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some meaning. If a state statute in force at the time of cession can control in the enclave, nothing is left for the word "exclusive" to mean except that subsequently passed state statutes can never control in the enclave. This argument can be effectively countered, however, because the exclusiveness of federal legislative power is not at all impaired by the control in the enclave of a state statute passed subsequent to cession. Congress can nullify the application of a state statute passed subsequent to cession by enacting a contrary statute. Congress retains the ultimate or "exclusive" control of the enclave. Article I, Section 8, Clause 17 is satisfied.

Therefore, no reason appears why the Supreme Court should stop short of allowing subsequently passed state statutes to control in a federal enclave. It now holds the midstream position that, if the state statute is enforced before the federal enclave is created and if the statute does not conflict with a federal statute, the state statute applies in the enclave. A federal statute can allow a subsequently passed state statute to control. Such is the Supreme Court's present position but the holding of the Colorado Supreme Court in *Donoho* and the dissenting opinion of Mr. Justice Frankfurter in *Pacific Coast* appear to this writer the better reasoning.

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SALE OF ENDOWMENT POLICY TO AVOID ORDINARY INCOME TAX TREATMENT

Congress introduced capital gain provisions into the tax structure with the Revenue Act of 1918. The 1954 Code, as well as its predecessors, contained similar provisions. One of the primary purposes for the retention of these provisions is the elevation of burdensome taxation in certain transactions falling within their scope. The constitutionality of such a tax has never been seriously questioned since the Supreme Court decided the case of *Merchant's Loan and Trust Company v. Smietanka.*[1] There the Court decided that income, within the meaning of the Sixteenth Amendment to the Constitution, included profit gained through the sale or conversion of a capital asset. The constitutional issue had thus been laid to rest; but since that date the courts have continually been asked to determine whether certain transactions give rise to capital gains or ordinary income. The government is anxious to prevent any attempt to deplete its revenue intake, while the taxpayer, with equal diligence, is seeking to minimize or to avoid taxes altogether. The battle lines are thus drawn.

In order to take advantage of the capital gain provision certain basic requirements spelled out in the Internal Revenue Code must be met. The property dealt with must be a capital asset as defined by the Code.[2] Secondly, any gain or loss resulting to the taxpayer must be the result of a sale or

1. 255 U.S. 509 (1921).
2. Int. Rev. Code of 1954 § 1221.

exchange.[3] If the property is then held for the length of time required,[4] the technical provisions of the Code will be satisfied and the gain realized by the taxpayer should be taxable at the capital gain rates.[5] Although this is an oversimplification of the tax structure, it is essentially the procedure used to determine whether the capital gain provisions apply. As will be seen from the decisions of the various courts, the application of these principles to different fact situations often results in inconsistent determinations. The "underbrush" of confusion is not being cleared away.

There are certain well defined areas in which the capital gain provisions do not apply. It is settled that the gain resulting from the surrender of an endowment or annuity contract, at maturity, is subject to ordinary income tax rates.[6]

The question of whether the gain resulting from a sale of such a policy to a third party before maturity is not so well settled. In 1941 the Tax Court held that the gain resulting from the sale of a life insurance policy was taxable at capital gain rates.[7] In 1958, The Tax Court in *Phillips v. Commissioner*,[8] one judge dissenting, ruled that the gain resulting from a sale of an endowment policy twelve days before its maturity date should be taxed at the capital gain rates. The Tax Court decided that there had been a bona fide sale of a capital asset. The Court was aware that the sale was primarily motivated by the taxpayer's desire to minimize his taxes. However the Tax Court pointed out that it is the legal right of a taxpayer to minimize his taxes or avoid them altogether by any means which the law permits. The Tax Court rejected the Commissioner's argument that though there was a bona fide sale, this fact alone could not convert what would be ordinary income at the maturity of the policy to a capital gain from the sale of the policy twelve days before maturity. The Tax Court further found that the gain to the taxpayer was to a large extent due to the appreciated value of the capital investment of the policy holder and not solely to interest earnings on this investment. The appreciation in value of the taxpayers capital investment was in a large measure the result of favorable investment practice and economic power of the insurance company.

Shortly after the *Phillips Case* was decided by the Tax Court, the Court of Claims was presented with a similar fact situation in *Arnfeld v. Commissioner*.[9] The issue presented in *Arnfeld* was whether money realized by the taxpayer upon the sale of an annuity contract, before maturity, constituted ordinary income or capital gain. The Court of Claims ruled that the gain

3. Int. Rev. Code of 1954 Subchapter P.
4. Int. Rev. Code of 1954 §§ 1222, 1223.
5. Int. Rev. Code of 1954 § 1201.
6. Bodine v. Commissioner, 103 F.2d 982 (3rd Cir. 1939), cert. denied, 308 U.S. 576 (1939).
7. Reingold v. Commissioner, B.T.A. Memo 868-B (1941).
8. 30 T.C. 866 (1958).
9. 163 F. Supp. 865 (1958), cert. denied, 359 U.S. 943 (1959).

realized by the taxpayer was taxable as ordinary income and not as capital gain. The decision was based on the theory that the sale of the right to future income will not result in capital gain treatment.

After the decision in the *Arnfeld* Case, the *Phillips* Case was appealed to the Court of Appeals in the Fourth Circuit.[10] This time the conflict was resolved in favor of the commissioner and against the taxpayers. In reversing the Tax Court, the Court of Appeals held that what transpired, under the facts of the case before it, was a present receipt by the taxpayer of a sum of money in exchange for the right to future income, and was thus taxable at ordinary income rates. The Court of Appeals did not question the right of the taxpayer to minimize his tax,[11] nor did the Court controvert the position taken by the taxpayer that there existed a bona fide sale. The Court did not deny that an endowment policy was "property" but stated that it did not necessarily follow that everything termed "property" or "capital" should be accorded capital gain treatment, citing *Hort v. Commissioner.*[12] The *Hort* Case involved the cancellation of a lease wherein the lessee, in consideration for said cancellation, paid to the lessor a sum of money substantially equal to the amount the lessor would have received as rent had the lease not been terminated. The court found that the taxpayer was in effect receiving future rental payments, clearly ordinary income.

It may very well be that the *Hort* Case can stand for the proposition that everything that is termed "property" need not be accorded capital gain treatment, but it seems apparent that at this point, a similarity of the *Hort* Case to the *Phillips* Case ends. In the *Phillips* Case there was a sale of an endowment policy by the taxpayer to a third party. The *Hort* Case did not deal with a total assignment or sale of a capital asset to a third party, but rather a cancellation or surrender of the lease to the lessors. The *Hort* Case is analogous to a situation where a policyholder surrenders his policy to the Insurance Company. In a situation where an insurance policy is surrendered or where a lessee effects a cancellation of his lease, there does not seem to be a true sale or exchange as required under the capital gain provisions.

However, the Court of Appeals in the *Phillips* Case did not rely heavily on the *Hort* Case, but rather on the *Arnfeld* decision and the Supreme Court's decision in *P. G. Lake v. Commissioner.*[13] *Arnfeld* had relied for much of its vitality on the decision in the *Lake* Case. The Supreme Court in the *Lake* Case had to determine the consequences of a transaction involving oil payment rights. There the taxpayers had assigned these oil payment rights for a present consideration. These partial assignments were to run for stipulated lengths of time, but for terms less than the terms held by the assignor. These assignments gave to the assignees certain percentage interest in the monies

10. Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960).
11. Gregory v. Helvering, 293 U.S. 465 (1935).
12. 313 U.S. 28 (1941).
13. 356 U.S. 260 (1958).

realized under the oil payment rights for the periods stipulated between the parties. When these assigned oil payment rights had expired, the total oil payment right again would be held by the assignors who had retained reversionary interests. The Supreme Court determined that the consideration received for these assignments was a present receipt of future income. The gain resulting to the taxpayer was held to be taxable at ordinary income rates.

Whatever the decision in the *Lake* Case represents, it does not appear to be controlling in either the *Arnfeld* or the *Phillips* cases. The Supreme Court in the *Lake* Case did not decide what the consequences would have been had the taxpayers sold their complete interests in the oil payments rights. If the *Phillips* Case is citing the *Lake* Case for this proposition, it seems to be an unwarranted extension of the Supreme Court's decision. The taxpayer in the *Arnfeld* Case attempted to distinguish the *Lake* decision on the grounds that in the *Arnfeld* Case the taxpayer had sold her entire property interests. In answering this argument, the Court of Claims conceded they were working in an uncertain area and reasoned from the *Hort* Case that whether or not the annuity contract was property was not dispositive of the issue. Since the taxpayer's argument was found "inconsistent" with the principle announced in *Hort,* the Court of Claims saw no reason to adopt it.

It is interesting to note a ruling made by the Commissioner in 1950.[14] The ruling involved the Commissioner's opinion as to transactions dealing with oil-payment rights. It reads in part as follows ". . . It is therefore the present position of the Bureau that the assignment of any in-oil payment right . . . which extends for a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interests. Therefore the assignment . . . results in the receipt of ordinary income by the assignor. . . Notwithstanding the foregoing, G.C.M., . . . and I.T. 3935 . . . , do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire interest of the property." It is apparent then, that the Commissioner has drawn a distinction between a partial and total assignment of property rights. There is a very close analogy between the Commissioner's I.T. Bulletin and the argument of the taxpayer in the *Arnfeld* Case.

A re-argument was had in the *Phillips* Case in which the Commissioner conceded that in certain circumstances a taxpayer could realize a capital gain by selling his endowment policy before maturity. In this re-argument, a hypothetical situation was posed wherein the taxpayer, dying of an incurable disease, sold an endowment policy before maturity for more than its then present surrender value but less then its value at maturity.

We are thus faced with a rather perplexing situation. The Court of

14. I.T. 4003 (1950).

Appeals in the *Phillips* Case concedes that there existed a bona fide sale. The Commissioner conceded that under certain circumstances an endowment policy could be the subject of a capital gain. Yet, under the facts as they existed in the *Phillips* Case, the Commissioner had ruled that the gain from the sale should be taxed at ordinary income rates. Furthermore, the Commissioner, in his I.T. Bulletin mentioned above, gives good grounds for distinguishing the *Lake* Case from the *Phillips* Case. Taking these things as they stand, there exists all the requirements necessary to obtain capital gain treatment, yet that is not the result in the *Phillips* Case. It may very well be that the Court of Appeals and the Commissioner, seeing an evasion of tax at ordinary income rates, decided to plug the gap through which the taxpayer squeezed. But in the same breath, the Court of Appeals freely admits that a taxpayer suffers no penalties for legally attempting to evade tax.

It is difficult to justify the position taken by the Fourth Circuit in the *Phillips* Case. At least one writer feels that the Court's decision might be construed to mean that the sale of an endowment policy will not be considered as within the capital gains provisions if there is an obvious attempt on the part of the taxpayer to avoid ordinary income tax rates.[15] Even if the holding is construed this narrowly, the result does not seem justifiable. No one would question the decision of the Court of Appeals had there appeared some type of collusion between the taxpayer and the third party who purchased his policy. It is precisely in a collusive scheme where the Courts should look behind the technical provisions of the law and expose an illegal means of avoiding tax. But when the courts admit that there exists an arm's length transaction resulting in a bona fide sale and the technical provisions of the Internal Revenue Code have been met, the logical result should be a determination that the sale gives rise to a capital gain.

Certiorari was not applied for in this case because there was not a conflict of circuits, i.e., no other Court of Appeals, including the Court of Claims, had rendered a decision on the question involved, which was contrary to the result reached by the Fourth Circuit in *Commissioner v. Phillips*. The significance of the situation for the individual litigant is that he may not get his case reviewed by the Supreme Court no matter how erroneous the decision of the Court of Appeals may be. The broader implication of the Supreme Court's refusal to review unless there is a conflict in the circuits, imports the dire consequences of having bad law, roaming abroad and capable of much harm, until the fortuitous occurrence of an opposite decision in a different circuit.

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15. 12 J. Taxation 350 (1960).