

**Department of  
Veterans Affairs**

# Memorandum

Date: February 15, 2005

VAOPGCPREC 2-2005

From: General Counsel (023)

Subj: Applicability of SGLI and VGLI Tax Exemption – 38 U.S.C. § 1970(g)

To: Under Secretary for Benefits (20)

**QUESTION PRESENTED:**

Does the tax exemption provided to beneficiaries of the Department of Veterans Affairs' (VA) Servicemembers' Group Life Insurance (SGLI) and Veterans' Group Life Insurance (VGLI) programs under 38 U.S.C. § 1970(g) apply to the Federal tax on generation-skipping transfers (GST) imposed by chapter 13 of title 26, United States Code?

**COMMENTS:**

1. On November 1, 2000, Congress amended 38 U.S.C. § 1967 to increase the maximum amount for which a person may be insured under VA's SGLI and VGLI programs to \$250,000. See Pub. L. No. 106-419, § 312(a), 114 Stat. 1822, 1854 (2000). The Prudential Insurance Company of America (Prudential), which is the primary insurer under the SGLI and VGLI programs, has suggested that this change in law may trigger the provisions of the GST tax. Prudential is concerned that it may be liable to the Government for the GST tax and be required to deduct the tax from the insurance proceeds payable to certain beneficiaries of VA's life insurance programs in spite of the tax-exempt status of those proceeds under 38 U.S.C. § 1970(g).

2. We believe that resolution of the issue presented depends primarily on the interpretation of a statute administered by VA concerning VA's provision of benefits to veterans, specifically, 38 U.S.C. § 1970(g), which states:

Any payments due or to become due under [SGLI] or [VGLI] made to, or on account of, an insured or a beneficiary shall be exempt from taxation . . . and shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, either before or after receipt by the beneficiary. The preceding sentence shall not apply to . . . levy under subchapter D of chapter 64 of the Internal Revenue Code of 1986 . . . , and . . . the taxation of any property purchased in part or wholly out of such payments.

VA's express purpose is "to administer the laws providing benefits and other services to veterans." 38 U.S.C. § 301(b). The Secretary of Veterans Affairs "is responsible for the proper execution and administration of all laws administered by [VA] and for the control, direction, and management of [VA]."

38 U.S.C. § 303. The VA General Counsel is authorized to interpret the laws administered by VA and to advise the Secretary concerning implementation of those laws. See 38 U.S.C. § 311. Pursuant to this authority, we conclude, as explained below, that section 1970(g) exempts SGLI and VGLI proceeds from the GST tax and precludes Prudential from withholding a portion of such proceeds for purposes of the GST tax. We have consulted with the Office of the Associate Chief Counsel (Passthroughs and Special Industries) of the Internal Revenue Service, which has advised that it agrees with our analysis.

3. Life insurance beneficiaries are generally liable under current law to reimburse decedents' estates for Federal estate taxes based on the value of the insurance proceeds. Section 2206 of title 26, United States Code, provides "if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate." Under this provision, the beneficiary of a life insurance policy is liable to the insured's estate for the portion of an estate tax attributable to the insurance proceeds. See Commissioner v. Pupin's Estate, 107 F.2d 745, 746-47 (2<sup>nd</sup> Cir. 1939) (interpreting the predecessor to section 2206). If a payment of insurance proceeds involves a generation-skipping transfer, however, the insurer itself may be liable for payment of the GST tax, as explained below.

4. The GST tax is levied upon transfers of interest in property to a skip person (a beneficiary that is more than one generation below the transferor). 26 U.S.C. §§ 2613, 2651. Taxable transfers include, among other things, any distribution to a skip person under a trust arrangement. 26 U.S.C. §§ 2611-12. A taxable trust arrangement is any agreement, such as a contract for life insurance coverage, that has substantially the same effect as an explicit trust. 26 U.S.C. § 2652(b). Congress has provided to each person making taxable transfers a GST exemption, which the transferor or the executor of the transferor's estate may allocate to the transferred property. 26 U.S.C. §§ 2631-32. For transfers before 2004, the GST exemption is \$1,000,000, adjusted annually for inflation in the case of transfers made after 1998 and before 2004. 26 U.S.C. § 2631 note. For transfers after 2003, the GST exemption is equal to the applicable exclusion amount under 26 U.S.C. § 2010(c) for the relevant year. 26 U.S.C. § 2631(c). For 2005, the GST exemption is \$1,500,000. 26 U.S.C. § 2010(c). If the value of the transferred property exceeds the exemption allocated to that property, the GST tax is applied to the excess value at the highest estate tax rate. 26 U.S.C. §§ 2602, 2641-42. Section 2603 of title 26, United States

Code, provides that the tax imposed upon a "generation-skipping transfer shall be charged to the property constituting such transfer." See also 26 U.S.C. § 2621(a) (taxable amount derived from the value of the property reduced by the transferee's expenses). Generally, an insurer holding a taxable transfer of \$250,000 or more must deduct the GST tax from the policy proceeds prior to any distribution to beneficiaries. See 26 C.F.R. § 26.2662-1(c)(2)(vi) Examples 2 and 3. An insurer holding a taxable transfer of less than \$250,000 must pay the full amount of the insurance proceeds to the beneficiary, who may then be liable to the executor of the insured's estate under 26 U.S.C. § 2206. See 26 C.F.R. § 26.2662-1(c)(2)(iii) (executor's liability for GST tax).

5. This office has not previously issued an opinion on the specific question of whether the Federal Government may, under the GST tax provisions, levy a tax directly upon the proceeds of VA's life insurance programs that are to be paid to a non-estate beneficiary. Nor are we aware of any published court opinion holding that the Government may do so. As noted above, the plain language of section 1970(g) provides that payments under SGLI or VGLI "shall be exempt from taxation" and "shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, either before or after receipt by the beneficiary."

6. VA's life insurance programs have long been an important component of the benefits authorized for servicemembers and veterans, and Congress has consistently exempted the benefits provided under those programs from direct taxation. During World War I, Congress established a program of War Risk Insurance to provide life insurance protection for active-duty servicemembers and their dependents during a time of war. Act of Oct. 6, 1917, ch. 105, § 400, 40 Stat. 398, 409. In its 1924 enactment of the World War Veterans' Act, Congress exempted War Risk Insurance from "all taxation." World War Veterans' Act of 1924, ch. 320, § 22, 43 Stat. 607, 613. A 1935 amendment of the World War Veterans' Act established the provision on which current 38 U.S.C. § 5301(a) is based, which stated the tax exemption generally applicable to veterans' benefits as follows:

Payments of benefits due or to become due shall not be assignable, and such payments made to, or on account of, a beneficiary under any of the laws relating to veterans shall be exempt from taxation . . . and shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, either before or after receipt by the beneficiary.

Act of Aug. 12, 1935, ch. 510, § 3, 49 Stat. 607, 609 (codified at 38 U.S.C. § 454a (1940)).

7. Prudential's concern is based upon the Supreme Court's construction of former section 454a, which contains language very similar to current 38 U.S.C. § 1970(g). Prudential suggests that, in United States Trust Co. v. Helvering, 307

U.S. 57 (1939), the Supreme Court held that the proceeds of SGLI are subject to Federal estate taxes. In United States Trust, the executor of a veteran's estate asserted that former section 454a not only exempted the proceeds of a War Risk Insurance policy from taxation, but also precluded consideration of the value of those proceeds in calculating a decedent's gross estate for Federal estate tax purposes. However, the Supreme Court construed former section 454a as meaning "only that the proceeds or benefits of a War Risk policy are exempt from taxation." Id. at 59 (emphasis added). Noting that the Government paid the War Risk Insurance proceeds directly to the veteran's widow, the court held that "[a]n estate tax is not levied upon the property of which an estate is composed," rather, it is levied upon the value of the decedent's gross estate, which includes the value of life insurance proceeds. Id. at 60. Therefore, in United States Trust, the Supreme Court construed the exemptions in former section 454a as prohibiting the collection of taxes from the widow's War Risk Insurance proceeds. The exemption, however, was held to have no impact upon Federal estate taxation, which is based on the "value" of the insurance benefits and is not levied upon the insurance proceeds themselves. Accordingly, Prudential's concern based upon United States Trust is unfounded.

8. Although the GST tax under chapter 13 of title 26, United States Code, is related to the general Federal estate tax under chapter 11 of title 26, there are significant differences. The estate tax is a tax on the transfer of the entire estate and not upon any particular legacy, devise or distributive share, see 26 C.F.R. § 20.0-2(a), and, as noted in United States Trust, the estate tax is not levied on the specific property of which an estate is composed, such as veterans' life insurance proceeds. In contrast, the GST tax applies to a specific distribution and is "charged to the property constituting such transfer." 26 U.S.C. § 2603(b). Further, the GST tax is to be paid directly from insurance proceeds, by the insurer's withholding of a portion of the proceeds from the beneficiary and payment of those proceeds to the Government. Accordingly, unlike the general Federal estate tax at issue in United States Trust, the GST tax would involve taxation and levy or seizure of SGLI or VGLI proceeds in direct contravention of 38 U.S.C. § 1970(g).

9. The intention of Congress that taxation or seizure of VA insurance benefits be prohibited is clear from legislative history and judicial precedent subsequent to United States Trust. Before the United States commenced its military involvement in World War II, Congress enacted the National Service Life Insurance (NSLI) Act of 1940, which, like War Risk Insurance, provided a life insurance program for servicemembers and their designated beneficiaries. See Second Revenue Act of 1940, ch. 757, §§ 601-18, 54 Stat. 974, 1008-14 (1940) (codified as former 38 U.S.C. §§ 801-818). Former section 816 of title 38, United States Code, incorporated the exemption contained in section 454a. The scope of the exemption was addressed by the Supreme Court in Wissner v. Wissner, 338 U.S. 655 (1950), a case involving the Veterans' Administration's payment of NSLI proceeds directly to a deceased veteran's designated beneficiary, rather

than to his widow. The Supreme Court found that "[a] liberal policy toward the serviceman and his named beneficiary is everywhere evident in the comprehensive [NSLI] plan." Id. at 658. Because an insured veteran had the right to designate a beneficiary and could, at any time, change that designation, the court concluded, "Congress has spoken with force and clarity in directing that the proceeds belong to the named beneficiary and no other." Id. The Court concluded that a diversion of NSLI proceeds away from the designated beneficiary would constitute a prohibited "seizure" under section 454a. Id. at 659.

10. In 1958, Congress repealed the exemptions contained in section 454a and reenacted them in former 38 U.S.C. § 3101 without making substantive changes. See Pub. L. No. 85-857, § 3101, 72 Stat. 1105, 1229 (1958). The Supreme Court has held that former section 3101 (now 38 U.S.C. § 5301) must be liberally construed to protect funds granted by Congress for the maintenance and support of beneficiaries. See Porter v. Aetna Casualty & Surety Co., 370 U.S. 159, 162 (1962).

11. Although Congress allowed Federally sponsored life insurance for servicemembers to lapse after the end of Korean hostilities, it revisited the issue in 1965 when escalating casualties in Vietnam made it difficult for servicemembers to obtain private insurance coverage. See Ridgway v. Ridgway, 454 U.S. 46, 50 (1981). That year, Congress directed the Veterans' Administration to implement the SGLI program by purchasing a group life insurance policy from a commercial insurer. See Pub. L. No. 89-214, 79 Stat. 880 (1965) (codified as former 38 U.S.C. §§ 765-776). VA purchased that policy from Prudential. Former section 770(a) of title 38, United States Code, provided that SGLI "shall be paid . . . to the person or persons surviving at the date of [the insured's] death" in the order of precedence established by statute. Listed first in order of precedence was the insured's designated beneficiary. 38 U.S.C. § 770(a). However, the 1965 SGLI legislation did not expressly incorporate the exemptions afforded by section 3101. The Senate Committee on Finance has stated that SGLI provides a lump sum benefit that surviving family members may use to pay off debts that would have been paid if the servicemember had survived, to pay ordinary expenses of the family, to cover the costs of education, and to pay the unusual expenses associated with the loss of a principal wage earner. See S. Rep. No. 91-398 (1969), reprinted in 1969 U.S.C.C.A.N. 3317, 3319.

12. In 1970, Congress recognized that some doubt existed about whether the section 3101 exemption applied to the payment of SGLI proceeds to beneficiaries. See H.R. Rep. No. 91-1025, at 17-18 (1970). This doubt apparently arose because the SGLI legislation, unlike the statutes governing NSLI, did not expressly incorporate section 3101 and provided for the payment of benefits by a private insurance company under a group life insurance policy, rather than for direct payment by the Government. Id.

at 17-18. In its report on a draft bill addressing, among other things, the applicability of section 3101, the House Committee on Veterans' Affairs asserted that a court decision interpreting section 3101 as being inapplicable to SGLI payments would, in effect, mean that Congress "created a collection agency for various creditors, thus, depriving widows, orphans, and other dependents of benefits the Congress intended them to receive." Id. at 18. The committee distinguished SGLI benefits from private insurance, which an insured purchases solely through the payment of premiums, and stated that SGLI should perhaps have the same exemptions as other VA benefits. Id. at 18. Congress addressed these issues in Pub. L. No. 91-291, § 5, 84 Stat. 326, 330-31 (1970), which incorporated the exemption language of section 3101 in a new 38 U.S.C. § 770(g) (now 38 U.S.C. § 1970(g)).

13. In Ridgway, the Supreme Court reaffirmed its prior holdings concerning the exemptions afforded beneficiaries of VA's life insurance programs. As in Wissner, the court emphasized Congress' intent to provide protection for deceased servicemembers' designated beneficiaries. Ridgway, 454 U.S. at 55-56. It held that "[a]ny diversion of the proceeds of [an SGLI] policy by means of a court-imposed constructive trust would . . . operate as a forbidden 'seizure' of those proceeds." Id. at 60. In this regard, the Supreme Court found that section 770(g) did not differ from other anti-attachment provisions and that "'it ensures that the benefits actually reach the beneficiary.'" Id. at 61 (quoting Hisquierdo v. Hisquierdo, 439 U.S. 572, 584 (1979)).

14. Construing 38 U.S.C. § 1970(g) as being inapplicable to the GST tax would, in effect, result in the direct taxation and levy or seizure of SGLI and VGLI proceeds before receipt by certain beneficiaries. Such an interpretation would clearly be at odds with the will of Congress, as recognized by 65 years of Supreme Court precedent consistently interpreting the language that Congress used in section 1970(g) as exempting the proceeds of VA's life insurance programs from taxation or seizure.

**HELD:**

Under 38 U.S.C. § 1970(g), Servicemembers' Group Life Insurance and Veterans Group Life Insurance proceeds that are to be paid directly to a beneficiary who is more than one generation below the insured are exempt from the Federal tax on generation-skipping transfers imposed by chapter 13 of title 26, United States Code.

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