ORIGINAL

In the

Supreme Court of the United States

UNITED CALIFORNIA BANK AND LILLIAN DISNEY TRUYENS, CO-EXECUTORS OF THE ESTATE OF WALTER E. DISNEY,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

No. 77-1016

Washington, D. C.
October 4, 1978

Pages 1 thru 39

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Petitioners	:	
vs	:	No. 77-1016
UNITED STATES OF AMERICA	:	
Respondent	:	

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Washington, D. C.

Wednesday, October 4, 1978

The above-entitled matter came on for argument at 10:44 a.m.

BEFORE:

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

APPEARANCES:

RONALD E. GOTHER, ESQ., 515 South Flower Street, Los Angeles, California 90071; on behalf of the Petitioners

M. CARR FERGUSON, ESQ., Assistant Attorney General of the United States, Department of Justice, Washington, D. C.; on behalf of the Respondent

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments in 77-1016, United California Bank and Lillian Disney Truyens v. United States.

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

ORAL ARGUMENT OF RONALD E. GOTHER, ESQ.,

ON BEHALF OF THE PETITIONERS

MR. GOTHER: Yes, Mr. Chief Justice, and may it please the court:

The facts of this case involve the Estate of Walt Disney. Under Mr. Disney's will he provided that 45 percent of the residue of his Estate was to pass to the Disney Foundation, where it was to be held for certain charitable and educational purposes, primarily for the support of California Institute of the Arts, a school which he helped to found.

During 1967 and 1968, the Executors of his Estate sold stock of Walt Disney Productions at a substantial gain. In computing its tax for those years in which the gain was incurred, the Estate excluded from tax 45 percent of the gain, being the gain which was permanently set aside for and would ultimately pass to charity, and paid tax, therefore, on only 55 percent of its gain.

Such 55 percent passed basically to taxable taxpayers, a trust for the family of Walt Disney.

The IRS has taken the position that, if the Estate wanted to exclude 45 percent of the gain which was passing to charity, then in computing its tax on the 55 percent of the gain passing taxable beneficiaries, it had to compute such gain -- I should say it could not use in computing the tax on such gain the alternative tax rate which during those years placed a 25 percent limit on the amount of tax on capital gains.

What the Internal Revenue Service said was that if you wanted to use the 25 percent tax rate, that tax rate must be applied against 100 percent of the gain, including the 45 percent of the gain that passed to charity.

While the facts of the case are easy to understand, unfortunately the law is not. And this is due to some very complex style of legislative drafting, and also to the interrelationship of several different Code sections.

I believe that the taxpayer has accurately interpreted these Code sections and put together these Code sections in a way that carries out the intent of Congress. I would say that the correctness of our interpretation must be judged against the two basic intents of Congress, which are quite evident from this particular fact pattern.

QUESTION: Mr. Gother, in your primary brief you did not cite Foster Lumber.

MR. GOTHER: No, we did not.

QUESTION: You cited it rather collaterally in your reply brief. Do you feel that Foster Lumber has no significance in this case at all?

MR. GOTHER: I believe it has no significance for a couple of reasons. The first is that it was dealing with an entirely different set of Code sections. It was not dealing with a charitable set aside deduction.

QUESTION: That is conceded, of course.

MR. GOTHER: It was not dealing with the taxation of an Estate, which is I think a major factor here. It was dealing with a carry-back,of a lost carry-back to a prior year during which the taxpayer calculated his tax using the alternative tax rate.

QUESTION: But is not the -- we know all of that. Is not the general principle saying, however, here is a statute that seems to say one thing and conceded the intent of Congress the other way. And I just wondered whether your failure to cite it is indicative of the fact that maybe it is against you?

MR. GOTHER: I do not believe so, Your Honor, at all. I think also that our interpretation of the Code is a literal one and that we are literally interpreting our Code section correctly and that the government is not.

QUESTION: What we get down to then in your approach is whether the Estate is a conduit period, nothing more?

MR. GOTHER: In part and whether the conduit system is applicable to the 1201(b)(2) alternative tax rate calculation, yes.

Foster Lumber is no different than the Weil case in essence, that you had an excess of an ordinary deduction which you could not use against your alternative tax rate. And that was a regular ordinary lost carry-forward deduction.

I am saying that our charitable set aside deduction is an entirely different animal; that it is not an ordinary deduction that an individual taxpayer, individual or corporate, such as in Foster Lumber had, but it is a different type of deduction and it is more of a manifestation of this conduit.

Also in Foster Lumber the issue is the definition of taxable income. If there is anything that is relatively clear in the Internal Revenue Code it is the definition of taxable income, and I do not believe that that is an issue here at all.

We say that there are two basic intents of Congress here that are evident. One is that there is to be no tax imposed on that part of any capital gain which an Estate realizes or any income which an Estate realizes, be it ordinary income or capital gain, which passes ultimately to a charity. 642(c) in the Internal Revenue Code says that any gain, any item of income, gain or ordinary income which is permanently set aside for charity is entitled to 100 percent deduction, even though it is not paid out.

So we have 100 percent deduction whether we pay it or do not pay it out in the particular year. It is referred to as the set aside deduction. It is perfectly clear from that that the intent of Congress was to exempt from tax that part of income realized by a fiduciary.

The second intent of Congress, which is perfectly evident, is that capital gains were to be taxed in those years at a maximum of 25 percent.

Now you have got these two intents and I believe they are perfectly reconcilable in our case, and our interpretation carries both of those out. The government's interpretation does violence to one if not both of those.

The basic issue which separates ourself and the government is best explained in the question whether the capital gains tax base for computing the alternative tax rate under Section 1201(b)(2) includes the gain going to the charity. This is by far the biggest area of disagreement between ourselves and the government. Section 1201(b) is set forth on pages 8-A and 9-A of the Appendix to the government's brief.

Before getting into the specific language of those sections, I think it is essential to take -- stand back just a bit and take a look at what is the overall concept of the taxation of estates and trusts. We have a peculiar system of taxation here because we have interposed a fiduciary, a third party here. We do not have a taxpayer and his tax. We have a fiduciary.

And the system -- the basic system for taxation of estates or trusts is first you determine what part of the income that a fiduciary realizes is either required to be distributed or will be distributed or is distributed to a taxable beneficiary. And that is one set of income. And you put that off to a side.

The next is that you look to see if there is any income permanently set aside for charity. Under 642, if it is, you set that aside.

You are then left with a third group, a third body of income that is taxed to the fiduciary. And then the question is: What tax rate applies to that tax income?

Now you go to Section 1201; 1201(b) says that if you have some capital gains in that year, you compute your tax in a two-step approach. You divide this taxable income that I have over here into its component parts, the first part being ordinary income, the second part being capital gain. And you do that by taking the taxable income that you have here and deduct out the part that is capital gain. And on the remaining part you compute your tax at your ordinary income rate. That is your ordinary income.

The part that is capital gain you then tax at a maximum of 25 percent.

Now what our position is that if you look at 1201 and apply it literally to what is the taxable income of the

Estate, our interpretation is as literal as any interpretation can be of that Code section; that the capital gains referred to in that section, the long-term capital gains, is the long-term capital gain that is in this pot taxable to the estate.

It is not in the pot that is going out to the taxable beneficiaries; it is not the gain that is in the pot over here for charity.

And the best way I think I can --

QUESTION: May I interrupt you, Mr. Gother? Do you take the position that the Weil case is wrong?

MR. GOTHER: No.

QUESTION: You do not, do you?

MR. GOTHER: Not in a fiduciary context.

QUESTION: Then you take the position that the word "excess" of long-term capital gain over net short-term capital loss means one thing for a fiduciary and another thing for an individual case?

MR. GOTHER: I believe that is correct.

QUESTION: And how do you reconcile that with the fact that 1201(b) refers to any taxpayer.

MR. GOTHER: Well, I think you are talking about the taxable income of that taxpayer. If you look at 1201(b)(1) --

QUESTION: 1201(b) starts out: "If for any taxable year the net long-term capital gain of any taxpayer" and then it goes on. And I would read it as prescribing the same procedure for individual taxpayers as for fiduciaries. I am just questioning your literal argument now.

MR. GOTHER: Well, my literal argument says that any taxpayer presupposes that you are talking about the taxable income of that taxpayer, not in the fiduciary context. So that in the fiduciary context that is literally being applied to this other part of income that is over here and not to these.

And I think another way of emphasizing that is look at 1201(b)(1) which now talks about the computation of the partial tax. The partial tax is computed on taxable income. Well again, that has got to be the taxable income that is taxed to the taxpayer. It cannot be some taxable income that is sitting over -- that is taxed to somebody else.

It seems to me we are applying it as literally. Let me show you that the government does not apply that literally; it does not even come close to applying it literally in the context of gain which is set aside -- a gain which is to be distributed or is distributed to a taxable taxpayer.

Remember, I have got that gain sitting over here. If you had gain that is to be distributed to a taxpayer, a taxable taxpayer, it is sitting over in this other pile. The government does not contend that when you compute the 1201 tax that this reference to the excess of capital gains -- excess long-term capital gain includes that taxable gain that goes over to the taxpayer. No, no. That is already out.

QUESTION: So they would take that out of the fiduciary's pot --

MR. GOTHER: They would.

QUESTION: -- of capital gain?

MR. GOTHER: And yet, if you want to read that as literal as the government seems to read it literally, that should not happen. The tax should be --

QUESTION: Well, at least you are saying that it ought to be the same for both pots, for both the charity and for the --

MR. GOTHER: That is exactly my position, yes.

QUESTION: And the government says they can be different?

MR. GOTHER: That is correct.

QUESTION: I take it that the government not only does not object, but it actually concedes that the respect of a taxable distributee this is the correct method under the statute?

MR. GOTHER: I have not seen that in the briefs, but we have computed -- we have given an exhibit in our reply brief of the instructions in computing your tax under 1041 and in the example of working it out in the form.

The court in Statler made the same observation. And I do not anticipate that the government would refute that. So they are not applying it literally. They are not even applying it literally in another context and that is in the context of the 691 deduction. The 691 deduction is a deduction for the amount of estate tax attributable to income in respect of a decedent item.

There are a series of cases which says that that deduction, if it relates to capital gain taxable to an estate, that deduction works as an exclusion from the capital gains tax face. And the government itself in the Sidles case argued that that 691 deduction reduced the capital gains tax base from 100 percent to something less than 100 percent.

So clearly the literal interpretation is not one which is there for the government. Our interpretation, it seems to me, is as literal as theirs. And ours does no offense to the basic --

QUESTION: But the government position does not reduce the amount distributable to the charity, does it?

MR. GOTHER: That is correct. That is their position here.

QUESTION: There is just less money in the estate? I mean you pay out more tax.

MR. GOTHER: You pay out more tax.

QUESTION: But it does not reduce the amount distributable to the charity?

MR. GOTHER: That would depend upon how the tax is allocated under your will -- how the tax burden is allocated.

QUESTION: Well, what about in this case? Is the charity hurt?

MR. GOTHER: Yes. Any tax payable out of the residue of this Estate is going to reduce the amount going to charity under the terms of Mr. Disney's will.

QUESTION: You mean the will was specific in that respect?

MR. GOTHER: The will was specific in that the charity shared in the net residue -- 45 percent of the net residue, this would be a residue charged.

QUESTION: Is the will in the record incidentally?

MR. GOTHER: Yes, it is.

Getting to the conduit argument, one other point that I want to emphasize very much is that the Ninth Circuit and the government both contend that this conduit principle does not apply to the amount going in this pot over here to charity. And they cite as an example of that Section 643(a)(3).

Now 643(a)(3) is a very complex section, but the position they take is that that section provides that capital gains that are in the pot going to charity are included or added to distributable net income. That is absolutely wrong -- absolutely wrong.

If you read through 643, 643 starts with the concept of taxable income. You have some taxable income now and you want to determine how much of that taxable income is going to be taxed to a taxable beneficiary. So taxable income already has a distributions deduction off, already has a charitable deduction off and so you have got to kind of gross this back up to see how much is going to be taxed to the beneficiary.

And in the process of grossing up, one of the things they gross up -- or one of the things they do is they -- 643(a)(3) says you exclude all capital gain. So they were in taxable income, but now you are going to take them out.

When you take them out, if you take out 100 percent of the capital gain, you would take out also those capital gains which are going to a charity, but they are already out of taxable income. So you would be taking them out twice if you did that.

So the statute has a double negative there, and they said, no, no, do not take out all the capital gains. Leave in there the capital gains that are going to stay in the trust and are going to be taxable to the trust, and the gains that are permanently set aside for charity, those having already been deducted above.

So you cannot contend that distributable net income includes any capital gains passing to charity. It was a basic error in the Ninth Circuit's opinion and a basic error in the government's brief.

As an example of that, the Ninth Circuit then goes on to say another example of why the conduit theory does not apply to this pot of gain set aside for charity over here is that Section 663(a)(2) says that -- excuse me, 662(a)(2) says that when you are going to allocate distributable net income in a particular circumstance among taxable beneficiaries, you take distributable income and then it says in parenthesis "and add to it the amount of the deduction that you have taken for charity under 642(c)."

Well, obviously, distributable net income, therefore, does not include anything going to charity;for the limited purpose of 662, they have that added back.

So the basic error that 643 does not provide that distributable net income includes the amount going to charity. The limited purpose of this add-back in 662 of the 642 charitable deduction is -- has nothing to do with estates as such. Very seldom does it apply to estates. It has something to do with taxable income of trusts and it has to do with this concept of tier beneficiaries, that they wanted to make sure -- Congress wanted to make sure that the taxable beneficiary for whom income was required to be distributed would pay the tax on the maximum taxable income, not reduced by anything that was permanently set aside for charity. And it just sets up an order of priorities, as we see it, of these --

QUESTION: In this case, what is the basis for saying that current income is distributable to a charity?

MR. GOTHER: Excuse me. I am not sure I follow the question.

QUESTION: Well, the question is: What is the Estate's income tax for a year, for a particular year? Is that the question in the case?

MR. GOTHER: Keep going again. I am still lost.

QUESTION: Is this an income tax case?

MR. GOTHER: Yes, it is.

QUESTION: Is it a question about the income tax of an estate?

MR. GOTHER: Yes.

QUESTION: For a year?

MR. GOTHER: For a year.

QUESTION: Now we are together. What is the basis in this case for saying that the income that was earned in the years in question was distributable to a charity?

MR. GOTHER: The terms of the will provide that 45 percent --

QUESTION: Of all current income?

MR. GOTHER: That would include current income. That is just a matter of State law; 45 percent of the current income and 45 percent of the principal --

QUESTION: Did the will say currently distribute this year's income to a charity or was it just a question of saying, whenever you close the estate, give 45 percent of the residue to the charity?

MR. GOTHER: It is the latter.

QUESTION: So if I die and I have a business -- I tell my Executor operate my business until you can sell it; then sell it, sell all my stocks and bonds, and then take the cash that is all left and give it to a charity -- say, everything to a charity, now does the Estate pay any income tax?

MR. GOTHER: No, it does not, Your Honor.

QUESTION: Ever?

MR. GOTHER: That is the essence of the 642(c); 642(c), charitable deduction, is an unlimited deduction.

QUESTION: And even though the charity gets only the residue, you cannot take out of the residue any income earned before you distribute?

MR. GOTHER: That is correct.

QUESTION: Is that the law?

MR. GOTHER: That is the law.

QUESTION: Is there any argument about that law?

MR. GOTHER: No. All of the income earned during the course of the Estate proceeding in an Estate where the will provides that ultimately all of the assets are to pass to charity -- all of the income, even if that Estate were open ten years -- would be free of tax.

QUESTION: Now there is no question about that?

MR. GOTHER: No question about that.

QUESTION: What you are saying when you say that is that the tax exempt entity is the de facto owner from the instant of the death, are you not?

MR. GOTHER: We are. We have even cited the Probate Code Section in California which embodies that concept, that in an estate proceeding the assets of an estate really title vest in the beneficiary subject only --

QUESTION: And you are saying that Congress has indicated that in these statutes that that exemption should attach from the outset --

MR. GOTHER: That is right.

QUESTION: -- and continue wherever it goes?

MR. GOTHER: Exactly; that is exactly --

QUESTION: So in this case you are saying that the government's position in effect reduces the amount distributable to the charity contrary to the will of Congress?

MR. GOTHER: It has to; yes, Your Honor.

QUESTION: Could you help me on one problem I have with the whole case? One way of stating the issue for the year 1967 would be, I think, to say that you are contending that the word "excess" in 1201(b)(1), the alternative tax computation, is $275,000, and the government contends it is $500,000 because you take the 45 percent out first?

MR. GOTHER: That is right.

QUESTION: Do you make the same contention with respect to the word "excess" in 1202?

MR. GOTHER: Identical.

QUESTION: You contend it is 275,000 in either case?

MR. GOTHER: That is correct.

QUESTION: But you did not so compute it when you stipulated what the ordinary tax would be. That is one thing that puzzles me. You computed it as $500,000 in your statement of why you have to use the 1201(b) procedure to get the lower tax. You agreed to the government's computation under 1202.

MR. GOTHER: Not when we got to the computation of the alternative tax.

QUESTION: No, no, in the computation of the normal method of computing, you agreed -- when you get your comparison deciding which one to use, you did the normal tax by treating $500,000 as the excess and you stipulated that was the right way to do it.

MR. GOTHER: Only because that is the way the form was set up. We were not doing it because we are saying --

QUESTION: Well, you did not follow the tax form on your computation.

MR. GOTHER: No, we did not; we could not. The computation that we used we had to exclude at some point this 45 percent of the gain going to charity.

QUESTION: You see what my problem is? I think you stipulated there was $500,000 under 1202 and you argued that it is 275,000 under 1201(b). And I do not know how you can have it both ways. Maybe you made an unwise stipulation. I do not know.

MR. GOTHER: Perhaps, I am not sure, but maybe the confusion is with the 1202 section itself. The amount that passes to charity in the capital gains situation really gets deducted the way the Code sets it up in two categories: a half of that capital gain gets deducted in the 642(c) charitable deduction and the other half in the 1202.

Now those two interrelate and 643 has reference to 1202.

QUESTION: I think your return used 500,000 for that purpose.

MR. GOTHER: We had to get all of the gain going out to charity deducted out in two places.

QUESTION: Well, you could have computed the 275,000 from the very beginning, it seems to me, and had quite different figures on it.

MR. GOTHER: Yes, we could have. As a matter of fact, this came up in the Ninth Circuit. We could have in the very basic capital gains schedule, when we had 500, we could have deducted 45 percent there and then went on with the calculation.

QUESTION: The fact that you did not suggested to me that you thought the word "excess" had a different meaning in the two different sections. But now you say that really is not your theory.

MR. GOTHER: If I did when I prepared the tax return, I have changed my mind at this point in time.

Thank you, Your Honor.

MR. CHIEF JUSTICE BURGER: Mr. Ferguson.

ORAL ARGUMENT OF M. CARR FERGUSON, ESQ.,

ON BEHALF OF RESPONDENT

MR. FERGUSON: Mr. Chief Justice and may it please the court:

I am afraid our differences are more basic than I had originally anticipated from reading the briefs. The government simply does not accept the basic premise that there are three pots or three conduits or three shelves, whatever they are.

QUESTION: What would you say, Mr. Ferguson, about Justice White's hypothetical case if the entire estate were given to the University of California or some recognizable tax entity that was exempt, income tax on these earnings during the period of probate proceedings?

MR. FERGUSON: Sir, I would have to say that, first of all, the Estate is nonetheless a taxpayer, a private taxpayer under the provisions of the Code as it would be in any other case.

QUESTION: You mean until distribution the entity takes on the cloak of the decedent and not the cloak of the legatee?

MR. FERGUSON: I think that is one way of looking at it.

QUESTION: Well, is it not just that simple in the long run?

MR. FERGUSON: I think it is that simple.

QUESTION: Does it pay tax or does it not on its current income?

MR. FERGUSON: It depends upon whether or not the provisions with respect to the ultimate distribution to a charity qualify as a charitable deduction for --

QUESTION: Let us assume that it does.

MR. FERGUSON: If it does, then the charitable deduction would eliminate any taxable income assuming --

QUESTION: While the Estate is open?

MR. FERGUSON: That is correct.

QUESTION: So that essentially you agree with your brother's answer with the qualification that it is a qualified charitable deduction?

MR. FERGUSON: I agree that as long as it is a charitable deduction which qualifies and the amount of that deduction equals gross income, there would be no net tax due from the Estate.

QUESTION: In other words, it has the same status under that theory as though the decedent had made a gift on the last day of his life?

MR. FERGUSON: Exactly. There are certain limitations on the charitable deduction which apply to an Estate which would not have applied to the decedent, and there are likewise certain benefits or allowances which would not have been permitted to the decedent during his life.

QUESTION: But you seem to agree that that was the basic intent of Congress, to put the ultimate distributee in the shoes of the testator who made a gift inter vivos?

MR. FERGUSON: No, Your Honor, I do not. I think that the ultimate intent of Congress was to treat the Estate as a taxpayer separate and apart from the decedent on the one hand and separate and apart from the distributees and beneficiaries, on the other hand.

QUESTION: If I hear you correctly, you have answered the same question in two different ways now, Mr. Ferguson.

MR. FERGUSON: Your Honor, your example posited a particular kind of estate, one in which the entire residue was to go to charity. In that case, I would assume that the provisions of the Estate would be sufficient to satisfy the conditions of the charitable deduction, and leave no net taxable income.

For that reason I answered your first question that there would be no net taxable income. In response to your last question, which was whether there is a general intent of Congress to exempt all income going ultimately to charities, as my learned friend suggested, I must disagree with that.

I think that the clear intent of Congress was to strain all items of gross income coming into the custody and management of the Estate through the Estate's gross income and through the deductions which are allowable so as to make sure that any amounts which are paid out or set aside to charity meet the conditions of the charitable deduction.

And if they do not, then the Estate has a tax, a tax which it pays and which obviously ultimately becomes a burden on that part of the residuary estate indicated by the will to bear the burden of the tax.

QUESTION: Mr. Ferguson, in the government's view who held title to this share of the residue?

MR. FERGUSON: We do not dispute that under the provisions of California law title to all parts of the residue, personalty and realty, was vested as of the moment of death in the ultimate takers, charitable and non-charitable.

QUESTION: So you do concede that legal result?

MR. FERGUSON: Oh, indeed. We think, however, that is irrelevant. In fact, I had not thought that there was a significance to that.

The taxpayer did not contest on brief that the estate was a taxpayer with respect to the property which it was administering.

Even this ingenious argument which is suggested because of some dicta in Bowers versus Slocum does not go so far as to suggest that the gross income arising from sales which the estate made was not gross income of the estate. Indeed, it is gross income of the estate, all of it. There is a case not cited in the parties' briefs in which the tax court considered the effective California law, and that case is Estate of Cohen, 8 Tax Court 784.

The tax court followed the general rule which had been followed in many other earlier cases that title to property does not define the gross taxable assets in the estate. The estate for sub-chapter J purposes -- sub-chapter J being those sections dealing with the income taxation of estates -- is defined in Section 641 to include all income arising from assets within the custody, management and control of the Executor.

These assets, the shares of stock in Walt Disney Productions, were clearly assets of the estate, and when those assets were sold, they generated gross income for the estate. The estate indeed, as Bowers versus Slocum pointed out in page 351 of that Second Circuit's opinion -- and I quote from page 351: "Cannot escape from taxation except by taking the deductions provided therefor" in the statutory scheme.

So I think that the question properly framed is whether the payments here in question constitute a deduction which is allowable under 1201(b) in the calculation of the alternative tax.

QUESTION: This may be elementary, Mr. Ferguson, but I take it that the government submission -- and perhaps it is conceded by both parties for income taxation an estate is treated as an entity in a way that it is not in most states for purposes of decedent's estates, where you have the Executor as an individual and the distributees as an individual, but the estate is simply an accumulation of assets. For income taxation, then the estate is an entity.

MR. FERGUSON: Yes, sir, that is correct. Sub-chapter J, I think, makes it clear that an estate, like a trust, is a taxable entity which is taxable as if it were an individual according to Section 641 with the various modifications in that general scheme set forth.

One of the modifications which is critical here is the different kind of charitable deduction permitted. An individual, for example, can take a charitable deduction by giving property to a charity. An estate may not. An estate may only claim a charitable deduction if it can establish that the amount paid a charity was out of its gross income.

There is no dispute here that the capital gains which were set aside for the charity were out of the estate's gross income. I had not thought there was such a dispute anyway. The 45 percent of the residue of the estate which was earmarked for qualified charities meant that 45 percent of the capital gains generated by the estate, its capital gains, qualified for the charitable deductions set aside in arriving at the estate taxable income.

And I think that is where we must begin as Judge Sneed did in the Ninth Circuit by pointing out that in the normal computation of an estate's taxable income, its capital gains are first computed, including all of the sale of the shares of stock. The 1202 deduction, the deduction of 50 percent of the capital gains is then computed on the full amount of those gains which would include the 45 percent as taxpayer's first position had indicated.

And then the balance left in taxable income, after an appropriate adjustment for the fact that there has been a 1202 deduction already for part of those capital gains, is then permitted as a deduction under Section 642(c), as long as it meets the conditions of that section; that is, they must be permanently set aside for charity.

The set aside deduction is really a rather special deduction because it involves allowing an estate to take a deduction for an amount not actually paid out. There is, obviously, room for abuse for sheltering income which will be going to the private beneficiaries of the trust. And for that reason the set aside deduction, like the rest of the charitable deductions in 642(c),is restricted to gross income items.

Now if I may proceed from that basic point, which I think is the statutory scheme, the estate must report and take into account all of the gross income which it generates by sale of the estate assets.

QUESTION: There is really no argument about any of these things.

MR. FERGUSON: I had not thought so.

We come now to the question of whether the estate in computing its tax on its net taxable income can achieve a lower rate by using the so-called alternative tax under 1201(b) by combining this deduction for charitable contributions with the 1201(b) alternative lower tax rate by offsetting it against capital gains.

I think that the reasoning of the Weil case, the reasoning of Judge Sneed below and the reasoning of the tax court in the Statler Trust case which was reversed by the Second Circuit all are perfectly consonant with the assumption which this Court made, both the majority and the dissenting opinions in Foster Lumber that the alternative capital gains tax is a tax upon all of the capital gains of the taxpayer, unreduced by deductions which, as my learned friend has described them, are taken into account in arriving at taxable income, so-called ordinary deductions.

QUESTION: Is it not true that the Ninth did not follow --

MR. FERGUSON: That is quite true, Your Honor. The Ninth Circuit agreed with the tax court decision in Statler Trust which the Second Circuit by a divided vote reversed.

So it seems to me, if I can refer to it this way, the line up of authorities directly on point would be the Statler Trust tax court decision, the Ninth Circuit's opinion below in this case, and the Sixth Circuit's decision in the Weil case, and, of course, the dissenting of Judge Dooling in the Second Circuit against the majority opinion in Statler Trust.

QUESTION: Mr. Ferguson, is that quite fair to treat the Weil case because that was not an estate case, was it?

MR. FERGUSON: The Weil case was a charitable deduction case involving an individual.

QUESTION: So it really did not present this problem.

MR. FERGUSON: I think that is correct.

QUESTION: And if you are right that in the alternative tax computation, 1201(b), you do not reduce capital gains by deductions which may be taken against ordinary income, how do you reply to the argument in their reply brief about reducing the capital gain for distributions to non-charitable beneficiaries?

MR. FERGUSON: That, Your Honor, is a place where we do depart from the literal language of the statute. However, I would suggest that the statutory scheme which we must look at is 1201 and 1202 together; 1202 which is the normal method of tax if the alternative computation is not used specifically provides that capital gains which are distributable to beneficiaries under 662 -- 661 which do not include charities -- these are the so-called private or taxable beneficiaries -- are not taken into account in making the capital gains computation of the estate or trust. That is because the statutory scheme of Subchapter J, as we have heard from the taxpayer, treats the taxable entity of the estate or of a trust as essentially sharing in the income with its taxable beneficiaries to the extent the income is currently distributable.

Now to the extent the income is currently distributed, the conduit rule which has been taken out of context and used for the charitable deduction -- but the conduit rule, as Congress explained it in the committee reports, is appropriate to treat the estate income currently paid out as carrying with it a share of all of the various categories of income, including capital gain.

Since the individual beneficiaries will receive a part of the capital gain currently of the estate, will each make their own election whether to use 1202 or 1201(b) -- I really should not call it an election; that is an alternative tax computation.

QUESTION: That is a requirement, is it not?

MR.FERGUSON: That is a requirement.

But since each will make their own individual computation, the applicability of 1202 or 1201(b) to each beneficiary will be separately determined.

I would have been clearer if a similar sentence had also appeared in 1201(b) with respect to --

QUESTION: What if in this case the income had been currently distributable in these years to a charity, would you agree then that the charity should be treated like the taxable distributees?

MR. FERGUSON: Your Honor, there are two cases below which involve --

QUESTION: I would have thought you would have said yes from your description.

MR. FERGUSON: The answer is no because charity -- the two questions which have reached this question in the Court of Claims in the Mott case and the Tax Court very recently in the O'Connell case have both held that the charity cannot be a distributee of DNI under any circumstances. It is not a beneficiary within the 661, 662 scheme.

In fact, Section 663, as Judge Snead pointed out, specifically holds out charities from the scheme.

QUESTION: And it is that difference, Mr. Ferguson, that makes you say that the administrative practice with respect to non-charitable distributees described in the petitioner's reply brief is not inconsistent -- under which you basically do follow the conduit concept is not inconsistent with the argument you are making in this case?

MR. FERGUSON: That is right, Your Honor.

QUESTION: There is that difference?

MR. FERGUSON: That is the difference.

QUESTION: That a charity cannot be a beneficiary or is not a statutory beneficiary?

MR. FERGUSON: Right, and distributees are. So that the allowance for a charity is the charitable deduction, which is a true deduction from taxable income.

Now the 691(c) cases which deal with what is clearly a deduction are by their terms not deductions in arriving at taxable income. It is a special deduction as indeed the Meissner case made this point and distinguished the Tax Court's decision in the Statler Trust case, and also distinguished the Weil case and said those cases involved deductions in arriving at taxable income.

QUESTION: Real deductions?

MR. FERGUSON: Real deductions. And it said that 691(c) in some Pickwickian sense perhaps was like a credit. It was like an offset to the capital gain.

And as you know, the United States had a great deal of difficulty in accepting that line of cases, but the cases themselves distinguished the 691(c) deduction from the deduction which we are here considering and I think properly so.

I think that the cases here flow from the same -- the decision below is consonant with both opinions in Foster Lumber in that the decisions do recognize that the 1201(b) computation relates to all capital gains without subtractions for deductions in arriving at taxable income.

The special 691(c) deduction, I think, can be explained as an offset in the nature of a credit to make sure that items which were taxable subject to the estate tax are not again subject to an income tax, which might duplicate and indeed exceed the principal amount of the item itself.

There are special considerations there, I think, just are not present in any of the so-called ordinary deductions described.

QUESTION: Mr. Ferguson, I said this seems to answer the same question in two different ways, and I realize that in these exchanges here can make the difference. And let me try again even with the risk of over-simplification.

Taking Mr. Justice White's hypothetical case that Mr. Disney left everything, his entire estate after the expenses of administration, to this tax-exempt entity, do I understand you concede no income tax during the pendency of the probate proceeding -- no income tax after the date of death, is that right?

MR. FERGUSON: Assuming -- Your Honor, if I might add one more fact, I can agree with you. Assuming that the gross income of the estate could be offset by a deduction under 642(c) which met the various requirements of that deduction section, I would agree.

QUESTION: In other words, the tax-exempt ultimate distributees takes hold at the instant of death, rather than having the Executor stand in the shoes of the decedent?

MR. FERGUSON: Your Honor, again I have to disagree. Perhaps I can offer another illustration of why we are having trouble of coming to a common agreement as to the nature of the taxable estate.

Let us suppose that the Executor had the duty to make payments from income or corpus as necessary to provide for the comfort and well-being of Mrs. Disney and the children, but that any amount not so expended would then be left in its entirety to charity.

In that case because of the discretion, the conditions in 642(c) would not be met. The amount going to charity would not be guaranteed and the estate would be fully taxable on all of that income. There would be no refund for the amount ultimately determined to go to charity. Charity, indeed, would take the amount,which it will take here as a residuary legatee, reduced by whatever expenses including income taxes the estate encounters during the course of administration.

I think that every case -- even the extreme case you have suggested, if an estate left outright to charity, the estate must file an income tax return to report its gross income and demonstrate that the income earned does qualify for the charitable set aside deduction.

QUESTION: But if it does in the Chief Justice's question, even though the entire income is capital gains income, you would not need the alternative tax, you would just make the deduction?

MR. FERGUSON: Clearly, in that case the lower tax would be the regular tax.

QUESTION: Without the alternative tax?

MR. FERGUSON: That is right.

QUESTION: You are required to figure the alternative tax, I guess.

MR. FERGUSON: Clearly.

QUESTION: Mr. Ferguson, that has nothing to do with the estate law at all.

MR. FERGUSON: No, Your Honor, we do not feel that does. That has been decided long ago, that the placement of title is irrelevant to custody and management of the assets which is the activity generating the tax liability and the reason that Congress has seen fit to treat the estate as a taxpayer.

Now if I may return for one moment to the so-called confusion as to the development of the charitable deduction, I think that the preoccupation of the Second Circuit and of counsel for the taxpayer on Section 643 and the computation of DNI is irrelevant. I think for purposes of this argument we would be willing to concede that the taxpayers' version of the computation of distributable net income and its attack on the example which we set out in our brief is correct.

But we do submit that that is just utterly irrelevant.

You come to the question of distributable net income only after you have arrived at taxable income. And in the course of that, the taxable income of the estate has started out with gross income, which includes all of the capital gains, and then has been diminished by that part of a charitable deduction or that part of a set aside for charity which comes out of gross income.

And it is only at that point, after you have arrived at taxable income, that the DNI or distributable net income adjustments become relevant.

We suggest that the only point of looking at the distributable net income scheme is to demonstrate, as Judge Sneed did, that the only conduit, the only distribution theory of Subchapter J, has to do with private beneficiaries who share in the tax load to the extent there is a current distribution of income.

To the extent the income is retained, it remains taxable to the estate regardless of how it is ultimately distributed. And the charity set aside deduction of 642(c) is simply one of the deductions in arriving at taxable income.

When you go to look at the alternative tax in 1201(b), we suggest that there is no more reason for pulling out the charitable deduction than there would be for pulling out the Executor's commissions which may be deductions in looking at the way the computation of net capital gains is to be made.

We suggest the court was quite correct in its assumptions in both opinions in Foster Lumber that net capital gains means net capital gains for purposes of the alternative tax.

Thank you very much.

MR. CHIEF JUSTICE BURGER: You have a few minutes left, Mr. Gother.

REBUTTAL OF RONALD E. GOTHER, ESQ.

ON BEHALF OF PETITIONERS

MR. GOTHER: Thank you, Your Honor.

Just one quick point: Do not be misled by the use of the word "deduction" in 642; 642 speaks of it in terms of a deduction, and I think the government is emphasizing that word more than need be. 642 provides for an unlimited deduction and it provides that it is available even if there is not a distribution.

You put those two concepts together, and you have got something other than a deduction.

QUESTION: Well, some deductions are unlimited.

MR. GOTHER: Some deductions are unlimited but only if you have paid them out.

QUESTION: Yes, but your second point is --

MR. GOTHER: My second point is that you do not even have to pay it out.

QUESTION: Then that is contrary to the ordinary concept of a deduction.

MR. GOTHER: Also the deduction that you get for distributing amounts to a taxable beneficiary under 661 -- to a taxable beneficiary -- is worded as a deduction; the same word, deduction, but it works to take that capital gain out as an exclusion.

So do not be misled by the word "deduction". Thank you, Your Honor.

QUESTION: What do you have to say just before you sit down, Mr. Gother, about Mr. Ferguson's explanation of the administrative practice pointed out in your reply brief that you assert is inconsistent with the position the government takes in this case? Do you know what I am talking about?

MR. GOTHER: No.

QUESTION: The government's treatment of non-charitable devisees, legatee, distributees administratively is said to be in your reply brief inconsistent with the argument the government is making in this case in that that administrative treatment of non-charitable distributees seems to rely or recognize the conduit theory.

And now you have heard Mr. Ferguson's explanation of the difference, i.e. that charities are not beneficiaries within the meaning of the statute, and that that explains the difference in practice which he concedes does not follow the literal terms of the statute with respect to non-charitable distributees.

MR. GOTHER: The answer to that is that the charitable entity does not need this deduction, this distribution. It does not need to be a distributee to get the deduction.

The taxable beneficiary needed that and that is the conduit which carries the taxable amount off to the taxable beneficiary. The charity because of the fact that it gets this deduction without a distribution just was not unnecessary to deal with a charitable entity as being a distributee.

QUESTION: Is that to avoid double taxation of the taxable distributee in part, that deduction allowance?

MR. GOTHER: No. I do not think it relates to a double tax.

QUESTION: Well, if it was taxed in the estate's income and then taxed again to the distributees' income --

MR. GOTHER: Oh, yes, that is right. You need the distribution out to eliminate the double tax on that. And in the case of the charity, you do not have that. You are not eliminating a double tax.

Thank you.

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

(Whereupon, at 11:41 a.m., the above-entitled case was submitted.)