ORIGINAL

In the

Supreme Court of the United States

United States Of America)
Petitioner)
v.)
Foster Lumber Company, Inc.,)
Respondent)

No. 74-799

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v. : No. 74-799

FOSTER LUMBER COMPANY, INC., :

Respondent. :

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Washington, D. C.

Tuesday, October 5, 1976

The above-entitled matter came on for argument at 2:02 o'clock, p.m.

BEFORE:

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

APPEARANCES:

STUART A. SMITH, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D. C., 20550, for the Petitioner.

RUSSELL W. BAKER, ESQ., 15th Floor, 1006 Grand Avenue, 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 next in 74-799, The United States against Foster Lumber Company, Incorporated.

Mr. Smith, you may proceed.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.

FOR THE PETITIONER

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

This is a Federal income tax case which comes here on a writ of certiorari to the United States Court of Appeals for the Eighth Circuit. It involves Section 172 of the Internal Revenue Code of 1954 which permits carrybacks and carryovers of net operating loss deductions.

The question presented is whether Respondent, a corporation, can carry back a $42,000 loss incurred in 1968 as an offset against its 1966 taxable income of $174,000 and thereby reduce its taxable income to $132,000, and after that offset take $35,000 of that $42,000 loss and use it as an offset against its 1967 taxable income.

We submit that from a mathematical and statutory standpoint the answer to this question is plainly no. $42,000 can only be used once to offset the $174,000 of taxable income and no part remains for further use as an offset for 1967.

The facts are fairly straightforward and were stipulated to the District Court and can be summarized as follows.

In 1966, Respondent had taxable income of $174,000. In 1968, it had a loss, a net operating loss, of $42,000. Pursuant to Section 172, Respondent carried back its $42,000 loss to the third year, that is, 1966, and then proceeded to compute its 1966 tax liability as if it, that $42,000 loss, was incurred in that earlier year.

Now, the Code for Corporations prescribes two methods of taxation. One, the so-called regular method under Section 11 of the Code, provides for regular corporate income tax rates. In this case, that regular method yielded a tax liability of $58,000, that is, those are the corporate rates on $132,000 of taxable income, which was the $174,000 minus the $42,000.

Now, under Section 1201(a) of the Code, Respondent was required to compute its tax under the alternative tax computation which corporations can avail themselves of when they have capital gains. It engaged in the prescribed computation which we have set forth in our brief at page 4, under The Alternative Method. It took -- basically, it's a two-step approach -- It took its $173,000, or what we say was $174,000, essentially, subtracted the $42,000 loss, got taxable income of $131,000, or $132,000. And then what it had to do was to subtract out its capital gains. Basically, the Step One operation of the tax yielded zero or a negative number.

It then had to compute the capital gains segment, the Step Two part of the partial tax, the capital gains tax, which was a flat 25% of the $166,000 of what the statute refers to as long-term capital gain over short-term capital loss, but for these purposes we will simply call capital gains, and it got a tax liability of $41,000.

Now, under the Code, Respondent was required to report its tax liability under the lower -- under the method that yielded the lower liability. So it did and it paid tax of $41,000 in 1966.

Now, this suit involves the year 1967. Respondent filed a refund claim and asserted that even though its $42,000 loss had been used to offset its taxable income in its entirety, that somehow it still had $35,000 of this loss which was available to offset income in 1967.

Respondent's claim, essentially, is that a segmented approach is the proper approach, and that is that the $42,000 1968 loss should only be offset against its $7,000 of ordinary income and that yielded $35,000 for use in a subsequent year.

The District Court in Missouri upheld Respondent's claim and the Court of Appeals for the Eighth Circuit affirmed.

In so holding, I think it is significant that the

Eighth Circuit acknowledged that its holding was contrary to the Treasury regulations which were promulgated shortly after the 1954 codification and have existed more or less in the same state ever since.

QUESTION: On the other hand, the Eighth Circuit had a consistent holding in the tax court and elsewhere.

MR. SMITH: That is true, Mr. Justice Blackmun. I was just getting to that.

QUESTION: That's a little more persuasive than Treasury regulations.

MR. SMITH: Well, we think the Treasury regulations are correct and we think the tax court in this case is incorrect, as I will attempt to demonstrate.

At the time of the Eighth Circuit's decision, the First Circuit and the Ninth Circuit had, indeed, rejected the Government's position, but albeit in brief procuream affirmances. In fact, the First Circuit characterized this question an unimportant and seldom occurring, even though I think that subsequent developments have indicated that the issue is important and frequently occurring.

In our petition for certiorari, we told the Court that there are about $34 million of taxes riding on this issue and that frequently occurs because of the operation of the alternative tax and the net operating loss carryback.

I think it is fair to characterize the Court of

Appeals decision as influenced largely by the cumulative weight of two appellate decisions rejecting the Government's position. But thereafter, in fact, within three or four months after the decision in this case, the Fourth Circuit rendered its decision in Mutual Assurance Society v. Commissioner which we submit to the Court is a well reasoned and proper analysis of the statutory problem here. Thereafter, the Sixth Circuit, in Axelrod v. Commissioner, upheld the Commissioner's position in a case involving an individual taxpayer, but its opinion largely criticizes the Tax Court's decision in Chartier Real Estate Company and speaks approvingly of the Fourth Circuit's decision in Mutual Assurance Company.

The resolution of this problem depends upon a careful analysis of the applicable statutory provision which in this case is Section 172(b)(2) of the Internal Revenue Code.

We have set out the pertinent part of this provision at the top of page 18 of our brief. The statute reads:

"The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried."

QUESTION: Isn't the key phrase, in your submission at least, "taxable income," and the technical meaning of that?

MR. SMITH: Indeed, Mr. Justice Stewart. We submit that taxable income is a statutory term of art and that it is defined in Section 63 of the Code which we have set forth at page 36 in our Appendix to our brief on the merits which, again, says that "taxable income means gross income, minus the deductions allowed by this chapter."

Now, in 1966, the Respondent's taxable income was $174,000. Carrying back that loss and determining the excess, if any, of the amount of such loss over the sum of the taxable income for 1966, demonstrates, in our view, that that loss is completely absorbed and that there is no longer any part of it available for use in a subsequent taxable year.

Now, Respondent, basically, does not dispute the definition of taxable income which is set forth very plainly in the Code. But it submits that because it used the alternative tax computation in the earlier year that somehow that requires a different result in this case.

Now, we submit that the statutory language is plain and that this operation of subtracting $42,000 from $174,000, yielding $132,000 in taxable income is dictated by the statute, and that there is no basis for inferring any further modifications from the statutory term "taxable income."

Indeed, if the Court would examine Section 172(d) of the Code, you will find that there are basically a group of modifications that Congress has prescribed from the term "taxable income." But the modification that Respondent seeks to ingraft on the Code is not here. These are detailed statutes and we think, in the first instance, the language has to be employed pretty much in a mechanical sort of way because these are detailed and mechanical statutes designed to provide limited kinds of relief for averaging, so to speak, and alleviating some of the harsh results that might be caused by the annual accounting method which is sort of the bedrock of our tax system.

QUESTION: I understand your position. You think the language is perfectly clear, but it is true, is it not, that the Tax Court takes a different view as to the meaning of the language, particularly the meaning of "taxable income" in the context in which it is used?

MR. SMITH: That is true --

QUESTION: It can't be all that clear, can it, if the agency --

MR. SMITH: Well, as we argue in our brief, we think, and as the Fourth Circuit has set forth at great length in its opinion, we think that the Tax Court's reading of the statute is somewhat forced and unnatural because it would require the insertion of -- bear with me a minute. Looking again at page 24 of our brief which sets forth the statute again, we say here "...the Tax Court's construction views the statute as if it reads--'...the sum of the taxable income [to which such loss may be carried] for each of the prior taxable years to which such loss may be carried.'"

Indeed, the phrase, "to which such loss may be carried," would have to be repeated twice in order to shore up the Tax Court's construction, or as we would submit modification of the statute.

But as the Fourth Circuit pointed out, even if you were to say that loss had to be carried back against taxable income, it still requires some substantial, we think, re-writing of the statute. You would have to say loss carried back against taxable income which, in this case, is still the same \$174,000. But you would have to further say but only to the extent that there was no reduction in tax liability.

We think the fact there was a reduction in tax liability here for 1966, this is a function of Congress' attempt to impose a lesser burden on long-term capital gains. And we think this is basically a statutory tradeoff. Essentially, you either get the alternative tax benefits or you get the operation of the net operating loss carryback.

We think that it is improper for the Tax Court to have concluded that these benefits be pyramided, in effect, cumulated, if you will.

QUESTION: In this case, the benefits are hardly pyramided, are they? Don't you end up, under your formulation--

MR. SMITH: Well, they are, in a sense --

QUESTION: May I finish?

-- taxing this taxpayer on $35,000 that he never earned if you aggragate these three years?

MR. SMITH: We don't think so because I think that, you know --

QUESTION: Don't the mathematics work out that way, precisely?

MR. SMITH: I think that there may be some confusion over tax base and taxable income.

To be sure there is a tax computation on $166,000, but it is at a markedly lesser rate than the corporate rate. It is a flat 25%. This is an enormous benefit. And this produced a taxable -- a tax liability of $41,000. Otherwise, the corporation would have had to pay a $58,000 tax.

In this particular case, although I think it is coincidental, I think it is somewhat graphic that the very -- quote -- lost benefit that the taxpayer complains of, that is, the loss of a $35,00 loss which, in effect, is worth $17,500 is made up, pretty much equally by the difference between $58 and $41 which is also $17,000.

Congress, basically, said you either do it one way or the other. You know, this is basically a statutory tradeup. We don't think that, you know, we agree that there is, you know, the loss of the benefit of this $35,000 loss, but --

QUESTION: Isn't it true that that $17,000 isn't pure coincidence?

MR. SMITH: I think it is, but I think it is a helpful gauge in this case because, essentially, corporations generally pay a tax on 50% of their taxable income. In this particular case, they are paying a tax on $25,000 of a larger base.

We think that, essentially, you can't sort of cumulate these benefits and we think that the statutory language -- the use of the term, "taxable income," signals Congress' clear intent to provide this kind of strict mathematical equation.

I think, if there is evidence in the legislative history here, I think I can enter the Court of Appeals for the Fourth Circuit's exploration of the history of this statute which indicated that this result, the result that the taxpayer seeks in this case, would not have been available under Section 122(d) of the 1939 Code which did not use the phrase "to which the taxable"-- you know that last phrase, "prior tax years to which such loss may be carried. It simply talked about "over net income of the intervening year."

I think the fact that Congress reenacted this statute without any attempt to buttress, you know, the Committee report is totally silent. It said, essentially, prior law is reaffirmed. And prior law, under the old statute, clearly would have rejected the taxpayer's position.

I also think that it is not without coincidence that shortly after the 1954 Code was codified and before the Tax Court decided -- rendered its Chartier decision, that the commentary was uniformly to the effect that there could be situations where a loss would be -- quote -- lost, so to speak, that, essentially, you are either going to get the alternative tax computation or you are going to get the net operating loss carryback.

Then, after Chartier came down, I must confess that I've looked into this question and asked people in the Internal Revenue Service and they received a lot of calls from private tax people also expressing surprise about the Chartier decision. And I know that the history of this litigation is somewhat dogged from the Commissioner's point of view. We have sought to establish a conflict of decisions and we have succeeded, but it's basically because we think that our approach corresponds with the legislative history.

The post-Chartier commentary is pretty much uniformly in our favor, as well. Since the filing our our briefs, a new article has come out, more or less, so to speak, to balance a critical -- the only critical article we have been able to find in the Tax Lawyer which is the publication of the ABA section on taxation, but an article in 29 Tax Lawyer in Fall 1975 issue, entitled, "Net Operating Losses in Capital Gains, a Deceptive Combination." That, again, supports the Commissioner's view that you can't cumulate, and it supports the view of the Fourth Circuit that you can't cumulate the benefits of these provisions.

I think it's also useful, if I may, to sort of try to explore for a moment the underpinnings of this whole net operating loss deduction and to demonstrate, as I think can be done, that the Fourth Circuit's approach here is eminently a sound one. For example, what the net operating loss carry-back deduction is attempting to do is to, in effect, say okay, this $42,000 loss occurred in 1968 but we are going to pretend as if it occurred in 1966, and let's assume that it occurred in 1966.

I think, in this case, it is absolutely plain that what would happen would be that the same $41,000 of tax would be paid by the taxpayer and that there would be no net operating loss carryover. There would be no net operating loss, for that year.

QUESTION: Or to put it a different way, if in 1968 he had the same income picture as he, in fact, had in 1966, there would have been no excess loss. Is that right?

MR. SMITH: Exactly. Exactly.

To the extent that there have been complaints about timing and that our position, more or less, exacerbetes accidents of timing, as Mr. Justice Stewart points out the taxpayer's position also turns on the timing of these things.

I think the fact that --

QUESTION: Are you trying to say that you are glad Mr. Justice Stewart asked that question?

(laughter)

QUESTION: Let me ask you this and let's see if you are glad about this one.

Is it correct that if a taxpayer has a lower tax by use of the alternative method that he must use that method?

MR. SMITH: That is correct.

QUESTION: He has no option?

MR. SMITH: That is statutorily prescribed.

QUESTION: I don't know if you are glad or sorry about that question, but I just --

MR. SMITH: I think in this sphere you can neither be glad nor sorry. There are things that just are. These are legislative pronouncements and we think that the statutory language is such that to demonstrate that this loss is no longer available for use in 1967.

I just want to mention one other point and that is this decision in Weil v. Commissioner which seems to have been covered at length in the briefs, and that is that the Tax Court held, in Weil, that when you use the alternative tax computation you cannot take an ordinary loss and net it against your capital gains segment.

Now, while that is an independent sort of rule, we think that its existence and the fact that it has never been questioned is instructive for the issue here. And that is simply there is a situation where deductions are lost, so to speak. They can't be used, but this is simply a fact that Congress is giving with one hand the benefits of the 25% flat rate and taking something away with the other. That decision was affirmed by the Sixth Circuit and it has never been questioned since.

We think here the same rationale applies. Yes, there is a loss of the benefit of a deduction that might otherwise be available, but we don't think the tax law concerns itself with what might otherwise be available. These are the facts. These are the configurations of income and the statutory network has to be applied in its prescribed manner.

We think when it is applied in its prescribed manner the answer is simply that the Fourth Circuit was right and that the Tax Court, in Chartier Real Estate Company, was wrong.

I don't have anything further to say unless there are questions.

QUESTION: I take it that in figuring the alternative tax, the taxable income still exceeds the amount of the loss carryback?

MR. SMITH: In figuring the alternative tax, the taxable income -- yes. Yes.

QUESTION: I mean, any way you figure it, even though the rate is lower and they are sifting out capital gains, the taxable income to which the 25% rate is applied is still exceeds --

MR. SMITH: Taxable income is a statutory term. And taxable income, we submit, no matter how you view it, how you parce it, in this case, is $132,000. That's what -- the tax base is $166,000, but the taxpayer's taxable income, in this case -- no matter what method is applied -- is $132,000.

QUESTION: So, any way you figure the tax, the taxable income exceeds the amount of the loss carryback?

MR. SMITH: Yes.

I have nothing further. I'd like to save the rest of my time for rebuttal.

QUESTION: I suppose, Mr. Smith, as far as the Government is concerned, the burr on the sadle is Judge Raam's decision in Chartier.

MR. SMITH: That is the burr on the sadle. It is really the only exposition of the problem rejecting our position, and we think that it pretty much relied on -- it stands on two prongs: one, this extrapolation of the statute or, you know, the -- you know, essentially saying that the loss is carried back to taxable income and that taxable income is only that ordinary income segment. We think that is wrong as a statutory matter.

And the other thing that Judge Raam relied on is this rationale which was expressed by the Court in Libson Shops v. Koehler, but as we point out in our reply brief, this is not -- you know, the net operating loss carryback and carry forward provisions are not a fluid system to enable the tax-payer to sort of use a loss to hunt around for a place where it will do some benefit. In fact, the three years back and five years forward is essentially a statutory system designed to say well, at some point, we are going to cut off these benefits and reassert the strictures, however harsh they may be, of the annual accounting system.

We think that to the extent that there is policy here it has to be squared with the detailed rules that Congress prescribed. I refer the Court to its three decisions in Wolford Realty Company, Lewit and Olympic Radio, and Real Motors, where the Court, more or less, said that these things are detailed rules and they have to be prescribed with their detailed verbiage.

Indeed, in Real Motors, their loss carryover was denied, basically, because of timing. While that may sadden a particular taxpayer, we think that's really a question for Congress to address itself and not for the statute to be --

QUESTION: Has the Service endeavored to get the statute clarified?

MR. SMITH: Has the Service endeavored to get the statute clarified? Not that I am aware of, although the statute has been --

QUESTION: Seven years since Chartier --

MR. SMITH: It has been seven years since Chartier and I would tell the Court that the statute has undergone revisions, both in '69 and only yesterday, but they have been revisions of lengthening the carryback year -- and, again, I think that these revisions demonstrate that Congress works on these problems in detail and it has made certain decisions as to how to alter these things and it has never suggested that -- there has never been any suggestion that the -- in the Congress, that the Tax Court decision in Chartier was a correct exposition of the statute.

QUESTION: Has there ever been any suggestion that it was an incorrect one?

MR. SMITH: No. Congress has been silent on the question.

QUESTION: I would think that you would be up to that if you really felt strongly about it.

MR. SMITH: Well, my principal occupation is litigation, but --

QUESTION: But, that's not the principal occupation of the IRS.

MR. SMITH: Not the principal occupation of the Treasury Department, and I am not aware of any legislative effort to solve this problem.

This problem, unfortunately, has to be solved by this Court.

QUESTION: Temporarily.

MR. SMITH: Temporarily, right.

QUESTION: Have any new briefs been filed in this case since --

MR. SMITH: No. In fact, the only new piece of information that I've given the Court today which is not in our brief is that article.

QUESTION: 29 Tax Lawyer.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Baker.

ORAL ARGUMENT OF RUSSELL W. BAKER, ESQ.

FOR THE RESPONDENT

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

The Government's real position, to us, is this: That our net operating loss is to be wasted in our circumstances. That's a different way of putting it than we have been charged with in the argument which was just concluded.

Now, I mean by wasted that it cannot be used to offset income in another year, income which was taxed at 48%.

The Government says, and it made a very clear statement of its case, that the capital gain in 1966 on which we paid tax is deemed to absorb our loss, leaving it unavailable for use in the following year.

The consequence is that on that part of the capital gain which absorbs loss, we pay, effectively, 73% in taxes, 25% capital gains tax and 48% by not being able to use the loss the following year.

Now, today, in 1976, were the problem to arise, the alternative tax now being 30%, the compounded effect desired by the Government would be 30 plus 48, or 78%.

QUESTION: Mr. Baker, the Government argues that precisely the same thing, in essence, would have happened if the loss had occurred in 1966, the same year in which the capital gain had occurred.

What's your response to that argument along the line you are drawing now?

MR. BAKER: Mr. Justice Stevens, that situation is what I often call the same-year situation. It is a situation where the -- a deficit in ordinary income occurs in the same year that one has a large capital gain.

The Weil case which has been much mooted in arguments before this Court, says -- and it said in 1954 and, so far as I know, it has been uniormly followed --

QUESTION: 1956.

MR. BAKER: 1956?

It says that if it occurs in the same year the one does not offset the other, the full capital gain must be taxed under the alternative method and there is no reduction of it by reason of the deficit in ordinary income.

Now, the Tax Court has looked at this and it has found that the directions in the alternative tax statute on this very point are unqualified and it has no choice. This is what the unqualified directions of the statute say and, therefore, there is no reduction in tax there.

I see a further question, perhaps, on your face or in your mind, and that is in such case is there a net operating loss to be carried over to another year?

The answer is there is not because Subsections C and D of the statute tell just exactly how that is to be computed. So that in the same year situation one must agree that the loss disappears. It does a vanishing act.

QUESTION: Why should there be a different rule for a different year situation?

MR. BAKER: Mr. Justice Stevens, the policies that have moved Congress to this are beyond my powers to detail to you. But may I say that since 1918 when the prototype of the net operating loss statute came into our laws, that Congress has, ever since then, provided a different method of calculating the loss in the same year than it has in the carry year. They have put a certain threshold on taxpayers which taxpayers must meet in order to have a net operating loss. But, once they pass that threshold, then Congress has always provided other tests in the carry years to see how much of it would be absorbed.

The policy implications of that I cannot explain.

QUESTION: Doesn't it come down, then, to what we really think the words Congress used mean? Isn't that our task, to just read the language as carefully as we can?

MR. BAKER: Yes. And that is, of course, the task of the Court in this case.

What is the taxable income of each of the prior taxable years to which such loss may be carried?

The Tax Court found that to which such loss may be carried results in a favorable result to the taxpayer here, because it said it modifies taxable income, the taxable income to which it may be carried.

And, in that case -- in our case, since the loss had not been carried against our capital gain, that $35,000 not so carried was available for carryover to another year.

So, of course, it is the interpretation of that sentence of the statute, but, may it please the Court, we would suggest that it is perhaps a little more than an exercise in merely reading a sentence. It, perhaps, requires the Court to examine the consequences of these interpretations, if it finds the statute at all ambiguous, to determine, and the consequences may tell the Court some significant things about the possible intent of Congress.

I should like to follow the Government's argument, in describing the Chartier case, which is the one which started this all off in 1969.

It may be noted that the Government had not, for many years before that, ever taken an administrative position on this point, but it did take a litigating position in Chartier.

Consequently, the Tax Court was the first court that got to speak on the problem. There, as in our case, the taxpayer had a loss which it carried to a year that had ordinary income and capital gain in it. The loss wiped out the ordinary income but then there was some still left, and in his first petition the taxpayer said, "May I take this against the capital gain in computing the alternative tax?" The Tax Court said no. As I was indicating in my answer to Mr. Justice Stevens, there is an unqualified direction in the statute to that effect.

The taxpayer then said, "May I then carry over my loss to the next year and use it to reduce the ordinary income of that year to the extent that there is some?"

The Government objected, but over that objection the Tax Court allowed this, saying that the loss statute permitted this treatment.

Now, the Chartier court is the only court which has had two petitions before it at the same time which was confronted with both these questions. It answered the first one in favor of the Government and the second one for the taxpayer. And it is the second one that the Government today wants overturned by this Court.

QUESTION: The first one was what, the Weil case point?

MR. BAKER: Yes, Your Honor.

One can say it is the Weil case all over again, but one also could say it was the first time that a court said Weil applies in a carry year; but it is, in effect, Mr. Justice Stewart, the Weil doctrine.

We should like the Court to take note of certain irrationalities which we think are introduced by the Government's position.

The Government has to admit, notwithstanding its argument against cumulating benefits, the Government has to admit that in many cases a taxpayer may use his net operating loss fully and also have the favorable rate on the capital gains.

What they claim is that in a few cases where the capital gain comes early in the prescribed eight year period, the absorption without tax benefit may take place. But they have to admit that if the capital gain comes a little later in this prescribed eight-year period, giving enough time for ordinary income to accumulate in the first year or two, the loss will be applied against that ordinary income, favorable rate will be available on capital gains.

So, it is really a matter of accident within the prescribed period, under the Government's position, they would treat the Foster class of taxpayers in a fluctuating fashion. Some would have all of their loss allowed, some part of it, some get none of their loss allowed.

What this means to someone like Respondent Foster Lumber Company is that, according to the Government, Foster Lumber must waste $35,000 of its net operating loss because its capital gain occurred in the first of the possible years. Whereas, its competitors across the street, identical in every way to Foster Lumber Company, can get the net operating loss and get the favorable rate on its taxable gain if only one thing is different, and that is that the loss occurred in the second of the possible -- that the, excuse me -- that the capital gain occurred in the second or later of the possible years.

QUESTION: All that means is that the losses -- you can carry back the loss and deduct it against ordinary income.

MR. BAKER: Yes, Your Honor.

QUESTION: And you think that is irrational?

MR. BAKER: Your Honor, if there is ordinary --

QUESTION: Every taxpayer that has ordinary income can use his loss to offset --

MR. BAKER: Mr. Justice White, that is --

QUESTION: Within the period.

MR. BAKER: That would not be true in this --

QUESTION: So they are not being discriminated against. It is just that people who have -- just can't deduct it from capital gains. Just as the case is in the same year.

MR. BAKER: With respect, Mr. Justice White, I think there are cases where it cannot be deducted and I would suggest this to you: that if in the first year there is only capital gain taxed at the alternative tax rate, and in the next year, then, there is ordinary income, the loss carries back, is absorbed with that tax benefit, and, under the Government's position, cannot be used in the second year.

QUESTION: Because it has been fully absorbed in the first, in the Government's position.

MR. BAKER: Yes, under their position.

QUESTION: Because there is taxable income that has been taxed at capital gains rates.

MR. BAKER: They say that absorbs the loss, and our position is that it doesn't.

QUESTION: Let me see if I have this straight. Your position is that the irrationality of the Government's posture is that for one purpose they take capital gains into account and for the other they do not.

MR. BAKER: That would be one way of putting it, Mr. Justice Blackmun.

QUESTION: This reminds me of a badly drawn will. One could make arguments either way and there is illogic on each side of the case.

MR. BAKER: That certainly is a way of putting it, Mr. Justice Blackmun.

QUESTION: This is precisely the same irrationality as the distinction between the same year and the different year situation. One could give a hypothetical example showing that that's equally illogical, and it does seem awfully illogical, I have to admit.

MR. BAKER: I quite agree, Mr. Justice Stevens, that the same year situation is also illogical, but taxpayers have no argument there, under the Code, because the language is clear.

QUESTION: But if you are arguing policy and what seems arbitrary, and all, you could make precisely as strong an argument.

MR. BAKER: You could, indeed, Mr. Justice Stevens, and it is something that some day, when Congress has time to think about things like that, that perhaps it will take care of.

It might be of assistance, in the point we are making, and if there is any question in the Court's mind about the discrimination between taxpayers of the Foster class, to refer the Court again to the table on page 25 of our brief. This tells what happens to the taxpayers in a way that exposition can hardly do. It gives a general overview of the full nine-year period involved, not with numbers but with a plain statement of what happens to a net operating loss when it encounters a capital gain in any one of the eight carry years. It states the Government position and our position for each year.

An examination of that table will show that the Government's position gives eight different results in the carry years, depending upon the timing of the capital gain. Whereas, our position gives a consistent result in all eight carry years, regardless of the year in which the capital gains falls.

We have included this table for the reason that if this Court discerns that one interpretation of the statute gives a crazy-quilt pattern to taxpayers in this situation and another interpretation gives rise to a rational pattern, we think the Court will no doubt consider those results in selecting between the two interpretations.

QUESTION: Do you think that contributes to the predictability of the thing -- situation?

MR. BAKER: A judgment for us would certainly contribute to the predictability of the situation, yes, Mr. Chief Justice.

QUESTION: And you have a consistent pattern.

MR. BAKER: The Government filed a reply brief just before the hearing last year. We have filed nothing in writing, as was brought out in the question by Mr. Justice Stewart, with the Court since that time.

I should, therefore, like to comment briefly on certain points -- on the points made in that reply brief.

First, the Government there says, as it has said again today, that the statute is clear and that policy and consequences should play little, if any, part.

Now, on this question of whether the Government's reading of the statute is plain and clear, as it insists, we think reference should be made to the period during which it has been litigating the question and the results it has obtained.

Perhaps, I am repeating here, but I think it is worthy of emphasis, that which was brought out on a question by the Court. The Government took its first position in Chartier and lost in 1969.

And, as the Government counsel indicated, it fought for five years in the courts of this country to get a conflicting decision. And for five years, the courts continued to rule, without a dissenting vote, that the language was either in favor of the taxpayer or was at least ambiguous. And they all ruled for the taxpayer.

Not until the Mutual Assurance case was handed down by the Fourth Circuit by a two to one vote, did it obtain the conflicting decision that enabled the case to be brought here.

In view of that history, it's a little hard to accept the Government's assertion that the reading of this statute is that plain and clear.

It seems to us that it is more fair to say that we are in an area of genuine dispute and we can look not only at the Tax Court for a serious opinion, but also at the opinion of the Court below, the Eighth Circuit. And the Eighth Circuit found both readings of the statute to be equally plausible, but it selected the one that favored the taxpayer because it said it was supported by the basic policy considerations underlying Sections 1201 and 172.

We think the Court should realize that during the many years that the Government says this question has been open, the Government never, before Chartier, took a public position on it.

The examples in its regulations carefully avoid the problem. The regulations are in effect in the language of the statute which doesn't advance the inquiry very much. The examples might have helped, but there is no example in the regulation which helps resolve this issue.

The IRS never published a ruling on this point. In other words, it never communicated to Congress or to the public any intimation of a view that losses could be absorbed by taxed capital gains.

Perhaps, this is why Congress has never seen fit to clarify what now is a matter of controversy before this Court.

I should like to reply now to the Government's assertion that the taxpayer would not have prevailed under the provisions of the 1939 Code.

QUESTION: Prior to Chartier, in 1969, I think you said the Government had not undertaken any interpretation of this language in any official way. How was the tax law enforced? Prior to '69, would Foster Lumber Company have been permitted by the practice of the IRS to have carried the loss back as you now propose to do?

MR. BAKER: If I knew the answer to that, Mr. Justice Powell, I would gladly give it to you. I imagine that the practice was variable. I do not think the Government can state with any confidence that the practice was uniformly its way.

For example, prior to 1954, or as you corrected me, perhaps 1956, the date of the Weil decision, it may not have even been clear to taxpayers that they couldn't deduct it from their capital gain. So they may have been taking it there until the Weil decision.

QUESTION: In the same year.

MR. BAKER: In the same year, until that came about. Beyond the Weil decision, I don't know what taxpayers were doing. I think it is normal practice for accountants and tax advisers of corporations to advice their corporations where there is doubt about a matter to take -- to report it favorably to themselves.

The Government did say, with respect to the '39 Code, that had a similar situation arisen under that Code, the taxpayer would have lost, that in 1954 when the Code section was rewritten the addition of the words "to which such loss may be carried" -- they admit they were added at that time, but they say they are of no significance because the Committee reports didn't bring out what the addition of these words was intended to do.

We don't see any basis, as I have indicated in my answer to the last question, we don't see any basis for the Government's assertion that the taxpayer would not have prevailed under the '39 Code. There is no decided case to that effect. There is no ruling to that effect. The same policy factors were acting then as now and there is a case in the amicus brief of the North River Insurance Company, Merrill v. the United States, which shows how the term "net income," the term used instead of "taxable income" in the '39 Code, could have been construed so as to avoid the unnecessary wasting of a loss.

And when the Government asserts that the addition in 1954 of the very words "relied on the Tax Court" are of no significance because the Committee reports didn't say anything about it, we feel that hardly needs a reply. Surely silence in the Committee reports can't properly be used to advance that argument.

We have analyzed the '54 rewrite and we've put the Committee reports side by side with them and we find at least two conspicuous changes made in Section 172, other than this one, which were not commented upon in the Committee reports.

So I don't think the Government should attempt to make too much out of a decision by a Congressional Committee to comment only upon those changes which they deem of general importance to large classes of taxpayers.

But there is one aspect of the Congressional history of the net operating loss provision which we would like to remind the Court of.

During the early New Deal years, there was no net operating loss provision. The Government needed the revenue too badly to have one.

QUESTION: Could I stop you for a minute to be sure I follow this one argument? I am not sure I do.

You say the law -- the result under the 1939 Code is not clear. They say they clearly would have gone for the Government and you say there are no decisions. Do you not rely on the words "to which such loss may be carried" to support your position? And is it not correct that they were not a part of the 1939 statute? Therefore, doesn't it follow that you wouldn't have had an argument under the language of the '39 statute?

MR. BAKER: That is one way of putting it, Your Honor.

In that case, I would have retreated to the arguments of the Merrill case, the case I cited, and argue the policy factors in the construction of the word "net income" as it appeared in the '39 Code.

QUESTION: I see. Thank you.

MR. BAKER: The Revenue Act of 1939 introduced the modern net operating loss provision and it allowed two years in which you could carry your loss. If you couldn't get your loss absorbed in those two years, it was gone forever.

Since then, they have been expanding this period. We think that has significance. There is only one reason why you expand the period for using losses and that's so you can use them, so they won't die and be wasted.

In 1942, they expanded the period to four years. In 1950, they expanded the period to six years. In '54 to seven years. In '58 to eight years. And yesterday, when the President signed the Tax Bill, they had, by the 1976 Law, expanded it to ten years for the carryover of a net operating loss.

We say this record exhibits a great and increasing concern by Congress that net operating losses be used and not wasted.

I would turn now to a point which can strongly affect one's view of the merits of this case.

In our brief, we showed that under the Government's position, Foster would be taxed on $396,000 over the three-year period. Whereas, everyone agrees that the aggregate taxable income for the period is $361,000.

The Government, in its reply brief, says we are wrong about this, that Foster was not taxed on more than $361,000.

The dispute traces to one computation. The alternative tax in 1966 was 25% of the capital gain of $167,000. It is agreed that ordinary income was erased by the loss carry-back, leaving only 25% capital gains tax to be paid.

If you multiply $167,000 by 25%, you get the tax of $41,000 which we paid. So we say that $167,000 of capital gains has been taxed.

The Government reply brief says otherwise. It says computing the tax on $132,000 of taxable income by the alternative method produced the tax of $41,000.

Is that true? It doesn't sound right.

You take 25% of $132,000 and by ordinary arithmetic that yields a tax of in the neighborhood of $33,000. So the $41,000,which we paid, is the 25% tax on $167,000 capital gain, as we argued.

To say that it is a tax on $132,000 is plainly not so. And the Government brief does not show any explanation, metaphysical or otherwise, to account for the inaccuracy.

So, we submit again, as we did in our basic brief, that Foster has been taxed on $167,000 of capital gain in 1966. And if we must waste our loss, as the Government contends, we will be taxed on $396,000 over the three-year period.

In the end, the Government's attempt to force a wasting of loss in our circumstances is based, more than anything else, on its often repeated insistence regarding the meaning of the word "carried" as it appears in the sentence of the statute.

If any court is qualified by close contact with the Internal Revenue Code to pass upon the meaning of the word "carried" that should be the Tax Court. We have mentioned throughout this argument its pioneer decision in the Chartier case in 1969. The Tax Court has adhered to its reading of the word "carried" in subsequent decisions.

As recently as 1974, in the Continental Equity case, it declined the Government's request to reconsider Chartier and said, "We remain convinced of the soundness of Chartier and following in this case."

QUESTION: Was this opinion reviewed by the full Court? Chartier was not, as I recall.

MR. BAKER: I believe -- not to my knowledge, Mr. Justice Blackmun.

QUESTION: But, in any event, they are different judges. They are not all Judge Raam.

MR. BAKER: That is correct, Your Honor.

Only Judge Raam wrote Chartier, and another judge wrote Continental Equity and the other cases which follow it.

May it please the Court, Respondent asks that this Court affirm the judgment of the Eighth Circuit Court of Appeals for the reasons mentioned in our brief and here today.

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

Do you have anything further, Mr. Smith?

You have about two minutes left.

REBUTTAL ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF THE PETITIONER

MR. SMITH: Two final points.

My brother, Mr. Baker, has described at great length this array of decisions rejecting the Government's position. But when stripping all that away, the only decision that attempted in detail to come to grips with our position was the Tax Court's original Chartier decision. The First Circuit affirmed pro curiam. The Ninth Circuit in Olympic Foundry, affirmed pro curiam on the authority of the First Circuit. The Eighth Circuit, in this case, although it rendered a more lenghty opinion, when that opinion is analyzed in depth all it did was follow the other circuits because it was impressed with the cumulative weight of the decisions.

QUESTION: They must have thought it was very simple.

MR. SMITH: Perhaps. Although we would submit that all of these courts were wrong, including the initial decision. Now, as far as the administrative history, pre-Chartier, I inquired of the Internal Revenue Service and they don't have any information about what was being done before, but I submit to the Court that since the regulations, as promulgated in 1954, support the position that we are taking here --

QUESTION: Your opponent says the regulations really just parrot the language of the statute and that there are no examples in point, nothing really clarifying it. Do you disagree with that?

MR. SMITH: Well, I disagree in the sense that I -- I suppose I would say that the language of the statute, in our view, prescribes the very mathematical test that --

QUESTION: Then the regulations don't add anything to the statute?

MR. SMITH: The regulations don't add anything, but I -- they don't add anything other than the statute, but I would submit that the revenue agents, we have no information that they were doing anything but following -- there is no information at all. And, as far as the Internal Revenue Service communicating its view as to the proper interpretation of the statute, it seems to us that the decision in Chartier and the appeal by the Government in the litigation that follows, more than sufficed to communicate to the private tax bar the Government's view that the Tax Court was wrong in Chartier and that those other circuits were wrong as well.

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

(Whereupon, at 3:02 o'clock, p.m., the case in the above-entitled matter was submitted.)