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The Effect of Federal Tax Liens on the Cash Value of Life Insurance Policies

The Government has sought by various means to enforce its tax liens against the contractual property rights in life insurance policies owned by delinquent taxpayers. The normal but expensive and time-consuming method of foreclosure has resulted in the diminution in value of the lien through the application of the cash value to various benefits under the policy prior to collection by the Government. However, the courts have refused to allow summary recovery by levy upon the cash value in the hands of the insurer. The author of this Note discusses the remedies currently used by the Government to reach cash value and the obligations of insurers to protect the value of the Government's liens. He concludes by discussing proposals for affording the Government better protection, without prejudicing the interests of insureds and their beneficiaries in the insurance feature of the policies or imposing undue burdens upon insurers.

INTRODUCTION

A lien in favor of the United States automatically attaches to all property of any person who neglects or refuses to pay any federal tax after demand. This tax lien is general in nature and 1. Int. Rev. Code of 1954, § 6321 provides:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.


applies to all of the taxpayer's property and rights to property — tangible and intangible. It is a continuing lien in that it also attaches to property or rights to property acquired by the taxpayer subsequent to his default and to increments in the value of property held by him when the lien arises. Although the value of a lien may be reduced or lost through destruction or dissipation of the property subject to it, it is not defeated by a change in the form of the property. The attachment of a lien merely establishes a governmental interest in the taxpayer's property. Thereafter, the Government must move under appropriate statute to collect the delinquent taxes from the property subject to it.

The lien attaches to a delinquent taxpayer's contractual property rights in life insurance policies owned by him. In United States v. Bess, the Supreme Court held that the taxpayer's right to receive the cash value was "property or rights to property" and thus subject to the tax lien. However, the owner of a typical life insurance policy possesses certain rights the exercise of which during the period between the effective date of a tax lien and

3. E.g., United States v. Bess, supra note 2; Glass City Bank v. United States, supra note 2.
5. United States v. Hoper, 242 F.2d 468 (7th Cir. 1957); Behrens v. United States, 130 F. Supp. 93 (E.D.N.Y. 1955), aff'd, 250 F.2d 504 (2d Cir. 1956).
6. E.g., United States v. Bess, 357 U.S. 51 (1958); United States v. Sullivan, 333 F.2d 100 (5th Cir. 1964). State statutes which purport to exempt life insurance from the reach of the owner's creditors do not affect the Government's tax collection powers. However, ownership of the policy is determined by state law.

For convenience the words "taxpayer," "insured," "policyholder," and "owner" are regarded as synonymous and used interchangeably in this Note.
7. 357 U.S. 51, 56-57 (1958). In Bess the delinquent taxpayer died after a lien had attached to his "property or rights to property" represented by cash value in an insurance policy. The Government was allowed to follow the proceeds into the hands of the beneficiary on the basis of the priority of its lien. However, the Government was allowed recovery of only that part which represented cash value at the time of the taxpayer's death. No recovery of the balance of the proceeds (a sum large enough to cover the tax debt) was allowed, since the taxpayer had no rights to the proceeds while alive.

The Bess case has been extensively commented upon. E.g., 44 CORNELL L. Q. 278 (1959); 8 DE PAUL L. REV. 131 (1958); 47 KY. L.J. 556 (1959).
collection against his property may diminish the cash value available to him and thus the amount of property subject to the tax lien. Consequently, the Government has urged the courts to assist it in minimizing or eliminating this "leakage" (1) by affording the Government summary remedies for reaching the cash surrender value of the policies before such "leakage" can occur, and (2) by subjecting insurers to liability to the Government if they permit the diminution in value of liens by allowing insureds to exercise these contract rights.

This Note discusses various optional rights relating to cash surrender value available to a policyholder under a typical life insurance policy; examines various collection remedies available to the Government to enforce its liens against cash surrender value in the hands of the insurer; evaluates the Government's attempts to thrust upon the insurance companies the risk of diminution in the cash surrender value of insurance policies subject to tax liens; and suggests changes in and clarifications of existing law.

I. POLICY PROVISIONS

In addition to insurance protection, the owner of a typical life insurance policy commonly obtains rights in a sum called cash value. This amount represents both a savings factor and a reserve or prepayment of future premiums; the difference between it and the face amount of the policy at any time is the insurance feature of the policy. Cash value is generally avail-


In the level premium system of life insurance the net level premium must be higher than the monetary value of the annual risk during the early policy years, and the excess must be accumulated with interest to provide funds for payment of claims after the age is reached where the value of the annual risk exceeds the net level premium . . . . On surrender of a policy the insurer, being relieved of the obligation to provide death benefits during future years . . . no longer needs to retain the surrendering policyholder's contributions to the funds . . . . [The
able to the policyholder upon demand and surrender of the policy; the insurance obligation of the company is thereby terminated. However, the policyholder may elect to utilize his cash value in various ways short of surrender and termination. After the policy has been in force for a specified length of time, usually two or three years, the insured is entitled to obtain policy loans in a total amount slightly less than cash value. Cash value continues in existence after a policy loan is made and increases as subsequent premiums are paid. However, upon making a policy loan the insurer establishes a separate loan account to be set off against cash value in the event of surrender (the net difference may be termed “cash surrender value”), or against the proceeds of the policy if payment is made to the beneficiary. Until final settlement of the loan, annual interest, representing the income which the insurer would have earned had the loan not been made, is charged to the loan account. Although the policyholder may repay a policy loan and the accrued interest thereon, there is no obligation to do so, and in fact the insurer does not

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> Though this excess of premiums paid is legally the sole property of the company, still in practical effect, though not in law, it is moneys of the assured deposited with the company in advance to make up the deficiency in later premiums . . . . So long as the policy remains in force the company has not practically any beneficial interest in it, except as its custodian, with the obligation to maintain it unimpaired and suitably invested for the benefit of the insured. This is the practical, though not the legal, relation of the company to this fund.

*But see* Equitable Life Assur. Soc'y of U.S. v. United States, 831 F.2d 29, 35 n.10 (1st Cir. 1984), where it is said that this characterization is not strictly accurate:

The amount of real insurance at any moment during the life of the policy is the difference between the cash surrender value and the face amount. An election to take the cash value prior to maturity is a discharge of the insurance feature of the contract. We cannot agree with . . . *In re McKinney* [*supra*] . . . . Actually the surrender value is less than the reserve which must be maintained against the policy. See Maclean, Life Insurance 181 (8 ed. 1957). Moreover, it represents matters in addition to an advance for payment of future premiums, or it would ultimately decrease as the policy approaches maturity. The fact is, . . . as we might judicially notice, [that in] ordinary life and endowment policies generally, . . . [cash value] continuously increases.

necessarily expect repayment. The existence of an outstanding policy loan does not alter the effectiveness of the insurance protection or the obligation to pay premiums as they fall due.\(^\text{13}\)

The typical policy also contains optional, alternative nonforfeiture benefits. Under one option the existing cash value will be used to purchase paid-up life insurance if the insured defaults in payment of premiums. However, since the insurance coverage thus acquired is substantially less than that which it replaces, this option is seldom chosen by insureds.\(^\text{14}\) Under another option the insured elects, in the event of default, to have the existing cash value applied to purchase paid-up term insurance for the face amount of the original policy for as long a period as possible. The advantage of this option is that insurance coverage at the original level continues, and for a significant period of time if a large cash value has been built up. Of course, the disadvantage inherent in nonrenewable term insurance — deprivation of insurance protection at some future date — is also present. Nonetheless, policyholders often elect conversion to extended term insurance as the applicable nonforfeiture benefit in case of default. In fact, many policies provide that the extended term option shall apply unless the insured specifically elects an alternative.\(^\text{15}\)

A third option available under the policy to avoid forfeiture may be automatic premium loans to cover defaults in the payment of premiums.\(^\text{16}\) No money is paid to the insured, but the company makes entries in its books acknowledging premiums paid and debiting a newly-created loan account. This loan account operates exactly as the one created upon the extension of a regular policy loan. Cash value continues in existence; in fact the immediate effect of the loan is to increase cash value just as it would have been had the premium been paid by the insured.\(^\text{17}\) Of course, the amount payable in event of death or a


\(^{16}\) See MACLAIN, \textit{LIFE INSURANCE} 186 (9th ed. 1962): An automatic premium loan "is not, strictly speaking, a 'nonforfeiture option' or 'option on lapse' since the policy does not lapse but remains in full force subject to the loan." This technical distinction is not important for the purposes of this Note.

\(^{17}\) McGill 320–23; see United States v. Sullivan, 393 F.2d 100, \textit{supra} note 16 at 106 n.13 (3d Cir. 1964).
demand for cash value is subject to a setoff of the loan account. The maturity of the policy determines whether cash surrender value increases or decreases after an automatic premium loan.\textsuperscript{18} The right to premium loans, when available, is frequently chosen as the nonforfeiture option.\textsuperscript{19}

\textbf{II. PROCEDURES AVAILABLE TO THE GOVERNMENT FOR THE ENFORCEMENT OF TAX LIENS}

Ordinarily, considerable time elapses between the Government's determination of a tax deficiency and its initiation of collection proceedings against the delinquent taxpayer's assets. The first step is normally to notify the taxpayer of the deficiency and attempt to work out a payment arrangement with him.\textsuperscript{20} If such an arrangement cannot be negotiated or is not adhered to, the Government formally demands affirmative action by the

\textsuperscript{18} Because the automatic premium loan option operates to maintain the flow of premium payments, cash value continues to increase at the same time as the loan account is increasing. During certain years of a policy's life, automatic premium loans may cause cash value to increase by a larger amount than the offsetting loan account and thus create an increase in cash surrender value. For example, see United States v. Bankers' Nat'l Life Ins. Co., 198 F. Supp. 727, 728-29 (D.N.J. 1961), where a policy increased in cash value from $7,620 to $22,500 (i.e., by $14,880) in 11 years although the policyholder evidently paid no premiums. At the end of that period the charge against cash value in the automatic premium loan account was $12,356. Thus the policyholder, by electing the automatic premium loan option and without paying any premiums, was able not only to keep the insurance in force, but also to realize an increase in cash surrender value of $2,524.

However, in the early years of a policy an automatic premium loan may decrease cash surrender value because the amount of the loan exceeds the increase in cash value. In United States v. Salerno, 229 F. Supp. 664 (D. Nev. 1963), \textit{modified sub. nom.} Mutual Life Ins. Co. v. United States, 343 F.2d 71 (9th Cir. 1965), the cash and cash surrender value of the policy when the lien attached was $979. Subsequently, four automatic premium loans were made and, with interest added, the total charge in the loan account was approximately $700. The cash surrender value of the policy upon foreclosure of the lien was $494. Thus the cash value rose only $215, less than one-third the amount of the loan account.

\textsuperscript{19} McGill 320-23.

\textsuperscript{20} See Plumb, \textit{Federal Tax Collection and Lien Problems} (pt. 1), 13 \textit{TAX L. REV.} 247 (1957), where it is asserted that the use of drastic measures such as levy or foreclosure is the exception rather than the rule. "[T]he Service's policy is not to force the taxpayer into bankruptcy, leave him home-less, or otherwise oppress him, if he is sincerely trying to make up his delinquencies and there is a good chance that he will succeed if given time." \textit{Id.} at 288; see MERTENS, \textit{FEDERAL INCOME TAXATION} §§ 49.104-25 (1968, Supp. 1964, 1965) [hereinafter cited as MERTENS].
taxpayer within 90 days. At the end of this period, an administrative deficiency assessment is issued and demand for payment served upon the delinquent. The tax lien, establishing a governmental interest in the taxpayer's property, arises as of the time of assessment. Notice of the lien is filed in the county of the taxpayer's residence and copies are sent to interested third parties as the Government becomes aware of them. Only after the taxpayer has refused to pay on demand after assessment of deficiency may the Government move to collect against his property.

It has been seen above that collection proceedings may be initiated only after the taxpayer refuses to pay on demand after assessment of deficiency. It will be seen below that lengthy collection proceedings produce further delay before collection is effective against a taxpayer's insurance policy. This part of the

21. INT. REV. CODE OF 1954, §§ 6212–13. This demand is the so-called ninety-day letter. The Service is prohibited from assessing a deficiency or attempting to collect it by levy or foreclosure during this period to afford the taxpayer an opportunity to petition the Tax Court for an adjudication of its validity. See MERTENS § 49.188.

22. Assessing deficiencies is a complex and time-consuming procedure. Provisions designed to protect the taxpayer and governmental red-tape contribute to delay quick and efficient collection of delinquent taxes. See MERTENS §§ 49.180–226.


25. See, e.g., United States v. Ison, 67 F. Supp. 40, 41 (S.D.N.Y. 1946); United States v. Malter, 58-1 U.S. Tax Cas. ¶ 9485 (S. D. Fla. 1958). Actual notice is required by INT. REV. CODE OF 1954, § 6329(c), to protect the Government vis-a-vis mortgagees, pledgees, purchasers, and judgment creditors. Although § 6329 apparently does not require actual notice to protect the Government vis-a-vis the taxpayer's general creditors, the courts apparently expect the Government to notify all interested parties of which it is aware. See notes 84–88 infra and accompanying text. This Note proceeds upon the assumption that the Government has information relating to the taxpayer's assets, including his life insurance policies. Obviously this is not always the case and numerous examples of successful concealment of assets doubtless exist.

However, § 7206 of the Code provides for a severe penalty, (fine of not more than $5,000 and/or imprisonment for not more than three years) if a taxpayer conceals property when seeking a compromise settlement of his deficiency. A taxpayer whose financial condition is such that the Government would seek to foreclose upon his rights in life insurance policies is quite likely to seek a compromise. Thus, there may be no problem in discovering the identity of the taxpayer's insurers in the usual case.

Note focuses upon the problem of "leakage" or diminution in cash surrender value by operation of the policy during the period between the effective date of the tax lien and ultimate collection by the Government.

A. Collection by Foreclosure of Lien

It is now well established that the Government may reach the cash surrender value of a delinquent taxpayer's life insurance policy by judicial foreclosure of its lien on his rights thereto. In such a proceeding the court ordinarily has all interested parties before it—insured, insurer, beneficiary, and the Government—and can, therefore, order surrender of the policy. Alternatively, the court may adjudicate rights to the policy in rem and order

27. In Equitable Life Assur. Soc'y v. United States, 381 F.2d 29, 31 n.2 (1st Cir. 1964), the court summarized the procedure required by § 7403 of the Code as follows:

[S]ubsection (a) . . . provides for an action in the district court "to enforce the lien of the United States under this title with respect to such tax or liability or to subject any property, of whatever nature, of the delinquent, or in which he has any right, title, or interest, to the payment of such tax or liability." . . . (b) . . . provides that all persons "claiming any interest" in the property shall be made parties. . . . (c) . . . provides for an adjudication of all matters involved, and permits a sale of the property by decree of court and distribution in accordance with the interests of the parties. . . . (d) . . . permits the court to appoint a receiver with power, inter alia, to enforce the lien. 28. Several courts have indicated that the foreclosure action is a particularly appropriate method of collecting the cash surrender value of an insurance policy because it affords judicial protection of the interests of beneficiaries. E.g., United States v. Sullivan, 383 F.2d 100, 118–21 (3d Cir. 1964); United States v. Metropolitan Life Ins. Co., 226 F.2d 17, 23–25 (4th Cir. 1955). In United States v. McWilliams, 234 F. Supp. 117, 123 (D. Conn. 1964), the court stated that the Supreme Court decision in United States v. Bess, 357 U.S. 51, 57 n.2 (1958), would seem to require that anyone with a conflicting claim, such as a beneficiary, must have that claim adjudicated in a court action. Section 7403 of the Code provides that persons having an interest in the property shall be made parties in any action to enforce the lien. This section has been relied upon to protect the interests of beneficiaries. Equitable Life Assur. Soc'y v. United States, supra note 27, at 36. But see Mutual Life Ins. Co. v. United States, 349 F.2d 71 (9th Cir. 1965), modifying United States v. Salerno, 222 F. Supp. 664 (D. Nev. 1963), where the court disagreed with the proposition that a beneficiary is an indispensable party to any proceeding to collect the insured’s interest in the policy, and pointed out that the beneficiary usually has no vested interest in the policy but only an expectancy subject to termination at the will of the insured or by court order. See generally, Pyle, Liability of Life Insurance and Annuities for Unpaid Income Taxes of Living Insureds, Annuities, and Beneficiaries, 9 Tax L. Rev. 205, 222–27 (1954).
payment by the insurer when it does not have personal jurisdiction over the insured and the beneficiary so as to be able to order surrender.\textsuperscript{29}

In the event of foreclosure, the judgment of the court will terminate the policy and the insurer, upon payment of cash surrender value to the Government, will no longer be liable to the insured, whether or not the latter has physically surrendered the policy.\textsuperscript{30} The powers of the court in a foreclosure action were summed up in \textit{United States v. Metropolitan Life Ins. Co.}:\textsuperscript{31}

When the insured's interest in the policies is subjected to the tax lien under this proceeding, this amounts to a seizure of such interest by the United States. . . . [T]he United States, by virtue of such seizure may exercise any right which the insured might have exercised under the policies, including the election to take the cash surrender value. . . .

The court can unquestionably condemn the interest of the insured under the policies to the satisfaction of the lien and can direct that such interest be paid by the insurance companies to the United States, the holder of the lien. This interest is the cash surrender value of the policies. It is argued . . . that the court may not do this, because the policies must be surrendered as a condition to obtaining the cash surrender value; but the surrender is for the protection of the companies and they will be as well protected by the judgment of the court as by the surrender of the policies, since the policies are not negotiable.

Certain considerations of public policy justify requiring the Government to use judicial foreclosure as its collection device. The presence of all interested parties at the judicial foreclosure makes possible the assertion of all interests before the policy is terminated to pay taxes. Also, the court may fashion a remedy to protect the beneficiaries and insured to the extent consistent with the Government's rights, rather than simply ordering cancellation of the policy and payment of cash surrender value to the Government. For instance, the court might order sale of the policy to a beneficiary, or arrange for the insured to take a policy

\textsuperscript{29} \textit{E.g.}, United States v. Bell, 226 F.2d 898 (4th Cir. 1964); United States v. Metropolitan Life Ins. Co., 256 F.2d 17 (4th Cir. 1958); United States v. Hopkins, 193 F. Supp. 207 (S.D.N.Y. 1960). In these cases, jurisdiction was premised upon 28 U.S.C. §1655 (1958), which authorizes an action "to enforce a lien upon . . . real or personal property within the district" of the court. In such an action service by publication is sufficient where defendants cannot be served within the state. The insurance company, which does business within the state, is served personally. The courts reason that although the insured has left the jurisdiction, he has left behind the res, to which the lien has attached.


\textsuperscript{31} \textit{Supra} note 29, at 23–25.
loan to pay the deficiency. It should be noted that a foreclosure in rem obviously does not afford an opportunity to the insured and the beneficiaries to protect their interests. The Second Circuit recently upheld such a foreclosure action on a matured policy but criticized the procedure and questioned its propriety if applied to an unmatured insurance contract.

However, from the point of view of the Government, judicial foreclosure is a disadvantageous collection device because, as with all litigation, it is expensive, time-consuming, and cumbersome. The delay lengthens the period between the effectiveness of the lien and collection of the tax, thus increasing the risk that cash surrender value will be impaired during the interim through operation of one of the policy options.

B. COLLECTION BY LEVY ON PROPERTY UNDER A TAX LIEN

As an alternative to foreclosure against the insured's bundle of policy rights, the Government has attempted to move directly against cash value in the hands of the insurer by summary administrative levy. Collection by levy is very attractive to the Government. Contrasted with judicial foreclosure it is relatively


33. In Equitable Life Assur. Soc'y v. United States, supra note 32, at 37-38, the rule enunciated in United States v. Metropolitan Life Ins. Co., 256 F.2d 17 (4th Cir. 1958), was criticized on the basis that 28 U.S.C. § 1655 provides for the setting aside of any judgment reached in the absence of a defendant who was not personally served upon the behest of the defaulting defendant, and upon his payment of costs within one year of entry of judgment. The court suggested that to protect this right where a lien upon an insurance policy is foreclosed, it may be necessary to limit recovery to the loan value of the policy, as opposed to its cash surrender value, pending expiration of one year from entry of judgment.

inexpensive, simple, and quick, and therefore will shorten the period of potential leakage of cash value after attachment of the tax lien.

The Government is authorized by statute to seize and sell property or rights to property to which a tax lien has attached to satisfy assessed deficiencies. Subject only to certain exceptions for bare necessities, this power of levy is available against the delinquent taxpayer’s real and personal property, both tangible and intangible, whether in his or a third party’s possession. The statute thus contemplates that the Government may levy on property in the hands of the taxpayer’s bailees, including property which takes the form of a debt owed the taxpayer. If a third party fails to turn over property or pay a debt upon levy

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85. Int. Rev. Code of 1954, § 6331(a) provides in part:
If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary or his delegate to collect such tax (and such further sum as shall be sufficient to cover the expenses of the levy) by levy upon all property and rights to property (except such property as is exempt under section 6334) belonging to such person or on which there is a lien provided in this chapter for the payment of such tax... Levy is said to include the power of distraint and seizure by any means. Int. Rev. Code of 1954, § 6331(b).

86. Int. Rev. Code of 1954, § 6334(a), exempts clothing, necessary tools, and a limited amount of provisions, furniture, livestock, and personal effects. Section 6334(c) provides that these exemptions shall be exclusive.

37. The scope of the statutory power of levy thus reaches far beyond that of common-law distraint, since the latter historically reached only tangible personal property. Originally a means by which a private party took possession of the personal property of another to enforce a debt or duty, distraint later came to be used to collect taxes. See United States v. Aetna Life Ins. Co., 46 F. Supp. 30, 35-36 (D. Conn. 1942); Brewster, DISTRAINT UNDER THE FEDERAL REVENUE LAWS 4-8 (1937).

88. Int. Rev. Code of 1954, § 6332(a) provides:
Any person in possession of (or obligated with respect to) property or rights to property subject to levy upon which a levy has been made shall, upon demand of the Secretary or his delegate, surrender such property or rights (or discharge such obligation) to the Secretary or his delegate....


Any possible distinction between distraint upon property in the possession of the debtor and garnishment of property in the possession of a third party has generally been ignored in construing the scope of the Government’s levy. E.g., United States v. Eiland, 228 F.2d 118 (4th Cir. 1955); United States v. Morris & E.R.R. 135 F.2d 711, 718 (2d Cir. 1943); see Note, 52 YALE L.J. 928, 930–31 (1943).
and demand, he is liable to the Government for an amount equal
to the value of the property or the amount of the debt or the
amount of the tax liability upon which the levy is based, whichever
is less. Of course, the third party may defend on the ground
that the taxpayer’s property is not in his possession. Payment to
the Government of property or an obligation subject to levy is a
complete defense in a subsequent action brought by the taxpayer-
creditor against the third party.

Levy upon cash value in the hands of the insurer to satisfy a
tax obligation was upheld in several early cases. However, three
courts of appeals held in 1942 that this was not an appropriate
collection method. Two recent court of appeals decisions, United
States, reaffirm these holdings.

The most persuasive legal argument against levy directly upon
an insurer is that cash value is not itself property of the insured
in the possession of the insurer, as required by the levy statute.
This is premised on the view that where a contract calls for
alternative performances at the obligee’s choice, the obligor owes
neither until the obligee makes his choice. Since cash value is
not a specific debt, it is not property of the insured; it constitutes
merely an integral part of the entire “bundle of rights” — one
of several alternative performances among which the insured may
choose. Because the Government may levy only as a lienor and
not as an owner, it follows that levy cannot serve as an exercise

41. See United States v. Manufacturers Trust Co., 198 F.2d 366 (3d Cir.
1952); 9 Mertens § 49.203.
42. E.g., United States v. Bowery Sav. Bank, 297 F.2d 880 (2d Cir. 1961);
United States v. Eiland, 229 F.2d 118 (4th Cir. 1955).
43. See, e.g., Kyle v. McGuirk, 83 F.2d 212 (3d Cir. 1936); Columbian
339 (1st Cir. 1939).
44. United States v. Penn Mut. Life Ins. Co., 130 F.2d 495 (3d Cir.);
United States v. Metropolitan Life Ins. Co., 130 F.2d 149 (2d Cir.); United
States v. Massachusetts Mut. Life Ins. Co., 127 F.2d 880 (1st Cir.). See also
Pyle, supra note 28, at 325-32; Note, 52 Yale L.J. 928 (1943).
45. 333 F.2d 100 (3d Cir. 1964).
46. 331 F.2d 29 (1st Cir. 1964); cf. Mutual Life Ins. Co. v. United States,
345 F.2d 71 (9th Cir. 1965).
47. Equitable Life Assur. Soc’y v. United States, supra note 46, at 331
F.2d 35.
49. Id. at 116-17. The court noted that trustees or court-appointed re-
ceivers have the power to step into the shoes of the taxpayer and, as owner,
convert cash value into a matured obligation. See Cohen v. Samuels, 245
of the owner’s option to receive cash value and thereby create property in the hands of the insurer in the form of an unconditional debt. By analogous reasoning state courts have held that cash value is beyond the reach of private creditors under state garnishment statutes.

However, strong legal arguments can be made for permitting levy directly upon cash value in the hands of the insurer. In United States v. Bess the Supreme Court held that although cash value is “legally the sole property of the company,” it “should be treated for some purposes as though in fact a ‘fund’ held by the insurer for the benefit of the insured.” One court apparently took this holding to mean that the “fund” was property against which levy could be made. This assumes that physical surrender and election by the insured are not necessary to bring cash value itself, as opposed to the insured’s “bundle of rights,” under the tax lien. Recognition by the courts in the lien foreclosure cases that an election of cash value by the insured is not necessary to foreclose the Government’s lien on the policy weighs in favor of treating cash value as a presently owing obligation upon which

However, the levy statute cannot be read to confer comparable authority on the Government.

The court stated in Equitable Life that “the insurance obligation [coverage] was already operative. The company would remain liable for that obligation unless some positive action, binding on the insured, could affirmatively terminate it . . . .” 381 F.2d at 29, 35.


These cases reflect a strong judicial predisposition to avoid serious prejudice to the beneficiaries of insurance policies. See Isaac Van Dyke Co. v. Moll, 241 Mich. 255, 259, 217 N.W. 29, 30 (1928), where the court said: “If garnishment will here lie, it could be enforced by a creditor were the insured at time of service lying on a sick bed with dissolution near at hand.”

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52. 357 U.S. 51 (1958).

53. Id. at 59.

54. United States v. Salerno, 222 F. Supp. 664 (D. Nev. 1963), modified sub nom. Mutual Life Ins. Co. v. United States, 346 F.2d 71 (9th Cir., 1965). In the district court the insurer was held liable for diminution of cash value through the operation of the automatic premium loan provision of the policy after receiving notice of levy and demand under the penalty statute, § 6332. Until recently, the Salerno case stood as authority directly contrary to the holdings in Sullivan and Equitable Life. The Ninth Circuit modified the decision by excluding the judgment for penalty against the insurer.
levy should operate. Moreover, there is some judicial support for the view that levy is a "meaningful demand for whatever amount the insured could then require the insurer to pay him." Footnote 65

Nevertheless, the cases are unanimous in refusing to permit levy against cash value in the hands of an insurer and have consistently distinguished the Bess decision. They emphasize that Bess held cash value to be property "for some purposes" only. Footnote 6

Thus, although cash value was held to be property to which a lien attached, under the facts of Bess this was not a determination that it was also property subject to levy. Other factual distinctions between the situation under discussion and that in Bess are also stressed to demonstrate that levy on the insurer was not a "purpose" contemplated by the Supreme Court. Footnote 57

Considerations of public policy would seem to dictate that levy against cash value as a debt owed the insured in the hands of the insurer should not be made available to the Government. Al-

Footnote 55. United States v. Sullivan, 333 F.2d 100, 122 (3d Cir. 1964) (dissenting opinion). Sullivan was a 6-1 decision. The lone dissenting judge agreed with the district court decision in Salerno, see note 54 supra, that notice of levy was a meaningful demand upon the insurer and would have fixed the minimum recoverable sum as the cash value of the policy at that time. Cf. Mutual Life Ins. Co. v. United States, supra note 54, modifying the Salerno decision, where it was held that the Government had erroneously attempted to levy on cash value in the hands of the insurer as if it were equivalent to cash or a matured debt. The court reasoned that the Government had failed to follow the requirement of the levy statute that a distraint sale be held for property (other than cash or its equivalent) seized by levy:

We are not, then, faced with the question (which both Sullivan and Equitable Life seem to have answered in the negative) whether there was any property at all belonging to the insured in the possession of the insurer which could be reached by levy and realized upon by sale.

343 F.2d at 74 n.5. This language may be construed to imply that levy upon the insured's "bundle of rights" in the hands of the insurer may be available if the Government follows the statutory requirements. However, the court did not develop this possibility.


Footnote 57. United States v. Sullivan, supra note 55, at 111, Equitable Life Assur. Soc'y v. United States, supra note 56 at 35-37, and United States v. Birrell, supra note 56, at 923, carefully distinguish Bess as a case which dealt with the rights of the insured and not those of the insurer. The Bess Court had pointed out that the insured had died and the policies therefore matured. The case consequently is read as holding that the Government's tax lien will not be defeated by the fortuitous intervening death of the insured, and not as controlling any questions raised in connection with executory insurance contracts.
though summary levy is clearly the most efficient means by which the Government can reach the cash value of an insurance policy, on balance it has significant undesirable features. It is a drastic and blunt instrument.\textsuperscript{58} Contrasted with judicial foreclosure, at which all interested parties ordinarily are present and heard before any property interests are affected, levy on cash value cuts off beneficiaries' rights without affording them an opportunity to protect their interests.\textsuperscript{59} For reasons relating to the health and life expectancy of the insured, cash value represents only the minimum worth of the policy.\textsuperscript{60} It therefore would seem unjust to terminate a policy by the levy procedure that the Government has attempted to use.

The Code affords the delinquent taxpayer a right to redeem property seized by levy prior to sale.\textsuperscript{61} However, the Government has attempted to levy on cash value as the equivalent of cash which would not require a distraint sale.\textsuperscript{62} Such a procedure would terminate the insurance policy, thereby thwarting any possibility of meaningful redemption. This situation has seemingly influenced the courts against permitting such levy.\textsuperscript{63} Yet the levy and redemption statutes nowhere specifically provide that levy is available only as to property which will be preserved for possible redemption. Moreover, bank accounts and other debts are regularly


\textsuperscript{59}. See note 28 \textit{supra} and accompanying text.

\textsuperscript{60}. See Equitable Life Assur. Soc'y v. United States, 381 F.2d 29, 86 (1st Cir. 1964), where the court emphasized that because of poor health the taxpayer may not be reinsurable at any price.

\textsuperscript{61}. INT. REV. CODE or 1954, § 6387(a).

\textsuperscript{62}. See notes 119-24 \textit{infra} and accompanying text.

\textsuperscript{63}. The court said in Sullivan, 333 F.2d at 118:

First and foremost, [the redemption provision] strongly tends to indicate that the remedy of levy and distraint was not meant to be applied against assets in such a manner as to destroy them by that very action. Second, it manifestly makes relevant considerations of fairness to the insured, albeit possibly delinquent, taxpayer. . . . A right of redemption would be of no utility in the present circumstance and would therefore be illusory. Moreover, the instant situation represents the very type of case in which such a right would be of most critical import and practical utility inasmuch as the value of an insurance policy of the present nature is not strictly defined by its monetary worth.

See also the discussion of the redemption statute and its affect on the availability of levy in the \textit{Equitable Life} case, 381 F.2d at 86-88.
levied on, although no property survives, and the 1954 Code specifically provides for the collection of intangible assets by levy on the obligor. However, seizure of a matured debt is really not prejudicial to the taxpayer since the value of the debt is applied to his tax liability and its seizure does not deprive him of more value than that for which he receives credit. On the other hand, since cash value represents the minimum worth of the insurance, its summary seizure will most probably result in a tax credit of less value than the true worth of the asset which the taxpayer has lost.

Even in the absence of an effective right of redemption, it is arguable that levy upon cash value ought to be permitted since the delinquent taxpayer had ample opportunity to protect his and the beneficiaries' interests before resort to levy was made. He could have paid his taxes in the first place or during the investigation period. Or he could have arranged a policy loan to the satisfaction of the Government. These suggestions may afford little solace for the taxpayer who believes that no deficiency exists. Actual liability may not be determined for several years—until administrative and judicial review of the merits of the assessment have run their course. Yet levy is available upon assessment of deficiency by the Internal Revenue Service. And it is clear that unlike judicial foreclosure of a lien, levy is not subject to a defense that the underlying deficiency assessment is without merit.

64. See, e.g., United States v. Eiland, 223 F.2d 118 (4th Cir. 1955); United States v. Manufacturers Trust Co., 198 F.2d 366 (2d Cir. 1952).

65. Int. Rev. Code of 1954, § 6332(a), incorporated the Internal Revenue Code of 1939, § 3710, with the following change (italicized): "Any person in possession of (or obligated with respect to) property or rights to property" shall surrender them to the collector.

66. Compare note 60 supra and accompanying text.

67. See note 85 supra and accompanying text.


The correctness of the deficiency assessment is conclusive and immune to challenge when collection is sought by means of levy, but only presumptive and subject to adjudication when the Government attempts to foreclose its lien. The O'Connor case, supra, contains an excellent analysis of the rule and examination of the legislative history of the relevant statutes.

69. See, e.g., Abel v. Campbell, 334 F.2d 339, 342 (5th Cir. 1964); United States v. First Capital Nat'l Bank, 89 F.2d 116, 124 (8th Cir. 1937); United States v. City State Bank, 19 F. Supp. 775 (W.D. Tenn. 1937); United States
However the taxpayer will normally petition the Tax Court for an adjudication of the validity of the assessment if he questions it. Until this decision becomes final, no levy may be made. Thus the taxpayer would be subjected to levy on the basis of an assessment which he believes to be erroneous only if he fails to file a petition for review. The effect of permitting levy in this context would therefore be to require the taxpayer to protect his property from the Government's claim by asserting his defense to the assessment in the Tax Court rather than waiting for the Government to move against his property.

III. INSURER'S LIABILITY FOR DIMINUTION OF CASH VALUE OF INSURANCE POLICY SUBJECT TO TAX LIEN

Thwarted in its attempts to levy on cash value directly, the Government has advanced arguments which, if upheld by the courts, would prevent or diminish its loss of tax revenue from leakage of cash value through operation of the insurance contract by fixing liability for such leakage upon the insurers in various situations. The situations involved and the theories invoked are discussed in this part of the Note.

A. CHARACTERIZING THE INSURER AS A CREDITOR

The Government has argued that an insurer becomes a creditor with a security interest in the policy when it makes policy or automatic premium loans. Certainly an insurer in this position resembles a creditor in several respects: it maintains a separate loan account, charges interest, carries the loan on its books as an account receivable, and often receives investment credit for the loan under state regulations. If the insurer is regarded as a


70. The other traditional method of challenging an erroneous assessment—payment and suit for refund under § 7422 of the Code—is clearly inapplicable to the context here under discussion.


73. United States v. Sullivan, supra note 72 at 12, 333 F.2d at 113.
creditor secured by cash value to which a tax lien has attached, some determination of priority of lien will be required to resolve conflicts between the insurer and the Government. While general in the sense that it attaches to all of the taxpayer's property, the tax lien has been found to be "perfect" and "choate" as to each specific piece of property.74 Consequently the Government would be protected from leakage of collectible assets through loans made by an insurer-creditor after attachment of the tax lien.75 The claims of private creditors, even though perfected under state law, have usually been found "inchoate," under a rather stringent federal test, and therefore inferior even to subsequently attaching tax liens.76 It is likely that policy and premium loans would be regarded as creating inchoate liens upon the policies under which

76. To be choate under federal law, a lien must meet three tests: (1) the property subject to the lien must be established; (2) the identity of the claimant adverse to the Government must be definite and certain; and (3) the claim must be in an exact amount which has been determined with finality — ordinarily by the entry of a final judgment. E.g., United States v. R. F. Ball Constr. Co., 355 U.S. 587 (1958) (rights of surety under performance bond held inferior to subsequently arising tax lien); United States v. Vorreiter, 355 U.S. 15, reversing 134 Colo. 543, 307 P.2d 475 (1957) (recorded mechanics lien held inferior to subsequent tax lien); United States v. Acri, 348 U.S. 211 (1955) (attachment lien perfected by state law inferior to later tax lien); United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950); see, e.g., Brown, Process of Law, Foreward to The Supreme Court, 1957 Term, 72 Harv. L. Rev. 77, 82–87 (1958); Burroughs, The Choate Lien
they were made. Thus the insurer’s claim to set off its loans against cash value would probably fail even as to loans made after the lien attached.

However, the courts have rejected the Government’s arguments that insurers should be characterized as creditors when they make policy and premium loans. They have held instead that, notwithstanding the form of these transactions, the companies are in substance debtors rather than creditors. In doing so they have relied upon the following factors: Under the terms of the policies, loans must be made upon the demand of the policyholder; the “interest” charge is merely an estimate of what would have been earned by the company if no advance had been made; the form of the transaction is merely an accounting procedure used by the insurer for its own convenience; and, no obligation rests upon the policyholder to repay.

Considerations of public policy support the results of these cases. It is undesirable to force the companies into a position where they must either incur double liability or breach their


The favorable treatment accorded the tax lien is said to be based upon the Government’s imperative need for revenue. _Bull v. United States_, 295 U.S. 247, 259–60 (1935); see _Anderson, supra_ note 74, at 242.


In _Board of Assessors_, 216 U.S. at 523, Mr. Justice Holmes stated: The so-called liability of the policy-holder never exists as a personal liability, it never is a debt, but is merely a deduction in account from the sum that the . . . [insurer] ultimately must pay . . . . In substance it is extinct from the beginning, because . . . [the transfer of funds] is a payment, not a loan.

_78. See United States v. Sullivan, note 77 supra._

_79. In United States v. Penn Mut. Life Ins. Co., 130 F.2d 495, 498 (3d Cir. 1942), the court stated that “the result in a case such as the present would be to require the insurance company to pay doubly when the policy binds it to pay singly.” In United States v. Massachusetts Mut. Life Ins. Co., 157 F.2d 880, 884 (1st Cir. 1946), the court said more tentatively that “we cannot say with confidence that there would be no danger of a double liability if the government should prevail in the case at bar.”_
insurance contracts at the possible risk of subjecting themselves to disciplinary action by state insurance commissions. Furthermore, the commercial practices of insurance companies in applying cash value to policy or premium loans resemble those of one paying a debt more than one making a loan. Because the insurer never advances more than cash value, it checks only its own records before honoring policyholders' demands. It does not check the owner's credit or search appropriate lien records. Requiring it to take such precautions solely to escape double liability on account of the tax delinquencies of the policyholder would be to impose an unreasonable burden.

B. CHARACTERIZING THE INSURER AS A DEBTOR OR OBLIGOR

1. Attachment and Filing of Lien

At one time concern existed among some legal writers that attachment of a tax lien would compel obligors of a delinquent taxpayer to pay their debts to the Government or risk double liability even though notice of the lien had not been filed. The

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82. Six of the defendant insurance companies in a companion case tried with Sullivan made 1,408,051 policy loans totaling $455,298,956 during 1960. A survey by one of the companies estimated that a normal search of lien records would cost six dollars per policy. 333 F.2d at 113. See Pyle, LIABILITY OF LIFE INSURANCE AND ANNUITIES FOR UNPAID INCOME TAXES OF LIVING INSURED, ANNUITANTS, AND BENEFICIARIES, 9 TAX L. REV. 205, 209 (1954). Obviously, an insurance company could not search the lien records of some 3000 counties to determine whether notice of a tax lien had been filed against a policyholder.
83. See, e.g., Rankin & Funk, THE DESIRABILITY OF AMENDING THE INTERNAL REVENUE CODE AS TO TAX LIENS ON BANK COLLATERAL AND BANK DEPOSITS, 8 BUS. LAW. 59 (1953); Note, EFFECT OF A FEDERAL TAX LIEN ON A BANK DEPOSIT, 42 IOWA L. REV. 418 (1957).
In Beeghly v. Wilson, 162 F. Supp. 726, 730 (N.D. Iowa 1957), the court stated by way of dictum that:

Where there is a tax lien outstanding, . . . if the Government chose to enforce that lien against intangibles to the fullest extent, then any bank paying a check of such taxpayer, any insurance company making payments of cash surrender values, . . . any party settling either a contract or tort claim . . . would be subject to the hazard of paying the same over again to the Government. . . . It would appear that the Government . . . has been sparing in its enforcement of tax liens against intangibles of the kind noted.

One of the leading writers on the subject of federal tax liens, Walter T.
Government recently advocated this position. Even if this view were rejected, it could be argued that filing the lien in the county of residence operates as constructive notice to the taxpayer's obligors, so that they thereafter make payment to the taxpayer at their peril. However, the courts have uniformly rejected both arguments. It seems clear, therefore, that a debtor-obligor may safely pay his creditor without searching the records to discover tax liens against the creditor. The Fourth Circuit recently stated:

[D]ebtors could not be expected to search the clerk's office before paying a debt, to see whether or not tax liens had been filed against their creditors, nor could banks be expected to make such search before honoring checks drawn upon deposits. ... Prior to ... [actual notice a] debtor may discharge his debt by payment to the creditor, whatever may have been filed in the clerk's office.

Originally, the Commissioner took the position in a revenue ruling that insurers who grant policy loans or pay out cash value before actual notice of the lien would not be liable to the Government for doing so. This ruling was subsequently withdrawn with respect to policy loans, apparently to test the argument that the insurer acts as a creditor in extending such loans. Since this argument was recently rejected by the courts, it appears that the Government has been forced back to the position of conceding that mere attachment or filing of the tax lien does not operate to fix

Plumb, Jr., debunks the suggestion that debtors paying debts without notice of the tax lien may be subject to double liability by stating that "the history of recent litigation is persuasive that the Government's failure to argue for such a position is based not on self-restraint, but entirely upon a conviction that the position could not possibly be sustained." Plumb, supra note 76, at 309.

85. See Rankin & Funk, supra note 86.
90. The Government argued in two district court cases that policy and automatic premium loans constitute a credit arrangement. However, this position was abandoned on appeal. See note 72 supra.
the extent of the insurer's liability to the Government. This would seem to be proper. Ordinarily the effect of a lien is merely to establish the interest of a creditor vis-a-vis others asserting claims against the same property, and some other doctrine must be relied upon to direct the debtor to discharge his debt to a lienor rather than the creditor.

2. **Actual Notice of Lien to Insurers**

It has been suggested that actual notice of a tax lien imposes upon unconditional debtors of a delinquent taxpayer the duty to discharge their debts only to the Government at the risk of subjecting themselves to double liability if they fail to do so. One school of thought asserts that this liability arises because the tax lien acts similarly to garnishment, with actual notice of the lien being equivalent to notice of garnishment. The effect of garnishment is to bind the property of a person in the hands of his obligor (the garnishee) so as to make the garnishee act at his own risk if he delivers the property to his obligee or a third person pending collection proceedings. Alternatively, it is sometimes suggested that this liability results from the debtor's tortious impairment of the tax lien by payment to the taxpayer-creditor, who may squander the money. Thus it was said in *United States v. Sulli-

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92. *E.g.*, Kirby v. United States, 329 F.2d 735, 736 n.3 (10th Cir. 1964); United States v. Eiland, 223 F.2d 118, 123 (4th Cir. 1955).


94. See Rogge, *The Tax Lien of the United States*, 13 A.B.A.J. 576, 581 (1927); Plumb, note 776 *supra*, at 307–11, who notes an analogy between the liability of a bank with notice of a tax lien and the "liability that a bank may incur when it honors checks on a fiduciary account with knowledge of circumstances indicating a breach of trust." *Id.* at 308 n.394. (Citations omitted.) See also Savings Bank v. Loewe, 243 U.S. 327 (1917).

At common law, tort liability resulted from the impairment of a nonpossessory lien if property was negligently or willfully transferred in a manner by which the lien was destroyed. See Michelson v. All, 43 S.C. 459, 21 S.E. 323 (1895). No cases involving the liability of insurance companies or banks for such a tort with respect to tax liens were found, probably because such
van that upon receiving actual notice a duty arises not to act inconsistently with the lien.96

The practice of banks illustrates the application of the doctrines discussed above. The Government normally advises a bank to protect itself from incurring double liability following receipt of actual notice of a lien against its depositor's property by notifying the Director of Internal Revenue of any demand against the assets and withholding payment until receiving his instructions.98

The threat of double liability under either of the theories usually causes the bank to "freeze" its depositor's account upon receiving such notice.97

In light of the above, the Government might well assert that after receipt of actual notice of a tax lien, the insurer bears the risk of all subsequent diminutions of cash value by operation of the policy.98 In making this argument substantial reliance would no doubt be placed upon United States v. Bess,99 where the Supreme Court indicated that the insured's right to cash surrender value constitutes "property" or "rights to property" to which a tax lien may attach. However, Bess arose from an effort by the Government to trace the insured's right to cash surrender value immediately prior to his death into the hands of the beneficiary after the policy had matured. It was not sought to hold the insurer liable for having performed its obligations under the matured contract subsequent to attachment of the tax lien. Later lower court decisions arising from attempts by the Government to hold insurers liable for their applications of cash surrender value pursuant to policy obligations after attachment of the tax lien have emphasized the peculiarity of the facts in Bess100 and dis-

95. 333 F.2d 100, 114 (3d Cir. 1964).
96. Rev. Rul. 367, 1957-2 Cum. Buil. 846. The possibility that the banks will incur double liability if they satisfy their depositor's demands after notice and thereby diminish the collectible value of the lien is a somewhat academic point, however, since the Government ordinarily does not merely give notice to banks but rather makes a summary levy on the account. Special Comm. on Federal Liens, ABA, Report 84 A.B.A. Rev. 645, 654-55 (1959).
97. See Plumb, supra note 76, at 308.
tinguished that case in reliance upon the statement of that Court that "cash surrender value should be treated for some purposes as though in fact a 'fund' held by the insurer for the benefit of the insured." These courts have argued that so long as the obligation of the insurer to apply cash value is contingent upon the election of the policyholder or the maturation of the policy, the insurer holds no "property" as a "fund" of the insured in the sense of an unconditional obligation to make a disbursement to the latter. As will be shown in the following discussion of specific policy provisions, the effect of this distinction is to avoid requiring an insurer with actual notice to choose between risking double liability and seriously prejudicing the interests of the insured and the beneficiaries in the policy.

a. Payment of Cash Value on Surrender or Extension of a Policy Loan After Receipt of Actual Notice

In United States v. Metropolitan Life Ins. Co., the court stated by way of dictum that after actual notice the insurance companies "were bound to take . . . [tax liens] into account before

101. 357 U.S. at 59 (1957). (Emphasis added.) The Bess Court approved the statement in In re. McKinney, 15 Fed. 535, 537 (C.C.S.D.N.Y. 1883), that while the "practical, though not the legal, relation of the company to . . . [cash value is as its] custodian, with the obligation to maintain it unimpaired and suitably invested for the benefit of the insured . . . it is] legally the sole property of the company."

102. United States v. Sullivan, 333 F.2d 100, 111-12 (3d Cir. 1964); Equitable Life Assur. Soc'y v. United States, 331 F.2d 29, 36-37 (1st Cir. 1964); United States v. Birrell, 233 F. Supp. 921 (S.D.N.Y. 1964). The Sullivan court stated that nothing in the Bess opinion even implied "that the tax lien attached to any specific property held by the insurers." (Emphasis added.) The Equitable Life court stated that the Supreme Court was "very carefully not saying . . . [that cash value] was a fund. It was not a holding that the surrender value was an open debt . . . ." It should be noted that neither court stated that the insurer held no property of the insured, to which the tax lien might attach. Rather, the courts were merely saying that if the "bundle of rights" of the insured were regarded as being in the possession of the insurer, this "property" could not be treated as a fund to which a lien might attach.

But see Mutual Life Ins. Co. v. United States, 353 F.2d 71 (9th Cir. 1965); United States v. Burgo, 175 F.2d 190 (3d Cir. 1949). The Mutual Life court indicated that the Sullivan and Equitable Life cases suggested that the insurer has no property at all in its possession belonging to the insured prior to an election. Id. at 74 n.5. However, this is an incorrect reading of these holdings since both courts held that they could, in a foreclosure action, fashion an appropriate remedy and order the insurer to comply. This can only mean that the lien attaches to the "bundle of rights" held by the insurer.

103. 235 F.2d 17, 22 (4th Cir. 1956), 45 Va. L. Rev. 783.
making any payments to the insured under the terms of the policies.” Insurance companies make such “payments to the insured under the terms of the policies” only in effecting policy loans or paying cash value on surrender. Similarly the Sullivan court, although generally hostile to the Government’s positions, stated that upon receipt of actual notice, “a duty arises on the part of the insurer to act in a manner consistent with safeguarding the Government’s interest.” This comment was made in the course of a discussion of the insurer’s potential double liability for policy loans, wherein the court suggested that granting such a loan after actual notice would be inconsistent with the Government’s interests. In accord with these dicta, a revenue ruling advises insurance companies that upon actual notice of a tax lien, they should defer cash payment of surrender value or policy loans to the insured and notify the Government of such demands. This affords the Government effective protection against leakage arising from the payment of sums of cash to the insured which represent most or all of the interest of the policyholder in his insurance policy — probably the most serious threat to the Government’s collectible interest in the lien.

This result is not inconsistent with the analysis contained in this Note. Rejection of levy as a collection device is founded on the view that the insurer possesses no “property” of the insured. A lien too, can attach only to “property and rights to property.” However, the argument that cash value in the hands of the issuer is not the “property” of the insured becomes unavailable once the insured demands cash value or a policy loan. At that point the nature of the contract is changed. It is no longer an agreement providing for alternative performances, but one under which a current debt in the amount of the demand is due and payable. It can then be said without dispute that the insurer holds property of the insured in the form of an unconditional debt. Because the obligation is unconditional the doctrines of tortious impairment of a lien and garnishment are applicable to force the insurer to protect the Government’s interest. The insurer’s obligation has become conceptually identical to a bank deposit.

Considerations of public policy also support imposition of a limited burden on insurers with respect to demands for cash value

104. 333 F.2d at 114.
106. See note 47 supra and accompanying text.
108. See notes 96-97 supra and accompanying text.
and policy loans after receipt of actual notice. The insurer has the means available to protect itself in this situation. Under the terms of the typical policy, it may defer the payment of cash value or the extension of a policy loan for a stipulated period of time (usually six months) after it is requested.\textsuperscript{109} Moreover, it is authoritatively reported that insurers are "generally... willing to communicate with the proper officials before making any payment to delinquent taxpayers... and to withhold payment if advised to do so."\textsuperscript{110} Nevertheless, it is also true that most of the demands for policy loans or cash value are of an emergency nature. Therefore, it is not surprising that many companies take pride in furnishing twenty-four hour service.\textsuperscript{111} Deferments of payment pending consultation with tax authorities would no doubt result in the loss of some good will. However, it should be noted that similar interference with banks' ordinary services does not prevent the imposition of a burden on them to act consistently with known tax liens. It is submitted, therefore, that the Government is clearly correct in insisting that a duty to act consistently with a lien ought to be imposed on insurance companies when demand for payment is made on them after receipt of actual notice of the lien. This need not be an absolute duty. The company should notify the Government of the demand by the delinquent taxpayer, stating the period for which it may delay payment under its contract. The burden would then be on the Government to take effective action to enforce its rights, such as moving to collect, during this period. If the Government fails to act, the company should be able to honor its insured's demand without risking double liability.

b. Extension of Automatic Premium Loans and Other Non-forfeiture Benefits After Receipt of Actual Notice

Unlike its position when called upon to pay cash value or extend policy loans, the insurer cannot protect the tax lien from diminution by operation of the various nonforfeiture benefits contained in a typical insurance policy without violating its contract.\textsuperscript{112} Thus, it has been held and the Government has reluc-

\textsuperscript{109} See, e.g., United States v. Sullivan, 333 F.2d 100, 105 n.13 (3d Cir. 1964); McGnL app. B.

\textsuperscript{110} Walker, \textit{Life Insurance and the Federal Tax Lien}, 15 \textit{J. Am. Soc'y C.L.U.} 831, 841 (1961). At the time of publication Mr. Walker was Assistant Counsel of the Life Insurance Association of America.

\textsuperscript{111} See United States v. Sullivan, 333 F.2d 100, 113 (3d Cir. 1964).

\textsuperscript{112} See id. at 105 n.13; McGnL 309-23. The insurer may ordinarily defer payment of cash value or the making of a policy loan for a period of time
tantly conceded that even after receipt of notice of a tax lien, the insurer may make automatic premium loans or apply cash value to purchase extended term insurance without risking liability to the Government for the resulting diminution in cash value.118

Apart from the difference in the contractual obligation of the insurer, the application of cash value to nonforfeiture benefits is probably less prejudicial to the Government than is distribution of cash value in the form of outright payment or extension of policy loans. Should the insured elect to have cash value applied to the purchase of paid-up life insurance, the Government will not be prejudiced since the new policy will have cash value approximately equal to that of the original.214 On the other hand, automatic premium loans may diminish the amount of cash value available on surrender115 and the election of extended term insurance will certainly do so as time passes.216 However, even the latter two are likely to be less prejudicial to the Government than a distribution to the insured of surrender value or a policy loan. In the case of nonforfeiture benefits, the cash value is applied gradually within the company and, when used to fund automatic premium loans, may even experience a net increase;117 while in the case of a payment as surrender value or policy loan, cash value is distributed to the delinquent and may well be immediately squandered and forever lost to the Government.

The distinction between payments and loans on the one hand, and application to nonforfeiture benefits on the other, is consistent

specified in the terms of the policy. See authorities cited note 109 supra. Obviously, no such deferment is possible when cash value must be immediately applied to the appropriate nonforfeiture benefit upon a default of premium payment to maintain the insurance protection in force.


114. See McGlG 312-14.

115. The effect of applying cash value to the payment of premiums under the automatic loan provision depends on the maturity of the policy. If it is at least several years old, there may be a net increase in cash value (i.e., an increase in cash surrender value) for a period of time. Of course, since cash value will increase at a rate less than the increases in the loan account, continuous use by the insured of the premium loan provision will eventually operate to diminish and perhaps finally extinguish cash surrender value. See note 18, supra.


117. The courts have recognized this possibility although thus far no determination of its legal significance has been made. See United States v. Sullivan, 333 F.2d 109, 109 n.18 (3d Cir. 1964); United States v. Wilson, 333 F.2d 137, 143 (3d Cir. 1964); note 18 supra.
with the analysis contained in this Note. It has been shown that receipt of actual notice binds the insurer to protect the Government’s tax lien after its conditional bundle of obligations has become an unconditional debt payable as cash value on surrender or as a policy loan. However, upon default in payment of premiums one of the nonforfeiture benefits becomes automatically binding on the insurer. Although it now owes an unconditional debt in the sense that it must apply cash value, this obligation is distinguishable from the debt arising upon an election to receive surrender value or a policy loan because the policy directs that it be applied to a particular purpose other than distribution to the policyholder. In this very real sense the debt is still a conditional obligation.\footnote{118} 

IV. PROPOSED GOVERNMENTAL REMEDIES

A. LIMITED AVAILABILITY OF LEVY ON CASH VALUE

This Note has suggested that a limited burden be placed on insurers with actual notice of a tax lien to notify the Government of any demand for cash value or a policy loan by the delinquent taxpayer and to defer payment during the period permitted by the insurance contract if that is desired by the Government. The burden would then be on the Government to enforce its rights during this period. It is now proposed that the Government be permitted to levy upon the amount demanded to facilitate its collection during this period. No authority relating to the propriety of this suggestion has been discovered. However, levy would afford the Government the means to act quickly during this limited period to prevent leakage of cash value from under its lien. It would make possible a saving of time for all parties, and, in addition, avoid expensive court action to foreclose the lien. By reducing the time necessary to obtain collection, the levy would also minimize any risk that the insurer would become ensnared in a conflict between its obligations to the insured and to the Government.

\footnote{118. In United States v. Sullivan, supra note 117, at 114, the court stated that “the lien on any debts brought about by the functioning of the automatic premium loan clauses is subject to those provisions’ further operational requirement that such amounts be applied to premium payment.” This means that while the unconditional obligation of the insurer upon default may be regarded as a debt, it is an unusual debt in that it is not payable to the insured as a sum of money, but may be satisfied only by the application of cash value to pay a premium—a paper transaction consummated wholly within the insurance company. Accord, United States v. Mitchell, 210 F. Supp. 810, 815 (S.D. Ala. 1962).}
Moreover, the policy objection to the general availability of levy against cash value does not appear to apply in this situation. Once the insured has made an election to receive payment of all or part of his cash value, levy upon that amount will not prejudice the insured or the beneficiaries. Any impairment of their insurance protection which occurs would have resulted from the insured's decision, whether or not the Government intervened. Nor is the theoretical argument that levy against cash value is unavailable because cash value in the hands of the insurer is not "property" of the insured applicable to this situation. After election by the insured to receive cash value, the insurer owes an unconditional obligation which may properly be viewed as the insured's "fund" or property, to which a lien may attach and against which levy ought to lie.

B. LEVY ON THE INSURED'S "BUNDLE OF RIGHTS"

In attempting to realize the cash surrender value of defaulting taxpayers' insurance policies, the Government has consistently taken the position that such value constitutes a liquidated, unconditional debt similar to a bank deposit. If that view were accepted, levy upon cash value would be permitted without benefit of the distraint sale otherwise required by statute. The courts, however, have refused to treat cash value as the equivalent of cash. It is nevertheless arguable that the Government ought to be permitted to levy upon the entire "bundle of rights" owned by the insured in the policy, represented by the contractual obligations of the insurer. Since this bundle is clearly not cash, a distraint sale would have to be held after the seizure at which the insured's entire interest in the policy would be sold.

At the distraint sale the Government would establish a minimum bid equal to the cash surrender value of the policy. Receipt of this bid would fully satisfy the Government's interest in the policy. If the minimum were not met, the policy would become the property of the United States. As owner rather than lienor the Government could then demand and obtain cash value from the insurer. If this procedure were followed many of the considerations underlying the preference of the courts for judicial

120. Mutual Life Ins. Co. v. United States, 343 F.2d 71, 74 (9th Cir. 1965); United States v. Sullivan, 333 F.2d 100, 116-21 (3d Cir. 1964); Equitable Life Assur. Soc'y v. United States, 331 F.2d 29, 85-86 (1st Cir. 1964).
122. Ibid.
foreclosure as opposed to levy as a means of reaching cash value would be inapplicable. During the period between levy and sale, the operation of the policy would remain unaffected and the insured would be free to redeem.123 At sale all interested parties (probably restricted to beneficiaries or others with an insurable interest) would have an opportunity to purchase the policy to protect their interest in the insurance feature of the policy.124 The principal advantage for the Government, of course, would be to reduce drastically the period of time following attachment of lien during which leakage could occur.125

Unfortunately the Government has not sought to avail itself of this procedure. However, in Mutual Life Ins. Co. v. United States,126 the Ninth Circuit recently refused to permit a levy upon cash value solely on the ground that the Government had erroneously regarded cash value as the equivalent of cash and consequently had not subjected the insured's rights to a distraint sale after their seizure.127 The court expressly left open the question whether levy might be made upon such rights.128 Moreover, this use of levy appears supported by a reading of the Bess case and the levy statute. In the former it was held that a tax lien attaches to an insured's right to cash value.129 The latter provides that levy shall be available against all property or rights to property to which a lien attaches.130 Consequently it would seem that levy ought to be available to reach cash value as a bundle of rights even though it is not available against cash value as the equivalent of cash.

123. INT. REV. CODE OF 1954, § 6337(a).
125. INT. REV. CODE OF 1954, § 6335(d) provides that the distraint sale shall take place not less than 10 nor more than 40 days from the giving of public notice of the sale.
127. Id. at 74. The Salerno case, note 126 supra, until modified, was the sole authority opposed to Sullivan and Equitable Life. In that case levy was held to be a meaningful demand upon the insurer which fixed the minimum amount of cash value subject to the tax lien. A penalty under INT. RSV. CODE OF 1954, § 6332(b) was imposed upon the insurer for leakage due to the application of automatic premium loans subsequent to the levy and demand. On appeal the Mutual Life court refused to hold the insurer liable for such leakage.
128. See note 55 supra.
129. 357 U.S. at 55-57.
130. INT. REV. CODE OF 1954, § 6331(a).
It is sufficient to indicate that apparently no conceptual or practical objection exists to making available to the Government the remedy of summary levy on cash value in the hands of the insurer, so long as it is regarded as an integral part of the insured's bundle of rights held by the insurer rather than as a liquidated debt.

C. LEVY ON THE POLICY

There is no direct judicial authority supporting the proposal advanced above for levy upon the insured's bundle of rights in the hands of the insurer. However there is another, related means by which the Government might protect itself against diminution in the value of its liens through the operation of nonforfeiture benefits prior to the completion of foreclosure actions. This is direct levy on the policy in the hands of the insured, which apparently is available and is sufficiently expeditious to afford the Government substantial protection. Levy on the policy is also consistent with existing legal doctrine. It has always been conceded that the lien attached to the rights of the insured in his policy because they are "property or rights to property." Therefore, seizure by levy ought to be available against the physical document embodying these property rights. After levy, the Government would have to subject the policy to a distraint sale which would afford substantial protection for the interests of the insured and the beneficiaries.

Although levy on the policy would provide summary relief against the operation of nonforfeiture benefits, the Government evidently has neglected the device. This is perhaps explained by its unworkability in certain situations. For example, it is unavailable if the policy cannot be located, as when the taxpayer has absconded and taken it with him.

131. Kyle v. McGuirk, 82 F.2d 212 (3d Cir. 1936). The Kyle case was noted by the three 1942 cases which held that levy against cash value in the hands of the insurer was not possible: United States v. Metropolitan Life Ins. Co., 150 F.2d 149, 152 (2d Cir.); United States v. Penn Mut. Life Ins. Co., 130 F.2d 495 (3d Cir.); United States v. Massachusetts Mut. Life Ins. Co., 127 F.2d 880, 883 (1st Cir.). These cases indicated that Kyle was correct in deciding that the taxpayer's right to cash surrender value could be seized and sold at a distraint sale and the proceeds would be applied to reduce his tax liability. Further, in Sullivan, 333 F.2d at 119, the court assumes that levy on the policy in the insured's possession is completely acceptable as a means of summary collection of the insured's interest in his life insurance.

132. See notes 121-25 supra and accompanying text.

133. In United States v. Metropolitan Life Ins. Co., 256 F.2d 17 (4th Cir. 1958), and Equitable Life Assur. Soc'y. v. United States, 331 F.2d 29 (1st Cir.
D. Judicial Equity

The Sullivan court refused to impose upon the insurer the risk of diminution in cash value through the operation of the automatic premium loan provisions after the commencement of judicial foreclosure proceedings. However, it went out of its way to suggest that after commencement of suit, the Government "could have properly availed itself of the court's [equity] processes . . . to take effective steps against the insurers before the time when the automatic premium loan provisions . . . became operative." The Government does not appear ever to have availed itself of this protection, and no case has been found which directly considers its right to do so. Prompt exercise of such a power could preclude or at least mitigate operation of policy provisions detrimental to the Government's interest. This would afford the Government effective protection against leakage by operation of the nonforfeiture benefits and other policy provisions. A court might, for example, enjoin all operation of the policy including the automatic premium loan provision and other nonforfeiture benefits. Short of this, it could order the insurer to limit charges against cash value to a minimum until the hearing commences. For instance, the court might order the insurer not to effect an automatic premium loan for a full year's premium but only for lesser periods until the hearing. Finally, the foreclosure action could be moved ahead on the trial calendar to minimize the exposure of the Government's lien to risk of leakage.

CONCLUSION

It is well-settled that a federal tax lien attaches to the delinquent-taxpayer-insured's right to the cash value of his life insurance. However, the Government has developed no effective method for reaching this asset quickly or preventing leakage from the collectible value of its lien prior to a judicial foreclosure action. The courts have not permitted the Government to treat cash value as the equivalent of cash and employ the summary collection device of levy against cash value without holding a distraint sale. This result is doubtless sound. It would be an injustice to the insured and the beneficiaries to allow the Government summarily to terminate all interests in an insurance

1964), the taxpayer-insureds had fled the country, forcing the Government to foreclose its tax lien in district court following the assertion of in rem jurisdiction over the policy by published service.

135. Id. at 120–21.
policy without affording these parties an opportunity to protect such interests.

As a result, however, the Government has usually been forced to fall back upon judicial foreclosure as the means to realize upon its liens on rights to cash surrender value. This method is slow, cumbersome, and expensive. The time consumed in pursuing it affords considerable opportunity for leakage of cash value from under the lien as a consequence of elections by the insured and the operation of various nonforfeiture benefits. Therefore the Government has sought to hold insurers responsible for leakage which they have permitted after receiving actual notice of the existence of liens. It has met with varying degrees of success depending upon the policy provision in question. For example, the insurer may make automatic premium loans or effectuate extended term insurance at any time prior to actual foreclosure without risking liability to the Government. However, it would appear that if the insurer extends policy loans or pays cash surrender value it will be subjected to liability to the Government for diminution of the tax lien. This distinction between nonforfeiture benefits and cash value payments or policy loans is based on the impact of the operation of the provisions upon the interests of the insured and the beneficiaries. Since interruption of the nonforfeiture benefits would prejudice the rights of the insured and of the beneficiaries, such provisions continue to be operative until foreclosure. However, no prejudice to the insured or the beneficiaries will result from requiring the insurer to pay to the Government rather than the insured any actual disbursements elected by the insured. Since the insured has elected to terminate or reduce his interest in his insurance, it is only fair to require that any actual payments be made to the Government to reduce his tax delinquency.

This Note suggests four possible methods by which the Government may prevent or mitigate the effects of leakage.

First, it might levy upon cash value in the hands of the insurer after an election by the insured to take a policy loan or receive cash surrender value. Such a procedure would enable the Government to reach the distribution quickly and inexpensively and without requiring the insurer to breach its policy obligations.

Second, the Government might levy against the insurer on the entire "bundle of rights" owned by the insured, which necessarily includes cash value as an integral part. Such a procedure will protect the interests of the beneficiaries through the distraint sale
required by statute. The insured, in addition to his right to bid at such a sale, would also have a right to redeem the entire “bundle” prior to sale.

Third, the Government might levy on the physical policy in the hands of the insured, an approach related to the second proposal. This idea has found some judicial support and involves seizure and sale of the document which represents the “bundle of rights” owned by the insured. While levy on the policy would have the same net effect as levy upon the “bundle of rights” in the hands of the insurer, it may be somewhat preferable because the protection afforded the insured might be greater.

Fourth, the equity powers of the courts are probably available to the Government to mitigate the effects of leakage if the Government acts with diligence to foreclose its lien.