PETITION FOR WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. ~~608~~ 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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SUBJECT INDEX

TABLE OF AUTHORITIES CITED

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.

OPINION BELOW.

The District Court made findings of fact and reached conclusions of law [R. 55-61]. It rendered an oral opinion at the time it decided the case. [R. 103-105.] The opinion of the Court of Appeals is reported at ....F. 2d .... and is unofficially reported at 59-2 USTC 9767. (App. A, *infra.*)

JURISDICTION.

The judgment of the Court of Appeals was entered on November 16, 1959. (App. B, *infra.*) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED.

Whether the courts below have the power to disallow as a deduction from gross income interest paid on indebtedness incurred to purchase and carry a single premium annuity acquired on or before March 1, 1954, in view of the clear intent of Congress when in 1954 it amended Section 24(a)(6) of the 1939 Internal Revenue Code, and said:

> ". . . 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 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. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.
>
> The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954." (Emphasis supplied.) H.R. No. 1337, 83rd Cong., 2d Sess. 31 (1954); Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954).

STATUTES INVOLVED.

The pertinent provisions of Sections 23(b) and 24(a)(6) of the 1939 Internal Revenue Code and Sections 163 and 264(a)(2) of the 1954 Internal Revenue Code are set forth in Appendix C, *infra*.

STATEMENT.

On or about December 11, 1953, Karl F. Knetsch, one of the petitioners, purchased ten separate single premium annuities from the Sam Houston Life Insurance Company [R. 38, 56, Exs. 1-12]. The purchase price of each annuity was $400,400 or a total of $4,004,000 for all ten annuities [Exs. 1-12]. The total purchase price was paid by Knetsch's delivery to Sam Houston of his check for $4,000 and by borrowing $4,000,000 from Sam Houston [R. 56, Exs. 1-22]. As evidence of the $4,000,000 debt, Knetsch executed and delivered to Sam Houston ten individual contract loan agreements each in the principal sum of $400,000 [R. 56, Exs. 13-22]. Each of the ten contract loan agreements provided that interest, at a rate specified in the respective annuity contracts of 3½% per annum, must be paid in advance [Exs. 13-22]. Therefore, on December 11, 1953, Knetsch delivered to Sam Houston his cashier's check for $140,000 which amount is 3½% of $4,000,000 [R. 57, Ex. 23]. This sum of $140,000 constitutes $140,000 of the $143,465 which Knetsch claimed as an interest deduction for the year 1953 [R. 39]. The additional $3,465 was paid to Sam Houston by Knetsch on or about December 16, 1953, as a result of the following transaction.

On or about December 16, 1953, Knetsch borrowed and received an additional sum of $99,000 from Sam Houston and agreed to pay interest at the rate of 3½% per annum [R. 28-40, Ex. 25]. Thus, on or about December 16, 1953, Knetsch delivered to Sam Houston his check for $3,465 which amount is 3½% of $99,000 [R. 38, 39, Ex. 36]. Concurrently with the payment of the $3,465 to Sam Houston, Knetch delivered to Sam Houston ten separate contract loan agreements each in the principal amount of $9,900 [R. 38, Exs. 26-35]. It is the $3,465 payment of December 16, 1953, plus the $140,000 payment of December 11, 1953, which comprise the total of $143,465 deducted by petitioners as interest paid to Sam Houston during 1953 [R. 39, Exs. 23, 36].

During 1954 the $4,000,000 loan was renewed by Sam Houston and Knetsch again delivered to Sam Houston another cashier's check for $143,465 [R. 39-41, 57, Ex. 49]. In addition, Knetsch increased the $99,000 loan by the sum of $104,000 to $203,000 and paid interest thereon of $3,640 [R. 39-41, 57, Exs. 38-47, 50]. It is the $143,465 plus the $3,640 or a total of $147,105 which petitioners deducted as interest paid to Sam Houston during 1954 [R. 39].

In short, Knetsch purchased each of the ten single premium annuities for a nominal cash payment ($400) with a loan to cover the balance of the cost ($400,000) of the annuity. This is precisely the transaction which is described in the 1954 Senate Finance Committee and House of Representatives Ways and Means Committee reports quoted above.

REASONS FOR GRANTING THE WRIT.

1. There now exists a conflict among the Courts of Appeal on this issue. In *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577, a case involving the same insurance company, identical annuity contracts, and the same method of purchase, as found herein, the taxpayer's interest deduction was sustained by the Fifth Circuit. On the other hand, the Third Circuit in *Weller v. Commissioner*, 3 Cir., 1959, ...F. 2d ...., unofficially reported at 59-2 USTC 7026 (App. D, *infra.*) and the Ninth Circuit in this case, *Knetsch v. United States*, 9 Cir., 1959, ...F. 2d .... disallowed the interest deduction.

2. The conflict which exists adversely affects a large number of cases involving the same issue which are pending in the Tax Court of the United States and the several U. S. District Courts some of which will be appealed to other Courts of Appeals. The respondent is, no doubt, able to advise the Court of the exact number of such cases and the amount of tax involved.

3. The Court below had no power to disallow the interest paid by petitioners to purchase and carry single premium annuities acquired before March 1, 1954, because the Congress of the United States had already preempted the field in 1954 and decided that such interest was a proper deduction. That is, the Congress of the United States has enacted legislation dealing with the particular problem which was before the Court below and has clearly stated that payments, such as those made by Knetsch, not only constituted interest but were allowable as deductions if paid to purchase or carry an annuity acquired on or before March 1, 1954. H. R. No. 1337, 83rd Cong., 3d Sess. 31 (1954); Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). Thus, to sustain the lower court, it would be necessary to contravene the decision which has already been reached by the Congress regarding the particular issue involved herein. One United States Court of Appeals, in the case involving the same insurance company, identical annuity contracts, and the same method of purchase, *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577, refused to do so saying instead at page 584:

> "We emphasize that whether and to what extent interest deductions are to be permitted involves consideration of many complex, intricate, and sometimes technically significant factors which Congress, the weaver, evaluates as it weaves and unweaves the seamy web men call tax law. In that process Congress

has purposefully distinguished between annuity contracts and the other two. In that light Sections 23(b) *and* 24(a)(6) reflect a purpose to treat *payments of the kind made here as interest* and allow them as a deduction." (Emphasis supplied.)

In view of the fact that both the instant case and the *Bond* case, *supra,* involve the same insurance company, identical annuity contracts, and the same method of purchase, the question arises as to why the court below reached a different result. The answer is found in its opinion:

> "The problem has been carefully considered in *United States v. Bond,* 5th Cir., 258 F 2d 577, which adopted the viewpoint of the taxpayer, and in *Weller v. Commissioner,* 3rd Cir., ... F 2d ...., which agreed with the arguments of the government. We find ourselves in agreement with the opinion expressed by the judges of the Third Circuit."

Thus, the issue is posed. Which of the two Circuits (the Fifth or the Third) has based its decision on more careful research, more penetrating analysis and better reasoning?

In order that an intelligent answer to the above question be reached, it is necessary to examine the applicable statutory language itself and review the legislative history of the statutes involved. (Secs. 23(b) and 24(a)(6) of the 1939 Int. Rev. Code and Secs. 163 and 264 of the 1954 Int. Rev. Code.)

The Language of the Statute.

Section 23(b) of the 1939 Code and Section 163 of the 1954 Code both allow, as a deduction from gross income,

> **"All interest paid or accrued within the taxable year on indebtedness."**

However, Section 24(a)(6) of the 1954 Code provided for an exception to Section 23(b) saying that no deduction was to be allowed in respect of:

> "Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium *insurance* or *endowment* contract." (Emphasis supplied.)

In 1954 the disallowance was extended by Section 264 (the successor to Sec. 24(a)(6) of the 1939 Code) to cover annuities. The applicable language provides that no deduction shall be allowed for:

> "(2) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance, endowment, *or annuity* contract.
>
> Paragraph (2) shall apply in respect of annuity contracts *only* as to contracts purchased *after* March 1, 1954." (Emphasis supplied.)

In other words, until Section 264 of the 1954 Code was adopted, there was no question that interest paid on indebtedness incurred to purchase an annuity was an allowable deduction. In fact the Commissioner of Internal Revenue issued rulings to this effect.[1]

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[1]See Exhibit 63. Also, one of these rulings appeared in the 1947 Prentice-Hall Tax Service at paragraph 16,145 as follows:

"Interest on loan obtained to purchase a single premium annuity contract.—

"The observation at Par. 6414-7 that the prohibition against the deduction of interest on a debt incurred to buy single premium life insurance or endowment contracts does not extend to annuities receives added confirmation in the following letter ruling from the Treasury Department:

"'Reference is made to your letter of July 14, 1947, in which you request a ruling with respect to the deductibility, for Federal income tax purposes, of interest paid on a loan obtained to purchase an annuity contract. A copy of the pro-

However, in the fall and early Winter of 1953, the Commissioner of Internal Revenue asked Congress to change the law.

The Legislative History of the Statute.

When the Commissioner of Internal Revenue asked the Ways and Means Committee of the U. S. House of Representatives to broaden the disallowance of certain interest payments to include situations where indebtedness was incurred to purchase a single premium annuity, he supported his request by citing the Committee to the very transaction now before the Court. Thus, the Ways and Means Committee Report, *supra*, states on page 31 that:

> ". . . 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 omission of annuities from

posed contract and a copy of a Bureau ruling accompanied your letter of July 14, 1947.

" 'The contract, which you are contemplating entering into with The Great-West Life Insurance Company of Winnepeg, Canada, provides for the payment of a single premium of $25,000 in return for which the Company will pay a life annuity of $284.58 monthly, the first payment to be made on the maturity date, July 7, 1965. Upon your death prior to the due date of the first annuity payment the Company agrees to pay to your wife a sum equal to the premium of the policy or the cash surrender value of the policy at the time of your death as determined from Table A of the policy, whichever is greater.

" 'Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness, with certain exceptions not here material.

" 'Based upon the information submitted, it is the opinion of this office that if you purchase a contract with the photostatic copy submitted with your letter of July 14th, 1947, the interest paid or accrued on a loan obtained to pay the premium thereon will be allowable as a deduction under Section 23(b) of the Internal Revenue Code.'

(Letter signed E. I. McLarney, Deputy Comm. 88 47)."

> 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. *Interest on the loan* (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting *tax saving* that reduces the real interest cost below the increment in value produced by the annuity." (Emphasis supplied.)

In short, Congress, acting through the Ways and Means Committee of the House of Representatives and the Finance Committee of the Senate, was fully aware of the transaction now before this Court.

But what did Congress give to the Treasury as opposed to what it was asked to do? The answer is in the statute itself (Sec. 264) and the sentence of the Ways and Means Committee Report, *supra*, immediately following the above quoted Committee language. The report, after describing the annuity transaction involved herein said on page 31:

> "Your committee's bill will deny an interest deduction *in such cases but only as to annuities purchased after March* 1, 1954." (Emphasis supplied.)

In other words, Congress gave the Commissioner only half of the apple. It said: You are now able to deny the interest deduction "in such cases" if the annuity is purchased after March 1, 1954, but you may not deny an interest deduction "in such cases" if the taxpayer acquired the annuity on or before March 1, 1954. Thus, Congress thereby protected taxpayers who had already contracted to pay an insurance company a fixed amount of interest to purchase a single premium annuity during the time when the law permitted a deduction for interest paid to purchase a single premium annuity.

However, the Commissioner of Internal Revenue, discovering on or before March 9, 1954, (the day upon which the Ways and Means Committee bill was sent to the floor of the House of Representatives) that his request for remedial legislation had been granted only in part, refused to abide by the decision of the Ways and Means Committee and determined to seize the other half of the apple by creating a legal issue to submit to the courts so that payments made "in such cases" could be disallowed even where the annuity was purchased on or *before* March 1, 1954. Therefore, on March 17, 1954, eight days after the Ways and Means Committee provision reached the floor of the House of Representatives, the Commissioner issued Revenue Ruling 54-94.[2] (App. D, *infra.*). This Revenue Ruling, which was the Commissioner's open move to avoid the effect of Congress' refusal to retroactively legislate against the interest deduction "in such cases," held that such payments were not to be allowed as interest deductions.

In other words, after telling the Congress that the type of annuity purchase described in the above quoted Committee report necessitated a specific amendment to disallow interest paid on such nonrecourse loans and after obtaining legislation authorizing such a disallowance with respect *only* to annuities purchased after March 1, 1954, the Commissioner reversed his field and said, in Revenue Ruling 54-94, that these payments never constituted interest and therefore were not allowable whether the annuities were purchased after March 1, 1954, or not.

Putting aside only for the moment the question of whether Revenue Ruling 54-94 correctly interprets the applicable law, it is necessary to examine the method by which *Weller v. Commissioner, supra,* and the lower court here have attempted to avoid the above legislative history.

[2]1954 Int. Rev. Bull. No. 11 at 6 (1954), 1954-1 Cum. Bull. 53.

The Response of the Courts to the Above Legislative History.

Although the first opinion rendered in any of the Circuit Courts of Appeal agreed with the above legislative analysis, the court below, after stating that the problem was whether petitioners' payments were payments of interest, adopted the opinion of the Third Circuit in *Weller v. Commissioner, supra.* In the *Weller* opinion, the above legislative history was "answered" by the following:

> ". . . However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, *therefore,* legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible." (Emphasis on "therefore" supplied.)

The above language from the *Weller* opinion is the same technique which was used by the dissenting opinion in *United States v. Bond, supra,* where Judge Wisdom said:

> "With all due deference to my able associates, it seems to me that the majority opinion does not meet the issue squarely.
>
> The case presents the question: Were the amounts the taxpayer paid the insurance company interest under Section 23(b)? This question is not answered by showing that Section 24(a)(6) does not prohibit deductions for amounts paid on indebtedness to purchase an annuity contract, as distinguished from a life insurance or endowment contract. Section 24(a) applies to specific items that are not deductible. It does not purport to say what items are deductible,

As I see it, regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b)." (At p. 584.)

In other words, Judge Wisdom, and the Third Circuit say that no matter what Section 24(a)(6) provides, the payments involved must still qualify as interest under Section 23(b). This is true, insofar as the statutory language itself is concerned, but does such a statement refute the 1954 Committee language showing that Congress has already legislated with respect to the particular problem involved? The Third Circuit and Judge Wisdom conclude that since the quoted Committee language appeared in an explanation of section 264 of the 1954 Code, the successor to Section 24(a)(6) of the 1939 Code, such Committee language did not answer the question of whether the payment involved herein constituted interest under Section 23(b) and 163. Is this correct? For the following reasons, petitioners submit that such a conclusion is wholly without support.

In the first place, if the payments involved herein and described in the Committee reports explaining Section 264 did not constitute interest under Section 23(b) of the 1939 Code and Section 163 of the 1954 Code, why did the Commissioner ask Congress to disallow such interest "in such cases" in Section 264?

Secondly, the following language from both the Ways and Means Committee Report, *supra*, and the Senate Finance Committee Report, *supra*, clearly shows that Congress, along with the Commissioner, concluded that the payments "in such cases" did constitute interest:

> "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 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. *Interest* on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.
>
> The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954." (Emphasis supplied.) (House Report at p. 31; Senate Report at p. 38).

When the above language refers to "*interest* on the loan . . . taken as a deduction," after describing the method of purchase used herein, it is certainly saying that there is interest within the meaning of Section 23(b) since that is the only section allowing interest as a deduction. Furthermore, the above phrase "Your committee's bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954," when read in conjunction with the first sentence thereof that "existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase a single-premium annuity contract," surely demonstrates that the respective Committees had concluded that existing law (Sec. 23(b)) allowed an interest deduction "in such cases." Since the phrase "in such cases" refers to the description of the very method of purchase of single-premium annuities now before this Court, it can hardly be said that the Committee language sheds no light on the question of whether the payments involved herein did or did not constitute interest under Section 23(b). Also, what is the meaning of the Committee language that "an interest deduction *will* be" denied "in such cases" but only as to annuities purchased after March 1, 1954, if such payments never constituted interest under Section 23(b) as the Commissioner now contends.

Therefore, while it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b), it does not at all follow that the Committee language explaining Section 264 (the successor to Sec. 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" as interest and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954.

In disposing of the problem presented herein in the manner adopted, Congress has merely followed its usual practice in the income tax field of not legislating retroactively so that taxpayers who have relied upon existing law would not be penalized. This is a basic rule of fair play.

When the language of the above Committee reports is read along with the phrasing of Section 264, it is patently clear that Congress has already preempted the field and ruled that the payments made by petitioner not only constitute interest but are allowable as a deduction since his annuity contracts were purchased before March 1, 1954. It may be that a court, being composed of human beings who are also taxpayers, would conclude that Congress was wrong when it preserved the interest deduction "in such cases." However, it is submitted that while it is often necessary for a court to make policy when Congress has not spoken, it is neither necessary nor desirable for a court to contravene the expressed policy of Congress unless a constitutional right has been infringed upon. If it were, the provisions allowing percentage depletion and capital gain treatment would not have had a long life.

However, even if it is assumed, *arguendo*, that Congress had not ruled on the problem, the review, reasoning and research of *Weller v. Commissioner, supra*, is still not correct.

Interest Is Not Confined to Payments for the Use of Money.

After the Third Circuit once concluded that the legislative history of Section 24(a) of the 1939 Code and its successor need not be considered, it then proceeded to adopt the reasoning found in Revenue Ruling 54-94 (App. D, infra.). This is reflected by the following language from *Weller v. Commissioner, supra*:

> "Section 23 of the Internal Revenue Code of 1939, 'Deductions from gross income,' provides for deductions of indebtedness * * *.' The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In Old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U. S. 552, 560 (1932), it was held to be 'the amount which one has contracted to pay for the use of borrowed money.' Again, in Deputy v. du Pont, 308 U. S. 488, 497-498 (1940), the Court stated that '* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b). Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense.' Applying these definitions to the instant cases, we come to the *crux of the government's case*. It contends that since *interest for tax purposes is confined to payments for*

the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest." (Emphasis supplied.)

The above quoted language should be compared with the language from Revenue Ruling 54-94:

"It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as 'interest' in the above examples are not interest within the meaning of section 23(b) of the Code and are not deductible for Federal income tax purposes. Cf. *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, Ct. D. 456, C. B. XI-1, 274 (1932), where the Supreme Court *indicated* that interest is 'the amount which one has contracted to pay for the use of borrowed money.'" (Emphasis supplied.)

"In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no 'debt' on which he pays 'interest' . . ."

This was the same theory which was advanced by the Commissioner in *United States v. Bond, supra,* as evidenced by statements in the majority opinion therein at p. 579, and in Judge Wisdom's dissent therein at p. 584 where he said "The crux of the case for the government, however, is that for purposes of tax deduction, interest is confined to payments made for the use of borrowed money."

In short, according to the Commissioner, the ultimate question is whether the taxpayer *really* borrowed *money* from the insurance company. The Court is asked to note the chain of reasoning which serves as the support for

the Commissioner's Ruling and the rule adopted in the *Weller* case:

Major Premise	Interest is the amount which one has contracted to pay for the use of borrowed money.
Minor Premise	The taxpayer does not, in substance, borrow any money from the insurance company.
Conclusion	Hence there is no debt on which the taxpayer pays interest.

Once this major premise is accepted, then it is possible to argue that "in substance" the taxpayer did not borrow *money*.

However, assuming for the sake of argument that taxpayers did not borrow money, the crucial question is whether there is any such rule of law that interest is confined to payments made for the use of *money*. The Commissioner cites *Deputy v. du Pont*, 1940, 308 U. S. 488 and, the following language at p. 498 thereof as authority therefor:

"In the business world 'interest on indebtedness' means compensation for the use *or forbearance of money*." (Emphasis supplied.)

The Court's attention is called to the phrase "or forbearance of money." Taxpayers ask whether in the face of such language it can be said that *Deputy v. du Pont, supra*, means, as the Commissioner claims, "interest is confined to payments made for the *use* of borrowed *money*." The Commissioner's argument ignores the phrase "or forbearance of money," and misinterprets *Deputy v. du Pont, supra*. For example, the Tax Court in *Northwestern Pennsylvania Gas Corp.*, 3 TCM 52, Dec. 13, 705(M), 1944 P-H T. C. Memo. Dec. Par. 44,017 p. 65, said:

"Respondent's position, we think is wholly untenable. The indebtedness upon which interest may be deducted *is not limited to money borrowed.* Deputy v. du Pont, 308 U. S. 488." (Emphasis supplied.)

Furthermore, the above quoted statement is the only one which makes sense unless the words "or the forbearance of money" are to be read out of *Deputy v. du Pont, supra.*

Certainly the phrase "or the *forbearance of money*" contemplates that interest may come into existence in cases other than where money is used or received by the debtor. Here there was property (the ten annuities) having a cash value equal to the amount of loans transferred to Knetsch in return for his promissory notes, and a promise by Sam Houston not to collect the sum of the loans for one year. The taxpayers received consideration (annuities having cash values equal to the loans) for their promise to pay. However, it is not even necessary that the taxpayers receive any consideration for the indebtedness. Thus, in Surrey and Warren, Cases and Materials on Federal Income Taxation (1955), the authors state at p. 272:

> "As long as the interest obligation is legally enforceable, it is immaterial that the obligation had its origin in a transaction in which the taxpayer did *not* receive consideration for the indebtedness. Thus, in Commissioner v. Park, 113 F. 2d 352 (3rd Cir., 1940), a husband was permitted to deduct interest on a demand note given to his wife, the note being enforceable by state law because under seal . . ." (Emphasis supplied)

If it is not even necessary that a taxpayer receive consideration—the test being merely that the interest obligation is legally enforceable—how can it be concluded that "interest is confined to payments made for the use of borrowed money?" If the receipt of nothing (no consideration) supports an interest deduction, how can it be sustained that the use or receipt of money is a pre-requisite?

As the Second Circuit pointed out in *Preston v. Commissioner*, 2 Cir., 1942, 132 F. 2d 763, in answer to the Government's contention that Section 163 (Section 23(b)) was limited to money borrowed to beget income, interest on a mortgage given for the purchase of a residence is not disallowed.

And this point from *Preston v. Commissioner, supra,* brings the Commissioner's position into better focus. He says that interest is confined to payments made for the use of borrowed money. Yet what money is used or received when a wealthy man delivers to his intended bride a $250,000 promissory note carrying interest at 6% per year in consideration for her resigning her job and marrying him? Or again, what about the millions of Americans who purchase homes, automobiles, television sets, and trips to Europe without down payments and the receipt of nothing but the house, the automobile, the television set or the airplane ticket. Where is the receipt of money or use of money any more than in the case at bar where the taxpayer received annuities having a cash value of $400,000 each plus each year's accumulations?

The Court is asked to consider the consequences, in a credit economy, of adopting the Commissioner's rule that interest is confined to payments made for the use of borrowed money. Also it is important to remember that there is another side to the coin. If an item is not interest when paid, it is difficult to see how it could become interest when received. If the amounts paid to Sam Houston and other taxpayers cannot be interest deductions unless money is used or received, are the items to be excluded as interest income by the recipients?

Suppose Mr. Doe, whose only asset is a $75,000 home with no mortgage against it but who has no cash and whose liabilities are $175,000, sells his $75,000 house to Mr. Jones, who has no assets or liabilities but an annual income of $35,000 per year. The terms of purchase are nothing down and the $75,000 to be paid over a fifteen

(15) year period with interest on the unpaid balance at 6% per year. Is Mr. Jones prohibited from the interest deduction because he did not receive or use Mr. Doe's money, but only the use or possession of his house? This is what the Commissioner's rule would require.

Nor is the Commissioner aided by the citation of *Gregory v. Helvering*, 1935, 293 U. S. 465, in support of the contention that in substance there was no money used. The doctrine of *Gregory v. Helvering, supra,* can add nothing if there is no rule of law that interest is confined to payments made for the use of borrowed money. If the receipt or use of money is not a pre-requisite to the allowance of an interest deduction, what difference does it make whether the doctrine of *Gregory v. Helvering, supra,* does or does not support a conclusion that the Court may find that in substance no money was received or borrowed from Sam Houston. Assuming for the sake of argument that *Gregory v. Helvering, supra,* would sustain the proposition that in substance no money was borrowed, how does that provide a solution when there is no requirement that money be used or borrowed? That is, for what purpose are the forms being pierced? To get through to a non-existent rule of law?

Furthermore, taxpayers submit that if *Gregory v. Helvering, supra,* has any application here, it requires that the lower court be reversed.

The *Gregory* opinion, written by Judge Learned Hand, turned on the point that Congress did not intend to include the subject transaction within the meaning of the corporate reorganization sections of internal revenue law. This is made clear by Judge Hand's opinion in *Commissioner v. National Carbide Corporation*, 2 Cir. 1948, 167 F. 2d 304, 306, affirmed, 336 U. S. 422 wherein he said:

> "... In Gregory v. Helvering the taxpayer had organized a corporation only to serve as a means of transfer; it was used once and only for that purpose, and was dissolved as soon as it had done so. The Court held that it was not a 'corporation' within the meaning of that term, *as Congress must be understood to have used it*, because in common speech, it means a jural person created to conduct industry, commerce, charity or some other commonly practised activity, and not to serve merely as an escape from taxation ..." (Emphasis supplied.)

The touchstone of the *Gregory* case is that *Congress did not intend* to include within the term "reorganization" the transaction involved in that case. But here the history of Section 23(b) and 24(a)(6), the committee reports, and the language of Section 264 are such that it can only be said that Congress did intend to include within the meaning of Sections 23(b) and 163(a) "payments of the kind made here as interest." This legislative history shows without question that Congress intended to include such payments as interest within the meaning of Section 23(b) and did not intend to disallow the deduction of such payments after the effective date of the Revenue Act of 1934 except with respect to annuity contracts purchased after March 1, 1954. Consequently, since *Gregory v. Helvering, supra,* applies the rules of "substance over form" to sustain "the tax policies of Congress" thereby giving effect to the intent of Congress the *ratio decidendi* of that case requires the allowance of the payments of the kind made here as interest because the intent of Congress is that such payments, the kind made here, be allowed if the annuity contracts were purchased on or before March 1, 1954.

In other words, the doctrine of the *Gregory* case cannot serve as a ground for disallowing the deduction here because Congress intended that such payments be allowed as a deduction. That is, to disallow a deduction intended to be allowed by Congress is an anomaly under the doctrine of *Gregory v. Helvering, supra.*

However, there is a second reason why the *Gregory* case and the cases following it have no application here. The reason is that each of those cases hold that the doctrine applies only where the transaction is entered into by the taxpayer solely to escape taxation. This limitation upon the application of the rule is found in the following language from *Commissioner v. Transport Trading & Terminal Corp.*, 2 Cir., 1949, 176 F. 2d 570, 572, certiorari denied, 339 U. S. 916:

> "The doctrine of Gregory v. Helvering, supra, which we here hold to be controlling . . . means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon *for no other motive* but to escape taxation." (Emphasis supplied.)

In the instant case there is no evidence to sustain a finding that taxpayers' sole motive was to escape taxation.

Indeed the evidence shows incontrovertibly that taxpayers have lost $50,650.36, even if the claimed interest deductions are allowed, as a result of the annuity transactions, rather than the "tax benefits" of $113,684.48 for 1953 and $119,613.20 for 1954 claimed by the Commissioner (App. E. infra). This is an important point because it removes the substantive basis upon which *Gregory v. Helvering, supra,* must rest. In addition, the fact was stipulated that if Knetsch continued to borrow the full cash value each year less $1,000, he would be entitled at the expiration of thirty (30) years to an annuity of $43 per month.

Furthermore, the Commissioner and the taxpayer, upon a request made by the United States Court of Appeals for

the Fifth Circuit during oral argument in *United States v. Bond, supra,* at p. 582, n. 13, filed a stipulation showing that for each $1,000.00 of annuity the Net Cash Value exceeded the amount of annual interest paid at approximately the tenth year. Consequently, it is actuarily not correct for the Commissioner to say that the investment made no commercial sense since the interest the taxpayer had to pay on the loan was higher than the increment in cash value of the annuity bonds.

Conclusion.

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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