

TAXATION OF EMPLOYEE ACCIDENT AND HEALTH PLANS BEFORE AND UNDER THE 1954 CODE

MANY employers have established accident and health programs in order to compensate their employees for off-the-job disability.¹ These arrangements generally provide reimbursement for medical or hospitalization expenses, compensation for loss of earnings, or both.² Some programs are established voluntarily by the employer, others are set up through collective bargaining, and still others are required by state nonoccupational disability statutes.³ These programs may be financed by employer contributions, employee contributions, or joint contributions.⁴ They may be commercially insured, funded, or administered by the employer.⁵

Before the 1954 Code the tax treatment of employee health plans was uncertain because of the absence of explicit statutory provisions. Under the old Code, amounts paid under such programs were taxable unless they fell within the exemptions for damages, workmen's compensation, or accident or health insurance.⁶ Controversy particularly centered about the scope of the accident or health insurance exemption. Since the term "insurance" could clearly not be applied to all types of accident or health arrangements, and since the criteria of "insurance" were uncertain, this provision of the old Code bred both confusion and inequity. In an attempt to remedy these problems, Congress, in revising the Internal Revenue Code in 1954, established specific rules relating to accident and health programs.⁷ An examination of the meaning and merit of the new statute in its application to such arrangements focuses upon three questions: Are proceeds tax-free when received by the employee? Are the employer's contributions taxable to the employee? Can the employee deduct his own contributions?

1. See, in general, Gordon, *Tax Effects of Union Welfare Funds*, 6 TAX L. REV. 1 (1950); Schlenger, *Disability Benefits Under Section 22 (b)(5)*, 40 VA. L. REV. 549 (1954); Rubenstein & Wolk, *Sickness and Accident Benefits in Union Agreements, 1949*, 70 MONTHLY LAB. REV. 636 (1950).

2. See, e.g., *Epmeier v. United States*, 199 F.2d 508, 509 (7th Cir. 1952) (providing medical, hospitalization, surgical, and loss of earnings benefits). Some programs also include compensation for specific disability such as loss of a limb or sight. See *Van Zantan v. National Casualty Co.*, 333 Mich. 28, 30, 52 N.W.2d 581, 583 (1952).

3. On voluntary and collectively bargained programs see authorities cited note 1 *supra*. For a general discussion of state nonoccupational disability statutes, see Comment, 60 YALE L.J. 647 (1951); Honey, *Compulsory Nonoccupational Disability Benefits Legislation, 1952* INS. L.J. 691 (1952).

4. See Rubenstein & Wolk, *supra* note 1 (employer and employer-employee contributions); Rev. Rul. 208, 1953 INT. REV. BULL. No. 21, at 1 (1953) (employee contributions).

5. See Gordon, *supra* note 1, at 3; Rubenstein & Wolk, *supra* note 1.

6. INT. REV. CODE OF 1939, § 22(b)(5); I.T. Info. No. 4, 5 CCH 1952 FED. TAX REP. ¶ 6051 (1951). For a discussion of damages and workmen's compensation as exempt from federal income taxation see Schlenger, *supra* note 1, at 553, 557.

7. INT. REV. CODE OF 1954, §§ 104(a)(3), 105, 106.

PROCEEDS

Old Code

Under the old Code,⁸ taxability of proceeds received by an employee from an accident or health program hinged on whether that program could be categorized as "insurance."⁹ Section 22(b)(5) excluded from gross income "amounts received, through accident or health insurance . . . as compensation for personal injuries or sickness . . .,"¹⁰ except to the extent such amounts were attributable to medical expense deductions taken in any prior year.¹¹ The term "accident or health insurance" was interpreted to include both loss of earnings and medical expense insurance.¹² Commercially insured arrangements¹³ automatically

8. INT. REV. CODE OF 1939.

9. See, in general, Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549 (1954); Comment, 21 U. OF CHI. L. REV. 277 (1954); 51 MICH. L. REV. 1248 (1953).

10. INT. REV. CODE OF 1939, § 22: "(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";

The exclusion is available to beneficiaries who have an insurable interest in the health of the insured, such as the insured, his family or his employer. *Castner Garage, Ltd.*, 43 B.T.A. 1 (1940). *But cf.* *Peoples Finance & Thrift Co. v. Commissioner*, 184 F.2d 836 (5th Cir. 1950), *affirming* 12 T.C. 1052 (1949) (creditor transferees for value not entitled to the exemption).

11. The exception to § 22(b)(5) is designed to complement the medical expense deduction allowed by § 23(x). See U.S. Treas. Reg. 118 § 39.23(x) (-1) (1953), as amended by T.D. 5687, 1949-1 CUM. BULL. 9, 15. The latter section grants a deduction for medical expenses not compensated for by insurance or otherwise in the taxable year. The § 22(b)(5) exception probably means that insurance proceeds received in subsequent years are taxable only if they would have reduced the medical deduction if received in a prior year. The Tax Court has held that only medical and hospitalization benefits reduce the medical deduction while loss-of-earnings proceeds do not, since they "compensate" for lost wages rather than medical expenses. *Robert O. Deming, Jr.*, 9 T.C. 383 (1947), *acq.*, 1948-1 CUM. BULL. 1. Therefore, it may be inferred that only medical and hospitalization benefits fall within the meaning of the § 22(b)(5) exception.

Section 105 of the new Code specifically adopts this interpretation. *Deming* is codified by new § 105(f). And the old § 22(b)(5) exception is made applicable only to medical reimbursements by § 105(b).

12. See *Epmeier v. United States*, 199 F.2d 508 (7th Cir.), *reversing* 52-1 U.S. TAX CAS. ¶9261 (N.D. Ind. 1952); *Fred W. Staudt*, 12 T.C.M. 1417 (1953); *Robert O. Deming, Jr.*, 9 T.C. 383 (1947); I.T. 3928, 1948-2 CUM. BULL. 9.

13. For a general discussion of commercial accident or health insurance, see Curran, *The Fundamentals of Accident and Health Insurance*, 1953 INS. L.J. 555 (1953). See also VANCE, *INSURANCE* 179-94, 203, 205 (3d ed. 1951).

qualified as "insurance,"¹⁴ but private programs of an employee association or an employer often did not.¹⁵ When a private arrangement failed to qualify, its proceeds were fully taxable to the employee,¹⁶ except for a tax-free recovery of his contributions.¹⁷ The status of such private programs was uncertain because of a dispute between the Internal Revenue Service and the Seventh Circuit over what constituted "insurance."

The Service's definition of "insurance" excluded certain private loss-of-earnings programs which it labeled "sick-leave."¹⁸ Such classification resulted in taxation of proceeds.¹⁹ Programs might fall into this sick-leave category even

14. Fred W. Staudt, 12 T.C.M. 14-17 (1953); Castner Garage, Ltd., 43 B.T.A. 1 (1940). See Wong Wing Non, 18 T.C. 205, 209 (1952); I.T. 4060, 1951-2 CUM. BULL. 11, 13, *modified on other grounds*, I.T. 4107, 1952-2 CUM. BULL. 73.

Accident or health plans of an employee association which qualified as an insurance company within U.S. Treas. Reg. 118, § 39.3797-7 (1953), and state fund accident or health plans established under state sickness and disability statutes also qualified as "insurance" within § 22(b) (5). I.T. 3928, 1948-2 CUM. BULL. 9 (employee association); I.T. 4015, 1950-1 CUM. BULL. 23 (state-fund), *modified on other grounds*, I.T. 4107, 1952-2 CUM. BULL. 73; I.T. 4060, 1951-2 CUM. BULL. 11 (same).

15. See text at notes 18-21 *infra*.

16. See I.T. Info. No. 4, 5 CCH 1952 FED. TAX REP. ¶ 6051 (1951); Press Release, 5 CCH 1953 FED. TAX REP. ¶ 6136 (1953); rulings cited note 20 *infra*.

17. Rev. Rul. 54-2, 1954 INT. REV. BULL. No. 1 at 6 (1954). Cf. I.T. 1918, III-1 CUM. BULL. 121 (1924) (private unemployment compensation plan). The tax-free recovery is based on the theory that, to the extent of his contributions, the employee is receiving a return of capital rather than income. Since the ruling states that benefits are to be tax-free to the extent of *all* the employee's contributions, whenever made, it presumably applies to contributions of prior years as well as the year of receipt. The ruling has the policy justification of avoiding the harsh results of full taxation of benefits to a recipient who has made contributions out of previously taxed income. But it seems legally incorrect, since accident or health arrangements have no savings feature. Benefits are attributable only to current contributions, which are thus more properly regarded as expenses than investments. See VANCE, INSURANCE § 179 (3d ed. 1951).

18. Press Release, 5 CCH 1953 FED. TAX REP. ¶ 6136 (1953); G.C.M. 23511, 1943 CUM. BULL. 86. See rulings cited note 20 *infra*.

Prior to January 1, 1953, private plans approved under state sickness and disability statutes were regarded by the Service as "insurance." I.T. 4000, 1950-1 CUM. BULL. 21; I.T. 4015, 1950-1 CUM. BULL. 23; I.T. 4060, 1951-2 CUM. BULL. 11. However, the Service subsequently ruled that, beginning in 1953, private plans approved by state statutes would be subject to the criteria of "insurance" laid down for non-statutory, private plans. I.T. 4107, 1952-2 CUM. BULL. 73.

On state sickness and disability statutes in general, see Comment, 60 YALE L.J. 647 (1951); Honey, *Compulsory Nonoccupational Disability Benefits Legislation*, 1952 INS. L.J. 691 (1952); 1 SYRACUSE L. REV. 278 (1949).

19. I.T. Info. No. 4, 5 CCH 1952 FED. TAX REP. ¶ 6051 (1951); see rulings cited note 20 *infra*.

Many private accident or health arrangements provide for payment of the difference between amounts received as workmen's compensation and regular salary. Prior to August 1, 1953, such differential payments were excludable under § 22(b) (5) either as "workmen's compensation" if received for injury or sickness which arose out of and in the course of employment, or as "damages received . . . by . . . agreement" if the terms of the plan required the employee to waive his rights at law on electing payment under the plan. Special

though they met such undisputed criteria of insurance as contractual enforceability, definition of risks covered, and specification of benefits provided.²⁰ Factors which might result in the Service's designation of a plan as sick-leave were: relation of amount or duration of benefits to rate of salary or length of employment; lack of substantial employee contributions; payments of benefits by the employer directly to the employee rather than through a separate fund.²¹ It was not clear what weight the Service would assign to each of these factors, and consequently the tax status of many private arrangements was uncertain until specific rulings were obtained.

The Seventh Circuit defined "insurance" more broadly in *Epmeier v. United States*.²² There an insurance company had provided its employees with sickness benefits based upon rate of salary and length of service. The employees made no contributions other than their usual services. Benefits were paid directly by the employer, rather than from a separate fund. Thus the program contained all the factors regarded by the Service as indicia of sick-leave. Nevertheless, the court held that the plan was one of "insurance," since it provided contractually enforceable benefits indemnifying against loss from specified contingencies.²³ Despite the fact that the employer was an insurance company, the

ruling, 5 CCH 1951 FED. TAX REP. ¶6243 (1945) (workmen's compensation); Special ruling, 5 CCH 1952 FED. TAX REP. ¶6036 (1951) (same); I.T. 3306, 1939-2 CUM. BULL. 149 (damages). *But cf.* Special ruling, 5 P-H 1947 FED. TAX SERV. ¶76,215; G.C.M. 23511, 1943 CUM. BULL. 86.

However, the Service more recently ruled that differential payments received after Aug. 1, 1953, which are not paid under a plan of accident or health "insurance" are taxable as income unless either paid pursuant to a court-sanctioned agreement which, according to state statute, is in lieu of workmen's compensation, or paid as damages under an agreement in satisfaction of tort liability other than liability under a workmen's compensation act. Rev. Rul. 103, 1953-1 CUM. BULL. 20; Rewrite bulletin, 5 CCH 1953 FED. TAX REP. ¶8598 (1953). See Schlenger, *Disability Benefits under Section 22(b)(5)*, 40 VA. L. REV. 549, 553 (1954).

20. G.C.M. 23511, 1943 CUM. BULL. 86; Rev. Rul. 54-1, 1954 INT. REV. BULL. No. 1 at 5 (1954); Rev. Rul. 209, 1953 INT. REV. BULL. No. 21 at 3 (1953); Rev. Rul. 103, 1953 INT. REV. BULL. No. 13 at 2 (1953); I.T. 4107, 1952-2 CUM. BULL. 73. *But cf.* Rev. Rul. 269, 1953 INT. REV. BULL. No. 26 at 3 (1953); Rev. Rul. 208, 1953 INT. REV. BULL. No. 21 at 1 (1953).

Neither the Service nor the courts regarded accident or health arrangements which failed to meet these criteria as "insurance" within § 22(b)(5). *Epmeier v. United States*, 52-1 U.S. TAX CAS. ¶9251 (N.D. Ind.), *rev'd*, 199 F.2d 508 (7th Cir. 1952); I.T. 3738, 1945-1 CUM. BULL. 90.

For discussion of the elements of insurance, see VANCE, *INSURANCE* § 1 (3d ed. 1951); 12 APPLEMAN, *INSURANCE LAW AND PRACTICE*, § 7001 (1941).

21. See authorities cited notes 18 and 20 *supra*; Rewrite Bulletin, 5 CCH 1953 FED. TAX REP. ¶8515 (1953).

22. 199 F.2d 508 (7th Cir. 1952). See Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549, 575 (1954); Comment, 21 U. OF CHI. L. REV. 277 (1954); 51 MICH. L. REV. 1248 (1953); 14 OHIO ST. L.J. 338 (1953).

23. *Epmeier v. United States*, 199 F.2d 508 (7th Cir. 1952).

"Insurance, of ancient origin, involves a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified

court apparently treated the plan as a typical sick-leave arrangement rather than as commercial insurance.²⁴

Epmeier correctly established that a plan could be both sick-leave and insurance. The Service's requirement that benefits be unrelated to rate of salary and length of employment was irrelevant to the issue of whether a program was one of insurance. Although an arrangement cannot constitute insurance without provision for some benefits, the particular kind of benefits is pertinent only to a description of the insurance provided.²⁵ Likewise, substantial employee contributions are not an essential constituent of insurance. The existence of insurance does not presuppose that the beneficiary pay the premiums.²⁶ Furthermore, even if separate fund maintenance be regarded as a necessary safeguard to financial security in certain types of private plans,²⁷ the security function in other such arrangements is satisfied by statutory regulation. These regulated arrangements include the *Epmeier* kind of situation, where the employer is a regulated insurance company, as well as plans approved under state compulsory disability insurance statutes.²⁸ However, despite *Epmeier's* re-

contingencies or perils. Fundamentally and shortly, it is contractual security against possible anticipated loss. Risk is essential and, equally so, a shifting of its incidence from one to another. [cases cited]" *Id.* at 509-10.

24. The fact that the employer is a licensed insurance company is mentioned in the case only in the statement of facts and is not alluded to as a factor in the decision. The following discussion in the opinion indicates that it was not such a factor: "In determining whether the benefits under consideration are within the statute and in accord with these general principles, we observe, first, that the plan under which the payments were made is not in the physical form of ordinary formal insurance contracts sold commercially, but instead is included in a company document with other subject matters having to do with the employer-employee relationship." *Epmeier v. United States*, 199 F.2d 508, 510 (7th Cir. 1952).

25. See VANCE, *INSURANCE* § 7 (3d ed. 1951). Loss-of-earnings insurance has become very important. It is written in individual and group commercial policies. See Curran, *The Fundamentals of Accident and Health Insurance*, 1953 *INS. L.J.* 555 (1953); SOMMER, *MANUAL OF ACCIDENT AND HEALTH INSURANCE* 21-4 (1928); and it is required for employees by statutes in some states. See Comment, 60 *YALE L.J.* 647 (1951); Honey, *Compulsory Nonoccupational Disability Benefits Legislation*, 1952 *INS. L.J.* 691 (1952).

26. *Monast v. Manhattan Life Ins. Co.*, 32 R.I. 557, 567, 79 Atl. 932, 936 (1911). *Accord*: *New York Life Ins. Co. v. McJunkin*, 227 Ala. 228, 149 So. 663 (1933); VANCE, *INSURANCE* 303 (3d ed. 1951).

And even if premium payments by the beneficiary were considered a requisite of insurance, the employees covered by a sick-leave arrangement could be regarded as paying the premiums through services rendered or to be rendered. *Equitable Life Assurance Soc'y of United States v. Commonwealth*, 113 Ky. 126, 67 S.W. 388 (1902); *The Kentucky Mutual Ins. Co. v. Jenks*, 5 Ind. 96 (1854).

27. Where the plan calls for direct payment of benefits from employer to employee, the requirement of a separate fund may be necessary to assure payment to the employee.

28. Private plans under state sickness and disability statutes must be approved by state authorities. Generally the employer must post a bond or deposit securities as evidence of financial security. CAL. UNEMPL. INS. CODE §§ 3258, 3262 (Deering, 1954); N.Y. WORKMEN'S COMP. LAW § 211. *But cf.* 43 N.J.S.A. §§ 21-32 through 21-35 (1950).

jection of the dichotomy between insurance and sick-leave, the Service continued to insist that the two were incompatible.²⁹

The strange criteria of "insurance" promulgated by the Service were based upon policy considerations which could not be consistently implemented under the inflexible provisions of the old Code. The Service's bias against arrangements which tied benefits to rate of salary and length of employment was based upon the seeming unfairness of excluding payments in lieu of earnings while taxing earnings.³⁰ Consistent application of that policy would have required taxation of all loss-of-earnings proceeds. But loss-of-earnings features were often written in commercial accident or health policies,³¹ and therefore were clearly excludable as amounts received through "insurance."³² The Service's preference for arrangements supported substantially by employee contributions apparently was motivated by the fact that tax-free compensation of employees would result if a program principally supported by employer contributions were labeled "insurance."³³ This would occur because employer contributions to such arrangements were generally not taxable to the employee,³⁴ and proceeds attributable to such contributions would also be tax-free if the arrangement qualified as "insurance." Yet such tax-free compensation of employees was obtainable under commercially insured plans, since it was clear that these plans constituted "insurance."³⁵ In order to apply a consistent policy against tax-free compensation of employees through accident or health arrangements, the Service would have had to tax to the employee all proceeds attributable to tax-free employer contributions. But the rigid phrase in the old Code excluding all "amounts received, through accident or health insurance" precluded any interpretation upon which such a policy could be predicated.

New Code

General Provisions

While the new Code pretends to establish a statutory framework within which the Service's policy views can be implemented, in reality it is only a facade. Section 104(a)(3) continues the general exclusion from gross income of amounts received through accident or health insurance.³⁶ But complementary

29. Press Release, 5 CCH 1953 FED. TAX REP. ¶ 6136 (1953); I.T. 4107, 1952-2 CUM. BULL. 73.

30. Press Release, 5 CCH 1953 FED. TAX REP. ¶ 6136 (1953); G.C.M. 23511, 1943 CUM. BULL. 86.

31. See note 25 *supra*.

32. See note 14 *supra*.

33. Press Release, 5 CCH 1953 FED. TAX REP. ¶ 6136 (1953).

34. See text at notes 108-10 *infra*.

35. See note 14 *supra*.

36. INT. REV. CODE OF 1954, § 104(a)(3):

"(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 for personal injuries

clauses in Sections 104(a)(3) and 105 (a) provide that, as a rule, gross income includes accident or health insurance proceeds attributable to employer contributions not taxable to the employee.³⁷ These clauses embody the view of the Service that accident or health arrangements should not be used as a device for tax-free compensation of employees.³⁸ But this rule is rendered a virtual nullity by sweeping exceptions contained in Sections 105(b), (c), and (d). They exclude from gross income all insurance proceeds which represent medical reimbursements,³⁹ permanent injury payments related to the nature of the injury and not to the period of disability,⁴⁰ and loss-of-earnings benefits up to \$100 per week.⁴¹ Thus the Service's policy against tax-free compensation actually is effectuated only with regard to loss-of-earnings proceeds in excess

or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer)."

37. *Ibid.*

INT. REV. CODE OF 1954, § 105(a) :

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

38. See text at notes 33-4 *supra*.

39. INT. REV. CODE OF 1954, § 105(b) :

"(b) AMOUNTS EXPENDED FOR MEDICAL CARE.—

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 amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152)."

40. INT. REV. CODE OF 1954, § 105(c) :

"(c) PAYMENTS UNRELATED TO ABSENCE FROM WORK.—

"Gross income does not include amounts referred to in subsection (a) to the extent such amounts—

"(1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and

"(2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work."

41. INT. REV. CODE OF 1954, § 105(d) :

"(d) WAGE CONTINUATION PLANS.—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of \$100. In the case of a period during which the employee is absent from work on account of sickness, the preceding sentence shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid."

of \$100 per week. However, the Service's principle of distinguishing between loss-of-earnings and other types of benefits is established by the limitations on excludability of loss-of-earnings benefits.⁴² But this too must be considered a pyrrhic victory, since loss-of-earnings proceeds up to \$100 per week are tax-exempt and probably few arrangements provide greater benefits of that type.⁴³

A primary objective of the House version of Section 105 was to equalize tax treatment of commercially and privately insured accident or health programs financed by employers.⁴⁴ This reflected the principle of the *Epmcior* case.⁴⁵ The House replaced the old "insurance" criterion with a new test—whether benefits were received under a "qualified plan (through insurance or otherwise)."⁴⁶ Qualification depended upon compliance with detailed requirements that a plan be in the nature of insurance and not discriminate in favor of high salaried employees.⁴⁷ However, the Senate not only eliminated the House's qualification provisions, but also entirely removed the "qualified plan" test and reinserted the old Section 22(b)(5) standard of "insurance."⁴⁸

42. Other types of accident or health benefits which fall within § 105(a) are excludable in full under §§ 105(b) and 105(c). INT. REV. CODE OF 1954, §§ 105(a), (b), and (c). For the Service's view on the need for a distinction between loss-of-earnings and other accident or health benefits, see text at note 30 *supra*.

43. Curran, *The Fundamentals of Accident and Health Insurance*, 1953 INS. L.J. 555, 568 (1953), estimates that the usual group disability policy provides weekly benefits at two-thirds of salary up to \$40 per week plus optional medical, surgical, and hospital benefits.

44. See H.R. 8300, 83d Cong., 2d Sess § 105 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 15, A32 (1954).

45. See text at notes 22-4 *supra*.

46. H.R. 8300, 83d Cong., 2d Sess. § 105 (1954):

"(a) GENERAL RULE.—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, and except as provided in subsection (b), gross income does not include amounts received by an employee under a qualified employer's accident or health plan as compensation for personal injuries or sickness

"(c) DEFINITIONS.—

"(1) QUALIFIED EMPLOYER'S ACCIDENT OR HEALTH PLAN.—For purposes of this section, the term "qualified employer's accident or health plan" means a plan of an employer for the exclusive benefit of his employees—

"(A) which provides (through insurance or otherwise) compensation for personal injuries or sickness;

"(B) under which all employees covered by the plan have (while the plan remains in effect) an enforceable right to the compensation provided under the plan;

"(C) which (if the plan were a pension plan) would qualify under section 501(e) with respect to—

(i) the employees covered by the plan,

(ii) the contributions to the plan, and

(iii) the benefits payable under the plan;

except that for purposes of this subparagraph, wages shall be taken into account without regard to the \$4,000 exclusion contained in section 501(e)(4)(A); and"

47. *Ibid.*

48. Senate Amendment No. 32 to H.R. 8300, 83d Cong., 2d Sess. (1954). See note 37 *supra* for the new Code version of § 105(a), which is substantially as inserted by the Senate.

Thus, commercial insurance proceeds continue to be excludable under the new Code. But whether a private program constitutes "insurance" remains as uncertain as ever.⁴⁹

Yet the Senate was not unaware of the need for equalizing tax treatment in this field. Section 105(e) of the new Code, inserted by the Senate, states that amounts received under a "plan for employees" shall be treated as "insurance" within the meaning of Sections 104 and 105.⁵⁰ This raises the question of whether the phrase "plan for employees" is to be interpreted together with the term "insurance" or as a separate category of qualification. If they are considered related terms, a reasonable interpretation would treat "insurance" as meaning only commercial insurance, and "plan for employees" as limited to private plans of the *Epmeier* type, that is, plans in the nature of insurance.⁵¹ The desirability of this interpretation lies in the predictability of its application and the ease of its administration.⁵² However, the term "insurance" can be interpreted as retaining its uncertain Section 22(b)(5) meaning,⁵³ and the phrase "plan for employees" may be regarded as an independent qualify-

The Senate Report gives no explanation for the insertion of the term "insurance" as a qualifying test in § 105. There is not even a reference to the fact that the change was made, other than a bare recitation of the amendment. It is quite possible that the term "insurance" was unintentionally inserted in an attempt to clarify the meaning of § 105. The Report states that "the exemption is to be granted only to benefits paid out under an arrangement which constitutes a plan," although it is not clear whether that statement applies to all of § 105 or only to private arrangements for employees. SEN. REP. NO. 1622, 83d Cong., 2d Sess. 185, 15 (1954). Whatever the intent of Congress might have been, the statutory language of § 105 clearly grants the exemptions therein for amounts received through insurance.

49. See pp. 223-27 *supra*.

50. INT. REV. CODE OF 1954, § 105(e) states:

"For purposes of this section and section 104—

"(1) amounts received under an accident or health plan for employees, and

"(2) amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance."

See SEN. REP. NO. 1622, 83d Cong., 2d Sess. 15, 183 (1954).

It is not clear whether § 105(e) (2) applies only to state-fund plans or to all plans approved under a state statute. This question does not seem too significant, since a statutorily approved private plan will probably qualify as a "plan for employees."

51. See text at notes 22-4 *supra*. Under this interpretation, requisites of a "plan" would be contractual enforceability, definition of risks covered, and specification of benefits provided.

52. If the standards of insurance are cast aside, there do not appear to be any objectively determinable criteria allowing for a clear definition of "plan" short of a definition which would include all accident or health benefits received by an employee. Since such an all inclusive interpretation is apparently prohibited by the statute and commentaries, see note 61 *infra*, "plan" would become not only an undefined but an undefinable entity.

The question of the necessary breadth of a "plan" in terms of number of employees covered is a separate issue and is discussed pp. 233-35 *infra*.

53. See pp. 223-27 *supra*.

ing test. If this view is adopted, beneficiaries of employer-financed accident or health arrangements will have the double-barrelled argument that the program constitutes either "insurance" or a "plan for employees." The old Code dispute as to what private plans constitute "insurance" will be revived.⁵⁴ And the new phrase, "plan for employees," will become a subject of speculation; for if it is not defined to mean only plan in the nature of insurance, the number of its possible interpretations is almost infinite.

What is a plan for employees?

If "plan for employees" is viewed as an independent qualifying test, it is likely to become a focal point for litigation. Important consequences attach to qualification as a "plan for employees." Employer contributions to such a program are excludable from the employee's gross income under Section 106.⁵⁵ And since Section 105(e) provides that "plan[s] for employees" be treated as "insurance" within the meaning of Sections 104 and 105,⁵⁶ proceeds attributable to employee contributions will be exempt under Section 104(a)(3),⁵⁷ and proceeds attributable to employer contributions or paid directly by the employer will be exempt under Section 105.⁵⁸ But if an arrangement fails to constitute a "plan for employees," the exemptions granted by Sections 104(a)(3) and 105 will be lost unless the arrangement independently qualifies as "insurance."⁵⁹ And whether or not the arrangement constitutes "insurance," the Section 106 exclusion, applicable to employer contributions, will be unavailable if the arrangement is not a "plan for employees."⁶⁰ The Code fails to define "plan for employees" and the legislative commentaries are both sketchy and ambiguous.

The term "plan" signifies something more than one or more ad hoc benefit payments.⁶¹ Thus an employer payment to an injured or sick employee will

54. *Ibid.*

55. INT. REV. CODE OF 1954, § 106:

"Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness."

See general discussion of employer contributions, pp. 239-43 *infra*.

56. See note 50 *supra*.

57. See note 36 *supra*.

58. See notes 39-41 *supra*. A \$100 per week limitation will apply to amounts received in lieu of wages.

59. An accident or health arrangement which does not qualify as a "plan for employees" will not fall within the provisions of § 105(a), unless it is an "insurance" arrangement. See text at note 48 *supra*. The exemptions in §§ 105(b) and (c) are available only to arrangements which fall within § 105(a). See notes 36, 37, and 39-41 *supra*. Therefore, proceeds from a non-qualifying arrangement are ineligible for the exemptions in §§ 105(b), (c), and (d).

60. See note 55 *supra*.

61. The Senate Finance Committee Report on § 105 contains the limiting statement that exemptions under § 105 are to be granted "only to benefits paid out under an arrangement which constitutes a plan." SEN. REP. No. 1622, 83d Cong., 2d Sess. 185 (1954).

probably not constitute a "plan" without evidence of an established practice or a prior arrangement. But to state what types of arrangements will constitute "plan[s]" is impossible because of congressional failure even to suggest any definition.⁶² One possibility is that the term "plan" requires merely an informal, unenforceable understanding that an employer will "take care" of his employees at his discretion during a period of disability.⁶³ From this extreme, interpretations run the gamut to the view that a "plan" must provide specific coverage and benefits, and be communicated to the employees covered.⁶⁴ This would bring the meaning of "plan" close to a codification of *Ephmeier* and be both practicable and predictable.⁶⁵ But unless the Regulations adopt this position, it is likely that arrangements of a more discretionary nature will qualify.

An additional interpretive problem is whether general partners and sole proprietors can be included in a "plan for employees." Cases and rulings dealing with the somewhat analogous employee pension plan section of the Code treat corporate executives as employees,⁶⁶ but hold that general partners and sole proprietors are not.⁶⁷ An entire pension plan may be disqualified if a partici-

Furthermore, § 104 of the new Code specifically enumerates the types of payments for personal injuries or sickness which are exempt. They are workmen's compensation, damages, accident or health insurance, and payments for injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service. INT. REV. CODE OF 1954, § 104. If the term "plan" included within its meaning all payments for personal injury or sickness, it would render most of the specific exemptions unnecessary. That result, if intended by Congress, could have been accomplished more easily by a broad statement exempting all payments received from an employer for personal injuries or sickness.

62. See note 61 *supra* and notes 63 and 64 *infra*.

63. Support for this interpretation lies in the Senate's deletion of the House qualification provisions, which included a requirement of contractual enforceability. See note 46 *supra*. However, this position is weakened by the Senate Finance Committee's limiting statement that exemptions are to be granted under § 105 "only to benefits paid out under an arrangement which constitutes a plan." SEN. REP. No. 1622, 83d Cong., 2d Sess. 185 (1954) (emphasis added). Moreover, there are indications that the phrase was intended to cover only private plans in the nature of insurance. See note 64 *infra*.

64. This interpretation can be supported by analogizing "plan for employees" under § 105 to old § 22(b) (1) (B), which excluded from gross income certain death benefits received under a contract of an employer. INT. REV. CODE OF 1939, § 22(b) (1) (B). The regulations provide that, for a "plan" to qualify under this section, it must make provision for payments and be promulgated to the employees covered. U.S. Treas. Reg. 118, § 39.22 (b) (1)-2 (1953). For another possible supporting analogy, see INT. REV. CODE OF 1939, § 165(a) and regulations, delineating qualification provisions for employee's pension, profit-sharing, stock bonus, and annuity "plans."

65. See notes 51 and 52 *supra*.

66. See *Kintner v. United States*, 107 F. Supp. 976 (D. Mont. 1952); *Volckening Inc.*, 13 T.C. 723 (1949); *Betty C. Stockvis*, 10 T.C.M. 74 (1951); P.S. No. 27, 3 CCH 1944 FED. TAX REP. ¶ 6557 (1944). But cf. *Bentley v. Commissioner*, 184 F.2d 668 (2d Cir.), *affirming* 14 T.C. 228 (1950), *cert. denied*, 340 U.S. 943 (1951); *Smith & Sons Co. v. Commissioner*, 184 F.2d 1011 (6th Cir. 1950), *cert. denied*, 340 U.S. 953 (1951).

67. *Bentley v. Commissioner*, *supra* note 66; I.T. 3350, 1940-1 CUM. BULL. 64; P.S. No. 15, 3 CCH 1944 FED. TAX REP. ¶ 6531. (1944); see I.T. 3268, 1939-1 CUM. BULL. 196;

pant is not an employee,⁶⁸ since the relevant Code section provides that such a plan must be for the exclusive benefit of employees.⁶⁹ But Section 105(e), relating to accident or health plans, does not have an exclusive benefit clause.⁷⁰ The House bill contained such a clause but the Senate deleted it,⁷¹ apparently in response to urgings that plans should not be disqualified on technicalities.⁷² It may be reasonably inferred from this deletion that participation of general partners and sole proprietors in an arrangement which otherwise qualifies as a "plan for employees" will not cause disqualification. Moreover, proceeds received by a general partner or sole proprietor under a "plan for employees" will probably be wholly tax-exempt under Section 104(a)(3) by virtue of the Section 105(e) provision that such amounts be treated as received through accident or health insurance.⁷³ This result seems justified, since the partner or proprietor will be unable to deduct that portion of his contributions allocable to his coverage as an ordinary and necessary business expense.⁷⁴ If he had purchased commercial insurance, the proceeds would be clearly tax-exempt under Section 104(a)(3).⁷⁵ Therefore, in accordance with the policy of the Code to equalize tax treatment between commercially insured and privately financed arrangements,⁷⁶ the partner or proprietor should not be penalized for participating in a "plan for employees."

Ambiguity prevails as to how broadly based a "plan" must be in terms of employees covered. One view is that even an arrangement including only one or a few employees is sufficient to qualify as a "plan," regardless of exclusion

P.S. No. 23, 3 CCH 1944 FED. TAX REP. ¶ 6553 (1944). *But cf.* Arthur R. Kintner v. United States, 107 F. Supp. 976 (D. Mont. 1952).

68. *Ibid.*

69. INT. REV. CODE OF 1939, § 165(a); INT. REV. CODE OF 1954, § 401(a).

70. See note 50 *supra*.

71. See H.R. 8300, 83d Cong., 2d Sess. § 105(c)(1) (1954); Senate Amendment No. 32 to H.R. 8300 (1954).

72. See, e.g., *Hearings before Committee on Finance on H.R. 8300*, 83d Cong., 2d Sess. pt. I, pp. 197-200 (1954); *id.* at pt. IV, pp. 1943, 1947-49.

73. See notes 36 and 50 *supra*.

It might be argued that amounts received by a partner or proprietor are not received pursuant to a "plan for employees" and therefore do not constitute "insurance" within either § 104 or § 105. But if such amounts are considered received through a "plan for employees," they will probably be wholly tax-exempt under § 104(a)(3) rather than subject to the \$100 a week limitation in § 105(d). Amounts received fall within § 104(a)(3), unless covered by the parenthetical exception, which applies only to amounts received by an employee. The exception will therefore not affect amounts received by a partner or proprietor.

74. That portion of the contributions allocable to coverage of a general partner or a sole proprietor will constitute non-deductible personal expenses under § 262. INT. REV. CODE OF 1954, § 262. *Cf.* Joseph Nussbaum, 19 B.T.A. 868, 870 (1930) (life insurance premiums; alternative holding).

75. See note 36 *supra*.

76. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 15 (1954); SEN. REP. NO. 1622, 83d Cong., 2d Sess. 15 (1954).

of the remainder of their class or other classes of employees.⁷⁷ A second position is that a "plan" must be available to at least an entire class of employees, although other classes may be excluded.⁷⁸ A third approach is that protection must be available to substantially all employees without discrimination either within or among classes.⁷⁹ Neither the Code, commentaries, nor hearings establish which of these interpretations Congress intended. And there is no clear policy directive on which a choice can be predicated. The tax advantages conferred on "plan[s] for employees" must be deemed to rest upon the policy of

77. This interpretation gains support from the Senate Finance Committee's statement that the § 106 exclusion of employer contributions to a plan is applicable regardless of whether the employer's plan covers one employee or a group of employees. SEN. REP. NO. 1622, 83d Cong., 2d Sess. 186 (1954).

Further support lies in a presumption of deliberate vagueness in the Senate removal of the House qualification provisions and substitution of the ambiguous phrase "plan for employees." See text at notes 46-8 *supra*.

The interpretation may be countered by the contention that the § 106 statement applies to an employer who has only one employee or one employee in a class. See also notes 78 and 79 *infra*. Moreover, this interpretation seems the worst from a policy view. It would allow tax-free compensation not only of executives as a class but of executives and other employees as individuals. Under such an interpretation, the employer could reward employees *A* and *B* with an accident or health "plan" rather than a straight cash bonus and both contributions and proceeds would be tax-free to the recipient. Policy justification is difficult to find. Although empirical data is unavailable, it may at least be tentatively assumed that such allowance of tax-free compensation to individuals would not promote broad coverage in the classes of employees who most need both the coverage and the tax advantage.

Another factor which might indicate congressional intent against use of the phrase "plan for employees" as a device for tax-free compensation of individuals is the President of the United States' recommendation to Congress that accident or health protection on a *group basis* be tax exempt. President's Budget Message to Congress, 100 CONG. REC. 570 (1954).

78. This position draws support from the Senate deletion of the House non-discriminatory qualification provisions. See text at notes 46-8 *supra*. Further support is derived by analogy from the regulations on employer death benefits under the old Code, which provided that a plan, to qualify, had to cover at least a "class" of employees. It may be noted that under those regulations an express contract covering less than a class would also qualify. U.S. TREAS. REG. 118, § 39.22(b)(1)-2(c) (1953). See also INT. REV. CODE OF 1954, § 3121(a)(2) (specifying the exclusion of certain amounts from definition of "wages" under the Federal Insurance Contributions Act). Such amounts include payments by employers for employees' retirement, disability, medical, and hospitalization expenses, or death, if such payments are made under a "plan" covering at least a "class" of employees. An identical provision relating to definition of "wages" under the Federal Unemployment Tax Act is contained in INT. REV. CODE OF 1954, § 3306(b)(2).

Another argument in favor of this interpretation is that Congress by providing a \$100 per week maximum exemption on loss-of-earnings benefits established the non-discriminatory limitation which it thought necessary. Therefore, any inference of further non-discriminatory meaning is precluded. But see note 79 *infra*.

79. This approach derives support from the Senate Finance Committee statement (explaining the Senate deletion of the House non-discriminatory qualification provisions) that the § 105 exemptions are "to be granted only to benefits paid out under an *arrangement* which constitutes a *plan*." SEN. REP. NO. 1622, 83d Cong., 2d Sess. 185, 16 (1954) (emphasis

encouraging accident or health coverage.⁸⁰ But a broad competing policy is to tax all income. Congress has the means to compile and evaluate the facts necessary to select the definition of "plan for employees" which would best balance these conflicting policies.⁸¹ But courts cannot collect this empirical data. And even if they could, different courts would assign different values to the competing policies and create conflicting rules of interpretation. Consequently, the new Code increases judicial unpredictability in this area.

Because of the uncertainty as to the requisites of a "plan," employers contemplating the establishment of an accident or health program of restricted employee participation would be well advised to utilize commercial insurance. This suggestion is especially applicable to companies where the number of employees sought to be covered is small and includes executive or highly compensated employees. If the program is commercially insured the proceeds will be tax-exempt under Sections 104 or 105 even if it fails to constitute a "plan,"⁸² and whether it is a "plan" will be significant only with regard to exclusion of premium contributions under Section 106.⁸³ And if that Section is unavailable because the program is not a "plan," the employee can still contend that the premiums are not sufficiently realized to constitute income.⁸⁴ If a privately financed sick-leave program is set up wherein the employer continues wage payments during employee disability, the hypothetical premiums which the

added) (perhaps indicating that the House qualification provisions were deleted merely for technical reasons and that an implied non-discriminatory meaning still remains).

Further support for the non-discriminatory interpretation of the phrase "plan for employees" is derived from the general assumption of the Treasury Department and witnesses appearing before the Senate Finance Committee that such plans were meant to be non-discriminatory. See, *e.g.*, Statements of Marion B. Folsom, Under Secretary of the Treasury, *Hearings before Finance Committee on H.R. 8300*, 83d Cong., 2d Sess. pt. I, p. 115 (1954); James L. Madden, for the Chamber of Commerce of the United States, *id.* at pt. IV, p. 1948 (1954), suggesting the removal of the House qualification provisions on grounds that such mechanical tests are inappropriate to accident or health arrangements and that the issue of discrimination can be handled better by testing the availability of comparable benefits to all employees.

80. See President's Budget Message, 100 Cong. Rec. 570 (1954), where President Eisenhower stated: "Insurance and other plans adopted by employers to protect their employees against the risks of sickness should be encouraged by removing the present uncertainties in the tax law."

81. To determine whether a "plan for employees" should be permitted to involve discrimination within or among classes, the competing policies must be weighed on the basis of the answers to such questions as: How much do the favored employees need tax relief in time of sickness? To what extent is it necessary to encourage health and accident programs for such employees? To what degree, if at all, would allowance of tax relief to these employees impede the establishment of broadly based programs? How much revenue would be lost through granting exemptions to such programs? With answers to the above questions, Congress could decide whether the social benefits derived from any type of arrangement justify the social cost paid by compromising the policy of taxing income.

82. See text at note 48 *supra*.

83. See text at notes 120-24 *infra*.

84. See pp. 240-43 *infra*.

employer pays himself will probably not constitute income to the employees,⁸⁵ so that the Section 106 exclusion will be superfluous. But if the program fails to constitute a "plan," the proceeds may be fully taxable.⁸⁶ The recipient of benefits from a private arrangement which is not a "plan" but is in the nature of insurance can make the *Epmeier* argument that the arrangement should be treated as "insurance."⁸⁷ But that contention may have been weakened by inclusion in the new Code of the term "plan," for it may be inferred that Congress thereby intended "plan" to be the sole test for qualification of private arrangements.

Company Charity

Although an employee may receive tax-exempt accident or health benefits through a "plan for employees,"⁸⁸ that type of program may require regularity in payment of determinable benefits and therefore constitute a relatively fixed charge to the employer.⁸⁹ While his employees may prefer this kind of arrangement, the employer may desire a more flexible one.⁹⁰ And even if he does establish a "plan," the employer may wish to supplement its benefits when an employee is struck by a particularly catastrophic sickness or accident. But if the employer pays such benefits on an ad hoc basis, they will probably be taxable as compensation, especially since the employer will attempt to deduct them as ordinary and necessary expenses of the business.⁹¹ However, by establishing

85. Cf. authorities cited note 110 *infra*. See also Comment, 21 U. OF CHI. L. REV. 277, 280, 286 (1954).

"The mere contractual right to a payment from any employer on the occurrence of stated conditions would not seem to constitute income in the absence of the occurrence of such conditions for an accrual basis taxpayer, and in the absence of both the occurrence of the conditions and the receipt of payment for a cash basis taxpayer." *Id.* at 280. But see Guttentag, Leonard, & Rodewald, *Federal Income Taxation of Fringe Benefits: A Specific Proposal*, 6 NAT. TAX. J. 250, 263 (1953), where it is suggested that the value of the employee's coverage be taxed to him.

86. The proceeds will be taxable as "income" unless they fall within an exclusion provision. I.T. Info. No. 4, 5 CCH 1952 FED. TAX REP. ¶ 6051 (1951); see text at notes 105-07 *infra*.

87. See text at notes 22-4 *supra*.

88. If the employer protects his employees through an arrangement which qualifies as "insurance" but not as a "plan," the contributions may be taxed to the employee though the proceeds will be tax-free. See text at note 60 *supra*.

89. See text at notes 61-5 *supra*.

90. If the term "plan" is very broadly construed, an employer may be able to set up a committee with general instructions to grant aid in deserving cases. In the more likely event that defined standards are necessary to qualification as a "plan," the employer would need to restrict coverage of risks and benefits to a point where flexibility would be lost.

91. See text at notes 93-4 *infra*. The § 105 exclusions apply only to amounts received through "insurance" or under a "plan for employees." Employer ad hoc payments will certainly not constitute "insurance" and will probably not constitute a "plan." See text at note 61. *supra*.

and contributing to a company charity, the employer may be able to retain wide discretion and assure that payments will be tax-exempt to the recipients.⁹²

Ordinarily a payment by an employer to an employee is taxable because classified as compensation rather than as a gift, even where the employee had no legal claim to the payment.⁹³ And this classification is almost conclusively established if the employer treats the payments as compensation in order to gain a business expense deduction.⁹⁴ But if the employer makes contributions to a company charity, they can be labeled gifts since the employer can deduct them as charitable contributions instead of as business expenses.⁹⁵ Although such treatment by the employer will not conclusively establish that the pay-

92. On the tax incentives for private charitable foundations generally, see, Latham, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. OF PA. L. REV. 617 (1950); Note, 34 VA. L. REV. 182 (1948).

93. See, e.g., *Walker v. Commissioner*, 88 F.2d 61, 62 (1st Cir. 1937); *Commissioner v. Bonwit*, 87 F.2d 764, 765 (2d Cir. 1937); *Yuengling v. Commissioner*, 69 F.2d 971 (3d Cir. 1934).

94. *Botchford v. Commissioner*, 81 F.2d 914 (9th Cir. 1936); *Cora B. Beatty*, 7 B.T.A. 726 (1927); *E.B. Tousek*, 1 B.T.A. 1164 (1925). But cf. Rev. Rul. 131, 1953 INT. REV. BULL. No. 15 at 7 (1953) (tornado disaster benefits paid to employees).

And if the employer is a corporation, the directors may have to treat the payment as compensation in order to remain within the scope of their authority. See *Commissioner v. Bonwit*, 87 F.2d 764, 765 (2d Cir. 1937).

95. Contributions to a charitable fund are deductible for federal income, estate, and gift tax purposes within the Code's limits on charitable deductions. Moreover, not only employers, but also stockholders, subsidiaries, or any other person can deduct contributions to a charity. INT. REV. CODE OF 1954, §§ 170 (income tax; individuals and corporations), 702(a) (4) (income tax; partners), 642(c) (income tax; estates and trusts), 545(b) (2) (income tax; personal holding companies), 2055 (estate tax; citizens or residents), 2106 (a) (2) (estate tax; nonresidents not citizens), 2522 (gift tax), 503(e) (disallowance of certain charitable deductions), 681 (limitation and disallowance of certain deductions for contributions made in trust).

Contributions to a company charity have been held deductible as charitable contributions in the following cases: *T. J. Moss Tie Company*, 18 T.C. 188 (1952), *appeal dismissed*, 201 F.2d 512 (8th Cir. 1953); *Gimbel v. Commissioner*, 54 F.2d 780 (3d Cir. 1931); *Eagan v. Commissioner*, 43 F.2d 881 (5th Cir. 1930); *Proctor Patterson*, 34 B.T.A. 689 (1936), *petition dismissed*, 90 F.2d 1009, 1016 (6th Cir. 1937); *John R. Sibley*, 16 B.T.A. 915 (1929). Cf. *Estate of Tarrant*, 38 Cal. 2d 42, 237 P.2d 505 (1951); *In re Westinghouse's Estate*, 156 Misc. 320, 281 N.Y. Supp. 603 (Surr. Ct. 1935). See Notes, 28 A.L.R.2d 428 (1953); 71 A.L.R. 870 (1931).

Unlike contributions to a "plan for employees," which are deductible as business expenses, see text at note 104 *infra*, charitable deductions do not have to be justified either as ordinary and necessary or reasonable. Thus, within the limitations on charitable deductions, employers are free to choose both the taxable year and the amount in which to make contributions. By donating appreciated property instead of cash, the donor can deduct the fair market value while avoiding taxes on the appreciation in value. See U.S. Treas. Reg. 118, § 39.23(o)-1 (1953). On the avoidance of taxation on the appreciated value of charitable gifts generally, see Griswold, *Charitable Gifts of Income and the Internal Revenue Code*, 65 HARV. L. REV. 84 (1951); Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375 (1952); Griswold, *A Reply*, 65 HARV. L. REV.

ment received by the employee will constitute a "gift,"⁹⁶ which is tax-exempt, at least there will be no major obstacle to that classification. Where payments have been received from an employer because of sickness and it did not appear that the employer had treated the payments as business expenses, it has been held that they were "gifts."⁹⁷ Therefore, it seems probable that sickness benefits received through a company charity will be excludable from gross income as "gifts."⁹⁸

A series of cases has held that a fund set up for the benefit of the employees of a fairly large corporation can qualify as a charitable foundation.⁹⁹ To establish the charitable nature of the company fund, payments from it must be solely for charitable purposes, *i.e.*, based on sickness or need,¹⁰⁰ and no part of its net

1389 (1952); *Roehner & Roehner, Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953).

For the authority of corporate directors to make charitable contributions, see Note, 31 COL. L. REV. 136 (1931).

96. *Bass v. Hawley*, 62 F.2d 721, 723 (5th Cir. 1933); *cf. Frank Knowles*, 5 T.C. 525 (1945).

97. *Schall v. Commissioner*, 174 F.2d 893 (5th Cir. 1949), *reversing* 11 T.C. 111 (1948); *David R. Daly*, 3 B.T.A. 1042 (1926).

98. INT. REV. CODE OF 1954, § 102(a) (excluding from gross income the value of gifts).

Other cases holding that payments received by employees constitute tax-free gifts are: *Bogardus v. Commissioner*, 302 U.S. 34 (1937); *Mutch v. Commissioner*, 209 F.2d 390 (3d Cir. 1954), *reversing* 12 T.C.M. 705 (1953); *Abernethy v. Commissioner*, 211 F.2d 651 (D.C. Cir. 1954), *reversing* 20 T.C. 593 (1953); *Hershman v. Kavanagh*, 120 F. Supp. 956 (E.D. Mich. 1953), *aff'd per curiam*, 210 F.2d 654 (6th Cir. 1954); *Frank Knowles*, 5 T.C. 525, 534 (1945); *William R. Ginn*, 47 B.T.A. 41, 49 (1942). See Note, 42 GEO. L.J. 577 (1954); Note, 110 A.L.R. 285 (1937).

99. See *T.J. Moss Tie Company*, 18 T.C. 188 (1952), *appeal dismissed*, 201 F.2d 512 (8th Cir. 1953) (800 employees); *Eagan v. Commissioner*, 43 F.2d 881 (5th Cir. 1930) (1470 employees, 6,000 beneficiaries including employees' dependents); *John R. Sibley*, 16 B.T.A. 915 (1952) (1800 to 3300 employees); *Proctor Patterson*, 34 B.T.A. 689, 691 (1936) (860 to 1234 employees).

See also 3 SCOTT, TRUSTS § 375 (1939).

Employee contributions to a company fund, even if required as a condition to eligibility for benefits, will not *per se* defeat charitable status. *Young Men's Christian Ass'n Retirement Fund, Inc.*, 18 B.T.A. 139 (1929); *Mutual Aid and Benefit Ass'n of Forstmann and Huffmann Employees v. Commissioner*, 42 F.2d 619 (3d Cir. 1930), *reversing* 17 B.T.A. 967 (1929); *Union Pacific Ry. v. Artist*, 60 Fed. 365 (8th Cir. 1894); G.C.M. 19028, 1937-2 CUM. BULL. 125.

But if the fund is supported principally by regular employee contributions in consideration for fixed benefits it will not constitute a charitable organization. *C.R. Lindback Foundation v. Commissioner*, 150 F.2d 986 (3d Cir. 1945), *affirming per curiam*, 4 T.C. 652 (1945); *Philadelphia and Reading Relief Ass'n*, 4 B.T.A. 713 (1926); G.C.M. 20015, 1938-1 CUM. BULL. 169; I.T. 2109, III-2 CUM. BULL. 224 (1924). See also *Shell Employees' Benefit Fund*, 44 B.T.A. 452 (1941); *Pontiac Employees Mutual Benefit Ass'n*, 15 B.T.A. 74 (1929); *Employees Benefit Ass'n of American Steel Foundries*, 14 B.T.A. 1166 (1929).

100. INT. REV. CODE OF 1954, § 501(c)(3). See *Eagan v. Commissioner*, 43 F.2d 881 (5th Cir. 1930) (to insure a living wage and to pay an income to employees unavoidably unemployed because of a plant shut-down, accident, or sickness); *Mutual Aid and Benefit Ass'n of Forstmann and Huffmann Employees v. Commissioner*, 42 F.2d 619 (3d Cir. 1930),

earnings may inure to the benefit of any private shareholder or individual.¹⁰¹ Retention of a large degree of control by the company's officers or directors acting in a fiduciary capacity will not impair the charitable status of the foundation, at least where contributions have been irrevocably made and the directors' control consists in selecting appropriate cases for charitable bounty.¹⁰² But if the foundation engages in certain prohibited transactions or improperly accumulates income, it may lose its charitable status.¹⁰³

EMPLOYER CONTRIBUTIONS

Under both the old and new Codes, employer payments for employee accident or health protection are deductible as business expenses, whether made indi-

reversing 17 B.T.A. 967 (1929) (to provide medical and dental service and fixed sick and death benefits); *Harrison v. Barker Annuity Fund*, 90 F.2d 286 (7th Cir. 1937) (to provide annuities for employees and their widows of dissolved corporation); *Y.M.C.A. Retirement Fund, Inc.*, 18 B.T.A. 139 (1929) (same); *Proctor Patterson*, 34 B.T.A. 689 (1936), *petition dismissed*, 90 F.2d 1009, 1016 (1937) (to loan or assist employees, former employees, or their dependents); *T.J. Moss Tie Co.*, 18 T.C. 188 (1952), *appeal dismissed*, 201 F.2d 512 (8th Cir. 1953) (to provide sick, disability, and death benefits); *John R. Sibley*, 16 B.T.A. 915 (1929) (same); *Gimbel v. Commissioner*, 54 F.2d 780 (3d Cir. 1931) (to grant pensions, life insurance, relief, and educational scholarships); *Estate of Tarrant*, 38 Cal. 2d 42, 237 P.2d 505 (1951) (to provide pensions for retired employees); *In re Westinghouse's Estate*, 156 Misc. 320, 281 N.Y. Supp. 603 (Surr. Ct. 1935) (for the benefit and welfare of employees); *G.C.M. 19028*, 1937-2 CUM. BULL. 125 (relief for disabled employees). See also *Van Horn v. Lewis*, 79 F. Supp. 541 (D.D.C. 1948) (*United Mine Workers Welfare and Retirement Fund of 1947* providing sickness, disability, and death benefits held a charitable trust for purposes of administration); *Union Pacific Ry. v. Artist*, 60 Fed. 365 (8th Cir. 1894) (holding a company hospital for employees a charitable institution as a defense to a malpractice suit). But see *Harvey v. Campbell*, 107 F. Supp. 757 (N.D. Tex. 1952) (a company trust which provided loans to employees to purchase company houses was not a charitable trust); *United States v. Community Services*, 189 F.2d 421 (4th Cir. 1951) (company corporation which operated a canteen refreshment service, a coal and wood yard, a filling station and an electric appliance store exclusively for employees, and the profits of which were destined for charitable organizations held not a charitable organization); *Matter of Altman*, 87 Misc. 255, 149 N.Y. Supp. 601 (Surr. Ct. 1914) (a company corporation organized to promote the social, physical or economic welfare and efficiency of employees held not a charitable but a benevolent corporation).

On charitable purposes generally, see 3 SCOTT, TRUSTS §§ 368-76 (1939); Brunyate, *The Legal Definition of Charity*, 61 L.Q. REV. 268 (1945).

101. INT. REV. CODE OF 1954, § 501(c) (3). See *Northern Illinois College of Optometry v. Commissioner*, 2 T.C.M. 664 (1943) (denying tax-exempt status to an educational institution, the net earnings of which inured to the benefit of an individual).

The activities of a tax-exempt charitable organization must not consist in any substantial part of carrying on propaganda influencing legislation, or participating in any political campaign in behalf of any candidate for public office. INT. REV. CODE OF 1954, § 501(c) (3).

102. See *T.J. Moss Tie Company*, 18 T.C. 188 (1952), *appeal dismissed*, 201 F.2d 512 (8th Cir. 1953) (broad discretionary powers maintained by president and two directors of the company). On the application of the Clifford rules, U.S. Treas. Reg. 118, § 39.22(a)-21 (1953), to controlled charitable foundations in general, see Latcham, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. OF PA. L. REV. 617, 623-30 (1950).

103. INT. REV. CODE OF 1954, §§ 503, 504. See Brown, *The New Restrictions On*

rectly through contributions or directly by imbursements.¹⁰⁴ Under the old Code such payments were taxable to the employee if they constituted "income" within the meaning of old Section 22(a).¹⁰⁵ Where payments were made directly by the employer without prior contributions to an insurance company or a private fund they were generally taxed to the employee as "income,"¹⁰⁶ unless excludable as accident or health insurance proceeds or under some other provision of the Code.¹⁰⁷ But, where the employer made contributions to a separate fund or purchased premiums on commercial insurance, the taxability of such payments to the covered employee was less certain.

The Internal Revenue Service ruled that employer premium payments for individual accidental death and disability policies were taxable as "income,"¹⁰⁸ but that such payments for group medical and hospitalization insurance were

Charitable Exemptions and Deductions For Federal Tax Purposes, 13 U. OF PITT. L. REV. 623, 637 (1952).

104. I.T. 4011, 1950-1 CUM. BULL. 32; Rev. Rul. 210, 1953 INT. REV. BULL. No. 21 at 5 (1953) (indirect through insurance premiums); I.T. 4060, 1951-2 CUM. BULL. 11, *modified on other grounds*, I.T. 4107, 1952-2 CUM. BULL. 73 (direct payment by employer).

Employer contributions to state-fund plans under the California and New Jersey compulsory sickness and disability insurance statutes are deductible as "taxes." I.T. 3966, 1949-2 CUM. BULL. 27 (California); I.T. 3970, 1949-2 CUM. BULL. 23 (New Jersey). See INT. REV. CODE OF 1939, § 23(c) (1); INT. REV. CODE OF 1954, § 164(a).

See also Rev. Rul. 160, 1953 INT. REV. BULL. No. 18 at 2 (1953) (contributions to an employee's hospital association deductible); Rev. Rul. 131, 1953 INT. REV. BULL. No. 15 at 7 (1953) (contributions for tornado relief to employees deductible).

105. INT. REV. CODE OF 1939, § 22(a); U.S. Treas. Reg. 118, § 39.22(a)-3 (1953).

106. Glen E. Blackburn, 15 T.C. 336 (1950); H.N. Henry, 47 B.T.A. 149 (1942); E.B. Tousek, 1 B.T.A. 1164 (1925); Rev. Rul. 209, 1953 INT. REV. BULL. No. 21 at 3 (1953); Rev. Rul. 103, 1953-1 CUM. BULL. 20; I.T. 4107, 1952-2 CUM. BULL. 73; G.C.M. 23511, 1943 CUM. BULL. 86. See I.T. Info. No. 4, 5 CCH 1952 FED. TAX REP. ¶ 6051 (1951); *Epmeier v. United States*, 52-1 U.S. TAX CAS. ¶ 9261 (N.D. Ind.), *rev'd*, 199 F.2d 508 (7th Cir. 1952). *Contra*: Rev. Rul. 131, 1953 INT. REV. BULL. No. 15 at 7 (1953) (tornado disaster payments ruled not income); Special Ruling, 5 CCH 1952 FED. TAX REP. ¶ 6196 (1952) (food, supplies, and other forms of subsistence received from Red Cross by a disaster victim ruled not income).

107. *Epmeier v. United States*, 199 F.2d 508 (7th Cir. 1952) (accident or health insurance); *Theodate Pope Riddle*, 27 B.T.A. 1339 (1939) (damages); I.T. 3977, 1949-2 CUM. BULL. 92 (same); I.T. 2420, VII-2 CUM. BULL. 123 (same); *Frye v. Commissioner*, 72 F. Supp. 405 (D.D.C. 1947) (same); *William L. Neill*, 17 T.C. 1015 (1951) (workmen's compensation); I.T. 3877, 1947-2 CUM. BULL. 15 (same); I.T. 3281, 1939-1 CUM. BULL. 97 (same); I.T. 3917, 1948-2 CUM. BULL. 10 (same); *Prince v. United States*, 119 F. Supp. 421 (Ct. Cl. 1954) (payments for injury from active service in armed forces); I.T. 3855, 1947-1 CUM. BULL. 9 (same); I.T. 3817, 1946-2 CUM. BULL. 34 (same); *Schall v. Commissioner*, 174 F.2d 893 (5th Cir. 1949) (gift); *David R. Daly*, 3 B.T.A. 1042 (1926) (same).

On excludability of damages see Schlenger, *Disability Benefits under Section 22(b)(5)*, 40 VA. L. REV. 549, 553 (1954). For excludability of workmen's compensation see *id.* at 553, 557 (1954); Note, 16 A.L.R.2d 1334 (1951).

108. Rev. Rul. 210, 1953 INT. REV. BULL. No. 21 at 5 (1953) (accidental death and total disability). This ruling has been generally assumed to concern accident or health insurance, see text at note 111 *infra*, but the insurance policies involved seem more closely to

not.¹⁰⁹ Employer contributions to privately funded group arrangements were also ruled not taxable as "income" to the employees.¹¹⁰ Although the rulings do not specify the key factor of differentiation, the distinction has generally been assumed to be between individual and group accident or health insurance.¹¹¹ If this assumption is correct, the distinction may be partially explained in terms of administrative convenience. Whereas the value to the employee of employer purchased premiums on an individual policy may be presumed to be the amount paid by the employer, difficult questions of premium allocation arise in attempting to fix the value to the employee of a group premium. For example, if a group policy requiring no medical examination includes a person uninsurable under individual policies, coverage will be more valuable to him than to other group members.¹¹² Another explanation for the differentiation between individual and group arrangements is that it constitutes an extension to accident or health insurance of a similar rule regarding life insurance. While employer-purchased premiums on individual policies or group permanent policies of life insurance are taxable to his employees as income, employer purchased premiums on group term-life policies are not.¹¹³ The distinguishing factor is that the group term insurance is forfeited by the employee on termination of employment,¹¹⁴ whereas the other

resemble life insurance. There does not appear to be any ruling that employer purchased premiums on individual policies of accident or health insurance, *i.e.*, temporary disability or medical expense insurance, are taxable to the employee.

109. Special Ruling, 3 CCH 1943 FED. TAX REP. ¶ 6587 (1943) (group medical and hospitalization).

110. Rev. Rul. 130, 1953 INT. REV. BULL. No. 15 at 6 (1953) (private plan under New York compulsory sickness and disability insurance statute); *cf.* I.T. 3738, 1945 CUM. BULL. 90 (union fund wherein employees had no contractual right to benefits).

111. See Comment, 21 U. OF CHI. L. REV. 277, 279 (1954); Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549, 568 (1954); SEN. REP. NO. 1622, 83d Cong., 2d Sess. 185 (1954).

The distinction could have been between loss of earnings (disability) insurance and medical and hospitalization insurance, although there would be no apparent reason for such a distinction.

See note 108 *supra*, for the possibility that employer purchased premiums on individual accident or health policies are not taxable to the employee.

112. See Guttentag, Leonard, & Rodewald, *Federal Income Taxation of Fringe Benefits: A Specific Proposal*, 6 NAT. TAX J. 250, 260 (1953).

113. Mimeo. 6477, 1950-1 CUM. BULL. 16 (group-term and group permanent distinguished), *modifying* L.O. 1014, 2 CUM. BULL. 88 (1920), and U.S. Treas. Reg. 118, § 39.22 (a)-3 (1953); G.C.M. 16069, XV-1 CUM. BULL. 84 (1936) (individual and group life policies distinguished). See also Beacham, *Taxable Income From the Receipt of Property Other Than Cash*, 22 MISS. L.J. 189, 200 (1951); Note, 7 A.L.R.2d 766 (1949).

114. *Ibid.*

For a discussion of termination of the employee's insurance under group life and disability policies see Collier, *Termination of Employment Under Group Policies*, 9 ASS'N OF LIFE INS. COUNSEL PROCEEDINGS 237 (1946); VANCE, INSURANCE § 203 (3d ed. 1951); CRAWFORD, GROUP INSURANCE § 32 (1936); Note, 105 A.L.R. 418 (1936). See also Note, 36 COL. L. REV. 89 (1936).

types of life policies have savings features such as paid-up values.¹¹⁵ The rationale is that coverage which is forfeitable has not been sufficiently realized by the employee to constitute income.¹¹⁶ Like group term-life policies, group loss-of-earnings policies are generally forfeited by the employee on termination of employment.¹¹⁷ Therefore, application of the group term-life insurance rule to such policies would seem appropriate. But the rationale is inapplicable to group medical and hospitalization insurance of the Blue Shield-Blue Cross type, which generally provides non-forfeitable coverage on a monthly basis.¹¹⁸ Therefore, under the old Code, if the Service had decided to tax the employee for the employer purchased premiums on such insurance it might well have been sustained by the courts. Furthermore, several commentators have suggested that employer contributions to all accident or health arrangements be taxed as "income" to the employee.¹¹⁹ Thus, while the issue of taxability to the employee of employer contributions was ostensibly settled by the assumed distinction of the Service between group and individual policies, uncertainty actually prevailed as to what contributions could be taxed to the employee.

In attempting to bypass the "income" problem with its inherent uncertainties, the new Code establishes another indefinite standard. Section 106 provides that employer contributions to accident or health "plans for . . . employees" are not taxable to the employee.¹²⁰ The ambiguities of that crucial phrase have already been discussed.¹²¹ The Section 106 exclusion applies to both individual and group insurance policies which fall under "plans."¹²² Since most group insurance policies will probably constitute "plans," the new Code appears to establish that employer-purchased group premiums are not taxable to the employee. However, many individual commercial policies probably will neither themselves constitute "plans" nor be secured pursuant to "plans,"¹²³ and therefore the taxability of their employer contributions will again hinge on the uncertain "income" test. On the other hand, the new Code confirms that employer contributions to privately financed arrangements are not taxable to the employee. If such an arrangement constitutes a "plan," the employer's contributions are

115. See rulings cited note 113 *supra*.

116. *Ibid.*

117. See *Van Zanten v. Nat. Casualty Co.*, 333 Mich. 28, 34, 52 N.W.2d 581, 584 (1952); *Prudential Ins. Co. of America v. Howard*, 238 Ky. 108, 36 S.W.2d 857 (1931); CRAWFORD, *GROUP INSURANCE* §§ 32, 63-5 (1936).

118. Communication to the YALE LAW JOURNAL from Adrian Conway, Director of Public Relations, Connecticut Medical Service Inc. (Connecticut Blue Shield Plan), dated Nov. 12, 1954, in Yale Law Library.

119. See Guttentag, Leonard, & Rodewald, *Federal Income Taxation of Fringe Benefits: A Specific Proposal*, 6 NAT. TAX J. 250, 260-3 (1953).

120. See note 55 *supra*.

121. See pp. 230-36 *supra*.

122. H.R. REP. NO. 1337, 83d Cong., 2d Sess. A35 (1954); SEN. REP. NO. 1622, 83d Cong., 2d Sess. 185-6 (1954).

123. See interpretations of "plan" in notes 78 and 79 *supra*. But see interpretation in note 77 *supra*.

excluded from gross income of the employee by Section 106. And if the arrangement does not qualify as a "plan," the employer's contributions will probably not be sufficiently realized by the employee to constitute "income."¹²⁴

EMPLOYEE CONTRIBUTIONS

Tax treatment of employee contributions remains the same under the new Code as under the old. To the extent that employee contributions for accident or health protection are allocable to medical coverage, they are deductible as medical expenses.¹²⁵ But to the extent that such contributions are apportionable to loss-of-earnings protection, they have been ruled not deductible either as medical expenses¹²⁶ or business expenses.¹²⁷ Where an accident or health arrangement contains both medical and loss-of-earnings features, contribution allocation is necessary to determine the employee's proper deduction.¹²⁸ If both employer and employee contribute to the program, they may gain maximum deductions for the employee by agreeing that his contributions be allotted first to medical coverage.¹²⁹

The ruling that employee contributions to loss-of-earnings arrangements are not deductible as ordinary and necessary business expenses is of doubtful merit. Courts have allowed employers to deduct contributions to strike-funds designed in part to compensate them for income lost during periods of economic

124. See text at notes 85 and 110 *supra*.

125. INT. REV. CODE OF 1954, § 213(e) (1) (A); INT. REV. CODE OF 1939, § 23(x); U.S. Treas. Reg. 118, § 39.23(x)-1 (1953); Rev. Rul. 19, 1953-1 CUM. BULL. 59; *cf.* Jess H. Taylor, 11 T.C.M. 652 (1952).

126. Rev. Rul. 19, 1953-1 CUM. BULL. 59; Special Ruling, 5 CCH 1950 FED. TAX REP. ¶ 6124 (1950); I.T. 3967, 1949-2 CUM. BULL. 33; I.T. 3970, 1949-2 CUM. BULL. 28. *But cf.* Jess H. Taylor, 11 T.C.M. 652 (1952). See Rewrite Bulletin, 5 CCH 1953 FED. TAX REP. ¶ 8674 (1953).

127. I.T. 4005, 1950-1 CUM. BULL. 47; I.T. 3966, 1949-2 CUM. BULL. 27; I.T. 3663, 1944 CUM. BULL. 110; *accord*: I.T. 1265, I-1 CUM. BULL. 193 (1922); *cf.* I.T. 1918, III-1 CUM. BULL. 121 (1924) (private unemployment compensation plan). The issue was raised but not decided in *Elwood J. Clark*, 5 T.C.M. 236, *aff'd per curiam*, 158 F.2d 851 (6th Cir. 1946). See also I.T. 2888, XIV-1 CUM. BULL. 54 (1935) (contributions to labor union for unemployment benefits deductible but contributions for sick, accident, and death benefits non-deductible). This ruling has been criticized for holding contributions for sick and accident benefits non-deductible. See Gordon, *Tax Effects of Union Welfare Funds*, 6 TAX L. REV. 1, 40-1 (1950).

However, if the employee contributions are made to a state-fund plan under a compulsory disability statute, they are generally deductible as "taxes." See note 140 *infra*.

128. Rev. Rul. 19, 1953-1 CUM. BULL. 59. See Rewrite Bulletin, 5 CCH 1953 FED. TAX REP. ¶ 8674 (1953).

129. See P.S. No. 32, 3 CCH 1944 FED. TAX REP. ¶ 6568 (1944), concerning a pension plan which contained both life insurance and annuity features and to which both employers and employees contributed. The plan provided that the employer's contribution should be first applied to the annuity feature, in order to save the employee from taxation on life insurance premiums purchased by the employer. The ruling was that the plan qualified as a pension plan under old § 165(a), thereby implying that the allocation would achieve its purpose.

inactivity.¹³⁰ Employee loss-of-earnings arrangements are similarly devised to cushion employees during periods of unemployment due to sickness.¹³¹ Thus employee contributions to such arrangements should be considered deductible business expenses.¹³² Moreover, since employer contributions are now generally excluded from the employee's gross income,¹³³ denial of deductibility to employee contributions results in a tax discrimination between employer and employee financed arrangements. Employee *A* who receives \$39 in cash plus \$1 in excludable loss-of-earnings contributions pays a lower tax than employee *B* who receives \$40 in cash and contributes a non-deductible \$1 for coverage. The same discrimination exists between employer and employee financed medical programs whenever any part of the employee's contributions is denied deductibility because the employee's other medical expenses are too small.¹³⁴ However, this latter inequity cannot be corrected under present law since such contributions are more in the nature of personal than business expenses.¹³⁵

The situation is further complicated by an irrationally diverse treatment of contributions made under non-occupational disability statutes. These statutes provide for loss-of-earnings payments to employees during periods of disability due to accident or sickness incurred outside the scope of employment.¹³⁶ Al-

130. George M. Cohan, 11 B.T.A. 743, 760 (1928); Sam H. Harris, 11 B.T.A. 871, 874 (1928); H. A. Allen, 7 B.T.A. 1256, 1275-6 (1927).

Employee contributions for unemployment benefits have also been ruled deductible as business expenses. I.T. 2888, XIV-1 CUM. BULL. 54 (1935); Mimeo. 4595, 1937-1 CUM. BULL. 63. *But cf.* I.T. 1918, III-1 CUM. BULL. 121 (1924).

131. See 1 APPLEMAN, *INSURANCE LAW AND PRACTICE* §§ 16-17 (1941); SOMMER, *MANUAL OF ACCIDENT AND HEALTH INSURANCE* 12, 33-7 (1928); Curran, *The Fundamentals of Accident and Health Insurance*, 1953 INS. L.J. 555-71 (1953).

132. See Gordon, *Tax Effects of Union Welfare Funds*, 6 TAX L. REV. 1, 40-1 (1950) (suggesting that contributions for loss-of-earnings benefits be deductible as ordinary and necessary business expenses). The issue was raised but not decided in *Elwood J. Clark*, 5 T.C.M. 236, *aff'd per curiam*, 158 F.2d 851 (6th Cir. 1946).

But see INT. REV. CODE OF 1954, § 265(1); INT. REV. CODE OF 1939, § 24(a)(5); and U.S. Treas. Reg. 118, § 39.24(a)-4 (1953), disallowing deduction for expenses allocable to classes of tax-exempt income. Since commercially insured loss of earnings proceeds attributable to employee contributions are tax-exempt under new § 104(a)(3), any suggestion of deductibility of such contributions would seem mooted by new § 265(1). But because of uncertainty as to whether proceeds of private arrangements attributable to employee contributions will be excludable as received under a "plan for employees," see pp. 230-36 *supra*, the issue remains alive with regard to employee contributions to such arrangements.

However if the standard deduction under § 144 or the optional tax under § 3 is elected the deduction would not be available. INT. REV. CODE OF 1954, §§ 3 and 144.

133. Employer contributions may be excludable either as contributions to a "plan" under § 106 or as not constituting "income" within § 61. See text at notes 120-4 *supra*.

134. As a general rule, § 213 permits deduction only of medical expenses in excess of 3 percent of adjusted gross income. INT. REV. CODE OF 1954, § 213.

135. Personal expenses are non-deductible under INT. REV. CODE OF 1954, § 262.

136. Such statutes have been enacted by California, New Jersey, New York, and Rhode Island. CAL. UNEMPLOY. INS. CODE §§ 2601 *et seq.* (Deering, 1954); 43 N.J.S.A. §§ 21-25 *et seq.* (1950); N.Y. WORKMEN'S COMP. LAW § 200 *et seq.*; R.I. ACTS c. 1200 (1942). See generally, Comment, 60 YALE L.J. 647-72 (1951); Honey, *Compulsory Nonoccupational*

though the statutes provide for financing the payments by requiring employee or employer-employee contributions to a state fund,¹³⁷ they generally permit commercial insurance or employer self-insurance as alternatives to the state-fund plan.¹³⁸ Employee contributions to commercially or privately insured arrangements approved under a statute have been ruled non-deductible.¹³⁹ However, employee contributions to a state fund are deductible as "taxes" where the statute imposes the obligation to pay the state fund directly on the employee.¹⁴⁰ But the New York statute requires employees to contribute to the employer, upon whom a direct liability to pay benefits is imposed and who may elect from the alternatives of private, commercial, or state-fund insurance.¹⁴¹ Even if the employer elects the state-fund plan the employee contributions are not deductible, probably on the theory that the incidence of the tax is only indirectly on the employee.¹⁴²

Since state-fund plans do not differ functionally from private loss-of-earnings plans, either statutory or non-statutory, the tax treatment of their employee contributions should be the same. This result can be accomplished in two ways within the present statutory framework.¹⁴³ Employee contributions to state-fund plans could be denied deductibility as "taxes" on the long-standing rule that monetary levies which are regulatory rather than revenue-raising are not deductible "taxes" within the meaning of the income tax laws.¹⁴⁴ Or employee contributions to non-state-fund plans could be considered deductible business

tional Disability Benefits Legislation, 1952 INS. L.J. 691 (1952); Note, 1 SYRACUSE L. REV. 278 (1949).

137. *Ibid.*

138. *Ibid.* The Rhode Island statute does not have such a provision. R.I. ACTS c. 1200 (1942).

139. I.T. 3967, 1949-2 CUM. BULL. 33 (California); I.T. 3970, 1949-2 CUM. BULL. 28 (New Jersey); I.T. 4005, 1950-1 CUM. BULL. 47 (New York); Special Ruling, 5 CCH 1950 FED. TAX REP. ¶ 6124 (1950) (New York).

140. I.T. 3966, 1949-2 CUM. BULL. 27 (California); I.T. 3970, 1949-2 CUM. BULL. 28 (New Jersey); I.T. 3663, 1944 CUM. BULL. 110 (Rhode Island). INT. REV. CODE OF 1939, § 23(c)(1); INT. REV. CODE OF 1954, § 164.

141. N.Y. WORKMEN'S COMP. LAW §§ 209-11; see Note, 1 SYRACUSE L. REV. 278 (1949).

Despite the technical way in which liability is imposed on the employer, the effect of the statute is clearly to place a tax burden on the employee.

142. I.T. 4005, 1950-1 CUM. BULL. 47 (denying deductibility as a tax or business expense); see also Special Ruling, 5 CCH 1950 FED. TAX REP. ¶ 6124 (1950) (denying deductibility as a medical expense).

For the probable rationale underlying denial of deduction as a "tax" see, *e.g.*, G.C.M. 15101, XIV-2 CUM. BULL. 65 (1935) (denying deductibility as a "tax" to gasoline consumers in Mississippi where state gasoline taxes were imposed on the dealer). When the Mississippi statute was amended to provide that the tax "may be passed on to the ultimate consumer and such consumer in ascertaining his net income for [State] income tax purposes may deduct any such taxes he has actually paid . . ." the ruling was reversed. See G.C.M. 25579, 1948-1 CUM. BULL. 36 (allowing deductibility by the consumer as a "tax").

143. *I.e.*, INT. REV. CODE OF 1954.

144. See, *e.g.*, I.T. 3511, 1941-2 CUM. BULL. 90.

expenses. The latter solution would not only remove tax discrimination between employee contributions to state-fund and other types of plans but would also eliminate inequity between employer and employee financed plans. However, this proposal would create a loophole on the proceeds level which would allow high salaried employees to gain unlimited tax-free accident or health benefits. The \$100 per week limitation in Section 105(d) on loss-of-earnings benefits attributable to employer contributions could be avoided if the employee purchased insurance, thereby coming within the unlimited exclusion provisions of Section 104(a)(3).¹⁴⁵ Thus, given the treatment of proceeds under the new Code, deductibility of employee contributions would be undesirable. And while the alternative proposal of disallowing all employee contributions as deductions would not engender any problems on the proceeds level, it would exacerbate the tax inequity between employer and employee financed arrangements.¹⁴⁶

The new Code not only does not deal with the problem of discrimination between employee contributions to state-fund and other types of plans, but it also fails in its attempt to alleviate the inequitable distinction between employer and employee financed programs. The new Code seeks equality of treatment by adjusting proceeds taxation. While proceeds remain basically excludable under Section 104(a)(3), the general provisions of Section 105 require taxation of amounts received through accident or health insurance (including all "plans for employees") which are "attributable" to employer contributions not previously "includable" in the employee's taxable income.¹⁴⁷ Even disregarding the numerous exceptions in Section 105, this general rule would be only a slight improvement, since it avoids making a policy decision on the question of whether accident or health arrangements should be taxed on the contribution or proceeds level, and constitutes instead a hodgepodge compromise.¹⁴⁸ Moreover, it creates

145. See note 36 *supra*.

146. This proposal would merely extend non-deductibility of employee contributions to the area of state fund plans.

For a discussion of the inequity between tax treatment to the employee of arrangements financed by employer contributions and those financed by employee contributions, see text at notes 133-4 *supra*.

147. See note 37 *supra*.

148. The theory underlying the general rule of § 105 is to adjust the existing tax discrimination against employee-financed arrangements on the contributions level by creating a countervailing discrimination against employer-financed arrangements on the proceeds level. Hence the § 105 phrase "amounts . . . attributable to contributions by the employer which were not includible in the gross income of the employee . . ." However, discrimination now exists on two levels instead of one. Thus, employee *A*, covered by an employer-financed "plan," receives \$10 in employer contributions tax-free but then receives \$1000 in proceeds wholly taxable since attributable to the employer contributions not taxed to him. Employee *B* contributes \$10 in non-deductible contributions to an employee-financed "plan" and receives \$1000 in proceeds tax-free. If the figures are reversed the outcome is equally absurd. This is indeed an odd form of equity. Either contributions should be tax-free to the employee and proceeds taxed or vice versa, regardless of whether the "plan" is employer or employee financed.

the new problem of defining "plan for employees."¹⁴⁹ However, at least it contends with the problem of discrimination on the contribution level by establishing a countervailing discrimination on the proceeds level.¹⁵⁰ Unfortunately, the rule's many exceptions substantially negate whatever beneficial effect it otherwise might have had. All medical reimbursements, payments for permanent injuries, and loss-of-earnings benefits up to \$100 per week are excepted from the "rule" of Section 105.¹⁵¹ There are presumably few accident or health arrangements providing benefits which fall outside these exempt categories.¹⁵² And therefore the discrimination between employer and employee financed arrangements remains substantially as before.

CONCLUSION

The new Code fails to remedy the inequality of tax treatment between employer and employee financed accident or health arrangements. And although it pretends to distinguish between loss-of-earnings and medical expense arrangements, in practical effect it does not. Moreover, instead of resolving the controversy over what constitutes "insurance," it has increased uncertainty by adding the undefined phrase "plan for employees."

It would not be difficult to improve tax treatment of accident or health arrangements. To remedy the inequality between employer and employee financed programs, employee contributions to both loss-of-earnings and medical benefit arrangements should be made fully deductible.¹⁵³ And all employer contributions to such arrangements should be excludable from the employee's gross income. Loss-of-earnings proceeds should be taxable since their function is to replace income and they are in no way related to the amount of medical or other expenses incident to sickness or injury.¹⁵⁴ Medical and hospitalization benefits, however, are directly related to the amount of extraordinary expenses resulting from sickness or injury and are therefore deserving of a special tax exemption.¹⁵⁵ And since there is no reason to confine either the deductibility of contributions or the exemption of medical benefits to employees, or to employees covered by "insurance" or a "plan," these provisions should be available to all individuals.

149. See pp. 230-36 *supra*.

150. See note 148 *supra*.

151. See notes 39-41 *supra*.

152. See note 43 *supra*.

153. This deduction should be allowed in addition to the standard deduction so that election of the latter will not vitiate the effectiveness of the former.

154. However, in some cases the only type of accident or health proceeds received will be loss-of-earnings benefits. Since a portion of these benefits will in effect reimburse the recipient for medical expenses, they should be tax-exempt to that extent.

155. As the receipt of medical benefits will serve to reduce the medical expense deduction if received in the same year or be includable in gross income to the extent attributable to prior years' medical expense deductions, see note 11 *supra* and INT. REV. CODE OF 1954, §§ 105(b), 213(a), the proposed exemption will be significant only with regard to amounts below the minimum or above the maximum of allowable medical expense deductions.