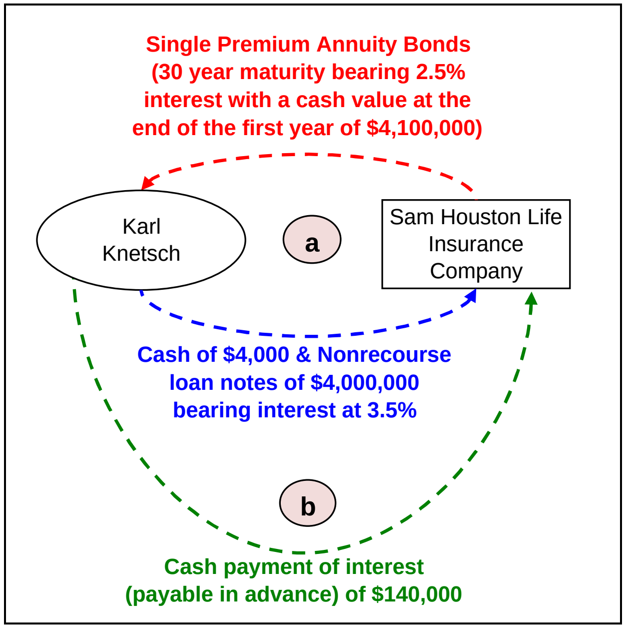
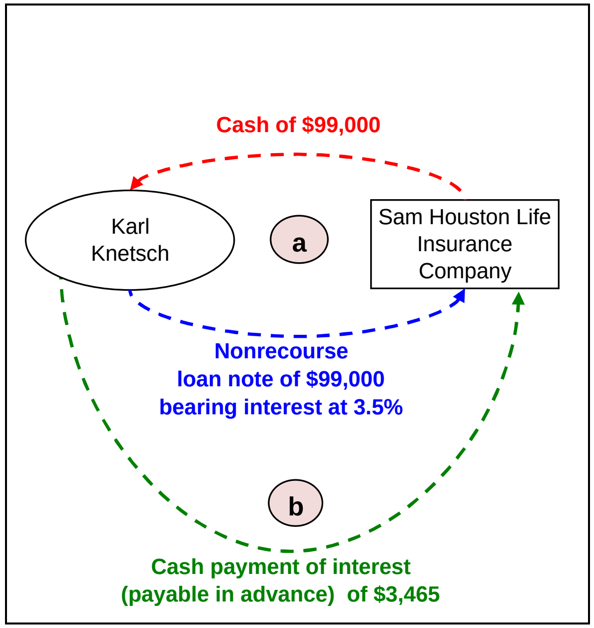
Knetsch v. United States
364 U.S. 361 (1960)

Sham Interest Expense

Annuity Purchase & Interest Payment (Dec. 11, 1953)



Additional Borrowing & Interest Payment (Dec. 16, 1953)



Pre-Tax Cash Flows

	- 1953 -	- 1954 -
Purchase of Annuity	($4,000)	
Payment of Interest	($140,000)	($143,465)
Borrowing	$99,000	$104,000
Payment of Interest	($3,465)	($3,640)
Net pre-tax cash flow	($48,465)	($43,105)
Net pre-tax cash flow for both years		($91,570)

Tax Deductions & Tax Savings

	- 1953 -	- 1954 -
Payment of Interest	$140,000	$143,465
Payment of Interest	$3,465	$3,640
Tax Deduction	$143,465	$147,105
Tax Deduction for both Years		$290,570
Tax Savings (marginal rate of 80%)		$233,298

After-Tax Cash Flows

Net cash cost of annuity	($91,570)
Net cash tax savings	$233,298
Net after-tax cash flow (if it worked)	$141,728

In ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), the Third Circuit summarized Knetsch as follows:

> In Knetsch, the taxpayer had purchased annuity savings bonds from an insurance company, borrowed virtually their entire value against them, made payments back to the insurance company, and characterized those payments as deductible interest. Because the borrowing against the bonds had reduced their value to a mere "pittance," leaving the taxpayer with nothing of value apart from tax deductions, the Court concluded that the net effect of the transfers between the taxpayer and the insurance company amounted only to payment of a "fee for providing the facade of 'loans' whereby the [taxpayers] sought to reduce their . . . taxes" and therefore could not be characterized as payment of interest on a debt.