Defining Taxable Consumption: A Comment on Personal Insurance Premiums

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Professor Andrews has reminded us that taxable income is a proxy for identifying taxable savings and consumption\(^1\) and that the most pressing definitional problem is to distinguish taxable from nontaxable consumption, because a deduction for savings only postpones taxation until the time when the savings are consumed, but tax exempt consumption will never be taxed.\(^2\) The standards for defining taxable consumption, however, are vague and sometimes controversial. For example, on the income side, a discussion of fringe benefits offers as the standard for defining taxable consumption the taxpayer's "incremental well-being . . . above some base level of welfare," but then notes that "there is no uniquely preferable base to select."\(^3\) Similar uncertainty exists on the deduction side. A proponent of the medical expense deduction suggests that such expenses "reflect differences in need rather than choices among gratifications" but that the "distinction holds, to be sure, only as a general matter."\(^4\) And an analysis of charitable contributions urges that taxable consumption include only "private consumption of divisible goods and services."\(^5\) Not unexpectedly, these justifications for deducting medical expenses and charitable contributions have been sharply challenged.\(^6\)

The reason for the vagueness and controversy is not hard to find. The standards for defining taxable consumption give content to the principle of the fair tax base, which defines the individual's obligation to contribute to public expenditures. Like any important political principle, the fair tax base must be derived from the community's conception of the individual and the individual's relationship to the state, issues on which a precise and uncontroversial consensus is difficult to obtain. Although proof of a cause and effect relationship between political concepts and specific tax provisions seems impossible, we can hypothesize several

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\(^{2}\)Id., at 1115-16.


\(^{5}\)Id., at 346.

\(^{6}\)See S. Surrey, Pathways to Tax Reform 21 (1973).
ways in which such concepts might affect the tax system. For example, in a socialist society where people are expected to function more as community members than as self-willed individuals, we might expect more reliance on sales taxes, which cannot take account of variations in individual circumstances, than on income or consumption taxes, which can make such adjustments. And in a society as individualistic as ours, we might expect private decisions about whether or not to work in the market economy to be respected by excluding from the base leisure income (that is, the psychic benefit of leisure) and income from personal services performed for oneself, and we might also expect charitable contributions to be deductible on the theory that public goods do not provide enough individual gratification to be subject to tax.

This essay suggests that the standard for defining taxable consumption which best explains our existing tax system and which seems most compatible with our individualistic traditions is one that includes only expenses that express particular life-style choices. The strategy followed is to examine the existing rules dealing with personal expenses, with primary focus on arguments for and against the deduction of personal insurance premiums. This analysis indicates that the standard for defining taxable consumption as expenses for particular life-style choices has considerable explanatory power.

There are two possible objections to this strategy. The first objection is that the rules produced by the political process, especially as it applies to the tax law, are not principled. This cynicism seems to overstate a legitimate point. Political compromise, like any bargain, may be devoid of an animating principle. But legislation, no less than the common law, often proceeds in a piecemeal fashion to produce a principled pattern. Up close, the pattern can easily be missed but from a distance a distinct outline is often discernable.

The second objection is that the principle uncovered by an analysis of existing rules may be unpalatable. However, the purpose of this analysis is not to demonstrate either the wisdom or inevitability of a particular standard for defining taxable consumption. The purpose is to expose the operating principle to public debate. Indeed, there is an important relationship between rejecting the view that the political process is unprincipled and the rejection of any particular principle. As long as there is no effort to find patterns in the political process, the results are likely to retain greater vitality than would be the case if there were open discussion of underlying principles.

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2. Although there is no constitutional obstacle to requiring work as a form of taxation, see Butler v. Perry, 240 U.S. 328 (1916), such a tax would be very unpopular. The relationship of welfare recipients to the government, however, differs sharply from that of taxpayers and work requirements are a standard feature of welfare programs. Cf. Wyman v. James, 400 U.S. 309, 343 (1971) (Marshall, J., dissenting) (contrasting treatment of taxpayers and welfare recipients).
3. See Andrews, supra note 4, at 346.
Personal insurance premiums buy protection against personal risks, the most common examples of which are insurance against loss of personal property, term life insurance, and nonoccupational medical and disability insurance. The current tax law treats these premiums, with the exception of medical insurance premiums, as nondeductible personal expenses, in sharp contrast to business insurance premiums which are usually deductible. Before developing a theory to justify this treatment of personal insurance premiums, however, we must focus on two preliminary issues. First, we must address the question whether an expenditure is consumption, in the sense of being a current expense, or savings. If an expenditure is savings, not consumption, it is not deductible when incurred even if it falls in the income-producing sphere of an individual's activities, but is deductible as a cost when the asset is sold or otherwise disposed of. For example, an expenditure for a building is not deductible when incurred, whether or not the building is used as a personal residence or place of business, but would be deducted in arriving at gross income when the building was sold. The distinction between savings for income-producing and for personal purposes is, to be sure, an important one because the availability of depreciation and loss deductions often turns on that distinction. But the sharpest disputes are over the deductibility of expenditures that are for consumption because an expenditure for consumption is deductible when incurred or not at all.

Second, the question whether the expenditure falls in the personal or

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10 Only term life insurance is discussed because life insurance with a cash value includes a savings feature as well as pure insurance protection.

11 Disability insurance compensates the insured for loss of use of part of the body or loss of income resulting from sickness or accident. It is “nonoccupational” if the disability does not arise out of and in the course of employment. Workers Compensation is the best known occupational disability insurance.


But see I.T. 3607, 1943 C.B. 110 (nonoccupational disability insurance premium is a deductible business expense). This ruling does not explicitly describe the disability insurance as nonoccupational, but a recent case McGowan v. Commissioner, 67 T.C. 599 (1977) characterized the insurance in I.T. 3607 as the same as that dealt with in Rev. Rul. 75-148; 1975-1 C.B. 64, which involved nonoccupational disability insurance. See also Rev. Rul. 55-264, 1955-1 C.B. 11 (premiums deductible if insurance proceeds replace overhead expenses).

14 Treas. Reg. § 1.162-1(a) (1958); § 1.446-1(c)(1)(1957); § 1.461-1(a)(1)(1957). See Louis S. Cohn, Co. v. Commissioner, 12 B.T.A. 1281, 1284 (1928) (premium deductible when paid even though insurance contract cancelled in the following year; refunded premium taxable in year of refund). Occasionally, business insurance premiums are capital costs; see infra note 32.


16 I.R.C. § 167(a) limits depreciation deductions to business and income-producing property. I.R.C. § 165(c) allows loss deductions for business and income-producing property, but allows deductions for personal losses only in certain situations.
income-producing sphere of activity must be considered before we can explore the deeper meaning of taxable consumption. The definition of taxable consumption clearly excludes income-producing expenses because they do not provide the taxpayer with personal gratification. The interesting problems only arise when we must decide whether a personal expense ought to be included in the tax base. As it turns out, an analysis of personal insurance premiums provides an excellent opportunity to distinguish between consumption and savings and between personal and income-producing expenses, as well as an occasion to consider the definition of taxable consumption.

**CONSUMPTION OR SAVINGS**

The term "consumption" usually refers to "personal" expenses rather than expenses incurred for income production. However, "consumption" also refers to "expenses" as contrasted with capital costs. Capital costs, unlike expenses, provide value for the taxpayer's future use and are taxable when incurred because savings are subject to income tax whether or not they are allocated to the taxpayer's personal or income-producing sphere of activity. Insurance premiums would be capital costs if they were considered costs of producing future insurance proceeds. In that event, the premiums would not be deductible when incurred but their deduction would be deferred until the investment in the insurance policy became useless or was disposed of. If an insured loss did not occur, the investment would no longer be useful and the premiums would be deducted when the period of insurance coverage expired. If an insured loss occurred, the investment would be disposed of in exchange for insurance proceeds and the cost of the insurance would be deducted from the insurance proceeds, unless the taxpayer elected to defer tax by reinvesting the proceeds in similar property. If such an election were

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17See, e.g., Andrews, supra note 1, at 1114.

18The Supreme Court has stated that the test is whether there is a "separate and distinct additional asset." Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 354 (1971). As a descriptive test, however, this phrase misses the mark. For example, expenditures which provide intangible value may not satisfy this test, but are often capital costs. See, e.g., Woodward v. Commissioner, 397 U.S. 572 (1970), where the Court required capitalization of appraisal fees incurred by a corporation to acquire its own stock, even though such stock is not an asset after the corporation acquired it. Moreover, this test may be misleading if it equates a capital expenditure with the creation of a physical asset or an asset recognized by property law. See Gunn, The Requirement that a Capital Expenditure Create or Enhance an Asset, 15 B.C. IND. & COMM. L. REV. 443 (1974).

19I.R.C. § 165(c)(1), (2). The difference between a current deduction and deferral of a deduction until a later time when the insurance coverage expires may be inconsequential if the effect is only to defer the deduction one year. Nonetheless, the distinction between an expense and a cost is important because insurance premiums which are costs would not necessarily be deducted in the year coverage expired if the taxpayer elects to defer tax by reinvesting the insurance proceeds; see I.R.C. § 1033.


21I.R.C. § 1033. Deferral of the deduction until the proceeds are collected or until the
made, the cost of the insurance would be carried over as part of the cost of the replacement property.\textsuperscript{22}

Insurance premiums incurred to protect against business risks, are usually treated as current expenses,\textsuperscript{23} not capital costs. The choice between viewing insurance premiums as expenses or capital costs is not completely obvious, however. As a general proposition, some types of expenditures are clearly capital costs, such as savings account deposits, because they acquire a separate item of property with a long life.\textsuperscript{24} And we have little trouble deciding that an expenditure for a roof shingle, though a long-lived asset, is a deductible expense incurred to maintain a building.\textsuperscript{25} It is often unclear, however, whether an expenditure ought to be considered for tax purposes as the cost of a separate long-lived item of property or as an expenditure which maintains another item of property.\textsuperscript{26} How, for example, should expenditures to correct land drainage problems be treated; do such expenditures maintain the taxpayer's income-producing capacity or acquire separate income-producing assets with future value to the taxpayer?\textsuperscript{27} Similarly, insurance premiums might be viewed as expenses to maintain income production or as capital costs of the insurance policy with a potential for future income production.\textsuperscript{28}

replacement property is disposed of will probably result in the income being taxed as capital gains because the insurance proceeds or the proceeds realized on disposition of the replacement property is likely to be taxed as a sale or exchange of a capital asset. I.R.C. § 1231(a). However, if the proceeds replace lost profits, they are taxed as ordinary income; Shakertown Corp. v. Commissioner, 227 F.2d 625, 628 (6th Cir. 1960).

\textsuperscript{22}I.R.C. § 1033 (b).

\textsuperscript{23}See supra note 14. \textit{But see infra} note 32, citing examples of business insurance premiums which are capital costs.

\textsuperscript{24}See Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 354 (1971) ("a separate and distinct additional asset").

\textsuperscript{25}United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) ("Certainly the expense incurred in the replacement of a broken windowpane, a damaged lock, or a door, ... may well be treated as a deductible repair expenditure even though the benefits endure quite beyond the current year.").


\textsuperscript{27}Mt. Morris Drive-in Theatre Co. v. Commissioner, 25 T.C. 272, 275 (1955), aff'd, 238 F.2d 85 (6th Cir. 1956) (deduction disallowed — "acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system."). \textit{But cf.} American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376-77 (1948), aff'd, 177 F.2d 200 (6th Cir. 1949) (deduction allowed); Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 642-43 (1950) (deduction allowed); Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471, 482-83 (1967) (deduction allowed).

\textsuperscript{28}The question might be avoided if the tax consequences of distinguishing between a current expense and a capital cost are so small that making the distinction is not worth the effort. There are two rules which implement that policy. First, small recurring expenditures are deductible as current expenses even though they acquire long-lived assets when the difference between depreciation of capital costs and current expensing is negligible. Cincinnati, N.O. & T.P. Ry. v. United States, 424 F.2d 663, 672 (Ct. Cl. 1970). Second, expenditures are generally deductible if they acquire assets with a life that does not extend substantially beyond the taxable year in which they are incurred. Treas. Reg. § 1.461-1(a)(1), (2) (1957).

However, when these rules of convenience result in distortion of income, the expen-
This question must be resolved by reference to common understanding of the function of the expenditure for the taxpayer. Business insurance premiums are usually deductible expenses in the year they are paid, because they are commonly understood to maintain income-producing potential, not to provide the taxpayer with value lasting beyond the year when the premiums are paid. Indeed, the last thing the taxpayer wants is for the loss to occur and the proceeds to be collected.

Occasionally, however, insurance premiums are incurred primarily to produce future value and should be deducted only from the insurance proceeds when they are collected. This is clearly true of life insurance with a cash value, but it is also true of life insurance on a debtor's life. Such insurance should be viewed primarily as assuring the creditor that the debt will be collected in the future and the premiums should therefore be costs of debt collection. In this respect, life insurance premiums on a debtor's life are similar to the cost of a put, which allows the taxpayer to sell property at a price fixed by contract so that a decline in value will not produce a loss. The cost of the put is not deductible when incurred but instead reduces the proceeds of sale of the property disposed of by exercising the put, or, if the put is not exercised, the cost is deducted when the right to exercise the put expires. Puts, like insurance on a debtor's life, provide future value realizable upon disposition of property, rather...
than assure the taxpayer that an income-producing activity will continue despite a loss. With this exception, however, personal and business insurance premiums are expenses of maintaining the taxpayer's income in the event a loss occurs, not costs of producing the insurance proceeds.36

PERSONAL OR INCOME-PRODUCING EXPENSE

The discussion has so far suggested that insurance premiums are usually expenses of maintaining income which would be threatened if the insured risk materializes. Distinguishing personal from income-producing expenses for tax purposes is complicated, however, by the requirement that expenses "originating" in personal activities are personal expenses even if they maintain the taxpayer's flow of income. The leading case espousing the origin test is United States v. Gilmore,37 in which a taxpayer incurred expenses to maintain his income-producing property but was not allowed a deduction because the threat to his property originated in a personal marital dispute with his wife.38 The origin test is not self-defining, however. It cannot be mechanically applied or else it would be possible to trace most expenses back to some personal choice in which an activity originated. The personal decision to engage in a particular line of work, for example, is the remote physical cause of later business expenses. The purport of the origin test is that the distinction between income-producing and personal expenses depends on which decisions made by the taxpayer are considered most appropriate for characterizing a particular expense. Thus, the expenses in Gilmore are considered personal because the earlier personal decisions leading to the marital dispute are thought to dominate most subsequent related decisions, including the decision to resist claims by a spouse to income-producing property.39 By contrast, it is less certain that child care ex-

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36 The Internal Revenue Service has ruled that employee contributions to a disability plan which is not "insurance" are costs which reduce taxable disability benefits; Rev. Rul. 54-2, 1954-1 C.B. 30. The Ruling incorrectly assumes that if there is no insurance there must be a savings feature. But a savings feature exists only if payments in one year augment benefits in a later year. There is nothing in the cited ruling to suggest the presence of a savings element even if the payment was not for "insurance." See Note, Taxation of Employee Accident and Health Plans Before and Under the 1954 Code, 64 YALE L. J. 222, 224, n. 7 (1954) (criticizing Rev. Rul. 54-2).
38 Id. at 47-48, 51-52.
39 The implication of the Gilmore holding for deciding whether the expenditures should be added to the cost of the threatened property were not fully understood in Gilmore v. United States, 245 F. Supp. 383 (N.D. Calif. 1965), where the district court held that the Supreme Court had not decided whether the expenses could be added to the cost of the retained property. Despite some language suggesting that possibility, 372 U.S. at 52, the thrust of the Supreme Court's opinion was that the personal origin of the expenditure marked the expense as personal. That conclusion should prevent the expenditure from being related to income-production either as an expense or as a capital cost. Id. at 45-51. See also Hinkle v. Commissioner, 47 B.T.A. 670, 672 (1942).

Similar problems in deciding whether to allocate expenditures to personal or income-producing activities and whether they are current expenses or capital costs arise con-
expenses should be attributed to the taxpayer's earlier personal decision to have children rather than to a later decision to work.\textsuperscript{10}

The application of the origin test to personal insurance premiums is illustrated by the Revenue Rulings distinguishing taxes paid by an employee for Unemployment Insurance, which are deductible because they arise from carrying on trade or business,\textsuperscript{41} from taxes paid for nonoccupational disability insurance, which are not deductible because they are personal expenses.\textsuperscript{42} Unemployment Compensation protects against loss of income due to an economic slowdown.\textsuperscript{43} A deduction as a business expense might therefore be allowed on the theory that the expense is incurred to maintain income. However, that analysis proves too inclusive; it would allow a deduction for personal insurance premiums as well because they also maintain income. An analysis which better explains the distinction would follow the lead of the \textit{Gilmore} case. It would find the origin of expenses to maintain a flow of income from catastrophic loss in the nature of the risk to the flow of income, not in the effort to retain the income.\textsuperscript{44} But in what sense is the risk of economic slowdown a business risk? The risk does not necessarily arise from any special attribute of the taxpayer's employment, such as working in an industry which is becoming economically obsolete. The point is that the risk "originates"

\begin{footnotes}
\footnotetext[10]{Concerning expenditures to establish a taxpayer's reputation. \textit{See} Draper v. Commissioner, 26 T.C. 201 (1956) (deductible business expense); Welch v. Helvering, 290 U.S. 111, 115 (1933) (capital cost for business asset); Lloyd v. Commissioner, 55 F.2d 842 (7th Cir. 1932) (personal expenditure); Kleinschmidt v. Commissioner, 12 T.C. 921 (1949) (same).}
\footnotetext[41]{Compare Smith v. Commissioner, 40 B.T.A. 1038, 1039-40 (1939), \textit{aff'd} no opinion, 113 F.2d 114 (2d Cir. 1940) \textit{with} Feld, \textit{Deductibility of Expenses for Child Care and Household Services; New Section 214, 27 Tax L. Rev.} 415, 426 (1972). \textit{Cf.} F.Lowers v. Commissioner, 326 U.S. 465, 473 (1945) (commuting expenses incurred as a result of taxpayer's desire to live apart from work, not his desire to work).}
\footnotetext[42]{Rev. Rul. 75-48, 1975-1 C.B. 62; Rev. Rul. 75-156, 1975-1 C.B. 66. Business taxes are deductible under I.R.C. § 164(a). If the insurance payment is not a tax but pays for insurance against the same type of risk as Unemployment Insurance, it is a deductible business expense under I.R.C. § 162(a); I.T. 2888, XIV-1 C.B. 54, 56 (1935); I.T. 3096, 1937-2 C.B. 81; I.T. 3085, 1937-1 C.B. 64.}
\footnotetext[43]{If there is a savings element in contributions to an Unemployment Compensation plan, the expenditures are capital costs and the proceeds are taxable only if they exceed the cost. Rev. Rul. 59-5, 1959-1 C.B. 12; Rev. Rul. 57-383, 1957-2 C.B. 44; I.T. 1918, III-1 C.B. 121 (1924).}
\footnotetext[44]{Rev. Rul. 75-48, 1975-1 C.B. 62; Rev. Rul. 75-148, 1975-1 C.B. 64; Rev. Rul. 75-149, 1975-1 C.B. 64. In McGowan v. Commissioner, 67 T.C. 599 (1977), the court held that the Rhode Island tax in Rev. Rul. 75-148 was an income tax and therefore deductible even if it did not originate with a trade or business. The IRS originally accepted the \textit{McGowan} decision for Rhode Island only, IR-1742, 1/29/77, but then extended the decision to New York, New Jersey, and California, IR-1967,3/10/78. Nonoccupational disability insurance premiums which are not taxes are nondeductible personal expenses. \textit{See supra} note 13.}
\footnotetext[13]{\textit{Freeman, Able to Work and Available for Work}, 55 \textit{Yale L.J.} 123, 124 (1945). Personal activities may be the immediate occasion for losing a job without disqualifying the claimant, but the claimant is entitled to benefits only if he or she retains an attachment to the labor market which does not generate enough jobs. \textit{Id.} at 129-30; Menard, \textit{Refusal of Suitable Work}, 55 \textit{Yale L.J.} 134, 135, 147 (1945); Kempfer, \textit{Disqualifications for Voluntary Leaving and Misconduct}, 55 \textit{Yale L.J.} 147, 148-53 (1945).}
\end{footnotes}
with the business if it is generally viewed as a hazard of doing business. Thus, fire insurance is business insurance whether or not carrying on the business increases the risk of fire and Workers Compensation is business insurance whether or not the covered loss arises from any peculiar risk of the taxpayer's employment activity. Similarly, the risk of unemployment due to an economic slowdown originates from the employee's business activities because it is considered a normal hazard of being an employee.

Nonoccupational disability insurance protects against risks originating from personal activities in the same sense that Unemployment Compensation protects against a risk arising from business. In some instances, the link between the risk and personal activities may be very clear. Disability insurance for a taxpayer who engages in mountain climbing is as much an expense of that hazardous activity as the price paid for picks and shovels. But disability insurance usually protects against the risks which befall everyone in their daily personal activities in more or less the same way, without regard to the specific activities. The risks "originate" from personal activity because the risks of sickness and accident against which disability insurance protects are viewed as a normal hazard of everyday personal life. Similarly, life, personal property, and nonoccupational medical insurance also protect against risks which are considered normal hazards of personal life. The premiums are therefore personal consumption.47

**TAXABLE OR NONTAXABLE PERSONAL CONSUMPTION**

Once we conclude that personal insurance premiums are personal consumption, we are ready to consider whether they are taxable consumption. We already are accustomed to the idea that personal medical expenses should be excluded from taxable consumption pursuant to a standard that excludes personal expenses arising from need rather than

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42 Vickrey distinguished between the portion of the premium allocable to the risk and that portion required to defray expenses of the insurance company. He argued that the latter were personal expenses if the taxpayer's personal activity involved a special risk. *W. Vickrey, Agenda for Progressive Taxation* 63-64 (1947).

43 If personal insurance premiums were related to income-production, their deduction would be disallowed if the personal insurance proceeds were tax exempt. Rev. Rul. 66-262, 1966-2 C.B. 105. This justification for disallowing the deduction can be best explained by considering a hypothetical involving exempt life insurance proceeds. If the proceeds were used to purchase an annuity, the cost would be deducted from future income, see I.R.C. § 72(b), and the income shielded by the cost would never be taxed. The deduction for insurance premiums should therefore be disallowed when the proceeds are tax exempt because the flow of income shielded by the invested proceeds is exempt. Current law exempts proceeds from most personal insurance. See I.R.C. § 101(a) (life insurance proceeds tax exempt); §§ 104(a)(3) and 105(b) (medical insurance proceeds tax exempt); §§ 104(a)(3)
gratification. Admittedly, personal insurance premiums cannot be analogized to medical expenses on the theory that they arise from need. However, a closer analysis of the notion of taxable gratification will suggest why the premiums might not be taxable consumption.

We are all engaged in personal activities which, no matter what we do, carry the risks against which personal insurance protects. An accident prompts the statement, “That’s life,” and only occasionally do we attribute the misfortune to some personal activity peculiar to the taxpayer. The issue is whether the origin of insurance in the general undifferentiated personal life of a taxpayer is an argument against including the premiums in taxable consumption. Put another way, is the definition of taxable consumption limited to particular life-style choices? This standard for defining taxable consumption is not, of course, a necessary inference from the more general political concept of a fair tax base. But it deserves our careful consideration, given its close relationship to our historical attachment to the idea that the distinguishing mark of the individual personality is choice of particular life-style, what Boorstin calls the choice of “consumption communities.”

Admittedly, this intuition might not survive a trend towards a more communitarian, less individualistic view of the relationship of individual to society. Any change in philosophical attitude, however, would simply demonstrate the questionable validity of this analysis in the future, not deny its accuracy in explaining current law. Moreover, individualism might persist as the dominant strain in defining equitable taxation, where the issue is fairness in withdrawing private resources for public use, whatever may be its more general fate in shaping government regulatory or expenditure policy. The intuition that taxable consumption includes only expenditures for particular life-style choices is therefore

and 105(c), (d) (disability proceeds excluded from income, except that proceeds are only partially excluded if employer buys the disability insurance for the employees as a tax-free fringe benefit). With one exception proceeds of personal property insurance are taxed in the same manner as the lost item which they replace. Proceeds compensating for the loss of property itself are taxed as an amount realized on the disposition of property; McCabe v. Commissioner, 54 T.C. 1745, 1748 (1970). The exception is the exclusion of reimbursements for living expenses exceeding normal living expenses when a casualty prevents the taxpayer from living in his principal residence. I.R.C. § 123.

However, if the premiums are personal consumption, rather than being related to production of the insurance proceeds, their deduction should not be disallowed just because the proceeds are tax-exempt. Cf. Hughes v. Commissioner, 65 T.C. 566 (1975) (dissenting opinion) (expenses to move to foreign country deductible under § 217 even though foreign personal service income is exempt from United States tax, because the deduction for moving expenses is not a deduction for income-producing expense).

"See supra note 4. The extra personal exemption for blindness is another example of a deduction which adjusts the tax base for diminished gratification. I.R.C. § 151(d). On the income side, the exclusion of disability benefits is sometimes justified on this basis; see Epmeier v. United States, 198 F.2d 508, 511 (7th Cir. 1952).


sufficiently plausible to warrant looking more closely at existing law to
determine its explanatory power.31

General Sales Taxes

The law allows a taxpayer to deduct sales taxes imposed on a broad
range of items.42 This deduction is usually defended as an effort to main-
tain federal neutrality with respect to state and local taxes.43 However, it
can also be defended on the basis of a standard limiting the tax base to
expenditures for particular life-style choices. The argument for this con-
clusion comes into focus if we analyze the weaknesses and strengths of
the argument that the general sales tax should be deductible because it is
a forced payment extracted from the consumer.44 Certainly the fact that a
payment is not voluntary is some evidence that it does not provide the
consumer with sufficient gratification to be taxable consumption.
Casualty losses, for example, do not qualify as taxable consumption be-
because they are involuntary,65 but losses on property voluntarily given to
charity are not deductible.56 There are important qualifications to the
deductibility of forced payments, however, which shed light on the defini-
tion of taxable consumption. First, deduction for all forced payments
would destroy the origin test.57 Mr. Gilmore was in a sense forced by his
wife's lawsuit to pay lawyers' fees to defend his property but the origin of
the expenditure in his personal life justified disallowing the
deduction.58 Second, selective sales taxes are forced exactions originating in the tax-
payer's consumption decisions and would be deductible if all forced
payments could be deducted. But if forced payments are characterized

31Surrey suggests that defining consumption is not relevant under an income tax. S. SUR-
REY. supra note 6, at 20-21. However, deciding whether employer-provided fringe benefits
are taxable income inevitably involves a definition of taxable consumption, see Note, supra
note 3, at 1144-48, and there is no reason why the definition should be relevant only to
receipts and not expenditures.
42A deduction for all state sales taxes appeared in the Int. Rev. Code of 1913, ch. 16, § 11
G(b), 38 Stat. 174. In 1964, the deduction was limited to general sales taxes. The Senate
Finance Committee explicitly based the deduction on the importance of maintaining
neutrality among major sources of state revenue. S. Rep. No. 830, 88th Cong., 2d Sess. 54
(1963). The point in the text is that the deduction may, as at least one other commentator
has noted, be justified by reference to considerations of fairness as well as federal-state
fiscal relations. See Brazer, The Deductibility of State and Local Taxes under the In-
dividual Income Tax, in 1 TAX REVISION COMPENDIUM 407, 416-17 (House Comm. on Ways
and Means, 86th Cong., 1st Sess., Comm. Print 1959) (most families lack freedom to choose
among taxed and untaxed items).
43The dominant economic view is that such taxes are borne by consumers. Due, Sales and
sales tax, however, a general sales tax affects consumption only by reducing income. R.
MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 446-48 (1973); P.
44I.R.C. § 165(c)(3).
46See supra note 37-40 and text accompanying.
47372 U.S. at 42, 49.
for tax purposes by reference to their origin, both general and selective sales taxes would be taxable consumption because they originate in the taxpayer's decision to consume in accordance with his particular preferences. General sales taxes can be deductible, therefore, only if they differ from selective sales taxes in some manner that is significant for defining taxable consumption.

The critical difference between general and selective sales taxes lies in the fact that a selective sales tax can be avoided by not indulging a preference for the particular consumption item subject to the tax, but a general sales tax can be avoided only by foregoing consumption altogether. Even if the general sales tax falls on something less than all consumption, it can be avoided only by choosing to forego consumption of a large group of items. The argument for deducting the general sales tax rests on a judgment that it asks too much of a taxpayer to avoid a burden falling indiscriminately on a wide range of consumption items rather than on particular consumption items.

The point is similar to one frequently made in the context of conditions on receipt of welfare. A welfare claimant may obtain benefits conditioned on accepting burdens or may choose to reject the benefits, but courts have sometimes refused to consider this choice "voluntary" and have prohibited imposition of the condition. Describing the choice as "in voluntary" is not meant to describe mental processes but to pass normative judgment on the nature of the choice. In the tax context, this judgment would lead to the view that a condition on consumption in the form of a forced payment that cannot reasonably be avoided should not be taxable consumption. This principle, as it applies to a burden falling on a wide range of consumption items, translates into the standard for defining taxable consumption discussed earlier, that only expenses for

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39Both general and selective sales taxes affect different consumers differently, depending on their particular preferences. This can be seen graphically from constructing a demand curve from the tangency of budget lines to an individual's indifference curves. The demand curve depends on the location of the particular individual's indifference curve tangent to the budget line created by the tax. See D. Watson, Price Theory and Its Uses 103 (3d ed. 1972).

40Hagans v. Wyman, 399 F. Supp. 421, 423 (E.D.N.Y. 1975) (welfare recipient's decision to accept rent payment conditioned on sacrificing future welfare benefits is not a "voluntary" consent to reduction of future payments). But see Wyman v. James, 400 U.S. 309, 317-18, 324 (1971) (welfare can be conditioned on home visit).


42Similar reasoning underlies the view that income should be adjusted for inflation, even after the costs of generating income have been adjusted so that costs and receipts are measured in dollars having the same purchasing power. The effects of inflation on income appear to fall indiscriminately on all consumption and therefore call for some adjustment of the tax burden. See Aarons, Inflation and the Income Tax in Inflation and the Income Tax 6, 23-26 (H. Aaron ed. 1976). The argument for adjusting the tax burden for inflation is weaker, however, than the argument for deducting general sales taxes because inflation
particular life style choices are taxable consumption. The choice of particular items is "voluntary" and costs imposed only on those items can fairly be included in the tax base, but a decision to consume a wide range of items cannot reasonably be considered "voluntary" and the cost of a burden on that choice is therefore not taxable consumption.

Interest on Loans for Current Personal Consumption

The deduction of interest on loans for current personal consumption can also be defended on the ground that it is not taxable consumption. To see why that is so, we must distinguish loans for current personal consumption, such as a vacation, from loans to acquire personal assets, such as a residence.

The use of personal assets clearly provides the owner with taxable consumption analogous to rent. That does not mean, however, that interest on loans to acquire such assets should be a nondeductible personal expense. Expenses to produce personal consumption are nondeductible personal expenses when the value they produce equals the expense. If there is a discrepancy between the expense and the value produced, the correct tax result is obtained only by including the consumption in income and deducting the expense incurred to produce that income. For example, if interest is $100 and gross rental value is $90, the correct result is a $10 loss, produced by a $100 deduction and a $90 gross income. Disallowing the $100 deduction would overstate the taxpayer's income. If gross rental value is $110, there should be $10 net gain, which is avoided if gross income excludes the $110 rental value from income, even if the interest is not deductible. Disallowing the interest deduction can only be justified as an effort to include some or all of the rental value of the property in the tax base, thereby reducing the discrepancy between borrowers and renters. Because the underlying problem is the exclusion of the rental value from income, however, this solution will discriminate in favor of taxpayers who finance the acquisition of personal assets out of

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4See text accompanying notes 49-51 supra. A deduction for selective sales taxes imposed at a rate less than the general sales tax can be justified on the ground that the selective sales tax is avoidable only at the price of paying a higher tax. I.R.C. § 164(b)(2)(C) (sales tax on certain items deductible if less than general sales tax rate). The deduction of selective sales taxes is also justified if the taxed items are necessities, which cannot be "voluntarily" foregone.

5I.R.C. § 163(a).

6Andrews, supra note 1, at 1155-59.

7This problem also arises in the case of bargain sales to employees. Treas. Reg. § 1.61-2(d) (1977) (taxing bargain sales); but see Proposed Fringe Benefit Regulations, 40 Fed. Reg. 41118, 41120 (1975)(example 3).

savings, as a result of their being permitted to exclude rental value from income.\(^8\)

When interest is paid on loans for current personal consumption, the analysis of the interest deduction raises very different issues. The interest should be nondeductible personal consumption only to the extent it produces an equivalent return in personal consumption. However, unlike interest on loans to acquire personal assets which produce value that should be taxable income, it is by no means clear that interest on loans to finance current personal consumption produces taxable consumption. If, for example, an individual borrows $1000 to pay for a vacation, it is far from certain that the individual's taxable consumption should be $1000 plus interest, rather than $1000. Unquestionably, the borrower has obtained something he did not have before, namely a vacation now rather than later. But the "nowness" of consumption is not necessarily an item of taxable consumption.

We might argue that the interest measures taxable consumption on the theory that current consumption foregoes future income in the amount of the interest paid and foregone income is good evidence of the value of taxable consumption.\(^9\) There are two defects in this argument, however. First, foregone income is good evidence of value only when the income is foregone at the same time that the consumption is enjoyed, as when a taxpayer enjoys his home rather than renting it. Second, the ability to value consumption does not demonstrate that it ought to be taxed. We might argue against taxing such value on the ground that the individual who finances current consumption out of savings enjoys the same acceleration of consumption as the borrower, but is not taxed on that value. However, we often encounter situations where some consumer surplus is tax exempt but equivalent value is taxed if it is paid for by the taxpayer. The "nowness" of current consumption might therefore be taxable consumption even though self-financing consumers would avoid tax on this value.\(^10\)

A conclusion about taxing the value of consuming now rather than later can only be reached, therefore, by squarely confronting the question whether "nowness" should be taxable consumption. The answer to that question emerges from a consideration of the costs confronting a taxpayer who is deciding when to consume. When a taxpayer decides

\(^{8}\)This discrepancy now exists as a result of several Code provisions. I.R.C. \$ 189(a) disallows deductions of construction period interest, even though self-financing builders do not add this value to cost. This provision equalizes borrowers with taxpayers who buy the asset from someone else. I.R.C. \$ 265(2) disallows an interest deduction to produce tax-exempt income but self-financing taxpayers enjoy the exemption of the entire return on the invested assets. See Denman v. Slayton, 282 U.S. 514, 519-20 (1930) (discrimination between borrower and self-finance constitutional).


\(^{10}\)See Klein, Timing in Personal Taxation, 6 J. LEG. STUD. 461, 470 (1977).
whether to consume now rather than later, he is confronted with an interest cost or a cost in the form of foregone income which is proportional to the price of the items. For example, if interest is 10%, the borrower confronts a 10% increase over the price of the purchased items, whatever the price. That burden, like the burden of a general sales tax, falls indiscriminately on all consumption items and can be avoided only by giving up consumption, not by sacrificing any particular consumption item. The same reasoning that excluded general sales taxes from taxable consumption would therefore exclude from the tax base interest on loans for current personal consumption.

Personal Insurance Premiums

At this point in the analysis, personal insurance premiums would be excluded from taxable consumption because they originate from risks associated with the taxpayer's general personal activities, not particular life-style choices. There is, however, another feature of personal insurance which requires instead that the premiums be taxable consumption. Personal insurance premiums are an expression of particular consumption preferences because they indulge the taxpayer's preference for economic security in the conduct of personal activities, even though the personal activities from which the premiums originate are not an expression of a particular life-style. The preference for security is as much an item of taxable consumption as the choice of particular food, clothing, or shelter. Personal insurance premiums should therefore be taxable consumption because of what they buy for the taxpayer, not because of the activity from which the expenditures originate.

Several objections might be made to including individual preference for security in taxable consumption. First, security is a subjective state of mind and no tax system can effectively measure the tax base subjec-

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1 An analogous argument can be made for not deducting general sales taxes if government benefits received for tax payments coincided more or less with taxpayer preferences. This argument for including sales taxes in the tax base is rejected by Professor Bittker on the ground that preferences for government expenditures are not measured by taxes. Bittker, Income Tax Deduction, Credits, and Subsidies for Personal Expenditures, 16 J. LAW & ECON. 193, 200-01 (1973).

2 See H. SIMONS, PERSONAL INCOME TAXATION 97 (1938) ("[I]t seems hard to deny that acquisition of property rights may mean increase of power, greater freedom, security, prestige, and respectability. These are as much objectives of endeavor as are lapels on one's coat or diamonds on shirt fronts.")

Security was a relevant factor in determining taxable income in the following cases: United States v. Basye, 410 U.S. 411, 453 (1973) (partnership income taxed to partners, even though it was diverted by prior agreement to a pension plan trust, in part because retirement income security is a benefit taxpayers often seek); United States v. Drescher, 179 F.2d 863, 867 (2d Cir. 1950) (Clark, J., dissenting in part) (nonassignable annuity provided by employer taxable because security is taxable economic benefit); Egtvedt v. United States, 112 Ct. Cl. 80, 95 (1948) (return on capital can be taxed because investment provided security).
But eschewing a subjective measure of taxation is intended to avoid the problem of making individual case by case determinations of subjective enjoyment in defining the particular individual's tax base. A consensus about subjective enjoyment is nonetheless embedded in the idea that gratification should be taxed and is used to determine whether the U.S. dollar value of expenditures is the appropriate tax base. When we can reasonably assume that in most instances subjective enjoyment is far less than the taxpayer's expenditure, as in the case of medical expenses and casualty losses, the taxpayer is allowed a deduction. Similarly, when an expenditure is likely to be less than the enjoyment received, we are reluctant to let the expenditure measure taxable consumption, as in the case of employee bargain purchases. And when expenditures cannot be made in U.S. dollars, as in the case of income received in nontransferable foreign currency by a taxpayer living abroad, the taxable amount must be measured by reference to the normal standard of living of a U.S. resident living in the foreign country in order to approximate the level of gratification enjoyed by the taxpayer. Subjective enjoyment is therefore a necessary underlying principle in defining taxable consumption, even though the objective market value of expenditures usually measures the taxable amount.

Second, the enjoyment from security might be considered too intangible to be taxed. Certainly no effort would be made to tax many of life's intangible pleasures, such as watching sunsets. But all consumption produces intangible states of mind, whether the expenditure is for food,
clothing, shelter, or security. Whether the consumption should be taxed depends on whether the enjoyment is achieved by an expenditure of resources to which society can lay claim. Simply enjoying a sunset while walking along a beach is an essentially private activity, but the enjoyment is taxed to the extent it is reflected in the purchase price of a vacation seaside cottage. For the same reason, security acquired through purchase of personal insurance is taxable consumption.

This rationale for taxing personal insurance premiums has broad implications for the definition of taxable consumption. If the purchase of security in the conduct of personal activities justifies taxing personal insurance premiums, then it seems unfair to allow the security derived from wealth to go untaxed. Wealth is, of course, a stock, not a flow, and it is difficult to impute a use value to wealth. But at least one country made the effort through legislation, by adding a fixed percentage of wealth to the individual’s income tax base. Admittedly, a similar provision would pose constitutional problems in the United States and the administrative burdens of ascertaining and measuring wealth are formidable. Nonetheless, if an effort to tax the security from wealth is not made, the fairness of taxing personal insurance premiums can be questioned because taxable consumption arising from different sources would be taxed differently.

CONCLUSION

The discussion of personal insurance premiums opens up a wide range of fundamental questions about the tax base. The major substantive conclusions are (1) that premiums for personal insurance are current expenses to maintain a flow of income, rather than capital costs of producing insurance proceeds; (2) that the premiums originate from the tax-

8Andrews, supra note 1, at 1169-70.
10If the tax is a direct tax but not a tax on income, it must be apportioned among the states according to population. U.S. Const., art. I, § 9 and amend. XVI.
13Inequality in taxing personal insurance already exists because insurance purchased by employers is often tax free to employees. See I.R.C. § 79 (group term life insurance) and I.R.C. § 106 (medical and disability insurance).
payer's personal sphere of activity because they protect against the normal risks of everyday personal life; (3) that this fact alone is insufficient to justify their taxation because the activities giving rise to the expenses do not express particular life-style choices, which in our society seems to be the standard for defining taxable consumption; (4) that personal insurance premiums should nonetheless be taxable, because they express a particular preference for economic security in the conduct of personal life; with the proviso (5) that there is an element of unfairness in taxing security purchased through insurance if security is untaxed when it is derived from wealth.