ORIGINAL

In the

Supreme Court of the United States

DON E. WILLIAMS COMPANY,)
)
Petitioner,)
)
v.) No. 75-1312
)
COMMISSIONER OF INTERNAL REVENUE,)
)
Respondent.)

Washington, D.C.
December 8, 1976

Pages 1 thru 50

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Petitioner, :
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v. : No. 75-1312
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COMMISSIONER OF INTERNAL REVENUE, :
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Respondent. :
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- :

Washington, D. C.,

Wednesday, December 8, 1976.

The above-entitled matter came on for argument at 10:08 o'clock, a.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 PAUL STEVENS, Associate Justice

APPEARANCES:

MARVIN L. SCHRAGER, ESQ., 912 Sixteenth Avenue, East Moline, Illinois 61244; on behalf of the Petitioner.

KEITH A. JONES, ESQ., Deputy Solicitor General of the United States, Department of Justice, Washington, D. C. 20530; on behalf of the Respondent.

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C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We'll hear arguments first this morning in Williams Company against the Commissioner of Internal Revenue, No. 1312.

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

ORAL ARGUMENT OF MARVIN L. SCHRAGER, ESQ.,

ON BEHALF OF THE PETITIONER

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

My name is Marvin L. Schrager, and this is Durward J. Long, co-counsel for the Don E. Williams Company.

The Don E. Williams Company is located in Moline, Illinois, and engages in the sale of small tools. The corporation maintains its books on an accrual basis method of accounting, and also has an employees' profit-sharing plan for the benefit of its company employees.

The company has a fiscal year ending April 30th, and, according to the accrual method of accounting, must file its tax return on or before July 15th of each year.

For the years April 30th, 1967, '68 and '69, the board of directors of the corporation, before the end of the year, accrued a liability for the employees' profit-sharing plan. Subsequent to the end of the corporation fiscal year, but prior to the time for the filing of the tax return, the company transferred to the trustees of the profit-sharing plan a secured demand interest-bearing note of the corporation, guaranteed by the president, vice president and treasurer of the company.

It has been stipulated that the value of the collateral and net worth of one of the guarantors exceeded the value of the note, which was the amount of the claimed deduction.

QUESTION: Mr. Schrager, am I correct in my impression, the note actually was paid within ten or eleven months later?

MR. SCHRAGER: Yes, sir.

QUESTION: Was there a -- perhaps you will cover it as you go along; was there a business reason for the deferral of actual payment when it followed so closely upon the issuance of the note?

MR. SCHRAGER: Well, I think the note was paid within approximately, as you say, ten or eleven months, and at that time there were several reasons, one of which was that the company was an expanding company and its capital intents, and needs a lot of inventory, and also they felt that the company was a good place to invest the money and could pay as good a return as they would be getting in investing the stocks or some other investment.

QUESTION: I take it that, on the Commissioner's computations anyway, the deduction was allowed for the year in which payment was made?

MR. SCHRAGER: That is correct.

QUESTION: So that we come down really to which year that you end up getting your deduction?

MR. SCHRAGER: Right. As set forth in our factual situation, you will note that the first year is the largest denial of the deduction, and it becomes correspondingly less, because he allowed the deduction for the cash that was paid the following year.

QUESTION: And did they in fact invest in -- what -- Treasury bills or something? Didn't you indicate one reason was because of better return than other investments?

MR. SCHRAGER: Well, the corporation paid interest to the profit-sharing plan, and they felt, in the years in question, this would be as good a return as they would get by investing elsewhere.

The Commissioner of Internal Revenue Service, upon examination, disallowed the claimed deduction, contending that the transfer of the note in satisfaction of the accrued liability did not constitute payment under Section 404(a) of the Internal Revenue Code.

After the denial, the petitioner filed a case in the Tax Court, and after all of the facts were stipulated to, arguments and briefs submitted, the Tax Court, as it has consistently done, reaffirmed the Commissioner and denied the deduction.

An appeal was then taken to the U. S. Court of Appeals for the Seventh Circuit, and, after arguments, the Court of Appeals held for the Commissioner. But, by doing so, they declined to follow decisions of the Third, Ninth and Tenth Circuits, which had previously held that the transfer of a note by an accrual basis taxpayer did constitute payment under Section 404(a) of the Internal Revenue Code if the transfer was made and the delivery was made within two and a half months after the close of the taxpayer's fiscal year.

This created a split in the Circuits, and we filed a petition for a writ of certiorari, which was granted by this Court; and that's the basic issue.

The issue before the Court is whether or not, as I have stated, the transfer -- the delivery of a note by an accrual basis taxpayer constitutes payment of an accrued liability to a profit-sharing plan, if made within two and a half months after the close of the taxpayer's fiscal year.

QUESTION: Is this an interest-bearing note, did you say?

MR. SCHRAGER: Yes, Your Honor.

QUESTION: It was.

MR. SCHRAGER: It was an interest-bearing note.

QUESTION: At what rate?

MR. SCHRAGER: Different rates that corresponded to the rates that were being charged by banks in our local community. And the rates would differ from the larger money centers; they don't fluctuate quite as much in our area.

In dealing with the issue, I believe that we have to talk about three sections of the Internal Revenue Code.

First, Section 162, which provides for the deduction of ordinary and necessary business expenses, which are paid or incurred by the taxpayer.

We also must deal with Section 267, which refers to deductions which are allowed when paid; and Section 267 deals with related taxpayers.

We also are dealing with Section 404, which deals with contributions to an employee's pension or profit-sharing plan, and which also contains the language that the deduction is allowed when paid.

The reason that we have to take into consideration these three sections is that, were it not for the express establishment of these sections, the deduction would have been allowable under Section 162 of the Internal Revenue Code. We maintain that contributions to an employees' pension or profit-sharing plan are considered as additional employee compensation and would be covered under 162, were it not for Section 404.

Now, prior to the Court of Appeals decision below, twenty years of case law have treated Section 404 and Section 267 and their predecessors, which 23(p) is the predecessor to

Section 404, and Section 24(c) is the predecessor to Section 267.

And case law has treated them synonymously. And we feel that this is important in following the evolution of the point where we are today.

Petitioner maintains that, first, Section 267 was established by Congress, and then Section 404 was established by Congress, to stop tax avoidance and to close a tax loophole that existed under the Internal Revenue Code for the following reason:

Suppose that I am the president and stockholder of a closed corporation; the corporation is on a fiscal-year and on an accrual basis method of accounting. I, as the president, would be on a cash basis. Under Section 162, the corporation could have accrued a liability to me, say I got a salary and a bonus, they could have paid me the salary and accrued the bonus, but never paid it. And therefore they would be entitled to a deduction. I, as a cash-basis taxpayer, not having received the money, would not have to report that on my income tax return until the year that it was paid.

If I never took the money out of the corporation, I would never have to show it. They would just keep it as an accrued liability, but would have taken the deduction.

QUESTION: But isn't this the natural state of affairs in the overlapping of a cash basis and an accrual basis taxpayer?

MR. SCHRAGER: It would --

QUESTION: It isn't peculiar to this pension plan kind of thing, is it?

MR. SCHRAGER: It was, Justice Blackmun, until such time as Section 267 was established, at which time they stated that certain related taxpayers, if you accrued it, it must be paid within two and a half months after the end of the year; and I must take it into income at that time.

If you were an independent creditor of the company or a non-owner employee, they could have accrued the liability, taken the deduction, but you would not have to report it until received. But I, as a related taxpayer -- and that's what we're talking about -- must show it in income within two and a half months after the end of the year, it must be paid within that time.

This was the reason that 267, we feel, was enacted by Congress, to close that tax loophole between related taxpayers.

Subsequently, we feel that Section 404 was also enacted to do the same thing with employee profit-sharing plans. We feel that Congress felt that because of the possible closeness and relationship between the owner and maybe the trustees of the plan, that they felt that something must be paid within two and a half months, that you must transfer, something of value must be transferred and delivered to the trustees of the profit-sharing plan.

QUESTION: The profit-sharing plan is not a taxpayer, though, is it?

MR. SCHRAGER: It is not a taxpayer because of the grace of Congress. However, --

QUESTION: So the reason that you explained was behind the enactment of 267 is it does not exist here?

MR. SCHRAGER: We feel it is, Your Honor, because it's quite conceivable that I, as an owner of a corporation, could have accrued a liability to the employees' profit-sharing plan. But if I never paid it, but took the deduction, when the employees went to retire, there may be nothing in there but just an accrual on the books of the corporation.

And prior to the enactment of ERISA, many corporations, small corporations, the shareholder was the sole trustee of the plan. And I think that there was this type of related taxpayer basis between the owner and the corporation that they were trying to stop potential misdealings, and they wanted something actually delivered to the trustees of the plan. So that an employee, in seeing the plan, could know that something was there.

And also, under the Internal Revenue Code, the corporate -- the trustees of the plan are obligated to file annual reports showing the assets of the plan.

In this area there has been much litigation, and the Commissioner of Internal Revenue Service, starting with Section 267 and following through with Section 404, has always maintained, in the beginning, that "paid" meant paid in cash. You had to liquidate the obligation in cash.

QUESTION: Well, it could be in other tangible property, too, couldn't it?

MR. SCHRAGER: Their wording was "cash" or "cash value".

In 1943, the case of Musselman Hub-Brake Company vs. Commissioner dealt with an accrual basis corporation owing its controlling stockholder a debt for royalties and interest which were accrued at the end of the year, and notes were transferred within two and a half months after the end of each year.

The corporation took a deduction, and the Commissioner disallowed it, stating that notes paid, "notes" did not constitute payment under -- and that was Section 24(c), which was the predecessor to Section 267, in that case.

The Tax Court affirmed, and the Court of Appeals for the Sixth Circuit overturned, and ruled that "paid" included the transfer of a note, the delivery of a note; that a note constituted payment under Section 24(c) for an accrual basis taxpayer.

In that case they talked about the things which I have talked about today, the tax avoidance and the history of why they wanted to establish this section. And they also, in addition, stated that were it not for 24(c) this would have been deductible under 24(a).

In holding for the taxpayer, Musselman Hub-Brake Company, the Court explicitly rejected the Commissioner of Internal Revenue Service's position that accrual basis and cash basis taxpayers were on equal footing under Section 24(c). And this is one of the main themes of our argument, that there is a difference between a cash basis taxpayer and an accrual basis taxpayer. They are not on equal footing, and they are not so treated by the Internal Revenue Code.

In the Musselman case, they rejected the argument, refused to follow the cases of Eckert v. Burnet and Helvering vs. Price, which is the basis for the Commissioner's argument in those cases and also in the case before you today.

Following the Musselman Hub-Brake Company case, the Court, in Anthony P. Miller vs. Commissioner, which is a case following the example that I gave to you before, held that a corporation which transferred notes to its president within two and a half months after the close of the fiscal year of the corporation, constituted payment under Section 24(c) which is the predecessor to Section 267.

They felt that the delivery of the note completed the transaction and relationships between the parties changed as of that time.

They also felt, in that case, that a note was similar to a check, and they again rejected the Eckert and the Price line of cases.

QUESTION: There's some dispute in the briefs, I gather, as to what the Uniform Commercial Code provides in this area.

MR. SCHRAGER: Yes. Well, I don't know if there's exactly a dispute, Your Honor, we maintain --

QUESTION: I guess the Illinois version of the Code provides that a note is equivalent to a check; that is your submission, isn't it?

MR. SCHRAGER: Yes, Your Honor.

QUESTION: But in other States and in the proposed Uniform Commercial Code, it is not; is that correct?

MR. SCHRAGER: Well, I think -- I think that we're dealing here, first of all, we think that the Uniform Commercial Code argument is very miniscule. I think we're dealing here with a matter of federal law and the practice --

QUESTION: Well, I just wondered if you agreed as to what the state of the law was.

MR. SCHRAGER: We maintain that if we're going to get into the Uniform Commercial Code, then the Illinois Code should be the one that's applicable, and they define both checks and negotiable notes as negotiable instruments. And that they both suspend the underlying debt, pro tanto, until the time of payment.

Finally, after the Musselman and the Miller cases, in Revenue Ruling 55-608, the Commissioner acquiesced to the decisions and the line of reasoning in those cases. And they state: Where a solvent taxpayer on the accrual basis issued its notes or other evidence of indebtedness, it constituted a valid deduction.

We feel that at that point in time the Commissioner, in not also acquiescing in the Section 404 line of cases, created an inconsistent position and a conflict which we feel was wrong and untenable. We feel that if it constitutes "paid" under Section 267, to have consistency it should be "paid" under Section 404(a), and a taxpayer should know what he's dealing with in reading the language of the Code.

We do not feel that -- and we also feel that when they acquiesced in that Section, in talking about an accrual basis taxpayer, that they can't argue that accrual basis means one thing under 267, but in Section 404 accrual and cash basis are identical. We don't feel that that's a valid argument.

After the decisions and the acquiescence, we then get into the area of cases dealing specifically with Section 404. The first case to come before the Court of Appeals was really a consolidation of two cases, the Sachs case and the Slaymaker Lock Company case.

In both of these cases, the corporation transferred to the trustees demand notes of the corporation in satisfaction of its accrued liability to its pension trust. The Tax Court, after hearing arguments by both parties, disallowed the deduction and affirmed the Commissioner's ruling.

However, the Court of Appeals reversed the decisions and felt that transfer of the note did constitute payment within the meaning of Section 23(p), the predecessor to Section 404.

They felt --

QUESTION: Do you think, Mr. Schrager, and do you care to comment on the use of the word "paid" only four lines apart: "if contributions are paid by an employer" and then four lines down there is a reference, "or if compensation is paid". Do you think the word "paid" means the same thing in an operative sense in each of those lines?

MR. SCHRAGER: I think you're dealing -- one is paying it in the plan, the other is paying a bonus to --

QUESTION: Paying compensation.

MR. SCHRAGER: Paying compensation.

QUESTION: Yes.

MR. SCHRAGER: I think that, yes, when they're talking about paying compensation to somebody, I think it's clear that if I give an employee a note that they must report it as income, and that's paid.

QUESTION: Well, if that's the case, what difference does it make whether or not you're an accrual or a cash basis taxpayer?

MR. SCHRAGER: As the tax -- the cash basis taxpayer, if you are the payor, you are not allowed a deduction under the Code until you pay in cash.

QUESTION: A check is the same, isn't it?

MR. SCHRAGER: Right.

QUESTION: You told us that a check and a note are the same.

MR. SCHRAGER: We have not dealt with -- and there have been no cases decided, Your Honor, wherein a cash basis taxpayer --

QUESTION: Has delivered a note.

MR. SCHRAGER: -- has delivered a note and taken a claimed deduction in this area of cases.

QUESTION: Well, as I understand your argument, the same argument, basically the same argument could be made in the case of a cash basis taxpayer.

MR. SCHRAGER: Well, maybe it could, we're not making that argument, Your Honor, we're limiting it to --

QUESTION: Because, on the other hand, you do not claim that a mere accrual is sufficient. Do you?

MR. SCHRAGER: A mere accrual of what?

QUESTION: On the books of your client.

MR. SCHRAGER: A mere accrual of the profit-sharing contribution?

QUESTION: Yes.

MR. SCHRAGER: That is correct. We --

QUESTION: You don't claim that?

MR. SCHRAGER: No, we feel that --

QUESTION: And normally that would be sufficient for an accrual basis taxpayer.

MR. SCHRAGER: Under Section 162 deduction, yes, it would.

QUESTION: Than on rule?

MR. SCHRAGER: Right.

QUESTION: But you concede that you must at least have transferred a note?

MR. SCHRAGER: We concede, yes.

QUESTION: And why should that be, if you are an accrual basis taxpayer?

MR. SCHRAGER: Well, we can get into the -- we feel that the word "paid" means delivery of something.

QUESTION: So -- to go back to my original question, couldn't -- isn't this same argument applicable in full force to a cash basis taxpayer?

MR. SCHRAGER: The Courts, in Eckert and Price have held -- of course that was dealing with a bad debt deduction, --

QUESTION: Yes.

MR. SCHRAGER: -- but they held in that case, no; and there has been some -- there have been some cash basis cases, I think mainly in the gift area, where they have held that a cash basis taxpayer -- no, I don't know -- I think some of those are on appeal now; but to date they have never held that it qualified a cash basis taxpayer to give a note, but they have for an accrual basis.

QUESTION: I'm not saying your argument will prevail, but your argument didn't prevail in the Court of Appeals, either. For an accrual basis taxpayer.

MR. SCHRAGER: In three Courts of Appeals, it did, Your Honor. In three Courts of Appeals, it has prevailed. And also w@UE@@IOMhat under their acquiescence in Section 267, the Commissioner has acknowledged the difference between cash and accrual basis taxpayers.

QUESTION: Well, certainly there's a difference, but the basic difference has always been that an accrual basis taxpayer can accrue a liability or accrue -- or, on the other side of the ledger, income on his books, and that that's sufficient.

MR. SCHRAGER: Correct.

QUESTION: With or without payment.

MR. SCHRAGER: Correct.

QUESTION: But here you concede that an accrual of the liability to the fund would not be sufficient to give you a deduction, if I understand your argument.

MR. SCHRAGER: Yes. That is --

QUESTION: That there must be a note, and the reason there must be a note is you concede there must be payment. And you say the note is equivalent to payment, and that would be equally true for a cash basis taxpayer, I should think.

MR. SCHRAGER: Right. Yes.

There is -- there has been some discussion about, in the regulations, talking about the word, or it was in the Congressional Report prior to the time that the final draft of the section came out, talking about the word "actually paid". And the Commissioner has maintained that "actually" means paid in cash.

We contend that if the word "actually" has any significant meaning at all, that it means that you actually delivered something of value.

QUESTION: Well, but your basic argument is that "actually paid" doesn't add anything to the word "paid".

MR. SCHRAGER: Right.

QUESTION: It's like a sign, whether it says "no smoking" or "positively no smoking", it means the same thing.

MR. SCHRAGER: That's correct. If you've paid it, you've paid it. And "actually paid" has really no significance to that.

QUESTION: Mr. Schrager, could I ask a factual question? In your brief, at page 13, you say, "the parties have stipulated that the notes equaled the amount of the claimed deduction."

Now, did you mean to say that the fair market value of the notes equaled the amount of the --

MR. SCHRAGER: Your Honor, that was a misinterpretation. I thought I had corrected that, and that was brought to attention by counsel.

The stipulation was that the value of the collateral and the net worth of one of the guarantors exceeded the value of the notes.

QUESTION: There is no -- nothing in the record to tell us whether or not the fair market value of the notes at the time of their delivery to the trust equaled the amount of the obligation, is there?

MR. SCHRAGER: No. That was an error, Your Honor, in our brief.

QUESTION: Well, I'm not concerned about the error in the brief, I'm concerned about the ultimate fact.

MR. SCHRAGER: Right.

QUESTION: The record -- there really is no support in the record for what I assume to be, must be your ultimate contention, that you paid by property having value at least equal to the obligation?

MR. SCHRAGER: Equal to the obligation, and it was in one of the -- and this has been decided in, I believe it was, one of the, either the Sachs or the Slaymaker case, and in the several cases that follows, they were remanded for a hearing on the value of the notes in those cases. So that is one of the points that has been covered, and one of the arguments that is made by counsel that it places a burden on the Commissioner to have to make valuations.

We contend that the Internal Revenue Service is making valuations every day on corporate stock, on the valuations of gifts. In the Colorado National Bank case they transferred real estate and they found a way to value that.

QUESTION: No, but that's, I suppose, to be opposed to the notion that you could have avoided the whole problem by giving them the cash and then letting them come back and buy a note from you, which would have been payment, and then a reinvestment of the paid funds.

MR. SCHRAGER: Yes.

QUESTION: But you say that's too much trouble.

MR. SCHRAGER: Well, yes, we feel that they're making it tougher and tougher on the small companies to do this, and I think after they -- I don't want to get into philosophy -- but after they enacted ERISA, which was supposed to solve all the problems, while it solved many of them because a lot of the small corporations cancelled their plans. So, instead of benefitting the people, they ended up hurting them again, because they weren't going to -- didn't want all of this --

QUESTION: Well, is it in the stipulation that the value of the security is in excess to the value of the note?

MR. SCHRAGER: I believe that -- yes, that is, and it's also contained in --

QUESTION: And plus interest?

MR. SCHRAGER: Yes. They pay interest.

QUESTION: Well then, what is the value of the note, when it's backed up by security like that?

MR. SCHRAGER: We believe that it's worth the face amount of the claimed deduction, Your Honor.

QUESTION: If you took it to a bank, what would you get for it, in your local community?

MR. SCHRAGER: Oh, 100 percent on the value of this company's notes.

QUESTION: Right that day or --

MR. SCHRAGER: Yes.

QUESTION: -- several days later?

QUESTION: Well, with the security behind it, then?

MR. SCHRAGER: Yes.

Well, even with the balance sheet -- you know, that's not in there; I don't want to get off into things that aren't in the record -- but even on the balance sheet of this company, it would have been --

QUESTION: Well, the note wasn't payable on demand, was it?

MR. SCHRAGER: Yes, it was.

QUESTION: Oh, I misunderstood. I thought it was payable at a later date.

MR. SCHRAGER: It was paid at a future date, Justice Stevens, but it was a demand note.

QUESTION: It was a demand interest-bearing note, --

MR. SCHRAGER: Secured --

QUESTION: -- at the going rate of interest.

MR. SCHRAGER: Yes.

QUESTION: But the trustees, the holders of the note who could make the demand, make the decision to demand, were --

MR. SCHRAGER: Three officers of the company, plus a bank. There was an independent trustee.

QUESTION: But only one?

MR. SCHRAGER: Only one, yes.

QUESTION: If it came down to that, the three trustees could outvote the fourth trustee, could they not, on the question of a demand?

MR. SCHRAGER: Theoretically, yes, they could.

QUESTION: Well, theoretically?

QUESTION: Fact.

MR. SCHRAGER: Right, it's factual. They could.

QUESTION: Three always can outvote one.

MR. SCHRAGER: Yes.

The other cases that supported the petitioner's position were the Wasatch Chemical Company case, another case involving a profit-sharing plan in which notes were transferred to the trustees, and the Court of Appeals felt that "paid" or "payment" does not necessarily mean in cash. Payment was made when the note was delivered. There was a significant change in legal relationships between the parties. And their real question and issue in that case was: What was the value of the note transferred? Was it equal to the amount of the claimed deduction?

They felt that that was the real issue.

And for twenty years before this case was decided, that was the state of the law, and we felt that it was rightly so, and even Justice Quealy, in his dissenting opinion, felt that taxpayers had a right to rely on twenty years of established law.

My time is running out, I'd like to just briefly talk about the -- which I've touched on -- ERISA, and since the enactment of ERISA, and as we stated in our brief, the case doesn't have any perspective meaning because it is now a prohibited transaction. But it does have meaning to this taxpayer and it also has meaning to settle the conflict between the Circuits as it now stands.

We feel --

QUESTION: Mr. Schrager, before you sit down, could I follow up on one of my earlier questions? These notes were actually paid in about ten or eleven months.

MR. SCHRAGER: Yes.

QUESTION: And why were they paid then? Why wasn't payment deferred for ten years, if the pension fund, or if the fund was better off -- interest payments than by investing them?

MR. SCHRAGER: The company had the cash and paid it in at that time, Your Honor.

QUESTION: Well, it had the cash at the time it delivered the notes, didn't it?

MR. SCHRAGER: Yes. I don't know exactly --

QUESTION: But interest went down.

MR. SCHRAGER: Pardon?

QUESTION: Maybe the cost of money went down.

QUESTION: Not at that time.

MR. SCHRAGER: That was in 1967. I don't know the reason, then, Your Honor.

QUESTION: The record doesn't show that.

QUESTION: Anyway, it was the company that elected to pay?

MR. SCHRAGER: Yes.

QUESTION: Mr. Schrager, let me just follow up on my misapprehension of the facts before. Am I correct in believing your argument would be the same if the note were not payable on demand, but had a value at least equal to the amount of the obligation?

MR. SCHRAGER: Yes, there -- I believe one of the cases, I think it was the Wasatch case, had time notes, Your Honor. And the same line of reasoning followed in the decision. They didn't care, in that case, exactly when it was paid, as long as it had value.

Thank you.

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

Mr. Jones.

ORAL ARGUMENT OF KEITH A. JONES, ESQ.,

ON BEHALF OF THE RESPONDENT

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

As Mr. Schrager has indicated, the issue in this case is whether an accrual basis taxpayer, who delivers its promissory note to an employees' profit-sharing trust, is entitled to a deduction under Section 404 of the Internal Revenue Code. That statutory provision allows for a deduction for contributions to such trusts in the year in which such contributions are paid. Thus, the narrow issue in this case is whether the delivery of the note constitutes payment.

Consideration of this issue is assisted by two limiting propositions, on which there can be little basis for disagreement.

The first of these is the normal accrual basis rules do not apply in determining whether there has been a payment under Section 404.

And the second is that under the cash basis method of accounting, the delivery of a promissory note does not constitute payment.

These two propositions, taken together, do not completely dispose of this case, but they do considerably narrow the range of permissible debate. I will therefore briefly explain why these propositions are sound, and then turn to a discussion of the area of disagreement that remains.

The first proposition, as I have indicated, is that normal accrual basis rules do not apply in determining whether a contribution has been paid for purposes of Section 404. The statute provides, and I quote, "a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is not made" -- excuse me -- "is made not later than the time prescribed by law for filing the return for such year."

QUESTION: Where do we find the statute in these papers, in your brief?

MR. JONES: In the Appendix to our brief, Mr. Justice Stewart.

QUESTION: Appendix to your brief; thank you.

MR. JONES: Page 33 of our brief.

If accrual basis rules had applied, the deduction would always have been available for the year of accrual. No provision, such as the one I have just quoted, would have been necessary.

But Congress understood that such a provision was necessary to permit an accrual basis taxpayer to take a deduction for the year of accrual if payment was not in fact made during that year.

And the provision applies, it should be noted, only with respect to payments made shortly after the end of the year, in a two and a half month grace period.

Thus, it's plain that Congress understood and intended that the normal accrual basis rules do not apply.

The second proposition is that the issuance and delivery of a promissory note by a cash basis taxpayer would not constitute payment. This Court so held in Eckert v. Burnet, and Helvering v. Price, and the lower federal courts have uniformly followed those decisions.

The rationale of Eckert and Price is straightforward. A cash basis method of accounting focuses upon movements, inflows and outflows of cash or its equivalent. And the giving of a promissory note or an I.O.U. does not affect an outflow of property, an outflow of cash or its equivalent.

QUESTION: How do you square that with the wellsettled and certainly well-understood proposition that the drawing of a check for a deductible purpose is a deduction at the moment the check is delivered or mailed?

MR. JONES: Well, I think that --

QUESTION: One is a sight draft and the other is a note, each depends upon the --

MR. JONES: Yes. Basically, Eckert and Price --

QUESTION: There can be bad checks just as there can be bad notes.

MR. JONES: That's true, Mr. Justice Stewart.

Basically, Eckert and Price rejected the argument that checks are to be treated -- that notes are to be treated as equivalents to checks. The reasoning, it seems to me, is that as a practical accommodation to the everyday business realities of -- everyday realities of business life, the payment of a check is considered to be equivalent to the payment of cash. And it has long been for tax purposes.

QUESTION: Well, I know it is, but that is to beg the question.

MR. JONES: Well, it's --

QUESTION: It's a sight draft is what it is.

MR. JONES: That's my first step, Mr. Justice Stewart. It's -- a check is an order to a payment -- excuse me -- an order to a bank to make immediate payment --

QUESTION: To pay to the order of the endorser of the --

MR. JONES: That's right. It's an order directing a bank to make immediate payment.

A note is not like that at all. When a maker issues a note, the maker himself, or itself, still has something left to do before the basic obligation is going to be satisfied. The maker himself must pay the note.

QUESTION: Mr. JOnes, I thought the truth of the matter with the check is that the bank is ordered to pay the money if there's anything in there, in that account.

MR. JONES: Well, that's true, Mr. Justice Marshall, and if there's no bank -- excuse me -- if there's no money in the bank account, and the check bounces, then of course the check does not constitute payment.

There's a common-law doctrine known as constructive payment in relation back, or conditional payment in relation back, under which the check is taken as payment. But the note is not a direct payment, a note is just a mere promise that the maker himself, not the bank, is going to make payment in the future.

And they have always been treated by this Court and the lower courts as different for cash basis taxpayers.

QUESTION: But sometimes it's not all that easy to make the distinction.

MR. JONES: Well, it's really --

QUESTION: One is an order to a drawee, and a note is much more personal and direct.

MR. JONES: That's correct, Mr. Stewart, it's really a practical distinction.

QUESTION: That's what it is.

MR. JONES: A note -- I mean a check is the conventional mode of effecting payment; a note is not. And the courts have drawn the distinction really on a practical rather than on a theoretical basis.

QUESTION: But a note is a promise to pay in the future; the check is a direction to pay on presentation.

MR. JONES: That's correct, Mr. Chief Justice.

QUESTION: But if you have a demand note, it's a promise to pay right now.

MR. JONES: A promise that the maker will pay, not a direction to the bank to pay. The maker still has to pay it by check. In fact, in this case, the maker paid the note by check, which indicates that there is a difference, a very real practical difference between the two transactions.

QUESTION: On which side of the line would a 30-day draft on a bank fall?

MR. JONES: Well, I would think that -- let me make sure I understand you. Is a 30-day draft a draft that's payable within 30 days or at the expiration of 30 days?

QUESTION: No, at the expiration of 30 days.

QUESTION: Any time after the expiration.

MR. JONES: I would think that that would only be payment at the time of the expiration of the 30-day period.

QUESTION: Because if it came after the taxable year, it would be out -- it would be in the same category as this note, in your view?

MR. JONES: Well, you're asking me about a hypothetical that I really haven't devoted much thought to; but I think that's the answer that I would give.

QUESTION: If it were a payment to a pension fund.

MR. JONES: That's true. Or if it were a payment by a cash basis taxpayer.

QUESTION: Yes.

MR. JONES: And really I was, at this point, advancing the proposition that the delivery of a note is not payment by a cash basis taxpayer under any circumstances, whether it's to the pension trust or to any other creditor.

QUESTION: And that's the Eckert holding.

MR. JONES: Eckert and Price, Helvering v. Price.

Petitioner has argued this similarity between checks and notes, and also in its brief it's argued that delivery of a note should be treated as equivalent to the payment of cash, followed by a receipt of the cash back in exchange for the note.

And it seems to us that Eckert and Price foreclose this argument as well. In those cases, this Court treated the delivery of a note as the delivery of a note and not as the end result of some series of hypothetical transactions that never took place.

QUESTION: Of course, the statute doesn't say that payors will be treated as cash basis taxpayers.

MR. JONES: That's correct, Mr. Justice Brennan. It's something else --

QUESTION: Well, I gather that's anticipating the rest of your argument.

MR. JONES: That's right. I said at the outset that I'm really advancing two limiting propositions.

QUESTION: Right.

MR. JONES: Well, as Mr. Justice Blackmun recently observed on behalf of the Court in the National Alfalfa case, and I quote, "While a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not." Had they not enjoyed the benefit of some other route he might have chosen to follow, but did not.

And because of the multiplicity and the imperfection of possible analogies between different transactions, the Courts have long followed the doctrine stated by Mr. Justice Blackmun, that a taxpayer must accept the adverse tax consequences of the form in which he casts his transaction. And that the courts will not recast that transaction to mitigate the tax liability that he has incurred.

And the transaction here was the mere giving of a note, not the payment of cash followed by a loan, and it should be treated as what it was and not as what it was not.

QUESTION: What effect did the guarantors on the note have, did it make any difference?

MR. JONES: I think that the fact that the net worth of the guarantors exceeded the face value of the note provided adequate security. Under Section 503 of the Code, if the note had not been adequately secured, it might have been a prohibited transaction that would have resulted in the loss of taxes. I think that's the only effect, from our point of view.

QUESTION: What was the security for this note?

MR. JONES: There were three forms of security. One was --

QUESTION: The guarantors.

MR. JONES: -- stock in the bank -- I mean stock in the company.

QUESTION: Right.

MR. JONES: One was the interest of certain of the officers in their share in the pension trust. But the third security, which we think is most relevant, was the personal liability of the wife of Mr. Williams -- the personal liability of Mrs. Williams and her net worth apparently was about four times that of the value of the note.

QUESTION: Let's assume that the stock of this company was listed, so that you had the market value readily ascertainable, and that instead of giving a promissory note, the taxpayer had discharged its indebtedness, as it viewed it, by delivering the appropriate number of shares of its own stock from its treasury. Just an outright transfer. Would that have been payment?

MR. JONES: Well, I think it would be payment, Mr. Justice Powell. The reason I briefly hesitate --

QUESTION: You say you think it would or would not?

MR. JONES: I think it would constitute payment if it were shares of a publicly traded corporation. The reason I hesitate --

QUESTION: The statute or the regulations specifically refer to property, don't they, somewhere?

MR. JONES: Well, the actual payment of property, I think that's right. As I say, the reason I hesitate is that if the corporation had given a note that was secured by stock in the corporation, I think the Commissioner would take the position that that does not constitute adequate security, because if the corporation goes bankrupt, the stock is not sufficient security. But if he actually --

QUESTION: Well, let's say the stock was in AT&T.

MR. JONES: Well, as long as the pension trust has to look to the assets of the company, if the company goes bankrupt, the stock is not going to be very helpful, because it is subordinate even to the unsecured liability of a creditor.

However, if the taxpayer corporation actually transfers the stock to the pension trust, then, it seems to me, that that is property.

QUESTION: Well, Mr. Jones, I didn't -- you mean your argument in the Court here really does depend on what the value of the note is? I thought your argument was wholly independent of whether -- that even -- you make the argument that even if the note was concededly worth more than the amount of the contribution. Right or not?

MR. JONES: Yes, that's right. From our point of view, the market value of the note is irrelevant to the question here.

QUESTION: So it wouldn't make much difference what the security was.

MR. JONES: Well, the difference is that -- the actual issuance of the stock does decrease the holdings of the --

QUESTION: Okay. Well, I wasn't talking about issuance of the stock.

MR. JONES: I'm sorry. Perhaps I misunderstood.

QUESTION: But even if the stock was secured by -- two to one by government bonds, you would say --

MR. JONES: You mean the note? Even if the note were securd.

QUESTION: I mean the note, yes.

MR. JONES: That's correct. Security is irrelevant to the determination of whether there's a deductible contribution.

QUESTION: And even though, if it were stipulated, that you could go to the bank and get 100 percent on the note?

MR. JONES: That's correct. Especially in circumstances such as we have here.

QUESTION: Because until it's paid, the company still has the use of the money.

MR. JONES: That's right.

QUESTION: Still has the asset in it.

MR. JONES: It hasn't given up anything of its own, other than a promise to give up something in the future.

QUESTION: But instead of transferring AT&T stock, an asset of the corporation, as security for the note to the pension plan, the stock itself were paid over in the amount of the obligation to the pension fund, then there would be a payment.

MR. JONES: I think that would be payment, yes, Mr. Justice Brennan.

QUESTION: So that this whole thing turns on the fact that it's a note, that is the primary --

MR. JONES: That's correct. Well, so far as I know there has never been an issuance of stock that's been litigated, but it --

QUESTION: But doesn't the -- I can't find it -- but doesn't the statute or the regulation specifically refer to money or property?

I thought I remembered that from reading these briefs, but I can't find it now.

MR. JONES: I think the regulation does.

QUESTION: You're not saying that payment has to be made in cash, are you?

MR. JONES: No, cash or its equivalent in property.

QUESTION: It could be paid in real estate, couldn't it?

MR. JONES: That's correct, there's no question about it, and it was so held in the Colorado case that's cited in our brief.

Well, --

QUESTION: It could have been paid in the note of someone else, couldn't it?

QUESTION: Yes.

MR. JONES: Yes, that's true. If it were someone else's note, that would constitute payment. We're just focusing here on the question of the taxpayer's note, which we say does not give up anything, any property of the taxpayer as of yet.

QUESTION: But here we have, with that note, collateral that could have been seized the day the note was dishonored, presumably under the terms of the note, that exceeded --

MR. JONES: That's correct, although that --

QUESTION: -- the face value of the note.

MR. JONES: -- collateral would not have come out of the taxpayer. There's no reason to give the taxpayer a deduction for payment of collateral out of some third party's hands.

QUESTION: Well, the taxpayer would owe the people who gave it --

MR. JONES: Well, we're hypothesizing a situation in which the taxpayer is bankrupt, I suppose; because otherwise the requirement of collateral would probably -- I mean the collateral would probably never have to be reached.

QUESTION: Mr. Jones, do you rely at all on the facts that the principal beneficiaries and the trustees of the trust were the same, basically the same people as the obligor on the note?

MR. JONES: Yes, we do think that's important, Mr. Justice Stevens. And I think if I can develop our affirmative arguments under Section 404, the relevance of that will become clearer.

Well, to summarize my argument up to this point, we think petitioner finds itself between Scylla and Charybdis; that is, the accrual basis method of accounting is not available under Section 404, but under the cash basis method of accounting, petitioner is not entitled to the deductions it claims.

Now, petitioner, perforce, must argue, as it has, that Congress intended to permit accrual basis taxpayers to utilize a hybrid or intermediate method of accounting for purposes of Section 404. Our position, to the contrary, is that Congress intended to place all taxpayers on the same footing, for purposes of this provision, and that cash basis rules govern.

We rely upon the legislative history, the language of the statute, the statute's overriding purpose, and considerations of administerability.

QUESTION: And what? Considerations of what?

MR. JONES: Administerability.

Now, the legislative history and the statutory language admittedly are not conclusive. But they are, we submit, highly suggestive.

A witness before the Senate Finance Committee testified, apparently without contradiction, that, and I quote, "the law has been drafted in such a way that all corporations are put on a cash basis on the payment to trusts", end quote.

The Senate and House Committee Reports refer to a requirement of actual payment, which is a cash basis concept. The statute itself refers to the requirement of a payment.

Now, the construction of this term "payment", which at least alludes to cash basis rules, must be informed by an inquiry into the underlying legislative objective.

In enacting Section 404, -- I think this point is crucial -- Congress was not principally concerned with providing a precise measure of the taxpayer's economic net income. Section 404 predominantly reflects non-tax concerns related to the general social welfare. Congress understood that millions of workers depend on their employer's pension plans for a large portion of their retirement income. And we submit that Congress sought to insure the financial viability of those plans by encouraging employers to make their contributions in cash or its equivalent. And that it did so --

QUESTION: Well, there's a 1974 law that takes care of those concerns, isn't there?

MR. JONES: That's true as to the future, Mr. Justice Stewart. We have about 116 cases pending for the past, and we're talking about what interpretation should properly be given such a statute, in prior cases.

QUESTION: In other words, when Congress wanted to deal with and meet those concerns, it directly did so, --

MR. JONES: Well, it has now done so --

QUESTION: -- it did it through the Internal Revenue Code.

MR. JONES: It has now done so more fully. But ERISA does constitute an amendment to the Internal Revenue code.

QUESTION: I see.

QUESTION: Mr. Jones, is there any other Court of Appeals opinion in the pipeline now that favors the government on this issue?

MR. JONES: To my knowledge, this case has not been decided in a Court of Appeals since the Williams case.

But there are a lot of cases pending, either in the Tax Court or in an administrative stage. But, so far as I know, there has been no subsequent Court of Appeals action.

QUESTION: Well, the Tax Court is always kind of hopeless for the taxpayer, isn't it?

MR. JONES: Yes, but, nevertheless, this taxpayer and many others have continued to go there. There is an advantage, as you know.

In other words, we believe that Congress' purpose in requiring a payment was to insure that the employees' trust would secure the full advantage of any contribution for which a tax benefit in the form of a deduction was made available to the employer.

Now, petitioner argues, and I take it that this is part of the essence of his argument, that that purpose is sufficiently served by the delivery to the trust of a note having value.

But that argument, and this is responsive, Mr. Justice Stevens, to your question, that argument, it seems to us, overlooks the fact that the trust and the employer are ordinarily not dealing at arm's length in situations such as this. Often, as is true here, a majority of the trustees are also officers of the corporation, and there can be no assurance that such trustees will treat the note in its hands as salable property. It's far more likely, we submit, that they will, as the trustees here did, hold the note until the corporation itself is willing and able to make payment.

But this cause of action jeopardizes the interests of the affected employees that Congress sought to protect.

QUESTION: But surely your argument today doesn't -- isn't limited to cases in which it may depend upon the identify of the trustees, does it?

MR. JONES: No. That's correct, Mr. Justice Stewart. But, as a practical matter, it's frequently true that the trust, which, after all, is established by the corporation, will have trustees that are also officers of the corporation. Indeed, it would be surprising if that were not the case.

QUESTION: Your position would be precisely the same if these were complete strangers?

QUESTION: Yes.

MR. JONES: As to Section 404, that's true, Mr. Justice Blackmun. We think they would -- the term "payment" would have to have the same meaning in all the situations in which it was applied under Section 404.

QUESTION: What if the company had delivered, instead of a note, one of its corporate bonds?

MR. JONES: That's a difficult question, Mr. Justice Stewart.

QUESTION: I know it is.

MR. JONES: And I'm not sure that I can speak for the Commissioner. So far as I know, there's no ruling directly on point.

I think that we would take the position that the bond is more properly analogous to a note than it is to the corporate stock, and that it would not be treated as payment for purposes of Section 404.

QUESTION: Well, this is a bond that's publicly traded.

MR. JONES: Well, to avoid problems of administerability, Mr. Justice Stewart, I think that the Commissioner would probably seek to avoid a case-by-case determination of whether a particular bond was more like a note or more like a share of stock. But, as I say, I can't --

QUESTION: Well, we know it's more like a note, it's indebtedness, it's not equity.

MR. JONES: Well, I mean like a note for purposes of this provision.

But it seems to me that analytically it would be appropriate to treat the bond as a note. But, as I say, I cannot speak for the Commissioner because I am unaware of any rulings to that effect, and I'm not sure what position he would take.

QUESTION: On that same analysis, in light of some of your prior responses, the bond of a third party could constitute the transfer of property.

MR. JONES: Oh, there's no question about that, Mr. Chief Justice. When a taxpayer holds the bond of a third party, that's property in his hands; and when he gives it over to the trust, he's actually giving up property.

We think that Congress' purpose in this provision can be fully served only by requiring an actual outlay or transfer of cash or property from the employer to the trust. But when the employer holds the property in the form of a note of a third person, and transfers it over, that would be sufficient, in our view.

QUESTION: Well, Mr. Jones, you keep arguing about the investment, the fund holding the money; what about them holding the check for a year without cashing it?

That would be all right?

MR. JONES: Well, again, Mr. Justice Marshall, the only reason the check is treated as equivalent as cash, are practical reasons. Theoretically, I mean if you only adhered to theory, you would treat a check not as cash but like a note. But as a practical matter, to accommodate what actually goes on in the marketplace, the Commissioner does what the taxpayers do, which is to treat a check as cash until it's proved otherwise.

Well, finally, I want to --

QUESTION: Does the new law, the '74 law, make it illegal -- I know it makes it illegal to purport to make payment by the note of the employer; how about the -- does it make it illegal to make payment in anything other than cash, or what does it do?

MR. JONES: To my knowledge, it does not. I think that the only prohibited transaction with which we're concerned here is the loan of money, or its equivalent, from the trust back to the employer. And the new law treats the payment of a note, or the delivery of a note in the first place, as the equivalent to a loan.

QUESTION: To the borrowing of money.

MR. JONES: That's right.

QUESTION: By the employer.

MR. JONES: As far as I know, nothing would prohibit the transfer of a piece of real estate.

QUESTION: So that wouldn't cover the bond, would it? Or would it?

MR. JONES: Well, I think it would.

QUESTION: It would be the purchaser of a --

MR. JONES: Because the purpose is to --

QUESTION: -- of a bond would be a lender to the company, I guess.

MR. JONES: The purpose of the statute is to protect the financial viability of the trust, and that purpose is best served by making its investments independent of the employer. So if the employer suffers financial bad weather, the trust will, nevertheless, --

QUESTION: It won't affect it.

MR. JONES: That's right.

QUESTION: Yes.

MR. JONES: All these considerations, we submit, point toward the uniform application of cash basis rules under Section 404.

The cash basis method of accounting affords a fair objective, easily administerable, set of rules that further the underlying statutory purposes.

It was therefore reasonable for the Commissioner to construe the statute as requiring actual payment in cash or its equivalent.

We submit that this long-standing interpretation by the agency charged with the administration of the statute should be sustained.

Now, petitioner's argument for a different treatment, for special treatment for accrual basis taxpayers rests almost exclusively upon an analogy to Section 267, a section which we believe is not relevant here.

Broadly speaking, that provision deals with transactions between related taxpayers. And the most familiar example may be the wage expense incurred by an accrual basis corporation in hiring one of its cash basis shareholders. And Section 267 provides that the corporation is entitled to a deduction on account of the wages only if they are paid.

Now, early in the history of the predecessor of this provision, the lower federal courts, in these circumstances, held that the delivery of a note to the shareholder constituted payment, because the note was income to the cash basis shareholder.

And in 1953, Congress amended the statute to insure that the deduction would be available only if the income was in fact realized by the cash basis recipient. And after that amendment, the Commissioner acquiesced in the earlier decisions, but in doing so explicitly distinguished between Section 267 and Section 404.

Now, this history does not support the petitioner's construction of Section 404. The meaning of the term "paid" in Section 267 turns on the specific purpose of creating symmetry in the treatment of related taxpayers, and that is the result that has been achieved.

QUESTION: Do you think the symmetry isn't there because the plan is exempt?

MR. JONES: That's true, Mr. Justice Blackmun.

Now, the petitioner, in its reply brief, says, well, Section 267 and 404 really are similar, because sub-section (b)(9) of 267 applies to certain charitable organizations.

But the history, or the purpose of Section 267(b)(9), as its legislative history plainly shows, is to prevent the deduction of losses on the sale of property to a charitable organization controlled by the seller. And the rationale of that provision is that since the seller attains effective control of the property, he should not be entitled to the benefit of a loss deduction.

But that consideration lends nothing, sheds no light on the meaning of the term "paid" in either Section 267 or 404.

My final point is that the proper analogy here is not to Section 267 but to Section 170, which allows, in language virtually identical to that of Section 404, a deduction for contributions paid to charitable organizations.

The term "paid" is used in Section 170 as it is in Section 404 to insure that the tax-exempt recipient of the contribution will attain a substantial present benefit, not just the promise of a future benefit,as a result of the transaction giving rise to the tax deduction.

And for that reason Section 170 has always been interpreted as requiring more than the giving of a promissory note.

And the same result, for the same reason, is appropriate here.

Congress intended that the taxpayer should part with something more than its bare promise to part with something in the future, for obtaining the benefit of a deduction.

But Petitioner gave only its promise, not its property.

The judgment of the Court of Appeals denying the deduction should therefore be affirmed.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 11:09 o'clock, a.m., the case in the above-entitled matter was submitted.]

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