Life Insurance as Alimony - Income Tax Aspects

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LIFE INSURANCE AS ALIMONY — INCOME TAX ASPECTS

In certain separation and divorce cases, a husband may be bound by agreement or decree to insure his life in order to guarantee his wife a minimum amount of alimony.1 This situation raises two tax problems. First, are the premium payments made by the husband for such insurance considered alimony? Secondly, how should the proceeds the wife receives be treated for tax purposes?

It is not settled in Louisiana2 whether, absent agreement between the parties, the husband’s obligation to pay alimony continues past his death, and there is a conflict in other jurisdictions concerning this issue.3 In most cases, the obligation has been incurred by the husband through a negotiated divorce or separation agreement.4 In other cases, courts, pursuant to their statutory authority, have ordered that alimony be paid over a specific period notwithstanding the death of the husband.5 The obligation may be performed by using an existing policy or by purchasing a new one; however, the federal income tax question arises once premium payments are commenced pursuant to the decree or agreement.

Premiums as Alimony

Under the Internal Revenue Code of 1954, alimony payments to a separated or divorced wife are includible in her gross income and


2. Article 160 of the Civil Code provides that the wife is entitled to alimony when inter alia “she has not sufficient means for her support . . . .” In Succession of King, 184 So. 2d 583 (La. App. 4th Cir. 1966), the husband had stipulated that he would pay to the wife $50 per week for the remainder of her life. The Fourth Circuit stated “[t]he obligation to pay alimony stipulated by the deceased was merely the confirmation of a duty imposed by law and governed by law as to its duration and future amount.” 184 So. 2d at 584. (Emphasis added.) The court further noted that the stipulation only fixed the alimony amount and that the stipulation that the alimony right and obligation was to be for life was immaterial because “[t]he law requires payment of alimony to the wife ad infinitum as long as she is in necessitous circumstances. . . .” 184 So. 2d at 584. (Emphasis added.) While the language in King may imply that the obligation could continue past the death of the husband, it is dictum.


4. Thus, in these situations, the policy appears to function as a bargaining device. For example, the wife may accept a smaller alimony payment in exchange for the assurance that she will receive this amount.

5. Stevens v. Commissioner, 439 F.2d 69 (2d Cir. 1971); Kiesling v. United States, 349 F.2d 110 (3d Cir. 1965).
are deductible from the gross income of the husband.⁴ Alimony is defined as *periodic payments* received after a decree of divorce or legal separation or the execution of a written separation agreement.⁵ Although the insurance premium payments are clearly periodic, the courts have had difficulty in determining whether the wife has received a payment from the husband when he pays the premium.

Earlier cases held that the husband’s payment of premiums would not be considered alimony if the policy was mere security insuring that the wife would receive the entire amount stipulated in the agreement or decree.⁶ Later cases evolved a more positive judicial test—if there had been an economic gain to the wife in actual or constructive receipt of cash or property, the payment was alimony.⁷ It was also indicated that the wife was considered to have received no benefit unless she had a non-contingent right to the proceeds—a right to the proceeds which continues even though she may die or remarry.⁸

In *Weil v. Commissioner*⁹ both the Tax Court and the Second Circuit indicated that the wife's ownership of the policy was neces-

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7. Section 71(c) of the Internal Revenue Code of 1954 provides that where a principal sum is specified in the decree or agreement in terms of money or property, such installment payment shall not be considered as periodic. See Treas. Reg. § 1.71-1 (1957) for examples of periodic and installment payments.
8. Section 71(a) provides that the payments must be in discharge of a legal obligation imposed by the decree or written instrument incident to the divorce or separation because of the marital or family obligation.
9. Blumenthal v. Commissioner, 183 F.2d 15 (3d Cir. 1950). The wife was irrevocable beneficiary and her husband was prohibited from encumbering the policies. The husband retained ownership of the policies and the wife’s interest in the policies ceased upon her death or remarriage. She was permitted to obtain loans on the policy for payment of overdue premiums. The court made no attempt to state what would qualify the payments of premiums as alimony. Accord, William J. Gardner, 14 T.C. 1445 (1950), aff’d mem., 191 F.2d 857 (6th Cir. 1951).
10. Seligman v. Commissioner, 207 F.2d 489 (7th Cir. 1953); Mandel v. Commissioner, 23 T.C. 81 (1954), aff’d, 229 F.2d 382 (7th Cir. 1956). The Seligman court stated that realization of economic gain, as a prerequisite to its taxability, must be capable of ascertainment in extent or amount. The court found that the taxpayer had received no economic gain because there was no constructive receipt of cash and no property right capable of measurement was received since any right she may have had was too contingent. See also Commissioner v. Smith, 324 U.S. 177 (1945); Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Bruun, 309 U.S. 461 (1940) (dealing with the doctrine of constructive receipt).
11. Seligman v. Commissioner, 207 F.2d 489, 494 (7th Cir. 1953).
sary to obtain alimony treatment, and eight years later in *Piel v. Commissioner*, the Second Circuit stated:

> It is apparent that the weight of recent authority has equated benefits with ownership and has refused to allow a deduction where the beneficiary has failed to obtain non-contingent substantial proprietary rights in the proceeds of the policies and thus in the benefits generated by the premium payments.

Thus the search for an economic benefit seems to have culminated in a determination that the wife derives economic benefit only from the policy proceeds when there is substantial certainty that she will receive the proceeds; that is, she must be both owner and irrevocable beneficiary of the policy.

The recent Second Circuit case of *Stevens v. Commissioner* indicates a change in approach. In that case the wife was held to be an irrevocable beneficiary despite the designation of the children as contingent beneficiaries, and the husband received an alimony deduction equal to the cost of a reducing term policy premium. More importantly, *Stevens* indicated that receipt of the proceeds was not the only benefit accruing to the wife. The court stated that the wife received an additional economic benefit in the "protection, during a limited term, of the wife's right to receive alimony over the full alimony period."

The Tax Court, however, in *William H. Broderson, Jr.*, declined to follow *Stevens* and disallowed a deduction for premiums paid on

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13. The Second Circuit stated: "She had no right to change the beneficiary, to assign the policies, or to obtain the cash surrender values. Her interest ceased upon her death or remarriage during his lifetime. While certain restrictions were placed upon the husband's control of the policies, he clearly retained ownership." 240 F.2d at 587. (Emphasis added.)

14. 340 F.2d 887 (2d Cir. 1965).

15. Id. at 890. (Emphasis added.) In *Kiesling v. United States*, 349 F.2d 110 (3d Cir. 1965), the court noted that not only must the wife own the policy, but her interest must not be contingent. Factors demonstrating the contingent nature of the wife's interest included: cessation of her interest in the policy upon her death or remarriage; revocability of her designation as beneficiary; the fact that the policy had not been assigned to her and she had no right to assign or borrow on it.


17. 439 F.2d 69 (2d Cir. 1971).

18. Id. at 72. (Emphasis added.) Although the policy in question was a whole life policy, the court noted that a wife could receive an economic benefit from a term policy because a term policy provided insurance protection for the year.

a reducing term policy, even though ownership was assigned to the wife incident to a decree of divorce. In refusing to treat insurance protection as an economic benefit, *Stevens* was distinguished on three grounds: first, *Stevens* involved a whole life policy which conferred additional benefits; secondly, the wife in *Stevens* had possession of the policies; and finally, the applicable language in *Stevens* was “clearly dictum.”

The *Stevens* case appears to be more in accord with economic reality because insurance protection as well as the proceeds constitute recognized economic benefits. Moreover, the Internal Revenue Service, in *Paul L. Frost*, successfully asserted that insurance premiums paid by the employer on the life of an employee constituted compensation and were therefore to be included in the employee’s gross income. The court recognized that the cash surrender value of the policies was an economic benefit received by the taxpayer, but added:

In addition petitioner received each year in question basic insurance protection. During the course of these years his family was the beneficiary against his sudden disability or demise. This protection was of *current economic value to him.*

Both compensation and alimony are specifically included in the definition of gross income. If insurance protection constitutes an economic benefit for purposes of compensation, there seems to be no basis for holding that insurance protection is not an economic benefit for purposes of alimony. The traditionally broad application given Section 61 by the courts should apply equally to compensation and alimony, and thus insurance protection should be recognized as an economic benefit in both cases.

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20. *Id.* at 419. Procedurally, the Tax Court is bound, under *Jack E. Golson*, 54 T.C. 742 (1970) to follow a court of appeals decision which is squarely on point, where the only appeal from the Tax Court is to that court of appeals. However, since the Tax Court in *Broderson* was sitting in the Seventh Circuit, it was not bound to follow *Stevens*. Thus it may be better to proceed in United States District Court where a term policy is involved, unless the action is in the Second Circuit. See *Int. Rev. Code of 1954*, § 7422.

22. Members of the taxpayer’s family were the policy beneficiaries.
25. The *Frost* court noted the broad scope given to Section 61 and cited as authority Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Commissioner v. Smith, 324 U.S. 177 (1945). In *Smith* the Supreme Court said of the comparable section of the 1939 Code: “[It] is broad enough
If the insurance protection received by the wife is recognized as an economic benefit, several changes in existing law would follow. Both whole life and term policies confer insurance protection on the wife; consequently, the type of policy utilized should be irrelevant. Furthermore, the requirement that the wife actually own the policy should be discarded if the wife does, in fact, receive the policy’s protection. Similarly, the irrevocable beneficiary requirement appears unnecessary, provided the wife is clearly the policy beneficiary for the duration of the alimony period. Although upon death, remarriage, or by the terms of the agreement the wife may cease to be the policy beneficiary, cognizance should be taken of the protection actually received during the alimony years.

If life insurance premiums paid by the husband are treated as alimony where the wife is neither the owner nor irrevocable beneficiary, then only that portion of the premium allocable to the cost of insurance protection for the year should be considered alimony. Thus, that portion of the premium allocable to the cash surrender


27. All courts have not recognized the benefit of insurance protection in term policies as is evidenced by the Broderson decision.

28. Stevens v. Commissioner, 439 F.2d 69 (2d Cir. 1971); Kiesling v. United States, 349 F.2d 110 (3d Cir. 1965); Piel v. Commissioner, 340 F.2d 887 (2d Cir. 1965); Weil v. Commissioner, 22 T.C. 612 (1954), aff’d, 240 F.2d 584 (2d Cir.), cert. denied, 353 U.S. 958 (1957); Turpin v. United States, 240 F. Supp. 171 (W.D. Mo. 1965) (all recognizing the requirement that ownership of the policy be vested in the wife). It seems unfair to require a husband to divest himself irrevocably of a policy in which he may have built up a great deal of cash value in order to obtain alimony treatment of the premium payments. This is especially true where the husband, because of his age or health, has become uninsurable from the standpoint of obtaining a new policy.

29. The Stevens court while indicating that insurance protection for a year is an economic benefit, did not have to address the ownership requirement as the wife in that case did own the policy. The court, by proper shaping of the decree, can insure that the wife will receive the policy protection and thus its economic benefit without ownership. For example, the decree could prevent the husband from borrowing on the policy, surrendering it for cash, or allowing it to lapse so long as the alimony obligation is outstanding. Additionally the husband may agree to pledge the policy to the wife thereby making her a preferred creditor in the event of his demise. LA. CIV. CODE art. 3133.

30. The reference to “cost of insurance” means the portion of the premium used to buy actual insurance and not the portion allocable to the policy reserve of a whole life policy. Such portions allocable to the policy reserve represent excess premium payments above the amount insuring against the actuarial probability of death.
value in a whole life policy should not be taxed to her because she is receiving no economic benefit from it. Conversely, where the wife owns a whole life policy and is the irrevocable beneficiary, the entire premium should be considered alimony because she receives economic benefit from the increase in cash surrender value as well as from the insurance protection.

These changes would be in line with economic realities and properly balance all the interests. The husband would be able to realize the tax benefit of the deduction; the wife would be assured of receiving her alimony; and the government would still receive revenue from the inclusion of the premiums in the gross income of the wife.

**Tax Treatment of the Proceeds**

Upon the death of the husband and receipt of the proceeds by the wife, the question arises as to the tax treatment of the proceeds. Although this question has not been decided, under Section 101, insurance proceeds are generally not includible in gross income. However, Section 101(e) denies this exclusion to "any payment as is includible in the gross income of the wife under Section 71 (relating to alimony). . . ." Thus the question becomes whether such proceeds are alimony. Since most proceeds will be taken in a lump sum, it could be argued that the payment does not constitute alimony because it is not a periodic payment.

If the proceeds are, however, held to be alimony, the amount of proceeds included in her gross income should be reduced by that amount representing premium payments made by her husband which have been included in her gross income. Support for this position is found in the "transfer for valuable consideration" rule of the

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31. A suggested method of setting up the policy is to designate the wife as primary beneficiary of the policy only to the extent of the remaining alimony obligation and to allow the husband to designate whomever he chooses as primary beneficiary of the remaining portion. Thus, regardless of the type policy used, only the amount of the policy premium used to purchase the insurance amount payable to the wife for a given year would be deemed alimony.

32. See note 28 supra. Adoption of these recommendations would allow the husband who has become uninsurable to retain his existing policy and merely designate the wife as beneficiary for the duration of the alimony period. If the husband is insurable, he would have the option of purchasing a new policy or using an existing policy with the wife as beneficiary.


34. Id. § 101(e).

35. This situation is analagous to a lump sum settlement by a husband which would not be deductible as alimony. See note 7 supra.

36. See notes 6-8, 33-35 and accompanying text supra.
Internal Revenue Code. That rule denies the normal exclusion of life insurance proceeds from gross income where a policy is transferred. It does allow a deduction to the extent of the consideration paid for the policy and the premiums paid by the transferree. The policy in question may not have been actually transferred, but the situations are analogous, and to the extent the wife is required to include the premiums in her gross income, it seems she is giving consideration for the policy.

**Tax Planning Under Existing Law**

The use of insurance policies is a valuable device in divorce or separation agreements. Notwithstanding the judicial uncertainty concerning such agreements, there are several means by which the practitioner can achieve the intended results.

If the husband is insurable at the time of the divorce, the most certain method is for the wife to purchase a policy on his life and pay the premiums herself with the cost of premiums being considered in determining the amount of the husband's alimony obligation. An agreement structured in this manner would prove advantageous to both parties. Payments to the wife should be deductible as a normal Section 71 alimony payment. The wife is assured of receiving her alimony in one form or the other, and she should avoid being taxed on the proceeds in the event of the husband's death. If an existing

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38. Actual ownership should make no difference if she is receiving benefit from the policy.
39. Such treatment would avoid placing a double taxation burden on the wife.
40. See notes 6-8 and accompanying text supra. The parties must, of course, comply with all the requirements of Section 71.
41. **See Wenig, Use of Life Insurance in Divorce and Separation Agreements, N.Y.U. 28th Inst. on Fed. Tax. 837, 852 (1970).**
42. The applicability of this proposal is subject to state insurance law regarding insurable interests. **La. R.S. 22:613 (1950) provides that there is an insurable interest in the cases of persons not related by blood or law (for example divorced spouses are no longer related by law) and having a lawful and substantial interest in the life of the insured.**
43. **See Int. Rev. Code of 1954, § 101 (providing rules for exclusion and inclusion of certain life insurance proceeds). See also notes 33-35 and accompanying text supra.**
44. **Cosman v. United States, 440 F.2d 1017 (Ct. Cl. 1971) requires a degree of caution on the practitioner's part. There the taxpayer transferred a life insurance policy to a trust incident to the separation agreement and divorce decree. The wife was to pay the premiums with money received by her from the husband. The amount at issue was the payment of the exact amount of the premium to the wife with which she would pay the premium. The Court of Claims in denying the deduction of the husband**
policy is transferred, complete ownership should pass to her, and she should be designated as irrevocable beneficiary. There should be no contingencies upon her right other than naming the children as contingent beneficiaries.  

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found that the former wife had received no economic benefit and that she “has been a conduit through which the payment passed . . . .” However, the court also seemed to have been greatly influenced by the very limited interests of the wife in the trust.

45. See Stevens v. Commissioner, 439 F.2d 69 (2d Cir. 1971); Rev. Rul. 218, 1970-1 Cum. Bull. 19. An additional problem where a policy is transferred is that under United States v. Davis, 370 U.S. 65 (1962), the husband must recognize gain upon the transfer of the policy to the extent that its value exceeds its basis.