ROSS V. ODOM: INCOME TAX TREATMENT OF PROCEEDS FROM EMPLOYER FUNDED AND ADMINISTERED SURVIVORS' BENEFIT PROGRAMS

Even though an independent insurance company was not utilized, the Court of Appeals for the Fifth Circuit recently held in Ross v. Odom *that the proceeds from a state established and administered survivors' benefit program were tax exempt as proceeds of a life insurance contract under section 101(a)(1) of the Internal Revenue Code. This note analyzes and inquires into the ramifications of the court's rationale, which was based on a functional approach to the concept of insurance and an interpretation of the legislative history. Of particular interest is the extension of the* Odom *precedent to privately funded, self-administered insurance plans in private business.*

DUE to ever-increasing use of employee fringe benefits in private industry,[1] governmental bodies have been compelled to establish similar benefit programs in order to remain competitive with private industry in the contest for talented employees.[2] One such benefit has been the establishment of group insurance plans for governmental employees.[3] The attractiveness of such plans was increased recently by the Court of Appeals for the Fifth Circuit when it held in *Ross v. Odom*[4] that proceeds from a state-established Survivors' Benefit Plan, which was not funded through an insurance company but which satisfied the functional aspects of life insurance, were tax exempt under section 101(a)(1) of the

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[1] *See generally* R. MEHR & E. CAMMACK, PRINCIPLES OF INSURANCE 546-47 (4th ed. 1966); Anderson & Hahn, *Health and Insurance Benefits for Salaried Employees*, 86 MONTHLY LAB. R. 1266, 1267-68 (1963); Jackson, *Developments in Group Insurance*, 19 J. AM. SOC'Y C.L.U. 319, 320-21 (1965); Paine, *Directions of Employee Benefit Plan Growth*, 18 J. AM. SOC'Y C.L.U. 222 (1964).

[2] *See, e.g.*, Riddlestorffer v. Rahway, 82 N.J. Super. 36, 45-47, 196 A.2d 550, 555-56 (1963); Nohl v. Bd. of Educ., 27 N.M. 232, 236-37, 199 P. 373, 374-75 (1921); 1 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 42 (1941).

[3] See note 2 *supra*.

[4] 401 F.2d 464 (5th Cir. 1968).

Internal Revenue Code[5] as the "proceeds from a life insurance contract."[6]

The Survivors' Benefit Program was enacted by the State of Georgia[7] in 1953 to provide for payment of specified amounts[8] to beneficiaries designated by the program participants. Each participating employee had one-half of one percent of his monthly pay deducted and paid, along with matching contributions from the State, into the Survivors' Benefit Fund, a separate branch of state government. The amounts payable to beneficiaries are not funded or reinsured by any independent insurance company but are paid out of the Survivors' Benefit Fund. However, the Board of Trustees of the Fund is required to use an actuary in establishing and periodically reviewing the tables, rates, and regulations of the program to insure that they remain actuarially sound.[9]

Robert Odom, a participant in this program, paid $662.33 into the fund prior to his death and an equal sum was contributed on his behalf by the State. His widow, the named beneficiary, received $27,450 from the Survivors' Benefit Fund. She claimed that the amount was fully excludable from income under section 101(a)(1)[10] as the "proceeds from a life insurance contract," while the government contended that only a $5,000 death benefit exclusion under section 101(b)(1)[11] was available. The district court held that

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[5] INT. REV. CODE of 1954, § 101(a)(1).

[6] Section 101(a)(1) provides: "[G]ross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." INT. REV. CODE of 1954, § 101(a)(1).

[7] GA. CODE ANN. § 40-2523 (1957). The State had previously enacted a retirement program for its employees. GA. CODE ANN. §§ 40-2501-29.

[8] The amount receivable under the plan is computed by multiplying the decedent's monthly salary by a certain figure. In arriving at this multiplier, the trustees of the fund take into consideration actuarial computations of experience and expectancy factors. *Amended Survivors' Benefit Rules and Regulations Per Board Action of June 17, 1959,* a copy of which is on file with the *Duke Law Journal.* The amount payable to the beneficiary in *Odom* under the Survivors' Benefit Program was computed as 18 times decedent's monthly compensation as of July 1, 1960.

[9] GA. CODE ANN. § 40-2509 (1957).

[10] INT. REV. CODE of 1954, § 101(a)(1). Taxpayer received periodic payments from the retirement program which were reported as employee death benefits under § 101(b)(1) and were not in dispute. 401 F.2d 464, 466 n.3 (5th Cir. 1968).

[11] INT. REV. CODE of 1954, § 101(b)(1). 101(b)(1) provides: "Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee."

§ 101(b)(2)(A) provides: "The aggregate amounts excludable under paragraph (1) with

the sum of $27,450 received by the plaintiff from the State of Georgia as survivors' benefits constituted an amount received under a *life insurance contract* paid by reason of the death of the insured excludable from her gross income under the provisions of section 101(a) of the Internal Revenue Code of 1954.[12]

Affirming the district court, the Fifth Circuit found that the Georgia plan incorporated both risk-shifting and risk-distribution, thereby satisfying every definitional element of an insurance contract.[13] In addition, the Fifth Circuit refused to limit the exclusion to $5,000 as an employee death benefit under section 101(b)(1), since the court could not find a mandate for such result in that section's legislative history.[14]

The Elements of an Insurance Contract for Tax Purposes

While precedents as to what constitutes "amounts received under an insurance contract . . . paid by reason of the death of the insured" are meager,[15] the requirements for a life insurance contract as used in the Internal Revenue Code have been considered in several cases. All courts which have decided the issue agree that the term *insurance* is used in the Internal Revenue Code to denominate agreements or plans which have the essential insurance characteristics, rather than only formal contracts with insurance companies.[16] The requisite characteristics of insurance were prescribed by the Supreme Court in its often quoted language in *Helvering v. LeGierse*:[17]

> Historically and commonly insurance involved risk-shifting and risk-distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That these elements of

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respect to the death of any employee shall not exceed $5,000." INT. REV. CODE of 1954, § 101(b)(2)(A).

[12] Odom v. Ross, 7 P-H 1966 FED. TAXES (18 Am. Fed. Tax R. 2d 5890) ¶ 66-5242 (N.D. Ga. Oct. 17, 1966).

[13] 401 F.2d 464 (5th Cir. 1968).

[14] *Id.* at 473.

[15] *See generally* 1 J. MERTENS, FEDERAL INCOME TAXATION § 7.03, at 5 (1962).

[16] *See* Comm'r v. Treganowan, 183 F.2d 288, 291 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950); Mary Tighe, 33 T.C. 557, 564 (1959); Estate of Clarence L. Moyer, 32 T.C. 515, 535-36 (1959).

[17] 312 U.S. 531 (1941).

risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.[18]

Further judicial definition of risk-shifting and risk-distribution came in two estate tax cases involving stock exchange gratuity funds—*Commissioner v. Treganowan*[19] and *Estate of William F. Edmonds*.[20] In *Treganowan*, the Commissioner contended that death benefits paid to decedent's beneficiaries out of a fund established by the New York Stock Exchange were actually proceeds of insurance and thus includible in the decedent's gross estate.[21] Upon being admitted to membership and again upon the death of any fellow member, the New York Stock Exchange required a payment of $15 into its gratuity fund. The fund thus accumulated and augmented by a portion of the Exchange profits was used to finance the payment of lump sum benefits to beneficiaries of deceased New York Stock Exchange members. The Court of Appeals for the Second Circuit found that the plan constituted insurance since the loss from the premature death of the Exchange member was shifted from his family to the fund, and, in turn, the risk of loss shifted to the fund was distributed to the 1373 other members by means of their periodic contributions.[22] The *Edmonds* case involved a similar gratuity payment made out of the same fund, and the Tax Court followed *Treganowan* in holding that payments out of the fund were proceeds of insurance.[23]

The same analysis of risk-shifting and risk-distribution led to a finding that a statutory retirement benefit system constituted insurance in *Estate of Benton L. Snyder*.[24] Snyder was a teacher in the New York City School System which had a statutory retirement program. Salary deductions from teachers, along with

[18] *Id.* at 539. For a discussion of the insurance fundamentals relating to risk-shifting and risk-distributing, see S. ACKERMAN, INSURANCE 3-4 (rev. ed. 1938); 1 G. COUCH, CYCLOPEDIA OF INSURANCE LAW §§ 1:2-1:3 (2d ed. 1959); J. MAGEE & D. BICKELHAUPT, GENERAL INSURANCE 20-22 (7th ed. 1964); R. MEHR & E. CAMMACK, PRINCIPLES OF INSURANCE 34-35 (4th ed. 1966); Comment, *Estate Taxation of Employee Death Benefits*, 66 YALE L.J. 1217, 1233-37 (1957); Note, *The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance*, 59 YALE L.J. 780 (1950).

[19] 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950).

[20] 16 T.C. 110 (1951).

[21] See note 26 *infra*.

[22] 183 F.2d at 291. It is interesting to note that in *Treganowan*, the Internal Revenue Service was arguing that even though no ordinary insurance policy or life insurance company was involved, the arrangement still constituted life insurance for tax purposes.

[23] 16 T.C. 110 (1951).

[24] 14 P-H Tax Ct. Mem. 1067 (1945).

money received from the City, were used to pay retirement annuities and death benefits. Citing *Helvering v. LeGierse*, the *Snyder* court found that the death benefits were insurance since the statutory plan shifted the risk from Snyder's family to the system which in turn distributed the risk among all participating city employees through periodic deductions from their pay checks.[25] Accordingly, as in *Treganowan* and *Edmonds*, the court included the death benefits in the decedent employee's gross estate as proceeds of insurance on the life of the decedent.

While the *LeGierse, Treganowan, Edmonds* and *Snyder* cases were all estate tax cases,[26] the same principles have been held applicable to the income tax provisions of the Internal Revenue Code by cases which have considered the question[27] and a Revenue Ruling.[28]

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[25] *Id.* at 1068.

[26] The applicable estate tax provision is INT. REV. CODE of 1954, § 2042 which provides: "The value of the gross estate shall include the value of all property—(1) Receivable by the executor.—To the extent of the amount receivable by the executor as *insurance under policies on the life* of the decedent." (Emphasis added.) Compare this wording with INT. REV. CODE of 1954, § 101(a)(1) which is worded: "amounts received . . . under a life insurance contract."

By contending that insurance was present in estate tax cases, the Commissioner could increase the amount of the gross estate while in an income tax situation, an opposite contention would allow the Commissioner to increase the amount of gross income.

[27] *See* Mary Tighe, 33 T.C. 557, 564 (1959); Estate of Clarence L, Moyer, 32 T.C. 515, 535-36 (1959). *Moyer* involved a stock exchange gratuity fund similar to that involved in *Treganowan* and *Edmonds*. Payments were made by members of the Philadelphia-Baltimore Stock Exchange upon their admission to the Exchange and upon the death of a fellow member. The Exchange itself also transferred funds to the Gratuity Fund. Out of these payments, amounts were paid to the survivors of the deceased members. Relying on the risk-shifting and risk-distributing approach of *Treganowan* and *Edmonds*, the *Moyer* court found that the "arrangement established by the [stock exchange] constituted insurance upon the lives of the members of such Exchange." 32 T.C. at 527. The court then went on to hold that the payments received from the Gratuity Fund were excluded from the gross income of the beneficiaries under section 22(b)(1) of the 1939 Code and section 101(a)(1) of the 1954 Code. "Although the arrangement under which the Gratuity Fund provided the benefits in question did not take the form of the usual or ordinary life insurance policy or contract, we think it contained the essentials requisite to such a policy or contract and was sufficient to constitute a 'life insurance contract' as that term is used in the above-mentioned sections of the Codes." 32 T.C. at 535-36. The *Moyer* court thereby determined that the same elements found essential to constitute insurance under the estate tax cases, risk-shifting and risk-distributing, also constituted insurance under the income tax provisions.

[28] Rev. Rul. 65-57, 1965-1 CUM. BULL. 56. "The concept of insurance laid down in *Le Gierse* was predicated not upon elements peculiar to the estate tax but upon fundamental principles of what constitutes insurance. The concept is equally applicable to the term

In the related field of health and accident insurance, several recent cases, notably *Haynes v. United States*,[29] have discussed whether payments to employees under employer-operated and funded health and accident compensation plans constituted "amounts received through accident or health insurance," and thus were excluded from gross income under section 104(a)(3) of the Internal Revenue Code.[30] The *Haynes* Court saw no reason why the presence of an insurance company was necessary to constitute "health insurance."[31] Furthermore, in the Court's view, neither payment of fixed premiums at regular intervals nor a definite, segregated fund were necessary elements of insurance. Instead, *Haynes* held that if a plan met the requirements of insurance under the *Helvering v. LeGierse* analysis, then it qualified as an "accident and health plan" under the Internal Revenue Code.[32]

'insurance' found in section 101(a) of the Code in reference to the income tax, as the term is employed in that section not in any specialized sense but with its normal meaning." *Id.* at 58:

The Treasury Regulations seemingly do not dispute this statement. "The term 'insurance' refers to life insurance of every description . . . ." Treas. Reg. § 20.2042-1(a)(1). The government also agrees with the *Helvering v. LeGierse* approach as constituting the minimum qualifications for insurance as used in section 101(a)(1). Brief for the Appellant at 16 n.6, 401 F.2d 464 (5th Cir. 1968).

[29] 353 U.S. 81 (1957). The *Haynes* case arose after extensive litigation on the issue in the lower courts. Courts holding for the government were: United States v. Haynes, 233 F.2d 413 (5th Cir. 1956), *rev'd*, 353 U.S. 81 (1957); Cary v. United States, 141 F. Supp. 750 (D. Neb. 1956); Branham v. United States, 136 F. Supp. 342 (W.D. Ky. 1955), *rev'd*, 245 F.2d 235 (6th Cir. 1957); Moholy v. United States, 132 F. Supp. 32 (N.D. Cal. 1955), *aff'd*, 235 F.2d 562 (9th Cir. 1956); Joseph Oliva, 25 T.C. 1289 (1956). Courts holding for the taxpayer were: Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952); Priebe v. United States, 4 P-H 1956 FED. TAXES (51 Am. Fed. Tax R. 1247) ¶ 72,611 (D. Ariz. 1956); Adams v. Pitts, 140 F. Supp. 618 (E.D.S.C. 1956); Tinsley v. United States, 4 P-H 1956 FED. TAXES (51 Am. Fed. Tax R. 1300) ¶ 72,606 (W.D. Okla. 1956); Herbkersman v. United States, 133 F. Supp. 495 (S.D. Ohio 1955), *aff'd* 245 F.2d 244 (6th Cir. 1957).

For a discussion of some of the issues raised by the above decisions, see Jetter, *Sickness Benefits as Tax-Free Compensation*, 39 A.B.A.J. 329 (1953); Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549 (1954); Comment, *Employer Health or Accident Plans: Tax Free Protection and Proceeds*, 21 U. CHI. L. REV. 277 (1954).

The possibility of the *Haynes* approach being extended to the field of life insurance has been noted by at least one commentator. *See* B. BITTKER, FEDERAL INCOME ESTATE AND GIFT TAXATION 159 n.4 (3d ed. 1964).

[30] INT. REV. CODE of 1954, § 104(a)(3), *formerly* Int. Rev. Code of 1939, ch. 1, § 22(b)(5), 53 Stat. 10.

[31] 353 U.S. at 84 (1957).

[32] *Id.* at 84-85.

The LeGierse *Analysis Applied in* Odom

By holding that the Georgia plan constituted insurance, the Fifth Circuit in *Odom* appears to have followed this body of precedent. Applying the "risk-shifting and risk-distributing" test advanced by *LeGierse,* the *Odom* court found that the first element—risk-shifting—was present.[33] Approximately 20,000 state employees, including the deceased, were paying identical percentages of their monthly paycheck into the common fund out of which definite prescribed benefits would be paid to the employee. Therefore, to the extent of the prescribed benefit, the employee had shifted the risk of his premature death from his family to the fund.[34] The second element—risk-distributing—was also accomplished by the Georgia plan. Since the amount of the contributions was actuarially sufficient to pay the prescribed benefits of all employees in the program, the risk of loss which had been shifted to the fund was in turn distributed to a large number of people—the 20,000 contributing employees and the State.[35]

The Commissioner argued, however, that there could be no true risk distribution unless the employees of the State, the insureds, paid the *full* amount of the premiums necessary to finance the benefits provided.[36] Relying on the decisions in *Snyder, Treganowan,* and *Haynes,* the *Odom* court dismissed the argument as being without legal or economic validity. In *Snyder,*[37] part of the premiums were paid by the employer. In *Treganowan,*[38] the Stock Exchange added part of its profits to the fund, and in *Haynes,*[39] no premiums whatsoever were paid by the employees. Yet in all three cases, the plans in question were held to be *insurance.* Furthermore, the practice unchallenged by the IRS of allowing employees in group insurance plans to pay only part of the premium with the employer paying the balance undercut the Commissioner's position.[40] On the basis of these prior cases and

[33] 401 F.2d at 468.

[34] See note 18 *supra* and accompanying text.

[35] 401 F.2d at 468. See note 18 *supra* and accompanying text.

[36] *See* Brief for the Appellant at 17-22, 401 F.2d 464 (5th Cir. 1968).

[37] See notes 24-25 *supra* and accompanying text.

[38] See notes 19 & 22 *supra* and accompanying text.

[39] See notes 29-32 *supra* and accompanying text.

[40] For an example of insurance industry practice, see *National Association of Insurance Commissioners Model Bill. Group Life Insurance Definition and Group Life Insurance Standard Provisions Adopted June 1, 1956,* reprinted in 11 1956 PROCEEDINGS OF THE NAT'L ASS'N OF INS. COMM'RS 361.

accepted insurance industry practice, the *Odom* court rejected the contention that full payment of premiums by employees was necessary to constitute true risk-distributing.[41]

A second government contention was that a ruling in favor of the taxpayer would open the way for private employers to set up a self-insured plan whose benefits were rendered illusory due to uncertainty of solvency through non-funding of the plan and by the employer's reservation of a right to cancel at will. This contention was rejected by the *Odom* court since the Georgia plan provided the employees with a binding enforceable obligation which could be discharged through a fund assured of continued solvency.[42] Although the Retirement System had a right to suspend payments,[43] exercise of that right was closely guarded by the courts[44] so that it adequately protected all participants and was unlikely to occur.[45] Neither would an order terminating or suspending the program prejudice the payment pending in the case of a then deceased member.[46] Solvency of the fund was assured by actuarially computed contributions and benefits[47] and carefully guarded fund investments.[48]

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[41] 401 F.2d at 468-69.

[42] *Id.* at 473.

[43] "A notice by the board of trustees through the department heads to the membership . . . shall within itself suspend any and all survivors benefit coverage then in effect." GA. CODE ANN. § 40-2523(5)(b) (1957).

If a notice reinstating the benefits is not given by trustees within 12 months of original notice, the Survivors' Benefit Plan is null and void. GA. CODE ANN. § 40-2523(5)(d) (1957).

[44] The action of the board in suspending benefits had to be applicable to all members alike and could not prejudice any survivors' benefits pending in the case of a then deceased member. GA. CODE ANN. § 40-2523(5)(b) (1957).

In addition, Georgia courts have held that a citizen who accepts an offer made by a state statute has a contract right which the State may be compelled to perform. *See, e.g.*, Franklin v. Mayor of Savannah, 199 Ga. 426, 34 S.E.2d 506 (1945); Winter v. Jones, 10 Ga. 190 (1851); Annot., 52 A.L.R.2d 437 at 454-55 (1957). Therefore, after a member had performed, his beneficiaries had a right to bring suit against the Retirement System to compel payment of the death benefits.

[45] 401 F.2d at 471. The right to suspend payments had not been exercised since the plan's creation in 1953, and there was no indication that it would be exercised in the future since to do so would destroy an integral part of the entire employee benefit plan provided by the state.

[46] *Id.* at 471-72.

[47] GA. CODE ANN. § 40-2509 (1957).

[48] *Id.* at § 40-2510 (1957).

The Interaction of Sections 101(a)(1) and 101(b)

Taking another line of attack, the Commissioner argued that the proceeds from the Survivors' Benefit Fund, even if considered proceeds from life insurance, were also employee death benefits paid "by or on behalf of any employer," and therefore came under section 101(b) which limited the exclusion to five thousand dollars.[49] The court rejected the Commissioner's argument since it could find no legislative intent dictating a limitation of the section 101(a)(1)[50] exemption by the section 101(b) five thousand dollar amount.

The predecessor of the present section 101(a) was first enacted in 1913[51] and has retained substantially the same meaning since that enactment.[52] Prior to 1951, the amount received under a life insurance contract was the only type of death payment excluded by the Code. Any other death benefit could not be excluded unless it could be shown that it was a gift instead of extra compensation.[53] Such treatment created an inequity since two taxpayers could receive the same amounts by reason of the death of their benefactors, but one would be taxed on none of the proceeds since it came from a life insurance contract while the other would be fully taxed on his receipts. In order to mitigate this hardship, Congress, in 1951, enacted section 101(b)[54] which excluded from gross income death benefits not in excess of five thousand dollars. The Senate Report[55] accompanying the bill stated that the death benefit provision was limited to five thousand dollars in order to prevent abuses. Also, the Report stated that the revenue loss under the new provision would be negligible.[56]

On the basis of the wording of the bill and the language of the report, the Court of Appeals for the Second Circuit in *Essenfeld v.*

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[49] 401 F.2d at 473. *See* Reply Brief for the Appellant at 8-9, 401 F.2d 464 (5th Cir. 1968).

[50] 401 F.2d at 473.

[51] Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 167.

[52] The 1913 Act excluded "proceeds of life insurance policies paid upon the death of the person insured." *Id.* Compare this language to the present section which excludes "amounts received . . . under a life insurance contract." INT. REV. CODE of 1954, § 101(a)(1).

[53] *See, e.g.*, Estate of Arthur W. Hellstrom, 24 T.C. 916 (1955); Ruth Hahn, 23 P-H Tax Ct. Mem. 366 (1954); Alice M. MacFarlane, 19 T.C. 9 (1952).

[54] INT. REV. CODE of 1954, § 101(b), *formerly* Int. Rev. Code of 1939, ch. 1, § 22(b)(1)(B), 65 Stat. 483.

[55] S. REP. No. 781, 82d Cong., 1st Sess. 50 (1951).

[56] *Id.*

Commissioner,[57] while holding that the payments in question were not life insurance, went on to add as dicta that even if they were life insurance, since they were paid by the employer they would come within the provisions of 101(b)(1) instead of 101(a)(1), limiting the exemption to five thousand dollars. The court reached this conclusion by reasoning that the general language of section 101(a) was over-ridden by the specific, subsequently enacted provision of section 101(b).[58]

On the basis of the legislative history of section 101(b)(1), the *Odom* court rejected the dicta of the *Essenfeld* case advanced by the Commissioner to show why the amount excluded should be limited to five thousand dollars.[59] First, the court saw the legislative history of 101(b)(1) as evidencing an intent to liberalize deductions under section 101 since it spoke of lessening hardship, not increasing it, and of losing revenue, not gaining it.[60] Therefore, the two provisions should be interpreted to allow the maximum amount of income to be excluded as death benefits. In *Odom* this was accomplished by holding that the payments in question fell under section 101(a)(1) as insurance proceeds rather than under 101(b) as death benefits. Second, the court did not read 101(b)(1) as a specific provision which governed a general provision, since 101(b)(1) "clearly" was not intended to limit the effect of 101(a)(1).[61] Finally, the court felt that the Commissioner's contention was similar to the argument that 101(b)(1) was intended to limit the total exclusion for widow's benefits found to be gifts under section 102.[62] Since this similar argument on the limitations of an employer-paid benefit by 101(b)(1) had been rejected,[63] the

[57] 311 F.2d 208 (2d Cir. 1962). *Accord*, Laura V. Lilly, 45 T.C. 168 (1965). In *Essenfeld*, the court said, "Even looking at the particular provision alone, we find no resemblance to life insurance. Premium payments are not required, nor is there a shifting and spreading of the risk of death in a meaningful sense." 311 F.2d at 209.

[58] 311 F.2d at 210.

[59] 401 F.2d at 473. One judge dissented on the grounds that "the history of the over-all problem, considered with the language and juxtaposition of the two provisions of the Internal Revenue Code of 1954 . . . show a congressional intent . . . that the payments to the widow . . . are to be governed . . . by the provisions of Section 101(b) . . . ." *Id.* at 474 (Fahy, J., dissenting).

[60] 401 F.2d at 473; *see* S. REP. No. 781, 82d Cong., 1st Sess. 50 (1951).

[61] 401 F.2d at 473.

[62] *Id.* INT. REV. CODE of 1954, § 102 provides: "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

[63] In Rodner v. United States, 149 F. Supp. 233, 237 (S.D.N.Y. 1957), the court stated in

court felt the present argument should meet the same fate.[64] For these reasons, the *Odom* court allowed the taxpayer to exclude the full death benefit of $27,450 from her gross income.

Analysis of the Odom *Rationale*

Emphasizing substance over form,[65] the rationale in *Odom* makes the availability of a section 101(b) exclusion depend on whether the plan underlying the death benefit is functionally equivalent to a plan funded through an ordinary life insurance company. When the Georgia Survivors' Benefit Program is compared to a straightforward insurance company plan,[66] it is apparent that the two are functionally indistinguishable. Both

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dicta that "the general language exempting gifts is controlled by the particular language of section 101(b) limiting the death benefits by $5,000. Gifts in general are exempt but gifts in the form of death benefits are taxable insofar as they exceed $5,000." Thereafter, the Internal Revenue Service began to litigate the issue of whether 101(b)(1) limited 102. In United States v. Reed, 277 F.2d 456 (6th Cir. 1960), the court, in a *per curiam* opinion, approved the decision in 177 F. Supp. 205 (W.D. Ky. 1959), which had rejected the government contention that 101(b) was designed to limited the gift exclusion under 102. The Internal Revenue Service, in Rev. Rul. 60-326, 1960-2 CUM. BULL. 32, announced that it would not follow the *Reed* decision. However, in Poyner v. Comm'r, 301 F.2d 287, 290-91 n.7 (4th Cir. 1962), the government refused to argue that Section 101(b) limited the provisions of Section 102. The Internal Revenue Service accepted this position in Rev. Rul. 62-102, 1962-2 CUM. BULL. 37, which said: "The Internal Revenue Service will no longer contend that section 101(b) of the Internal Revenue Code of 1954 applies to limit to $5,000 the exclusion from gross income of an amount paid to the widow of a deceased employee, where the payment otherwise qualifies as a gift excludable under section 102(a) of the Code."

[64] 401 F.2d at 473.

[65] *Id.* at 468, 470, 471; *see, e.g.*, Comm'r v. Southwest Exploration Co., 350 U.S. 308, 315 (1956); Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961).

For a discussion approving the use of such a functional approach for employee death benefits, see Comment, *Estate Taxation of Employee Death Benefits*, 66 YALE L.J. 1217, 1237-47 (1957). That comment states: "[T]he funetional analysis also seems appropriate when death benefits are paid direetly by the employer and not by a commercial insurance company." *Id.* at 1240.

"Moreover, the employer can even duplicate the insurer's 'terminal reserve' operation by deducting actuarially predicted mortality costs from projected earnings. In this manner, risk can be spread among all participating employees, though actuarial calculations are necessarily less certain due to the small sampling of individuals involved." *Id.* at 1242. Uncertainty in the actuarial calculations in the Georgia plan were greatly reduced since there were over 20,000 state employees taking part in the program, thus increasing the sample size and improving aecuracy.

[66] Such a straightforward plan would be one in which employee/employer contributions are paid over to an insurance company as premiums on a policy covering all the employees. The Commissioner admits the tax-exempt nature of proceeds from such a plan. *See* Reply Brief for the Appellant at 5, 401 F.2d 464 (5th Cir. 1968).

programs seek to alleviate the financial burden placed upon the deceased employee's survivors by monetary payments. Both systems use actuarial computations designed to predict the amount of premiums which will be sufficient to support the payment of predetermined benefits.[67] Assured solvency of both plans is achieved through carefully restricted and guarded investment of the premiums.[68] Both plans involve the requisite risk-shifting and risk-distribution. The only distinction which the Commissioner could draw between the Georgia plan and one funded through an insurance company was the failure of the state plan to provide for a conversion privilege. However, a conversion privilege, as noted by the court, is not a necessary element of an insurance contract.[69]

On the issue of the interaction of sections 101(a) and 101(b), the court's disapproval of the *Essenfeld* dictum seems in accord with the purpose of section 101 as evidenced by its legislative history. A Senate Report accompanying the bill which became section 101(b) of the 1954 Code, stated that the exclusion granted by section 101(a) was limited to life insurance payments and did not extend to death benefits paid by an employer.[70] This conclusion, however, as to the non-exclusion of employer payments under 101(a), was made without reference to *Treganowan* and its progeny, and most likely indicated the committee's failure to conceive of an employer making a payment in the capacity of an insurer. When an employer pays death benefits pursuant to a plan which qualifies as insurance under the *Treganowan* precedents, he is not acting as an *employer,* but as an *insurer,* and such payments should come within the exclusionary ambit of section 101(a).

When Congress spoke of correcting a hardship by excluding five thousand dollars of death benefits paid by the employer under a pre-existing contract, they probably were not referring to an employer death benefit which constituted life insurance since it was

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[67] GA. CODE ANN. § 40-2509 (1957).

[68] *Id.* § 40-2510.

[69] 401 F.2d at 470-71. A conversion privilege is the right of the insured to exchange the term contract for permanent insurance at some time in the future. *See generally* S. ACKERMAN, INSURANCE 27 (rev. ed. 1938); 1 G. RICHARDS, LAW OF INSURANCE § 15 (5th ed. W. Freedman 1952); J. MAGEE & D. BICKELHAUPT, GENERAL INSURANCE 697 (7th ed. 1964). All of these commentators agree that a conversion privilege is only one of many different variables which can make up a group life insurance contract.

[70] S. REP. NO. 781, 82d Cong., 1st Sess. 50 (1951).

already fully excluded and posed no hardship.[71] The *Odom* court correctly interpreted this intention when it determined that when a payment was found to be life insurance, it would not be limited by section 101(b).

The use of a functional approach to determine whether an employer's payment is insurance will not, contrary to government contentions,[72] rule section 101(b)(1) a dead letter in the law. Instead, it will relegate the five thousand dollars exclusion to situations where it is particularly beneficial—the area of voluntary payments to widows of deceased employees which are made due to a custom or out of a feeling of charitable considerations.[73] Prior to the enactment of section 101(b)(1) these payments would have been fully taxable unless it could be shown that a gift was intended.[74]

The Impact of Odom

The immediate effect of the holding in *Ross v. Odom* should be an increased interest in self-funded plans by those state governments having similar provisions creating a self-funded retirement and/or death benefit plan.[75] As noted above,[76] the area of fringe benefits is becoming one of the most important selling points in the quest for talent. By providing a tax-free benefit plan for employees' beneficiaries, a state government could add a selling point to its position in the employment market.

However, since the court did not limit its decision solely to

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[71] S. REP. No. 781, 82d Cong., 1st Sess. 50 (1951), stated that the Code provisions prior to the enactment of the present section 101(b) granted exclusion only to life insurance payments and did not extend to employer-paid death benefits. But under the estate tax section analogous to the predecessor of 101(a) referred to in the Senate report, a payment received under a fact situation similar to that in *Odom* had been held to be insurance in Estate of Benton L. Snyder, 14 P-H Tax Ct. Mem. 1067 (1945). Therefore, it seems that payments such as those received in *Snyder* and *Odom* were not considered employee death benefits under the predecessor of 101(b) and should not be so considered under the new provision since there is no evidence of congressional intent to effect this change.

[72] *See* Reply Brief for the Appellant at 5, 401 F.2d 464 (5th Cir. 1968).

[73] *See* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.09 at 18 (1962).

[74] See note 53 *supra.*

[75] For examples of statutes establishing death benefits plans similar to the Georgia plan, see ILL. ANN. STAT. ch. 108½, §§ 14-101 to -201 (Smith-Hurd 1964); IND. ANN. STAT. §§ 60-1601 to -1638 (1962). For examples of statutes providing only retirement benefits but which could be adapted to provide death benefits similar to Georgia, see ALA. CODE tit. 55, §§ 456-75 (1960); ARIZ. REV. STAT. ANN. §§ 38-741 to -764 (1956).

[76] See notes 1-3 *supra* and accompanying text.

governmental use, there will probably be an attempt to extend the *Odom* rationale to justify employers' use of self-funded plans to obtain a potential cost saving by eliminating the "middleman."[77] Although the *Odom* court was apparently worried about the possibility of abuse in this area,[78] a court which looks to the substance rather than the form of individual employer plans should preclude unjustified tax benefits.[79]

The *Odom* case suggests the requirements which a private plan would have to meet in order to qualify as "substantive insurance." First, of course, "risk-shifting" and "risk-distributing" would be required. Second, there would have to be a definite, separate fund[80]

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[77] *See generally* Jackson, *Self-Insurance and Group Insurance,* 16 J. AM. SOC'Y C.L.U. 304-05 (1962).

[78] 401 F.2d at 471. Such abuse could occur if an employer was allowed to set up a self-insurance plan, make contributions to a fund completely under employer control, and reserve the right to cancel the program at will or refuse to pay individual claims as they came due. 401 F.2d at 471. Such a plan could cause abuse in several areas. First, the employer would still have control over the fund which could be used for working capital purposes. Second, if the yearly contributions were to become bothersome, the plan could be terminated with no liability on existing claims. Third, especially in close corporations which experience little turnover in ownership, the plan would provide a tax-free method of transferring retained earnings to the owners. See note 85 *infra* and accompanying text.

[79] *See generally* Comm'r v. Hanse, 360 U.S. 446, 461 (1959); United Grocers, Ltd. v. United States, 308 F.2d 634, 641 (9th Cir. 1962); Morgan v. Comm'r, 277 F.2d 152, 153 (9th Cir. 1960); Mt. Mansfield Television, Inc. v. United States, 239 F. Supp. 539, 543 (D. Vt. 1964), *aff'd per curiam,* 342 F.2d 994 (2d Cir. 1965); Metropolitan Co. v. United States, 176 F. Supp. 195, 200 (S.D. Ohio 1959). The *Odom* court rejected several government contentions as being based on form, rather than substance. These arguments included the necessity for a contract with an insurance company, 401 F.2d at 468, the lack of risk-distribution when the employees did not pay all of the necessary premiums, *id.*, and the necessity for the inclusion of a conversion privilege in the contract, *id.* at 470-71. The court preferred to analyze the substance of the plan under the test outlined in text generally accompanying notes 80-81 *infra.*

[80] Although the *Odom* court emphasized the existence of a separate, carefully invested fund as one of the features of the Georgia plan which prevented abuse of the plan by the employer, 401 F.2d at 472, the Supreme Court, in Haynes v. United States, 353 U.S. 81, 84 (1957), stated there was "no necessity for a definite fund set aside to meet the insurer's obligations." However, in *Haynes,* the plan in question was one of health insurance which necessarily involves benefits payable to the individual which are contingent both as to time and amount. Therefore, a health insurance plan would not lend itself very well to manipulation to enable a tax-free transfer of retained earnings from the company to the individual through exclusion from gross income under § 104, since there is no certainty that any amount will ever be paid. But in a life insurance plan, such as *Odom,* the amount of benefits were certain and the event upon which they were payable was one certain to occur. Such a life insurance plan would easily adapt itself to a tax-free transfer of retained earnings. See note 85 *infra* and accompanying text for an example of how such a transfer would be made. The requirement of a separate, carefully invested fund would reduce the possibility of abuse since the employer could not use the fund for any purpose other than for providing insurance benefits.

which would be carefully invested. In this regard, a court might require, as did the Georgia statute,[81] that investments be made according to standards followed by life insurance companies in that particular state. Third, definite prescribed benefits would be required which, following sound actuarial principles, were capable of being met out of the fund. Finally, there would have to be a binding contract to pay the benefits, upon the fulfillment of certain conditions. The Commissioner's contention that such a scheme would provide untaxed compensation in the form of employer-paid premiums[82] could be met by including in the employee's gross income the employer-paid premiums for the amount of insurance in excess of $50,000 on the same basis used for group-term life insurance purchased by employers.[83] Since uniform premium rates are established by the Commissioner, employees receiving benefits under such a self-funded plan would be taxed on the same amount of premiums as would employees covered by an ordinary group insurance plan.[84]

A second argument advanced by the Commissioner against such a "functional" approach was that companies could set up such a plan, call its contributions "premiums" and achieve a tax-free distribution of retained earnings through the exclusion of the death benefits from the employee's gross income under 101(a).[85] The possibility of this abuse seems negligible. The employer's contributions, when made, would be placed in a separate fund which could not be used for ordinary business purposes,[86] and

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[81] GA. CODE ANN. § 40-2510 (1957).

[82] Reply Brief for the Appellant at 6, 401 F.2d 464 (5th Cir. 1968).

[83] INT. REV. CODE of 1954, § 79(a) provides: "There shall be included in the gross ineome of an employee for the taxable year an amount equal to the cost of group-term life insurance on his life provided for . . . under a policy (or policies) carried . . . by his employer (or employers); but only to the extent that such costs exceeds the sum of (1) the cost of $50,000 of such insurance, and (2) the amount (if any) paid by the employee toward the purchase of such insurance."

[84] Actually, the employee who participates in the self-funded plan might be overtaxed under the uniform rates since a higher premium would be required to purchase a contract containing "extras" such as conversion privileges which are normally found in group insurance plans but would not be found in the self-insured plan. However, with a uniform rate, the employee will have an amount sufficient to purchase these "extras" included in his taxable income, whether he receives them or not.

[85] Brief for the Appellant at 14-15, 401 F.2d 464 (5th Cir. 1968).

[86] The *Odom* court was worried that retention of funds under the employer control could lead to uncertainty of solvency. 401 F.2d at 471.

employer-paid premiums for insurance in excess of $50,000 would be taxable to the employee.[87] Therefore, it seems that this is identical to the requirements imposed upon an employer who purchases an ordinary life insurance policy, and could not be viewed as any greater an abuse.

While it seems probable that a private employer could qualify for treatment similar to that accorded the Georgia plan, the obstacles which he might encounter are numerous. In order to facilitate payments to beneficiaries, the employer would have to establish some system for handling claims which could involve more personnel and a great deal of paperwork.[88] Also, competent actuarial assistance would be required to establish the fund and insure its continued effectiveness.[89] In addition, the federal disclosure laws[90] could apply to the insurance system, requiring still more paperwork. Finally, since the employer is providing insurance, he might find himself subject to state insurance laws.[91] Therefore, while such private plans would be allowable under the rationale of *Ross v. Odom*, the attractiveness of such plans may be seriously hampered by the administrative and legal problems of putting them into operation.

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[87] See notes 82-83 *supra* and accompanying text.

[88] *See generally* Jackson, *Self-Insurance and Group Insurance*, 16 J. AM. SOC'Y C.L.U. 300, 305-06 (1962).

[89] *Id.* at 308.

[90] 29 U.S.C. §§ 301-09. These sections cover, among others, "any plan, fund, or program which is communicated or its benefits described in writing to the employees, and which was . . . established by any employer . . . for the purpose of providing for its participants . . . [death] benefits . . . ." *Id.* at § 302(a)(1). Plans falling within the above category must publish, among others, a description of the plan and a detailed annual financial report. *See generally* Seligman, *The Federal Disclosure Act*, 15 J. AM. SOC'Y C.L.U. 79 (1961).

[91] *See generally* People v. Cal. Mut. Ass'n, 441 P.2d 97, 68 Cal. Rptr. 585 (1968); Maloney v. Am. Independent Medical & Health Ass'n, 119 Cal. App. 2d 319, 259 P.2d 503 (1953); State v. Anderson, 195 Kan. 649, 408 P.2d 864 (1965); Associated Hosp. Serv. v. Mahoney, 161 Me. 391, 213 A.2d 712 (1965); Texas v. Memorial Benevolent Soc'y, 384 S.W.2d 776 (Tex. Civ. App. 1964).