Supreme Court of the United States

OCTOBER TERM, 1970

In the Matter of:

Docket No. 544

COMMISSIONER OF INTERNAL REVENUE

Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION

Respondent

Place Washington, D. C.

Date February 23, 1971

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

C O N T E N T S

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

COMMISSIONER OF INTERNAL REVENUE, Petitioner	
vs.	No. 544
LINCOLN SAVINGS AND LOAN ASSOCIATION, Respondent	

Washington, D.C.
Tuesday, February 23, 1971

The above entitled matter came on for argument at 1:30 p.m.

BEFORE:

WARREN E. BURGER, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HENRY BLACKMUN, Associate Justice

APPEARANCES:

MATTHEW J. ZINN, ESQ.
Office of the Solicitor General
Washington, D.C.
Department of Justice
On behalf of Petitioner

ADAM Y. BENNION, ESQ.
Los Angeles, California
On behalf of Respondent

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We'll hear arguments next in No. 544, Commissioner of Internal Revenue against Lincoln Savings and Loan Association.

Mr. Zinn, you may proceed whenever you're ready.

ARGUMENT OF MATTHEW J. ZINN, ESQ.

ON BEHALF OF PETITIONER

MR. ZINN: Mr. Chief Justice and may it please the Court.

This federal income tax case is here on a Writ of Certiorari to the Court of Appeals for the Ninth Circuit. It raises a question that affects the tax liability of every savings and loan association that insures its depositors accounts with the Federal Savings and Loan Insurance Aorporation.

Respondent is such an association.

During 1963, the only taxable year at issue, it paid a regular annual insurance premium for depositors insurance to the insurance corporation, amounting to approximately $135,000.

This payment was required by Seciton 404 (b) of the National Housing Act, and the Commissioner allowed it as an ordinary and necessary business expense deduction under Section 162 (a) of the Internal Revenue Code. The treatment of this payment is not in dispute.

Also during 1963, Respondent contributed an additional

$882,000 to the insurance corporation. This contribution was required by Section 404 (d) of the National Housing Act, and it is described in the statute as being in the nature of a prepayment with respect to future premiums.

The question presented here is whether the $882,000 is an ordinary and necessary business expense or 1963 on the ground that it is simply an additional cost fof current insurance as Respondent claims or whether as the Commissioner urges the $882,000 is a capital expenditure, which is deductible in future years if actually used to pay Respondents regular annual insurance premiums or to meet insurance losses of the insurance corporation.

In other words, the basis question here is not whether a deduction should be allowed, but when a deduction should be allowed.

Q Does it have to be one or the other?

A No, Mr. Justice.

Q Is it an ordinary business expense or a capital expenditure? Frankly I have trouble seeing how it fit into the statutory definition of either.

A Mr. Justice let me deal first with the capital expenditure---

Q ---don't have to decide this case, but I wondered if those are the only two possible---

A Oh. Let me start with capital expenditure.

The term capital expenditure appears and is defined in section 263 of the Code---

Q And it doesn't fit that definition.

A Right. That issue has been dealt with explicitly by Mr. Justice Blackmun when he sat on the Eighth Circuit, in a case called General Bank Shares Corporation, which is not cited in either of the briefs but was cited below and it was rpported at 326 Fed. 2nd.

There Mr. Justice Blackmun, speaking for a unanimous Eighth Circuit in a case in which this Court subsequently denied Certiorari, said this about Section 263: "Section 263, with its denial of deductibility, for specified capital expenditures, and Section 162 (a), with its grant of deductibility for ordinary and necessary business expenses are not, of course, mutually exclusive. Neither are they together all inclusive. Section 263 obviously is not in itself an exclusive list of non-deductible capital expenditures."

Apart from Mr. Justice Blackmuns comments in that case, this Court only last term, in two unanimous decisions, in the Woodward and (Hilton) cases, held that appraisal expenses incurred in connection with evaluation of dissenting share holders stock, were non-deductible capital expenditures, but they, too, are not new buildings or permanent improvements or betterments. And the Court did this, of course, without mention of the fact that Seciton 263 has only a limited definition.

So I think it's fair to say, Mr. Justice, that this Court has on innumerable occasions done that.

Q At least once.

A No, on innumerable occasions, as early as 1938, in Helvering v. Winmill, it held that brokerage expenses in the acquisition of capital stock, are capital expenditures, to be added to the cost of the stock.

Q And that increases the basis.

A Yes, sir. And capital stock itself, Mr. Justice, is not described in Section 263, but we nevertheless don't allow a deduction for it.

And so---

Q For what?

A Capital stock. If I go out and buy some---

Q For the purchase of---

A That's right,.For the purchase of capital stock. It is a capital expenditure, which at least temporatily cannot be deducted.

Q But a capital expenditure, as defined in 263 (a) at least those definitions and under ejusdem generis other similar ones would not be the kind dealt with last term in Woodward, nor would they be the kind coming under in the general category of brokerage fees.

A No, the---

Q But would be expenditures that could be

depreciated annually. Depreciated. That's what 263 (a) says to me.

A I'm not prepared to say whether 263 could also include a non-depreciable asset, but I don't think it really matters.

The point is that I think it's clear that capital expenditures are more broadly defined than in Section 263 that this Court, and so far as I know, all courts, have consistently subscribed to that, we don't think it's any real bar to our position here that the cost that we're talking about here are not described in Section 263.

Q Well really perhaps what I'm asking is very consistent with the language that you read to us from Justice Blackmuns opinion in the Eighth Circuit. Is it necessary to your argument when you say that these expenditures do not come under 162 (a), is it necessary for you to say that they do come under 263 (a)?

A I don't think it is, Your Honor.

Q You just have to stop with the first one, don't you?

A Right, Mr. Justice, and that's what the Court did in the Woodward and (Hilton) case---

Q You don't need to say that they're capital expenditures, do you?

A We did not cite Section 263 in our brief.

Q I know you didn't.

A But---

Q Then you don't need to say that they're capital expenditures.

A No. We call them capital outlays, I don't think that the verbage is important. The question is what they really are. And we dnn't---

Q Well, what they really are, of course, depends on the verbage of the Internal Revenue Bill.

A Well, we rely on verbage of the Treasury regulations, Section 1.461 which appears on pages 41 and 42 of our brief, and reads, in pertinent part, that if an expenditure results in the creation of an asset, having a useful life, which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part for the taxable year in which made.

Perhaps it would be helpful if I point out why it is that we capitalize anything. Why do we capitalize buildings? Now---

Q Would you mind giving me the name of Justice Blackmuns case?

A Yes, sir. It's General Bank Shares Corporation against The Commissioner, 326, Fed.2nd, 712, and the material that I quoted was at 716.

The reason why we require the capitalization of anything, as I was saying, in our judgement, is that if you didn't capitalize, you would be charging against the income of a single year cost of an asset that was going to benefit a number of future years. In the case of a building, for example---

Q And a building will depreciate over its---

A As you recover---

Q ---useful life.

A As you recover its costs.

Q Land you don't depreciate and shares of stock you don't depreciate.

A But I was---

Q ---a matter of your basis.

A Right. But the point is that we require capitalization in the first instance because to charge the whole thing off would destroy the income.

And I would suggest to this Court, Mr. Justice, that we'd have precisely the same rules if there were no Section 263 in the Internal Revenue Code, because Section 446 of the Internal Revenue Code requires that income be reported clearly, and it seems to us that a clear reflection of income in the case of a cost that's going to benefit future years and can properly be described as an asset within the meaning of the regulation that I have quoted, is one that should not be deducted currently.

Q I think perhaps all of my problems are caused by your characterizing this as a capital expenditure. You don't need to , you simply need to argue that it&s not deductible under 162 (a).

A Right, but we didn't refer to capital expenditure in the sense of the statute, but in the sense use by Mr. Justice Blackmun.

At all relevant times, Respondent has been a member of the Federal Home Loan Bank of San Francisco, and has insured its depositors accounts with the Insurance Corporation.

Prior to 1962, Respondent was required to own stock in its Federal Home Loan Bank in an amount at least equal to 2% of its mortgage loans, and to maintain this percentage of ownership.

Respondent has always capitalized its purchases of such stodk. Also prior to 1962, it was required to pay an annual insurance premium to the Insurance Corporation of1/12 of 1% of all insured accounts and creditor obligation

This expense, corresponding to the$135,000 premium of 1963, has always been allowed as an ordinary and necessary business expense by the commissioner.

In 1961, Congress changed these requirements, effective January 1, 1962, This change resulted in the present litigation. First, Congress reduced the stock ownership requirement in the Federal Home Loan Bank from 2% to 1% of mortgage loans.

Second, it continued the regular annual premium requirement of 1/12 of 1% of savings accounts and creditor obligations.

And third, it imposed a new requirement in Section 404 (d) that in certain years, each insured institution contribute 2% of any increase in its savings accounts and creditor obligations during the preceding year to the Insurance Corporation.

Congress thought that the additional contributions required under Section 404 (d) would be about the same as the larger stock purchases that would have been made under the prior act.

Indeed, if a savings and loan association has to purchase any stock to meet the lower 1% requirement, its obligation under Section 404 (d) is reduced by that amount.

Regular insurance premiums recieved by the Insurance Corporation are part of its gross income to the extent that the Corporation does not use them to meet its current expenses and losses, they are transferred to the Insurance Corporations primary reserve, which the Corporation is directed to establish in the National Housing Act.

That reserve contains its cumulative net income and is available to meet losses if income of any year is insuffic - ient. Section 404 (d) contributions, on the other hand, ones that are here in dispute, are not considered part of the insurance

companies' gross income and are not added to its primary reserve.

They are transferred directly to the Insurance Corporations' secondary reserve, which the Insurance Corporation also is directed to establish in the National Housing Act. Unlike the primary reserve, this secondary reserve is not freely available to meet expenses and losses of the current year. It may be used only to meet losses and only if all of the Corporations other accounts are first exhausted.

Once Respondent makes a regular annual premium payment that payment is lost to it. The premium obligates the Corporation only to provide insurance coverage for the current year.

On the other hand, the contributions to the Corporations secondary reserve create a beneficial interest in that reserve. This interest is evidenced by annual statements which the Insurance Corporation sends to each insured institution, each year, advising it of its then current share of the secondary reserve.

Respondents share of the reserve amounted to nearly $5 million, as of the end of 1967. This share consists not only of the contribution made by the insured institution but also includes an annual return on investment at a rate equal to the return earned by the Corporation on its investments.

Q Now that is credited to the individuals account.

A That's right, Mr. Justice. The rate is av-

eraged 3 to 4½% annualy, roughly.

Q Now are the 4 (d) payments annual or are they terminated when the reserve gets to be a certain amount?

A If you could hold off, I'm just coming to that. This is a rather complicated background, as you know---

Q Yes.

A ---and I'm trying to give the picture---

Q All right.

A ---in the way I think will make it simplest to the Court.

Q I'm sorry.

A Although an insured institutions interest in the secondary reserve is not generally transferrable, an association may transfer its share in a merger, consolidation, or other similar transaction. Moreover, an association is entitled to a cash refund of its share, if it withdraws from the Federal Insurance system, or if it goes into voluntary or involuntary liquidation.

I come now to consider how an associations share in a secondary reserve is built up and how it is used to pay regular annual insurance premiums.

Contributions to the secondary reserve, the ones that are here in dispute, must be made until the primary and secondary reserves together equal 2% of all savings accounts and creditor obligations of all insured institutions. When that point

is reached, the obligation to make secondary reserve contributions is temporarily suspended.

While it remains suspended, an associations share in a secondary reserve is used to pay its regular annual insurance premium. This reduces its share in the secondary reserve.

Now if a particular savings and loan association has no remaining share in the secondary reserve, while the onligation to make contributions to the secondary reserve is generally suspended, it pays its annual insurance premium in cash.

The use of shares in the secondary reserve to discharge the regular annual insurance premiums continues until the total of the primary and secondary reserves falls below 1 3/4 % of all insured accounts and creditor obligations.

Q Mr. Zinn, when the secondary reserve is so used to pay insurance premiums, does the S & L then get a deduction, at that point?

A Yes, Mr.---

Q ---for the amount used?

A For the amount that is taken out of the secondary reserve and transferred to the primary reserve to pay the regular annual premium for that year.

Q That's my question.

Q (immediately following) Just like of they paid the premium in cash.

A Exactly, because they don't have to pay it in cash when they pay it out of their share of the secondary reserve.

That's why I stress the point. If a particular association doesn't have any share in the secondary reserve, it's going to have to come up with the money in cash instead of that share.

Q But the termination of the use of the secondary reserve to pay premiums isn't keyed to individual companies, it's keyed to the total of primary and secondary reserves.

A That's for the general obligation, but each individual company is stuck with it's own secondary reserve. For example, if you have---

Q I understand; if the primary and secondary reserve remain above 1 3/4% and some companies secondary reserve is zero, then it has to pay.

A It has to come up with the money, right.

Contributions to the secondary reserve are renewed as I have said, when the total of the two reserves falls below 1 3/4%. At that time, and until the total again reaches 2%, contributions to the secondary reserve must be made.

Contributions to the Secondary reserve are permanently terminated when the primary reserve alone reaches the 2% level. Regular insurance premiums must be paid annually, either in cash,

or through use of an associations share in the secondary reserve until the primary reserve alone reaches 2% of all insured accounts and creditor obligations, of all insured institutions.

When it does, any association whose full share in the secondary reserve has not been used to pay regular premiums, is entitled to a cash refund of its remaining share. Thereafter, regular premiums must be paid whenever the primary reserve falls below the 2% level.

All that this Court needs to understand about this complicated arrangement is, that in some years, like 1963, an association will be making regular premium payments in cash, and also contributing to the secondary reserve in cash. In other years, for example this year, it will make no cash payments, and its regular annual premium will be paid out of its share of the secondary reserve.

I think the matter can be further clarified if we look at what has actually happened since 1962 when this scheme went into effect. From 1962 through 1969, Respondent paid regular premiums in cash and also made contributions to the secondary reserve.

In its view it is entitled to two deductions in each of those years. We say that only the regular annual premium is deductible. By the end of 1969, the total of the primary and secondary reserves reached the 2% level. Consequently, the obligation to make payments to the secondary reserve was suspended,

and Respondents regular annual premium was paid out of its share of the secondary reserve in 1970.

It will continue to be paid out of the secondary reserve this year, and for the next several years. Respondents position is that no deduction should be allowed during these years. We say that a deduction should be allowed for the regular annual premium.

In short, under Respondents method, deductions for insurance coverage would be bunched in the years in which it makes contributions to the secondary reserve. Under our method the cost of the insurance would be spread over the entire period by allowing a deduction each year for the regular annual premium, irrespective of whether it is paid in cash, or out of an associations share of the secondary reserve.

The tax court upheld the governments position in a unanimous review decision, that these payments into the secondary reserve constituted capital outlays, if I may use that word.

The Ninth Circuit reversed in a two to one decision. As I have said before our position here is based on the Treasury Regulations that I quoted, and these regulations are not challenged by the Respondent, they are not cited by the Respondent in their brief, and they require that the government show two requirements.

First, that an asset has been created, and second,

that that asset has a useful life extending beyond the close of the taxable year.

Now we think this is shown by the undisputed facts in this case.

Q Where do I find that regulation that you were reading?

A On page 41 of our brief Mr. Justice, roughly half way down. We say that Respondent acquired an asset because it had an identifiable interest in the secondary reserve, evidenced by the annual atatements furnished by the Insurance Corporation. It is something that Respondent owns. It is transferrable, in limited circumstances, to another. It earns interest each year, based on the interest earned by the Insurance Corporation.

And it has real value, which would be recognized, for example, if Respondents parent corporation were to sell its stock in Respondent to another.

We think it is clear that the buyer would pay more for Respondents stock than it would for the stock of another savings and loan association that was in all other respects, similarly situated to Respondent, except that it had no interest in the secondary reserve.

We also believe it is clear that Respondents secondary reserve interest will provide a future benefit to Respondent, and thus that it has a useful life extending beyond the close

of the taxable year. If Respondent remains in business, that benefit will inure to it in the form of future insurance coverage. If it merges with another association, its parent will benefit from its share in the secondary reserve by recieving additional shares of stock in the surviving corporation. If Respondent leaves the Federal Insurance system or goes out of business, it will get a cash rebate of its share in the secondary reserve.

If any amount remains in the secondary reserve, when the primary reserve alone reaches the 2% level, that amount will be refunded to Respondent in cash.

In short, Respondent will get a benefit from its share in the secondary reserve in one form or another, in future years.

I should like to reserve my remaining time for rebuttal.

Q Just one question. There is a bit of a fuss in your brief about that Weber Paper Company brief, our case, I don't find it cited by your opposition here in their brief and s take it that they're not relying on it. Do you have any further comment on that case at all---

A No---

Q ---other than---

A No further comment other than what we said in our footnote.

Q All right. Mr. Bennion?

Q (immediately following, by another Justice) Which, I take it, you don't think the case is properly decided.

A And whether or not so, Mr. Justice, not applicable in these circumstances.

ARGUMENT OF ADAM Y. BENNION, ESQ.

ON BEHALF OF RESPONDENT

MR. BENNION: Mr. Chief Justice, and may it please the Court.

We are certaibly in agreement with the governmebt here that this question not to turn upon what the payments in question really are or were. It is the taxpayers position that in essence the payments were primarily insurance premiums, and constitut ed ordinary and necessary business expenses.

To go back to 1961 when the legislation in questipn was introduced, each association was required to pay an insurance premium of 1/12 of 1% of the savings accounts and creditors obligations. I will not keep repaating creditors obligations, but I refer to them by including them in savings accounts.

Had the savings and loan industry remained static, those insurance premiums of 1/12 of 1% would have produced a 2% reserve in approximately 24 years, but of course, with

the tremendous growth of the savings and loan associations, to continue to collect only 1/12 of 1% did not keep pace with the ultimate insurance risk which the statute has imposed on the F.S.L.I.C.

And therefore, Congress, when it introduced the Act in question, stated in both of the committee reports that there was general agreement that the some action should be taken to build up the Corporations reserves at a faster rate after pointing out the extent to which they had declined.

And therefore the legislation took the form of continuing the premium of 1/12 of 1% but the additional element that was then introduced was that if any association had an increase in its savings deposits it would have to pay this additional premium of 2% of the amount of the increase.

And to us it is sigmificant that this is right in line with the element of a premium for insurance. It's an attemp to measure the cost of protection by the increased risk that the insurance company is put to.

For example, in our particular case, Lincolns savings accounts at the beginning of 1962 amounted to approximately $90 million, and they increased during 1962 to over $135 million with the result that the potential insurance risk of the F.S.L.I.C. which it was obliged by law to insure, was increased by $44 million.

And to us the essence of what Congress required was

that because of the additional insurance risk thus imposed upon the F.S.L.I.C., there should be paid a 2% of that increase as a premium.

Not a premium to take effect 10 years later when there might be a bookkeeping entry transferring an amount from a secondary reserve to a primary reserve, but an insurance risk that was assumed immediately in 1962 because of the increased savings accounts of Lincoln Savings and Loan Association.

So therefore, it seems to us that basically the nature and the substance of what we paid was a premium measured directly to the increased insurance risk assumed by the F.S.L.I.C. and therefore it meets basically the criteria of an ordinary expense.

On the other hand there undoubtedly may have been associations which experienced no increase in their savings deposits.As to such an association there would have been no increased insurance risk assumed by the F.S.L.I.C.

There would have been no increased premium paid by such an association. Which to us gives further illustration of the fact that this really was in essence the payment for insurance risks.

Q Mr. Bennion, are you then making an ad hoc approach to the taxpayers concern? You seem to draw a distinction between one whose deposits had increased substantially and one whose deposits had not increased substantially. Do I under-

tand you to imply, I don't think you said it flatly, that for the latter one there would be no deduction?

A That is true, Your Honor, because there would be no payment due. In other words, if an association did not increase its deposits it would pay nothing more than the original 1/12 of 1%. It would not pay this 2% and therefore, having paid nothing, if of course, could be entitled to no deduction.

The government has argued that by this approach---

Q Let me carry on one more issue. What, then, is the statutory approach in setting out both 404(b) and 404 (d), why do you think they're separated?

A This would have to be my own personal opinion because I cannot climb into the minds of Congress, but I think it was primarily a device to bring about fairness. The plan of the insurance statute from the very beginning has been that there will come a time when the reserves reach a certain point when all payment of insurance premiums will be suspended.

Under the original Act it was 5% and then it was reduced to 2%. So there had been inherent in every payment, in every premium the possibility of a future benefit, when that reserve reached that point.

Now I personally think that the reason they adopted this complicated formula and said we'll charge the growing associations an additional 2%, was that when the combined primary

and secondary reserves should reach 2% and therefore there should be a suspension of payments, under the Congressional determination that 2% was high enough to cover the risk.

That early suspension would be available only to the growing associations which had paid this additional premium, whereas, if you had an association which had paid no secondary premiums and there fore had no secondary account, there would be nothing to transfer on their account and therefore they would have to continue to pay the 1/12 of 1% premium until the primary premium by itself got to be 2%.

And I believe that that is the only reason for this exceedingly technical anc complicated formula which was set up just as a matter of fairness and I think it is fair. I think that the associations that have been growing and have been building up this fund and paying insurance, when the 2% was arrived at which Congress thought was sufficient, that's fine. Let's give these associations a little bit of surcease while the others who have not been contributing will continue until all of the funds are transferred over to the primary reserve.

Q As I understood you to say, and as I understand the law, the Section 404 (d) payments are to be made only by institutions whose depository increases.

A That is correct.

Q If they're not increasing there are no 404 (d) payments to be made.

A That's correct.

Now from a practical standpoint, the government has referred to this transfer of a part of the Lincolns account from the secondary reserve to the primary reserve as an event which should give rise to a deduction at that time and also which prevents a distortion of income.

I'd like to just call your attention to what seems to me to be a true distortion of income. Under the governments theory, and as the government says this transfer started as far as Lincoln is concerned, in 1970. Under the governments theory the original payment of this $800,000 although it was completely beyond the control of the taxpayer, and in our view had gone for insurance, is set up on the taxpayers books as an asset.

Now in 1970, when the whole industry reserve gets up to 2% and instead of having to pay the original 1/12 of 1%, the taxpayer has the benefit of having transferred, let's say $500,000 from the secondary reserve to the primary reserve. This has the effect on the financial status of the taxpayer, of telling the public that its net worth has now decreased to $500,000.

And yet from a practical standpoint the day before that transfer was made and the day after it was made, we had exactly the same net worth as far as anybody could tell from th the outside it's worth exactly what it was, and yet under the governments treatment you show a decrease in net worth of a half

a million dollars.

Q Yes but there will be a half a million dollars less expense that would normally be recorded as an expenditure.

A No, Your Honor, because under the governments theory the expense is allowable in that year even though no payment is due.

Q Why---

A If I understood Your Honors point. But it---

Q Well, I know, but you actually haven't put put any money for it.

A that is correct.

Q Well, in another year you would have had to actually deplete the resources of the company by a half a million dollars.

A It seems to---

Q So you just end up with the same asset value, I would think.

A No, I think,---

Q In a different account, but I think it would end up the same way.

A The way it has worked out as the accountants have worked it out for us is that if by deducting, in other words by writing off this asset out of the secondary reserve which appears as an asset on the balance sheet---

Q That is reducing the 886 by 500,000?

A Yes.

Q This is the way your accountants would handle it?

A Yes, this is the way the government would handle it, and this is the way we are required to do it by our regulatory agency.

Q In other words the asset which had appeared at 886 would now appear at 386?

A That's right.

Q Well what about the half million that is now a deductible expenxe? By reason of the transfer--what happens to that?

A It's just allowed as a deduction.

Q But tarrifs would have been paid up for those premiums, otherwise, or still is in your cash register.

A Well, that's true, Your Honor.

Q Well, so it's a washout, isn't it?

A I wish I were a better accountant, but the way our accountants have explained it---

Q Well wouldn't it work out that way because if your cash balance had shown 2½ million dollars but you had had to pay out a half million, your cash balance would be 2 million. Plus 886. So now it's 2 million 5 hundred plus 386, isn't it? So it's exactly the same thing. Isn't it?

A I must say that sounds right, Your Honor.

Q It sounds reasonable anyway, doesn't it?

A Yes, sir. Now the government has placed stress upon this question on the fact that the secondary return earns a rate of return which the statute requires the F.S.L.I.C. to credit to the secondary accounts.

And it is true that the law does require such a credit, we have gone through in our brief the presentation in the committee hearings by one of the savings and loan people who was unhappy that this return was not going to be paid in cash but nothing happened with that.

And from the standpoint of the taxpayer, it is seen to us that this so-called return is really an illusory thing. It is credited to---

Q What's it supposed to realized from?

A The F.S.L.I.C., Your Honor, has invested most of its asset money in government bonds and by and large its income consists of the returns.

Q So that this means that if your contributions were a half a million dollars to the secondary reserve, and the secondary reserve had earned enough so that that half million now becomes$525,000, is that it?

A Yes.

Q Now do you have to return the $25,000 as income?

A Not in the year ---, Your HOnor, actually what happens is the F.S.L.I.C. does not earmark its bonds as between primary and secondary, it reports all of its investment income as income and then it deducts from that whatever return is credited to the secondary---

Q Does that $886,000 on your balance sheet include any increment in the secnndary reserve by reason of---

A No. The 886 is just dolely the amount we paid in the year 1963. The account has subsequently been credited with this increment.

Q I see.

A But the, and so the amount as credited to the secondary is then split up into the various savings and loans in accordance with their respective accounts.

Now the revenue ruling which was passed upon by the Internal Revenue Service on this whole question, held that the secondary premium payments were dnot deductible because of all of these limitations and possibilities of refund and what not. Then they ruled on the question of whether these credits of income would be taxable as income and the revenue ruling holds that no, that the income is not subject to taxpayers demands and is so fettered with conditions that it is not recieved either actually or constructively.

So the ruling is that the return is not taxable at the time it's credited but it will be taxable, become taxable,

when and if there are transfers made from the secondary reserve to the primary reserve.

Now---

Q Well, let's see. If you have $500,000 and it earns $100,000 so that now it's $600,000 and your annual premium is $100,000, and they're suspended because it's paid out of the secondary account, after you've got the $500,000 that's your investment. Then the sixth year the increment is used to pay your premium, in that year do you get the increment as a deduction and also have to return the increment as income?

Q (immediately following) It's a washout.

A It's a washout.

Q You know, this isn't complicated, is it?

A It's really nothing, the Ninth Circuit when we finished our argument there asked us if next time we wouldn't bring a complicated case.

Q Yes.

A I'll tell you, the complication arising out of what has just been mentioned here is tremendous. Actually, the industry is facing this exact situation right now where, in 1970, there were transfers made out of the secondary, and the associations don't know what was transferred, whether they're contributions, whether the income, and therefore, my recollection is that the only instructions that they have so far is that the F.S.L.I.C. is to treat it the way you want it.

But it is true that as far as the income is concerned, it seems to me that it would be a wash transaction. The income would become taxable, and it would be deductible becuase applied on this obligation. But the whole business of crediting this return, forgetting for a moment the possibility of refunds on termination or liquidation, really is of no great moment.

The amount that's credited from the primary reserve to the secondary reserve simply increases the secondary and decreases the primary, and yet any benefit to be derived by any taxpayer depends upon when the combined primary and secondary reserves reach 2%, so that the mere fact that one has increased and the other decreased really is not that significant.

One of the final arguments of the government and in this respect reliance was placed primarily on an argument which the tax court of the United States developed, and that is that the legislative history of this statute prooves that the payment is not an insurance premium, it was intended as a capital investment, in the F.S.L.I.C.

We have searched the legislative history and can find nothing in support of this argument. The tax code even said that the secondary reserve and the stock of the Federal Home Loan Bank Board were fungible, which to us indicated a failure to grasp the completely different functions of the two agencies.

The Federal Home Loan Bank Board is a credit organization and an association buys stock in that Board and thereby

becomes entitled to borrow funds. On the other hand, the FSLIC is solely an insurance company and is concerned solely with insuring the accounts of the savings depositors of the FSLIC.

The only reference between the two in Congress was that in order to lighten the financial burden on taxpayers that had to pay the additional 2% insurance premium, the amount required to be paid in for the bank stock was reduced from 2 to 1% because as Congress said, there was general agreement that the bank was overcapitalized, whereas the insurance company greatly needed to expand its insurance reserves.

There is no connection whatsoever in function or purpose of the two payments and we think that the fundamental fallacy of the tax court here was this point that this was in the nature of capital because it was fungible with the bank stock. You see, there's absolutely no basis for that.

If it please the Court, I think that that covers most of our arguments, other than those that we have set forth in our briefs and this is a complicated thing. We certainly agree with the government that the essence of these payments should govern whether they are deductible or not. We think that the government conceeds that they were necessary expenses, we think the facts show that they are ordinary in that all those faced in a similar situation paid them, and we do not believe that there was any element of a capital expenditure or a capital investment involved here. I think that the Ninth Circuit Court

of Appeals should be affirmed.

Q Thank you, Mr. Bennion. Mr. Zinn, you have about five minutes.

REBUTTAL ARGUMENT OF MATTHEW J. ZINN, ESQ.

ON BEHALF OF PETITIONER

MR. ZINN: Thank you , Mr. Chief Justice.

A few brief points. I think one of the difficulties in addition to the mathematical difficulties in this case is the fact that Respondent was required to both pay the regular annual premium in 1963 and also to come up with the additional money that would go into the secondary reserve, and this aspect of compulsion is one that goes through a lot of tax cases and a statement from this Court regarding its significance would be most welcome.

I should like to put a hypothetical to the Court, which raises---

Q Excuse me. Now what was the governments position as to the 1/12 ---

A Oh, that's---

Q And what about the other one, paid the same year?

A Paid the same year, no that is not deductible, that is a capital outlay.

Q Yes. You figure it should be treated as prepaid insurance premiums?

A Not quite---

Q Not quite?

A Just almost. The tax court has elaborated in great detail why it could not be considered ---

Q And in the year when the secondary reserve is resorted to for premium payments there are no payments in ---

A Well, no cash payments, but they still are obligated to pay the regular premium.

Q Well, I know, but there are no payments into the secondary reserve.

A That's right. They're suspended.

Q So that any payments into the secondary reserve are never used to pay any kind of a current expense?

A That's correct. It's used to pay the future premium.

Now this question of compulsion as we said I think is very important and I'd like to put a simple hypothetical to the Court to demonstrate what our position is.

Let us suppose there have been a lot of fires in a particular area and a local ordinance is passed requiring each business in that locality to obtain each year from the local fire department a certificate of fire safety. Let's suppose in order to obtain that certificate of fire safety, guards have to be postedon the business premises each night and also a modern, up to date sprinkler system has to be installed on the premesis.

I would suggest that although the salaries of the guards are ordinary and necessary business expenses, that this Court would held unanimously that the cost of the sprinkler system is a capital expenditure, this time within the meaning of Section 263. Even though, if I may quote from the Respondents brief, the purpose of making both expenditures is the same, the compulsion of making both expenditures is the same, and the consequence of not making both expenditures is the same.

Q Your point is, I gather, your sggestion is that whether or not these expenditures are compelled has nothing to do with the issue---

A Precisely, and the expression of this Court on that issue I think would do a great deal to resolve a whole lot of tax cases that are now pending.

Q Does anyone seriously raise any question that the cost of the sprinkler system would be amertized over it its useful life? It

A It seems to us, Mr. Chief Justice, that Respondents argument here, principle argument in its brief, which they did not elaborate this afternoon is that it had to pay the Section 404 (d) payments under the National Housing Act. It had to pay them, that's what the Ninth Circuit said, that's why they held adversly to the government. And we say that the fact that you had to pay them isn't any more significant in the resolution of this case than the fact that you're required to

put in the sprinkler system.

The question is, whether you have an asset within the meaning of those regulations, with a useful life extending substantially beyond the close of the taxable year. And that question is the same whether it be a sprinkler system or the contributions to the secondary reserve that are involved here.

Q Since you put a hypothetical to us, let me put one to you, if I can, Mr. Zinn. Suppose that in this insurance scheme you had a formula that fixed the amount to be paid---

A Each year?

Q Each year, and then, based on actual experience, each year there was a refund. Now I realize that mathematically it would be a little difficult to do that each year, but soppose it could come. You would say, then, that the dividend would reduce the total expenditure?

A Right. The hypothetical you put is very similar to a ruling relating to the Federal Deposit Insurance Corporation which is cited in both briefs and which we think is not relevant. Under that ruling, the banks would pay a premium each year, and would get back any excess in the following year. And the question was whether that was an ordinary and necessary business expense and the Internal Revenue Service ruled that it was.

The reason that it ruled that it was, was this: the

only reason the money wasn't paid back at the end of the same year was that the FDIC couldn't go and make all the computations to figure out how much was going to be needed to cover the expenses and losses of that year.

You didn't have an asset with the useful life extending substantially beyond the close of the year. The refund was made within a few months of the succeeding year. And as I say, we rely on this regulation which we think squarely fits this case.

I see that I'm out of time.

Q Thank you, Mr. Zinn, thank you, Mr. Bennion, the case is submitted.

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