In the

Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

Respondent.

No. 73-9

Washington ,D. C.
January 14, 1974

Pages 1 thru 34

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AND MILLING COMPANY, :

Respondent. :

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Washington, D. C.
Monday, January 14, 1974

The above-entitled matter came on for argument at 10:04 o'clock a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, 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:

STUART A. SMITH, Esq., Assistant to the Solicitor General, Department of Justice, Washington, D. C. 20530; for the Petitioner.

CHARLES WHITE HESS, Esq., Floor Three, Columbia Union Bank Building, 900 Walnut, Kansas City, Missouri 64106; for the Respondent.

C O N T E N T S

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in No. 73-9, Commissioner of Internal Revenue against National Alfalfa Dehydrating and Milling Company.

Mr. Smith, you may proceed whenever you are ready.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF THE PETITIONER

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

This income tax case comes here on a writ of certiorari to the United States Court of Appeals to the Tenth Circuit. It involves the question whether amortizable bond discount, which is deductible as interest under Section 163 of the Internal Revenue Code, arose out of a transaction accomplished by the respondent corporation in 1957.

Specifically, the transaction involved was an elimination of respondent's outstanding fifty dollar par, five percent cumulative preferred stock, and a substitution for this eliminated preferred stock of an issue of fifty dollar face amount, five percent bonds to be issued to the holders of the eliminated preferred on a dollar per dollar basis.

The detailed facts underlying this transaction are briefly as follows.

In 1957 respondent had two stock issues outstanding, first an issue of $1 par common stock, secondly an issue of 47,059 shares of fifty dollar par, five percent cumulative preferred, on which there were in 1957 dividend arrearages amounting to $10 per share.

According to the certificate of incorporation, the preferred stock was redeemable according to a fixed downward sliding scale, so that in 1957 the redemption price was $51 per share, plus the ten dollar dividend arrearages.

The preferred shares redeemed could not be reissued but, pursuant to provisions of the articles of incorporation, had to be cancelled upon receipt or ultimately returned to the redeeming shareholders.

On April 8, 1957, respondent's directors proposed a three-part plan which they characterized as a reorganization of the company by way of a recapitalization. The three steps to the plan were as follows.

First, the directors proposed a series of three amendments to the certificate of incorporation. Under the first amendment, the preferred issue would be eliminated. Secondly, the par value of the common would be increased from $1 to $3 and the authorization of the number of common shares would be increased from some 763,000 to one million shares. Finally, the corporation was to be authorized to issue warrants for the purchase of common stock.

The second part of the plan involved the issuance of 18-year bonds bearing a stated interest rate at five percent and a fifty dollar face amount to the holders of the eliminated preferred. These bonds were to be subordinate to bank loans for inventory and to supplier obligations. The bonds were to be redeemable at par, plus accrued interest. And like the preferred stock for which they were to serve as a substitute, they were subject to a sinking fund redemption provision.

Finally, the third step of the plan was to issue to the preferred shareholders a warrant enabling them to purchase common stock. The terms of the warrant enabled the holders of the eliminated preferred to purchase one half of a share of common stock at $10 a share. This warrant was to be in lieu of the dividend arrearages of $10 which existed in 1957.

The shareholders approved the plan, and the focus of this case is on the second step of the plan, that is, the issuance of bonds in substitution for the eliminated preferred stock.

A total of some $2 million of face amount bonds were issued, which was exactly iqual to the par amount of the eliminated preferred. Thus, the capital of the corporation was reduced by some $2 million in the preferred stock account, and the bonds payable account was correspondingly increased by the same amount.

At the time of this transaction in 1957 there had been sporadic transactions involving but a few hundred shares on an over-the-co-nter market of respondent's preferred stock. The price range of these transactions were bid ranging from $29 to $33 a share and an offering price of $32 to $35 a share.

Respondent claimed discount deductions for the seventeen dollar difference between the face amount of each bond issued, that is, $50, and the asserted fair market value of the preferred stock which was eliminated, that is, $33. This case involves the propriety of that deduction.

Q There is no argument about the $33?

MR. SMITH: No, there is no argument--

Q About the accuracy of that figure.

MR. SMITH: The accuracy of that figure is only questionable from the point of view of the sporadic nature of the transactions, since it only involved but a few hundred shares of the 47,000 shares outstanding. But for purposes of this case, there is no argument that the fair market value could have been $33.

The tax court upheld the commissioner's disallowance of the deduction in a unanimously reviewed decision, but the Tenth Circuit reversed with one sudge dissenting.

In a series of decisions of this Court, this amortizable bond discount has been correctly recognized as essentially in the nature of interest, and this Court has also defined in numerous decisions interest as the compensation for the use or forbearance of money, which has long been deductible under the Income Tax Acts and which is currently deductible under Section 163 of the Code.

The best way to understand how bond discount works we believe is by reference to the prototype transaction set forth in our brief at page ten. In this prototype transaction a corporation issues a bond with a face amount of $1000, bearing stated interest at a rate of five percent over a ten-year term. The bond is issued for $950.

The stated interest of five percent produces an interest obligation of five percent of $1000 or $50 a year. But because the issuer of the bond must pay back the holder an additional $50 after the bond is retired, that additional $50 is also a cost of borrowing money and, as such, is deductible as interest.

Because it is payable over the term of the bond, this Court and the appropriate Treasury regulations have permitted a rateable deduction over the term of the bond or amortization, if you will. Thus, the allowable deduction to the issuer on the prototype bond would be $55 a year and not $50 a year.

The critical question in this case is whether this transaction is analogous to the prototype transaction. Here we have a situation where the corporation issued a fifty dollar debenture in substitution for a share of eliminated fifty dollar par preferred stock.

There is no question that respondent, upon the original issuance of the preferred stock, received $50 in the corporate till, so to speak. It has now transformed that preferred stock investment into a liability which will be payable at the end of 18 years. It originally received this $50 and it now promises to pay $50 out over the end of the term.

This equivalence has been reflected in the journal entries of respondent where they have reduced their capital account by the fifty dollar par amount for each bond, for each preferred stock, share, which has been eliminated and have increased bonds payable account by a like amount.

This simple substitution of one security for another does not involve an obligation to pay in the future any more than the $50 originally received for the preferred stock. And we believe that as a matter of numerical equivalence there can be no discount in such a transaction.

Respondent and the Tenth Circuit have focused on these sporadic sales of the preferred shares at $33 a share. It held that there was $17 of discount on the issuance of each debenture. But recalling that discount simply involves an obligation to pay in excess of an amount borrowed, just as the corporation in the prototype transaction has promised to pay $1000, although it has only borrowed $950, we submit that there is no such excess in this case. For discount to exist in this case, the amount borrowed must be somehow analogous to the $33 in the same way that the $950 in cash is analogous to the amount borrowed in the prototype transaction.

But unlike the prototype transaction, the corporation has fully available $950 of cash for its use in the business. Here all respondent has is a certificate of its preferred stock, which is immediately canceled by the terms of the articles of incorporation.

Thus the so-called thirty-three dollar fair market value of the preferred stock is meaningless to the respondent an in no sene can it be said to have received $33 in a borrowing transaction.

Respondent disputes this analysis. It argues that it only entered into this transaction because it did not have $33 in cash to redeem its preferred shares. As a result, it had to issue bonds in the face amount of $50,and the argument goes that the $17 of excess is interest or deductible discount. It analogizes its preferred shareholders to a so-called financing medium as it uses the term in its brief.

Q What was the life of the bonds?

MR. SMITH: The life of the bond here was 18 years.

But respondent's argument assumes that it could have redeemed the $33 for cash. But recalling that the preferred shareholders were entitled to a redemption price of $51 a share in 1957, plus the $10 of dividend arrearages, this is a sixty-one dollar obligation per share to each preferred shareholder and not a thirty-three dollar obligation. There is no basis for inferring that the excess over the asserted fair market value of the preferred stock is a cost for the use of borrowing money.

Indeed, the inference that discount exists in this case becomes even weaker when we recall that the bonds themselves were a stated interest rate of five percent. Indeed, if respondent had redeemed the shares for cash at any price, the cases are clear that it would be entitled to no income tax deduction at all. It therefore becomes apparent that it is simply absurd to infer a seventeen dollar deduction for deductible interest when the redemption price was possibly as much as $61.

Q What if the respondent had sold the bonds to third parties, gotten cash from them, and used the cash to redeem the preferred stock?

MR. SMITH: Mr. Justice Rehnquist, that kind of analogy was one of the bases of the reasoning of the court below. And we feel that it is simply a variation, as I will point out, of respondent's financing medium argument. What the Tenth Circuit did was to analogize the transaction and to break it down into two elements--one, the issuance of a fifty dollar face amount bond for $33 in cash and then the use of the $33 in cash to redeem the preferred shares. The court claimed that looking at the transaction that way, that there would have been discount as a result of the first aspect of the transaction.

But this analogy we feel is erroneous from several different perspectives. First of all, it is the transaction at issue here, the unified transaction, which must be scrutinized and not a breakdown into what we regard as hypothetical non-existent components.

But there are also two factual misapprehensions about the analogy. To begin with, it is entirely unsupported in the record to make an assumption that respondent could have issued a--if it had issued a fifty dollar bond in 1957, it would have only received $33 in cash, especially unsupported in view of the fact that the bond itself carried a stated a stated interest rate.

But, as I have also pointed out, there is no basis for assuming that respondent could have redeemed its preferred shares for $33 in cash, because the redemption price in 1957 was $61. And if this sixty-one dollar obligation was settled for $50, which got put on the face amount of the bond, there is no reason to infer that any part of that $50 is the cost of borrowing. Even if respondent had--

Q How do you know there is no obligation on the part of the corporation to redeem?

MR. SMITH: There was no obligation.

Q They could have redeemed at sixty-one under the sliding scale at that particular time.

MR. SMITH: Yes.

Q There is no obligation, unlike the maturity of a bond; there is no obligation at all. What happened here was that each shareholder turned in a piece of property worth $33 in return for a fifty dollar bond; is that not right?

MR. SMITH: Worth $33--

Q In the marketplace.

MR. SMITH: Right, but not worth $33--

Q It was not worth $61 because he had no right to compel redemption.

MR. SMITH: He had no right to compel redemption. But if redemption were to be effected, as it was in this case, the shareholders could have insisted on $61 per share.

Q Had there been redemption, but there was not; there was an exchange of a piece of property worth $33, i.e., the preferred stock of the company, in return for a fifty dollar bond bearing a five percent rate of interest, an 18-year bond, is that not it?

MR. SMITH: That is correct, but--

Q You do not need to cut this thing into--dichotomize it.

MR. SMITH: No, exactly. And we feel that the Tenth Circuit having done so, that it was error to have done so.

Q You think that is an error. Let us assume there was error. Just look at it as a unitary transaction, an exchange of property worth $33 for a bond with a fifty dollar face value and a five percent interest rate, with an 18-year maturity.

MR. SMITH: If we look at it that way, first of all, the corporation did not receive property worth to it $33 in the same way that the corporation, the prototype transaction, received an amount less than an amount which it had obligated itself to pay in the future. There was no obligation to pay an excess over an amount borrowed. Here the numerical equivalents are such that the corporation originally took in $50 for its preferred shares. It has transformed that into a fifty dollar liability. And we believe that the reference to the thirty-three dollar asserted fair market value of the preferred shares becomes irrelevant, because this is simply a substitution of one security for another.

Q Is this the bookkeeping transaction?

MR. SMITH: A bookkeeping transaction in the sense that it is a reshuffling of one security for another, technically called a recapitalization.

Q They are very different kinds of securities, however, are they not? One is debt and one is ownership.

MR. SMITH: They are different kinds of securities, but we do not think that makes any difference in this case. In fact, the similarities, Mr. Chief Justice, far outweigh the differences; because just as the bonds were subordinate to supplier obligations and bank loans, the preferred share-ho lders could only get their $50 upon a voluntary liquidation of the corporation, so to speak. So that both really stood in somewhat the same position. We think that the similarities far outweigh the differences.

Q But the relationship to the parties very drastically changed, did it not, from ownership to a debtor-creditor relationship?

MR. SMITH; That is from a technical corporate point of view, that is correct. But we do not think that should make any difference in this case where we have simply $50 going into the corporation through the par value of the preferred stock. There is no dispute that the corporation received $50, and then it simply promises to pay $50 in the future. Discount involves the existence of an obligation to pay something in excess of an amount borrowed, and there was no obligation here to pay anything in excess of the $50 the corporation had originally received on the issuance of its preferred stock.

Finally, the Tenth Circuit's analogy becomes--flies squarely in the face, we believe, of this Court's decision in Great Western Power Company v. Commissioner, which specifically held that such a substitution of one security for another is a unified transaction and not a transaction involving a breakdown of the issuance of the second one for cash and then the use of that cash to eliminate the first security.

It seems to us that the Tenth Circuit misconceived the basic essentials of this transaction. So, what we have here is simply the substitution of one security for another, and we submit that a corporation's issuance of debentures for stock is simply a capital readjustment that does not give rise, with those facts alone, to an inference for the existence of discount. Thus the thirty-three dollar asserted market value of the preferred shares becomes completely irrelevant. And the correctness of this proposition, we believe, is amply demonstrated by two things in this case, where you have a dollor-fordollar exchange and where as a matter of corporate mechanics the corporation received nothing upon the exchange because the stock was immediately canceled.

The tax court decided this case on the basis of a dollar-for-dollar exchange. And, in so holding, it followed the reasoning of a series of a recent court of claims decisions which had also premised the non-existence of discount in transactions like these on a dollar-for-dollar equivalence between the par value of the eliminated preferred stock and the face amount of the bond.

We think while this rationale is certainly sufficient to reverse the judgment below, there are other ramifications of this problem which we believe this Court should consider in formulating a basis for its decision. As I have said, as a general proposition, we do not believe that a capital readjustment of this type gives rise to amortizable bond discount.

Consider the situation of the corporation having issued a fifty-five dollar face amount bond for the fifty dollar preferred stock. In such a situation we still think that there is no basis for inferring bond discount.

The court of claims has suggested and two district courts have more explicitly held that discount might arise in such a transaction. A district court decision has proposed a formula for the measurement of discount an the following transaction which would be as follows. It would measure the difference between the face amount of the bond in the example, \$55, and the greater of the following two quantities, first the par value of the stock--here \$50--or the value of the preferred stock to the corporation at the time of the exchange.

Under the district's formula, the value to the corporation of the preferred stock may be greater than the par value of the preferred stock but could in no instance be less than the par value.

Thus, for purposes of the example under the district court's approach, there could be as much as $5 of discount in this transaction, in the fifty-five/fifty transaction, but might be less.

Q How would the value of the corporation be measured? Would it be the sixty-one dollar figure?

MR. SMITH: It is not entirely clear, Mr. Justice Stewart, exactly what the district court had in mind, and that is one of our complaints about this test. We think that the concept of value to the corporation introduces a vague and meaningless term.

Q If they would have cost the corporation $61 in cash to redeem any one of these preferred shares as of the time of the conversion, would it not?

MR. SMITH: Yes.

Q So, I would suppose that would be the "value" to the corporation. That is what it would have cost the corporation to get it.

MR. SMITH: Oh, on a redemption.

Q Yes.

MR. SMITH: The problem with that kind of analysis is that--

Q Although the corporation could go out in the open market and buy it for $33.

MR. SMITH: Yes, but simply as a matter of real estate market mechanics, I wo-ld assume that if the corporation here attempted to buy up as many shares as it could on the open market, its intention to retire the whole issue would have become apparent, and the market price would have been pushed up toward the redemption price.

Q But you do not understand, in other words, what the court meant by the alternative. It is either the par value, assuming that par value had been the true amount paid in capital, or you would say alternatively the value to the corporation, and your reprepresentation is that you do not understand what it means.

MR. SMITH: I do not think the courts quite understand what the value to the corporation means, because the court of claims has suggested that fair market value of preferred stock is a relevant consideration for determining the value to the corporation, but it is not a determinant of consideration.

Thus it seems that the courts know that this approach wants to get away from fair market value, which of course we also contend is erroneous. But it is not clear to the courts exactly what this term value to the corporation is. Whatever it is, we submit that there still is no basis for an inference that discount arises in such a transaction.

To begin with, if the term value to the corporation means what the corporation would be willing to pay for the preferred stock, then even under the district court's formula there would be no discount because there would be a face amount of $55 for the bond, and the corporation would be willing to pay $55 for the stock. Thus there would be no element of that fifty-five dollar figure would constitute a cost of borrowing.

Indeed, there are many instances which we might call to mind to suggest why a corporation would be willing to purchase its preferred stock for more than its par value. It could be a call premium or whatever, which might force the corporation to be required to pay from its shareholder more than the par value of the stock.

So, if that value to the corporation means the price at which the corporation pays for the stock, there would be no discount.

But even conversely, if the face amount of the bond represents somewhat more than the corporation would be willing to pay for the stock, there is still no reason to infer the existence of discount. There are a variety of other corporate reasons completely unrelated to the cost of borrowing money which could form a basis for undersranding why a corporation would enter into a transaction like this.

For example, in this very case respondent wanted to eliminate the dividend arrearages. It could have decided that it wanted to transform non-deductible dividends on preferred stock into deductible interest. It could have decided it wanted to eliminate preferred shares which were held by a dissident group.

In any event, we submit that there are a variety of other independent reasons which would form the basis for a decision why a corporation would be willing to pay more for its preferred stock than the so-called market value or its value to the corporation which are totally unrelated to the cost of borrowing money.

Q What voting rights, if any, do the holders of the preferred shares have?

MR. SMITH: They did vote as a class and in fact voted on this very plan.

Q Share for share with the common shareholders?

MR. SMITH: I think simply it was a much smaller class. I think it was share for share. I am not exactly sure.

Q Far fewer shares?

MR. SMITH: Yes, far fewer shares.

Q And no increase in voting power when there were arrearages?

MR. SMITH: No, not that I am aware of.

I see that I have little time left. I would like to save it for rebuttal if the Court has no further questions.

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

Mr. Hess?

ORAL ARGUMENT OF CHARLES WHITE HESS, ESQ.,

ON BEHALF OF THE RESPONDENT

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

My name is Charles Hess. I am an attorney from Kansas City, Missouri, and with the firm of Linde Thomson Van Dyke Fairchild & Langworthy. We have represented the respondent National Alfalfa Dehydrating and Milling Company for many years and have represented them throughout this litigation.

Mr. Smith's presentation of the facts has been relatively accurate. However, we cannot agree with the facts which he emphasizes nor with his characterization of the redemption or exchange transaction which occurred in this case as a subtitution of securities.

In its simplest form, National Alfalfa issued a fifty dollar face amount, five percent debt obligation, repayable in 18 years, to its preferred shareholders in exchange for or redemption of each share of their preferred stock, which had a fair market value of $33 at the date of the exchange. The preferred shareholders retained no further equity interest in the corporation.

The economic realities surrounding the exchange, which are substantiated in the record, dictated that the issue price of each debenture was $33 or the fair market value of the preferred stock, and that the difference of $17 between the face amount of the debenture and its issue price of $33 represented discount.

The economic facts surrounding the transaction which dictated that $33 was the true and meaningful value to be attributed to the issue price of the debentures, are numerous. The preferred stock for which each debenture was issued had a fair market value in the over-the-counter market of $33 per share, seventeen--

Q Is that stipulated?

MR. HESS: Yes, it was a stipulated fact in the tax court.

Q Did they stipulate to the extent that it would have been possible to purchase it on a market at that figure or just that it had a value?

MR. HESS: There are two or three exhibits. The stipulation refers to the exhibits. One is the national stock summary which summarizes the activity in over-the-counter stocks, and it is used by the Internal Revenue Service for estate valuation, that type of thing. And we have all the bid and asks and exchanges made during two or three months around July of 1957.

The other exhibit is a letter from Francis I. Dupont which was the chief market maker in the stock at that time, quoting the bid and ask prices ten days either side of the date of the exchange. And the stipulation refers to this and states that the value was $33.

In addition to the preferred being worth $33 in the market, there were four years of dividend arrearages on the preferred. National's credit rating was so poor at that time that it could not borrow sufficient funds from banks to finance inventory requirements for its operations.

National's balance sheet and operating statement, which are reflected in the tax returns which are exhibits in our record, reflected that its overall financial picture was very poor. It did not have sufficient cash or liquid assets to redeem the preferred for $33 in cash.

The fact that the preferred shareholders were to be removed by this redemption as equity owners in National through the redemption meant that the negotiations preceding the exchange and the exchange itself were arm's length dealings taking into account the relative positions of each of the preferred shareholders at the time of the exchange.

The ruling letter issued by the Treasury prior to the exchange properly describing the exchange as a redemption and requiring the recognition by the preferred shareholders of gain or loss on the exchange, clearly acknowledged the arm's length dealing inherent in such an exchange, which took into account the economic status of the parties at that time.

Judge Phillips for the court of appeals recognized the economic realities existing in the transaction which led him to the proper conclusion that the debentures were issued for $33 and that the seventeen dollar difference was interest in the form of discount. He recognized that the financial statuts and negotiating position of the parties in 1957 and the then current value of the preferred stock determined the face amount, the stated interest rate, and the discount on the debentures, all of which are variable factors, depending upon the circumstances of any given exchange.

Q Mr. Hess, I suppose if National Alfalfa had actually done that, gone out into the market and done what was supposed, you would not be here, there would be no case.

MR. HESS: That is true.

Q And of course in tax law we have a lot of distinctions in cases, depending on what actually was done, not on what might have been done. But you feel that what might have been done equates with what was done?

MR. HESS: Very much so. I think his analogy, although it sets up slightly differing facts, really explains the economic realities of what happened. If Nationa had done that, I am not sure exactly what would have happened. They may not have been able to sell their debentures for $33 cash. The discount may have been greater. There is no guarantee that in the market place that they could have gotten $33. They might have gotten $25, and we would have been asking for deductions for $25 instead of $17.

Q Your tax court decision was reviewed by the full court, was it not?

MR. HESS: Yes.

Q It is a little surprising you did not pick up somebody in your favor among that array of tax judges.

MR. HESS: In all the cases that have been decided on the varint issues here, the court of claims and the tax court are the only ones that have gone in this direction. The courts of appeals have gone the other way, various circuit courts of appeal, and I think that they got off on a wrong tangent and I cannot explain that, their decision. I think it is wrong.

They purposely refused to follow the decision of the court of appeals of the Tenth Circuit in the Atchison, Topeka and Santa Fe case, which was a decision that was made in 1970, which allowed bond discount in a railroad reorganization situation.

Q Of course the tax court has been wrong before, but you hope they are wrong again.

MR. HESS: Right. I sure do.

Q Mr. Hess, in the real world of finance, are there many debentures with a face value of $50 that you would market for $25? I mean, is this something that happens with any frequency?

MR. HESS: I am not sure that I have the background to tell you that. I do know that from the calculations that Judge Phillips made, the actual dollar effect of this was that an additional 1.9 percent interest would be added to the stated interest rate of five percent. So that although the discount in terms of $17 on $50 sounds high, if you recognize it in the form of 6.9 percent total interest, that is not all that high.

Q Then a five dollar discount--say $45 out of $50 has just really a very insignificant effect on the stated interest rate, if seventeen would have that small.

MR. HESS: Yes. I cannot calculate it quite that fast, but I assume it would be much smaller than 1.9 percent. It might be .5. It might bring it up to 5.5.

Q You can get a very substantial discount sometimes, depending upon the stated interest rate in the debenture. If it were two percent, say, an old debenture, compared to today's interest rates, it would be a tremendous discount, plus the condition of the issuer. A debenture by definition is a basically unsecured debt obligation as contrasted to a bond, and that could amount to--you could get a very substantial discount in that area of magnitude.

MR. HESS: The discount will vary directly with the stated interest rate as one factor and--

Q And the strength of the issuing company, the financial strength.

MR. HESS: Yes. And National at this time was not strong.

Judge Phillips noted that the preferred shareholders were acting as a financing medium to the extent of the $33 of actual value of the debentures received by them, an amount which National did not have in cash to pay them.

Underlying these economic facts, the court of appeals understood that the preferred shareholders upon receiving the debentures became creditors and that National's relationship to them after the exchange was entirely different than before.

First of all, there was a requirement for repayment of $50 after maturity in 18 years. Secondly, there was a fixed interest payments that had to be made. The default provisions of the indenture exposed National's assets in the event that the interest or principal were not paid. Restrictions in the indenture prohibited numerous financing and operational activities of National, and the establishment of and payments to a sinking fund further protected the debenture holders. In fact, the sinking fund was used entirely properly. It was funded at every point that it was supposed to be funded, and the debentures have been retired in proper order.

In contrast to the economic analysis approach in our case, which the court of appeals took, the Erie Lackawanna case, which is a court of claims case, takes an historical approach, and it was mentioned by Mr. Smith. Erie Lackawanna, being a court of claims decision, is the cornerstone of all of the cases supporting the commissioner's position in this case and from which he has attempted to develop some theory which would prevent the use of fair market value of the preferred as the issue price of the debentures. The dissent in our case relied on the rationale of the Erie case.

But the approach used in Erie has been termed the arithmetical equivalence theory or the numerical equivalence theory, which Mr. Smith used today. Basically that approach is since $50 was originally received upon issuance of the preferred by National and ultimately many years later National will pay $50 to a debenture holder, then the corporation has not been hurt.

The total inadequacy of this arithmetical equivalence approach is threefold. First, it ignores the basic qualitative differences between debt and equity instruments, namely, the fifty dollar face amount on the debentures must be paid back. The fifty dollar par on the preferred is never required to be paid back. The debentures appear as a long term liability on the balance sheet. The interest of the preferred holders appears in a stockholders equity account, and these entries reflect the basic transformation that occurs in an exchange.

The debenture holder is a creditor and not an owner. He has no residual interest in the corporation or its profitability. He has no voice in corporate policy. And he takes no risk. None of these are true with the preferred.

The arithmetical equivalence theory also ignores the economic realities surrounding an exchange, in spite of the fact that the economic facts at the date of the exchange determine the elements of consideration given by each of the parties to the exchange.

The amicus, Norton Simon, set forth a hypothetical which I think is very appropriate in showing the impropriety of this arithmetical equivalence theory. If National's preferred had been ten dollar par but the fair market value at the date of the exchange were $50 and National went ahead and issued a fifty dollar face amount debenture for the preferred, under the <u>Erie Lackawanna</u> case and the arithmetical equivalence theory, we would be entitled to a deduction for a discount of $40, the difference between the fifty dollar face amount of the bond and the ten dollar par value of the preferred.

Obviously this is not right. We would be giving up a face amount debenture worth fifty and receiving something with a fair market value of fifty, and I think this points out the weakness of that arithmetical equivalence theory.

The arithmetical equivalence theory finds no support in Internal Revenue Code Sections dealing with bond discount.

In analyzing the appropriateness of National's deduction for interest in the form of discount, you must realize that the Internal Revenue Code contains counterparts of the interest deduction for amortized bond discount. These provisions provide the symmetry to the tax elements of a transaction normally found in the Internal Revenue Code. The debenture holder reports the interest which is in the form of discount as ordinary income. If a corporation repurchases its debentures in the market at less than face value, which National did in this case, the difference between the face value and the lesser price paid in the market is reported as ordinary income by the corporation on its tax returns.

If for policy reasons the commissioner or others, such as the court in Erie, feel that a corporation should not obtain a deduction for discount in a case such as this where it is clearly authorized by the code sections dealing with interest deductions and where it is clearly supported by the economic facts in the situation, then we believe that the place for them to look is to Congress.

However, it may be too late at this point, because Congress in the 1969 tax reform act resolved this problem for the future, and we believe did so in a manner consistent with the decision of the court of appeals in this case. The court of appeals decision in this case was appropriate. Respondent respectfully requests that the decision of the court of appeals for the Tenth Circuit be affirmed. Thank you very much.

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

Do you have anything further, Mr. Smith?

REBUTTAL ARGUMENT BY STUART A. SMITH, ESQ.,

ON BEHALF OF THE PETITIONER

MR. SMITH: Just a few points. Mr. Justice Blackmun asked about the fair market value of the preferred stock. The reference in the stipulation in the tax court is at page 27 of the record, paragraph 13. There is no stipulation between the parties with respect to fair market value. All the stipulation says is attached hereto and marked as Exhibit 17, is a letter from Francis I. Dupont & Company in which the bid and ask range prices are quoted. That is the only thing in the record with respect to the fair market value of the preferred stock.

Q Did the government put in any evidence contradicting that?

MR. SMITH: No, vecause from our point of view, the fair market value of the preferred stock, whatever the market value of the preferred stock, it does not make any difference. Since discount involves an obligation to pay an amount in excess of an amount borrowed, we do not think there was anything in excess of $50.

With respect to the similarities and alleged differences between the preferred stock and the debentures, let me just refer the Court to the discussion on pages 14 and 15 of our brief in which it is pointed out that both the preferred stock and the debentures were both subject to comparable sinking fund provisions which retire both of them. I think that simply as a matter of realism, both the preferred shareholders here and the debenture holders were both subject to the risk of the business. If the business did not make any money, then the debenture holders would not get paid nor would the preferred shareholders' investment really be worth anything.

I think in closing what I simply want to emphasize is that what the taxpayer is arguing for here is an automatic rule which would insist upon the existence of discount between the face amount of the debenture and this asserted fair market value of the preferred stock. We say on those facts alone there is no basis for inferring discount, and the basis for a lack of discount is graphically illustrated in this case by the equivalence between the par value of the preferred stock and the face amount of the debenture. The corporation took in \$50 and promised to pay out no more than \$50 over the end of the term.

But simply if the corporation had increased the face amount of the debenture, we do not think--to \$55--we do not think that there is a basis for inferring the existence of discount. We think that the taxpayer should be put to the burden of demonstrating that that excess really represents a cost of borrowing and that since there are a variety of reasons why a corporation would want to enter into a transaction like this--I see my time is up, I would just finish my sentence--we think that those reasons should control unless there is strong evidence inferring an additional cost of borrowing. Thank you.

Q Mr. Smith, may I ask you a question: Do you attach any significance to the 1969 amendment to the code arguing the amicus briefs and also in the reply brief?

MR. SMITH: We have filed a reply brief, Mr. Justice Powell, which discusses this point. Briefly we do not attach any real significance to the 1969 amendment. But we do know that the approach of Congress in 1969 is parallel to the approach we wo-ld take in this case, that as a general rule, when a corporation issues bonds for property, Congress has declared in 1969 that the issue price is equal to the face amount of the bond with only two exceptions, that either the bonds be traded on a public exchange or that the stock be traded on a public exchange. Neither of those facts exist in this case, and we think that the general rule, without the exceptions, lends support and is parallel to the approach we take here.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

[Whereupon, at 10:53 o'clock a.m. the case was submitted.]

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