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In the

Supreme Court of the United States

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IVAN ALLEN COMPANY,)
)
Petitioner)
)
v.) No. 74-22
)
UNITED STATES)
)
)

Washington, D. C.
April 14, 1975
April 15, 1975

Pages 1 thru 47

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Washington, D. C.

Monday, April 14, 1975
Tuesday, April 15, 1975

The above-entitled matter came on for argument at 2:19 o'clock p.m. on Monday, April 14 and, at 3:00 o'clock p.m., was continued for hearing until 10:08 o'clock a.m. the following day, Tuesday, April 15, 1975

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
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:

KIRK MC ALPIN, ESQ., 2500 Trust Company Tower, 25 Park Place, Atlanta, Georgia 30303 For Petitioner

SCOTT P. CRAMPTON, ESQ., Assistant Attorney General, United States Department of Justice, Washington, D. C. 20530 For Respondent

C O N T E N T S

PROCEEDINGS

MR. CHIEF JUSTICE BURGER: We will hear arguments next in No. 74-22, Ivan Allen Company against the United States.

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

ORAL ARGUMENT OF KIRK McALPIN, ESQ.

ON BEHALF OF PETITIONER

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

The case before you today is in behalf of the Taxpayer, Ivan Allen Company.

This is a penalty tax case. It is referred to also as an accumulated earnings tax case.

It arises under Section 531, 537 Internal Revenue Code.

If the Court would permit, I might, in one very brief moment, spell out the particular provision of 533 which is of issue in this case. The very section of 533 portion which is particularly pertinent to the consideration says this:

"The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders."

I might state briefly that Ivan Allen Company is involved in this case by reason of the purchase of Xerox stock in 19 -- for the years 1965, 1966.

The issue here is whether or not Ivan Allen Company accumulated earnings beyond the reasonable needs of the business. Do we -- did our earnings and profits exceed our reasonable business needs for those years?

The issue has been framed by stipulation to present a relatively simple issue insofar as the business figures of the corporation are concerned.

The amount of Xerox stock which we claim and did so claim successfully in the District Court, which was purchased from earnings -- accumulated earnings -- was $154,000.

That is the amount of investment which we have in liquid assets. That amount was reflected in the year 1965 as $154,000.

In the year 1966, a taxable year, and on June the 30th, that was reflected as $135,000 because some of that Xerox stock had been sold in the year 1965.

The question here before this Court is whether or not the earnings and profits in determining this question, of whether the earnings and profits exceed the original needs of the business are reasonable needs to be compared with the earnings and profits reflected in the liquid assets, as we contend, at cost or, as the Government says, as total resources available including unrealized appreciation, as the Government contends.

The Xerox stock went from basic cost of $154,000 in the year -- for the taxable year 1965 -- to $1,640,000, rough figures.

In the year 1966, as the records will show, that same stock -- at that time $135,000 -- had a net liquidation market value less costs of -- well, the market value at that time, of $2,500,000.

QUESTION: Mr. McAlpin, why does an office supply company buy stock like Xerox?

MR. MC ALPIN: All right, sir, the reason was, they were -- I don't know if it is in the record -- they were in the 3-M. They had the franchise for 3-M machine, the old machine that was Minnesota Mining.

They lost that franchise. They saw that Xerox on the market. They were aware and they saw that -- Mr. Allen, back in the 60's, he had some cash money, your Honor, and this was accumulated earnings which the record will show was needed in the operating capital. It is stipulated that this cash, we agree is operating capital.

He invested this in a security rather than leaving it idly in the cash or just in a savings account.

QUESTION: You say Mr. Allen had some money. You mean --

MR. MC ALPIN: No, no, I am saying he was the president of the company, Mr. Ivan Allen.

QUESTION: The corporation.

MR. MC ALPIN: The corporation. He was the president of the company at this time. It was the corporation.

QUESTION: It was the substitute for putting the money in the bank?

MR. MC ALPIN: Yes, your Honor. As a matter of fact, this case would not be here today if Ivan Allen Company had just wanted to be safe and just leave the $154,000 in cash because it is stipulated by the Government that -- and we so state -- that the cost of our investment -- the cost of our earnings, which is the investment of Xerox in liquid assets, is available to meet reasonable business needs.

We say the appreciation is not available, that these are not earnings, the amount of earnings, so we paid tax on $154,000 which went into the -- which are our accumulated earnings. Had we left -- and I don't think the Government will contend otherwise -- had we left that $154,000 just in cash and had management which was hesitant to make decisions, hesitant to look around and see what was a good investment for some contemporary money while they were waiting to use this as operating capital, and this was stipulated, as to costs it was operating capital -- had they left that $154,000 in cash as operating capital, there would be no claim because it is stipulsted in this case that the "amount of all reasonable business needs --" that is, the operating capital, $1 million 2 in 1965 and $1 million 4 in 1966 would equal exactly the accumulated earnings for the years, the same years of 1965 and 1966 if the stock is treated, as we respectfully submit, in earnings at the investment that they had in liquid assets.

That would be $1 million 2, which would be the accumulated earnings and $1 million 4.

So you see we are saying that the $154,000 and, respectfully the $135,000 of those two years in cash, that was all the earnings we had.

We put it into the liquid assets. It was part of our operating capital and available to meet the business needs.

Now, here is the case. And here is what the Government says.

QUESTION: Mr. McAlpin.

MR. MC ALPIN: Yes, sir.

QUESTION: Before you go on, you are talking about unrealized appreciation --

MR. MC ALPIN: We are, your Honor.

QUESTION: -- investment in the stock market.

MR. MC ALPIN: That is correct.

QUESTION: As of what date -- dates are we talking about --

MR. MC ALPIN: Well --

QUESTION: Did the Government take year-end market value?

MR. MC ALPIN: Yes, sir.

QUESTION: Fiscal year-end, as I recall it.

MR. MC ALPIN: Yes, sir, June the 30th of '65 and June the 30th of '66.

QUESTION: Right.

MR. MC ALPIN: Now, the Government contends --

QUESTION: Does the record show the high and low market --

MR. MC ALPIN: Statement of attorney at page 70 and page 90 --

QUESTION: Mr. McAlpin, I am asking you another question.

MR. MC ALPIN: Your Honor, excuse me.

QUESTION: Does the record show the high and low market price of Xerox in each of the fiscal years in question?

MR. MC ALPIN: I am not certain it does. It only shows what the Government refers to as the net liquidation value. They show the market and then in the record, show the cost of conversion which was the cost. That does not show the variation, no.

QUESTION: Does that take into account the capital gains tax?

MR. MC ALPIN: Yes, the cost of conversion --

QUESTION: The cost of conversion is different from the capital gains --

MR. MC ALPIN: Oh, no, that's the cost. We -- they have stipulated that there would be approximately -- I believe 37.5 percent if we did sell that stock. That would be capital gains, the 6 percent other tax and then there is some dispute about the Georgia tax but then we claim that there are three taxes which would apply if we were forced to convert and therefore we would not have the full value, even under their theory of available to meet business needs.

The cost -- I think that is in the record, your Honor, as stipulated.

QUESTION: Mr. McAlpin, on page 55 I think there is a stipulation about the cost of converting and I suppose, had the corporation, on December 30th -- or two days before the end of the taxable year or maybe on a fiscal year basis -- yes, June 30th -- on June 28th it had liquidated the Xerox stock that the net figure after capital gain and capital gain tax and brokerage commission -- you wouldn't be here arguing. Then there would be an improper accumulation of surplus.

MR. MC ALPIN: Had we converted it.

QUESTION: Had you converted it.

MR. MC ALPIN: Yes, sir, but what we would have done, we would -- naturally, we would have paid the capital gains tax shown at that time. We would then have -- as we did when we sold 1,000 shares of Xerox in 1966, we would have put it into our business for operation.

We would earn money. We would pay further income tax on that as we did in 1966. You'll notice our earnings went up from $341,000 to $629,000 and we would have then -- yes, we would have used it and put it in.

But the question, your Honor, may be this: Does the statute, 531 to 537, and the legislative history require a conversion? What the Government is claiming and which they did successfully in the Fifth Circuit and prevailing upon the Fifth Circuit to reverse Judge Morey, the District Judge, established the principles which we are urging in this Court.

What they would do then is force a conversion on a day certain, the last day of our taxable year. It would be without reference at all as to whether or not business judgment determined the time and the place and the best conditions under which investments should be sold and whether or not it would be wise to sell all of it at that time.

QUESTION: I didn't think that was the Government's theory. I thought it was -- first of all, I don't think that the Government claims at all that this unrealized appreciation is, itself, earnings and profits but that the Government's theory is that with the existence of this large, unrealized profit in the investment you made in this company, that your other earnings and profits were more than available to meet the needs of the business and, therefore, if --

MR. MC ALPIN: That's true, your Honor.

QUESTION: -- it were then declared, you are in trouble under the statute.

MR. MC ALPIN: What the Government says is --

QUESTION: It doesn't say you should have sold your stock or had to sell your stock.

MR. MC ALPIN: So much of it as would be necessary to pay the amount of the dividends. They claim -- they say we should have paid out all of our earnings and profits in these taxable years.

Now, your Honor, what they --

QUESTION: Often, earnings and profits are not in cash. That is true, isn't it?

MR. MC ALPIN: That is correct. That is correct. It would be reflected in property very frequently, yes, sir. But the point is, the statute makes a comparison. We would submit that the statute makes a comparison as to earnings with the reasonable business needs for the taxable year.

Now, what they say is that they are not taxed -- that is what they are taxed on, if that amount exceeds, when you put market on it, that that is what they are taxing.

But what they do, your Honor, they go to liquid assets and they claim that all amounts which we are holding as investment in liquid assets under the Smoot case, which we hold at cost, that is, our cost, $154,000, they take this and they put the appreciated value on it and then they say you look at total sources of funds in making the comparison.

Now, there is no statute, no regulation under 535 or 531 in any way that ever adopts except in this case and in the Fifth Circuit -- they did this in the tax court, which we say is wrong.

We ask this Court to disregard that decision but what they do is, that they take that figure which is in total -- which is in the liquid assets and they have interpreted, they say that all of your liquid assets, all the current liquid assets, that when you compare that with your business needs at a converted figure, which would be the $million 6, that if that exceeds your reasonable business needs, then you have accumulated earnings which you must pay tax on, a penalty tax. Now --

QUESTION: Now, wait a minute. Let's assume that a company buys some stock for $100,000 and it enhances and increases in value 10 times and it is worth a million.

MR. MC ALPIN: That's right.

QUESTION: And there it is. But the Government doesn't contend you have to pay any of that out -- any of that enhancement out.

MR. MC ALPIN: No, sir, they say --

QUESTION: But if you -- the next year if you have a dollar's worth of earnings in profits, you have to pay that out.

MR. MC ALPIN: That's right. They say --

QUESTION: But any year in which you have a loss, you don't have to pay anything out.

MR. MC ALPIN: That is correct. What they did --

QUESTION: It doesn't say that, certainly, that the enhancement is earnings and profits which must be converted and paid out.

MR. MC ALPIN: They admit that that is not earnings but, your Honor, the way they go about it is this, they have applied a different rule. They have -- they are forcing a conversion on your assets, so much of your liquid assets are at cost.

QUESTION: They don't force a conversion. They just say that your current year's earnings and profits must be paid out.

MR. MC ALPIN: Well, but your Honor, the measure there, the comparison is under Section 533 of the Code. In the comparison, the words are, "Earnings and profits" as you measure, you compare your earnings and profits for that year, accumulated earnings and profits -- your accumulated earnings and profits as against your reasonable business needs.

Now, if you look at costs, our reasonable business needs were $1 million 2 in '65. Our accumulated earnings were $1 million 2. They agree that then that is exactly the same. Now, what they are saying [is] that you take total resources, you take your liquid assets and when you take liquid assets, you appreciate the stock which has a cost value reflected in liquid assets and we'll come to that word. That is a very critical word because they have misstated the rule, we submit, in the Smoot case.

QUESTION: Which is the critical word?

MR. MC ALPIN: The word "reflect." The Smoot case, in 196 --

QUESTION: Incidentally, it is agreed that the Xerox stock is completely marketable. It is liquid, I take it, here.

MR. MC ALPIN: Yes, sir, but this case would be establishing a rule, though. In this particular instance, it is liquid. We would lose value -- and of course we have commented upon it. We would lose value of approximately -- from 30 to 37 percent or maybe by reason of conversion. We would be forced to sell. It is liquid.

But this would apply to closely-held corporations in which one of the concerns would be evaluation -- would a closely-held corporation stock be able to have an available ready sale?

You see, the Ninth Circuit, in Golconda, they held that -- even though that was tax court -- they held it wasn't applicable because it was a publicly-held corporation so the imposition that would be established in this case -- and the Fifth Circuit has established it -- says that at the end of every taxable year, that all your total resources, not your earnings and profits as the statute says, all your total resources must be looked to, to see whether or not you can meet their reasonable business needs.

Now, that means, on December the 31st, you have effectively been told that that market value, whatever the stock is at that time, the stock market value at that time, establishes and you have been told you are being placed a market value on it.

Now, let's assume, your Honor, we say and you have said it in thisCourt in Eisner, in 1938, you have very much -- you have expressed concern about forced conversion, the American Trading Company, Fourth Circuit, did the same thing in 19 -- I think in 1973. What you are doing, December the 31st, you forced, you make him determine the market value on that stock. The question is, and this is where the error is, there is no assurance that there will continue to be available into the next year or even into January the 2nd.

Supposing an antitrust suit or something or some, a fraud suit were filed. You say that stock is worth a billion and a half dollars or that an antitrust suit was filed against Xerox Corporation on January 1st. You have established that, not by business judgment but by the determination of the Government.

The Government has come in and told you when your sale is and on January the 2nd, the question is continued availability to meet current operations business needs.

Now, on January the 2nd, something completely -- happens, as Judge Morey says, Secretary of State Kissinger goes to Europe or something.

QUESTION: Well, even if that doesn't happen, isn't one of your responses to Justice White's earlier question that even though you are not told by the Government to liquidate your Xerox stock, if you have to distribute all of your earnings and profits to make up operating needs, you are going to have to liquidate some of your Xerox.

MR. MC ALPIN: Yes, but only -- your Honor, only to the extent of -- yes, operating needs, $154,000, we stipulate, as part of our operating capital. We would have to sell $154,000 worth to take care of it, but we wouldn't have to sell all of it.

Now, what the Government -- we wouldn't have to sell the whole thing, we would just have to sell that $154,000 amount. Or maybe it may be more. But what the Government is saying is, when you measure it, they say we'd have to pay out the whole $600,000 of profits for the taxable years. They said that we should have paid all of that out.

Now, we did pay out a dividend and we have been paying out dividends but they said all of it should be because when you take your appreciated value, they say they are not taxing him but they say appreciation is not income but what they have done is, they have converted earnings in some form or another to liquidity -- they use it on the liquidity test in which they say that you reach up in any total resources.

Now, the question I want to make, the Smoot test, they cite Smoot. Smoot was a case in which they referred to as pre-Smoot days and post-Smoot days. Before, it was the size of the accumulation or accumulated earnings. They looked at the accumulated earnings to determine whether or not you had accumulated in excess of your reasonable business needs.

In 1960, the _Smoot_ case, what they did, they separated it. They said "There are certain things. One is the earnings. There is no way you can use those to meet reasonable business needs. They are in your plant and your equipment." So they took that out.

They said, "To the extent your earnings are there, you can accumulate with impunity," and then they came and said, "Now, what we should do for the practicality of this, and this is the ruling, and this is the established or liquid assets -- your liquid assets" and said that "So much of surplus as is reflected in the liquid assets -- so much of the earnings as are -- earnings are separate. They use surplus as the same thing. "So much as is reflected in liquid assets are to be measured against the reasonable needs and if you exceed that, then you have violated the statute."

QUESTION: But wouldn't you be here making the same argument if for some reason or another the company had liquidated its Xerox stock and was sitting there at the end of the year with the money in the bank, having paid its capital gains tax?

Wouldn't you say that that --

MR. MC ALPIN: Well, we were paid the dividends, your Honor. That was -- if we had --

QUESTION: No, no, no, wouldn't you still be making the argument that insofar as the cash that you now had, absolute cash, reflected enhancement in stock value that you wouldn't -- that it could not be and should not be considered in --

MR. MC ALPIN: No, sir, no, sir, we have agreed that the stocks are invested -- our earnings are invested --

QUESTION: No, that isn't my point. I know you have agreed that your stock cost is $154,000.

MR. MC ALPIN: Is $154,000.

QUESTION: Yes, but --

MR. MC ALPIN: And it is part of the reasonable business needs.

QUESTION: Yes, but now let's assume -- let's assume that the stock had gone up to a million dollars and you sold it.

MR. MC ALPIN: We did do that in 1966.

QUESTION: All right, let's assume that you sold it and you had the cash in the bank. Now, is that available to measure --

MR. MC ALPIN: That would part of our liquid assets and reasonable business needs.

QUESTION: And the Government then could take that into account?

MR. MC ALPIN: That would go into our earnings. We did do just that. We sold 1,000 shares.

QUESTION: It would go into your -- it would be part of your earnings because it was gain. I mean, it was earnings. It was income because you sold the stock.

MR. MC ALPIN: That is correct. No question about it. But we elected and did the converting. It was a business judgment as to when it was viable.

QUESTION: All right. But now let's assume that you paid the tax on it that year and you took it as income that year.

MR. MC ALPIN: All right, sir.

QUESTION: Next year you have still got the money in the bank and then you had some more earnings and profits. Must you pay them out?

MR. MC ALPIN: Absolutely. That would then be income, and we --

QUESTION: So you have got still accumulated earnings and profits.

MR. MC ALPIN: But then we would make the -- pay the dividends. The question here, your Honor, is when is it wise to do that? I know we aren't trying to be in any way technical --

QUESTION: So you're -- this is unrealized income. Is that right?

MR. MC ALPIN: Unrealized income. It is unrealized appreciation.

QUESTION: Mr. McAlpin, this has to be your answer, what you just gave to Mr. Justice White, has to be your answer, really, and what you are pinning your case on is that it is unrealized --

MR. MC ALPIN: That is correct.

QUESTION: -- and unliquidated and you want the privilege of a business judgment as to when to liquidate.

MR. MC ALPIN: That is correct, your Honor. And while it may be that we are following and we say that it has good reason, the legislative history of this particular act since 1954 has been to favor the taxpayer, the language, the words "earnings" were deliberate.

They are to determine the source from which the funds are to be paid. The legislative history shows that every amendment has been favoring the small businessman.

Just this year, the exemption has gone from $60,000 to -- in 1975, $175,000.

The question of reasonable business needs, you used to have a specific plan. It was amended Section 537 to state "reasonably appealable needs" and here we come right down, now, to include these new ideas which the Government is injecting into it. There is no word of liquidity. There is no -- the statute doesn't use the liquidity test.

The liquid assets test, which they have misconstrued in this brief, we say, and the Fifth Circuit likewise, puts your evaluation on a basis of measuring of earnings and while the legislature has -- Congress has written it this way andin the Braunstein case in 1963, you recognized that, while it was a matter of taxation, that that is the way the legislation was written and if it was a matter of that was the way Congress did it and it didn't appear to be the type of situation for judicial determination -- we would submit, your Honor, that the question of the legislative interpretation is very deliberate here. It is very much designed, because they even recognize that they were concerned about the Government harassing -- it is in our brief -- harassing small businessmen and they nearly took the penalty tax off.

And another thing we must recognize is that this is a penalty tax. We have paid the income tax and the rule of Gould versus Gould is, in a case of penalty taxes, that you must construe any enlargement or misconstruction or interpretation question as against the Government and for the taxpayer.

We say there is no ambiguity.

The term -- in 1936, the word "gain" was changed to "earnings," so it would be earnings and profit and every measure, every deliberate concern of Congress has been on earnings and yet, they bring --

QUESTION: Mr. McAlpin, I don't understand the

Government to be contending -- of course, we'll hear from them in due course -- but I don't understand them to be contending that this unrealized depreciation is earnings and profits.

MR. MC ALPIN: They contend it is not, your Honor. But what they do, they --

QUESTION: They concede that it is not.

MR. MC ALPIN: They reach out for a new term called "total resources available."

QUESTION: Yes.

MR. MC ALPIN: That is not what the statute says. The statute says, "earnings and profits available."

QUESTION: Well, you did have earnings and profits.

MR. MC ALPIN: Yes, sir.

QUESTION: And the Government position is, with this unrealized appreciation of the Xerox stock, those earnings and profits were unreasonably accumulated if they weren't paid out.

MR. MC ALPIN: But they --

QUESTION: Now, also, I should point out that the dividend doesn't have to be a cash dividend. The dividend could have been paid out in the form of Xerox stock to your shareholders.

MR. MC ALPIN: Well, your Honor, that is very interesting. I am glad you mentioned it because one of the indications that cost is a proper value is that in the regulations, the 562, when you give your unrelated stock out, they give you credit only at cost. They don't give you market yet what they are trying to do is trigger us at market.

For example, when we gave -- when we transferred, gave 870 shares of Xerox to our shareholders in 1965, it had a market value of approximately $87,000.

If you will find on your balance sheet in that year, we were given a credit for $6,500.

Section 312 of the Internal Revenue Code, talking about earnings, says that there must be -- that when there is a recognition at the time, that that is when you gain and that is when earnings become indicative.

There is nothing in the statutes --

QUESTION: And is the shareholders' basis on receipt of a dividend in kind as the basis for each share the corporation's cost basis?

MR. MC ALPIN: Yes. When the shareholder gets it, they give the corporation only cost deduction but when he gets it, he must pay market value. He pays tax on the basis of market value.

QUESTION: Tax on the market value.

MR. MC ALPIN: Yes, sir.

QUESTION: And then his basis, if he later sells it, is the market value.

MR. MC ALPIN: Is the new market and as American Trading -- you asked about the dividend -- American Trading, the Government made the same contention there.

They said what that would do was dissipate the entire thing, that they would have to -- that first you would lose 37.5 percent. The Government determines when you sell your stock and on that very day you lose up to 37.5 percent in your value, which is not available to me, then you get a cost deduction and that is treating you at market and then your stockholder has to pay the full value when he gets it.

Now -- I'll finish -- as the Court said in the Koch, Nebraska, 1964 -- I hate to cite that to the Court but it is on point and I think it is very significant. They say they hope that they don't see the day -- the Court said -- when Government invades business to such an extent in this very issue that they can determine when stocks are sold and therefore they held in that case that forced conversion was not desirable, that what it was doing was putting Government into the management seat and that all decisions of management would be triggered thereafter.

We submit, as you have also said in Eisner, that this was not the effect desired and that other issues, I know, I could treat, but it is treated in our brief.

MR. CHIEF JUSTICE BURGER: Very well, Mr. McAlpin. Mr. Crampton.

ORAL ARGUMENT OF SCOTT P. CRAMPTON, ESQ.

ON BEHALF OF RESPONDENT

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

I'd like to start at the outset and try to put in focus our understanding of the statutes that we have before you. The basic purpose, of course, is to avoid the so-called incorporated "pocketbook."

Congress determined the stockholders should not be permitted to accumulate idle funds in a corporation in order to avoid dividend taxes that they would otherwise have to pay themselves. As we look at the statute, there is a two-fold test here.

The first, Section 531, imposes a tax on the accumulated taxable income. This is an additional tax on income for a given taxable year. It applies only to that income which is permitted to accumulate in that particular year.

The income involved is determined basically from the books of the corporation and it is determined in much the same way as your regular corporate income is determined but then modified for certain adjustments and so far, as we see it, this is simple bookkeeping.

We come up with income that is determined the way everyone understands it. If you have no income, you have no problem under this statute.

If income does exist, though, when you have done this computing and it is not distributed as dividends to the stockholders, then you look to see if this income can be distributed without a hardship to the company.

The statute speaks of the earnings and profits being permitted to accumulate beyond the reasonable needs of the business and I think the word "needs" here is the key word for our second test.

It seems to us that this is an economic test. Here, the statute departs from concepts of taxable income that we know under bookkeeping and it requires us to measure the resources of the corporation against its needs.

The cases construing this statute refer to this as "net liquid assets." You take your current assets and your current liabilities and you see what are the economic resources of the corporation.

QUESTION: Mr. Crampton --

MR. CRAMPTON: Yes, sir.

QUESTION: What do you mean by "liquid assets"? How would you define them for this purpose?

MR. CRAMPTON: I think those are assets that can be readily converted to cash, probably inventory receivable, things like that that would come into income within a year or less than a year.

QUESTION: Suppose you had a highly marketable piece of real estate that you could sell any day?

MR. CRAMPTON: I think that would probably be a liquid asset, then, assume -- on your premise.

QUESTION: Right. How would you determine the value?

MR. CRAMPTON: I think you have to determine the value of these properties the same day we determine values in many other areas, like you would for state tax purposes and the question of condemnation, you have a question here of -- it is a fact question that the Court would have to consider.

QUESTION: And that means that the Government would get an appraiser and the taxpayer would get an appraiser and they would be miles apart and they would compromise somewhere in the middle, is what usually happens?

MR. CRAMPTON: Well, I think, your Honor, in the situation you gave, where you said it was readily saleable, I doubt if you would have much of a valuation problem there. If there is somebody wanting to buy this property, you probably have a pretty good idea what the sales price would be.

QUESTION: You would have to sell it, though, to find out.

MR. CRAMPTON: That is true. But that is true of your -- of any security,like the Xerox stock here would have to be sold -- there is some fluctuation in the market from a day to day -- but we don't think you need to get into that much of a refinement. You look to see whether or not there is current assets here sufficient that the corporation could pay out these earnings and profits without disturbing its normal needs.

QUESTION: Do you recall what the fluctuation in Xerox stock was in the Year 1974?

MR. CRAMPTON: No, sir, I don't. I have got it here but I know this was a volatile stock and in '74 --

QUESTION: It ran a range, according to Moody, from 55 to 134. Now, which day would the Government pick?

MR. CRAMPTON: I don't think you would pick a day on this, as we view the case, your Honor. You would look at the situation over the year and if there is a minimum value of 55, certainly that would be, I think, a realistic value to take, if that is the low, because we are -- we are not trying to force a conversion here.

We are just saying that you know in the day to day marketplace you have got some assets here and if you are sure that you can realize at least $55 a share on it, then that is something we should look at.

QUESTION: Well, if there was a lower market value in the fiscal year in question, the taxpayer could have taken that for purposes of this case.

MR. CRAMPTON: I would think that would be reasonable.

QUESTION: I thought you took the market value on the last day of the taxpayer's fiscal year.

MR. CRAMPTON: I don't think it has ever been refined to that point.

QUESTION: Well, I thought that was your claim in this case.

MR. CRAMPTON: No, we have stipulated what the values were with counsel. We were trying to get out of the case some of these detailed factual things and we have agreed with counsel for the Taxpayer that these were the values and we have reduced those values by the capital gains tax and by the brokerage points so as far as this case is concerned, we have hard figures that these are the fair market values that both parties agree they could use and then we have the cost figures which are equally firm.

QUESTION: Mr. Crampton, before you go on, how would sound accounting principles require a corporation to carry the value of this Xerox stock at any particular date?

MR. CRAMPTON: Oh, I think cost, clearly.

QUESTION: There is no question about that, is there?

MR. CRAMPTON: Not in my mind. But I do know that most accountants will also -- and this Taxpayer did -- they showed the market value at -- I think at the end of the year as not quite a footnote but a parenthetical addition to their balance sheet.

QUESTION: And if you filed a registration statement with the SCC and undertook to show your assets at market, you would get a deficiency immediately, wouldn't you?

MR. CRAMPTON: You'd certainly -- they'd want it explained very carefully how you determined that this was the value you were putting on it.

QUESTION: And the reason for that is that there is nothing definite, really definite, except cost.

MR. CRAMPTON: That is true.

QUESTION: Market value varies, it can vary with respect to stocks from day-to-day, vary widely.

MR. CRAMPTON: I agree.

QUESTION: Mr. Crampton, what if this Taxpayer had purchased Xerox at the highest point, whatever that was, and that you were dealing with it in terms of today's market value so that there would be an enormous unrealized loss?

How would that figure in the process of taking into consideration in the language of the regulations, taking into consideration the total picture?

MR. CRAMPTON: It is our view that the rule works both ways. If you bought at the higher figure as your Honor suggests, and now it is not worth that, then it is the existing market value that you look at in determining the needs of the business and that was the holding of this Court in the National Grocery case to which we referred in our briefs and in that case they had earnings, I think, of some $800,000 and then admitted security losses of $2 million and the Court said, you do look at the present value of those securities and there is a quotation in our brief which is quite clear and I am coming to it in a minute, but the Court then went ahead and imposed the tax because as you looked over a ten-year average, they had accumulated earnings and profits of something $5 million and had never paid a dividend.

But the Court there announced a rule and we think this is just the opposite of that -- and we certainly say the rule works both ways.

Now, I think the pivotal question here is how the resources of the business should be measured. The counsel for Taxpayer has set forth some of the facts, but I would like to summarize them briefly against the statute.

As we have indicated, the facts have been stipulated. This corporation had earnings after federal income taxes of about $180,000 in '65 and almost $400,000 in 1966.

It paid less than a third of these amounts out in dividends. In 1965 it paid $49,000 in cash dividends and distributed 870 shares of Xerox stock.

In 1966 it paid out $50,000 in cash dividends and a 10 percent stock dividend.

Its reasonable needs, as I say, have been stipulated. For 1965 they needed almost $2 million -- I mean, $1 million,200,000 and in 1966, they needed practically a million and a half and these are liquid assets taken at book value and the parties have agreed that these amounts equal the needs of the business.

These are the liquid assets and they are the needs, if you look at the book figures. Now --

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QUESTION: Well, what are liquid assets/at book value? What are you talking about now? The earnings and profits of that year?

MR. CRAMPTON: No, these are the assets on the books that I indicated I think that would be realized within a year and the payables within a year.

It is the readily-receivable things that can be converted into cash if you need to and that brings us right to the point of how you value this Xerox stock. We have --

QUESTION: Because you concede that had there been no appreciation in value of the Xerox stock, there could have been no violation of this statute.

MR. CRAMPTON: Under these facts, there would be no liability at all. We agree with that and I think the stipulation was designed to point that up and the real question is, we have also stipulated that after allowance for the capital gains tax and brokerage fees, that the liquid assets of this corporation are practically double the figures that we have stipulated as the corporate needs.

The liquid assets, if you look at fair market value, are \$2 million 2-some in 1965 and over \$3 million in 1966 and here, 76 percent of the voting stock was owned by Ivan Allen, Senior and Ivan Allen, Junior and because of that, the Commissioner of Internal Revenue determined this assessment.

MR. CHIEF JUSTICE BURGER: I think we'll resume there in the morning, Mr. Crampton.

THE CLERK: The Honorable Court is now adjourned until tomorrow morning at 10:00 o'clock.

[Whereupon, at 3:00 o'clock p.m., the Court was adjourned until the following morning at 10:00 o'clock a.m.]