Mr. McLane: That, again, goes to the question of the avoidance and substance over form. I wanted to offer some evidence showing the extent of this company's other insurance activities than the annuity contracts before the court, and in rebuttal to the exhibits offered by the defendant. [39]

The Court: Very well. For that purpose the objection will be overruled. Paragraph 26 will be received. Likewise, paragraph 27, which I take it is offered for the same purpose.

Mr. McLane: That is correct, your Honor.

Mr. Wyshak: Exhibit 62 referred to in paragraph 30 was excluded. So that to be consistent, it would seem that paragraph 30 should be——

The Court: Is that the one submitted to the Commissioner?

Mr. Wyshak: Yes, sir.

The Court: The objection to paragraph 30 will be sustained.

Paragraph 31. The objection is overruled. Received in evidence. And, likewise, paragraph 32, the objection is overruled. It may be received in evidence.

If it is agreeable, gentlemen, it might be helpful in the record here to have the reporter copy into the record at this juncture paragraphs—we have another objection, don't we?

Paragraph 22.

Mr. Wyshak: That is what I was going to point out. Yesterday you sustained the objection, but I believe consistent with your Honor's rulings today you should overrule it.

The Court: Yes. I will reverse that ruling and

[40] overrule the objection of the plaintiff to paragraph 22 and receive that in evidence.

So, if it is agreeable, the reporter will copy into the record at this juncture paragraphs 1 to 21, pages 5 to 10 of the pretrial conference order, as part of the stipulated facts in the case. Also paragraphs 23 to 29 on page 10 and 11; and paragraphs 31 to 32 on page 11.

That covers it, does it not?

Mr. Wyshak: Did you omit 22, your Honor? 22 is in. It should be 1 through 29 of the stipulation.

The Court: Yes. I am sorry. I am glad you called my attention to that. 1 through 29, pages 5 to 11; and then only 30 will be omitted.

Mr. Wyshak: That is correct.

The Court: 31 and 32 will be copied.

[Note: Paragraphs 1 through 29 of Pretrial Conference Order appearing here are the same as set out at pages 37-43 of this printed record. Paragraphs 31 and 32 at page 43.]

* * * * *

Mr. Wyshak: We have a further oral stipulation, your Honor, which I suggest as follows: That advertisements comparable to Exhibit 59, which are the Wall Street Journal advertisements, were placed by the Sam Houston Life Insurance Company in the Wall Street Journal and in the Journal of Commerce periodically from and after August 1952 up until and through 1957. [48]

Mr. McLane: That is agreed, your Honor.

The Court: What exhibit is that?

Mr. Wyshak: 59, your Honor.

The Court: The Wall Street Journal and the Journal of Commerce?

Mr. Wyshak: Yes, your Honor. The Wall Street Journal, your Honor, has four different editions published throughout the country, and at various times these advertisements were placed in these various editions.

Mr. McLane: That is agreed.

The Court: During the period from when?

Mr. Wyshak: From and after August 1952 through 1957.

The Court: So stipulated?

Mr. McLane: It is so stipulated by the plaintiff, your Honor.

The Court: Received in evidence.

Is there any further evidence to be offered by either side?

Mr. McLane: Nothing to be offered by the plaintiff, your Honor.

Mr. Wyshak: Nothing by the Government, your Honor.

The Court: You both rest?

Mr. McLane: We both rest.

The Court: Have you briefed this as much as you [49] wish? You both indicated you wish to file further briefs.

Mr. McLane: Your Honor, I would appreciate the opportunity of filing, on behalf of the plaintiff, an opening brief. And I ask that I may be granted 30 days to so file.

Mr. Wyshak: We would like to reply, your Honor. And we would like a little oral argument

in order to orient the court with respect to the figures and the transaction. I think it would be simpler verbally rather than——

The Court: I think I would rather hear your oral arguments after I read the briefs.

Mr. Wyshak: That would be fine.

The Court: When will you have your brief in?

Mr. McLane: I would like to have 30 days from today.

The Court: 30 days for the plaintiff. When will the defendant have theirs, Mr. Wyshak?

Mr. Wyshak: Could we have 20 days thereafter?

Mr. McLane: 15 days would be enough for reply, your Honor.

The Court: 30 days plaintiff, 20 days defendant and 15 days to reply. That would take us into October, wouldn't it?

Mr. Wyshak: Yes, it would, your Honor.

The Court: Suppose we continue this matter for oral argument to October 20th at 2:00 o'clock in the afternoon. [50] Is that agreeable?

Mr. McLane: That is agreeable with the plaintiff, your Honor.

Mr. Wyshak: Very well, your Honor.

The Court: That's a Monday.

The Clerk: There is nothing on the calendar.

The Court: Very well. October 20th at 2:00 o'clock for oral argument, gentlemen. It's an interesting case.

Mr. Wyshak: It is, your Honor.

The Court: I am surprised this hasn't been adjudicated before.

Mr. McLane: We are the first ones here, apparently. I think it has a great deal to do, your Honor, with how the service picks certain returns, and sometimes by accident and sometimes——

The Court: Your client happened to be the lucky number, is that it?

Mr. McLane: Yes, your Honor. Certain returns can be picked by an office audit, and I think that is probably how this happened.

The Court: Very well, gentlemen.

Is there any objection to marking the pretrial conference order? You have offered all of it you wish to offer in evidence, have you?

Mr. Wyshak: I assume it isn't necessary to offer [51] the issues as they are set forth, your Honor. It is in the file.

The Court: Well, I mean, all the facts and——

Mr. Wyshak: The facts and exhibits are all in.

The Court: Then let the pretrial conference order be marked as Exhibit No. 71 for identification only. And that way we will have the designation in the record.

Mr. Wyshak: Very well, your Honor.

(The exhibit referred to was marked Exhibit No. 71 for identification.)

The Court: Anything further, Mr. Clerk?

The Clerk: No, your Honor.

Mr. Wyshak: Thank you, your Honor.

Mr. McLane: Thank you, your Honor.

The Court: Very well, gentlemen.

[Endorsed]: Filed January 9, 1959.

[Title of District Court and Cause.]

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California
Monday, October 20, 1958

* * * * *

The Court: Well, gentlemen, I could take this under submission and write an opinion after some time, but I feel prepared to decide it and I shall decide it now.

As we have discussed, Section 23(b) provides for a deduction of all interest paid or accrued within the taxable year on indebtedness, and so forth. The question here is whether the payments in controversy constitute interest paid or accrued on indebtedness. As the Supreme Court has said, interest on indebtedness usually means compensation for the use or forebearance of money.

It would serve no useful purpose here to go through another analysis of this transaction. We have discussed the non-recourse feature of the transaction and the other features of it. I am of the opinion that while in form the payments were compensation for the use or forebearance of money, they were not in substance, and that as a payment of interest the transaction was a sham.

As to the effect of the 1954 amendment, with all deference to Chief Judge Hutcheson and Judge Brown of the Fifth Circuit whom I respect highly,

I could adopt most readily here the first two paragraphs of Judge Wisdom's dissent. [3]

Finding that the payments in controversy do not constitute interest paid on indebtedness, the Court must necessarily find in favor of the defendant.

Accordingly, findings of fact, conclusions of law and judgment will be ordered in favor of the defendant.

Mr. Wyshak: Thank you, your Honor.

Mr. McLane: Thank you, your Honor.

The Court: It will be interesting to follow the course of this problem. I suspect you will hear some more of it in the future.

Anything further, Mr. Clerk?

The Clerk: No, your Honor.

The Court: Court will adjourn.

(Whereupon at 4:35 o'clock p.m. an adjournment was taken.)

[Endorsed]: Filed February 5, 1959.

[Endorsed]: No. 16356. United States Court of Appeals for the Ninth Circuit. Karl F. Knetsch and Eva Fay Knetsch, Appellants, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court, Southern District of California, Central Division.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 16356

KARL F. KNETSCH and EVA FAY KNETSCH,
Plaintiffs-Appellants,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee.

STATEMENT OF POINTS UPON WHICH PLAINTIFFS INTEND TO RELY AND DESIGNATION OF RECORD

Come now Appellants Karl F. Knetsch and Eva Fay Knetsch, and cite the following points upon which they intend to rely for the reversal of the judgment of the District Court:

1. The District Court erred in finding as fact that plaintiffs' only motive in purchasing ten annuity savings bonds was to attempt to secure an interest deduction.

2. The District Court erred in finding as fact that plaintiffs did not enter into a transaction for profit in the purchase of the ten annuity savings bonds.

3. The District Court erred in finding as fact that no economic gain could be achieved from the purchase of the ten annuity savings bonds without regard to the tax consequences, taking into consideration and compounding the loss of income on the payments made to the company.

4. The District Court erred in finding as fact that the plaintiffs could elect to accelerate the maturity of the ten annuity savings bonds at any time.

5. The District Court erred in finding as fact that the ten annuity savings bonds contained no insurance element whatever.

6. The District Court erred in finding as fact that there was no commercial economic substance to plaintiffs' transaction with the Sam Houston Life Insurance Company.

7. The District Court erred in finding as fact that plaintiffs did not intend to become indebted to Sam Houston.

8. The District Court erred in finding as fact that no indebtedness of the plaintiffs was created by any of the plaintiffs' transaction with the Sam Houston Life Insurance Company.

9. The District Court erred in finding as fact that the plaintiffs' payments were no more than annual premiums, the purchasing price of a contract on a deferred payment plan.

10. The District Court erred in finding as fact that no money or other economic benefit was received by the plaintiffs from the Sam Houston Life Insurance Company.

11. The District Court erred in finding as fact that neither the $143,465.00 paid by the plaintiffs to Sam Houston Life Insurance Company in 1953 nor the $147,105.00 paid in 1954 was a payment of interest.

12. The District Court erred in finding as fact that Sam Houston Life Insurance Company's profit

in the transaction was the difference between the 3½% received and the 2½% paid.

13. The District Court erred in holding that the plaintiffs did not enter into a transaction for profit in the purchase of these bonds.

14. The District Court erred in holding that no indebtedness of the plaintiffs was created by any of the plaintiffs' transactions with the Sam Houston Life Insurance Company.

15. The District Court erred in holding that there was no commercial economic substance to the plaintiffs' transactions with the Sam Houston Life Insurance Company.

16. The District Court erred in holding that no money or other economic benefit was received by the plaintiffs from the Sam Houston Life Insurance Company.

17. The District Court erred in holding that while in form the payments to the Sam Houston Life Insurance Company were compensation for the use or forbearance of money, they were not in substance and that as a payment of interest, the transaction was a sham.

18. The District Court erred in holding that neither the $143,465 paid by the plaintiffs to Sam Houston Life Insurance Company 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.

19. The District Court erred in holding that the fact that Section 24 (a) (6) of the Internal Revenue Code (1939) does not prohibit a deduction 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).

20. The District Court erred in that its decision is not supported by the evidence, it is clearly erroneous, and is not in accordance with law.

21. The District Court erred in holding that the defendant is entitled to judgment dismissing the complaint with prejudice and for its costs herein.

The plaintiffs designate the following portions of the record as certified by the United States District Court for the Southern District of California to the United States Court of Appeals for the Ninth Circuit on February 6, 1959, as necessary for a consideration of the points upon which they intend to rely, and to be printed in the transcript of record:

A. Complaint, filed 5/3/57.

Answer of Defendant, filed 7/3/57.

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.

Minute Order 8/5/58, further trial.

Minute Order 10/20/58, further trial.

Plaintiffs' 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.

B. Stipulation for Consideration of Exhibits in their Original Form.

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

D. Statement of Points upon which Plaintiffs Intend to Rely and Designation of Record filed with the United States Court of Appeals for the Ninth Circuit.

McLANE & McLANE,
/s/ By W. LEE McLANE, JR.,
/s/ By NOLA McLANE,
/s/ By JOHN JAY SCHWARTZ,
/s/ By THADDEUS ROJEK,
Attorneys for Appellants.

Notice of Mailing Attached.

[Endorsed]: Filed February 20, 1959. Paul P. O'Brien, Clerk.

[Title of Court of Appeals and Cause.]

STIPULATION FOR CONSIDERATION OF EXHIBITS IN THEIR ORIGINAL FORM

It Is Hereby Stipulated by the parties hereto through their attorneys that the exhibits entered into evidence at the trial of the above-entitled case before the United States District Court for the Southern District of California, being Exhibits 1 through 70, may be considered by this Court in their original form and need not be reproduced to constitute part of the record before this Court.

Dated: February 10, 1959.

/s/ NOLA McLANE,
Attorney for Appellants.

/s/ CHARLES K. RICE,
Assistant Attorney General,
Attorney for Appellee.

[Endorsed]: Filed February 20, 1959. Paul P. O'Brien, Clerk.

[fol. 111] Minute entry of argument and submission—September 17, 1959 (omitted in printing).

[fol. 112]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Before: Stephens and Hamlin, Circuit Judges, and Lindberg, District Judge.

MINUTE ENTRY OF ORDER DIRECTING FILING OF OPINION AND FILING AND RECORDING OF JUDGMENT—November 16, 1959

Ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the Clerk, and that a Judgment be filed and recorded in the minutes of the Court in accordance with the opinion rendered.

[fol. 113]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 16,356

KARL F. KNETSCH and EVA FAY KNETSCH, Appellants,

vs.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court
Southern District of California
Central Division

OPINION—November 16, 1959

Before: Stephens and Hamlin, Circuit Judges and Lindberg, District Judge.

Stephens, Circuit Judge

On December 11, 1953, the taxpayers purchased ten single premium annuity bonds from the Sam Houston Life Insurance Company. The purchase price of $4,004,000 was

paid by a note for $4,000,000 and $4,000 in cash. The note was without recourse, and was secured by the annuity bonds. Interest on the note at three and one-half percent per annum, amounting to $140,000 was paid in cash. On December 16, $99,000 was sent to the taxpayers by Sam Houston as an additional loan, and the taxpayers paid the company $3,465 in interest. The bonds bore interest at the rate of two and one-half percent per annum, compounded annually. They matured in thirty years, and at that time would pay the taxpayers a monthly income of $43.00. Maturity could be accelerated or the bonds cashed in, at any time at the taxpayers' option. Mr. Knetsch was sixty when he made the purchase in 1953.

A similar transaction involving an interest payment of $147,105 was entered into for 1954, prior to March 1, when [fol. 114] the provisions of the 1954 Internal Revenue Code affecting interest deductions for annuities went into effect.

These interest payments to Sam Houston were claimed as deductions in the taxpayers' 1953 and 1954 tax returns. When the deductions were disallowed, the deficiencies were paid under protest, and suit was brought in the District Court for refund. The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction. From that adverse judgment, the taxpayers have appealed.

This case arises under the Internal Revenue Code of 1939, which allows interest[1] as a deduction from gross income. The issue is whether such payments were payments of interest.

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.

The judgment of the District Court is affirmed.

[File endorsement omitted]

[1]Section 23 (b).

[fol. 115] [File endorsement omitted]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 16,356

KARL F. KNETSCH and EVA FAY KNETSCH, Appellants,

vs.

UNITED STATES OF AMERICA, Appellee.

JUDGMENT—Filed and entered November 16, 1959

Appeal from the United States District Court for the Southern District of California, Central Division.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Southern District of California, Central Division, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the Judgment of the said District Court in this cause be, and hereby is affirmed.

[fol. 116] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 118]

SUPREME COURT OF THE UNITED STATES
No. 603, October Term, 1959

KARL F. KNETSCH, et al., Petitioners,

vs.

UNITED STATES.

ORDER ALLOWING CERTIORARI—February 23, 1960

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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APPENDIX D

Revenue Ruling 54-94

"Section 23 (b).—Deductions From Gross Income: Interest Regulations 118, Section 39.23 (b)-1: Interest. Rev. Rul. 54-94

Amounts claimed as "interest" in connection with certain so-called tax savings plans the purpose of which is to obtain an interest deduction for Federal income tax purposes are not deductible under section 23(b) of the Internal Revenue Code.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23(b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1. M Insurance Company has sold to the taxpayer an "annuity savings bond" (herein called the "bond") under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000. To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, *i.e.*, the excess of the "cash value" over the unpaid balance on taxpayer's

note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value".

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½ percent investment.

Example 2. In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5,000,000 United States Treasury 1⅜ percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small down payment and purported to "borrow" the balance from the N Company, a dealer in securities, on a 2¼ percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N cov-

tion) supports an interest deduction, how can it be sustained that the use or receipt of money is a pre-requisite?

income of $35,000 per year. The terms of purchase are nothing down and the $75,000 to be paid over a fifteen

ered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5,000,000 of such notes at the then market price to cover its short sale.

(In some cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

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."

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". An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See Talbot

Mills v. Commissioner, 326 U. S. 521, Ct. D. 1660. C. B. 1946-1, 191; Matthiessen, et al. v. Commissioner, 194 Fed. 2d 659. In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums paid for the annuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24(a)(6) of the Code. In example 2, taxpayer in substance pays a sum of money to the N Company for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows". Cf. Commissioner v. Transport Trading & Terminal Corp., 176 Fed. 2d 570, 572, where the Court of Appeals for the Second Circuit emphasized 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."