b)(5) (1939) excludes from income amounts received from accident or health insurance. See infra note 96.
90 See supra note 32 and accompanying text.
the court involved the taxability of the dividends and interest received by Wong Wing Non. The court acquiesced to the IRS’s disability benefit argument deeming it a settled matter.\(^9\)

This case thus imparts a two-part holding: 1) dividends and interest received upon the maturation of a life insurance policy in excess of the policyholder’s investment in the contract are includable in gross income, and 2) under I.R.C. § 22(b)(5) (1939) (and subsequently I.R.C. § 104(a)(3) (2000)), disability benefits constructively received by a policyholder through receipt of insurance proceeds attributable to the operation of a disability provision of a life insurance policy that has waived a policyholder’s annual premiums, are excluded from gross income.\(^9\)

B. Wong Wing Non and the Current Code

Although *Estate of Wong Wing Non v. Commissioner*\(^9\) has neither been appealed nor overruled since 1952, the Code has continued to evolve.\(^9\) The court’s holding regarding waived

\(^9\) In the quoted passage, the court only mentioned § 22(b)(5) when it declared the $10,000 a settled issue. The court did not mention the IRS’s investment in the contract argument involving § 22(b)(2)(A). This decision to mention one statute and not the other, especially when the IRS mentioned both, was purposeful and reflects the court’s siding with the IRS that the waived premiums represent a disability benefit under § 22(b)(5). In the quoted passage, because the court expressly mentioned § 22(b)(5) and not § 22(b)(2)(A), the court bolstered the argument pertaining to the former and disregarded the argument pertaining to the latter.

\(^9\) See supra note 37. The policyholder’s constructive receipt of a disability waiver of premium benefit is the product of two transactions: In the first, the policyholder receives a benefit payment under a disability insurance contract in an amount equal to the premium due under the life insurance policy. In the second transaction, the policyholder uses the benefit received to pay the life insurance premium. Working simultaneously, the policyholder has constructively received a disability benefit that was used to pay the premium. See Pike, *supra* note 10, at 543 n.275 (citing KENNETH BLACK, JR. & HAROLD SKIPPER, JR., *supra* note 1, at 47-51, 68-76, 80-99). This double transaction theory of receiving the benefit and paying the premium is also evidenced in insurance industry accounting methods. Waived premiums are recorded in two accounts: a revenue account and an expenditure account. The premium is not exactly waived, but rather paid for by the company and reflected in their books like any other disability benefit in an expense account. Regardless of whether any cash actually reaches the now disabled policyholder, a disability benefit is accounted for when the premium payment is covered by the insurance company. The economic benefit to the disabled policyholder is that he no longer has to pay the premiums. See Belth, *supra* note 32, at 325.

\(^9\) See supra note 37.

premiums representing a disability benefit was dependent on I.R.C. § 22(b)(5) (1939). The current version of the Code also bolsters this holding.

Recall that the IRS raised two arguments why petitioners should exclude some or all of the $10,000: a disability benefit argument and an investment in the contract argument. Applying the current Code to these arguments, the former is akin to the IRS claiming that disability waiver of premium riders provide a benefit that falls under § 104(a)(3) as amounts received through accident or health insurance for personal injuries or sickness. The second argument is similar to the IRS claiming that under § 72(e), Wong Wing Non should only include amounts received in excess of his investment in the contract.

contained substantial amendments, but no formal re-codification. That is, the 1986 Code retained the most of the same lettering and numbering of subtitles, chapters, subchapters, parts, subparts, sections, etc. See supra note 32 and accompanying text.

As quoted earlier, the IRS stated the waived premiums were a disability benefit under I.R.C. § 22(b)(5) (1939) which has subsequently been incorporated in I.R.C. § 104(a)(3) (2000). See Haynes v. United States, 353 U.S. 81, 85 n.4 (1957) (discussing how I.R.C. § 22(b)(5) (1939) was subsequently incorporated in I.R.C. § 104 (1954)) (“Section 22(b)(5) can be traced to § 213 (b)(6) of the Revenue Act of 1918, 40 Stat. 1066. In §§ 104, 105 and 106 of the 1954 Internal Revenue Code, . . . Congress again exempted amounts received through health insurance.”); Kuhn v. United States, 258 F.2d 840, 843 (3d Cir. 1958) (discussing the relation between I.R.C. § 22(b)(5) (1939) and I.R.C. § 104(a)(3) (1954)) (“The Internal Revenue Service recently carried the concept of health and accident insurance one step further in Rev. Rule. 58-90, I.R.B. 1958 . . . . There the Service was presented with the question of the tax treatment of amounts paid as premiums on, and amounts received as benefits under, an individual insurance policy providing disability benefits purchased by an employer for a key employee. The Ruling concluded that ‘income payments received under the above policies, constitute amounts received through accident or health insurance within the meaning of Sections 104(a)(3) and 105(a) of the 1954 Code and Section 22(b)(5) of the 1939 Code.’”). Compare I.R.C. § 22(b)(5) (1939) (“(b) Exclusions from Gross Income. -- The following items shall not be included in gross income and shall be exempt from taxation under this chapter: (5) Compensation for injuries or sickness. -- Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 23 (x) in any prior taxable year, amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness, and amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country.”), and I.R.C. § 104(a)(3) (2000) (“(a) In general Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include — (3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness”). See supra note 16. As quoted earlier, the IRS stated the $10,000 received by Wong Wing Non represented a return of capital per I.R.C. § 22(b)(2)(A) (1939) which has subsequently been incorporated in I.R.C. § 72(e) (2000). See First Nat'l Bank v. Comm'r, 309 F.2d 587, 592 (8th Cir. 1962) (holding against petitioner’s argument that I.R.C. § 22(b)(2)(A) (1939) and I.R.C. § 72(e)(1) (1954) are materially different) (“The petitioner additionally argues that the Arnfeld and Phillips cases are inapplicable because they were decided under the 1939 Code, § 22(b)(2)(A) . . . . He points out that the 1954 Code § 72(e)(1) differs from the 1939 Code in that it includes the words ‘if no other
Applying the current Code to the holding, it can be surmised that subsequent cases might hold that under I.R.C. § 104(a)(3) (2000), disability benefits, constructively received by a policyholder through receipt of insurance proceeds attributable to the operation of a disability provision of a life insurance policy that has waived a policyholder’s annual premiums, are excluded from gross income. This has not occurred however because the only subsequent adjudication that even begins to interpret Wong Wing Non’s holding is an administrative ruling that contains no precedential value and is being applied incorrectly by the insurance industry.  

98 The main reason a court (as opposed to an administrative ruling) has never subsequently interpreted the holding is that it has simply not been contested. Besides Wong Wing Non, no other court has addressed the issue of whether disability waiver of premium riders provide a nontaxable disability benefit. This is due mainly to a lack of affected parties. Waived premiums in the life insurance industry are less than 1% of the total premiums that are allocated by state. See Belth, supra note 32, at 332. Also, the misguided tax consequences affect only those policyholders who purchase a life insurance policy with a disability waiver of premium rider, make their premium payments, become permanently and totally disabled, and remain disabled and alive until the policy matures, the policy is surrendered, or the policy dividends increase to an amount greater than the premiums actually paid. The only authoritative precedent remains Wong Wing Non and due to apparent misunderstanding of the case, the court’s holding has not been enforced on the insurance industry. As discussed further in this Comment, the only subsequent analysis has been in I.R.S. Priv. Ltr. Rul. 9106050 (Nov. 16, 1990) which seems to apply only a portion of the court’s holding, omitting the chief notion that waived premiums represent a disability benefit. Finally, private letter rulings may provide insight into the IRS’s policies but the ruling applies only to the specific taxpayer who requested it and by law may not be used or cited as precedent. See 26 I.R.C. § 6110(k)(3) (2000); Treas. Reg. § 301.6110-7(b) (2006). But see Duse v. IBM, 252 F.3d 151, 162 (2d Cir. 2001) (discussing how the issuance of a private letter ruling can notify other taxpayers to current legal requirements).
In *Wong Wing Non*, the court held that the $10,000 face amount of the policy was excludable from gross income while the $1,649.19 in accumulated mutual insurance dividends and interest was taxable.\(^9\) As previously discussed, the court reasoned that $10,000 should be excluded from gross income because it represented constructive receipt of a disability benefit. In addition, the court held the $1,649.19 should be included in gross income, because it was in excess of Wong Wing Non’s investment in the contract. This latter holding has been bolstered by subsequent cases interpreting § 72(e)(1)(b).\(^{10}\) The former holding regarding the constructive receipt of a disability benefit, has been grossly ignored by the insurance industry despite no judicial challenge since its foundation in *Wong Wing Non*.

The weapon of choice used by the insurance industry to set aside *Wong Wing Non* is IRS Private Letter Ruling 9106050 issued in 1990.\(^{11}\) In this ruling, a prospective purchaser of a life insurance policy requested that the IRS rule on the taxability of several aspects of the policy.\(^{12}\) One question the taxpayer asked was whether the waiver of any monthly deduction under the disability waiver of premium rider would increase either the taxpayer's investment in the contract under § 72(e)(6) or premiums paid under § 7702(f)(1)(A).\(^{13}\)

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\(^9\) *See Wong Wing Non*, 18 T.C. at 210.

\(^{10}\) *See Moseley v. Comm’r*, 72 T.C. 183, 186 (1979) (citing Helvering v. Meredith, 140 F.2d 973, 974 (8th Cir. 1944) and Estate of Wong Wing Non v. Comm’r, 18 T.C. 205, 209 (1952)) (“Section 72(e)(1)(B) provides that if any amount is received under a life insurance contract and if that amount is not received as an annuity, the amount is included in gross income ‘only to the extent that it . . . exceeds the aggregate premiums or other consideration paid.’ Courts have construed this cost recovery rule of the predecessor of this section [, I.R.C. § 22(b)(2)(A) (1939),] as excluding from income dividends received under a life insurance contract until amounts received under the contract exceed the aggregate premiums paid.”).


\(^{12}\) Priv. Ltr. Rul. 9106050 at 1. The other rulings provided by the IRS in this private letter ruling are not pertinent to this Comment.

\(^{13}\) *Id.* at 7.
Essentially, the taxpayer asked whether the IRS would consider waived premiums under the “Current Method” or the “Correct Method”. Naturally, the IRS ruled that the “Current Method” should be used:

A waiver of the monthly deduction under the disability waiver rider does not affect Taxpayer’s "investment in the contract" under § 72(e)(6) of the Code or the "premiums paid" under § 7702(f)(1)(A) for the Contract. See Wong Wing Non v. Commissioner, 18 T.C. 205 (1952) (premiums waived on account of disability not included in taxpayer’s cost basis of an endowment contract). This conclusion is consistent with the fact that no additional funds are contributed by Taxpayer as a result of the waiver.

The IRS insisted that the court in Wong Wing Non held that waived premiums do not effect a policyholder’s investment in the contract. This is not entirely correct. As previously mentioned, while this holding could be inferred, the court in Wong Wing Non did not expressly state whether waived premiums had an effect on a policyholder’s investment in the contract. This may be why the IRS used the introductory signal “see” as opposed to no signal when it cited Wong Wing Non. As insignificant as this sentence seems, this is the only published interpretation made by the IRS as to the holding of Wong Wing Non.

The letter ruling is particularly misleading because the taxpayer only asked about the effect of waived premiums on a policyholder’s investment in the contract; the taxpayer did not

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104 The “Current Method” and the “Correct Method” have been discussed in sections IV and V of this Comment. Increasing the taxpayer’s investment in the contract by the amount of each waived premium would correspond to the “Correct Method” while disallowing an increase would correspond to the “Current Method”.


106 As discussed in section VI(A) of this Comment, in its analysis of the dividends and interest, the court had an opportune time to discuss the application of waived premiums to a policyholder’s investment in the contract but didn’t. If the court thought the $10,000 was excludible because waived premiums increased Wong Wing Non’s invested amount, it would have expressly stated as such.

107 Rev. Rul. 55-349, 1955-1 C.B. 232 also cites Wong Wing Non but only so much as to show an example that when calculating total premiums paid, the charges for extra insurance riders are not included. This has very little to do with the taxability of the rider’s benefit. See supra note 80. Note however that this revenue ruling was still cited by an insurance representative as authority when questioned why the company did not include waived premiums in the policyholder’s investment in the contract. See supra note 20.
ask whether the waived premium produced a taxable benefit. As a result, the IRS does not mention that Wong Wing Non also held that even though they might have no effect on a policyholder’s investment in the contract, waived premiums still produce a nontaxable benefit that is constructively received by the policyholder.

Letter rulings apply only to specific taxpayers and specific transactions. The IRS regularly updates the list of topics it will not consider for private letter rulings. Given this enormous amount of guidance, taxpayers must structure detailed and specific requests to warrant a response. As such, it makes sense why the taxpayer who requested the ruling only questioned the effect on investment in the contract, and did not ask a broad question such as asking what tax law applied to disability waiver of premium riders.

Furthermore, even if this private letter ruling had precedential value, it still would not apply to a policyholder insured under a typical whole life policy. The policy in question in this ruling was a flexible premium universal life policy. This policy was unique because there was no separate and direct charge for the disability waiver of premium rider. Instead, the rider was “paid” for by the insurance company annually deducting from the policy’s cash value.

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108 Priv. Ltr. Rul. 9106050 at 5 ("You have requested the following rulings: ... 6. That the waiver of any monthly deduction under the disability waiver rider will not increase either Taxpayer's "investment in the contract" under section 72(c)(6) of the Code nor "premiums paid" under section 7702(f)(1)(A) for the Contract.").
109 See supra note 91 and accompanying text.
110 See supra note 98.
111 See Rev. Proc. 2006-3, 2006-1 I.R.B. 122 (providing a revised list of those areas of the Code relating to domestic issues on which the Internal Revenue Service will not issue letter rulings or determination letters); Rev. Proc. 2006-7, 2006-1 I.R.B. 243 (providing a revised list of those areas of the Code relating to international issues on which the Internal Revenue Service will not issue letter rulings or determination letters).
112 The scenarios previously illustrated in this Comment illustrate a typical whole life policy where a level annual premium includes a charge for a disability waiver of premium rider.
114 Id. at 3. Unlike whole life insurance policies, the cash values of universal life policies are not by-products of the leveling of premiums. Subject to company rules regarding minimums and maximums, the policyholder may pay whatever premium during a policy year that he or she wishes. From this premium may be subtracted an amount to cover the insurer’s expenses and mortality charges. The balance remaining, plus the previous period’s fund balance, then forms the policy’s cash value. KENNETH BLACK, JR. & HAROLD SKIPPER, JR., supra note 1, at 25. See RICHARD A. SCHWARTZ & CATHERINE R. TURNER, supra note 40, at 190 (“The universal life policy is the prime example of open architecture. The interest, cost of insurance, and expense elements that create the cash value are separately
payment-by-cash-value-deduction feature also applied to the annual premiums. This is why the taxpayer’s request concerned the “waiver of any monthly deduction”\(^{115}\) as opposed to a waiver of any monthly payment.

In a flexible premium universal life policy the policyholder may decide not to pay a premium in a given year resulting in the insurance company simply deducting insurance costs from the cash value.\(^ {116}\) Thus when the policyholder becomes disabled, premium payments are not exactly waived; they are simply not deducted from the cash value. The policyholder’s cash value, as well as investment in the contract, logically and naturally remains constant instead of diminishing.\(^ {117}\) This is very different from a whole life policy where waiving premiums hinders the natural growth of a policyholder’s investment in the contract. Waiving a deduction is not the same as waiving a payment.

For the foregoing reasons, this private letter ruling does nothing to disprove that disability waiver of premium riders produce nontaxable disability benefits constructively received by the policyholder.

**Conclusion**

_Wong Wing Non_ remains the only case since 1952 regarding the taxability of disability waiver of premiums.\(^ {118}\) The insurance industry has interpreted the holding incorrectly and without any subsequent judicial challenges, there is no authority instructing them to change their

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\(^{115}\) Priv. Ltr. Rul. 9106050 at 7.

\(^{116}\) See supra note 114.

\(^{117}\) The investment in the contract is deemed to be the maturity value or cash surrender value of the contract rather than the premium cost if such value has been constructively received by the annuitant. 1-6 MODERN ESTATE PLANNING § 6.03 (2006).

\(^{118}\) See supra note 20.
understanding and application of the case. The only way to repair the problem is through either a successive judicial proceeding or statutory reform.

As shown above, *Wong Wing Non* holds that disability waiver of premium riders produce a nontaxable disability benefit. The holding is not immediately clear however and the only subsequent publication that mentions the case’s holding (Private Letter Ruling 9106050), does not broach the topic of whether the rider produces a nontaxable disability benefit because the taxpayer did not ask. In order for a court to clarify this holding, another disabled taxpayer would have to bring a similar dispute to court.

A clarifying future case is unlikely however as the tax consequences discussed in this Comment affect only those policyholders who purchase a life insurance policy with a disability waiver of premium rider, make their premium payments, become permanently and totally disabled, and remain disabled and alive until the policy matures, the policy is surrendered, or the policy dividends increase to an amount greater than the premiums actually paid. Most disabled policyholders simply die before one of the taxable scenarios unfolds. Even if the policyholder lives long enough to be subject to the tax liability of this unique scenario, there is no guarantee the policyholder would have the knowledge or resources to dispute it. We are left with a policy that taxes the disabled individual who is lucky enough to survive.

The quickest and simplest way to correct this inequity is through statutory reform. By modifying one of three sections of the Code, the disabled taxpayer could be treated the same as a non-disabled taxpayer.

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119 See *supra* note 101.
120 See *supra* note 92 and accompanying text.
121 See *supra* note 109 and accompanying text.
122 See *supra* note 98 and accompanying text.
Section 104(a)(3) could be modified to incorporate the disability benefit holding from

_Wong Wing Non:_

§ 104. Compensation for injuries or sickness.
(a) In general... [F]or any prior taxable year, gross income does not include--

(3) amounts received (or constructively received) through accident or health insurance (or through an arrangement having the effect of accident or health insurance, or through a disability waiver of premium benefit) for personal injuries or sickness...123

Alternatively, the investment in the contract argument the IRS offered in _Wong Wing Non_124 could be incorporated in § 72(e)(6) by redefining “investment in the contract”:

(6) Investment in the contract. For purposes of this subsection, the investment in the contract as of any date is—
(A) the aggregate amount of premiums or other consideration paid (or waived by a provision of the contract) for the contract before such date, minus
(B) the aggregate amount received under the contract before such date, ...125

Another means of incorporating the investment in the contract argument would be to simply redefine “premiums paid” in § 7702(f)(1)(A):

(f) Other definitions and special rules. For purposes of this section--
(1) Premiums paid.
(A) In general. The term "premiums paid" means the premiums paid (or constructively paid through a premium waiver provision of the contract) under the contract less amounts (other than amounts includible in gross income) to which section 72(e) [26 USCS § 72(e)] applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.126

123 I.R.C. § 104(a)(3) (2000). Emphasis has been added to the suggested additions. The term “constructively received” has been previously used in tax cases to indicate an amount legally constructed as being received, though not actually received. See Aramo-Stiftung v. Comm’r, 172 F.2d 896 (2d Cir. 1949); Bennett v. United States, 293 F.2d 323 (9th Cir. 1961); Oliver v. United States, 193 F. Supp. 930 (D.Ark. 1961); GatliFF v. Helburn, 31 F. Supp. 495 (D.Ky. 1940).
124 See supra note 32 and accompanying text.
125 I.R.C. § 72(e)(6) (2000). Emphasis has been added to the suggested additions.
126 I.R.C. § 7702(f)(1)(A) (2000). Emphasis has been added to the suggested additions. The term “constructively paid” has been previously used in several cases to indicate an amount legally constructed as being paid, though not
Enacting one or all of these statutory modifications would ensure that policyholders will not be afflicted with unexpected tax liabilities arising from their disability.

Waived premiums are a disability benefit that should be excluded from taxation under § 104 of the Code. Absent statutory reform or a judicial challenge to *Wong Wing Non*, the case’s misinterpretation will continue to perpetuate the two scenarios mentioned in this Comment. The fact that *Wong Wing Non* has remained judicially unchallenged since 1952 proves the point that a future overruling decision is not likely to happen.

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_actually paid. See Hoerl & Assocs., P.C. v. United States, 785 F. Supp. 1430 (D. Colo. 1992), aff’d in part, rev’d in part, 996 F.2d 226 (10th Cir. 1993); Hennessey v. Federal Sec. Adm’n, 88 F. Supp. 664 (D. Conn. 1949); Morgan v. Social Sec. Bd., 45 F. Supp. 349 (D. Pa. 1942). Also, the IRS may have actually indicated that constructive payments in a life insurance policy qualify as actual payments. See Treas. Reg. § 1.72-11(b)(1) (2006) (“If dividends (or payments in the nature of dividends or a return of premiums or other consideration) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be subtracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72(d) and § 1.72-13, relating to employee contributions recoverable in three years.”) (emphasis added).