the policies were practically equivalent to the policy reserves; and that in fact the annuity saving bonds were not what they purported to be.

In addition, these exhibits——

The Court: How would this tend to show that? How would these exhibits tend to show that?

Mr. Wyshak: Well, these exhibits, first of all, contain balance sheets for each year and——

The Court: Well, what would that show? Suppose the company was in a very precarious financial condition. Would that be a circumstance?

Mr. Wyshak: No, your Honor. This does not affect their net worth or capital. I am not trying to show that they were under-capitalized or anything like that. I am merely looking to the assets and policy reserves. For instance, in the year in question, 1953, they show policy loans of $20,700,000 and policy reserves of $21,591,000.

My point is that these annuity savings bonds were not being sold as annuities. They were being sold on a down payment of less than one per cent of the face value. [11] And they could just as readily have jacked up the amounts of annuities by ten and increased the policy loans by ten, and one washes out against the other.

In addition, these exhibits in the footnotes——

The Court: That will be true whether the company is worth $10,000,000 or ten cents, wouldn't it?

Mr. Wyshak: That would, yes, your Honor.

The Court: Well, how does this help us materially, assuming it to be relevant? I don't see how it is relevant, in the first place, and even if it were relevant, I don't see how it could be material.

Mr. Wyshak: Well, I intend to show, your Honor, that each and every one of these annuity bonds sold by this company were sold on the same basis as to this plaintiff, and that these balance sheets, in addition to other schedules, show that the amount of the policy loans were practically equivalent to the policy reserves.

The Court: There were several of these exhibits, weren't there? Are they in the custody of the clerk?

Mr. Wyshak: There are five such exhibits, your Honor; 53 through 58 for identification.

The Court: And then the defendant objects on through to 70, does it not?

Mr. Wyshak: The defendant objects to Exhibits 59 through 70, your Honor. [12]

The plaintiff also objects to 59, 60 and 61.

Mr. McLane: Everything from 53 on, your Honor, I think is objected to by either one of the two parties.

The Court: Are those exhibits in the custody of the clerk?

Mr. Wyshak: No, your Honor.

The Court: Well, suppose you have them marked. Would there be any inconvenience to counsel to come in tomorrow?

Mr. Wyshak: No, your Honor.

Mr. McLane: That would be perfectly all right, your Honor.

If you are going to consider this overnight, I would like to add—before you exhibit any further thought—that these exhibits, it seems to me, do not

bear upon the issue of whether or not this plaintiff became indebted.

Now, the plaintiff does not dispute the fact, your Honor, that the purchase of this type of annuity was made by borrowing—and I use the term "borrowing" advisedly—on the cash surrender value of the policy. That matter was brought to the attention of the United States Court of Appeals for the Fifth Circuit in an identical case which has been ruled upon by the Fifth Circuit on July 15th.

The Court: Is a copy of the opinion here?

Mr. McLane: I have a copy here, your Honor, which [13] I was going to offer up. And I would ask your Honor leave to consider this opinion before you rule on these exhibits.

The Court: Have you shown it to Mr. Wyshak?

Mr. Wyshak: It's been published. It is in the tax services, so I have seen it.

The Court: Is there any objection to this copy?

Mr. McLane: It's a correct copy.

Mr. Wyshak: No objection, your Honor.

The Court: Suppose you have the exhibits marked by the clerk, and I will follow your suggestion, Mr. Wyshak. I will go over this again in the light of the exhibits, and read this opinion. And if there is no inconvenience, why, I will ask you to come back at 10:00 o'clock tomorrow morning, and we will proceed at that time.

Mr. Wyshak: Very well, your Honor.

The Court: Do you have the exhibits here now?

Mr. Wyshak: Yes, your Honor.

The Court: After adjournment you can hand

them to the clerk, if you will, and he will mark them for identification.

Mr. McLane: Your Honor, may I offer at this time, for the same purpose, those to which Mr. Wyshak is objecting, which are being offered by the plaintiff?

The Court: Yes. I would like to see them all.

Mr. McLane: If your Honor would like an unofficial [14] citation to that case, it is in the 1958 CCH volume advance sheets for July 23rd. It is paragraph numbered 9716.

Mr. Wyshak: If your Honor has the Prentice-Hall tax service more readily available it is paragraph 58-5088.

The Court: Very well, gentlemen.

Anything further, Mr. Clerk?

The Clerk: No, your Honor.

The Court: The trial will be continued until tomorrow morning at 10:00 o'clock.

(Whereupon a recess was taken until 10:00 o'clock a.m. of the next day, Tuesday, August 5, 1958.) [15]

Tuesday, August 5, 1958: 10:00 A.M.

The Court: Any ex parte matters?

The Clerk: No ex parte matters, your Honor.

The Court: You may proceed with the case on trial, 577-57, Knetsch v. United States.

Is it agreed by the plaintiff that the real test here is the substance of the transaction and not the form?

Committee report which was issued March 1, 1954, respecting this type of transaction.

"Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from the omission of annuities from the treatment accorded single premium life insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single premium cost of the annuity."

And then I call the court's particular attention to this language:

"Interest on the loan which may be a non-recourse loan is then taken as a deduction annually by the purchaser with the resulting tax saving that reduces the real interest cost below the implement and value produced by the annuity * * *"

and my last sentence of the committee report,

"Your committee bill would deny an interest deduction in such cases——"

"such cases" referring to the example that was just previously set forth——

"but only as to annuities purchased after May 1, 1954."

And I submit, your Honor, that that language

indicates as to the Congress that there was interest in the transaction which we have before your Honor now.

The Court: Otherwise the statute would not have been necessary.

Mr. McLane: It would not be necessary for the Commissioner to ask that it be amended. And certainly when the committee report said "in such cases" they were referring to that type of transaction. And so, while I do not mean to convey that your Honor is in any way limited in this matter, I simply would like my answer to your question to be qualified by that particular language—yes, I would say that the [20] substance over form is a proper issue; but it seems to me this matter has been presented to the Congress of the United States and that its power is paramount and it has been exercised. This particular case arose, as have the single premium annuity cases, as a result of the revenue ruling published on March 9, 1954, nine days after the publication of this committee report, and for the very first time since 1934 the Commissioner began to take the view that in this type of transaction there was no indebtedness. And I am going to argue in my brief that this was an after effect conclusion of the Commissioner in an effort to retain retroactive legislation, which Congress refused to give him.

So, I can't really honestly say that we think indebtedness is the real issue, although obviously there is an interest question, and the answer must be made to the question whether there is or is not in-

mit that it is completely irrelevant and immaterial to the issues before the court here. [23]

Mr. McLane: Except that that man is a real defendant here, your Honor.

The Court: How do you mean "a real defendant"?

Mr. McLane: The Commissioner of Internal Revenue issued the letter.

The Court: Well, of course, the Commissioner, if he is wrong on the law, he is hopeless, too, isn't he?

Mr. McLane: That is correct. I offer it only for the purpose of rebutting whatever arguments will be made with respect to the tax avoidance purposes of this transaction.

The Court: I don't suppose that the fact that the motive is tax avoidance is material at all if the transaction is a bona fide transaction having substance. The fact that one of the motivations was to save taxes, if that were a ground, why, the Internal Revenue would own the country today, wouldn't it, if that were a ground for disallowance of transactions?

Mr. McLane: Plaintiffs agree, your Honor.

The Court: And I had one the other day that makes me never cease to wonder. The situation there was that a corporation bought a piece of property, staked out a mining claim, spent about $30,000 on it several years ago, and then recently they set up a foundation, charitable foundation and gave the property to the foundation. And if they had sold [24] it, of course, they would have paid what, 25

per cent on the gain? Instead they gave it away. And I suppose their tax is at least 50 per cent. So it is just the same as if someone handed them the difference between the cost and the value, a check for it, with which to pay their income taxes.

But I was told by the attorney for the Government that there was nothing that could be done about it. In fact he doubted even if Congress would do anything about closing that kind of a loophole.

Mr. Wyshak: The Commissioner has always taken the view, perhaps rightly or wrongly, that no income is realized. But I don't think that the clear words of the statute necessarily spell that out, so it would be tenable to argue that the taxpayer did realize substantial economic benefit by giving this property to the foundation and it could be taxable.

The Court: I am glad to hear you say that. That certainly is not an argument that shouldn't be made, I think.

Mr. Wyshak: In fact, your Honor, there is an interesting series of correspondence in Harvard Law Review some years ago by Dean Griswold and someone else regarding such charitable gifts out of inventory, and the approaches are very nicely set forth there.

The Court: I don't recall it. Well, that isn't here. I will sustain the objections, defendant's objections [25] to Exhibits 62 and 63.

Isn't Exhibit No. 64 in the same category?

Mr. Wyshak: Yes, your Honor.

The Court: I will sustain the objection to those

as self-serving and incompetent, irrelevant and immaterial.

Mr. McLane: May I before you proceed—or shall I wait until you finish—ask that they be received under Rule 43(c) and be considered as excluded?

The Court: Yes. If so desired, both sides, all of these exhibits as to which objections are sustained will be made a part of the record as a record of excluded evidence pursuant to Rule 43(c).

Mr. McLane: Plaintiff does so desire, your Honor.

Mr. Wyshak: We so desire, your Honor.

The Court: Very well.

Mr. McLane: May I add one word on No. 64, your Honor?

The Court: Yes.

Mr. McLane: That letter is a letter issued by the Texas Board of Insurance Commissioners, and I offer that for the reason that in the Bonn case there was some reference made in the opinion to these being valid contracts issued by the insurance company, that when they were issued they were then bound by the laws of the State of Texas. And that has an effect on the non-recourse feature of this loan. And [26] in the revenue ruling the Government argued there was no indebtedness, but which in the State of Texas, under the law of that state, it is required by the state statute. And for those purposes I offer this letter from the Texas Bureau of Insurance Commissioner to show that the contract had been submitted to the Board and that they had

received a letter stating that it had been so submitted.

The Court: Isn't this relevant to the issue, Mr. Wyshak, of substance of the transaction?

Mr. Wyshak: Well, if your Honor will read that letter it appears to me that it merely recites that it was filed with the Texas Board——

The Court: You are speaking of weight now, aren't you?

Mr. Wyshak: Well, I wanted to add this, your Honor. We took the deposition of Mr. Salley, and at that time he testified that whenever they prepared a new contract they merely filed it with the Board of Commissioners.

The Court: Oh, I am not suggesting the weight it had. In other words, this was not an undercover transaction——

Mr. Wyshak: That is correct, it was not an undercover transaction.

The Court: ——without official sanction.

The objection will be overruled as to Exhibit No. 64. [27]

(The exhibit referred to, marked Exhibit No. 64, was received in evidence.)

The Court: Exhibit No. 65.

Mr. Wyshak: I submit, your Honor, that it is merely cumulative since we have stipulated to all the payments, et cetera, surrounding the bonds purchases, and in addition it contains conclusions of the life insurance company as to what those payments were.

The Court: It shows how it was treated on their

records. It seems to me that it's relevant to the issue of the substance of the transaction. It may not have much weight.

Mr. Wyshak: Although not binding on your Honor, in the Bonn case there was a similar offer and——

The Court: Well, I think a ruling could be made either way in the matter——

Mr. Wyshak: Very well.

The Court: ——without any great prejudice to either side and without being reversible error. But I shall receive it as Exhibit 65.

(The exhibit referred to, marked Exhibit No. 65, was received in evidence.)

The Court: Of course, in all of these situations where substance governs over form, why, the form is usually always impeccable in these situations.

Mr. Wyshak: That is correct, your Honor. [28]

The Court: Exhibit No. 66. It seems to me that that would be relevant as rebuttal evidence to the defendant's evidence on the financial condition of the company.

Mr. Wyshak: Your Honor, our objection is more than relevancy. We submit that it is not the best evidence, and contains opinion evidence and conclusions of the person who made this examination.

The Court: Yes, I recall that now. I had overlooked it at the moment.

Mr. McLane: I do not think that by "the best evidence" Mr. Wyshak does not agree this is not an accurate copy of the report.

Mr. Wyshak: That is correct. I don't state that

this report is not an accurate copy of the original report.

Mr. McLane: Plaintiff submits that this is relevant on the substance over form argument that the Government has made, because the insurance commissioner made an examination of this company and treated certain items in his report, not being a participant in the transaction.

The Court: If there are any incompetent opinions in here, the Court of Appeals will indulge this court the presumption that it did not consider any incompetent evidence. The objection will be overruled and Exhibit No. 66 will be received in evidence. [29]

(The exhibit referred to, marked Exhibit No. 66, was received in evidence.)

The Court: I assume the opinions you refer to are the opinions of the examiner.

Mr. Wyshak: Yes, your Honor.

The Court: Well, the opinions to which you object I assume are opinions—if the witness were on the stand he wouldn't be competent to express those opinions and, of course, the court would disregard them. It is like receiving an audit report where the auditor expresses some views that he wouldn't be permitted to express on the stand.

Mr. Wyshak: That is correct.

The Court: Exhibit Nos. 67 and 68.

Mr. McLane: Those are offered in rebuttal again, your Honor.

The Court: Yes. The objection is overruled. They may be received in evidence.

(The exhibits referred to, marked Exhibits 67 and 68, were received in evidence.)

Mr. McLane: May I explain to your Honor why I offered these next two exhibits, 69 and 70?

The Court: Yes.

Mr. McLane: Those are the two income tax returns of these plaintiffs for the two subsequent years to the years involved before, your Honor. They are not offered for any [30] purpose of label or classification, but merely to show this particular transaction as a closed transaction.

I believe it is fair to say that having read the revenue ruling and having once been employed by the chief counsel's office, I expect to be faced with an argument respecting the tax effects of this transaction as it relates to the substance of the transaction. And I think that when these two exhibits, if they are received in evidence, that from them it can be shown that there, in fact, mathematically, dollars and cents, is no tax avoidance; if this transaction is viewed as a closed transaction; that is the opening and closing of it.

Without these two exhibits, your Honor, the two subsequent years' Federal income tax returns, it is possible to argue that the effect of the transactions for the two years before was so many dollars less taxes to these two plaintiffs. Without these two exhibits it will not be possible for the plaintiffs to argue that considering the following two years and the surrender of this contract and the tax effect of the surrender that there was no tax avoidance. And I offer them for that purpose.

Mr. Wyshak: First of all, your Honor, Exhibit No. 65, which is a ledger sheet in the life insurance records, discloses the opening and closing, when it was closed; and I submit that the tax returns for the two later years would [31] have no bearing on this tax avoidance discussion since the taxpayer's income might fluctuate from year to year, and any tax avoidance argument would have to be based on a taxpayer's income substantially level over a period of years.

Now, why Mr. Knetsch may have surrendered the policy when he did in 1956, I don't know. But I submit that it is irrelevant and immaterial to the issue before the court as to whether there was any deduction allowable for the years 1953 and '54.

The Court: It would be admissible, would it not, on the auxiliary issue that the Government raises that this tax gimmick or the transaction is of no substance because it was engaged in solely for tax avoidance. I assume that if the taxpayer said, "Yes, I had in mind avoiding taxes, too, but I considered it a good transaction, also," and you might say it was 80 per cent tax avoidance and 20 per cent good business. I don't suppose the Government could challenge it.

Mr. Wyshak: Well, I don't know.

The Court: The Government could only say that the transaction lacks substance, if the Government could say that it was nothing, as you call it in one of your memorandums, a tax gimmick; that the sole purpose was for tax avoidance, that it had no economic purpose.

Mr. Wyshak: But when the plaintiff purchased it in 1953, or whenever he did, he could not possibly know what [32] the tax effect would be three or four years later. So that we must say that it's after the fact or incompetent to show what his intent may have been at an earlier time.

The Court: What do you say, Mr. McLane, to this suggestion that the purpose for which you offer it has already been met in the evidence?

Mr. McLane: No, your Honor. You see, I face this argument so many times now that I have left the Government about what the tax effects of the transactions are, because the Government persists in viewing these transactions as only a computation that is made from the year before the court and as if there is never an end to the transaction. But every business transaction, and other than business transactions that every citizen of the country goes into, has got to be evaluated in terms of its total tax effect.

The Court: Don't those ledger sheets, Exhibit 65, in effect show that the transaction was closed out?

Mr. McLane: Yes. But they do not show the figures from which computations of a tax effect can be made. In other words, you must have this particular taxpayer's return for those two subsequent years to show exactly what the tax effects were. And that is why I have offered these two.

The Court: How are they shown?

Mr. McLane: For example, in the year that the transaction was closed, your Honor, it shows his

income without [33] giving effect to an interest deduction, showing the surrender of the policies. And based on the Government's position here——

The Court: Of course, I assume when the policy is surrendered the interest will cease and the tax deduction on account of interest would cease. But what bearing would that have upon whether or not it was good while it lasted?

Mr. McLane: Well, your Honor, this is the problem: When contracts are surrendered, when any annuity contract is surrendered, it will be argued in our brief, and the general counsel so states, the Commissioner views the cancellation of the indebtedness as ordinary income to the purchaser of the annuity. In this particular case when this plaintiff surrendered the contract there was $307,000 of ordinary income thereby resulting. If that $307,000 is added to his income for the year 1956, which is Exhibit 70, and the tax computed on that basis, assuming the court should find that interest is an allowable deduction in this case, then the total tax—the plaintiff will argue—exceeds that which he would have paid had he not claimed these interest deductions.

And so it seems to us that it follows that there couldn't possibly be any tax avoidance.

Mr. Wyshak: Your Honor, I think it is clear that what the plaintiff would like is a determination by this court of the tax liability for the year when he surrendered [34] the policy.

Mr. McLane: I recognize, your Honor, that we can't do that since the year is not before the court.

The Court: On these returns, Exhibits 69 and 70, the deduction is taken, isn't it?

Mr. McLane: For the third year, yes, your Honor, but not for the fourth.

The Court: Isn't it taken for both of them? Here is on Exhibit No. 69, interest deduction, interest claimed $150,956.26, and on Exhibit 70, "Miscellaneous deduction, loss on surrender of annuity contract."

Mr. McLane: That is correct, your Honor. In other words, there is a loss if the interest is not an allowable deduction. If the interest is an allowable deduction, then that loss is eliminated from the return and $307,000 must be added to his ordinary income for that year. And that is exactly the argument that I would like to make in my brief.

The Court: It does not appear from these returns?

Mr. McLane: Yes, your Honor. The tax is merely a matter of computing it from the table which appears in the Code.

The Court: Where does the three hundred thousand appear?

Mr. McLane: That appears in the prior exhibit which shows the closing of the transaction in the year 1956, and [35] we have stipulated——

The Court: The "prior exhibit" is No.—you mean the 1955 return, Exhibit No. 69?

Mr. McLane: Let's see, your Honor. I think it's Exhibit—may I see 65, please?

The Court: You mean the ledger sheet?

Mr. McLane: Yes, I believe so.

The Court: The ledger sheet of the company? The life insurance company?

Mr. McLane: Yes. Exhibit No. 65. It shows the closing of the transaction and surrender of the contracts. And I believe there is a stipulation in the statement of facts.

The Court: Well, here again it may have some bearing on the substance of the transaction.

Mr. Wyshak: Your Honor, may I be heard one bit further?

The Court: Yes.

Mr. Wyshak: I know that the year 1956 is presently being audited, and I suspect that the year 1955 is also under audit. And if the taxpayer is introducing these returns to show what his income was and what the tax liability would be, it would seem to me that we are opening up the door to complete liability for the years '55 and '56.

Mr. McLane: I assure the court there is no such purpose in mind at all. [36]

The Court: The plaintiff disclaims it, and I certainly wouldn't adjudicate it.

Mr. Wyshak: Could I have another statement now as to why these exhibits are being offered?

Mr. McLane: Our only purpose in offering Exhibits 69 and 70, your Honor, is to show the court that if the court should conclude that the interest is not a proper deduction—I am sorry. If the court should conclude that the interest is a proper deduction, that the total tax to be paid by this particular plaintiff as a result of that con-

clusion will be greater or equal to the tax he would have paid if the interest was considered not a proper deduction; which then he is putting in issue the amount of tax he should pay for the years '55 and '56, your Honor. And it seems to me that—I never went over this with the agent, but he has introduced no evidence aside from the returns to show what his income was for these years.

The Court: I don't see where that is necessarily so. As I understand it, the plaintiff is asking to assume for the purpose of this case that these other figures are correct. And upon that assumption—and they are presumably correct, are they not—when he verifies the return they are presumably correct.

Mr. Wyshak: I don't think that it is competent evidence for the taxpayer to come into court and say, "Here is my tax return. That is the income I had," and then prove what his income was by introducing a tax return. It's self-serving.

The Court: As I understand it, this situation would be the same whatever his income was that year.

Mr. McLane: I just want you to assume figures that are more realistic than just picking figures out of the air.

The Court: It's just a relative proposition. It is probably more properly argument than evidence. And the plaintiff disclaims any intention to have adjudicated here his income for those years, or his taxes for those years, and it can't be done.

Frankly, I have misgivings, Mr. Wyshak, about the propriety of receiving these, but the purpose

for which the plaintiff offers it appeals to me as being a proper purpose in rebuttal to the issue that this is merely a tax evasion device.

Overruled. Exhibits 69 and 70 will be received in evidence.

(The exhibits referred to, marked Exhibits No. 69 and 70, were received in evidence.)

The Court: Now, we will take up the admitted facts and the objections to those.

There are no objections to the first 15 paragraphs, as I read it. [38]

Paragraphs 16, 17 and 18.

Mr. Wyshak: Evidence comparable to that, your Honor, was excluded in the Bonn case, as I pointed out, over the Government's objection.

The Court: I have received it here. The objection will be overruled and the facts stipulated in paragraphs 16, 17 and 18 on page 8 of the pretrial conference order will be received in evidence on the issue as to the substance of the transaction.

The last two sentences of 19. The objection will be overruled and those will likewise be received in evidence.

Paragraph 20. That has a bearing also on the exhibits we were last discussing, 69 and 70.

Mr. McLane: That is correct, your Honor.

The Court: The objection will be overruled and it may be received in evidence for the purpose stated with respect to Exhibits 69 and 70. That is the purpose, as I understand it, for which they are offered.

Mr. McLane: That is correct, your Honor.

The Court: Paragraph 26.