ORIGINAL

In the

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

FIRST SECURITY BANK OF UTAH, N. A., et al.,

Respondents.

No. 70-305

Washington, D. C.
January 10, 1972

Pages 1 thru 45

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Washington, D. C.,

Monday, January 10, 1972.

The above-entitled matter came on for argument at 11:39 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

ERNEST J. BROWN, ESQ., Tax Division, Department of Justice, Washington, D. C., for the Petitioner.

STEPHEN H. ANDERSON, ESQ., 400 Deseret Building, Salt Lake City, Utah 84111, for the Respondents.

C O N T E N T S

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PROCEEDINGS

MR. CHIEF JUSTICE BURGER: We will hear arguments next in No. 305, Commissioner of Internal Revenue against First Security Bank.

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

ORAL ARGUMENT OF ERNEST J. BROWN, ESQ.,

ON BEHALF OF THE PETITIONER

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

This case, on certiorari to the Tenth Circuit, brings to the Court, for the first time since it was enacted as part of the Revenue Act of 1928, what is now Section 482 of the Internal Revenue Code. That provision is as follows:

"In any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary or his delegate" -- the Commissioner, as I'll phrase it -- "may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

This provision, of course, expresses the judgment that autonomous business units will exercise self-interest in bargaining power which will cause income and outlays to reflect the performance of function and the acquisition of benefits in accordance with the values of the market.

But, on the other hand, when we have units under common control, a host of factors, which may or may not include tax considerations, may distort this picture and cause considerable divergence between income/expenditures on the one hand, and performance of function or the acquisition of benefits on the other.

So that the regulations have always provided, as they provide now, since 1934 that the authority given here is not solely, or even necessarily primarily, to cases of improper accounting or fraudulent, colorable, or sham transactions, or a device designed to evade or avoid taxes. But the authority extends to any case in which, by inadvertence or design, taxable income, in whole or in part, of the controlled taxpayer is other than it would have been had the taxpayer, in the conduct of his affairs, been an uncontrolled taxpayer, dealing at arm's length with another uncontrolled taxpayer.

To bring performance of function and taxable income into line, to create what some courts have referred to as economic reality, the Commissioner may and often has found it necessary to analyze pricing, charges for services, distribution of receipts, or the bearing of burdens of expenditures.

In this case, the Commissioner found it necessary to allocate to the taxpayer banks a substantial part, some 40 percent, of the premium income received by a life insurance company under common control for the years 1954 through 1959.

His allocation was upheld by the Tax Court, relying on its previous reviewed decision in Local Finance Corporation, a decision which had thereafter been affirmed by the Seventh Circuit Court of Appeals.

In the Local Finance Corporation decision, the Tax Court had reviewed extensively, and reference was made in this case in the Tax Court to those findings -- had reviewed extensively the nature and customs ofthe business of credit insurance, which is much involved here.

The Tenth Circuit Court of Appeals, however, reversed the Tax Court, disagreeing with the Seventh Circuit in Local Finance.

Because of this conflict and because the significance of Section 482 increases as business aggregates grow not only larger but more gloried in their nature, we have more and more cases where a business aggregate includes corporations that are subject to methods of taxation other than the normal, foreign corporations, Western Hemisphere trade corporations, and life insurance companies, as in this case.

For those reasons, the government sought certiorari, which this Court granted.

The facts giving rise to the controversy are as follows:

The taxpayers are two national banks: First Security Bank of Utah, and First Security Bank of Idaho. They are wholly owned subsidiaries of First Security Corporation, a publicly owned holding company, which owns a number of other corporations as well, including First Security Company, a management company, which I will refer to as "management company" to avoid confusion, Smith & Sons, an insurance agency. And, beginning in 1954, First Security Life, an insurance company incorporated in that year, which is one of the prime actors in this case.

But we should go back to 1948, at the outset. Beginning then, and since that time, the banks have offered to their borrowers credit life insurance. This is diminishing term life insurance, under which, in case of the death of the borrower, his debt will be paid off to the creditor.

The premium charged throughout and by all here concerned was one dollar per hundred per year. This has been the usual and standard rate in the industry. This premium, though apparently it sounds small, permits generous commissions to be paid to the person who sells the insurance. It has been customary in the industry to pay commissions in the neighborhood of 50 percent of the premiums.

Q Is that of each year's premium?

MR. BROWN: Yes, Your Honor. They are often paid in advance. This is usually measured by the term of the debt. If the debt is, say, to be repaid in three years, then a single premium will be collected at the outset to cover the three-year debt. So that the --

Q And the commission approximates 50 percent of the --

MR. BROWN: Fifty percent of the premium paid.

Q -- whole premium?

MR. BROWN: Yes.

It is possible, and in many cases it happens, that a credit life insurance company will issue a policy directly to the borrower, and he will be the policyholder and hold it. However, in these cases, or in this case, as demonstrated by the exhibits in the record, the banks followed another procedure.

They took out group life insurance policies beginning in 1948 -- or each bank took out a group life insurance policy covering the lives of their borrowers who qualified. In 1948 this was with the Credit Life Insurance Company of Ohio; in 1953 this was changed to another group policy with the American Bankers Life Insurance Company of Florida.

So that the procedure that was followed was when the borrower came to the bank, his loan was approved, the loan officer, we are told, made available, informed him of, offered -- the record of course doesn't repeat the conversations, but there is hard selling and there is soft selling, and then there is just disinterested selling. Both sides were interested, and we don't suggest that it makes a difference whether this was pressed or not.

In any event, credit life insurance was offered or made available to the borrower; if necessary, it was explained to him, apparently, often it was desired. If he was interested, he was given by the bank an application form to fill out. There are copies in the record, they are relatively simple. The qualifications are minute; you have to be under 65, and there are some other minor matters. But this is a simple form. The borrower, if interested, filled it out.

It was then examined by a bank employee, and, if satisfactory, the premium was collected or added to the amount of his loan. The bank employee then made out and delivered to the borrower a certificate of insurance. And there are copies of those in the record. Well, there are a number of exhibits, and I assume they can be accepted. It is another very simple document.

It is important, I think, that at this time the insurance was effective. If the borrower had been killed in traffic on the way home from the bank, he was insured, his loan would be paid off.

The insurance companies which issued these group policies to the banks received the commissions -- well, I should go back a step.

When the bank had issued this certificate to the borrower, it turned over the premium and the papers involved to the management company, which made appropriate records, and then forwarded the premium and the appropriate records to the insurance company.

The insurance company, both Credit Life of Ohio and American Bankers of Florida, remitted generous commissions, varying, between 1948 and '54, from 40 to 55 percent of the premiums involved.

These were paid to Smith & Sons, the insurance agent subsidiary, though it had had nothing to do at all with either selling or perfecting the insurance; that had been done by the bank and their employees.

Oddly enough, and for reasons which an executive, a vice president and treasurer of the management company, testified he could not recall. These commissions were not included in the taxable income of the insurance agency or of the bank, but of the management company. And the testimony is, as I say, just a blank. The vice president and treasurer said, "I just can't remember why it was done that way."

In any event, this was the procedure that went on from 1948 until 1954.

Late in '53, the American National Insurance Company of Texas approached the holding company with a new plan, a slight variant on the old. It had noticed --

Q Mr. Brown, could I just ask one detail?

MR. BROWN: Certainly, Your Honor.

Q What was the difference in tax rate by the inclusion of those premiums in the management company's return as distinguished from the insurance company? Was this not to the advantage of --

MR. BROWN: Well, there was no insurance company at that time, Your Honor; the insurance company is formed and comes into being in '54.

Q But, in any event, it was reported by the management company --

MR. BROWN: Yes.

Q -- at the then corporate rates, I take it?

MR. BROWN: Yes. Yes.

Q Did the government lost by this?

MR. BROWN: Your Honor, these were all the same rates; as you know, there is very little graduation in corporate rates. The banks, the management company, and the insurance agency, none was a loss corporation in that way. So that I suppose, except for a purist, it made no great difference. There was no revenue difference, necessarily. There might have been. I can't say, because I haven't the returns before me. For all of those six years, all of the corporations, possibly involved, were in the roughly 50 percent bracket rather than in the roughly 22 percent bracket. But we will accept these were prosperous corporations, and I think it's highly probable that it may be.

If the management --

Q But you make no point of it, in any event.

MR. BROWN: If the management company was in the lower bracket, we are making no point of it, as you suggest.

These, however, as opposed to an insurance company, are corporations which are taxed all in the same manner of regular corporations.

Q But you will tell us later why the government chose to allocate to the banks rather than to the management company?

MR. BROWN: Yes. Well, I can tell you that now. The management company had no function at all; it just made copies and forwarded to the --

Q I know, but any paperwork that was done, it did.

MR. BROWN: No, that's not correct, Justice White.

Q Why isn't it?

MR. BROWN: The employees of the bank were the ones who filled out the -- who supervised --

Q But then they sent it to the management company?

MR. BROWN: For transmission, for making their own records and transmitting to the insurance company.

Q I know, but didn't the management company handle the bookkeeping for the bank?

MR. BROWN: It made records, Your Honor. It was an accounting company, but all of the contact with the customers, the filling out of the application, the delivery of the certificate was by bank employees, with the company.

Now, there is an alternative allocation to the management company. That's not before the Court, of course, in this case; and in case it should be remanded, I would be embarrassed if I stood here and cut the ground from under the Commissioner.

But to the best of my knowledge I have not considered the management company, and it seems to have been largely a transmittal route, keeping its own -- perhaps they didn't have Xerox machines, but they ran these through the Xerox machine and sent them on, why, I suppose, the function would have been performed.

In any event, in 1953, the American National Company came in with a new plan. It proposed that it be the prime underwriter on credit life insurance. However, that the holding company form a subsidiary and that the subsidiary re-insure all these risks. American National had noted that financial institutions were forming their own subsidiaries or affiliated insurance companies. And the record indicates it wanted to keep what business it could.

So it suggested that for a fee it would supply accounting services, some record keeping, the insurance company record keeping, actuarial services, the staff work of an insurance company. But this would be for a fee, and then it would re-insure all these risks with this subsidiary to be formed, so that the risk was then shifted.

Q Well, who's doing all this paperwork?

MR. BROWN: Well, I suppose the lawyers did the drafting of the documents, Your Honor, but --

Q Well, but the reinsurance, the blanket reinsurance policy doesn't take care of all the paperwork.

MR. BROWN: No. No. No. Well, we are told by the record that this was apparently done, mostly by American National. The findings are that other than the payment of losses, the bank charges, and taxes, that the newly formed re-insurance company had little in the way of expenses. Indeed, the findings of the Tax Court, which set out the expenses had, show a very minute figure there.

So it was -- I think I don't exaggerate if I say it was largely passive. It had investment problems, of course, because it had substantial funds.

Q Has the Comptroller taken any position on this advantage?

MR. BROWN: The Comptroller has come -- we are coming, Justice Douglas, to the question of the authority of banks to participate. The Comptroller has taken the position that a bank may, as an incident to its lending function, handle insurance. Now, the Court of Appeals of the Fifth Circuit, in the Saxon case, which is cited in both briefs, held that this was improper and invalidated the ruling of the Comptroller, and enjoined the banks from participating in the selling of insurance.

Q Well, the statute forbids banks from what? Being in the insurance business or participating --

MR. BROWN: No, Your Honor, this is very peculiar. The statute -- we have no statute at all that does anything. There is this 1916 statute which says that national banks in a small town may be insurance agents.

Now, the Comptroller says, Well, that's general business; he doesn't view that the banks can be in the general; but they can assist their own lending functions. The taxpayers -- and perhaps properly, I don't think we have to ask the Court for a decision on that banking question -- the taxpayers read that statute, or part of that statute, because this is one of the curious aspects, as though it said banks in small towns and only banks in small towns may do the following thing.

They, then, stress the thing, the section that says banks may receive commissions. They don't mention the fact that the statute also says that banks may collect premiums and sell insurance and act generally. The banks in this case clearly effectuated the insurance.

However, this was put into operation. Security Life was formed, with a capital of $25,000, paid-in surplus of $12,500; $37,500 net worth. At the end of the year it was reinsuring risks of over $6 million; at the end of '59 it was reinsuring risks of over $41 million.

MR. CHIEF JUSTICE BURGER: I think we will pick up after lunch with that.

[Whereupon, at 12:00 noon, the Court was recessed, to reconvene at 1:00 p.m., the same day.]

AFTERNOON SESSION

[1:00 p.m.]

MR. CHIEF JUSTICE BURGER: Mr. Brown, you may continue. You have nine more minutes, total remaining time.

MR. BROWN: Your Honors, as I was pointing out, beginning in 1954, the banks remitted premiums to American National. It kept some 13.5 percent of those premiums for its fees, the remaining 86.5 were remitted to Security Life.

This business was very profitable for Security Life, with a net worth of $37,500 at the outset in '54; by the end of 1959, it had a net worth of $850,000, and it paid a $389,000 dividend.

So in five years, with a capitalization or original net worth of $37,500, it had profits, after reserves, and after expenses, of $1,200,000.

The Commissioner allocated 40 percent of the premiums then the banks, on the theory that the banks had performed the services which resulted in the insurance, they had effectuated the insurance, and that the market demonstrated that commissions of a minimum of 40 percent were allocable.

On these facts, it would be very difficult even, I think, to raise a substantial question. But the Tax Court --

Q Could the bank have lawfully charged and received and kept the 40 percent commission at that time?

MR. BROWN: Well, that's the next question, Mr. Chief

Justice.

Q Excuse me.

MR. BROWN: The taxpayers make the point that -- and they repeat it frequently in their briefs -- that the banks could not receive these commissions.

And, as I was pointing out in answer to Justice Douglas' question, and Justice White suggested, this is considerably more complicated than that. The only statute is one that permits banks in small towns to engage in general insurance agencies.

The Comptroller of the Currency believes, and has ruled, that this type of transaction is perfectly proper for banks. However, the Fifth Circuit has enjoined the banks from participating in just this type of transaction.

It's interesting that the Fifth Circuit, and there is a substantial question of standing because the suit was brought by insurance agents, the Fifth Circuit ruled, surveying a fairly lengthy statutory history and more of what Congress had failed to do than what it had done, that there was an inhibition on the banks and that this was to protect insurance agencies, to avoid competition by banks with insurance agents.

Well, I think it's clear that what the banks did here ousted insurance agents of a substantial business. It's not our point either to exonerate or indict the banks for what they did, but only to describe what they did.

So even if you take the statute, as I suggested earlier, that authorizes small town banks to act as agents, to sell insurance, to collect premiums, and then to receive commissions, it seems to me a peculiarly narrow reading to focus only on the receiving commissions. The banks effectuated this insurance.

Now, it's not for me to say whether they were insurance --

Q Well, let's assume the statute does forbid the banks --

MR. BROWN: Yes, sir.

Q -- from collecting premiums.

MR. BROWN: Yes.

Q You make your argument, in spite of that, under the --

MR. BROWN: Yes.

Q Yes.

MR. BROWN: And that's on any ground, whether, it seems to me, this is correct.

Q Do you come to the same result on both Sections 61 and 482 in that respect?

MR. BROWN: No, Your Honor, I think not. I think under -- if it had involved the years before '54 we would have. As Judge Friendly pointed out on 61, this Court's decision in Lucas and Chicago and Joliet Railroad is, as he said, a blunt instrument. Usually that's an all-or-nothing.

Now, we wouldn't claim that all the payments to the life insurance company were income tothe banks, because the life insurance company did perform the function of reinsuring these risks. It was a minimum capital, but it did that.

So here 482 provides for allocation, as is often required, analysis of prices, of services. 61 is the blunter instrument. Judge Friendly's opinion in the Rubin case, which is cited, makes a point of that.

So we would -- I don't know, I shouldn't say that it's universal, that no court has ever analyzed a transaction and said part of the income was income under Lucas; but 482 is the more flexible and more surgical instrument, and it seems appropriate here that that should be. It presumes that there will be no receipt. It doesn't ask the bank to receive the money, but it says the bank is taxable as though it had. That's been true since Lucas v. Earl.

So that I don't think that makes any difference, and I would like to demonstrate this. I think two simple cases would demonstrate that even if this prohibition on receipt were verbatim in the statute, as indeed it was in Local Finance, the Indiana statute was there; quite explicit.

But two simple cases. The first, let's take a public officer, a purchasing agent, and let's make it federal since it's a federal statute, and some point is made of that. He is prohibited by statute, we will say, from receiving any funds or moneys from any person with whom he deals. A person who deals with his office customarily and would like more business than he's been able to get approaches him and offers him a substantial sum of money. He says, "I can't take it; the law prohibits it." And then he remarks, "I have a son in college, he could certainly use some extra money; he's always complaining that he doesn't have enough."

The visitor thinks he understands what's been said, and promptly mails a check to the son at college, who inquires of his father and is told to keep it.

Now, I assume there would be no question that's income to the father.

Let's bring it a step closer to this case, in fact, I would say almost identical with this case. Instead of the son in college, the purchasing officer says, "No, I can't take your money." And the conversation goes on, and then he indicates he'd inherited an orchard a few years back, he had incorporated it, his farm is incorporated, and they sell the produce.

The visitor, after a little polite indirection, says he's interested in acquiring apples and peaches and says, "I will pay Farms Incorporated a price", which is obviously far above the market. The price is accepted. Farms Incorporated receives the money.

I think there can be no question that, though the statute prohibits the officer from receiving these funds, that 482 would allow the Commissioner to allocate that money to him.

The Fifth Circuit has had no difficulty where purchasing officers who, in such oblique fashion, had funds paid to their nominees.

So that seems to me is this case. I can't believe the statute is more. We're not concerned with the legality or illegality of the banks, whether they skirted the edge of illegality makes no difference. They performed a valuable economic function. The Commissioner and the Tax Court reviewing him decided that it was highly appropriate that the market value of this function be allocated to the banks.

I would like to reserve, if I may, such remaining time as I have, Mr. Chief Justice.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Brown.

Mr. Anderson.

ORAL ARGUMENT OF STEPHEN H. ANDERSON, ESQ.,

ON BEHALF OF THE RESPONDENTS

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

The question as far as these national banks in Salt Lake City, Utah, and Boise, Idaho, are concerned is whether or not the Commissioner of Internal Revenue, purporting to use the authority of Section 482 of the Internal Revenue Code, can allocate to them insurance-related income which the banks neither received nor could lawfully receive, thus resulting in a tax where there is no income, and could never be any income, and will never be any income, notwithstanding any outcome of this case.

The Commissioner's position in this case is wrong for a number of reasons. It is wrong, so wrong, that commentators across the country have uniformly criticized it. Referring to this specific case, we've cited two of those articles in our brief: one is currently a review of an address given at the Chicago Tax Institute. It's Mr. Olan's ? article cited on page 9 of our brief. It attempts to overturn all applicable precedent in the area, with the sole exception, the sole aberration of Local Finance.

And I might add to the Court, and I'm sure the Court has probably already picked this up from the briefs, that both courts below in this case were in favor of the taxpayer's position. Judge Fay, who is in the courtroom today, I understand; Judge Fay, after hearing our case, dissented in Local Finance. And then seeing that -- feeling that he was bound by Local Finance, ruled against the taxpayer in the Tax Court.

In addition, Your Honors, and I understand this is correct, that the Comptroller of the Currency has made his opposition to the Internal Revenue Service's position known;

I'm informed that that's correct. And a copy of the letter which he sent to the Solicitor General's office has been made available to these member national banks. In the letter, the Comptroller of the Currency asks the Solicitor General to make his views known to this Court, that the Comptroller opposed the Internal Revenue Service's position.

I am not sure that that point was adequately made. I might request that it would be helpful for the Court to have a copy of the Comptroller's views attached to the record for review.

Q Mr. Anderson, in these remarks you made, are you attacking the implementation of Section 484 or the section itself?

MR. ANDERSON: The implementation.

Q You're not questioning the integrity of it as a tool in the tax structure?

MR. ANDERSON: No, Your Honor.

The errors which we question -- pardon me.

Q What would be your position if an officer of the bank had received or had embezzled income, and instead of keeping it himself, had placed it in the bank, and the bank in some way was responsible for it, would the bank be taxable on that embezzled income?

MR. ANDERSON: You say the employee embezzled the income?

Q Yes.

MR. ANDERSON: No. We would say the bank would not be taxable, the employee would. That is the James case, cited at pages 29 and 30 of the government's brief. And that's 180 degrees, we submit, from the present situation.

There, in that case, illegal income was actually received. In this case, illegal income was not received because it would be illegal to take it.

Q Well, the distinction you draw, then, is only in the fact of receipt --

MR. ANDERSON: That's correct, Your Honor.

Q -- not in the fact of illegality.

MR. ANDERSON: Well, it is correct, the fact of receipt is the controlling distinction; the illegality, in this case, goes further to buttress other points that we would make.

On the example you gave, it is the fact of receipt; that is correct.

We submit that the errors in the government's position -- and there are a number of them, and I'll go through at least three main errors in the government's position -- all find themselves bottomed on one main circumstance, which we don't think has been adequately represented to the Court.

For nearly a quarter of a century, these banks have made credit life, health, and accident insurance available to their borrowers. And, we might add, that their contact with this insurance was so small that it cost the banks, for the activity of all of their branches and all of their personnel, less than $2,000 a year per bank to process the insurance characterized by both courts below as negligible.

Q Well, then, at that point, let me ask you this --

MR. ANDERSON: Excuse me. Yes.

Q If you should lose, by chance, on this argument, are you also attacking the allocation itself, percentagewise?

MR. ANDERSON: We surely are, Your Honor.

Q All right.

Q Now, what is the relationship between the $2,000 figure you just mentioned and whatever percentage override was charged by the bank for handling, the service charge; how much did that amount to?

MR. ANDERSON: Your Honor, that is one of the main points of our case. The banks charge nothing. The banks received a substantial benefit just by having insurance available on the premises. As a matter of fact, the record shows that over one-half million dollars in bank loans were paid off by the discharge of this insurance on people who died. And the banks charged -- the banks received their benefit in that fashion.

Q Well, wasn't there some service charge that the bank received just for the paperwork?

MR. ANDERSON: No, Your Honor. The banks' paperwork was de minimis, both -- excuse me.

Q What's the 11 or 11.5 percent figure that --

MR. ANDERSON: That was the amount that was charged by American National Life Insurance Company for servicing the insurance for -- well, if I could draw the diagram this way:

Here would be the banks, here is their holding company, here is the sister life insurance company, Security Life until '59. American National was an independent, unrelated insurer up here. The insurance went from American National through a group policy in the banks to the borrowers. And the obligation was between the borrower and American National.

Then American National reinsured the risk, $41 million worth by '59, reinsured the risk down to Security Life, and did all of the actuarial work for Security Life and charged 11 cents, actually it's 15 cents, charged Security Life that much, and then remitted to Security Life the balance.

Q But if -- except for the fact that Security Life was a sister corporation, I suppose that Security Life would have had to pay out to somebody a commission?

MR. ANDERSON: That is another main point of our case. No. The amicus brief in this case -- first, let me -- may I make just two points on that?

The amicus brief in this case sets up the situation which we, arguendo, tried to point out in our brief, and that is that the Commissioner has had a basic underlying fallacy in his reasoning. He says that in an unrelated, uncontrolled situation, a commission would be paid.

Q Yes.

MR. ANDERSON: In the amicus situation, for many, many years the automobile dealers in Michigan made available credit life, health, and accident insurance in connection with GMAC financing, and they took no commissions, nor did any related entity or person take any commission; but GMAC kept 100 percent of the premiums paid. The reason for that being that it was against the law for the automobile dealers in Michigan to receive the commission. That's point No. 1.

Q Well, that may be so, but this family of corporations, when they were buying credit life insurance independently, made sure that there was somebody in its family that would take the commission, the Smith Agency, which then gave it to the management company; is that right?

MR. ANDERSON: Yes, you're entirely correct.

Q They weren't about to return 40 percent or 50 percent of the premiums to the life insurance company when somebody in their family could collect it; right?

MR. ANDERSON: That's the key phrase, when somebody in their family could collect it; and that is correct. As firmly established in -- excuse me.

Q Why did the Smith Agency turn the money over to the management company in the years gone by?

MR. ANDERSON: In the original years, 1948 to '54, the testimony is on the record that the income was so small that it just virtually passed notice, it should have been taken in income by Smith; it was taken into income by the management company. And when asked in testimony, the executive vice president said it just escaped notice. It was a mistake.

But as firmly embedded in the tax law as any principle the Commissioner cites here is the principle established by this Court in Moline Properties, in National Carbide, and in other cases, that the taxpayers may structure their affairs any way they please, notwithstanding that the Commissioner of Internal Revenue doesn't like the structure.

And you're right, Your Honor, so long as lawfully some related entity could take this money, then the holding company was anxious for the entity to take the money.

But the very bottom fact of this case, and I submit the Commissioner hasn't shown anything contrary, the very bottom fact of this case, if I haven't made any point at all while I'm up here, is this point: that if that bank in Salt Lake City or in Boise was completely isolated from any other related entity, on a desert island or some place, doing business, and there was no related entity, that it would not take these commissions, because it's a violation of the federal banking law so to do.

The penalties for violation of that federal banking law are very severe. Their loss of the corporation's banking franchise, and criminal liability on the part of the directors.

Now, this is no closely held tiny, little group that served to profit -- of people that served to profit by devices or contrivances, these are national banks, publicly owned through holding companies. The directors of these banks have no personal stake in this. They were trying to abide by the law. The law said the banks could not take this income, and again I can't -- excuse me.

Q But it was profitable -- I'm not saying there is anything wrong with this -- but it was profitable to form the intra-family insurance company which could take 89 percent of the premiums, or 85 percent of the premiums and be taxed at insurance company tax rates.

MR. ANDERSON: By all means.

Q Yes. It was profitable, which -- and without doing that, it would have retained 40 percent less the premiums?

MR. ANDERSON: Yes, sir.

Q And has the tax law been amended to tax insurance companies on these premiums?

MR. ANDERSON: It has, Your Honor. In 1959, the tax -- the income tax -- the Life Insurance Tax Act was passed, the lower court, Judge Fay, referred to that. Under that law the insurance companies are taxed at exactly the same rate as any other corporation; the only difference is that because of reserves, which must be set up to protect the policyholders, that the timing is slightly different, but the full corporate rates apply. The only thing that's different is timing.

But I again -- I must emphasize this point. If I sit down with no point made, it must be this point -- but this point, it must be this point.

And that is that these banks would not take commissions illegally, notwithstanding the outcome of this case, notwithstanding anything that would happen, these banks will not take insurance-related income. The record shows that they have been advised by counsel not to take that income. Our law firm gave that advice. The advice will be honored, and they will not take that income.

The only thing that the Commissioner could achieve in this case would be the unheard-of result of taxing these banks, exacting a tax out of the treasury of these banks when there is no income that the banks can get their hands on, ever. Thus there would be a tax without income. Ever.

Q But there is --

MR. ANDERSON: Yes, Your Honor?

Q -- income which the ultimate owners can get their hands on?

MR. ANDERSON: Now, that's another good point. The government infers in its brief that somehow all of this is mushed together, and the income is there to be paid down.

In 1959, Your Honor, the Security Life Insurance Company of Texas was spun off, pursuant to the Bank Holding Company Act of 1956, was spun off to a new holding company group. The record shows, at page 51, that after that spinoff, the dividend which Mr. Brown referred to was paid up to the new parent. The record also shows that there was a developing difference in the shareholders of those corporations, so that by 1967 they were substantially different.

Now, the Commissioner points out in his Reply Brief, and raises an implication that I'm glad is raised, because we haven't been able to get to the point, feeling the record was closed; but he implies in his Reply Brief that when these two entities were reconsolidated back in 1970 that somehow this money came back in. That's not so.

Q Well, let's assume that the banking laws were amended so it was perfectly clear that a bank could in connection with writing -- with generating credit life insurance take a commission.

MR. ANDERSON: One-half of my argument would fall.

Q And then let's assume that the bank, these banks continued not to take a commission, although, in terms of the service it performed, they would have been entitled to it, and they let the income instead be retained by the life insurance -- the family life insurance company. Then would you have the same argument under 482?

MR. ANDERSON: I would have one-half of my argument. One-half would fall --

Q Which half is it?

MR. ANDERSON: The half --

Q No receipt?

MR. ANDERSON: Then we would get into the earnings, the amount of allocation, the right of taxpayers to structure their affairs as they choose; and all of that would have to be examined.

The first half of my argument is that we don't even have to get to that in this case, because, as I'll point out in a minute, under Section 61 this Court has long held that the taxpayers will not be taxed unless there's an income. That's what it's called: an income tax.

And -- well, excuse me, Your Honor, have I finished answering your question?

Q That's all right. Go ahead.

MR. ANDERSON: All right.

Q I know your time is short.

MR. ANDERSON: I just wanted to say this, that it has always been the law, always, without any deviation. There is not one authority that the Commissioner has cited to this Court, not one. It has always been the law, that tax is not exacted unless there has been an actual receipt of money or the right to receive money.

In Harrison vs. Shafner, Lucas vs. Earl, Corliss vs. Bowers, Commissioner vs. Glenshaw Glass, and a host of other cases decided by this Court, that principle is as deeply embedded in the tax fabric of this country as any there is. There has never been a case contrary to that.

In Corliss vs. Bowers, this Court said this, it said: Income is that over which a man has an unfettered command, that he is free to enjoy at his own option.

In Commissioner vs. Glenshaw Glass, this Court described income as that which is clearly realized, over which a man has complete dominion.

None of those concepts are present in this case. I submit that complete dominion, the right to enjoy at his own option, unfettered command, clearly realized, are nowhere in this case; because of the national banking laws the banks could not take the income, they had no unfettered command, they had no complete dominion, and, foremost, they had no option. They had no option whether or not to take the income.

At the very heart of our tax laws, I submit to the Court, at the very root of it, tax has always followed the existence in the taxpayer of alternatives -- of options.

Q I suppose that isn't true in the estate tax side, is it?

MR. ANDERSON: In the State tax side, I would --

Q Estate, estate; federal estate tax law, where we have includable in the gross estate many things that are no longer owned by the decedent at his death. Not a good parallel?

MR. ANDERSON: Well, I'm a Mormon, I don't know what options a person would have after death -- [laughing] --

[Laughter.]

-- maybe he's exercising the supernatural. I don't know whether I got your point, Your Honor, but I --

Q Well, we have certain types of trusts that are included, we have gifts in contemplation of death, which are included, none of which are owned at the time of death, and yet are taxable for federal estate tax purposes.

MR. ANDERSON: Oh, yes. Yes, the rule would apply, Your Honor.

The point is well made that at the time of death the way the estate tax law operates is that -- I think it's Section, what is it, 2036? The way the estate tax operates is that a man must have had the right at his death to exercise ownership and control. And a whole host of cases have developed out of that concept, that at the man's death he had the right to exercise dominion over the property. But --

Q But this isn't true as to a gift in contemplation of death. My memory is hazy, but let me -- aren't there some old cases about gifts of future bond coupons due to be due in the future?

MR. ANDERSON: Yes, Your Honor. Lucas vs. -- or Helvering vs. Horst.

Q And certainly there is no right at the time that those coupons mature to receive them.

MR. ANDERSON: The critical distinction, and we cite Helvering vs. Horst in the brief, and we would cite the contemplation of death, is that at some point the taxpayer had -- he had dominion, he had the right to exercise dominion. That's the same with the gift in contemplation of death. At some point in time, Your Honor, the taxpayer either had the right to exercise dominion or, in fact, exercised dominion over the money.

Now, that's different; 180 degrees different from our case.

In our case there has been no right, there has been no dominion, there has been no exercise of dominion, and can be no exercise of dominion, at any time. That is the critical distinction. That is why the government's position is in direct collision with precepts undeviatingly perpetuated by this Court. It is in direct collision with those precepts, without the citation of authority. Rather, it overturns all applicable precedent, which we have cited and discussed in our brief.

Now, this is a tax case. Taxes are complicated things. They, themselves, adhere to and follow a statute.

In this case it's Section 482. We submit the error of the Commissioner's position, as Mr. Justice Blackmun pointed out, is in the implementation of the Commissioner's position on the statute.

There are two controlling factors under Section 482. Now, the government has made known a number of things. It has talked about money and controlled entities and such, but it hasn't gotten to the statute. The statute says that it will operate where a controlling entity, in this case the holding company, has the power arbitrarily to tamper with the income, understate the income of one of these controlled entities.

And when the holding company comes in and tampers with the income of this entity, in favor of this entity, when it arbitrarily shifts the income, then the Commissioner may come in and examine that situation. We don't have that here.

Stated in terms of this case, the holding company would have to have the right to effect the banks to take the insurance income. But no such right exists, because the banks would not operate in violation of the law.

The very fundamental premise upon which Section 482 operates is absent in this case. There is no control element which can arbitrarily shift income. The government's position dies at the very threshold.

The second home upon which Section 482 operates is in subsection (c) of Section -- of Regulation Section 1.482-1 (c), and it's in the government's brief, in the Appendix. And that states the frontiers of the Commissioner's authority. The very frontiers of his authority are stated in that regulation.

The regulation says something like this: The authority of the Commissioner to allocate, to take an action under this section -- and then, in effect, goes on to say: is limited to those situations -- and this is the key phrase -- those situations where the income of the taxpayer would have been different in an uncontrolled situation from that in a controlled situation.

Now, if the income of the taxpayer is no different in an uncontrolled situation, how can the Commissioner exercise authority in a controlled situation?

That test was applied by the Court of Appeals in this case, and not repudiated by the Commissioner in this case; it applies to this case, and the answer to it, as found by both courts below, is that these national banks, in an uncontrolled situation, would not receive the type of income which the Commissioner tries to allocate to them.

I -- excuse me, sir.

Q Tell me once again your posture with respect to the Seventh Circuit case of Local Finance. Do you feel it's wrong or do you feel it's distinguishable?

MR. ANDERSON: Both, Your Honor, but since this Court granted certiorari, I did not develop any argument on the differences. In Local Finance, for instance, all the finance company officers were licensed insurance agents. And when they made a loan, as licensed insurance agents, they went ahead and sold insurance. They also solicited very heavily, 95 percent of the borrowers in Local Finance took insurance, whereas in our case as little as 13 percent of the mortgage loan customers took insurance.

The time and effort, the amount of time it cost Local Finance to handle the insurance was much greater, and so on.

But all of the cases, with the sole aberration of Local Finance, if it does apply in some way, all of the cases are against the Commissioner.

May I call the Court's attention to three rules of law: one is the Shunk case, the only applicable precedent in this area when these taxpayers were trying to fix their affairs up. We cite it in our brief and discuss it. In that case, because of OPA price regulations, a manufacturer could not raise prices to its wholly controlled wholesaler. The Commissioner came in and tried to allocate income back, and the Tax Court said: We will not tax a taxpayer who neither had the right to receive the income nor received the income. That's precisely on the point of this case.

The Commissioner himself has recognized this. In the current wage-price freeze that President Nixon embarked upon last fall, the Commissioner, in Technical Information Release 1106, issued to the public, said that where the public, because of strictures of the law under this current wage-price freeze, where corporations did not pay out dividends and accumulated earnings, so that there might be otherwise a violation of Section 531 of the Code, that the Commissioner would not come in and exact a penalty tax. Because the taxpayer was prevented by law from doing something -- from distributing the money out.

The Commissioner himself has taken the position that he must follow the tenets of the law in other areas. The tax law does not operate in a vacuum. Congress did not pass the banking law and the tax law to operate independently of one another, but, rather, to operate in a harmonious, cooperative whole.

If a rule is going to be established affecting all of the regulated industries of banking and insurance, the insurance industries, Congress should do it, so the taxpayers could do it prospectively and not be penalized.

Q Well, what if the allocation had been to the management company? Same answer?

MR. ANDERSON: No, Your Honor. Then I'd be back to the other half of my case.

I might add that the Commissioner has -- well, I won't add that.

There is no income. May it please the Court, there is no income from which to discharge this tax. That income flowed out in the 1959 reorganization. It is gone. It will never come back.

There will never be any income from which to discharge the tax the Commissioner seeks to exact here. Never.

These taxpayers are in a position of this kind of a dilemma: either, one, they pay the tax where there's no income, ad infinitum, thus affecting the financial soundness of these national banks as opposed now by the Comptroller of the Currency in this Court; or, two, take the income, violate the federal banking law, and risk forfeiture of their charter, and criminal liabilities on the part of their directors; or, three, give up insurance altogether.

Now, we submit the taxing law has never been that unreasonable.

Q There is another alternative, isn't there?

MR. ANDERSON: You're right.

Q Perhaps -- let me put it this way: Is there anything illegal about their not charging any commission at all and just charging their customers the net, roughly one-half of the premium, and thereby getting all the banking business in that town by cutting the total cost to the borrower?

MR. ANDERSON: Well, Your Honor, the banks can't set the rates. As a matter of fact, the independent insurance companies would be very jealous of a situation where one bank on this corner was charging one rate and another bank on this corner was charging another, because it would throw all of its customers into chaos.

The testimony in the record is that the banks had nothing to do with the rates. But assuming, arguendo, that they did, if I may answer just a second further -- assuming, arguendo, they did, the testimony in this record, uncontradicted, is that there's no such thing as a set part of a premium rate which is commission. And so the banks would never be out of troubled waters. The Commissioner could always come in. A rate could be so low that an independent insurance company out here could be losing money, they could still choose to pay a commission. So the banks would always exist in jeopardy of the Commissioner's caprice to come in and say, Ah ha, there's so much commission, we allocate it to you, lose your franchise.

No, there wouldn't be any way.

Q Are the years from '59 still open?

MR. ANDERSON: Yes, Your Honor; more than a million dollars in tax is set up for those later years.

Q That turns on this case?

MR. ANDERSON: Turns on this case, and there's no --

Q You mean the 1959 amendments really didn't make a whole lot of difference?

MR. ANDERSON: Oh. That tax is all bunched in the first years because of the reserve deferral. Life insurance companies are taxed just like other corporations, but they set up reserves and there's a deferral. It would be on the setting up of the reserves and in the previous income, there was this tax.

Q So even in post-'59 years it will make a substantial difference whether the banks or the insurance company is paying the tax?

MR. ANDERSON: Well, there will be -- the difference tails off; the difference tails off.

Q Well, is the government purporting to reallocate income in the post-'59 years?

MR. ANDERSON: Yes, sir.

Q Well, is it your point that that which they are trying to reallocate to the banks has already been taxed at some rate, in some amount,on the insurance company?

MR. ANDERSON: For the years 1954 to '59, Your Honor, the life insurance companies were not subject to a tax, and it has not been taxed, no, sir.

Q I mean post-'59.

MR. ANDERSON: Post-'59 there has been a tax.

Q But there's still a difference whether it's a rate or amount?

MR. ANDERSON: Well, I gave you a figure -- now that

I start thinking about it -- I gave you a figure which would be reduced some by what I presume would be a correlative adjustment, and I don't know what the net would be. We haven't even studied that yet.

Q But those years still are open, and they still are in detention?

MR. ANDERSON: Boy, are they ever! Yes.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Anderson.

MR. ANDERSON: Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Brown, you have one minute left.

REBUTTAL ARGUMENT OF ERNEST J. BROWN, ESQ.,

ON BEHALF OF THE PETITIONER

MR. BROWN: Just a --

Q Mr. Brown, for the post-'59 years, have you any idea what the difference is to the government in dollars in tax revenue?

MR. BROWN: I don't have the record, Justice Brennan, I'm sorry; I don't know what the figures are. There is a substantial difference. Mr. Anderson is right in saying that rates are -- but there is still a substantial difference in the method of computation of income tax for insurance companies than for others.

I'd like to point out briefly, Your Honor, that at this time when the banks suggested they might cancel the reinsurance, American National said it would then pay insurance commissions to any designated agency.

But Mr. Anderson has referred to National Carbide, which is rather interesting, because there, by contract, income was payable to a parent corporation, but it was taxed to subsidiaries because they had earned it.

And in this case the adjustments to the parent corporation, there is no great hardship. The parent corporation can make any adjustments;the Commissioner will allow, of course, corresponding reductions to the --

Q Well, Mr. Brown, let's assume that in these years that the holding company that controlled the banks was different from the holding company that controlled the insurance company, in the sense that the stockholdings were not identical. Perhaps the boards were the same, or overlapping. Wouldn't that make a difference?

MR. BROWN: The statute doesn't require, of course, identical, it requires common control of 50 percent. But, in any event, the possibility of divorce, I take it, cannot frustrate the use of 482 for the years when there is common control.

Q Well, it would if it were actually proved that there was divorce.

MR. BROWN: For the years after the divorce, not for the years before, which are the years before the Court.

Q All right. All right. I see.

MR. BROWN: Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Brown.

Thank you, Mr. Anderson.

The case is submitted.

You had a letter that you wished to put in, if that's been submitted to counsel, you may leave it with the Clerk.

MR. ANDERSON: Thank you, Your Honor.

[Whereupon, at 1:42 p.m., the case was submitted.]

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