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## YALE LAW & POLICY REVIEW

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### Using Insurance Law and Policy To Interpret the Tax Code's Loss and Medical Expense Provisions

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## INTRODUCTION

Nancy and Robert Madsen co-owned and operated the Pit Stop Bar & Grill in Cushing, Wisconsin from 1979 until 1982, when Robert intentionally set the tavern ablaze, destroying the establishment.<sup>1</sup> Nancy had no prior knowledge of her husband's plans, nor any involvement with the arson. On their joint income tax return, she deducted one-half of the loss resulting from the fire as a loss under Tax Code § 165,<sup>2</sup> reasoning that she owned one half of the property destroyed.<sup>3</sup> The Tax Court, however, could find no tax case law or IRS regulations on point, and instead disallowed the deduction on other grounds.<sup>4</sup>

Several years after *Madsen*, Louis Kaplow published an article recognizing that Tax Code § 165, which allows a deduction for losses, including losses from fire, and § 213, which authorizes deduction of medical expenses, constitute a free partial insurance scheme.<sup>5</sup> The taxpayer's co-pay amounts

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1. *Madsen v. Comm'r*, 57 T.C.M. (CCH) 1307 (1989).
  2. I.R.C. § 165(a) (2000) ("There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.").
  3. The parties agreed that Robert could not deduct his half. *Madsen*, 57 T.C.M. (CCH) at 1308.
  4. These grounds—that Madsen had a "reasonable prospect" of recovery against their insurer at the Wisconsin Supreme Court, and hence that the loss might be "compensated for by insurance or otherwise"—turned out to be an empty hope. See *Madsen v. Threshermen's Mut.*, 443 N.W.2d 311 (Wis. 1989) (denying review). The case law says nothing more about the history of Nancy and Robert Madsen, but there are indications that Nancy might have eventually gotten some recovery from the insurance company. See *Madsen v. Threshermen's Mut. Ins. Co.*, 439 N.W. 2d 607, 613-14 (Wis. 1989).
  5. Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991) (first recognizing that §§ 165 and 213 are a type of insurance and arguing for their abolition) [hereinafter Kaplow, *Deductions*]; see

to 100% minus the marginal tax rate, with deductibles (in the insurance sense of the word) applying to individual taxpayers in some situations.<sup>6</sup> This important insight provides a potential solution for cases such as *Madsen*, where no tax cases or regulations help resolve the issue. In these cases, the IRS and federal courts could draw upon the rich and well-developed insurance case law and scholarship.<sup>7</sup> In insurance law terms, Nancy Madsen faced the problems of an “innocent co-insured,” which have been addressed by multiple courts and commentators.<sup>8</sup> LexisNexis even has a subject header dealing with innocent co-insureds.<sup>9</sup>

Substantial sums of money can hang in the balance. Combined federal, state, and local marginal tax rates easily reach 50% for many individuals and corporations.<sup>10</sup> Without having paid any “premium,” taxpayers get this

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*also* Louis Kaplow, *Income Tax Deductions for Losses as Insurance*, 82 AM. ECON. REV. 1013 (1992) [hereinafter Kaplow, *Insurance*].

6. I.R.C. § 56(b)(1)(B) (2000) (Alternative Minimum Tax requires medical losses reach 10% of Adjusted Gross Income); *id.* § 165(h)(1) 2000(\$100 limitation per casualty for individuals); *id.* § 165(h)(2) (individuals must exceed 10% of Adjusted Gross Income before deducting casualty losses); *id.* § 213(a) (individuals must exceed 7.5% of Adjusted Gross Income before deducting medical losses). The thresholds in § 165 do *not* apply for corporations or individuals engaged in trade, business, or for-profit transactions; viewed from a different perspective, the deductions are \$0. *Id.* § 165(c)(1)-(c)(2).
7. For example, there have been treatises on insurance law since the nineteenth century. *E.g.*, ROBERT C. CUMMING & FRANK B. GILBERT, *THE INSURANCE LAWS OF THE STATE OF NEW YORK* (1899); CHARLES FRANCIS MORRELL, *INSURANCE: A MANUAL OF PRACTICAL LAW* (Adam Black & Charles Black eds., 1892).
8. *See, e.g.*, *Williams v. Auto Club Group Ins. Co.*, 569 N.W.2d 403 (Mich. Ct. App. 1997); *Watson v. United Servs. Auto. Ass’n*, 566 N.W.2d 683 (Minn. 1997); *Allstate Ins. Co. v. LaRondeau*, 622 N.W.2d 646 (Neb. 2001); Michael Vincent Laurato, Sr., *A Return to Innocence: One Good Reason (Along with Several Other Arguments) Why the Extension of Florida’s Innocent Co-Insured Doctrine Makes Good Public Policy Sense*, 7 FLA. COASTAL L. REV. 59 (2005); C.T. Newsum, *Haynes v. Hanover Insurance Co.: Good News for the Innocent Co-Insured*, 19 CREIGHTON L. REV. 1076 (1986); Leane English Cerven, Note, *The Problem of the Innocent Co-Insured Spouse: Three Theories on Recovery*, 17 VAL. U. L. REV. 849 (1983).
9. “Insurance Law > Property Insurance > Innocent Insured Parties.” Westlaw provides extensive coverage of innocent coinsured law via Key Number 217k2166 (acts of insureds).
10. I.R.C. § 11(b)(1) (West Supp. 2006) (top corporate tax rate is 35%); *id.* § 1(a) (top individual rate is 39.6%, with Bush’s tax cuts temporarily lowering this to 35%). State income taxes often add nearly 10% to this top marginal tax rate. *See* FED’N OF TAX ADM’RS, *STATE INDIVIDUAL INCOME TAXES* (Jan. 1, 2007), [http://www.taxadmin.org/fta/rate/ind\\_inc.html](http://www.taxadmin.org/fta/rate/ind_inc.html) (highest being California at

insurance for free, with a “co-pay” as low as 50% applying.<sup>11</sup> Kaplow develops models showing how this free insurance discourages many from buying private insurance and creates a moral hazard.<sup>12</sup> While Kaplow suggests abolishing §§ 165 and 213,<sup>13</sup> this Note accepts the continued political vitality of these provisions and argues for using the law developed around private insurance to mitigate these problems and improve the functioning of this free insurance.

Part I of this Note gives a brief overview of §§ 165 and 213. Part II looks at a number of actual and hypothetical tax issues arising under these sections and shows how the application of insurance law principles leads to an equitable and efficient result. While this approach has great promise, it also has limitations. Part III examines three limitations of applying insurance principles in the tax context and explores what they reveal about the nature of §§ 165 and 213. Part IV considers the details of implementing this Note’s proposals, including its interaction with state law and its statutory basis. In light of Congress’s current push for additional tax revenues, Part V proposes a novel method for the IRS to increase revenues, using a legal tool often employed by private insurers: subrogation.

## I. BRIEF OVERVIEW OF SECTIONS 165 AND 213

### A. Section 165 Losses

The general rule of § 165 allows corporations and individuals to take “as a deduction any loss sustained during the taxable year and not compensated for by *insurance* or otherwise.”<sup>14</sup> This broad language encompasses a wide

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[http://www.taxadmin.org/fta/rate/ind\\_inc.html](http://www.taxadmin.org/fta/rate/ind_inc.html) (highest being California at 10.3%); FED’N OF TAX ADM’RS, RANGE OF STATE CORPORATE INCOME TAX RATES (Jan. 1, 2007), [http://www.taxadmin.org/fta/rate/corp\\_inc.html](http://www.taxadmin.org/fta/rate/corp_inc.html) (highest being Iowa at 12%).

11. For a taste of the philosophical justifications behind these deductions, see Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989). Note that the overall limitation on individuals’ itemized deductions in § 68 does not apply to the two sections covered in this Note. I.R.C. § 68(c) (2000).
12. See Kaplow, *Insurance*, *supra* note 5; see also Robert K. Lu, Note, *Gross Negligence and the Medical Expense Deduction*, 71 S. CAL. L. REV. 845 (1998) (showing how barring § 213 medical expenses deductions due to the taxpayer’s gross negligence would increase social well-being). Some have argued that the entire income tax acts as a form of consumption insurance. See Thomas J. Kniesner & James P. Ziliak, *Explicit Versus Implicit Income Insurance*, 25 J. RISK & UNCERTAINTY 5 (2002).
13. See Kaplow, *Deductions*, *supra* note 5, at 1509-10.
14. I.R.C. § 165(a) (2000) (emphasis added).