[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Karl F. Knetsch and Eva Fay Knetsch, plaintiffs above named, hereby appeal to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on November 6, 1958.

McLANE & McLANE,
/s/ By NOLA McLANE,
Attorneys for Plaintiffs. [177]

[Endorsed]: Filed December 1, 1958.

[Title of District Court and Cause.]

ORDER FOR EXTENSION OF TIME FOR FILING AND DOCKETING RECORD ON APPEAL

Motion and Order

Comes now the plaintiffs in the above-entitled case, by their counsel, and move the Court for an order extending the time within which plaintiffs must file and docket the record on appeal to and including March 1, 1959.

/s/ NOLA McLANE by DPC,
Attorney for Plaintiffs.

Order

Pursuant to the foregoing motion for extension of time to file and docket the record on appeal it is hereby

Ordered that the time within which plaintiffs must file and docket the record on appeal in the above-entitled case be extended to and include March 1, 1959.

Dated: January 9, 1959.

/s/ BEN HARRISON,
U. S. District Judge. [180]

[Endorsed]: Filed January 9, 1959.

[Title of District Court and Cause.]

CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the items listed below constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case:

A. The foregoing pages numbered 1 to 185, inclusive, containing the original:

Complaint, filed 5/3/57.

Answer of Defendant, filed 7/3/57.

Plaintiff's Memorandum, filed 10/14/57 (Contentions of Fact and Law).

Defendant's Memorandum of Contentions of Fact and Law, filed 6/20/58.

Plaintiffs' Memorandum in support of Objections to Exhibits 53-61.

Pre-Trial Conference Order, filed 7/22/58.

Minute Order 8/3/58 re trial.

Brief for Plaintiffs, filed 8/27/58.

Mr. McLane: Well, that is certainly the Government's argument in these cases, your Honor.

The Court: That is what the Supreme Court says, isn't it?

In other words, the same test is applied here as is applied in one of these partnership cases. Must we look through the form to the substance, in other words, to see what is the economic substance of the transaction?

Mr. McLane: I would agree, your Honor, that that is a proper view in any tax case. But here I would like to add this, that this is a section of the Code which is somewhat different than many of the sections of the Revenue Act. And I noticed yesterday, as in other of these types of cases, some reference was made to economic substance and the general approach of substance over form, and I would like to call your Honor's attention in that regard to this language from Mertens Law on Federal Taxation, paragraph 2601, which will [17] be found in our brief, where the volume says that,

"* * * The deduction for interest differs from some other deductions such as that for business expense in that aside from the express limitations contained in the Code interest paid or accrued is deductible whether it serves a business purpose or not * * *"

And I would submit to your Honor that the language of the section which provides, "all interest paid or accrued on indebtedness" may not be modified by reading into the statute that the transaction must have some sort of economic substance. That's the view of the plaintiff as to this particular deduction claim.

Also there is one other point I would like to make, your Honor, before we go ahead this morning, if I may: It is a little difficult for me to answer your question without covering this material because I am presenting this case, or I expect to present this case to the court on a slightly different basis than the case was presented in Bonn vs. Commissioner; although those arguments will be made, too.

Prior to 1954, as your Honor will see in reading the decision of the Fifth Circuit in the Bonn case, it was fairly clear and I think there is no dispute here that interest paid to purchase a single premium annuity was not disallowed. During the fall of 1953 and the spring of 1954 [18] the Congress, if your Honor will recall, was involved in changing the 1939 Internal Revenue Code. The very transaction which is now before the court and which went before the court in the Bonn case was presented to Congress, both to the Ways and Means Committee and to the Senate Finance Committee. The Commissioner asked that interest paid to purchase single premium annuities be disallowed. As is often the case, the Congress did not give the Commissioner all that he asked. The Congress said, "We will disallow it as to the future, but as to contracts acquired on or before March 1954, we will not disallow." And I ask that your Honor consider this language of the Ways and Means

more to the weight, your Honor, than to the admissibility of it.

The Court: I am just wondering how his subjective intent is relevant at all—his intent as objectively manifested.

Mr. Wyshak: Well, this was literature sent him by the company.

The Court: But is there any showing he acted upon it?

Mr. Wyshak: Well, his action was in purchasing these annuities, your Honor.

The Court: Well, he might have non constat purchased without the literature, might he not?

Mr. Wyshak: I beg your pardon?

The Court: He might have purchased without the literature, might he not? [4]

Mr. Wyshak: He might have.

The Court: I will sustain that objection. However, paragraph 22 of the pretrial conference order on page 10 will remain in the record, if you so desire, as a record of excluded evidence pursuant to Rule 43(*c*).

Is that your wish?

Mr. Wyshak: Very well, your Honor.

The Court: There is no need of it unless you wish it. If you wish it to remain in the record as a record of excluded evidence, it may.

Mr. Wyshak: I do, your Honor.

The Court: Very well.

That disposes of plaintiff's objections, does it not?

Mr. McLane: That is correct, your Honor.

The Court: Now, the defendant objects to paragraphs 16, 17 and 18.

16 and 17 embrace part of the transaction, do they not?

Mr. Wyshak: Your Honor, the manner in which the Sam Houston treated the sums received from the plaintiff would have no bearing as to the deductibility of those amounts with respect to the plaintiff. Merely the conclusion of the Sam Houston Company as to what they were and that would have no bearing on what your Honor's determination is of the [5] deductibility of these sums.

Mr. McLane: May I respond, your Honor?

The Court: Yes.

Mr. McLane: The Supreme Court of the United States in a case which has been cited by the Government and by the plaintiff in these types of cases was Deputy v. du Pont, 308 U. S. 488. In that decision, your Honor, and in the decision of Old Colony R. Co. vs. Commissioner, 284 U. S. 552, both of which have been submitted to you on brief, the court emphasizes that what interest was depended on what the parties determined the item to be. And in view of that statement, and in view of the Government's position in Revenue Ruling 5494, the basis of which I am positive will be advanced in this matter and which is the basis of the disallowance here, the plaintiff wishes to offer this evidence to show that this transaction did result in interest as to the parties; that it was so designated by them and understood by them; and that if the Government is going to argue substance over form, we be-

debtedness. But in view of that committee language it seems to me that the matter has been presented to the Congress and resolved.

The Court: Very well, gentlemen. Let's take up these exhibits in the pretrial conference order. We admitted Exhibits 1 to 52, inclusive, yesterday, as I recall.

I am of the view that Exhibits 53 through 59 should be likewise admitted. The objections of the plaintiff are overruled. [21]

(The exhibits referred to, marked Exhibits 53 to 59, inc., were received in evidence.)

The Court: Exhibit No. 60, that's the letter to you, Mr. Wyshak, I suppose as a prospective purchaser of an annuity. Is that what it was?

Mr. Wyshak: Yes, your Honor.

The Court: Don't we have the papers in the real transaction here?

Mr. Wyshak: Apparently not, your Honor. But paragraph 22 of the stipulation of facts in the pretrial order sets forth the comparable literature that was sent to Knetsch. We were unable to locate the comparable literature.

The Court: Then this would be admissible as being, in effect, in substance of what was sent to the plaintiff.

Mr. Wyshak: That is correct.

The Court: Very well. The objection will be overruled and Exhibit 60 will be received in evidence. Likewise Exhibit 61.

(The exhibits referred to, marked Exhibits 60 and 61, were received in evidence.)

The Court: That disposes of the plaintiffs' objections.

Now, Mr. Clerk, may I have Exhibits beginning with Exhibit 62 and on to 70, please?

I may have them here. [22]

The Clerk: I think you do have them, your Honor.

The Court: Some of these matters while logically relevant are material in a rather remote degree. But as Mr. Wyshak suggested yesterday, the objection, it seems to me goes to the weight rather than the admissibility of them.

But I am receiving this material as bearing on the issue of whether the transaction had substance as well as form.

Mr. Wyshak: With respect to Exhibits 62 and 63, your Honor, we submit that it's merely one man's opinion in Washington with respect to another taxpayer and in no way binding on this court and in no way binding on the United States.

Mr. McLane: We do not, of course, offer it with any thought that it is binding, your Honor, but merely as rebuttal to the arguments which will be made in the brief, and which these other exhibits which we have already admitted raise with respect to the substance of the transactions and whether or not a tax avoidance was the motive of the participants.

Mr. Wyshak: Your Honor, that correspondence merely relates to whether one man in Washington thinks that Mr. Salley would be entitled to a deduction under certain circumstances. And I sub-

lieve that the designation or classification or label placed upon the item by the other party to the transaction is relevant for the purpose of your Honor's decision as to whether the item before you is or is not interest.

The Court: If it is, I should reverse my ruling and adopt Mr. Wyshak's view of 22, should I not, paragraph 22? [6] If the subjective intention of the parties is relevant, then all the surrounding circumstances of the matters relevant to that issue should come in.

Mr. McLane: Your Honor, those facts which the plaintiffs are urging in paragraph 16 are facts that we are offering along with certain exhibits in rebuttal; and I think in view of the fact that your Honor has ruled that paragraph 22 should not be in that I should withdraw paragraph 16 in line with that ruling.

The Court: Well, if the subjective intention of the parties is the test—if that is the test of the substance as opposed to form——

Mr. McLane: Plaintiff thinks it is not, your Honor.

The Court: ——then it all should come in, shouldn't it?

Mr. McLane: That is our position, that if Mr. Wyshak's approach with respect to this advertising comes in, then this material that we are offering in these paragraphs to which he has objected and the exhibits should also come in. But we do not offer it as part of our direct case.

The Court: As part of your case in chief?

Mr. McLane: That is correct, your Honor.

With respect to paragraph 17, your Honor, the only taxable years before you are 1953 and 1954.

The Court: Now, let's go back to this pretrial conference order. I tried to do too much too fast, apparently.

Mr. Wyshak: May I suggest, your Honor, that you take a few minutes to read the whole thing, because we have tried to do a comprehensive job, and it is quite lengthy.

The Court: I read it. I didn't find a copy of it in my file. I read it when it was here before. And I read the file over the weekend, the memorandums.

Is there any objection to Exhibit 1? We will take it up orderly in that fashion. Or, if you can——

Mr. McLane: There was no objection—and Mr. Wyshak of course can correct me—from Exhibits 1 through 52.

The Court: Is that correct?

Mr. Wyshak: That is correct, your Honor. We have set forth our objections succeeding the mention of each exhibit in the pretrial order.

The Court: Very well. Exhibits 1 through 52 are now received in evidence.

(The exhibits referred to, marked Exhibits 1 through 52, were received in evidence.)

Mr. Wyshak: I assume, your Honor, that those are the exhibits referred to in the pretrial order. I believe the pretrial order may have been marked

was at the rate of 2½% per annum, compounded annually. No economic gain could be achieved from the purchase of these bonds without regard to the tax consequences, taking into consideration and compounding the loss of income on the payments made to the company.

X.

Plaintiff was sixty years old at the time he purchased these bonds. Although the bonds are described therein as a [172] thirty-year deferred annuity having an "original maturity date" when plaintiff became ninety, the plaintiff could elect to accelerate maturity at any time.

XI.

These bonds contained no insurance element whatever.

XII.

The sole security for the alleged loans according to the terms of the instruments executed by the plaintiff was the 10 annuity savings bonds. There was no personal liability whatever on the part of the plaintiff.

XIII.

There was no commercial economic substance to the plaintiff's transaction with Sam Houston.

XIV.

The plaintiff and Sam Houston did not intend that plaintiff become indebted to Sam Houston.

XV.

No indebtedness of the plaintiff was created by any of the plaintiff's transactions with Sam Houston.

XVI.

The plaintiff's payments were no more than annual premiums, the purchase price of a contract on a deferred payment plan.

XVII.

No money or other economic benefit was received by the plaintiff from Sam Houston.

XVIII.

Neither the $143,465 paid by the plaintiff to Sam Houston [173] in 1953 nor the $147,105 paid in 1954, was a payment of interest.

XIX.

Sam Houston's profit in the transaction was the difference between the 3½% received and the 2½% paid.

Conclusions of Law

I.

This Court has jurisdiction over the parties and of the subject matter.

II.

Plaintiff did not enter into a transaction for profit in the purchase of these bonds.

III.

No indebtedness of the plaintiff was created by

any of the plaintiff's transactions with Sam Houston.

IV.

No personal liability for indebtedness on the part of the plaintiff was created by the plaintiff's transactions with Sam Houston.

V.

There was no commercial economic substance to the plaintiff's transactions with Sam Houston.

VI.

No money or other economic benefit was received by the plaintiff from Sam Houston. [174]

VII.

While in form the payments to Sam Houston were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham.

VIII.

Neither the $143,465 paid by the plaintiff to Sam Houston in 1953 nor the $147,105 paid in 1954, was a payment of interest on indebtedness within the meaning of Section 23(b) of the Internal Revenue Code (1939) or Section 163(a) of the Internal Revenue Code (1954), respectively.

IX.

The fact that Section 24(a)(6) of the Internal Revenue Code (1939) does not prohibit a deduc-

tion for an amount paid on indebtedness to purchase an annuity, does not bear on the question as to whether the taxpayer paid interest deductible under Section 23(b).

X.

The defendant is entitled to judgment dismissing the complaint with prejudice and for its costs herein.

Judgment

In accordance with the foregoing findings of fact and conclusions of law,

It Is Hereby Ordered, Adjudged and Decreed that the plaintiffs take nothing, that the complaint be dismissed with prejudice, and that the defendant have its costs herein in the sum of $20.00 (taxed) to be taxed by the Clerk of the Court.

Dated: November 5, 1958.

/s/ WM. C. MATHES,
United States District Judge.

Affidavit of Service by Mail Attached. [175]

[Endorsed]: Filed November 5, 1958. Entered November 6, 1958.

Defendant's Brief, filed 9/16/58.

Reply Brief for Plaintiffs, filed 10/2/58.

Defendant's Reply Memorandum, filed 10/14/58.

Minute Order 8/5/58, further trial.

Plaintiff's Reply to Defendant's Reply Memorandum, filed 10/20/58.

Minute Order 10/20/58, further trial.

Plaintiff's objections to Defendant's proposed Findings of Fact and Conclusions of Law, filed 11/4/58.

Findings of Fact, Conclusions of Law and Judgment, entered 11/6/58.

Notice of Appeal.

Designation of contents of record on appeal.

Order for extension of time for filing and docketing record on appeal.

Statement of Points upon which Plaintiffs intend to rely on appeal.

B. Plaintiff's Exhibits 1 to 71, inclusive.

C. Two volumes of Reporter's Official Transcript of Proceedings had on: August 4 and 5, 1958 and October 20, 1958.

I further certify that my fee for preparing the foregoing record, amounting to $1.60 has been paid by appellant.

Dated: February 6, 1959.

[Seal] JOHN A. CHILDRESS,
Clerk,

/s/ By WM. A. WHITE,
Deputy Clerk.

In The United States District Court, Southern District of California, Central Division

No. 577-57

KARL F. KNETSCH and EVA FAY KNETSCH,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California
Monday, August 4, 1958

Honorable William C. Mathes, Judge Presiding.

Appearances: For the Plaintiff: Nola McLane, 210 West Seventh Street, Los Angeles, California; and W. Lee McLane, Esq., 806 Security Building, Phoenix, Arizona. For the Defendant: Laughlin E. Waters, United States Attorney; Edward R. McHale, Assistant United States Attorney, Chief, Tax Division; by Robert H. Wyshak, Assistant United States Attorney. [1]*

Monday, August 4, 1958; 2:00 P.M.

(Other court matters.)

The Clerk: Case No. 577-57-WB, Karl F. Knetsch versus United States of America.

* Page numbers appearing at top of page of Reporter's Transcript of Record.

Mrs. Nola McLane: The plaintiff is ready.

Mr. Wyshak: Ready for the Government.

Mrs. Nola McLane: I am the attorney for the plaintiff, and my name is Nola McLane. I am admitted to practice before this court.

At this time I would respectfully move the admission of W. Lee McLane, Jr., for purposes of this case only.

Mr. McLane is a member in good standing of the Bars of the States of Arizona and New York, and he is admitted to practice before the District Court in both of those states.

The Court: Very well. The motion will be granted.

Are there any issues of fact to be tried in this case? I have been over the file. Has there been a pretrial conference order prepared?

Mr. Wyshak: There is, your Honor.

The Court: There is?

Mr. Wyshak: Yes, your Honor. And signed and filed on July 22nd.

The Court: That is my recollection, but I don't have it here, my copy of it. [2]

Does the plaintiff offer the pretrial conference order in evidence?

Mr. McLane: The plaintiff now offers the pretrial conference order.

The Court: Any objections?

Mr. Wyshak: There are several objections by both the defendant and the plaintiff as to facts stipulated to, your Honor. They are set forth on page 11, paragraph V.

The Court: I am inclined to sustain plaintiff's objection to paragraph 22. I will be glad to hear from the defendant before ruling.

Mr. Wyshak: Well, your Honor, I have not had an opportunity to see the particular exhibits in question, but I submit, your Honor, that it would have bearing on the plaintiff's intent with respect to his purchasing of these annuity saving bonds.

I don't believe there is any question but that the literature referred to in the exhibit was comparable. In other words, there were no differences of substance between the literature sent the plaintiff and this particular exhibit. So that I would submit that it would have——

The Court: Would his intent control the situation?

Mr. Wyshak: It wouldn't control, but it would have some bearing on whether there was any indebtedness.

The Court: His subjective intent? I don't see how [3] it could.

Mr. Wyshak: Well, what I had in mind was, your Honor, the question is whether he intended to purchase an annuity and intended to become indebted, and this particular——

The Court: Well, whether he did or not, he went through the motions, didn't he?

Mr. Wyshak: That is correct.

The Court: And the form is there. The plaintiff isn't challenging the transactions, is he?

Mr. Wyshak: That is true. I think it goes

as Exhibit 1. I am [8] not certain. Will that be cancelled?

The Court: That will be cancelled. It has not been marked. It was merely offered and there was an objection. Is that right, Mr. Clerk?

The Clerk: Yes, your Honor.

The Court: So Exhibits 1 through 52 are received in evidence.

Now, plaintiffs object to Exhibits 53 through 58. There is no objection as to competency, I take it.

Mr. McLane: That is correct, your Honor.

The Court: Objection as to relevancy and materiality.

This has to do with the financial condition of the company?

Mr. Wyshak: Your Honor, may I have them marked for identification?

The Court: Yes. Well, what is the purpose of it, to show the financial condition?

Mr. Wyshak: They are to show, your Honor, the financial condition of the company as bearing on the issue of whether they were in fact annuities or not.

The Court: In other words, whether the company is financially capable of this transaction, is that it?

Mr. Wyshak: That is in part it, yes, your Honor. And in addition to show the amount of the policy loans and the reserves and the fact that almost all of the annuities [9] they sold during the years in question over 99 per cent of the so-called reserves

for those policies were loans. To show the fictitious nature of the——

The Court: Well, that wouldn't be any objection to it, would it? The fact that a man is operating on a shoestring or carrying his insurance on a shoestring wouldn't matter, would it?

Mr. Wyshak: Well, I think it would have a bearing, your Honor, to show the substance of the transaction. In other words, they could have added another zero to it and increased the interest tenfold.

The Court: But that is the inherent part of the transaction, isn't it?

Mr. Wyshak: We have no objection to this exhibit, your Honor.

The Court: No. But the plaintiff does object.

Mr. Wyshak: That is correct, your Honor.

The Court: And what would be the purpose of these exhibits? What do they prove?

Mr. Wyshak: They tend to show the fictitious nature of these bonds; in other words, that there was no economic substance to them. If your Honor will examine the balance sheets as set forth on these exhibits, referring to Exhibit——

The Court: Well, let's assume the company was financial irresponsible to this extent. Would that rule the [10] case?

Mr. Wyshak: No, your Honor, it wouldn't; and I am not trying to show that the company was financially irresponsible. I am merely trying to show that the assets and the policies sold, the loans on