Disability Provisions under Life Insurance Policies

# Premiums for Disability Provisions: Medical Expense Deduction

Premiums paid for disability provisions (e.g., waiver of premiums, disability income, accidental death) under life insurance policies, are not deductible medical expenses.

Section 213(d)(1) provides that only amounts paid for insurance covering the diagnosis, cure, mitigation, treatment or prevention of disease or for the purpose of affecting any structure or function of the body or for transportation to receive such treatment may be deducted by the taxpayer to the extent that these expenses exceed a certain percentage of the taxpayer’s adjusted gross income.

# Disability Income under Life Insurance Policies

Disability income received under a disability rider is treated as a separate accident or health benefit, and not as proceeds from the life insurance policy. Such income is excludable from gross income under Code section 104(a)(3) as “amounts received through accident or health insurance… for personal injury or sickness.” There is no limit on the amount of disability income that can be received tax-free under a personal policy (that is, a policy purchased with the insured’s personal funds).

The disability income is tax-exempt whether received by the insured or by a person having an insurable interest in the insured. Section 104(a)(3) does not expressly limit the availability of the exemption to the insured, but provides generally that such income is exempt. Moreover, the Board of Tax Appeals held, in Castner Garage, Ltd., that the disability income under a life insurance policy was tax-exempt to a corporation having an insurable interest in the insured, and stated that this rule would hold for any person having an insurable interest. Internal Revenue Service acquiesced in this decision, and apparently has followed it for many years. Castner Garage, Ltd., 43 BTA 1 (1940), acq. CB 1944, p. 5.

# Waiver of Premium Benefit

It is the general consensus that premiums which are waived upon the insured’s becoming disabled are excludable from the insured’s gross income as “amounts received through accident or health insurance… for personal injuries or sickness.” IRC Sec. 104(a)(3).

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# Cost of Policy: Additional Premiums for Double Indemnity, Disability Income, and Premium Waiver: Waived Premiums

Whenever lifetime proceeds are received under a life insurance, endowment or annuity contract, it is necessary to determine the “investment in the contract.” This is necessary in order to compute the amount of taxable gain, if any, or, where the proceeds are to be received as a life annuity or in installments, in order to compute the exclusion ratio for the payments.

Generally, “cost” is based upon the aggregate premiums paid for the contract, but does not include additional premiums paid for benefits such as double indemnity, waiver of premium or disability income. Rev. Rul. 55-349, 1955-1 CB 232; Estate of Wong Wing Non v. Comm., 18 TC 205 (1952).

Waived premiums, on the other hand, should be includable in “cost.” By paying an additional premium, the insured has purchased premiums to apply on the policy in the event of total disability. Consequently, he should be entitled to include the premiums waived as part of his investment in the contract.

Unfortunately, a much criticized decision of the Tax Court has cast some doubt on the treatment of waived premiums.

The case, Estate of Wong Wing Non, supra, involved a matured endowment. The insured had paid $5,406 in premiums before becoming disabled, and subsequently an additional amount of $5,406 was waived under the waiver-of-premium provision. Upon maturity of the endowment, the insured received the face amount of $10,000 plus $1,648.19 in accumulated dividends and interest.

The Commissioner argued, and the court agreed, that neither the cost of the waiver of premium provision nor the waived premiums themselves could be included in the investment in the contract. Instead, the court treated the $11,648.19 as follows: (1) Only the $5,406 actually paid in cash was cost; (2) the difference between this $5,406 and the face amount, $4,594 ($10,000 - $5,406) was tax-free as an accident or sickness benefit; and (3) the entire $1,648.19, representing dividends and interest was taxable income.

The decision appears to be clearly erroneous. The disability benefit purchased by the waiver of premium is not a portion of the face amount of the policy but the premiums which fall due during disability. Consequently, some commentators ignore the decision and state that a

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correct interpretation of the law requires the inclusion of the waived premiums as part of the investment in the contract.