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fact that the only expenditures of the Foundation since its establish-
ment had been for a library, the bequest was for educational purposes.

In the light of these two decisions it would appear highly desirable
for draftsmen of wills in which bequests are made to non-charitable
organizations for charitable purposes to use unequivocal charitable trust
terminology in order to avoid litigation and possible unfavorable tax
consequences.

FRANCES H. HALL

Taxation—Sale of a Life Insurance Contract—Capital Gain or
Ordinary Income?

Under a literal interpretation of the capital gain section of the 1939
Internal Revenue Code the endowment or annuity contract would classi-
fy as a capital asset. Accordingly, if the owner of such a contract, having
held it for more than six months, transferred it by a bona fide “sale or
exchange,” he would not be statutorily prevented from receiving long
term capital gain treatment on his profit.  

This reasoning was followed by a majority of the Tax Court in the
recent case of Percy W. Phillips, where the taxpayer was allowed cap-
ital gains treatment. The transaction involved the sale by taxpayer of a
life insurance endowment contract thirteen days prior to maturity. Tax-
payer received $26,750 in cash for the surrender of all rights, title,
and interest in the contract which at maturity had a value of $27,000.
Although the majority recognized that the taxpayer’s paramount motive
for the transaction was to effect a tax saving, they held that the en-
dowment contract was a capital asset in taxpayer’s hands, that there
was a bona fide sale, that the transaction was not an “agency arrangement

1 Int. Rev. Code of 1939, § 117, as amended, 65 STAT. 497 (1951) (now Int.
Rev. Code or 1954 § 1221). This section lists only those assets which are not
capital assets. Because endowments and annuities are not listed, it follows that
they must be considered capital assets.

2 The words “sale or exchange” do not include surrender of a life insurance or
annuity contract to the obligor wherein the obligee receives payment of an obliga-
tion by terms of the contract. Blum v. Higgins, 150 F.2d 471 (2d Cir. 1945); Bodine v. Commissioner, 103 F.2d 982 (3d Cir. 1939); Frank J. Cobbs, 39 B.T.A.
642 (1939).

3 “A capital asset under Section 1221 is any property held by the taxpayer
whether or not connected with his trade or business, with certain exceptions that
do not embrace insurance contracts. Since an insurance contract is property,
it must be a capital asset. Consequently, the capital gain provisions applying to
the sale or exchange of a capital asset must be available in respect to insurance
contract exchanges, and a long term capital gain should result if the exchanged
insurance contract has been held for six months or more.” Freyburger, Tax
Problems Relating to Life Insurance and Annuity Contracts, 389 Ins. L.J. 375, 386
(1955).


5 It is well accepted that a taxpayer may legally minimize his taxes or avoid
masquerading as a sale," and that accordingly capital gain treatment should be allowed.

The Commissioner contended that the increment realized by the taxpayer represented an interest element and that even a sale or exchange within the meaning of the Internal Revenue Code would not convert this ordinary income into capital gain. The majority answered that the cash value of the contract at the end of each year is fixed by the terms of the contract and is based upon certain actuarial assumptions. These assumptions are conservatively computed to insure the solvency of the company and the soundness of its insurance protection. Frequently, because premium receipts are in excess of the amounts needed for the conduct of its business, the company will declare dividends, thus in effect reducing the cost of the contract. From these considerations the court deduced that the excess of the cash value over the net cost of the policy represented not only accrued interest realized by the taxpayer on the date of sale, but also favorable actuarial experience and a rebate of unused operational expense allowance.

In less than a month after the Phillips decision, the United States Court of Claims, in Arnfield v. United States denied capital gains treatment to the sale of an annuity contract. There, the annuity matured three days following the taxpayer's complete assignment to a third party. The court found that this transaction was a bona fide sale within the meaning of section 117 of the 1939 Code. Admitting that all the other requisites of the capital gains section of the 1939 Code were met, the court thought the true issue to be whether taxpayer could convert ordinary income into capital gain by selling the contract prior to maturity.

"Amounts received as a return of premiums paid under life insurance, endowment, or annuity contracts, and the so-called 'dividend' of a mutual insurance company which may be credited against the current premium, are not subject to tax." U.S. Treas. Reg. 111, § 29.22(a)-12 (1943).

The Arnfield court did not cite Phillips although that case was handed down some sixteen days prior to Arnfield. Neither court cited the case of Jules J. Rien gold, P-H 1941 B.T.A. Mem. Dec. ¶41,319, where the petitioner purchased a mature, $100,000 life insurance policy from the beneficiary in 1933 for the sum of $15,000. In 1936 the beneficiary was adjudged an incompetent, and the conservators instituted suit to avoid the 1933 sale and to recover the policy. In settlement of the suit the petitioner transferred the policy to the conservators and received a cash payment of $55,000. The court held that the insurance policy was a capital asset in the petitioner's hand and allowed capital gains treatment.

Int. Rev. Code of 1939, § 22(b)(2), as amended, 67 Stat. 471 (1951) (now Int. Rev. Code of 1954, § 72(a), (b)). This section includes in gross income amounts received over and above the contract's cost, except there is allowed a 3% exclusion per annum for annuity contracts until cost is recovered. The 1954 Code still includes the gains in gross income, but provides for a different method of computation, viz., the use of an exclusion ratio to regain the cost of the contract.
The court found that the facts here fell clearly within the well-established line of authority holding that the proceeds received from a bona fide sale of future income rights are taxable as ordinary income and not as capital gains. It was contended that this line of authority was inapplicable because those cases dealt with the sale of a future income right, whereas, here, taxpayer sold not just the future income right but rather the entire ownership in the income producing property. This contention was summarily dismissed as being inconsistent with *Hort v. Commissioner*, where the court held that a sum received by a lessor for the cancellation of a lease was taxable as ordinary income despite the fact that the lease may for other purposes be treated as “property” or “capital.”

These two cases, from the facts presented, seem to be indistinguishable in principle. Each transaction involved a transfer of all rights, title, and interest in a contract which had appreciated in value over the years. Both contracts were destined to mature in the near future and upon maturity would be taxable as ordinary income. Moreover, there would not appear to be any difference in the two types of contracts involved here. If, then, the cases are factually the same, why the inconsistency?

The explanation for this inconsistency lies in an understanding of the avenues of approach that may be taken in evaluating this type of transaction. One approach is to concede that the capital gains section is applicable; and whether capital gain or ordinary income treatment will be accorded the taxpayer will depend on whether the requisites of that section are met. For example, the dissent in *Phillips* argued that the profit was ordinary income because there had been no “bona fide sale or exchange” of the endowment contract. On the other hand, it can just as logically be argued, as did the court in *Arnfield*, that since section 22(b) (2) of the 1939 Code would require ordinary income treatment upon maturity of the contract, the premature sale of the contract was, in effect, a sale of future income and clearly within the *Hort* line of

10 Commissioner v. Lake, 356 U.S. 260 (1958) (sale of oil and sulphur payment rights); Hort v. Commissioner, 313 U.S. 28 (1941) (sale of property rights in a lease by lessor to lessee); Fisher v. Commissioner, 209 F.2d 513 (6th Cir. 1954) (sale of corporate notes which were in default both as to principal and interest); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (sale of stock dividends before they became payable); Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937) (sale of partnership interest in earned fees); Charles E. Sorenson, 22 T.C. 321 (1954) (sale of stock options given as compensation by taxpayer's employer).

11 313 U.S. 28 (1941). It is to be noted that taxpayer (lessor) merely cancelled the lease while still retaining the fee to the property.

12 "The problems involving the sale or taxable exchange of an annuity are basically the same as shown for other insurance contracts. The annuity contract can be considered a capital asset .... The basis of the annuity sold or exchanged is cost less any amounts previously recovered tax free." HERZBERG, SAVING TAXES THROUGH CAPITAL GAINS 21 (1957).
cases. In other words, the result of the transaction in form looks like a capital gain while in substance it is not.

A quote from the dissent in the Phillips case illustrates the need for a judicial yardstick: "The conclusion which in my opinion cannot be escaped here might be different where a policy was not about to mature, or did not have a cash surrender value in an amount close to the full value at maturity, and where the taxpayer could recover his investment only through a sale to a third party." The court in Arnfield also recognized this need when it aptly stated that "the law holds no certainty in this area."

Thus by judicial admission a denial of capital gain benefits in this area is obviously left to a case by case determination, leaving no definite boundaries set for taxpayer to follow. Since the stakes are often worth the gambling, taxpayers do invent technical property devices in an effort to save taxes. Therefore it is urged that legislation be enacted whereby taxpayer will be accorded identical treatment on the proceeds of the policy whether they be obtained from a "bona fide sale or exchange" or surrender to the company. At present this area is merely a trap for the unwary.

RICHARD B. HART

Torts—Negligence—Automobiles—Owner's Liability After Leaving Ignition Key in Lock

The recent case of Williams v. Mickens presented a question of first impression in North Carolina. The defendant parked his automobile on a public street with the key in the ignition switch and left it unattended. The automobile was subsequently stolen, and shortly thereafter was involved in a collision with the plaintiff caused by the negligence of the thief. The plaintiff sued defendant for his negligence in leaving the key in the ignition on the theory that defendant should have foreseen that a thief might steal the automobile and drive it negligently. Since there was no statute involved, the court decided the case on common law principles. The trial court granted defendant's motion for nonsuit and the supreme court affirmed. Relying on the case of Ward v. Southern Ry., the court said that, while they were not willing to admit

13 Cases cited note 9 supra.
15 CCH 1958 STAND. FED. TAX REP. ¶ 9692 at 151.
1 247 N.C. 262, 100 S.E.2d 511 (1957).
2 206 N.C. 530, 174 S.E. 443 (1934). (Plaintiff was killed when struck by a piece of coal thrown from defendant's car; held, assuming defendant was negligent in allowing thieves to be on the train, nevertheless, the plaintiff cannot recover since the intervening criminal assault was unforeseeable.)