

69
Supreme Court of the United States

October Term, 1968

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FILED

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JOHN F. DAVIS, CLERK

In the Matter of:

-X Docket No. 473

JOHN H. BINGLER, DISTRICT DIRECTOR
OF INTERNAL REVENUE,

Petitioner,

VS.

RICHARD E. JOHNSON, et al.,

Respondents.

-X:

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Place Washington, D. C.

Date March 4, 1969

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C O N T E N T S

ORAL ARGUMENT OF:

P A G E

James C. Larrimer, Esq.
on behalf of Respondent 25

REBUTTAL ARGUMENT OF:

Harris Weinstein, Esq.
on behalf of Petitioner 42

1 IN THE SUPREME COURT OF THE UNITED STATES

2 October Term, 1968

3 - - - - - x
4 John H. Bingle, District Director
of Internal Revenue, :

5
6 Petitioner, :

7 v. :

No. 473

8 Richard E. Johnson, et al., :

9 Respondents. :
- - - - - x

10 Washington, D. C.

11 Tuesday, March 4, 1969.

12 The above-entitled matter came on for further
13 argument at 10 a.m.

14 BEFORE:

15 EARL WARREN, Chief Justice
16 HUGO L. BLACK, Associate Justice
17 WILLIAM O. DOUGLAS, Associate Justice
18 JOHN M. HARLAN, Associate Justice
19 WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
ABE FORTAS, Associate Justice
THURGOOD MARSHALL, Associate Justice

20 APPEARANCES:

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1 P R O C E E D I N G S

2 MR. CHIEF JUSTICE WARREN: No. 473, John H. Bingler,
3 District Director of Internal Revenue versus Richard E.
4 Johnson, et al.

5 Mr. Larrimer, you may continue with your argument.

6 ORAL ARGUMENT OF JAMES C. LARRIMER, ESQ.

7 ON BEHALF OF RESPONDENT

8 MR. LARRIMER: Mr. Chief Justice and may it please
9 the Court.

10 The issue in this case is essentially whether or not
11 an employer can make a scholarship grant to an employee with
12 that scholarship grant being excludable from gross income
13 under the Internal Revenue Code.

14 The Government's position is that it cannot because
15 Congress expressly stated that any continuing salary arrange-
16 ment was not to have attached to it tax exempt consequences.

17 This statement on behalf of the Government is re-
18 peated throughout its briefs as though the constant repetition
19 would add some validity to it.

20 The legislative history, however, does not support
21 the statement that a scholarship which may in fact be labelled
22 a continuing salary arrangement. The legislative history does
23 not support that statement.

24 The 1954 Code in which Section 117 was inserted with
25 respect to scholarships and fellowships was new with the 1954

1 Code. There was no specific provision of the Internal Revenue
2 Code previous to that time.

3 Q May I ask you a question?

4 The Fifth Circuit went the other way in this case,
5 did it not?

6 A Yes, sir.

7 Q Are there any other circuits that have gone that
8 route, too?

9 A There is another circuit. I think it is the
10 Fourth Circuit, if I am not mistaken. There are at least two
11 circuits which are in conflict with the decision of the Third
12 Circuit in this case.

13 The Congress at the time of enacting Section 117
14 recognized the state of confusion which existed as to the tax
15 consequences of the scholarship and fellowship grant. It set
16 about to attempt to provide what it labelled a clearcut method
17 of determining the tax consequences of these grants without the
18 necessity of deciding each case, case by case.

19 It did so under the format of Section 117 in which
20 it set forth specifically that a scholarship at an educational
21 institution shall not be included in gross income. It also
22 provided that a fellowship shall not be included in gross
23 income.

24 Then, considering the compensatory possibilities of
25 these grants, it inserted limitations in the Code in Section 117.

1 First it provided with respect to scholarships and
2 it is recognized by Congress at this point that scholarships
3 must be at an educational institution as it is defined in the
4 Internal Revenue Code.

5 The Internal Revenue Code specifically defines an
6 educational institution as an institution which has a regular
7 faculty and a regular student body and a regular curriculum.
8 So Congress intended that a scholarship would relate only to
9 a student at an educational institution.

10 Q Would you mind telling me precisely what is the
11 relationship of the student after they give him the scholarship
12 with reference to the company?

13 A The student is on a leave of absence from the
14 company.

15 Q Completely?

16 A Completely. He has got no duties whatsoever. He
17 does not report to the company. They either mail to him his
18 monthly stipend or is deposited in a bank in his account.
19 Other than that he has got no contact whatsoever with the
20 employer.

21 Q What is his contract for the future?

22 A He has no contract except that when he goes on
23 this educational leave he agrees that he will come back to the
24 employer for a period of at least two years.

25 Q Is that a binding contract?

1 A It is binding. I think so. Yes, Mr. Justice.
2 I think it is binding but I don't think it is enforceable to
3 the extent of requiring him to come back.

4 Q A suit could be filed for the breach?

5 A Yes.

6 Q What is the salary he had agreed to be paid when
7 he gets back?

8 A At the commensurate salary of other persons with
9 his qualifications.

10 Q What about in comparison with when he left?

11 A The record in this case establishes that they
12 receive the same salary when they return as they were receiving
13 at the time they left.

14 Q For how long?

15 A Pardon?

16 Q For how long? How long do they hold that same
17 salary?

18 A Well, they are classified. They have various
19 classifications of engineers, they have an associate engineer
20 and a junior engineer and so forth. These are classifications
21 that prevail throughout the company.

22 When they reach -- when they are elevated into another
23 classification, this is dependent on merit. When they reach
24 that classification, then their salary is adjusted accordingly.

25 Q And the company gets him for the same salary

1 after he had the two years' training in college?

2 A They get him for the same salary that he was
3 receiving at the time he left.

4 Q How long do they hold on that do you say?

5 A The agreement is for two years. But that doesn't
6 peg his salary. His salary is pegged -- the contract provides
7 the salary will be commensurate with the duties assigned to him.

8 In other words, if he is assigned as a junior engineer
9 he will be paid as a junior engineer. If he is assigned as an
10 associate engineer, he will be paid at that rate.

11 Q Well, that is inconsistent with, isn't it, with
12 the other thing you just said? He comes back at the same
13 salary.

14 A I am saying the record, the evidence in this
15 case was that when a man left he came back at that same grade
16 because there was no elevation of his classification. There
17 was no change of his classification.

18 Q But how long does he keep it?

19 A There is no contractual provision. As to how
20 long he stays at a certain salary. The agreement is that he
21 will come back at a salary commensurate with the duties
22 assigned.

23 Q At the salaries that are being paid at the time
24 he comes back?

25 A Right.

1 Q Not at the time that he leaves?

2 A That is right.

3 Q I thought you said the opposite to Mr. Justice
4 Black. I thought you said that he came back at the pay that
5 he left with.

6 A As a matter of fact he did, but that was ---

7 Q No, but he came back with all seniority rights,
8 didn't he?

9 A Yes, sir.

10 Q And that would entitle him to whatever pay was
11 being made for people in his grade at the time he comes back?

12 A That is right.

13 Q May I ask you, how did the company treat this
14 expenditure tax-wise?

15 A Mr. Chief Justice, the evidence in the case
16 established that this amount of money, this living allowance or
17 stipend as we call it, was classified on their accounting
18 records as indirect labor.

19 Q As indirect labor?

20 A As indirect labor.

21 Q Yes.

22 A And the company withheld income tax or with-
23 holding tax from this stipend, but did not withhold the income
24 tax from the tuition that was paid under the same program.

25 Q How does that break down in dollars?

1 A Well, the tuition is rather nominal compared
2 to the living allowance paid.

3 Q Most of it they counted as business expense?

4 A Yes, sir.

5 Q And they counted his service during the interim
6 as indirect labor so they could do that?

7 A That is right.

8 Q If they hadn't called it indirect labor, could
9 they have done that? Could they have taken a deduction for
10 that? Couldn't it be considered operating expenses?

11 A My opinion is that a company can have a scholar-
12 ship program or fellowship program and deduct the cost of it
13 as an ordinary and necessary business expense.

14 Q They call it indirect labor then?

15 A There is no clear answer to that except to the
16 extent that they had no account which they labeled fellowships
17 and scholarships.

18 Q Why shouldn't they if that was an exempt
19 expenditure?

20 A I don't know why they did not have, except
21 perhaps it may have been because of the contractual relationship
22 between Westinghouse Electric Corporation and the Atomic Energy
23 Commission, because these men were employed at Bettis Atomic
24 Power Laboratory which was a Government-owned but contractor-
25 operated plant, which means that the Government owned it and

1 paid for all the expense of operation, but it was operated by
2 Westinghouse. And perhaps it was an accounting method which
3 required this to be labelled as indirect labor.

4 Q Westinghouse was on a cost-plus basis?

5 A Essentially, yes.

6 Q And then they took a deduction for this?

7 A This would be charged to the Atomic Energy
8 Commission.

9 Q So they actually got from the Government 10 per-
10 cent more than they put out for this?

11 A Well, I don't know that, Mr. Chief Justice.

12 Q Why wouldn't they have, if it is an operating
13 expense and they are entitled to cost-plus, why couldn't they
14 get it?

15 A Well, assuming that premise is correct, that
16 they get 10 percent of whatever they spend, then that would be
17 true, yes. I am not sure that that is true in this case.

18 Q It might not be the exact percentage. That is
19 what you mean?

20 A Right.

21 Now, Congress established the tax exempt status for
22 a scholarship in an educational institution and a fellowship.
23 It then inserted limitations considering the compensatory
24 aspect of these two grants.

25 With respect to the scholarship at an educational

1 institution, the House report states ---

2 Q What do you mean by shuring the compensatory
3 aspect?

4 A Considering the compensatory aspect of the grant.

5 Q What do you mean by compensatory?

6 A Considering that there may be a compensatory
7 aspect to the grant. In other words, previous to 1954, the
8 tax consequence of a scholarship or fellowship grant was
9 determined by whether or not it was gift or compensation.

10 And you had to eliminate the compense in order to have
11 a scholarship considered tax free, you had to eliminate the
12 compensatory aspect of it.

13 Q How could they do that?

14 A Well, they couldn't very well do it. There was
15 only one case that held that a fellowship was a gift. But it
16 is difficult, and in my way of thinking you cannot eliminate
17 the compensatory aspect of a scholarship or fellowship because
18 the very nature of the grant requires you to render services,
19 to go to school.

20 The fact that those services are not of benefit to
21 the grantor does not eliminate a compensatory aspect.

22 Q Suppose one of those scholars had decided not
23 to go back to the company. Could he be sued?

24 A He can be sued, Mr. Justice, but I doubt if
25 there are any damages.

1 Q Why wouldn't there be? He was a capable man
2 and he was worth more than before, by reason of his training.

3 A Essentially they can replace him with another
4 employee.

5 Q At the same salary?

6 A At the same salary. They have other employees
7 that ---

8 Q Suppose it could be established that they couldn't
9 do that at the end of two year's training?

10 A If they could establish damages, yes, he would
11 be liable on damages for not returning.

12 Q Isn't that one of the big considerations on that?

13 A The basic consideration is the allowance of the
14 educational leave in return for the promise to come back to the
15 employ.

16 Q And work for them for that salary?

17 A For a salary commensurate with the other
18 employees.

19 But our position is that Congress specifically pro-
20 vided in the Code the compensatory aspect of a scholarship.
21 Once it is determined that a grant is made for the education
22 of an individual, if it is a scholarship at an educational
23 institution there is only one circumstance in which a part of
24 it is taxable and that is specifically provided under Section
25 117 in the limitation, and that provision is that if he is

1 required to render services, in the nature of part-time employ-
2 ment, then the value of those services is taxable, and it is
3 only the balance of the scholarship which is tax free.

4 And there is a further exception on that is if those
5 services which are required to be rendered are services which
6 are required as part of the curriculum for the grant of the
7 degree then even they do not result in taxable income. And
8 this is a classic ---

9 Q I take it the other way around.

10 Suppose the Westinghouse and the AEC said to one of
11 its employees, you go to the University. You are now engaged
12 full time with us, on the development of something or other,
13 the Wigid, let us say. You go to the University and you spend
14 all of your time now on that same project. The development of
15 the Wigid and we will give you what we call a scholarship or a
16 fellowship of 90 percent of your prior salary.

17 Is that payment for services that he has received,
18 payment for services to Westinghouse and AEC, is it taxable,
19 or is it within the statutory provision for deduction?

20 A Mr. Justice, I think the factual circumstance
21 which you have set forth is not possible under the ---

22 Q Well, it is possible. I just imagined it. And
23 I put it to you because I hope that it may serve to dramatize
24 what to me is one of the basic problems in this case, and that
25 is to some extent here, to some extent Westinghouse and the

1 AEC are keeping control over what this employee does, to some
2 extent what the employee does at the university is a thing of
3 value to Westinghouse and the AEC.

4 And I am asking you to assume a case where that is
5 crystal clear and dramatic, namely where the employee does at
6 the university precisely what he would be doing if he weren't
7 in the university and were working in the plant.

8 A Mr. Justice, I have to know one more fact and
9 that is whether or not this Wigid that this man is working on
10 is required research for investigation as part of the curriculum
11 of the university for the grant of the degree.

12 Q I don't know what you mean by required research.
13 I suppose that most of these people are working in areas where
14 they have a wide choice as to the subject of their thesis.
15 Your clients were all working on thesis, weren't they?

16 A Yes.

17 Q Well, they have a wide choice as to that and it
18 is permitted and approved by the university just as it was in
19 your case. I won't give you that fact.

20 A I would have to say then that if it is not part
21 of the curriculum that it would not be ---

22 Q Is a doctor's dissertation part of a curriculum?

23 A Yes.

24 Q The fellow looks over the whole spectrum of
25 knowledge and selects from it something of particular interest

1 to him. Is that part of the curriculum?

2 A The thesis topic in the dissertation and the
3 defense of it is part of the curriculum. It is required for
4 the grant of the degree.

5 Q Well, if that is what you are talking about, if
6 you are using curriculum in that sense that the topic of the
7 dissertation is approved, of course, it has to be approved
8 by the university authorities. Does that make any difference?

9 A It has to be approved and it has to be required.
10 That type of an investigation has to be required for the grant
11 of a degree. If it is not required for the grant of a degree
12 then it is services rendered and it would not qualify as a
13 scholarship at an educational institution.

14 Q Well, obviously some relationship between that
15 and this situation in which, as I understand it, the disserta-
16 tion has to be in some measure to some degree related to the
17 work of the laboratory, in any event if there is a dispute
18 between you and the Government as to what the record shows on
19 that, in any event the dissertation subject has to be approved
20 by Westinghouse or the AEC or both of them.

21 And so that there is some measure of service. I
22 should arguably there is some measure of service being rendered
23 by the scholarship recipient between Westinghouse and AEC?

24 A The best response I can make to this, your Honor,
25 is when in fact occurred in this case, and one of the students

1 selected a thesis topic which he had investigated during his
2 leave of absence. It was a course in an engineering field
3 which would have been of value to engineering generally. But
4 after studying it and investigating this for his entire leave
5 period he gave it up because he didn't have enough time and
6 he didn't have enough equipment to really arrive at an answer
7 which would satisfy the requirements of the university for the
8 thesis.

9 The evidence was then put in the record that Westing-
10 house was not interested in this particular thesis to the
11 extent that they would take it upon themselves to pick it up
12 where this man had left it off and get the answer to it.

13 So that the nature of the thesis topic had to be in
14 engineering, which is about the limit of the value of the
15 specific topic to Westinghouse itself.

16 Q May I ask you this? This is what is bothering
17 me. If this is justified as a business expense, on the basis
18 that it is part-time employment, why shouldn't there be some
19 pro tanto recognition of the part that is employment and the
20 part that is not employment when the tax returns are made?

21 A The answer must be, Mr. Chief Justice, that
22 Congress felt that if a student on a scholarship at an educa-
23 tional institution was pursuing the curriculum required by that
24 university, then no part of it should be treated as compensation
25 and taxable.

1 Q Well, might it not be one thing if the company
2 just out of the goodness of his heart gave this stipend to a
3 man for this particular period and did not consider it as
4 business expense in its operation? On the other hand, treating
5 it as a business expense and justifying it because it was part-
6 time employment?

7 A I don't think there has to be a correlation. I
8 don't think because it is deductible by the company it must
9 be taxable to the recipient. There are other ---

10 Q Don't you think one of them should at least pay
11 something by reason of it being part-time employment? Do you
12 think if it is part-time employment that the company should
13 take all of it as a tax deduction, or if the employee is being
14 paid partially for work he does for the company that he
15 shouldn't pay some income?

16 A I think that if it is in fact part time employ-
17 ment that -- and it is outside the curriculum requirements,
18 then he should pay tax.

19 Q Well, would you say then that they were wrong
20 in calling it part-time employment?

21 A Westinghouse was wrong?

22 Q Yes.

23 A I think they did it out of an abundance of
24 caution because of the fact that there are other sections of the
25 Code which say that if an employer does not withhold tax -- may

1 I answer your question -- there is another section of the Code
2 which provides that if an employer does not withhold tax from
3 something which is taxable, then the employee who receives it
4 does not pay tax on it, then both the employee and the employer
5 are responsible for the same tax.

6 So out of an abundance of caution, the employer
7 without fail, usually withholds tax unless the employee liti-
8 gate the tax consequences of it.

9 Q Does that mean that Westinghouse wanted to eat
10 its cake and keep it?

11 A No, I think Westinghouse was just attempting
12 to protect itself.

13 Q In that respect. In that respect, so it could
14 consider it as a business expense?

15 A Well, I don't -- I am not sure why Westinghouse
16 did it other than for the protective feature of it.

17 Q Is there any limitation of the amount in your
18 submission that could be exempt from tax as a scholarship under
19 -- if a person is working toward a degree?

20 A There is no limitation under amount so long as
21 the amount is initially determined to be a scholarship. An
22 amount to enable the student to pursue his education at an
23 institution. There is only a limitation on amount as to a
24 fellowship.

25 Q As to a fellowship, somebody not working toward

1 a degree?

2 A Right.

3 Q So this could be \$100,000 if you could show ---

4 A Well, I think there is a rule reason.

5 Q But as far as the statute goes there is no
6 limitation at all on amount is there?

7 A There is no limitation specifically in the
8 statute on amount with respect to a scholarship.

9 Q Working toward a degree?

10 A Working toward a degree.

11 Q As I understand in this case the employer did
12 pay the actual tuition and all the fees and so on of the
13 educational institution but that is not in issue here, that the
14 Government concedes that part is not income to your client?

15 A That concession was not made until this time.

16 Q Well, it has been made then?

17 A It has been made now and I can't see any
18 significance between a concession on the tuition and a
19 concession on the living allowance paid under the program.

20 Q The Government has some trouble justifying that
21 too, doesn't it?

22 A Yes.

23 Q Well, the Government put it in terms of arguably
24 it could be included in income of your clients but then it would
25 be a deduction so it would wash out. There would be a deduction

1 then of your clients as taxpayers?

2 A That is right.

3 MR. CHIEF JUSTICE WARREN: Mr. Weinstein.

4 REBUTTAL ARGUMENT OF HARRIS WEINSTEIN, ESQ.

5 ON BEHALF OF PETITIONER

6 MR. WEINSTEIN: Mr. Chief Justice.

7 If I may quickly deal with several points, particularly
8 ones of record and other decisions.

9 In response to Mr. Justice Harlan's question, the
10 cases in conflict are in the Fifth and Sixth Circuit and the
11 Court of Claims and there are two cases, one in the Tenth and
12 a procurium in the Fourth that would be leave in conflicting
13 rationale and they are discussed in our brief beginning on
14 page 23.

15 In terms of the relationship between Westinghouse and
16 the employer during the leave, there is a requirement of
17 periodic progress reports and this is discussed, I believe, in
18 the testimony of page 18 of the record, at least. It may be in
19 other places.

20 In terms of Westinghouse's rights against the
21 employer he who defaults on his obligation to come back, we
22 set out the Pennsylvania cases which we think at least give a
23 right to sue for the actual expenditures made on behalf of the
24 employee during the leave.

25 In terms of limitations on amount, respondents now

1 say there is a rule of reason. Congress didn't even think
2 things would go that far because as we pointed out in our
3 brief, Congress expected that this would be relatively small
4 amounts.

5 Although my time is up, if I may just speak to this
6 question of the relationship of the thesis topic to Westinghouse's
7 program, at page 104 of the record, which is Westinghouse's
8 regulations, on this subject, encourages employees to find
9 topics of technical interest to Bettis.

10 In the testimony at pages 61 and 62, a Westinghouse
11 official testifies on this question of thesis review; in the
12 first line of page 62 he uses the word 'relevance' to determine
13 the relationship between thesis topic and Westinghouse work.

14 Pages 74 and 75 the responsible official of the
15 Atomic Energy Commission speaks of job relatedness in terms
16 in connection with the thesis.

17 IN closing I would like to say that we do not depend
18 just on the fact that the thesis topic is reviewed, but this
19 thesis topic review and the entire program is part of an
20 overall package of compensation that Westinghouse and the AEC
21 have designed to obtain people like the respondents for six
22 or seven years, and in the fifth year they get this leave and
23 this obligates them to return as in the case of one respondent,
24 in the sixth year. In the case of the other two, for the sixth
25 and seventh years. And it is this obligation that to us is

1 the keystone of this case.

2 (Whereupon, at 10:42 a.m. the oral argument in the
3 above-entitled matter was concluded.)

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