In the

Supreme Court of the United States

ARTHUR FULMAN, et al., Trustees,

Petitioners,

vs

UNITED STATES OF AMERICA,

Respondent.

No. 76-1137

Washington, D. C.
November 29, 1977

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v.	:	No. 76-1137
UNITED STATES OF AMERICA, Respondent.	:	

Washington, D.C.
Tuesday, November 29, 1977

The above-entitled matter came on for argument at 11:36 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
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

DANIEL D. LEVENSON, Esq., One State Street, Boston, Massachusetts 02109; for the Petitioners.

MICHAEL L. PAUP, Attorney, Department of Justice, Washington, D.C. 20530; for the Respondent.

C O N T E N T S

* * *

Afternoon session begins on page 20

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in 1137, Fulman against the United States.

Mr. Levenson, you may proceed when you are ready.

ORAL ARGUMENT OF DANIEL D. LEVENSON, ESQ.,

ON BEHALF OF THE PETITIONERS

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

This case focuses on a section of the Internal Revenue Code dealing with personal holding companies and corporations which unnecessarily accumulate income. These special provisions have been placed in the Code to deal with the shareholders of those companies who wish to accumulate income in a corporation. Such accumulation would thereby shield the corporate profits from the second tax at the high tax rates imposed upon the recipients of dividends.

Until 1921, Congress dealt with these shareholders directly by taxing them on their pro rata share of corporate earnings, regardless of whether or not those earnings were distributed to them. However, after this Court's decision in 1921 in the case of Eisner v. Macomber, doubts arose as to the constitutionality of such a direct taxing scheme. Therefore, Congress provided an alternative method. It allowed the shareholders to determine if they wished to account for the corporate profits in their incomes directly, whether or not

distributed; but failing that, Congress created an incentive to encourage corporations which had been determined to be unnecessarily accumulating their income to actually make distributions of the unneeded income to their shareholders, which would then be taxed at the individual rate.

Congress did this by imposing what it thought to be a virtually confiscatory tax on the undistributed income of these corporations and then by providing a deduction for dividends distributed to shareholders which directly reduces the income subject to the additional tax. It is this dividends-paid deduction which is at issue in this case.

Specifically the question involves the determination of the amount of the deduction when a corporation distributes a dividend consisting of property rather than cash. The government maintains that the fair market value of the property at the date of distribution should be totally disregarded even though the shareholder who receives the property is taxed in full on that value. The government has done this by promulgating Treasury Regulation 1.562-1(a), the regulation involved in this case, which regulation states that when property is distributed by a corporation, the dividends-paid deduction shall equal the property's adjusted basis, not its fair market value.

We maintain that this regulation, as it pertains to this case, is inconsistent with the Internal Revenue Code, is

arbitrary, totally without statutory or legislative support, and leads to irrational results. For those reasons we submit that the regulation should be declared to be invalid.

Q Do you know when this regulation was promulgated, Mr. Levenson?

MR. LEVENSON: In 1958, the final regulation year.

The basic thrust of both the personal holding company and accumulated earnings taxes has always been the same, to force distributions from the business to be taxed again in the hands of the shareholders.

Q But this rule has always been the same too, has it not?

MR. LEVENSON: No, it has not, Your Honor.

Q I thought the rule before the '54 Code was the same.

MR. LEVENSON: The rule prior to the 1954 Code was to allow a deduction for the lesser of the adjusted basis or the fair market value of the property distributed.

Q So, it would work the same in this case?

MR. LEVENSON: In this particular case the regulation--

Q The rule was the same before the '54 Code as it is now.

MR. LEVENSON: Yes, but not in general.

Q Pre-'54, you had to take the worst, the worst of

the two deals, the taxpayer. Post-'54, according to the government, you take the adjusted basis whether it is higher or lower than the fair market value.

MR. LEVENSON: Yes, Your Honor, and that is what we will elaborate on further in our argument, that in fact the government's rule does not create more tax, does not create more equity, but in fact we will demonstrate that it creates a loophole through which corporations and shareholders who are the owners of those corporations with highly depreciated property can create a tax loss--

Q And therefore you should have a greater deduction in this case?

MR. LEVENSON: No, Your Honor, that is not the basis for our argument. Our argument will be based upon the meaning of the Code as we have divined it from the committee reports, not having to do with the equity or the inequity of any particular rule.

Q In view of what you say, why do you suppose the government is taking the position that it is in this case?

MR. LEVENSON: We have thought long and hard on that, Your Honor, and we think without any way to prove its correctness that the government regulation writing, the Treasury in 1956 when these regulations were proposed, saw the typographical error in the committee reports dealing with Section 562. That typographical error has been referred to in

our briefs and in particular in the opinion of the District Court judge in this case. The typographical error refers in the Senate report to Section 312. That was the original section in the House bill that dealt with, quote, "definition of a dividend." When the Senate did its work on the Code, it changed the numbering, changing the numbering of that particular section dealing with the dividend from 312 to 316.

Somehow the reference to 312--

Q Remained.

MR. LEVENSON: --remained in the report. What we have also done is to track down the actual Senate amendments which can be found in the Congressional Record, the technical wording of the amendment which said, regarding Section 562, "Change all references 316 to 312."

So, to answer your question specifically, I do not know the reason. I can only guess that someone was confused by the Section 312 reference, saw the provisions of Section 312, which talks about the reduction of earnings and profits only by adjusted basis, and wrote the regulation accordingly.

Q The 312 should be read as 316, should it not?

MR. LEVENSON: In the committee reports it should be read as 316, we maintain, yes.

To relieve the corporation of a penalty tax by providing a dividends-paid deduction to the same extent that a shareholder receives taxable income is not only symmetrical

but also accurately reflects the basic statutory purposes of these laws and the specific statutory relationships of the 1954 Code. If the deduction is greater than the amount taxed to the shareholder, then there would be no incentive to distribute the full amount intended to be distributed by Congress. A deduction for less than the amount taxed to the shareholder would require corporations to distribute property with a value in excess of the amount subject to tax. We submit that neither result is consistent with congressional purpose.

It is clear from the legislative history of the 1954 Code that Congress envisioned a coherent, integrated system of corporate shareholder taxation. As part of this scheme, it defined the definition of the term "dividend" to be a very precise term of art. It might be useful to think of a dividend as a molecule having several atomic components, each of which is absolutely necessary to the character of the final product.

First, there has to be a distribution. That distribution must be a distribution covered by Section 301 of the Code. Then that distribution must be of property, as that term is defined in Section 317(a) of the Code. The amount of the distribution must be determined as set forth in Section 301(b).

Finally, the corporation must have earnings and profits calculated, as indicated, in Section 312.

Q Mr. Levenson, on that point, supposing the corporation has earnings and profits that exceed the adjusted basis of the dividend but are not as great as the market value of the dividend, would the dividend then be permissible under your theory?

MR. LEVENSON: If the earnings and profits exceed the fair market value--

Q No, the other way around. The fair market value exceeds the earnings and profits, but the earnings and profits exceed the adjusted basis.

MR. LEVENSON: Then that portion of the appreciation in the property rising from the adjusted basis level to the earnings and profits level, that amount will be taxable as a dividend. To the extent that there is an excess of appreciation--

Q You say taxable as a dividend--

MR. LEVENSON: To the shareholders.

Q Under your theory, the market value is taxable in either event.

MR. LEVENSON: Only to the extent of earnings and profits, Your Honor.

Q I see.

MR. LEVENSON: This point in fact is recognized by the government in its regulations under Sections 316 and 312, which are footnoted on page 4 of our reply brief, and from those

regulations you can see the interrelationship of these various terms in both of those two Code sections. And you will see how the relationship of earnings and profits, fair market value, and adjusted basis relate to each other in determining the tax consequences to the shareholder.

Q Let me change my example. Assume the earnings and profits are sufficient to exceed the market value. What kind of accounting adjustment does the corporation make on its books to keep the assets and liabilities equal when it distributes more than the book value?

MR. LEVENSON: If the earnings and profits exceed--

Q Yes.

MR. LEVENSON: --the market value?

Q Correct.

MR. LEVENSON: Then the earnings and profits account would be adjusted only for the adjusted basis of the property distributed.

Q What happens on the corporate books to the difference between the adjusted basis and the market value, under your view?

MR. LEVENSON: There would be no adjustment on the accounting records of the corporation because the appreciation in the property was never reflected on the balance sheet of the corporation.

Q But they give a deduction, as I understand you,

for the full market value of the asset.

MR. LEVENSON: Only to the extent of the earnings and profits.

Q Yes, but I am assuming the earnings and profits are greater.

MR. LEVENSON: That is correct; they get a deduction for this special tax.

Q It seems to me that your asset and liability ratio may change by the difference between adjusted basis and market value.

MR. LEVENSON: For the purpose of the normal taxation of the corporation and the calculation of its earnings and profits account, the result would be as I indicated. Only the adjusted basis of the property would be reflected as a diminishment of the earnings and profits. For this special tax, which has nothing to do with the normal corporate accounting--that is, the balance sheet that you might read at the end of the year--it has no effect.

Q So, there would have to be really a difference in tax accounting and in normal accounting to carry out your theory.

MR. LEVENSON: For the purpose of this special tax, there certainly would be.

Our point is that if it is not a distribution covered by Section 301, it cannot be a dividend. If there are not any

earnings and profits, it cannot be a dividend. If the distribution is not of property, it cannot be a dividend. Every requirement has to be met. Each of the component sections can only be understood by reference to the others. It was this unitary, integrated concept that Congress referred to in Section 562 when it stated that for the purpose of the dividends-paid deduction, the rules of Section 316 encompassing all of these concepts that go to make up a dividend, that the rules of Section 316 would be used to determine what is a dividend specifically for the purposes of defining what would be included as a dividends-paid deduction.

This scheme of statutory interrelationships is made even clearer by reference to the statutory history of 316 in the 1954 Code, which is discussed in Part Two of our main brief. The government has not yet replied to the arguments contained in Section Two of our brief. Possibly we will hear it on reply.

Also, as I mentioned before, the regulations promulgated under Sections 316 and 312 further indicate the integrated nature of these Code sections. There is no reason indicated in the Internal Revenue Code or in the committee reports why the valuation of a dividend for the purposes of the personal holding company or accumulated earnings taxes should be different from the normal rules applicable to corporate distribution.

Quite to the contrary, instead of enunciating a separate rule, as under the Internal Revenue Code of 1939, Section 562 refers to Section 316 as stating the basic criterion of whether or not a distribution qualifies for the dividends-paid deduction.

The adjusted basis rule, which is the rule urged by the government in its Treasury regulation, is completely irrational. The fact of the matter is that the adjusted basis for property bears no consistent relation to a corporation's earnings or realized investment income. Not all assets owned by the corporation are owned by the corporation. Assets may be acquired by contribution to capital. They may be acquired by tax-free reorganization or in a myriad of other ways.

For example, the basis is often reduced each year of depreciable property by that bookkeeping adjustment which we know as depraciation. The rate and method of depreciation, however, can often be elected by the taxpayer within certain parameters set out by the Internal Revenue Code.

Q Is there any way of escaping this kind of artificiality in this sort of process?

MR. LEVENSON: We suggest, Your Honor, that the way to escape the artificiality of this process is to allow a dividends-paid deduction for the value of the property which in fact is distributed, whether that property is marketable, whether that property is not marketable.

Q But the taxpayer may properly and lawfully take steps and take decisions which will minimize or even avoid a tax liability, may he not?

MR. LEVENSON: Of course he may. We are suggesting that he be given the opportunity to determine which property to distribute from a corporation, based upon only the criterion that the property have the value necessary to carry out the equivalent of the corporation's improperly accumulated income be it a personal holding company or a corporation subject to the accumulated earnings tax.

We say that property with the same market value but with vastly different adjusted bases can be distributed by two different corporations. The tax impact on the corporation should not be dissimilar when the tax impact on the shareholders is the same.

As I mentioned earlier in our argument, the government's rule creates a significant--

Q Mr. Levenson, on that kind of fundamental proposition, why is that so? In the normal case the tax impact of a dividend is zero with respect to the corporation but it creates a tax obligation on behalf of the party receiving the dividend. Why is there this need for this similarity that is kind of crucial to your case?

MR. LEVENSON: Because of the nature of the special tax, Your Honor. The tax, as we have indicated, was enacted

first in the 1913 Revenue Act and consistently thereafter to force corporations to distribute out income to the shareholders. After 1921 the vehicle used were these taxes which were designed to impose a penalty of such an amount as to force the corporations or induce the corporations to distribute the money out by allowing a dividends-paid deduction. It is that incentive that is at work here that we wish to have--we wish to have the market value of the property be the measure of a dividend paid in property. We feel that that satisfies the statutory and historical philosophy behind these taxes.

Q What is directly at issue here is whether or not there remained any undistributed personal holding company income after this stock was paid out as a dividend, is it not?

MR. LEVENSON: Yes, Your Honor.

Q As that phrase is defined in the law.

MR. LEVENSON: In this case, what actually happened, as shown in the Appendix, is that the stockholders of our clients received marketable securities of a value in excess of their cost to the corporation, paid the normal income tax allocable to--

Q As shareholders.

MR. LEVENSON: --as shareholders, based upon the value of the property when it was distributed.

Q But the enhancement of the property had never been reflected in the corporate books as income.

MR. LEVENSON: It had never been reflected in the corporate books as income.

Q And the income that has been made and has been reflected on the corporate books will not be taxed--will not be distributed if you get this deduction at the market value.

MR. LEVENSON: The second part of your statement, Your Honor, I do not believe is the way the Congress intended to look at these taxes. Congress was intending not to--was intending to tax the shareholders on an amount equal to the amount which the Internal Revenue Service determined was improperly accumulated. That amount is--

Q But the earnings that have been accumulated on the books and reflected on the books remain in the company.

MR. LEVENSON: Our point is that the earnings reflected on the books are reflected only on the books. That is, they are a bookkeeping entry.

Q But they have been earned.

MR. LEVENSON: They have been earned, but they have been invested in other assets, Your Honor. They have been invested in real estate, in stocks, in equipment and machinery, whatever. And that--

Q But they are subject to the ordinary corporate income tax.

MR. LEVENSON: Yes, they are.

Q And they remain in the company undistributed.

MR. LEVENSON: Although they remain in the company undistributed, they nevertheless are available to be distributed upon a subsequent distribution. There has been no overall tax avoidance by the shareholders if you give effect to the rule for which we contend.

Q The other way of looking at it would be had those earnings been paid out, then this capital gain would have remained in the company undistributed.

MR. LEVENSON: The capital gain was never intended to be taxed by the Congress. In fact, Section 311 of the Internal Revenue Code specifically states that property may be distributed by a corporation--the general rule is that the property may be distributed--without the corporation--

Q Without recognition of gain or loss.

MR. LEVENSON: And that was a value judgment made by Congress in 1954 following a decision of this Court, I believe, in the General Utilities case in the forties or thirties; I am not sure which.

Q What does the Ivan Allen case have to do with your case? Does it help you or hurt you?

MR. LEVENSON: We believe that the Ivan Allen case helps us, Your Honor, because the majority of this Court in that case recognized that the value of the marketable securities held by Ivan Allen Company were to be considered in determining whether or not income had been accumulated beyond

the reasonable needs of the business. We believe that the recognition of the fair market value in Ivan Allen for purposes of computing what should be taxed, that that should also apply to the other side of the coin in determining the value of the dividends being paid out by the corporation. We find a symmetry in the reasoning of the majority in that case and our position in this case.

I would like to call to the Court's attention the loophole created by the government rule which can best be recognized by referring to the General Securities case, which we cited in our main brief, that being a case in the 1930s where property with a very high basis and a low value was distributed. The Court prior to the 1936 act--the distribution occurred prior to the '63 act--the Court refused to give a credit for the basis of the property and ruled that fair market value was the basis for the credit to be given to the distributing corporation.

The adjusted basis rule argued for by the government has never appeared in any statute. And as we pointed out in our brief, it is quite different from the rule that was in existence prior to 1939.

I might also call the Court's attention to the explanation in the case of C. Blake McDowell of the concurring judge. This is a Tax Court case. Judge Goff reported that 27(d) came into the law in order to plug a

loophole which involved intercorporate distributions of property. That was the reason why 27(d)--

MR. CHIEF JUSTICE BURGER: We will recess until 1:00 o'clock.

[A luncheon recess was taken at 12:00 o'clock noon.]

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AFTERNOON SESSION

MR. CHIEF JUSTICE BURGER: Counsel, you may continue.

MR. LEVENSON: Mr. Chief Justice, may it please the court--

Q Mr. Levenson, may I ask you was there any special reason for making this distribution in property rather than cash?

MR. LEVENSON: The reason was, Your Honor, that the value of the property was sufficient to take out all of the personal holding company income determined by the government. The failure to sell the property of course saved the corporation the capital gains tax that it would otherwise have had to pay.

Q So, it kept cash in the company.

Q Other assets. It kept other assets.

MR. LEVENSON: It kept other assets in the company, but that would have been the case if these assets--

Q It kept earnings in the company.

MR. LEVENSON: Your Honor, I would like to go back to the comments that you made concerning earnings a short while ago.

Q Questions.

MR. LEVENSON: Questions. A distribution can never be traced to a specific earnings account. An earnings account of that nature just does not exist. We discussed that point

in our reply brief and would like to again call your attention to the point that we made in footnote one on that issue. Earnings and profits are not a separate bank account. They are not a separate piece of property. They are not a separate anything. They are a historical record of corporate success or failure. Any distribution to shareholders--the taxation of any distribution to shareholders is based upon that historical record. That is what earnings and profits are. Whether the money or property that is actually distributed came originally from earnings or from stock subscriptions or from property acquired in a tax-free reorganization, that is completely irrelevant.

Q But you know that the appreciation of this property has not been reflected in that historical record.

MR. LEVENSON: That is correct, Your Honor, but Congress made the value judgement in Section 311 of the Code not to tax appreciation on property distributed by corporations.

Q I understand that.

MR. LEVENSON: So, it is not a tax avoidance maneuver that was engaged in by this taxpayer in making such a distribution.

Q But at least prior to '54, Congress had made the judgment that in circumstances like this, on these facts, the deduction would be at the book value.

MR. LEVENSON: To fully understand--

Q Is that not true?

MR. LEVENSON: That is true, Your Honor.

Q And you suggest there is evidence that Congress did not intend that under the '54 Code?

MR. LEVENSON: We submit that Congress did not intend it in the '54 Code. But to answer your comment more specifically, I think it is important to note the reason why 27(d) was incorporated into the Internal Revenue Code prior to that time because that has obviously given everyone a great deal of trouble in the consideration of this case.

Q This is in the '39 Code?

MR. LEVENSON: It came into effect in 1936. It carried over in the '39 Code, which was merely a recodification of all of its existing Internal Revenue laws at the time. It did not involve a value judgment in compiling the '39 Code, which sections were good and which were bad, as did the '54 Code.

There was a provision in the law which allowed corporations to distribute property to another corporation. The recipient corporation would receive that property as a dividend, take it into account, take as its basis the market value on the date of distribution, pay no tax upon that in the corporate dividend distribution because of an intercorporate dividends received credit, sell the appreciated property,

thereby having no tax imposed upon all of the gain.' What Congress chose to do in 1936, in the context of the undistributed profits tax that was enacted in that year, was to restrict the dividends-paid reduction to the lower of the adjusted basis or value.

In the '54 Code what Congress did to achieve exactly the same result was to distinguish the tax effects to a corporate and a non-corporate distributee upon receipt of the dividend from another corporation.

Q Was this any corporate distributee or an affiliated corporation?

MR. LEVENSON: Any corporate distributor.

Q Any corporate distributor.

MR. LEVENSON: Yes, sir. We would like to conclude that the role advocated by the government is neither reasonable nor consistent with the intent of Congress. It is not justified by the provisions of the Code. It is not justified by resort to legislative history. In short, the regulation in question, we believe, represents an arbitrary extension of administrative authority and should be struck down as an attempt to legislate by regulation. The statutory direction is that for all purposes of the Internal Revenue Code a dividend is defined by Section 316 and its component parts. Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Paup.

ORAL ARGUMENT OF MICHAEL L. PAUP, ESQ.,

ON BEHALF OF THE RESPONDENT

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

The only issue here is whether Section 1.562-1(a) of the regulations is valid. These regulations of course provide that a personal holding company's dividends-paid deduction with respect to a distribution in kind should be determined by the corporation's adjusted basis. Generally it is investment in property distributed.

We submit that the First Circuit below was entirely correct in holding that the regulations were consistent with the objectives and terms of the Revenue Act and were indeed consistent with congressional intent.

To begin with, this Court has often held that great deference should be accorded to interpretations given a statute by the officers charged with its administration. Indeed, this Court has held that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. The present regulations cannot be held deficient under those standards.

In our view, the whole of petitioner's argument that these regulations are invalid is premised on an unhistorical and oversimplified view of the personal holding company and accumulated earnings taxes.

Essentially, petitioner's argument begins with the premise that personal holding company and accumulated earnings taxes were designed to discourage the use of corporate vehicles as a means of avoiding the progressive tax appoicable to shareholders. It then notes that individual shareholders are taxable upon the full fair market value of the property they received from corporations as a distribution in kind.

The argument then jumps to the conclusion that the only measure appropriate for determining the corporate dividends pay deduction is the measure used to determine the amount includable in shareholder income. That argument cannot be squared with history.

Historically the personal holding company tax and the dividend-paid deduction first came into the Code in 1934. At that time, Congress did not define specifically the effect a distribution of property in kind would have with respect to the corporation dividend-paid deduction. The 1936 act, however, soon filled that gap.

In 1936 Congress passed Section 27(c), a section later recodified as Section 27(d) of the '39 Code. And in that section it explicitly provided that a corporation's dividend-paid deduction with respect to a dividend in kind should be determined by the lesser of basis or fair market value. That rule enacted by Congress in 1936 then would provide exactly the same result as the rule under the regulations would effect with

respect to this taxpayer.

As a part of the same revenue act, the Revenue Act of 1936, Congress also defined exactly the effect a distribution in kind would have upon individual shareholders. In Section 115(j) of the '36 act Congress explicitly provided that shareholder recipients of distributions in kind should include those distributions in their incomes to the full extent of the fair market value of the property received.

In the face of this history, it is a little difficult to concede how petitioners can now argue that the purpose of the personal holding company tax would be fully served by a rule that keys corporate dividends-paid deductions to the amount includable in shareholder income. Obviously when Congress faced the question in 1936, it concluded that such a rule would not fully serve the purpose of the personal holding company tax.

Specifically, these taxes--the personal holding company tax and the accumulated earnings tax--attached to undistributed or accumulated taxable income those income items specifically encompass only fully realized income items, income items realized and recognized at the corporate level. The rule taxpayer advocates here would permit a deduction with respect to those realized, fully recognized income items with respect to income items that have never been realized at the corporate level.

Q Is it your position that the basis should be

taken as the value of the distribution, whether the basis is higher or lower than the present market value?

MR. PAUP: That is what the regulations provide, Your Honor, yes.

Q Is there any fiscal advantage to the government in the position you are taking?

MR. PAUP: Clearly the law applicable under the 1936 act would generate more revenue, particularly with respect to distributions of property that had depreciated in value while held by the corporation. So, it is fiscally disadvantageous, but we think it is consistent--

Q So, you are just upholding the regulation as a matter of moral and legal duty?

MR. PAUP: No. I think it is logically consistent with the focus of the tax. It is in accord with congressional intent. It is consistent with the treatment of distributions at the corporate level for various other tax purposes as well.

Q Both briefs speak in tandem of the personal holding company tax and of the accumulated earnings tax. Is it necessary in analysis of this problem to consider them together. Or would it not be easier to isolate this tax? What we are talking about here is whether or not there remained personal undistributed holding company income within the meaning of the statute after this distribution. That is the precise question, is it not?

MR. PAUP: That is the precise question here involved, Your Honor.

Q Yes, under these rather complicated provisions of the Internal Revenue Code and under none other.

MR. PAUP: That is true. That is true. That is the precise question here involved. But I think it is instructive to note that the dividends-paid deduction also applies to the accumulated earnings tax and equally had this been an accumulated earnings tax problem the corporation here faced, accumulated earnings would have remained accumulated at the corporate level--

Q If this were a different tax, there would be different problems. But we are dealing here with a personal holding company tax.

MR. PAUP: The result is the same though in either case, Your Honor.

Q We are dealing here with what is in effect a confiscatory tax upon a corporation defined as a personal holding company, unless the corporation makes distributions to its shareholders.

MR. PAUP: Yes.

Q And we all know what the purpose of it was back in 1934, was to get away from incorporated yachts and race horses and so on.

MR. PAUP: And pocketbooks, yes, Your Honor.

Q Yes.

MR. PAUP: In our view, the only hope taxpayers have of winning this case is to convince the Court that somehow the thrust of the personal holding company tax changed drastically in 1954. We do not think that anything they have cited, either in brief or in oral argument, indicates such a drastic shift in the focus or the intent of the tax. Quite clearly nothing in the literal statutory language of the 1954 Code evidences an intention to shift the focus of the corporate dividend-paid deduction away from the effect that distribution has on the corporation to the effect that that distribution has upon shareholder income. Indeed--

Q But the rule did change in '54, did it not?

MR. PAUP: The regulations provide a slightly different rule from--

Q Not for this case.

MR. PAUP: Not for this case, no.

Q Well, a quite different rule.

MR. PAUP: A quite different rule for distributions with respect to property that has depreciated--

Q Before the taxpayer got the worst of whichever world there was.

MR. PAUP: That is exactly right.

Q Now he gets a fixed one, whether it be better or worse than the other.

MR. PAUP: That is right.

Q And in publishing their regulation, apparently the government divined that this was the congressional will or this sort of interpretation of the statute was permissible.

MR. PAUP: Specifically, I think they divined that this interpretation of the statute was permissible. And I think further--

Q There is a difference, whether this was specifically congressional intent or whether Congress intended to give an area of discretion in drafting the regulation.

MR. PAUP: I think basically the shift in the regulation--our view is that the legislative history underlying the '54 Code indicates that Congress intended to carry over Section 27(d). Now, there are certain counterindications.

Q But that is not what the regulation says.

MR. PAUP: No, Your Honor. There are--

Q What in the legislative history do you submit indicates that Congress intended to change the rule a little bit, as you say?

MR. PAUP: Specifically, in discussing the dividend-paid deduction the Senate report makes reference to Section 312 of the Code. We do not view that reference to Section 312 of the Code as a mere typographical error. There are certain ambiguities in the legislative history, we will grant. Section 312 of the Code of course provides for an adjustment at the

corporate level exactly the same and exactly equal adjustment at the corporate level with respect to distributions in kind, as does the present regulation.

Further, we think that the rule adopted by the regulation is consistent with really the thrust of the taxes involved. As you have pointed out, the thrust of the taxes involved is looking for the distribution of personal holding company income. To the extent a corporation distributes property in which it has invested personal holding company income presumably, it effects a distribution exactly equal to the amount of its investment. Therefore, we think the regulation, not taking into account depreciations in value, is entirely consistent with the tax.

Q Even where it depreciates.

MR. PAUP: Yes, that is right, Your Honor, because that depreciation has never been reflected on the corporate books.

Q Although it reflects an investment of income at the amount that the property cost.

MR. PAUP: That is exactly right. It is carried on the corporate books at exactly its cost basis.

Q Does a taxpayer accomplish any other avoidance by distributing in property rather than cash than the capital gains tax that he conceded he would?

MR. PAUP: Under the facts of this case, it appears

not. Just the capital gains tax. Although the record is a little vague.

Q And this is whether he wins or not on the evaluation question?

MR. PAUP: That is true, yes. Inevitably he is going to avoid capital gains tax at the corporate level. Section 311 in this Court's opinion in General Utilities make it clear that no income is recognized to the corporation upon the distribution.

Q Does he also avoid personal holding company income?

Q He avoids distributing it.

MR. PAUP: Oh, he avoids distributing personal holding company income--well, only if he wins.

Q Only if he wins, yes.

MR. PAUP: If he loses, then the tax will attach to the amounts of personal holding company income which we say remain undistributed.

To return to the '54 Code revision, the statutes themselves, the literal terms of the statutes, do not preclude adoption of the adjusted basis rule. Petitioner has even conceded that on brief. Neither Section 562 of the Code nor Section 316 of the Code provides a rule for valuing the effect of a distribution in kind at the corporate level.

There is certainly nothing in the committee report

that reflects in intention on the part of Congress to shift the emphasis or the focus of the dividend-paid deduction completely away from the corporation. Indeed, there are certain contrary indications, as I have pointed out. Specifically the reference to the 300 Code provisions and more particularly the reference in the Senate Committee report to Section 312 gives a certain legislative warrant for applying the adjusted basis rule under these circumstances.

And, more to the point, as a practical matter, that is the logical rule that should be applied--that is, the distribution out of the corporate shell for both accounting and tax purposes, other tax purposes.

Q Then do you say 27(d) was illogical?

MR. PAUP: 27(d) we think reflects a punitive--almost a punitive--goal with respect to distribution of property that had depreciated. The net effect of that section is to require that either the personal holding company realize losses at the corporate level and actually realize a diminution in corporate assets or distribute more of its invested property, more of its invested earnings, than it has undistributed personal holding company income in order to obtain a deduction equal to the amount of its undistributed personal holding company income. So, in effect, it reflects a congressional goal to see the end of these personal holding companies.

Q The whole personal holding company--all of the

provisions are punitive in a sense. They take away any incentive to incorporate your pocketbook, put it that way.

MR. PAUP: Oh, there is no doubt about that.

Q In that sense at least they were punitive provisions.

MR. PAUP: They are a healthy inducement to distributions of realized personal holding company income.

Q And remove any incentive whatsoever to incorporate.

MR. PAUP: Practically speaking, yes.

We do not find anything in either the legislative history or in this Court's opinion in Ivan Allen which runs contrary to our position here.

Q What do you think the bearing of the Ivan Allen case has?

MR. PAUP: On the specific problem here, there is no direct bearing. But I think certain dictums in the Court's opinion clearly supports the result here.

Q Both you and your brother on the other side of the table, at the other table, more or less rely on Ivan Allen. Each of you thinks it gives you at least some support.

MR. PAUP: Yes, Your Honor, I think it does give us some support.

Q And how and why?

MR. PAUP: As this Court pointed out, the accumulated

earnings tax specifically involved in Ivan Allen attaches only to realized income items, unrealized appreciation figures not at all in the computation of actual tax liabilities. We think that almost by a parody of reasoning that unrealized appreciation ought not to figure in a deduction critical to the computation of a tax attaching only to realized income items.

Under this Court's opinion in Ivan Allen, unrealized appreciation is important only in determining whether a corporation has a reasonable business need to accumulate fully realized income items. That affects only the purpose of the accumulations, not the computation of the taxes involved. We think the opinion clearly indicates that unrealized appreciation ought not to figure in the computation of the tax. And under our rule, that unrealized appreciation does not figure in the computation.

Petitioner's rule, on the other hand, would permit a deduction from realized income items for appreciation that--

Q You mean unrealized.

MR. PAUP: --has never been realized, never reflected on the corporate books.

Q It would permit a deduction for unrealized.

MR. PAUP: Exactly.

Q Not realized.

MR. PAUP: No, I am sorry, I intended to say unrealized.

Q But Ivan Allen does tend to the proposition that in computing accumulated earnings and profits, the taxpayer must take into account the unrealized appreciation of the security that--

MR. PAUP: No, I do not really think it really stands for that proposition, Your Honor. It stands for the proposition that in determining whether a taxpayer has a reasonable business need to accumulate any further fully realized earnings and profits, certain unrealized appreciation in investment assets--

Q Must be taken into account.

MR. PAUP: --can be taken into account.

Q Must be, I think.

MR. PAUP: Yes, must be, provided only that it is readily liquidatable.

Q Right.

MR. PAUP: But that unrealized appreciation does not figure into the measure of the accumulated taxable income subject to the tax, as this Court's opinion carefully points out. And we think since it does not figure in the computation of the income subject to the tax equally, it ought not to figure in a corporate deduction which operates to reduce that self-same tax.

Q It is relevant to the issue of liability but not damages.

MR. PAUP: Yes.

Q In a manner of speaking.

MR. PAUP: It is relevant only to the motive underlying the accumulation--

Q The motive, right.

MR. PAUP: --of fully realized income.

In sum, I guess, it is our view that the regulations here represent a reasonable interpretation of the revenue statutes involved. They are consistent with the history. They are consistent with the purpose, that purpose being to force a distribution of unrealized personal holding company income. They are consistent with the terms and focus of the tax involved, that focus being on only unrealized income items. They are finally consistent with the tax treatment accorded corporate distributions in kind for other purposes--general accounting purposes, accounting for purposes of earnings and profits under Section 312.

In our view, the First Circuit was correct in sustaining them. And we would submit that its decision ought to be sustained.

MR. CHIEF JUSTICE BURGER: Very well. Mr. Levenson, do you have anything further?

MR. LEVENSON: Yes, I do, Your Honor.

MR. CHIEF JUSTICE BURGER: You have about three minutes left.

REBUTTAL ARGUMENT OF DANIEL D. LEVENSON, ESQ.,

ON BEHALF OF THE PETITIONERS

MR. LEVENSON: Comment was made that--a question was asked, rather, whether the Congress intended to give to the Treasury an area of discretion in promulgating regulations under this statute. I would like to point out to the Court that in the Internal Revenue Code in particular, when Congress intends to give broad discretionary power to the Treasury, it specifically indicates, such as in the consolidated return regulations, allocation of income and deductions between taxpayers and other broad areas where Congress has stated its policy and says to the Treasury, "You fill it in." Those are known as legislative regulations and are usually given great weight by the courts.

My brother says that we, taxpayer's counsel, agree that nothing in the Code dictates how a dividend in property is to be valued at the corporate level. That is not correct. We do not agree that the Code is silent on that. In fact, we state that the Code indicates the unitary integrated concept about which we referred, and that this is the same method of valuing a dividend at the corporate level as at the shareholder level.

The regulation does not require that we prove that the property has been purchased with personal holding company income. The corporation can distribute property that has been acquired in any manner. The adjusted basis rule does not

necessarily reflect personal holding company income, that is, the adjusted basis of property. For example, if I had Penn Central stock of high basis and low value and had a personal holding company, I could under the government's rule, contribute that stock to the corporation, a non-taxable event, the following year or even maybe the same year have that corporation distribute out that high basis property and take away the personal holding company tax potential. That is the way adjusted basis can be utilized to defeat the intention of Congress and what should be the intention of the Treasury.

Comment was made that prior to 1936 there was no valuation rule. We believe that prior to 1936, the Court believed that the value of the dividend was to be the value of the property distributed, and it was only in the context of the undistributed profits tax in 1936 that the rule was changed, that it was not changed because Congress looked and thought hard on this issue but rather it was changed to accomplish the closing of the loophole that I referred to in the main portion of my argument.

Q Basically, unless you got into intercorporate distribution, it did not make any difference, did it, in an ordinary corporation because it was a corporation prior to the penalty on undistributed earnings?

MR. LEVENSON: But we could, Your Honor.

Q Could declare dividends out of its earnings and

profits in any amount in the discretion of the board of directors.

MR. LEVENSON: But the nature of the undistributed--

Q And it was clear that the value to the shareholders was the fair market value of what was distributed. That has always been clear, has it not?

MR. LEVENSON: Or the adjusted--oh, excuse me, yes, Your Honor.

Q To the shareholders.

MR. LEVENSON: Yes.

Q To the shareholders at the fair market value of what is distributed from the point of view of their income.

MR. LEVENSON: That is correct. But the nature of the undistributed profits tax of 1936 was a completely different animal than either of the normal income tax or the penalty taxes.

Q My point is that before 1936 it did not make any difference. How could it arise to the corporation as a taxpayer?

MR. LEVENSON: Prior to nineteen--yes, Your Honor, you are correct.

Q The issue could not arise vis-a-vis the corporation's tax returns, could it?

MR. LEVENSON: Not under the statutes existing prior to 1936.

Q That was my question.

MR. LEVENSON: Yes.

Q Mr. Levenson, on your loophole argument, even under the government's view, could not the corporation that has stock that has a market value of less than its basis simply sell the stock and take the loss and then distribute the money? Would it not all come out the same? Or am I missing something there?

MR. LEVENSON: If the corporation distributed the residue left after sale--

Q Right, and took a tax loss because it is selling for less than basis.

MR. LEVENSON: It might take a tax loss against its normal corporate income tax, but it will not thereby be able to take out all of the accumulated taxable income or personal holding company income under the government's rule because it will be distributing cash, the proceeds of the sale of the assets.

Q But it would also reduce its income by the loss on the stock.

MR. LEVENSON: Not under the different ways that capital gains and ordinary income--

Q Because the capital loss would not be a hundred cents on the dollar.

MR. LEVENSON: It would not be a hundred cents on the

dollar, Your Honor.

Q I see.

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

[The case was submitted at 1:35 o'clock p.m.]

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