Louisiana Law Review

Volume 19 | Number 2
The Work of the Louisiana Supreme Court for the 1957-1958 Term
February 1959

Income Tax - Profit on Sale of Endowment and Annuity Policies - Capital Gain or Ordinary Income?

Charles B. Sklar

language is retained in R.S. 15:461. Since this statute allows, but does not compel, testimony, it is readily seen that only the competency phase of the common law rule is removed, leaving the privilege.[32] But this privilege is severely limited because the statute has been interpreted to mean that it belongs only to the witness spouse,[33] to exercise at his option, which he must do before the jury.[34] The accused may force his spouse to testify in his favor,[35] and if he fails to do so the prosecutor may comment on this failure.[36] Thus unless the testimony of the spouse is especially damning, it would seem that the protection given by the privilege is negligible because the accused is subject to the prosecutor's comments, which quite likely will make his situation worse than if the testimony were given.

It is submitted that the decision in the instant case is sound, for it would seem that the protection of the sanctity of the marital relationship, indeed the institution of marriage itself, is more important than an ascertainment of truth in any particular case. This decision will naturally have no direct effect outside of the federal courts; however, its indirect influence may be felt in the state systems. It is hoped that this influence will lead to a reconsideration of the privilege statute in Louisiana, for it would seem that the purpose behind the statute is not unlike the reasons advanced by the majority in the instant case to support the privilege. This purpose cannot be realized, however, as pointed out in the concurring opinion, unless the privilege is in the hands of the accused spouse.

Ray C. Muirhead

INCOME TAX — PROFIT ON SALE OF ENDOWMENT AND ANNUITY POLICIES — CAPITAL GAIN OR ORDINARY INCOME?

Whether the sale of an endowment or annuity insurance policy to a third person prior to its maturity results in capital gain or ordinary income to the vendor is left in question by two

32. For a more complete treatment of Louisiana's position and the interpretation of the statute, see Note, 14 LOUISIANA LAW REVIEW 427 (1954). This note is current, as there seems to have been no cases on the points covered since its writing.

33. State v. McMullan, 223 La. 629, 66 So.2d 574 (1953); State v. Dejean, 159 La. 900, 106 So. 374 (1925); State v. Webb, 156 La. 952, 101 So. 338 (1924).

34. State v. McMullan, 223 La. 629, 66 So.2d 574 (1953), 14 LOUISIANA LAW REVIEW 427 (1954).

35. State v. Todd, 173 La. 23, 136 So. 76 (1931).

36. *Ibid.*

recent decisions. In *Phillips v. Commissioner*, 30 T.C. No. 87, CCH Dec. 23077 (1958), taxpayer transferred, twelve days before it matured, all his interest in an endowment policy which he had owned for many years. During this time he had received substantial dividends on it. The sales price of the policy exceeded taxpayer's cost basis but was slightly less than its cash surrender value at the date of the sale. Taxpayer admitted his major motive in making the transfer was to obtain a capital gain on the proceeds. In *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958), an annuity policy, owned for many years, was sold to a third person three days before it matured. The contract provided that cash values and death benefits prior to the commencement of annuity payments at maturity should be computed at the fixed rate of 3½ percent compounded annually on amounts deposited with the insurance company. As in the *Phillips* case, the policy was sold at a price in excess of taxpayer's basis, but slightly less than its cash surrender value at the date of sale. Taxpayer disposed of the policy to invest the funds in securities yielding a greater return. The *Phillips* case held that profit on sale of an endowment policy is taxable as a capital gain, and that such profit cannot be considered accrued interest where the excess of cash value at the date of sale over basis was caused by a reduction of total premiums due under the policy by mutual insurance company dividends.[1] In *Arnfeld* it was held that gain on sale of an annuity is ordinary income, for taxpayer cannot convert what is essentially interest income into capital gain by a mere sale. The court found that there was a *bona fide* sale in both cases.

The Internal Revenue Code provides that only a gain on the "sale or exchange" of "capital assets" may be taxed at the favorable capital gain rates.[2] In general, a taxpayer may arrange his affairs so as to minimize his taxes, and if his methods are not merely a sham for the purpose of tax avoidance they will be sustained.[3] Some cases indicate that arrangements which minimize

1. The court found that total premiums due under the policy would have approximately equalled cash surrender value at the date of sale. Thus, any interest which may have been allowed to taxpayer under the terms of this policy was negligible. If the policy had provided for such interest, it would have been taxed as ordinary income.

2. INT. REV. CODE OF 1954, §§ 1221, 1222; Int. Rev. Code of 1939, §§ 117(a) (1-11). Both *Phillips* and *Arnfeld* were decided under the 1939 code, but the provisions involved in these cases are substantially the same under either the 1939 or the 1954 Code. This Note will not deal with Section 1231 assets, nor will capital losses be considered as a separate problem, for their treatment would be essentially the same as that of capital gains.

3. Paine v. Commissioner, 236 F.2d 398 (8th Cir. 1956); Fisher v. Commis-

taxes, but which have no business purpose, may be treated as a sham.[4] In determining whether a given transaction has a *bona fide* business purpose, the courts look to its substance, rather than its form.[5] Theoretically a transaction which attempts to convert into capital gains what would normally be ordinary income should not be given effect, even though the transaction may also have a business purpose.[6] Under what circumstances capital gain rates will be allowed on gains realized from the sale or exchange of contract rights has long been a problem. Very few cases have dealt directly with the transfer of rights under insurance contracts, but transfers of rights under other types of contracts have been extensively considered by the courts. Allowance of capital gain on profit resulting from the transfer of rights under a contract has met with two major objections by the Commissioner: that the transfer is not a "sale or exchange" within the meaning of the Code, and that the consideration received on the transfer is in lieu of ordinary income either previously accrued, or yet to be earned under the contract rights transferred.[7]

Cases dealing with the transfer of rights under certain types of contracts have conclusively settled whether capital gain or ordinary income is realized. For instance, if consideration is received by the taxpayer for the transfer[8] or cancellation[9] of rights related to a contract for his personal services, the pro-

sioner, 209 F.2d 513 (6th Cir. 1954); Clara M. Tully Trust v. Commissioner, 1 T.C. 611 (1943); McKee v. Commissioner, 35 B.T.A. 239 (1937). *Cf.* Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946); Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943); Jules J. Reingold, Docket No. 100878 (1937), 10 P-H B.T.A. Memo. Dec. ¶ 41319 (1941).

4. Gregory v. Helvering, 293 U.S. 465 (1935); Higgins v. Smith, 308 U.S. 473 (1939) Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938).

5. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Griffiths v. Commissioner, 308 U.S. 355 (1939); S. A. Macqueen Co. v. Commissioner, 67 F.2d 857 (3d Cir. 1934); Lasky v. Commissioner, 22 T.C. 13 (1954), aff'd, 235 F.2d 97 (9th Cir. 1956), aff'd, per curiam, 352 U.S. 1027 (1957).

6. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1940); Burnet v. Hormel, 287 U.S. 103 (1932); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942); Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937); Sorensen v. Commissioner, 22 T.C. 321 (1954); Shumlin v. Commissioner, 16 T.C. 407 (1951).

7. Bechly, *Sale of a Contract — Capital Gain or Ordinary Income*, 35 TAXES 759 (1957).

8. Sorensen v. Commissioner, 22 T.C. 321 (1954); Jessop v. Commissioner, 16 T.C. 491 (1951); Parker v. Commissioner, 5 T.C. 1355 (1945); McFall v. Commissioner, 34 B.T.A. 108 (1936).

9. Lasky v. Commissioner, 22 T.C. 13 (1954), aff'd, 235 F.2d 97 (9th Cir. 1956), aff'd, per curiam, 352 U.S. 1027 (1957); Shumlin v. Commissioner, 16 T.C. 407 (1951); Williams v. Commissioner, 5 T.C. 639 (1945); Becken v. Commissioner, 5 T.C. 498 (1945); Shuster v. Commissioner, 42 B.T.A. 255 (1940), aff'd, 121 F.2d 643 (2d Cir. 1941); Gann v. Commissioner, 41 B.T.A. 388 (1940).

ceeds will be taxed as ordinary income, as they are considered compensation received in lieu of earnings. Payments by a lessor to a lessee for surrender of his rights of possession and enjoyment under the lease are considered capital gain to the lessee,[10] but an amount received by a lessor in consideration for the cancellation of a real estate lease is regarded as a substitute for rentals which would have been realized under the lease and is taxed to the lessor as ordinary income.[11] The owner of a life estate is held to have an interest in property, for tax purposes,[12] and any profit he receives on the transfer of the whole or a portion of his interest will be taxed at capital gain rates.[13]

In cases involving the transfer of rights held under certain other types of contracts the issue of ordinary income versus capital gain is somewhat less conclusively settled. Where taxpayer transfers to another all his interest in income-producing property[14] or in a going business,[15] there is more than an assignment of a contractual right to future income, and capital gain treatment is generally allowed. But for the transfer of rights under a contract to be a "sale or exchange," which is required to achieve capital gain treatment, rights formerly held by the transferor must exist in the transferee after the transaction. Thus, where rights are extinguished by a transaction, there is no "sale or exchange," and a capital gain is not realized.[16]

As to both endowment[17] and annuity[18] insurance contracts,

10. Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952); INT. REV. CODE OF 1954, § 1241.
11. Hort v. Commissioner, 313 U.S. 28 (1940).
12. Blair v. Commissioner, 300 U.S. 5 (1937).
13. Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946); Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943). *Cf.* McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1946).
14. Commissioner v. Goff, 212 F.2d 875 (3d Cir. 1954).
15. Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950); Smoak v. Commissioner, 43 B.T.A. 907 (1941).
16. In the following cases it was held that there was an "extinguishment" of the transferor's rights rather than a "transfer" of them, and the net proceeds were treated as ordinary income. Commissioner v. The Pittston Co., 252 F.2d 344 (2d Cir. 1958) (payment was for cancellation of an exclusive right to purchase a company's entire output); Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953) (amounts were received by a dealer for releasing a manufacturer from a contractual obligation to sell exclusively to him); General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953) (transfer agreement provided that rights under the contract transferred should be cancelled by the transferee). But the Third Circuit seems to doubt that the person to whom a right is transferred should affect the determination of whether the transfer was a "sale or exchange." Commissioner v. Goff, 212 F.2d 875, 876 (3d Cir. 1954).
17. Avery v. Commissioner, 111 F.2d 19 (9th Cir. 1940).
18. Bodine v. Commissioner, 103 F.2d 982 (3d Cir. 1939); Cobbs v. Commis-

it is clearly established that amounts in excess of total consideration paid, received upon surrender of the policy to the insurance company, are taxable as ordinary income. But where a life insurance policy was transferred for cash to a party other than the insurance company, a situation very similar to those presented in the instant cases, it was held that the transferor realized a capital gain on the transaction.[19] Prior to 1934 redemption by a corporation of its outstanding notes or bonds was not considered a "sale or exchange," and the excess of the redemption proceeds over the bond holder's basis was taxed as ordinary income.[20] But where corporate bonds were sold the day before they matured for the sole purpose of obtaining capital gain, seller was held to have realized capital gain even though the purchaser bought the bonds at par merely to accommodate the seller, and realized no profit on their redemption.[21] Life insurance and annuity contracts have been held to be in the same class as bonds.[22] Following these cases it would seem that if an annuity were sold to a third party several days before it matured, as in the *Arnfeld* case, any gain resulting should receive capital gain treatment.

It would seem that the apparent conflict between the *Phillips* and *Arnfeld* decisions may be rationalized. The insurance policies involved were certainly within the code definition of capital assets.[23] In deciding the issue of whether there was a *bona fide* sale, the courts in the instant cases seemed to be following the general rule that a taxpayer may act so as to minimize his taxes. In *Phillips* the decision that there was a *bona fide* sale might be questioned. There the cases requiring a business purpose[24] seem tc have been avoided, for taxpayer conceded that his major purpose was tax reduction. However, in the *Arnfeld* case it would seem that the taxpayer did have a *bona fide* business purpose,

sioner, 39 B.T.A. 642 (1939); Hellman v. Commissioner, 33 B.T.A. 901 (1936) (combined life insurance and annuity contracts).

19. Jules J. Reingold, Docket No. 100878 (1937), 10 P-H B.T.A. Memo. Dec. ¶ 41319 (1941).

20. Felin v. Kyle, 102 F.2d 349 (3d Cir. 1939); United States v. Fairbanks, 95 F.2d 794 (2d Cir. 1938). In 1934 Congress specifically provided that the redemption of corporate notes or bonds by the corporation was to be considered an "exchange." Revenue Act of 1934, § 117(f), 44 STAT. 715. This provision is still the law. INT. REV. CODE OF 1954, § 1232(a); Int. Rev. Code of 1939, § 117(f).

21. McKee v. Commissioner, 35 B.T.A. 239 (1937).

22. "In our opinion the surrender of the life insurance and annuity contracts in the instant case, does not differ in any material respect from the bond transactions in the cases above cited [the court refers to cases cited in note 20 *supra*]." Hellman v. Commissioner, 33 B.T.A. 901, 902 (1936).

23. INT. REV. CODE OF 1954, § 1221; Int. Rev. Code of 1939, § 117(a)(1).

24. See notes 4 and 5 *supra*.

and that the sale could be sustained even under the business purpose rule. Thus, as there was a sale of a capital asset in each case,[25] the capital gains provisions should have been applied, unless the sale had the effect of converting ordinary income into capital gains.[26] It is on this issue that the two courts reach opposite results, each of which seems justifiable.

In the *Phillips* case taxpayer sold his policy for slightly less than its cash surrender value. The total premiums payable under the policy from its date of issue to the date of sale approximately equalled the policy's cash value at the sale date.[27] But the dividends which taxpayer had received on his policy during the period that he had held it, had reduced his basis for the policy substantially below its cash value, for dividends paid on endowment policies before maturity are not taxed as ordinary income, but reduce the taxpayer's investment in the policy.[28] Thus in *Phillips,* the court reasoned that to tax the gain on sale of the policy as ordinary income would be tantamount to taxing dividends received on the policy as ordinary income, which would be clearly contrary to law.[29] The court further reasoned that the difference between sales price and basis, resulting from mutual company dividends, could not be considered accrued interest taxable as ordinary income, because such dividends are based on the contingency of company profits after expenses and were not guaranteed at a stipulated rate as is the normal case with interest. On the other hand the gain realized in the *Arnfeld* case was derived completely from amounts accrued at a fixed contractual rate on deposits made with the insurance company. Such sums are clearly in the nature of accrued interest, and to apply capital gain rates would be to convert ordinary income into capital gains.

Where the cost of insurance is dependent upon the insurance company's profits, the policy holder has, in effect, furnished venture capital for re-investment by the insurance company. Ordinarily dividends, that is, amounts paid for the use of venture capital, are taxed as ordinary income. But the Code provides exceptional treatment for dividends paid by an insurance com-

25. INT. REV. CODE OF 1954, § 1221.
26. See note 6 *supra.*
27. See note 1 *supra.*
28. INT. REV. CODE OF 1954, §§ 72(c), (e); U.S. Treas. Reg. § 1.72-11(b) (1956). However, as these sections provide, such dividends are taxable to the extent that they exceed total premiums or other consideration already paid on the policy.
29. See note 28 *supra.*

pany to its policy holders. Such dividends are not taxed as ordinary income, but rather reduce the taxpayer's investment in the policy.[30] The effect of this special treatment would seem to encourage the furnishing of venture capital to insurance companies for reinvestment by them, for an insurance company will have greater freedom to reinvest premiums when it is not obligated to pay a fixed return to its policy holders. Therefore, the special treatment of insurance company dividends appears to be in accord with the major purpose of the capital gains provisions, which is to encourage the free flow of investment capital.[31] Thus it would seem that a gain on the sale of an annuity or an endowment policy prior to its maturity should be accorded capital gains treatment where the policy holder has furnished the insurance company with venture capital. The mere fact that a particular policy is an endowment or an annuity should not be controlling in itself. In *Phillips,* taxpayer purchased term life insurance of a stipulated amount plus a promise to pay a fixed future sum, the net cost of these rights being determined by the company's profits. It seems that his purchase is like an investment in the insurance company, and that his position is analogous to that of an owner. But in *Arnfeld* the amount of cash surrender value and term insurance, and the sum to be applied to the future annuity all depended upon the fixed rate of return on the deposit made under the contract. The purchaser of this type of contract is in a position similar to that of a creditor of the insurance company, for the gain on disposal of his policy is a realization of an accrued return allowed for the use of money deposited with the company. Thus it seems that the instant cases are distinguishable, and that the decision in each is sound.[32]

Charles B. Sklar

MINERAL RIGHTS — IMPROPER PAYMENT OF DELAY RENTALS — AFTER-ACQUIRED TITLE — ASSUMPTION OF VENDOR'S OBLIGATIONS BY VENDEE

Landowner, owning only one-fourth of the minerals, executed a mineral lease to defendants' predecessor in title. Although

30. See note 28 *supra.*

31. S. Rep. No. 1631, 77th Cong., 2d Sess. 49, 50 (1942); S. Rep. No. 1567, 75th Cong., 3d Sess. 6 (1938); H.R. Rep. No. 2333, 77th Cong., 2d Sess. 29 (1942).

32. However, since life insurance and annuity contracts have been held to be in the same class as bonds, it could be argued that a contrary result could have been reached in the *Arnfeld* case. See text accompanying notes 20-22 *supra.*