In the

Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

MISSISSIPPI CHEMICAL CORPORATION, et al.,

Respondents.

No. 70-52

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 1:42 o'clock, p.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
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

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

JOHN C. SATTERFIELD, ESQ., General Counsel, Yazoo City, Mississippi, for the Respondents.

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in No. 52, United States against Mississippi Chemical Corporation.

Mr. Zinn.

ORAL ARGUMENT OF MATTHEW J. ZINN, ESQ.,

ON BEHALF OF THE PETITIONER

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

This federal income tax case is here on writ of certiorari to the Court of Appeals for the Fifth Circuit. It raises the question whether farmer cooperative associations, like the respondents, which are required to purchase the Class C stock of the New Orleans Bank for Cooperatives as a condition to borrowing from the bank, may deduct the cost of such stock as interest expense or as an ordinary and necessary business expense.

The New Orleans Bank for Cooperatives is one of twelve regional banks which, together with the Central Bank here in Washington, were created by Congress in 1933 to furnish credit to farmer cooperatives at the lowest possible cost.

The Bank's original capital was furnished by the United States, but under a congressional plan embodied in the Farm Credit Act of 1955, the government capital was to be replaced gradually by capital belonging to member borrowers which would purchase Class C stock.

The ultimate goal of the statute was complete borrower ownership of the banks.

The Bank's authorized capital consists of three classes of stock, A, B, and C, each with a par value of $100 a share. Class A stock represents the government's initial contribution to capital, is non-voting, pays no dividends, and is to be retired at par with the retirement proceeds coming from borrower contributions to capital and the Bank's earnings.

Class B stock is intended for sale to the public. It is issued at par, is non-voting, and may pay a non-cumulative dividend not to exceed 4 percent a year. After all Class A stock has been retired, Class B stock may then be retired at par. The oldest Class B stock to be retired first.

Class C stock is the voting common stock of the banks, it may normally be issued only to farmer cooperatives at its par value of $100 a share. Farmer cooperatives may acquire Class C stock in four ways: first, each must purchase at least one share of Class C stock to be eligible to borrow from the bank. Each of the respondents purchased the so-called qualifying share and capitalized its cost. The capitalization treatment oft he sole qualifying share is not here in dispute.

Second, each borrower must invest quarterly in Class C stock, an amount equal to at least 10 but not more than

25 percent of the interest it pays to the bank on its loan during the calendar quarter. The percentage of the New Orleans Bank during the years here in issue was 15 percent. It is the proper treatment of the cost of the Class C stock purchased under the 15 percent requirement that is here in dispute.

The respondents contend that they may deduct, in addition to the stated interest on their loans, the cost of Class C stock in excess of a nominal value of a dollar a share. They contend that this is deductible as interest or as ordinary and necessary business expense.

Q This is the stock that pays no dividends? Right?

MR. ZINN: It pays no dividends, that's right, Mr. Justice.

Q Actually, there is no stock certificate, is that it?

MR. ZINN: That's correct, Mr. Justice.

Q It's just a bookkeeping, is it,--

MR. ZINN: That's right, Mr. Justice.

Q -- transaction?

MR. ZINN: The situation is much the same as it was in the Lincoln Savings case, where there were no stock certificates.

Q And this is a -- it's not a transferrable interest of any kind?

MR. ZINN: Just like in the Lincoln Savings case, --

Q Yes.

MR. ZINN: -- it's precisely that. No transfer.

Q But the Class C stock pays dividends?

MR. ZINN: Yes, it does. Our position, Mr. Justice, is, however, that even though there is no stated return on this stock, that the farmer cooperatives do indeed earn a return in that they have a right to share in the profits of the year in which they purchase stock.

Q How do they share in that? Is that simply by an increment of the bookkeeping?

MR. ZINN: Well, in the first instance, that's the third way in which they acquire stock, Mr. Justice Brennan. At the end of each year each farmer cooperative gets what is called a patronage refund, and it's initially issued in the form of Class C stock. The patronage refund stock is distributed to farmer cooperatives in the proportion that the interest paid by each cooperative there --

Q Now, you say distributed --

MR. ZINN: Yes, sir.

Q How do you mean? How is that done?

MR. ZINN: It's allocated on the books.

Q I see.

MR. ZINN: That's the same situation as it was in Lincoln, where the credits to the secondary reserve --

Q How does the farmer cooperative ever realize on this bookkeeping item?

MR. ZINN: The way it realizes it, perhaps I could refer the Court to the graph on page 163 of the record, it shows a revolving wheel, and the farmer cooperative puts in its dollars at the top of that wheel, and gradually, as subsequent borrowers make investments in Class C stock, after the government's capital has been retired completely and the Class B stock has been retired completely, the Class C stock, whether purchased or issued as a patronage refund, is revolved out on the cooperative principle of retiring first the oldest contribution.

Now, to give you some idea of what's involved here, Mr. Justice Brennan, let me refer you to page 8 of our opening brief. There are several in this case. We set out there a figure for the Class C stock purchase, the patronage dividends, and the allocated surplus credits received by each farmer cooperative here, each of the respondent cooperatives.

Now, let's just take Mississippi Chemical for 1961. They paid in $18,940 and change for Class C stock. Now, that money presumably was used to retire Class A stock or Class B stock or earlier issued Class C stock. And the same -- now, they received the patronage dividend in the form of the Class C stock bookkeeping entry of $27,000, and they also received an allocated surplus credit of some $12,000.

Now, the way this thing works is that at some future time, after enough later people have purchased Class C stock, they're going to get back not only the 19,000 that they came up with at the outset, but the total of those three numbers in that line, which is just under $59,000, --

Q And they get that back in cash?

MR. ZINN: Yes, cash in hand, at an indefinite future time.

I've already referred to --

Q But that's all, that's the absolute ceiling, isn't it, --

MR. ZINN: Yes, it is.

Q -- it's only for that year?

MR. ZINN: That's right, Mr. Justice. But we see no reason why an ordinary corporation couldn't, instead of allowing stock to share in the profits of a corporation for all years, which is the way it works in an ordinary corporation --

Q You say you get the profits of the corporation -- you show the profits of the corporation --

MR. ZINN: For this year.

Q -- in the year you bought the shares?

MR. ZINN: Right.

Q That's what it comes down to.

MR. ZINN: And it's proportional. That's exactly what it comes down to, and it's proportional to the stock purchased in that year because of the cooperative mechanism, the statute does provide for an allocation in terms of the interest paid by each cooperative to the interest paid by all. But the stock is purchased in the same proportion. And respondents' contention is that this -- that we shouldn't decide this case by reference to cooperative principles, because it's perfectly clear that this is the provision of capital for the bank. And if that were recognized, this would be a non-deductible capital contribution.

And what we are saying is simply this: that if they don't want the case decided on the basis of cooperative principles, under which we clearly prevail, when we look at the substance of the thing, the substance is that you're sharing in the bank's profits for that year.

Q And if you use the -- and if you borrow money every year you would share in the profits every year?

MR. ZINN: Exactly.

Q What's the impact of this on the cost of renting or borrowing the money?

MR. ZINN: Well, Mr. Justice, under the statute -- and I'll refer the Court to the first page of Appendix B to our brief --

Q Of your main brief?

MR. ZINN: Of our opening brief, I'm sorry. That's on page 47. During the years here in issue, the statutory limit for stated interest was 6 percent.

Now, --

Q I'm not sure I follow you. Six percent?

MR. ZINN: Six percent stated interest was the most that any bank could charge. Now, if you have to pay -- come up with 15 percent of that in a -- to purchase Class C stock, that would raise the -- 15 percent of 6 percent is nine-tenths of one percent, so that would be the effective rate.

Does that answer your question, Mr. Chief Justice?

Q Well, I think so. I think so. You were about to supplement your answer to Justice White, I think, when I put my question.

MR. ZINN: Yes, I was about to say, when you say if you borrow every year, so long as your borrowing is outstanding, Mr. Justice, you don't have to make a new loan each year, you have to pay 15 percent of the interest each year --

Q I understand.

MR. ZINN: -- of the prior loan.

Q In any year that you are borrowing money --

MR. ZINN: Right. You share in the profits.

Q -- as long as you pay an override on your interest, and you get an underride back?

MR. ZINN: Well, we don't use those terms, because we don't find them in the legislative history. The respondents do. The legislative history refers to these as investments.

Q Yes.

MR. ZINN: And patronage refunds, and we'll stick with those statutory terms.

Q All right.

MR. ZINN: The position of the respondents here is that all they got was the right to receive the money they paid in at some indefinite future time. Now, we think we've already shown that they got more than that, that they got the right to receive that money back in cash, and also got the right to receive the profits of the year in which they made the purchase.

But our position here doesn't turn on whether there's a return or not.

In the last brief which we filed in October, we attempted to respond to the respondents' contention that there exists a universal principle that if, as a condition to a loan, a borrower is required to purchase an asset at more than its fair market value, the excess is deductible interest.

We attempted to dispute the assertion of that universal principle by putting the hypothetical of a case in which a borrower goes to a commercial bank and asks to borrow $10,000 for ten years, and the bank says, "Very well, we'll loan you $10,000 for ten years at a stated interest rate of 8 percent; but as a condition to that loan we're going to ask you to keep on hand, in a non-interest-bearing checking account, $1,000 during the term of the loan."

We say in that case that only $800 is deductible interest.

Now, the fair market value of that compensating balance may be zero. It may be that there is no market for restricted compensating balances, nonetheless, we say that it's clear that you can't deduct the whole thousand dollars, because you still own it. The present value of the $1,000 compensating balance, that is the right to receive $1,000 in ten years, we assume to be $650.

Nevertheless, we urge that the $350 difference is not deductible interest, it's simply interest that they might have earned but didn't earn, and they might have earned it had they been free to invest the thousand dollars at the going rate of interest for the ten-year period rather than in a non-interest-bearing checking account.

For this latter proposition we relied on this Court's decision 30 years ago in Hort v. Commissioner, in which the Court held that no deduction is allowable for income that might have been but was not earned.

In the paper which respondents filed last week, they now concede that only $800 is deductible interest in that hypothetical. Under their analysis, the borrower in the hypothetical really borrowed only $9,000, and so they say the proposition which they originally asserted that whenever a borrower is required to purchase an asset at more than its fair market value, the excess is deductible interest and remains intact.

We disagree, and we submit that by conceding the hypothetical respondents have conceded this case.

Let me put a second hypothetical to the Court. Instead of having to pay in to the checking account $1,000 at the outset, the borrower has to pay in only $100 at the outset, but on each succeeding anniversary of the loan must also pay in $100. Under respondents' analysis the amount of the outstanding loan during the first year would be $9900, the amount during the second year would be $9800, the amount during the third year would be $9700, and so on. So that in the tenth year the amount outstanding on the loan would be $9,000.

The average balance over the ten-year period would be $9,450. Nonetheless, no more than $800 would be deductible as interest in any of those years.

If a thousand dollars, placed at the outset, is not deductible, as respondents now concede, a _fortiori_ a hundred dollars placed each year is not deductible.

It is no more fictional to say in this second hypothetical that the amount of the outstanding loan was reduced gradually to $9,000 than it is to say that the amount of the loan is reduced gradually, or reduced in the first instance to $9,000 in the hypothetical put in our reply brief. In neither of those cases is this case.

But let me move the matter somewhat closer to home. Take the same facts as in the second hypothetical, except that instead of being required to keep the compensating balance on hand for only the term of the loan, ten years, the borrower has to keep the compensating balance on hand for 13 years. Under respondents' analysis, the borrower has borrowed $9,000 for ten years, or $9450 in the periodic payment case, and has had to leave on deposit for three additional years, in a non-interest bearing checking account, $1,000.

The Hort case tells us that the interest that they might have earned on that checking account, had it been invested at the going rate of interest instead of in a non-interest-bearing account is not deductible.

Finally, let me move to the last hypothetical, which I think approximates this case.

It's the same as the facts in the third hypothetical, except that instead of the banks agreeing to release the compensating balance at the end of 13 years, the release is to be made at an indefinite future time.

This, in effect, is the situation in the instant case on the respondents' assumption, which we do not agree with, that purchased Class C stock earns no return and that it has no other value to respondents. In other words, that it gives the respondents only the right to get their money back at some indefinite future time.

Now, here, just as in the third hypothetical, what the borrower has foregone is simply the interest income it might have earned from the end of the tenth year until the indefinite future time that it will receive its money back.

Q Would you -- I gather the government's position is it doesn't give up even that much?

MR. ZINN: That's right. We say that it is getting a return. We say that it does have --

Q Let's assume that over a period of five years, a loan lasts over five years, or there's been several loans in the five-year period --

MR. ZINN: Yes.

Q -- and each year there has been an allocation of Class C stock to the borrower.

MR. ZINN: Right.

Q And then the borrower goes bankrupt.

MR. ZINN: Oh, in that case --

Q And there's a balance owing.

MR. ZINN: Yes.

Q Is the Class C stock allocable to the loan?

MR. ZINN: The banks are empowered to offset the face amount of the Class C stock against the face amount of the loan.

Q Is the borrower dash Class C Stockholder legally entitled in the --

MR. ZINN: Legally entitled?

Q Yes.

MR. ZINN: No, it's in the discretion of the -- the discretion of the banks.

But, nonetheless, at some future time it will come back.

I think what you're referring to, Mr. Justice, the respondents intimate that the bank may never retire the Class C stock, so they will never get their money back. And it is true that there is discretion here as to the exact time in the Class C --

Q The question is really as to when.

MR. ZINN: That's right, as to when. And really, in this case, that argument is wholly unfitting, because, after all, we're talking about instrumentalities of the United States, and the only way they can achieve the purpose that Congress has put forth here is to allow farmer cooperatives to own the bank entirely, and to allow those who borrow from a cooperative bank to own it. And these purposes can only be achieved if the Class C stock is rolled over, and they will not be achieved if the Class C stock is never redeemed.

Furthermore, we're talking about a situation where the 13 people who are on the Federal Farm Credit Board are very responsible officials; 12 are appointed by the President of the United States, with the advice and consent of the Senate.

They are nominated by the farmers and the farmer cooperatives themselves. The 13th member of the Federal Farm Credit Board is appointed by the Secretary of Agriculture.

Now, as far as the boards of directors of these individual banks, six of them, six out of the seven are elected by farmers and farmer cooperatives; the seventh is appointed by the Governor of the Farm Credit Administration.

We agree that there's discretion as to timing, but we say that there's little doubt here that the stock eventually will be redeemed, and that even on respondents' assumption that they are only getting the right to get their money back, there is no deduction based on the four hypotheticals that I have put to the Court.

Mr. Chief Justice, I should like to reserve my remaining time for rebuttal.

MR. CHIEF JUSTICE BURGER: Very well.

Mr. Satterfield.

ORAL ARGUMENT OF JOHN C. SATTERFIELD, ESQ.,

ON BEHALF OF THE RESPONDENTS

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

In this case we have a very basic difference of opinion with the government in its position.

In order for the government to prevail, as has been indicated by counsel, they must establish that this proposition which appears on page 11 of their brief as being a statement of their position in the case, neither the fact that respondents are required to invest in Class C stock in connection with their loans, nor the limitation on the transferability of the stock, could convert his cost into a deductible expense if it otherwise would qualify as an income-producing asset providing benefits in future years.

Our position is, as I will, I believe, demonstrate, that this is not an income-producing asset, that in fact it has only nominal value, or, as the Fifth Circuit Court of Appeals held, while it is not worthless -- using the words of that court -- it was without an appreciable market value and had only a nominal value.

As said again by that court, Class C stock shares were of no appreciable value to the taxpayer; as that court said, these Class C shares had no fair market value and no more than a nominal value, and no value to the taxpayers "in the usual sense".

Now, reference has been made by counsel, both in the brief and in argument, taking the position that the patronage refund credited upon the books as Class C stock and allocated surplus credited upon the books as Class C stock were credited upon and earned by the amount paid as interest override or for purchase, so-called, of Class C stock.

Now, as a matter of fact, that is wholly without any foundation in the statute, in the regulations, in the law, or in fact.

The statute provides, in Section 1134(g), all patronage refund shall be paid in proportion, the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the year.

It has no relationship to the three entries made at the end of the year, called Class C stock, to wit: one entry being the amount paid as interest override under Class C stock column; another entry under patronage refund as Class C stock in the column; another entry as allocated surplus under Class C stock column.

And the regulations, 70 Part 162, which appear on page 65 of the brief, as an Appendix, ofthe government: Allocations shall be made, in what? They are wholly unrelated to this interest override itself. Allocations shall be made in proportion that the amount of interest accrued on the loans of each borrower bears to the total interest accrued on the loans of all borrowers during the fiscal year, and shall be recorded as allocations at the end of the fiscal year.

It is impossible to conclude that the interest made as patronage refunds, allocations of surplus are returns upon the interest made at the end of the year of the interest override amount under so-called Class C stock.

Let's take an illustration as to what this really means. Is Class C stock earned either in that year or in subsequent years any income?

Cooperative A has accumulated $150,000 in par or face value of Class C stock.

Cooperative B has just come in and bought one qualifying share of Class C stock, on the basis of $100.

Each borrows from the New Orleans Bank for Cooperatives that year the same amount of money, their loans are an identical amount.

The cooperative with $150,000 in par value of Class C stock, the cooperative with the $100 per value of Class C stock receive the identical amount of patronage refunds, the identical amount of allocated surplus. The same being related not to Class C stock or to interest override, it is related to the interest paid upon the loan for the year.

That is true both as to the first year ans as to every subsequent year. So that as a matter of fact it is impossible that this can be attributed to it.

Now, this has been recognized by the government. In this case, actually in the MFA case, and in other cases. In this case there was included, in the District Court, an attempt to recover patronage refunds. The basis being that the patronage refunds had a value which was a taxable value at the basis of $100 per share.

The District Court held against the government on that. In the Court of Appeals the government abandoned that position, did not appeal from the District Court to the Court of Appeals, has not appealed to this Court.

In the MFA case from the Eighth Circuit, it wasn't even involved in the District Court, although in one of the briefs it was indicated that it might have been involved. But at the Court of Appeals level it was not urged and now, on the petition for writ of certiorari now pending, it is not urged. And why is that?

Now, mind you, this is all the same Class C stock, no differential from one Class C to another Class, all entries, as Mr. Justice White indicated, on the books.

Now, why is it that we are not asked to pay tax on the Class C stock in the second column, under the heading Patronage Refunds, which may become Class C stock under the heading Allocated Surplus, but only those entries made at the same time at the end of the year under the first column, Class C stock said to be resulting from the payment of interest override.

Here's the reason: In Long and in Carpenter it was held by the Fifth Circuit and the Fourth Circuit, and in Treasury Regulation 162-5-B-123 and 124, the IRS has taken the position that where this type of certificate or stock is issued and is received as patronage refund, the market value shall be taxed to the patron at the time of the receipt. And, quoting the regulation -- this is taken also from those two decisions -- quote, "However, for the purpose of this subdivision, any document which is payable only in the discretion of a cooperative association shall be considered not to have any fair market value unless it is clearly established to the contrary."

Therefore, this Class C stock, whether it be in one, two, or third column, does not have market value "unless it is clearly established to the contrary". And this record, as we've shown in our briefs, as was found by the Fifth Circuit Court of Appeals, as was found by the District Court, not only was not clearly shown to have value or market value, it was clearly shown to have only a nominal value.

That is a matter of discretion. This illustration of the compensating balance is wholly inapplicable. If there's a compensating balance, it is repayable when the loan is repaid, it is kept there while the loan is there, it's -- the check is money. What effect does it have?

As we pointed out in our supplemental brief, if it's a $10,000 deal you have a compensating balance of $1,000, you simply borrow $9,000. So instead of paying 8 percent, you pay 8.9 percent. But the number of dollars is the same. You're paying $800 interest on a $10,000 loan, but you deposit $1,000, so actually you get 9,000 bucks.

Hence you are paying 8.9 percent, and you have a deduction for the full $800 paid, and you don't ask for or receive any more. But that's your money, it comes back to you, and you receive it.

Now, here, if or when or how, under what circumstances Class C stock may be revolved, it's within the discretion of three bodies: the bank itself in its recommendation to the Regional Farm Credit Administration; the Regional Farm Credit Administration's recommendation to the Farm Credit Administration in Washington. All three discretions have to be exercised in order for it to be repaid.

Now, not only that, but there have been some inadvertent errors or omissions in the brief, which has been filed by the government in this case. I think perhaps in receiving advice from the Farm Credit Administration by telephone, they just hung up the telephone too soon.

For instance, there's a statement made -- it's not in the record, no evidence to this effect whatsoever in the record; it's not before the Court, it's inadmissible, and wholly incompetent -- but the statement is made that they have been advised by the Farm Credit Administration, this is Note No. 26 on page 21, that all the A stock in New Orleans Bank for Cooperatives has been repaid.

But, as I say, they hung up the phone too soon. Because what actually happened was, the clear implication is it was repaid by the revolving of C stock, and running from C stock. The fact is the New Orleans Bank for Cooperatives borrowed several millions of dollars under market in order to pay it off, and now the effect of it, rather than hastening the repayment of C stock as a financial matter, it means it will be a longer period of time before the C stock can be revolved because they're paying a higher interest on the money they borrowed to pay off the A stock than they were paying returns to the government on the A stock.

Now, it is a fact that by borrowing that money and burdening themselves by that additional interest, and burdening themselves with taxes that are no longer exempt, they have reduced their financial ability to repay C stock, but they have removed the legal inhibition which existed because they couldn't revolve C stock as long as A was outstanding.

But that is a situation which has not improved the possibility of a revolving of the C stock.

In addition to that there, I mention only in passing another time in which apparently the phone was hung up too soon, where in Note No. 16 -- no, this other note, I'm sorry, was on page 7. This is the note on page 21.

Some reference is made to the possibility that if this Court holds this to be taxable income, there might be $100 million less lending power for the Banks for Cooperatives. I say that they hung up the phone too soon, because, as a matter of fact, if it should occur there on the other side of the coin, that the banks -- it should be held this is interest income to the bank, then under the statute having additional interest income or margins, the statute requires that that be paid to their patrons. It is not taxable income. It increases the amount of patronage refund, which is deductible from the bank and from their taxable sources.

In addition to that, depending on the discretion of the bank, and they have full discretion, it wouldn't affect their lending power in any way if they, in their discretion, simply said, "We'll simply delay the revolving of earlier C stock because we have a million dollars less or 500 thousand dollars less since this went out in patronage as additional margin."

Therefore, there would be no burden whatever upon the banks if that occurred.

Now, may I point out to the Court a few things, for instance, in connection with this Lincoln case.

Q Before you get to that, Mr. Satterfield, I'd like to have your comment on an analogy that Mr. Zinn suggested. I think he pointed out that, as he saw it, this situation was very much like a borrower going to a bank to borrow $10,000, if I followed his hypothetical correctly, and the bank said, "Yes, we'll lend you the 10,000 at 6 percent or whatever, provided you leave $1,000 at all times in a non-interest-bearing checking account."

Now, is he unduly oversimplifying this transaction when he puts that analogy to it?

MR. SATTERFIELD: May it please the Court, the answer is yes.

In that instance, the $1,000 is placed in the account; the actual $1,000 is repayable when the loan is repaid. It is true that the borrower receives 9,000, rather a net of 9,000 -- rather a net of 10,000 as the loan. The only result is he is paying a higher rate of interest, because if he pays 8 percent on 10,000, that amounts to 8.9 percent on 9,000.

And there there is no similarity with this situation at all, because it is the money of the borrower, it is repayable not in possible discretion depending on, as I have listed in the brief, 11 contingenices that may or may not happen. But it is funds, it is money there belonging to the borrower.

Therefore, there's no parallel to this case whatsoever. It is simply, in that case, you see, not that there is a lack by the taxpayer of claiming what he might have earned by the use of the thousand dollars; he is simply required to pay a higher rate of interest, because he gets a $9,000 loan and he's paying 8.9 percent interest by paying the same interest that he would have contracted for on the 10,000.

In other words, $800 a year is what he pays on the $10,000 loan at 8 percent. If he pays $800 a year on the

$9,000 loan, he pays 8.9 percent. And he has a right to deduct the full $800. He doesn't deduct more, he doesn't deduct less; he deducts what he pays.

Q But you would concede he isn't entitled to deduct the thousand dollars, and the reason is, I suppose, that the thousand dollars retains its value as a thousand dollars.

MR. SATTERFIELD: Well, now --

Q And you're saying in your case the money it costs you to buy Class C stock ends upon in a certificate that you say has no market value at all.

MR. SATTERFIELD: Right. Has no value, it has only a nominal value.

Q Yet the thousand-dollar compensating account remains a value of a thousand dollars.

MR. SATTERFIELD: Right. And it remains that during the entire extent of the loan. It is money belonging to the party involved. Contingencies as to possible repayment in 28.1 years, as the evidence showed in this case, or 31 years in the Penn Yan case, or some other indefinite period of years, does not exist. It's his money.

Like in Lincoln, for instance. Now, in Lincoln, as the Court will remember, there was a secondary reserve. Now, this secondary reserve in Lincoln, the money was deposited.

Now, under the statute there, there was a mandatory provision, as the Court said in discussing the effect, three instances in which the party would get the money back and was required to be paid the money back by the statute.

Said this Court in that case: The prospective refund, and in case, at that, of the institution of pro rata share upon termination of its insured status, one; or upon receivership or liquidation; or when the primary reserve of the loan reaches suspension level. It was required to be made by the statute.

In other words, if the primary reserve got big enough, the guy got back what he put in the secondary reserve.

And in addition to that, in that statute -- now there was income-producing, as a matter of fact, because the statute required that the home loan,or the insurance company, FLIC, pay interest upon the secondary reserve amounts in the identical percentage that they received from their obligations held by them with the United States Government or guaranteed by the United States Government.

And in the brief filed by the government in that case it was said without dispute that as a matter of fact, in the time involved in this particular case, that there was earned from 3.15 to 4.23 percent annually upon the secondary reserve. That was always there. It was mandated to be returned under any and all circumstances which might occur.

Whereas in this case, this credit entered upon the books is one as to which the funds may or may not be repaid.

There's quite a difference between a legal right to receive back a deposit in cash with interest, guaranteed by the statute, or a right to receive back a common savings deposit with the bank, with or without interest; as compared to a situation in which we have this.

Now, what is this interest override? The statute itself is clear. The statute says, in 26 USC 1134(d) -- now, it uses the words that the borrower shall be required to invest quarterly in Class C stock, and of course, as was stated in Lincoln, so the statutory labor of prepayment and advance premium, contained in 404(d), are not controlling.

The fact it called it the purchase of Class C stock is not controlling, the fact it was made is controlling. It comes under the old principle, recognized by this Court since the beginning of taxation, it's the substance and not the form, the incisive substance, the incisive facts, as distinguished from the form, that govern in all tax matters.

Now, how about these amounts? Now, these amounts required to be paid, which are here involved, is only the first of the three columns of Class C stock, that so-called interest override.

An amount equal to not less than 10 nor more than 15 per centum -- of what? I'm reading from the statute now. Of the amount of interest payable by it to the bank during the calendar period, 8 percent of the interest thus is required to be paid.

Now, this is right significant, essentially, it seems to me. This comes from the statute. I quote it: Payments for such stock shall be made quarterly and when the regular interest payments of the borrower are payable.

Now, there's no question about the regular interest, at all. We're paying regular interest of 6 percent at this time, this period of time; that limit has been removed, we're now paying 7 or 8 regular interest. But we paid 15 percent more upon the regular interest.

Therefore, we do have a question. A matter of the payment of funds for what purpose?

Now, let's look at that just a minute. Why were they paid? That's the real question. Why were these amounts paid? Were they paid as an investment? Were we paying 100,000 shares for the interest on the books, so-called Class C stock, as an investment, because we expected that it might be returned if the discretion were so exercised in 28.4 years or 31.6 years, without interest, without dividends, without any earnings? Why, of course not.

The incisive practicality of taxation required it be determined whether this taxpayer paid the $99, the difference between the $100 so-called par and the nominal value found by the Fifth Circuit and the District Court, for the use of money or to buy an investment?

I don't think there's any businessman in the United States who'd be foolish enough to pay $100 to buy these so-called Class C stocks which may, in the discretion of three bodies, be repaid at some unknown date, if the Congress doesn't change the law and if the bank doesn't decide to go ahead and pay the refunds in some other manner.

Q Mr. Satterfield, the Solicitor General made some argument with respect to Note 8, I think, on page 8 of his main brief, in which he set up the cost of the Class C stock purchased, and offset that with the patronage dividends and allocated surplus. Do you recall that point that he made?

MR. SATTERFIELD: Yes, I do; I think I do.

Q What do you have to say about his contention on that score?

MR. SATTERFIELD: May it please the Court, our position is this: that, as is set forth in the statute itself, these patronage dividends or refunds and allocated surplus are a participation in the margin of profit of a bank that year arising from the payment of the, as the statute says, regular interest.

Now, this 15 percent is entered at the end of the year, the statute so provides and so does 70.142 of the regulations. So the interest upon which the government now says we received patronage refunds, or received allocated surplus, didn't even exist during the year. They were made at the end of the year, at the same time that the patronage refund and allocated surplus were entered for the year.

Q Well, what's your theory of the impact of that patronage refund and the allocation on the cost of borrowing this money?

MR. SATTERFIELD: That actually has a result if and when it is repaid, 28 to 31 to 40 years later, to the extent of the value of the money in 1958, which makes the year paid in 1981. To that extent it would reduce the cost of the regular interest and also the interest override, which was added to the regular interest.

So it really would reduce the cost to the extent of its value by one dollar a share.

Q Well, in your theory, if the Class C stock were ever repaid, it would be income to the borrower then?

MR. SATTERFIELD: Yes, sir. We believe, it is our position that if it ever were repaid it would be income, ordinary income, taxable as ordinary income to the borrower. And that may be 28 years or 31 years from then.

Q In other words, you're saying this is just an <u>in coit</u> income, this $27,489 for 1961 is <u>in coit</u> income on which he may have to pay an income tax in some future year?

MR. SATTERFIELD: That is true, it is merely a possibility; and possibilities are not taxed. And we have pointed out on page 7 of our brief, and further on page 9 of our brief, 11 contingencies upon which depend the amount paid and on page 9 we've pointed out 7 contingencies or discretions which have to be exercised if it ever is repaid. So that's 7 and 11 is 18 different elements enter into whether or not we'll ever receive the in coit income which might come as a result of these actions, which arose from, actually, not the entry ofthe first column at the end of the year, so-called interest override or whatever it may be called, Class C stock purchase, but from the payment of the regular interest quarterly which was paid.

The interest of these entries under the regulations are made only at the end of the year.

Q Mr. Satterfield, is the Class C stock pledged as security for the cooperatives loan from the bank?

MR. SATTERFIELD: To this extent, Mr. Justice Powell, that the Class C stock is subject to a lien securing any borrowing by the borrower -- any loan by the borrower then or thereafter made. But the record shows on page 242 and 246, 246, the testimony of the president of the bank, uncontradicted, is that under no circumstances is it ever given any collateral value.

He testified that if an application is made for a loan, and if the balance sheet shows Class C stock, whether it be $1,000 or $100,000, they strike that out in arriving at the valuation or the security given. It is never used as security to obtain a loan, it is technically liable to a lien for the repayment of the loan.

The bank has never sold a single share of Class C stock other than under compulsion of the statute.

The testimony shows that unlike the situation in MFA, that there has never been a sale from one cooperative to the other of New Orleans Bank for Cooperatives stock, the situation being financially very different.

Q Has there ever been a failing borrower?

MR. SATTERFIELD: Yes, there have been failing borrowers.

Q And what did the bank do about the Class C balance?

MR. SATTERFIELD: If, in those instances, there was a Class C balance, they would credit up to the balance and would not pay one nickel on what was left over.

Q Well, I'm just asking -- did they get -- did the bank creditor or bank borrower get his loan reduced by the amount of the Class C balance?

MR. SATTERFIELD: Only to the extent that it was required to balance off the loan, if it was sufficient.

Q Well, all right. Dollar for dollar, then, the Class C stock was credited on the loan?

MR. SATTERFIELD: If it was required to pay the balance; otherwise not. In other words, --

Q Well, the answer is yes? In the actual instance you're talking about.

MR. SATTERFIELD: Mr. Justice, in the instance I'm talking about the answer would have to be no, because in that-- instances that were in the record, there was an insolvency.

Q Yes.

MR. SATTERFIELD: There was Class C stock which would balance off what was left, and additional Class C stock, quote, "owned by the borrower", unquote.

Q Yes?

MR. SATTERFIELD: Which was not balanced off.

Q Yes.

MR. SATTERFIELD: And this additional Class C stock so "owned", unquote, by the borrower was cancelled; he got no money.

Q Well, I understand that. But his loan was paid off?

MR. SATTERFIELD: If there was enough to balance it off.

Q Dollar for dollar?

MR. SATTERFIELD: Yes.

Q Dollar for dollar. The bank didn't attempt to collect from the bankrupt any of its loan?

MR. SATTERFIELD: To the extent that it might --

Q Except by setting off the -- except by reducing the Class C balance?

MR. SATTERFIELD: Right.

In other words, it was used to balance,to the extent it was available, it off.

Well, may it please the Court, we'd like to close in pointing out this fact: And that is that the real and only issue in this case is whether these payments of 15 percent of the regular interest were made for the use of money, because of the need of the use of money in order to obtain and use money or were they made as an investment to obtain a capital income-producing asset?

I can see there can be only one answer: They were made under compulsion of the statute, they were made in order to obtain and retain the loan.

May I call attention to the fact this intrinsic value argument has no substance whatever. Unlike the Home Loan Bank situation in lending, one share, the qualifying share, $100 was paid for it as far as our part was concerned, they show it as $100 when they got the first share qualifying them to receive loans.

But they, as they receive that, it made no difference how much stock they had, they had only one vote; they got that vote in 1956 in MCC, in 1957 in Coastal. And all the stock that's involved in this suit did not give them another vote, did not give them any additional asset in getting a loan, did not give them any additional right to call on the bank for services. They didn't give them anything, except that, perhaps, in the discretion of these parties they might receive -- what? The amount they had paid back in 28.1, 31.2, 17-point-so-many years.

And the reference of the government to 14 years is without any basis in fact whatever.

Thank you.

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

You have ten minutes left, Mr. Zinn.

At some point in here I wish you'd comment on Mr. Satterfield's comment on your footnote 8 argument.

REBUTTAL ARGUMENT OF MATTHEW J. ZINN, ESQ.,

ON BEHALF OF THE PETITIONER

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

We believe that there is a return on this investment. Mr. Satterfield has stressed the fact that the statute provides for the allocation of each year's profits on the basis of the interest paid by one cooperative to the interest paid by all, and that is what the statute provides.

But stock is purchased in the same proportion that interest is paid, and the statute might as well have provided that the return is payable in accordance with the ratio of the stock purchased by each cooperative to the stock purchased by all for the profits of that one year.

Now, this is different from the division of profits in an ordinary corporation. If you buy stock in an ordinary corporation, you're able to share in the profits of all years. In this situation you are able to share in the profits of only a single year.

As I mentioned earlier, however, it shouldn't make any difference, there's no reason why an ordinary corporation can't issue securities of the same type.

The fact remains that at the end of the period, whenever that indefinite time on the Class C stock is revolved, that these people put in $19,000 in 1961 and they're going to get back $59,000, whether it be 14 years later or 30 years later is of no consequence, they're going to get it back.

Interest, Mr. Chief Justice, is not something that you own, the divisible interest that you own and that you get back; you don't get interest back. And this is not interest.

It was the same situation in Lincoln. It wasn't current insurance, even though the only reason it was paid into the secondary reserve was to get current insurance, you got it back.

Q As I understand Mr. Satterfield's argument, though, he said, I think, in response to a question from Justice White, that whenever this windfall, this return comes, it will be taxable as ordinary income. Do you agree with that?

MR. ZINN: We'll accept that, Mr. Chief Justice.

Q Beg pardon?

MR. ZINN: We'll accept that, if that's his representation.

Q Well, you won't win -- I mean, you wouldn't say that if you win in this case?

MR. ZINN: That it's ordinary income?

Q Would you?

MR. ZINN: I'm not sure I understand.

Q In your case you'd say it's ordinary income even if you win this case?

MR. ZINN: Yes, sure.

In addition to attempting to show that this stock does, in substance, bear a return, Mr. Chief Justice, through the four hypotheticals I attempted to show that even if it bears no return, and that even if it gives the respondents only the right to get their money back at an indefinite future time, there's still no deduction.

What the respondents are seeking to deduct here is interest income that they might have earned had they been able to invest their money.

Q Well, this brings you back to your analogy of the $1,000 --

MR. ZINN: Yes.

Q -- non-interest-bearing checking account. It doesn't make any difference whether you get it back in one year, you're saying to us now, or forty years?

MR. ZINN: Or ten years. That's right. Or 13 years or 20. Because, under their analysis, you've borrowed $9,000 for ten years. Now, what you're left with, you have $1,000 on deposit after that. You don't earn interest. If you had it invested at an interest-bearing account you would have earned interest.

But in Hort v. Commissioner, 30 years ago, this Court held that income that you might have earned and didn't isn't deductible. And the respondents don't challenge the Hort case. We cite it in our brief, and they don't ask the Court to overrule it.

Q But if I borrow from this bank, and this year I have to pay $1,000 in to buy Class C stock because I've paid that much interest, if and when I get that particular Class C stock back you would say it's ordinary income, wouldn't you?

MR. ZINN: The thousand dollars you purchased?

Q Yes.

MR. ZINN: No.

Now, I'd like to make one final point --

Q Mr. Zinn, --

MR. ZINN: Yes, sir?

Q -- before you proceed, may I come back to a response you made a moment ago? Did I understand you to say that if the $99 is ever paid back to the cooperative, that it would be regarded as ordinary income?

MR. ZINN: The $99?

Q That is allocated to --

MR. ZINN: That it's deducting?

Q -- the Class C stock?

MR. ZINN: That is allocated?

Q That is allocated to the Class C stock, and which is at issue in this case.

MR. ZINN: On the assumption that they win this case or lose it, Mr. Justice?

Q No. On the assumption that some time in the future there is a distribution made on the Class C stock?

MR. ZINN: If the government prevails in this case, then we wouldn't attempt to tax the $100 that they'd be getting back.

Q That is what I wanted to know.

MR. ZINN: We attempt to tax the amounts in columns 2 and 3 on page 8.

Q The first $100 would be a return of capital?

MR. ZINN: Right.

Q Would it not?

MR. ZINN: Exactly.

Q But the patronage dividend and the allocated surplus, you would tax?

MR. ZINN: That's right. As ordinary income.

Q As ordinary income.

MR. ZINN: Now, one final --

Q And you say, I suppose, if I may interrupt you once more, in response to Mr. Satterfield's point about this being 30 or 40 years from now, that they knew that when they made the contract and borrowed the money, and it's part of the contract money?

MR. ZINN: Exactly. Exactly. And I think we pointed out in our brief that even if it was 30 years, and without regard to the allocated surplus credit, there would still be a return of slightly more than 3 percent.

Well, in Lincoln it was between 3.15 and 4 and a quarter percent return on investment.

But we don't, as I say, I want to stress, we don't rely exclusively on the fact that this has to be interest-bearing. We say even if the Court views it as merely the right to get your money back, that under the four compensating balance hypotheticals that I've referred to in my opening remarks, they are trying to deduct income that they might have earned but didn't.

Q But it is true that the only way he'll ever get his money back is if the bank is successful?

And can afford to pay off the Class A stock?

MR. ZINN: That's -- well, that's true in the case of any investment in a common stock, you only get your money back if there is --

Q That's right.

MR. ZINN: -- and it is successful.

Q Sort of like an income debenture or some such?

MR. ZINN: Exactly. That's the way we described it in our brief. At the end of the year you know you're going to get back $59,000, and you paid $19,000 for that certificate; and in the Midland-Ross case, Mr. Justice Brennan, writing the opinion for the Court, held that that differential was ordinary income.

One final point. The Court, in the Lincoln Savings case, not only discussed the secondary reserve but also the Federal Home Loan Bank stock that savings and loan associations are required to purchase in order to be members of the local Federal Home Loan Bank. And the Court said: Certainly the FHLB stock is an asset and its acquisition is capital in nature.

That's at 403 U.S. 356.

Mr. Justice Blackmun's statement there is not qualified by whether you get a return or not get a return on FHLB stock. He recognized that that's an asset and non-deductible cost, because it was a provision of capital for the Federal Home Loan Bank. It provided, as he put it, liquidity and availability of loan funds.

Now, that's precisely the function of the contributions to capital that we're concerned with here. They provide liquidity and availability of loan funds.

Now, the fact of the matter is that certain Federal Home Loan Banks throughout the entire 1960's paid a return of roughly one and three-quarters percent; one and three-quarters percent.

Now, the going rate of interest during the 1960's presumably was more than one and three-quarters percent, and, nonetheless, there's no room for the argument that any portion of the contribution to the Federal Home Loan Bank capital is deductible, because if they invested their money elsewhere they might have gotten 5 percent or 10 percent; but that is the respondents' argument in this case.

They even say that the Lincoln case is going to be back here next term, because they say -- well, let's say Lincoln got 4 percent, if Lincoln -- if the going rate of interest was 8 percent, they say that -- and the fair market value of the contribution to the secondary reserve therefore was only 50 percent of the amount paid, they say that Lincoln is entitled to deduct the other half as an ordinary expense, that this Court really didn't resolve the secondary reserve problem last term.

And we say that's inadmissible, because there's other value except value in the marketplace, and the Court recognized that other value at 403 U. S. 356.

That's all I have, Mr. Chief Justice.

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

Thank you, Mr. Satterfield.

The case is submitted.

[Whereupon, at 2:41 o'clock, p.m., the case was submitted.]

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