In the

Supreme Court of the United States

FRANK LYON COMPANY,	)	
Petitioner,	)	
vs	)	No. 76-624
UNITED STATES,	)	
Respondent	)	

Washington, D. C.
November 2, 1977

Pages 1 thru 49

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v. : No. 76-624

UNITED STATES, :

Respondent :

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Washington, D. C.,

Wednesday, November 2, 1977.

The above-entitled matter came on for argument at 1:44 o'clock, p.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
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

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APPEARANCES:

ERWIN N. GRISWOLD, ESQ., Jones, Day, Reavis & Pogue, 1100 Connecticut Avenue, N. W., Washington, D. C. 20036; on behalf of the Petitioner.

STUART A. SMITH, ESQ., Assistant to the Solicitor General, 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 will hear arguments next in Frank Lyon Company against the United States.

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

ORAL ARGUMENT OF ERWIN N. GRISWOLD, ESQ.,

ON BEHALF OF THE PETITIONER

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

This is a federal income tax case. It comes here on a writ of certiorari to review a decision of the Eighth Circuit Court of Appeals, which reversed a judgment for the taxpayer in the United States District Court for Arkansas.

The question involved is the effect of a sale leaseback transaction involving a bank building between the Petitioner, Frank Lyon Company, as lessor, and the Worthen Bank and Trust Company, as lessee.

Before stating the facts, I would like to place them in context by briefly indicating the basic approach which we take in this case.

In planning a substantial business venture of the sort involved here, taxpayers should be able to predict the tax consequences with some degree of certainty. To this end, the tax collector should avoid applying the tax laws to frustrate bona fide bargains, unless he can point to some reason for doing so, which is pragmatically based in tax policy.

This does not mean that taxpayers should be allowed to manipulate tax consequences with arbitrary labels, or with maneuvers which have no economic substance. But neither should the tax laws be a joker in the deck for business planning.

In a situation where ownership is inevitably divided -- and that's true of most business property -- no transaction can be safely planned if its tax consequences are made to depend on an abstract comparison of the ownership of bundles of sticks, which various parties carry.

The policy for which we argue is, in effect, that there should be a presumption in favor of taxing bona fide business transactions as they were bargained, structured, and understood by the parties, particularly where, as here, there is no realistic tax policy reason for scrambling the bargain which was made between Frank Lyon Company and the Worthen Bank.

QUESTION: Mr. Griswold, I take it no one -- well, you tell me. Did anyone question that these were independent companies and that the bargain was --

MR. GRISWOLD: No, Your Honor, that is not the question. They were independent. There is one, the president of Frank Lyon Company is a director of Worthen Bank; but the court found that they were independent, and that is not now contested.

Worthen Bank, in Little Rock for many years, in 1967 had a capital of $4 million. It decided to build a new building, and it was able to obtain a desirable site. It retained an architect and built a parking garage on an adjoining tract. The total bank project would cost -- the total project would cost about $12 million, of which about $1.5 million was the cost of the land, and $7.5 million was the cost of the bank building on this particular piece of land.

The bank sought approval for the financing of the building from the State Banking Commission of Arkansas, and the Federal Reserve Bank of St. Louis.

QUESTION: Mr. Griwold, could I interrupt for a second? What did the other $3 million represent, and was it part of --

MR. GRISWOLD: That represented an adjoining tract, which included a parking garage, several stories high, which was integrated in the ultimate project, but was not a part of the leases involved here.

QUESTION: So that three million really is not part of the package sold by --

MR. GRISWOLD: That three million is not part of this case, except that it consumed the four million which was the maximum -- most of the four million which was the maximum that Worthen Bank could invest in bank premises.

QUESTION: Is it correct that the costs to Worthen of the facilities that were sold to Lyon was about $7.5 million?

MR. GRISWOLD: Yes, sir.

QUESTION: I see. Okay.

MR. GRISWOLD: Lyon paid essentially the cost. There was a contract by which Lyon agreed to pay not in excess of $7,640,000, and that is the exact amount which they paid.

They were advised by the banking authorities that Worthen could not legally own the building either directly or through a wholly-owned subsidiary at a cost in excess of the amount of its capital stock, which was then $4 million. And that's Section 25(a) of the Federal Reserve Act.

In addition to this legal obstacle, there was also a practical barrier. Worthen Bank had planned to have a $5 million conventional mortgage, and to issue four million in debentures. But Arkansas law forbade Worthen from paying more than 6 percent on debentures, and the bonds simply weren't marketable at that rate.

In this situation, Worthen sought both legal and financial advice. It consulted a number of potential investors and lenders, including Goldman, Sachs and Company, and Eastman-Dillon Union Securities Company of New York; it also made preliminary contact with the First National City Bank of New York for interim financing, and with New York Life Insurance Company for long-term loan on the completed building.

In the course of these discussions, the suggestion was made that the practical and legal problem could be solved by a sale and leaseback with an independent buyer and lessor.

After these discussions were well under way, Frank Lyon Co. decided to enter the competition. Lyon, as I have said, is an independent company, though its chairman, Frank Lyon, is a director of Worthen Bank.

QUESTION: And what's its principal business, Mr. Griswold?

MR. GRISWOLD: What?

QUESTION: What is its principal business, your client, Lyon Company?

MR. GRISWOLD: Their principal business was the Central Midwest distributorship for Whirlpool and Zenith. But they had by this time also begun to branch out into other things, and among other things at about this time they bought the controlling interest in another bank in Little Rock, and they were engaging in other business activities. But their basic business was the distributorship for Zenith and Whirlpool.

QUESTION: Mr. Griswold, was Lyon a corporation?

MR. GRISWOLD: Frank Lyon Company is an incorporation, yes.

QUESTION: I see.

MR. GRISWOLD: Frank Lyon Company underbid the other potential buyers by reducing the rent payable by Worthen for the building by $21,000 a year for each of the first five years. And on this basis Frank Lyon Company was accepted by Worthen as the investor-owner, and Lyon was approved by the financing agencies.

After extensive further negotiations, Lyon entered into a number of agreements, both with Worthen and the financial institutions. There was first a ground lease by which Worthen leased the land to Lyon for a term of 76 years and 7 months. That was actually a year and seven months for construction and 75 years after the end of it.

The idea for leasing the ground had been suggested by some of the New York financiers as a way of simplifying the ultimate transaction.

There was, second, a sales agreement by which Worthen sold the building to Lyon -- and this is interesting, but I don't think greatly significant -- bit by bit as it was built, for a price not exceeding $7,640,000. As each piece of material was incorporated into the building, it was sold to Lyon.

Now, this was adopted because Worthen Bank could not own banking premises in excess of its capital, and if it built the whole building and then sold it, they would have violated the law, and also because Worthen Bank was not subject to the Arkansas sales tax on the materials which would have amounted to something like \$125,000.

Finally, there was a building lease, by which Lyon leased the building to Worthen for a term of 25 years, subject to two sets of options. There were, first, four options to purchase the building at stated figures, at the end of the 11th, 15th, 20th and 25th years of the lease. And the basic term of the lease, the original term of the lease was 25 years.

And then there were eight options to renew the lease, beginning with the 25th year, for consecutive five-year periods.

If all the options to renew were exercised, Worthen Bank would occupy the premises for a total of 65 years. But that still left a term of ten years at the end where Lyon's ground lease would continue and it would have full entitlement to the building, no matter what.

The transactions became effective on May 1st, 1968. During the construction period, Frank Lyon Company borrowed the money to finance the cost from First National City Bank of New York, in the amount of \$7 million. It did this on its own note, on which it alone was liable.

When the building was completed, Frank Lyon Company discharged its obligation to First National City Bank and to Worthen by putting in \$500,000 of its own money and by borrowing \$7,140,000 from New York Life Insurance Company.

Again, Frank Lyon Company alone signed this note.

Worthen was not a party to it. Although Worthen did join in providing additional security for the note by mortgaging the parking garage and the land to which it still owned the fee, and also consenting to ensignment of the lease to New York Life.

After Lyon had borrowed the $7,140,000 from New York Life, it paid off its debt to First National City Bank and had $500,000 of its own invested in the project.

The government has made much of the fact that the rent for the first 25 years under the ground lease was fixed at fifty dollars. There's some confusion in the record about this. The lease itself says fifty dollars for the term; at one place in the findings it says fifty dollars per year. I think fifty dollars for the whole term is correct, I don't think it's of any importance.

However, the amount of this rent is entirely irrelevant. Whatever rent was fixed for the land during the initial 25-year period would inevitably be taken into account in determining the rent for the building during this period. If the rent of the land had been fixed at $100,000 a year, then, for simple economic reasons, the rent for the building would have been increased by $100,000 a year.

It was a transaction that --

QUESTION: Mr. Griswold, you mean decreased, don't you?

If you increase the ground rent, you'd decrease the building rent.

MR. GRISWOLD: No, you would have to increase the -- if Lyon had to pay more ground rent --

QUESTION: The effect of it --

MR. GRISWOLD: -- it would have to get more building rent out in order to come out --

QUESTION: Well, but the effect of increasing the ground rent later was to decrease the net rent paid by the lessee.

MR. GRISWOLD: I'm talking about the initial 25-year period, and simply this apparently anomalous fifty-dollar rent for the term, I suggest that that is irrelevant.

QUESTION: Could you explain, while you're on that point, why it was that they made a substantial ground rent after the first 25 years, I think it was, rather than simply reducing the rent on the building?

MR. GRISWOLD: Because they contemplated the very real risk that Worthen would not renew the lease, that Lyon would be liable for the rent specified for the next fifty years, forty years at high rates; Worthen could walk away from it and could collect in the later period $250,000 a year rent, for which Worthen was liable.

QUESTION: For which Lyon was liable.

MR. GRISWOLD: After which Lyon was liable. Yes.

Of course, Mr. Justice.

After the first 25 years, as I've just said, the ground lease provided for substantial and increasing rents payable by Lyon over the next 40 years, aggregating $7.5 million. And for the final ten years of the lease, a reduced ground rent of $10,000 a year was provided.

The government contends that it's inconceivable that Worthen would walk away from the building at the end of 25 years, or at any subsequent time. But it's clear that these escalating ground rents were designed to deal with precisely this eventuality.

If it were a foregone conclusion that Worthen would continue to rent the building throughout the entire 65-year term, ground rentals of up to a quarter of a million dollars a year would not have been necessary, just as in the first 25 years, which were binding on the parties.

Lyon also had the absolute right to all the improvements made by Worthen to the building. At any time the building lease terminates, Lyon comes into full possession of the building and all its appurtenances. And this shows a significant benefit of ownership for Lyon, and operates as well to negate any inference that the parties never contemplated Worthen relinquishing control of the building.

Now, the ground lease must, of course, be considered together with the building lease. The rent payable by the bank during the first 25 years of the building lease exactly put Lyon in funds to meet its liability to New York Life on a quarterly basis.

Thereafter, as I have said, the bank had eight successive options to renew the lease for five-year periods, and the rent for such periods is fixed at $300,000 per year, and by that time time Lyon has no longer any obligation to the financial institutions.

Under the building lease, Worthen Bank had four options to purchase the premises, at the end of 11, 15 and 25 years; these options and the purchase price appear at page 419 of the Appendix. They are substantial amounts.

If Worthen exercised any one of these options to purchase, both the building lease and the ground lease would terminate.

However, if Worthen did not exercise the option to buy, the ground lease would continue in full force and Frank Lyon Company would be liable for the aggregate of $7,600,000 of rent due for the fifty years remaining under the ground lease.

In this respect, the government has significantly misstated the situation in a footnote on page 13 of its brief. I'm sure that this was unintentional, but it is significant.

The government says there that, and I quote, "The ground lease would terminate if Worthen did not renew the building lease", close quote.

As I have indicated, this is not true. The termination clause is paragraph 9 on page 369 of the Appendix. Under this, the ground lease would terminate on the exercise of one of the options to buy, under Article XX of the building lease; but there is no provision for termination of the ground lease on the failure to exercise one of the options to renew the building lease.

If the options to renew expire at any time between the 25th and the 60th year of the lease, Frank Lyon remains liable for the rent stated on the ground lease, including the rental stipulated for the final ten years of the lease. And during all of this period of potentially fifty years, if an option to renew is not exercised, Frank Lyon Company is the unqualified owner of the building, able to deal with it in any way it thinks desirable, lease it to a new tenant, replace it, sell it, or occupy it himself.

This is not a lease which provides for a bargain purchase. The prices payable if Worthen exercises the options to buy are substantial.

The trial court has expressly found, on evidence, that, and I quote from page 304 of the Appendix, "There has never been any understanding or agreement between Worthen and plaintiff that Worthen will ever exercise any of its options to purchase."

And the trial court also found -- and this actually appears at three places in the findings, but the quotation I give is also on page 304 -- the trial court found that "it is most unlikely and improbable that Worthen will exercise its hoptions to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods."

QUESTION: Did he give reasons for that conclusion?

MR. GRISWOLD: Yes, Mr. Justice. One of them, of course, is the same capital bind that Worthen Bank is in. Worthen Bank cannot exercise the option to purchase without becoming the owner of a bank building which is in excess of the -- of its capital, which violates the law.

QUESTION: Any finding about the possibility of increasing its capital?

MR. GRISWOLD: No, there's no finding about that. As I recall. Of course, there's always the possibility, but in these days of branch banking, this applies to all the banking premises, and the need of a bank not to put its capital in the banking premises was certainly one of the factors which led the court to come to that finding.

QUESTION: Worthen must have been -- is a very small bank, with a capitalization of only $4 million.

MR. GRISWOLD: Its capital has increased since 1968.

I don't know what it is. It has not increased to a Chase Manhattan Bank figure.

QUESTION: Or even close to it. And this building, this $9 million building, that was certainly more than just the offices of a small bank, wasn't it?

MR. GRISWOLD: Its capital has always been small, and the record contains a number of references from the banking authorities, saying Worthen Bank has a capital problem, it must increase its capital; and they were aware of this, and they were working at it.

QUESTION: What kind of a building was this, Mr. Griswold? It was more than just the offices of a bank, wasn't it? Of a small bank. Was it -- did it have -- was it an office building generally, or what?

MR. GRISWOLD: Well, Worthen occupied a third of the building --

QUESTION: A third.

MR. GRISWOLD: -- at the time it was completed. And they leased it to other tenants. But they did incorporate into the building and the adjoining premises quite a substantial amount of specialized bank equipment, such as vaults and teller cages and things of that sort. But at the time they started, they occupied a third of the building.

QUESTION: I share Mr. Justice Stewart's inquiry. I've always been under the impression the Worthen Bank is one of the major banks in Little Rock. And this $4 million figure does seem to me to be almost under-capitalization, per se. They've got a good location --

MR. GRISWOLD: I'm not an authority on the banking facilities of Little Rock. My knowledge extends to the fact that in 1968 their capital was $4 million and that it has increased somewhat since that time.

QUESTION: Mr. Griswold, may I return to the options? The trial court found that there was little likelihood of an exercise of the option to purchase at the end of 25 years. The option price of $2.1 million, I think it was. Is not one reason why the bank was unlikely to exercise the option to purchase was that the present value of the extended lease term was a lesser value, something like $1.8 million, and therefore there would be no reason to take the purchase, they probably could have bargained for the purchase of the building for less than the $2.1 million.

MR. GRISWOLD: No, Mr. Justice, that is the line which the government is now pursuing. After contesting the point vigorously below, the government now concedes that it is unlikely that Worthen will exercise a purchase option.

But the government maintains that the reason Worthen will not buy the building is because the rental options are so attractive, which is essentially your point.

QUESTION: Well, they are somewhat more favorable;

the difference between \$2.1 million and \$1.8 million, as I read it. Is that -- do I correctly understand the basic economics?

MR. GRISWOLD: The --?

QUESTION: That the value of the -- if they renewed on the lease basis rather than the purchase, it would be like buying it for \$1.8 million.

MR. GRISWOLD: This is a -- this, of course, is a question of assuming up to 25 to 65 years in advance what interest rates will be involved. But I think the real difference is a flaw in the way of reasoning that. It is said that it will only cost Worthen Bank \$50,000 to occupy this building in the later years, because the rental is \$300,000 in the later years; but the ground is \$250,000.

But that ignores the fact that Worthen can walk away and still get the \$250,000. Frank Lyon is liable for the rent on the ground lease, whether Worthen renews the lease at all or not.

So the real question is whether it is advantageous for Worthen to occupy the premises and, in contrast to moving away some place else, opening a new building and collecting \$250,000 a year from Frank Lyon the old one.

QUESTION: I just want to be sure I understand your side of the case on this, Mr. Griswold.

Do you dispute the figure -- I don't know whether it's a finding or just in the brief -- that $1.8 million is a fair estimation of the value of the --

MR. GRISWOLD: No, Mr. Justice, I don't know that we dispute that. We regard it as not necessarily controlling. There are various reasons why Worthen might not wish to keep its bank there. The banking community might move away to other parts of the city, as it has in various places, and, as was suggested by the president of Worthen Bank in the evidence in this case, with the development of electronic fund transfer, the whole nature of banking may change. You may have simply outlets in department stores and things, and your bank may be out in a suburb.

Between the two, it is clear that the option to renew is probably mathematically more advantageous than the option to buy. But it still does not follow that the option to renew the lease will be exercised. And if the option to renew is not exercised, then Frank Lyon remains liable on the ground lease for very substantial amounts.

Now, the government says that Frank Lyon is a mere conduit. It relies on the fact that the rental payments from Worthen to Lyon are exactly the same as the amount due from Lyon to New York Life on the long-term note. That simply means that they were not concerned with immediate cash flow.

What it means is that they were looking for protection on return to a combination of tax benefits in the early years, where they could use, as provided by law, double declining balance depreciation, and also to profitable operation, potentially, in the years following the 25-year period.

I've talked mostly about depreciation. Let me talk briefly about the interest deduction. I don't see how there can be any question about that.

Section 163 of the Code provides that there shall be allowed as a deduction all interest paid or accrued in the taxable year on indebtedness.

Here Frank Lyon Company, an independent entity, was indebted to First National City Bank and to New York Life on its notes. It borrowed the money and it paid interest. Worthen did not borrow the money. Worthen was not liable on the notes, and did not guarantee the notes. It didn't pay interest.

Under the statute it seems to me clear that Frank Lyon Company should be entitled to deduct the interest.

Lyon is not a finance company. It was an entrepreneur in this transaction. It invested a substantial amount of its own money and it undertook large liability on its notes and on the ground lease. With reason and with the advice of counsel, both parties proceeded on the understanding that Lyon is the owner of the building and is entitled to the depreciation deduction.

There is no reason in fairness nor in the terms of the Internal Revenue Code why Lyon should not have the deduction. There is no need to take the deduction away from Lyon in order to protect the revenue.

There is, I venture to say, no real justification for a system which says that the depreciation and interest deduction, in such a case as this, must wait until the final decision of the highest Court.

Here, if it had been known that Worthen was entitled to the deduction, as in effect held by the court below, despite the fact that Worthen could not legally be the owner of the building, then the parties could have bargained accordingly. The rent would necessarily have been that much higher.

It is important in a case like this, a three-party case -- not a case like some of the others where they are just dealing with a finance company, and in the Sun Oil case, with a tax-exempt pension fund -- it's important in a case like this, a three-party case, where the owner-lessor is not a financing corporation, that the transaction be given effect for tax purposes on the basis established by the agreement of the parties.

This is the conclusion which this Court reached in the Lazarus case, there's no valid reason in tax policy for not applying that conclusion here.

The judgment below should be reversed, and the judgment of the district court should be affirmed.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you.

Mr. Smith.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF THE RESPONDENT.

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

The question in this case is simply whether this transaction resulted in Frank Lyon having an investment in this bank building that would support its claimed income tax deductions for depreciation and mortgage interest.

As the arguments have thus far illuminated, this particular specie of transaction, the sale and leaseback, is no stranger to this Court, to the lower federal courts or to the tax bar.

For, more than 40 years ago, this Court held in Lazarus that the statutory tax deductions attributable to the ownership of property do not follow legal title, but turn on capital investment.

So the question really is: Who made the requisite capital investment in this bank building, to justify depreciation? And who --

QUESTION: As I understand that, the implication of what you just said, Mr. Smith, and I guess it's clear in your brief, that you do concede that somebody is entitled to the deductions for interest and depreciation?

MR. SMITH: Absolutely. Absolutely.

QUESTION: And you say it's Worthen?

MR. SMITH: We say it's Worthen.

QUESTION: Right.

MR. SMITH: And who enjoyed the use of the borrowed funds to justify the deduction for mortgage interest?

We submit that an analysis of the transaction compels the conclusion that the Court of Appeals properly applied the several principles in this area, so that Worthen Bank had the investment in the building, because Frank Lyon, when the transaction is properly analyzed, did nothing more than lend Worthen Bank $500,000 to earn 6 percent interest.

QUESTION: Do you draw all of what you've said up to now out of the Lazarus case?

MR. SMITH: We think the Lazarus case establishes the basic principles in the area -- the basic principle in the area, that the statutory right to deductions for the ownership of property do not follow title but rather follow capital investment.

QUESTION: Well, all that said was that it was going to treat it as a mortgage under the traditional equitable rule; what appeared to be a deed outright was going to be treated as a mortgage.

MR. SMITH: That's true, Mr. Justice Rehnquist, but I think --

QUESTION: It's a two-page or two-and-a-half-page opinion, isn't it?

MR. SMITH: That's true, and -- but I think that the part of the opinion you've cited is -- was authority for the Court adopting the Federal Tax Rule. That is, there is nothing unusual about the Court's decision, because essentially equity in your property had had a similar rule.

But since the Lazarus case, and I think this is really undisputed, the lower federal courts, the circuits, have uniformly applied the Lazarus principle to analyze these sale-leasebacks under the -- where the inquiry is: Who made the capital investment? And that person or that entity should get the proper tax deductions.

I think the thing starts from Lazarus, but we now have several jurisprudence with, you know, intermediate appellate courts, commissioner's rulings, and what-have-you, which set forth the basic settled principles in this area.

QUESTION: Mr. Smith, I'm just curious, you just said that Worthen was entitled to it. Does the record show or do you know whether Worthen in fact received the benefit of these deductions?

MR. SMITH: Well, my -- the record does not show. Although my information is that the -- for this particular taxable year, Worthen was audited -- in other words, the audits proceeded side by side, so that somebody would get it. And that the Worthen case was settled, I think in favor of Worthen.

QUESTION: It isn't a situation of the statute of limitations having run, as is usually the case?

MR. SMITH: No. No.

QUESTION: Mr. Smith, if the primary inquiry is, as you phrased it, Who made the capital investment?, would the government's position be precisely the same if there were no options involved in the case, no options to renew or options to purchase?

MR. SMITH: It would be a much harder case for the government.

QUESTION: But would the capital considerations all be precisely the same?

MR. SMITH: Oh, no, because what -- the capital -- well, yes and no, inthe sense that I think, you know, one of the basic -- one of the basic considerations in our conclusion and the Court of Appeals conclusion, that Worthen Bank made the capital investment, is that under the primary term of the lease, that is the 25-year term, when Worthen was paying, making these payments which, although contractually it obligated itself to pay directly to New York Life, it would -- it paid via Frank Lyon. It made the capital investment, because it obligated itself, it locked itself into the deal. In other words, New York Life insisted that Worthen's obligation to pay, to make the payments be absolute, without any deduction for setoff or counterclaim. And Worthen -- and Frank Lyon, excuse me, signed the lease to New York Life, and assigned its right to modify or terminate the lease.

Worthen in fact, in turn, agreed to that assignment and agreed that it would not cancel the lease. So you have a situation -- and I think that fact is significant -- that Worthen, by making these payments and being legally obligated, the documents themselves make it legally obligated to make these payments, which pay off the mortgage, that in effect it has made the capital investment.

I think, to answer your question, the option prices establish a second and basic point, which the courts have emphasized in this area; and that is, the option prices demonstrate that there was no way that Frank Lyon Company could get any more than $500,000 compounded at 6 percent in this deal. Because if Frank -- if Worthen exercised the option at any point down the line, that is, the 11th, the 15th, the 20th or the 25th year, those option prices -- and the record is undisputed on this point -- were calculated precisely to give Worthen -- to give Frank Lyon $500,000 back compounded at 6 percent interest.

QUESTION: Mr. Smith, in answering Justice Stevens' question a moment ago, you referred to our conclusion and then you corrected yourself to say that the Court of Apeals conclusion.

MR. SMITH: Well, I think that --

QUESTION: Well, let me finish my question, if I may. Just how free are either you or the Court of Appeals or this Court to substitute judgments as to what the realities of a transaction was for the judgment of the district court?

MR. SMITH: Well, I think, Mr. Justice Rehnquist, that there are two operative principles in this area established by this Court which make this question freely reviewable on appeal.

Now, let me just briefly mention them. The Lazarus case itself stated that in the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding. That -- we take that to mean, and the courts have taken that to mean that if Frank Lyon calls itself an owner in these documents, and Worthen Bank calls itself a lessee, that that -- those labels, that nomenclature is not controlling. Indeed, I suppose if A were to enter into a document with B and call it a lease and say, "I'm going to lease you these premises for $100,000 for one payment in perpetuity", that that would be rent by the terms of the document, but it would clearly be a sale.

Now, the second point -- and this is a point which I think needs addressing, because Mr. Griswold mentioned the parties' expectations -- that more than 17 years ago, in the Duberstein case, the Court said, with some compelling force, I think, that it scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct, in themselves have nothing to do with the matter.

QUESTION: But supposing you take both of the principles you've just stated as agreed to, that still doesn't fully delineate the scope of what is finally concluded by the district court's findings and what appellate courts and the Commissioner in the tax sphere may speculate about as to probabilities of things happening on appeal.

MR. SMITH: I think that's right. I think that the district court had a role to play here. But our point, as we've more fully elaborated in the brief, in our brief, is that the district court's finding did not -- whether they are accurate or not, didn't analyze the transaction fully.

Let me elaborate on that, if I may, because it's a matter of some concern between the parties.

QUESTION: In that process, will you say specifically what was clearly erroneous in the district court's finding?

MR. SMITH: Yes.

If I may call the Court's attention to page 6a of the Appendix, or actually going to the bottom of 5a, looking at the district court's findings.

The district court makes findings as to the annual rent during the primary term, which we have no --

QUESTION: That's in Volume I, I take it?

MR. SMITH: No. I'm sorry, Mr. Chief Justice, this is in the Appendix to the Petition.

QUESTION: Oh. Thank you.

MR. SMITH: This is finding No. 6, at the bottom of 5a actually.

The district court said the annual rent for the first eleven years was so much and so much, and the annual rent for the next 14 years was so much.

It then went on to say,"the rent on the building during the option periods totalling 40 years"-- turning over to 6a --"is $300,000 per year. The evidence reflected, and the court finds,that the rent to be paid by Worthen during the term of the lease is reasonable, a fact not contested by the defendant."

Well, let me say two things about that. The fact that the rents were reasonable during the primary term is the beginning of the inquiry and not the end of the inquiry. Because the district court's finding that the building rent of $300,000 a year for the next 40 years is reasonable, while not erroneous, misapprehended the fact that was brought out in the earlier part of the argument, the effect of the ground lease setoff. Because, as you can see on page 7a, the ground lease rents, after the first 25 years, started to mount up quite substantially. And those sharp increases in the ground lease had the effect of sharply decreasing the building lease -- the building rent.

QUESTION: Mr. Smith, is it correct, as your adversary points out, or says, that had the option to renew not been exercised, Lyon would have remained liable for these ground rents during that extended period?

MR. SMITH: That is true, and it's the -- the footnote in our brief was inadvertent. The ground lease would only terminate upon condemnation or taking or upon Worthen's exercise of the options.

QUESTION: Then isn't -- with that in mind, it's true the district court finding doesn't explain the fact that the net income will be the difference between the building lease and the ground lease, but the finding is really a realistic finding under that --

MR. SMITH: No, let me say this in response, Mr. Justice Stevens. I think the district court's finding can only be fairly read to say that the reasonable rent was $300,000 for 40 years.

QUESTION: Well, the part of the building on which the owner has to pay ground rent of a certain amount.

MR. SMITH: Right. But that point - that wasn't the real rent. The real rent that Worthen was going to have to pay, if it went into this option period, the renewal period, was going to be, first, $200,000 a year, and then ultimately, for 25 years, was only going to be $50,000 a year, and Worthen's own president characterized that as a very, very cheap price.

Now, let me make another point.

QUESTION: Well, but is that fair? Supposing they had rented a comparable building on some third party's land, and paid $300,000 for it, and that was a fair price, they'd still get income from the ground rent, ground lease to Lyon, to net it out anyway.

Don't you still look at the fair rental value of that which they're renting?

Because they always are going to get the ground rent.

MR. SMITH: Worthen is always going to get the ground rent, if --

QUESTION: Yes. Whether they rent this building or they rent a building on neighboring property.

MR. SMITH: Well, the point is, in this particular transaction, isn't the important point that Worthen, who is going to, in effect, pay a sharply -- I mean that Frank Lyon -- I'm sorry -- Worthen is going to pay a sharply reduced building rent. And that building rent, when you figure it out over the 40-year period, again was going to redound to

Frank -- that was only going to pay off Frank Lyon to the tune of $500,000 compounded at 6 percent interest.

QUESTION: Is even that completely correct? Is it not correct that if there had not been an exercise -- if none of the -- if all the options had been exercised, then the matter had run its course, so that at the end of the 65-year period Lyon owned the building and had the land there, it would not have gotten its $500,000 plus 6 percent compounded, unless it got some additional value during the ten-year tag-on period; isn't that correct?

MR. SMITH: It would have been slightly short of that point, which I -- it seems to me that that indicates that it wasn't even going to get $500,000.

All my point was --

QUESTION: There's a risk --

MR. SMITH: Yes.

QUESTION: -- as to whether they get the 6 percent.

MR. SMITH: Well, yes, but the risk goes the other -- I mean, our point is that the risk goes the other way.

In other words, that Frank Lyon, in this deal, could only hope to get $500,000 compounded at 6 percent interest, but might get less.

QUESTION: Well, supposing the building turned out to be very, very valuable at the end of the 65th year?

MR. SMITH: At the end of the 65th year, they might get more if they could rent it for more.

QUESTION: So is it not conceivable that, with the set of facts, that depending on what happened, they could have gotten either more or less than $500,000 plus 6 percent compounded?

MR. SMITH: May I suggest that if the building turned out to be terribly valuable, that Worthen probably would have exercised its option to repurchase.

QUESTION: You mean Lyon would have probably charged them a handsome rent for the last 11 years.

MR. SMITH: Assuming they wanted to be in the building.

QUESTION: Yes.

MR. SMITH: I think what -- I think the point, the important point, you know, and our discussion has indicated it, is that while Frank Lyon had some upswing during that last ten years, the basic -- it was basically limited to $500,000. The whole deal was structured to permit it to receive no more than $500,000 compounded at 6 percent interest.

I think that that's -- that is demonstrated from the condemnation and taking provisions. Because, at any point during the transaction, if the government condemned it or it was destroyed, Frank Lyon would -- first the mortgage would have to be paid off because New York Life was not going to jeopardize its position, then Frank Lyon would get $500,000 compounded at 6 percent interest, and then any excess would go to Worthen.

The point that we think is significant here, and the point that the Court of Appeals emphasized, is that any appreciation, any upswing, if this thing turned out to be terribly valuable, Worthen would benefit from the appreciation.

To us this is inconsistent with the notion of ownership of property. If you own real property and it goes up in value, you're an owner, you expect to be able to benefit from that appreciation in the profit. You don't expect to have it be taken away from someone in a set of documents who calls itself a lessee.

And if that someone can take it away, even though it calls itself a lessee, we submit that that indicates to us -- that it indicates that the transaction may simply be a loan and not --

QUESTION: But let's get it from the other side for a moment, Mr. Smith. You say if it appreciated in value it's likely Worthen would have exercised its options and retained control.

But supposing it went down in value, farther than the parties anticipated? Who assumes the risk of that happening?

MR. SMITH: If it went down in value, it drastically went down in value, then Frank Lyon would not get back his five hundred --

QUESTION: Then what is the purpose of the depreciation deduction, to protect against increases or decreases in value?

MR. SMITH: The purpose of the depreciation deduction, as Justice Brandeis said a long time ago in Ludey, is to permit a deduction for the --

QUESTION: For declining value.

MR. SMITH: -- for getting the cost of an asset over the period -- over the period of the investment.

But the point is, what Frank Lyon is -- Frank Lyon has put $500,000 in this building and has set up the transaction in a way to insure that it will never have to pay a penny of its own money to pay off the mortgage. Worthen is locked in to paying off the mortgage. And on this $500,000 investment, it is seeking depreciation deduction in excess of $7 million. To us there's something wrong with that.

If you look at it from the other side of the coin, it --

QUESTION: But my point earlier, Mr. Smith, -- I want to be sure you've answered it to the best you can -- that would all be true, even if there were no options to purchase or options to renew on the part of Worthen.

MR. SMITH: That is true. That is true. But the options to purchase and the options to renew, in our view, emphasize the fact that Frank Lyon was limited to what it could get out of this deal, limited to recover its $500,000 compounded at 6 percent.

Much like any note-holder. In other words, the way the deal really worked, when you strip it down to its essentials, is that Worthen spent the first 25 years paying off the New York Life mortgage, and then it was going to spend the next 40 years, if it didn't exercise, if it didn't pay it off immediately, paying off the, what I would call the Frank Lyon mortgage.

QUESTION: Mr. Smith, let me ask just one other informational question. Does the record tell us what the depreciable life of the building was?

MR. SMITH: The record does not tell us what the depreciable life of the building is, but we have a reference to the fact that the Treasury -- the appropriate Treasury guidelines in this area call for a 45-year useful life for such an office building.

And that, if I may, let me pursue that for a moment, Mr. Justice Stevens, because I think it's significant. What you have -- taking it from the other side of the transaction, if you look at it from Worthen's point of view, Worthen has, in effect, paid off a mortgage over 25 years, and called it rent. It, in effect, will be getting, writing off the cost of this building over 25 years, if this transaction has to be honored by the tax collector, when the useful life, the Treasury useful life of this building is 45 years.

And that leads me to a point I wanted to make about --

QUESTION: Mr. Smith, before you go on to your next point, you assume, of course, that the bank will pay off its rental obligations, it's a likely assumption, I would concede; but a number of banks do fail, including some fairly large ones.

In that event, who would be responsible for paying the New York Life?

MR. SMITH: If the bank failed, Mr. Justice Powell, Frank Lyon would be looking down this note. We don't have any quarrel with that. We think that, since it's been mentioned that the Worthen Bank is a substantial bank in Arkansas, I would think that that is despite the confusion over its capital, I would submit that that is --

QUESTION: You could name a substantial bank in New York City that had a certain amount of trouble, couldn't you?

MR. SMITH: Oh, yes. But that's New York City.

[Laughter.]

MR. SMITH: Anything can happen there.

QUESTION: Mr. Smith, since I've interrupted you, let me come back to a fundamental. What policy of the United

States and of the Internal Revenue Service is served by this litigation? I understand you concede that someone is entitled, I think you say the bank, to the depreciation and the interest deductions.

Now, granted, in a particular case that may -- it may fall in the government's favor or it may fall against the government, depending on the tax posture or the taxpayer at the moment; but what policy is served?

MR. SMITH: The policy, Mr. Justice Powell, we submit, is that when Congress enacts these deductions and permits people to claim them, it assumes -- and necessarily a rational system has to assume this -- that the proper person is going to claim these deductions.

Now, in the --

QUESTION: Well, that starts with a conclusion of proper person.

MR. SMITH: Well, no -- in other words, that -- and only -- well, in other words, if -- I don't think it's a conclusion; in other words, if someone goes to the doctor and spends money for a doctor you would assume that that person would be eligible for the medical deduction.

Now, here we have a two-party transaction, Worthen Bank and Frank Lyon. The depreciation deduction, as I've mentioned, is keyed to capital investment. In other words, who made the capital investment?

Here is a situation where Worthen Bank has locked itself into a deal and committed itself to pay $7 million for a building over 25 years. It managed to call it rent in the documents, but in fact it's buying a building.

We submit that it is the proper party to claim the depreciation deductions. And the fact that it has bargained them away, so to speak, to someone else --

QUESTION: But under the law of the State, it could not buy a building of that magnitude, a cost of that magnitude.

MR. SMITH: Let me address that point, Mr. Chief Justice. Under the banking regulations, petitioner has claimed that it could not own this building. But, as we read the statute, and it's set forth in our brief, the banking regulations simply require that it seek permission from the banking authorities, from the federal banking authorities, before it made an investment in its building in excess of its capital. It sought that permission and the banking authorities gave its blessing to this arrangement.

And, in fact, one of the letters called it a method of financing. I mean, this is a very standard method of financing a building. But it must be looked at as simply that: a method of financing. The courts have so looked at it, the authorities have -- the articles have looked at it.

And, in that sense, Mr. Justice Powell, we think the policy has -- the policy has to be that the proper person claim the deduction.

Now, in the ordinary case, -- the record is silent on this point -- we don't know what the tax situation, the tax positions of Frank Lyon Company and the Worthen Bank are, for any of these years in issue. But I can say that my examination of the litigated cases, and this Sun Oil case, which we've cited, which we set forth in a supplemental memorandum which the Third Circuit has just decided, specifically approved the kind of analysis that the court below, the Court of Appeals engaged in. That essentially the -- that the tax policy has to be that the right person claim the deduction.

And, as I was saying, to pick up the point, that normally in these situations the tax positions of the parties are entirely diverse, and what you have is a situation where a corporation in a lower effective bracket wants to finance a building and trades off its tax deductions to a wealthy individual. Down the road, this is a long deal, a bank like Worthen company -- after all, banks are subject to special tax treatment and have special ways to write off bad debts, the Worthen Bank may have losses at some point, it may have anticipated that it had losses; and this was the kind of deal that it could arrange with someone like Frank Lyon Company, which was a burgeoning and profitable business, to shelter its income.

Because what happens at the end of this whole deal is Frank Lyon Company had $3 million of deductions over the first eleven years of this deal.

QUESTION: Mr. Smith, you've answered my question at some length about policy, I'm not sure I understand your answer, but let me move to another policy question.

The Federal Reserve Board approved this transaction. If it hadn't, the bank would have been in violation of the Federal Reserve Act.

It is conceded that the transaction that was made was a bona fide transaction. Here another agency of the government comes along and says, in effect, No. 1, the transaction was really illegal because your position is that the bank still owns the building. If it owns the building, it's in violation of the Federal Reserve Act.

Now, what do private parties do in these circumstances? When one arm of the government tells them: Go ahead with the transaction, we've examined it and we approve it. And the Internal Revenue Service comes along, several years later, and takes a different view.

MR. SMITH: I don't think, if I may, that that is what happened. The banking authorities simply permitted Worthen Bank to finance this building in this particular sort of way. In giving its approval to this transaction, the banking authorities in no sense sought to speak to what the tax consequences of the deal would be.

QUESTION: I understand that. That was not my suggestion.

MR. SMITH: And I don't think that there is --

QUESTION: The banking authorities were interested in who owned the building, though, and that's the bedrock of your case.

MR. SMITH: Owned the building for tax purposes. In other words, --

QUESTION: Oh, you're saying there's a --

MR. SMITH: Well, what I'm saying --

QUESTION: -- distinction between legal ownership of the building and ownership for tax purposes?

MR. SMITH: What I'm saying is that the backing -- well, first let me repeat a point I made earlier, and that is, I don't think that it was illegal for the bank to own this building. That's not the way we read Title 12 U.S.C. 371(d).

QUESTION: It would have required approval.

MR. SMITH: They were required to give approval.

QUESTION: Yes.

MR. SMITH: And the banking authorities gave that approval.

Now, in giving that approval for this mode of transaction, I think what the banking authorities were concerned with is making sure that Worthen Bank did not carry this building on its books, and they were able to satisfy the banking authorities that it would not be doing that; indeed, it's not the nominal title holder.

But the Court in Lazarus, 40 years ago, said that nominal title holding is not significant in terms of who gets tax deductions attributable to the ownership of property.

QUESTION: Yes, but you've got something more here than nominal title. Would it be prudent banking to have a bank own a building valued at about twice its capitalization? Would you think any banking authority would approve that?

MR. SMITH: Mr. Chief Justice, I don't think that the -- I think that the banking authorities permitted the transaction as we see it, and the undisputed, you know -- the --

QUESTION: Are you suggesting that the banking authorities were simply winking at the idea?

MR. SMITH: I think that the banking authorities were addressing themselves to an entirely different point. I think that they were concerned with making sure that the bank was not overextending itself in some way to the detriment of its depositors. And I think that the -- that the -- that the bank convinced them this would not be a problem.

But, in fact, the bank, if you look at the undisputed legal import of the deal as the parties made it, the bank obligated itself to pay rent absolutely, without any setoff or deduction for the first 25 years of the term. And that obligation required -- that obligation had the effect of paying off the New York Life mortgage.

From the tax collector's point of view, that obligation looks very much not like rent.

Let me close, if I may, --

QUESTION: What happens if -- you have so much in Washington and other places -- where the government rents a whole building, what happens to the taxes on that?

MR. SMITH: When the government rents --

QUESTION: A whole building.

MR. SMITH: A whole building.

QUESTION: Like down at Buzzard's Point.

MR. SMITH: Yes.

QUESTION: Leases the whole building.

MR. SMITH: Yes. Well, the government is a good tenant. I'm not sure what -- that doesn't --

QUESTION: I think your whole point is that in the government ownership means something in one department and something else in another department.

MR. SMITH: Well, I think --

QUESTION: So why don't you just admit that?

MR. SMITH: I think that the government -- I think that the banking authorities were interested in who is carrying this bank on its books. I think the tax authorities are concerned with who is obligated to pay off this thing, and be obligated to have -- to that extent, I suppose that's right.

But I don't think that's a confusion that necessarily operates to the detriment of private parties. I seems to me that the principles in this area have been settled for a long time.

QUESTION: Mr. Smith, let me ask --

QUESTION: Just a minute. When this Lyon Company signs a personal note for the full cost of that building, that they didn't have a right to think that they were buying it?

MR. SMITH: When Lyon Company signed a personal note for this building, they managed to hook on the Worthen Bank and lock it into the deal and say, "You've got to pay me every month" --

QUESTION: Then what good was the note?

MR. SMITH: Thenote was simply -- that was simply --

QUESTION: The note which, if it fell through, Lyon would have to pay it.

MR. SMITH: Absolutely. If the bank defaulted, Lyon would have to pay it.

QUESTION: But they didn't own it?

MR. SMITH: But they didn't own it, because they locked in Worthen Bank to pay off. It's simply that Lyon is really in the posture of a guarantor, because Worthen Bank has to make these payments. It's a substantial -- it's a substantial entity, and if for some reason it failed, then the guarantor has to take over. But guarantors aren't entitled to deductions until the operative facts upon which the guarantee is premised arises.

I mean, that's our point. If essentially the -- if Frank Lyon Company -- if Frank Lyon Company ultimately found itself holding the bag on this thing, then and then only would it be entitled to depreciation deductions, because it would then have, it would be forced to have an investment in this building.

Until then, we submit that it was really simply a passerby who is receiving these rental payments from Worthen Bank and transmitting them, by contractual arrangement, to New York Life Insurance Company.

If the Court has no further questions -- thank you.

MR. CHIEF JUSTICE BURGER: You've had an extra three minutes here.

Mr. Griswold, do you wish to respond?

REBUTTAL ARGUMENT OF ERWIN N. GRISWOLD, ESQ.,

ON BEHALF OF THE PETITIONER

MR. GRISWOLD: Very briefly, Mr. Chief Justice.

First, I would like to correct one thing in the record. The question as to what Worthen Bank has been doing with this depreciation does appear in the record. It's at the bottom of page 201 and the top of page 202, where, about two inches below the top of page 202 counsel for the government says: "I believe the bank has continued to treat the transaction as it was treated originally", and though that is perhaps a little inconclusive, it was tied up by trial counsel, Mr. Williamson, on page 216 of the record, where he asked the president of Worthen Bank, "Has Worthen Bank contested that determination or agreed to it?" And President Penick said, "We have contested it."

The Worthen Bank is not accepting the determination.

Now, with respect to depreciation, I think that Mr. Smith has been a little glib in talking about 45 years. A building has lots of components, including plumbing and mechanical and electrical and elevators, and the depreciation period for them is 15 years. For architectural and general construction, it is 33 years. And finally, for the structural frame, it is 40 years.

The fact is that a very high proportion of this total depreciation is available within 25 years, more than close to 90 percent, and there isn't much difference over 25 years between double declining balance and straight-line depreciation.

And then, finally, I would like to say that it's perfectly plain here, Mr. Smith keeps saying in his brief here that permission was sought and it was given; well, it was given for this sale-leaseback arrangement. Permission was sought to build the building and own it, and it was refused.

And this isn't a purely cosmetic matter of a banking official trying to keep this from appearing on the balance sheet. If Lyon's liability is as lessee, and that is the way in which Lyon supported the -- that is the way in which Worthen supported Lyon's liability, the same way that any building owner looks to his tenants to pay the rent in order that he can pay the bank what he has to have.

If Worthen went insolvent, I'm not instantly familiar with the immediate details of the bankruptcy law, but my recollection is that there would be a claim on behalf of the depositors for two years' rent, but not for all the future.

On the other hand, if Worthen Bank was liable on the note, there would be a claim in its bankruptcy for the entire amount of the note, and that is a very real difference, and the reason why the banking officials, rightly, would not allow Worthen to own the bank.

Thank you.

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

[Whereupon, at 2:48 o'clock, p.m., the case in the above-entitled matter was submitted.]

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