In the

Supreme Court of the United States

THOR POWER TOOL COMPANY)
PETITIONER,)
V.) No. 77-920
COMMISSIONER OF INTERNAL REVENUE,)
RESPONDENT.)

Washington, D. C.
November 1, 1978

Pages 1 thru 48

Hoover Reporting Co., Inc.
Official Reporters
Washington, D. C.
546-6666

EM

IN THE SUPREME COURT OF THE UNITED STATES

- :
:
THOR POWER TOOL COMPANY, :
:
Petitioner, :
:
v. : No. 77-920
:
COMMISSIONER OF INTERNAL REVENUE, :
:
Respondent. :
:
- :

Washington, D. C.,

Wednesday, November 1, 1978.

The above-entitled matter came on for argument at 10:02 o'clock, a.m.

BEFORE:

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

APPEARANCES:

MARK H. BERENS, ESQ., Mayer, Brown & Platt, 231 South LaSalle Street, Chicago, Illinois 60604; 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.

- - -

C O N T E N T S

- - -

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in No. 920, Thor Power Tool Company against Commission of Internal Revenue.

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

ORAL ARGUMENT OF MARK H. BERENS, ESQ.,

ON BEHALF OF THE PETITIONER

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

This case presents two issues under the Internal Revenue Code: evaluation of excess inventory; and the calculation of bad debts by the reserve method formula.

Both issues, which are separate, seem to be of high frequency and inspire a considerable amount of feeling among the taxpayers involved.

The principal one involves evaluation of excess inventory.

QUESTION: I suppose it might be accurately added that they present infinite variations, is that not so?

MR. BERENS: They certainly do, Mr. Chief Justice.

The excess inventory issue is really a question of timing. When may inventory that a taxpayer reasonably determines to be in excess of foreseeable demands, when may it be written down; at the time he makes this determination or later when it is eventually scrapped, as the Commissioner contends?

The importance of this issue, I think, is indicated by the filing of very thoughtful amicus briefs by the United States Chamber of Commerce and the National Association of Manufacturers. The issue affects all manufacturers on the lower of the cost or market method, as well as wholesalers and dealers who stock replacement parts. This includes the automotive industry, farm equipment, machinery, electronics, electrical equipment of all sorts.

And good sound business sense requires these manufacturers and dealers to stock or really overstock spare parts if they are to serve their customers. When the parts are first produced, it is very difficult, and sometimes impossible, to predict exactly how much demand on a part, based on its wearing ability, breakage, et cetera. And so they are intentionally overproduced by most manufacturers.

After the part has been in use, after its main product has been in use for a while, it becomes evident that the part is overstocked. And at this time generally accepted accounting principles require that the excess part, the excess quantity be marked down to net realizable value. And it is this requirement, to clearly reflect financial accounting income, that we submit should be parallelly determinate of taxable income.

QUESTION: Did your client dispose of these excess parts at any time, Mr. Berens?

MR. BERENS: In the meantime, did you say?

QUESTION: At any time.

MR. BERENS: The excess parts in issue, Mr. Justice Blackmun, for '64 were 78 percent and were disposed of by 1971.

QUESTION: Disposed of in what way?

MR. BERENS: By scrapping. And this was by an exact tracing. Exhibit 17, I believe, shows that.

I am going to dwell a little bit on the facts here, perhaps a little more than I should, to get the proper perspective, because while the facts are not in dispute, the parties interpret them quite differently.

At the end of 1964, Thor's new management determined that its inventory was greatly overvalued. After making a number of specific writedowns, it was confronted with the fact that it had 44,000 different items of inventory, which comprised millions of pieces. Most of these, 33,000 different items, were replacement parts and accessories. And they were held, for the most part, in quantities greatly exceeding foreseeable demand.

It was impractical to value these individually, and so management developed two procedures, statistically sound, fairly common-place among manufacturers at the time, to write-down or to determine how much should be written down.

The primary procedure was to compare on an item-by-item basis the quantities on hand with the actual sales Thor had made during 1964 or the production usage of the parts. And I stress item-by-item. If there were no sales or use of that item, they were written off as obsolete, a writeoff that the Commissioner accepted. If there was some usage but the amount at hand exceeded two years' usage, then that portion in excess of two years was written off. Amounts between one and two years were partially written off.

At some locations of Thor there was inadequate data on usage for the preceding year and so additional, not substitute but additional, percentage writedowns were done for a limited number of limited categories of goods.

Thor's president testified that the writedowns were solely intended to accurately reflect current inventory value, at the end of 1964. He stated that income tax effects were not even considered at the time. The Tax Court, based on his testimony and that of several accounting experts, found three specific things:

That Thor's procedures for writing down the inventory -- and I'm quoting --"wrote down the inventory in issue to its estimate of current net realizable value." And I stress "current net realizable value".

The Court also found that this was required by generally accepted accounting principles; and it further found that this constituted a "best accounting practice" within the meaning of Section 471 of the Code, to which I'll return.

The findings of the Court, which were not disputed by the Court of Appeals nor by the Commissioner, were fully supported by the testimony of six expert accountants, five of whom were preeminent in the field of accountancy. They testified that generally accepted accounting principles required the excess inventory to be written down, to clearly reflect financial income. They stated that the use of a formula of this sort was essential as a practical matter, and it was commonplace.

They specifically testified that both procedures -- that is, the formula and the percentage,supplementary percentage writedowns -- conformed to generally accepted accounting principles. They testified that the writedown was reasonable in amount. And this was based on a hindsight basis, including the degree of scrapping.

And finally they testified that they would have withheld certification at the end of '64 had Thor not written down the inventory as it had.

They further testified that if Thor had not written it down but had waited until it was scrapped to write it down, financial income would have been distorted both in 1964 and in the later year or years when it was scrapped.

I want to stress that the testimony and the findings of the Court stated that this was an estimated current loss in existence at the end of 1964; it was not a provision for a future loss.

Now, throughout respondent's brief the writedown is characterized as an anticipation of or a reserve for a future loss. This, we submit, is contrary to the record.

Thor's writedown is authorized, we submit, by two sections of the Code. Section 446, which basically provides that taxable income shall be computed under a method of accounting the taxpayer uses in keeping his books, provided it clearly reflects income. But more directly governing is Section 471, which is the key section on inventory accounting. It imposes two conjunctive requirements binding on both the taxpayer and the Commissioner, that inventory accounting must conform, first, as nearly as may be to the best accounting practice in the trade or business and, secondly, as most clearly reflecting the income.

Now, the Tax Court found that Thor met the first requirement, conformance to the best accounting practice. The testimony of the experts, which said that if Thor had waited to scrap it, it would not have conformed to a best accounting practice, means that the Commissioner's scrapping method cannot meet the first requirement of Section 471. It cannot be a best accounting practice.

This --

QUESTION: May I ask this one question? You have twice used the phrase, "a best accounting practice". I take it it's understood that there is not a single best accounting practice?

MR. BERENS: No, Mr. Justice Stevens. And I'm quite aware of that from the Van Pickerill decision. There may be more than one best accounting practice.

QUESTION: It's an unusual use of the word "best", but it really means an acceptable or --

MR. BERENS: Yes. The statute actually says "the", but I think it is normally read as meaning "a", and I sometimes use them interchangeably.

QUESTION: Right.

MR. BERENS: But I agree with you.

QUESTION: I just wanted to be sure I wasn't misunderstanding it.

MR. BERENS: The question then resolves: Did Thor's method clearly reflect income under both Section 446 and 471? And we believe the test under both is identical.

Perhaps the best way of getting at that troublesome question is to relate the two methods to each other. And it seems a fair way of approaching it because there seems to be no other logical point of time when the writedown could occur than one or the other of these, the one side when the taxpayer reasonably determines it should be written down, or later when it's scrapped. I cannot think of any other point of time that could be used as the test.

Now, from this viewpoint, perhaps the best way of approaching is to look at the Commissioner's scrapping method. Does it clearly reflect income?

Now, from a financial accounting viewpoint it doesn't. It was established. But beyond that, the Commissioner basically contends that to clearly reflect income you should overstate your inventory by not writing unsalable goods down to their net realizable value, and that you should hold this overstatement in the inventory for a year or two or more until, whenever you eventually scrap it.

Now, the layman would not view an overstatement of inventory to clearly reflect income, because the higher the inventory is stated the higher the income is reported.

The Commissioner's view makes an assumption here, not only that it was a future loss, but tied in that, and it is in both the lower court's opinions and in the brief of the respondent, is that inventory losses do not occur until they are realized.

Now, we submit -- and I use a strong word -- that this is a radical argument. It has never, to our research been advanced in some sixty years. The administrative history, outlined at length in our reply brief, is completely to the contrary, starting with T.B.R. 48 issued in around 1919. There are no cases that hold realization of losses of inventory are required for -- and I should emphasize -- for a taxpayer using the lower-of-cost-or-market method, for a cost taxpayer that is a different method. And in particular I cite the discussion in Space Controls, 322 Fed at 147 and 48,which outlines the history of the realization issue in inventory accounting.

QUESTION: What do you -- you say the taxpayer writes the inventory down to net realizable cost?

MR. BERENS: Yes, Mr. Justice.

QUESTION: What is net realizable cost? Are you going to get to that? Is that different than what he thinks the scrap value would be?

MR. BERENS: No, in Thor's case it was specifically an estimate of scrap value.

QUESTION: And why is the inventory held rather than scrapped at that time?

MR. BERENS: Because, on an individual item basis, Mr. Justice White, --

QUESTION: You can make a mistake.

MR. BERENS: -- it is unknown. It is clear that Thor may have underestimated one of the 44,000 items and over-estimated the others.

QUESTION: Do you have some experience in that regard, as to what percentage of the inventory Thor would like to write down that later proves to be salable, and that it has a value?

MR. BERENS: In 1970, when Arthur Andersen was first engaged as Thor's accountant -- this is from the record -- they did a "first-time-through" special test of the inventory write-down of this excess system. And they found -- for using the exact system that the company used and doing very extensive sampling, they found in 1970 that the writedown -- I'm not speaking of '64 now; but in 1970 it was about, if I recall correctly, about five percent too low; and in 1971, it --

QUESTION: So five percent of the items were taken back into ordinary sales, is that it?

MR. BERENS: That they should have written off more than they did.

QUESTION: Oh, I see.

MR. BERENS: That the writedown was too little -- I know it's misleading there -- too little. And again in '71 it was too little by a larger degree.

In other words, Thor's formula was on the conservative side.

The testimony of Mr. Belda --

QUESTION: But, nevertheless, even so there would have been isolated or recurring instances of inventory that was written down that nevertheless was sold?

MR. BERENS: Absolutely. Absolutely. And at that time, to the extent that it was sold, that had already been written down, the taxable income in the later year would have been increased.

QUESTION: By the difference between the -- its net realizable value and the sales price?

MR. BERENS: Yes. Yes.

QUESTION: Things are segregated so you know which inventory you are --

MR. BERENS: No, they are not segregated, and I volunteer the observation that, while it was stated in both lower courts' opinions, neither cited any authority for it, for segregation; and we could find none.

QUESTION: Well, what happens if an item that's been written down is sold at the same -- at what it used to be sold for, how do you -- do you just put that amount in your gross income?

MR. BERENS: Yes, Your Honor, that's exactly what is done.

Let me stress that this is a statistical system for which -- where any particular item may not work. In fact, I'll go so far as to say it's unlikely to be accurate, and that's the very need for it, because it can't be accurate for one item. It is accurate because there's 44,000 items.

As all of the experts testified, a formula system like this is statistically sound, if it's properly conceived. And while every item could be wrong, in the aggregate it is right.

And I'd like to analogize here to the retail sales method, where the same problem exists for a department store, where there are sometimes hundreds of thousands of items priced at retail value, and when they take inventory they use average markup formulas in reverse to mark them down to cost. This is exactly the same statistical system -- and I should interrupt myself to say that that is specifically approved by the retail sales method regulation; that this is the same statistical premises upon which the writedown by Thor is based.

Now, I also stress that even on an over-all statistical basis it is not accurate. We do not contend it is perfectly accurate. But I harken to the Cohan rule promulgated by Judge Learned Hand in 1930, where he said: most important things can't be exactly accurate and that the tax law has to be practical, and as long as it is reasonably accurate, this is all that the law requires.

QUESTION: Well, ultimately your writedown is going to be adjusted, isn't it?

MR. BERENS: It's going to be adjusted --

QUESTION: When you scrap it, when you scrap it?

MR. BERENS: Or when it's eventually all sold. Say that you completely --

QUESTION: Yes, but suppose it's scrapped and suppose you get out of it more than you thought you would?

MR. BERENS: Then that's adjusted, too. The scrapping revenues go into gross income.

QUESTION: And if you get less, what about that?

MR. BERENS: Then you -- through the writeoff system you get an additional loss at that time.

QUESTION: So eventually things turn out accurately?

MR. BERENS: It rolls through, but I'd like to stress, Mr. Justice White, both when it's scrapped and when it is sold, either disposal eventually catches up.

QUESTION: Mr. Berens, your time is going on, but sometime before you sit down, you have a response to the argument that the inventory evaluation procedure was a change in accounting method; the government makes this, and I'd like to get your response to it.

At your convenience, just before you sit down.

MR. BERENS: Yes. I suppose -- would you prefer, Mr. Justice Blackmun, to give it now? I was going to save it for rebuttal time, but I'd be glad to respond.

QUESTION: All right, just so you catch it at some time.

MR. BERENS: Maybe I better, in case I lose my rebuttal time.

We submit that this is -- and again I use a strong term -- a non-issue, in reality. Apart from the fact that the Commissioner had the burden of proof, and we do not believe he met that burden. There are three requirements for a change of accounting method within the meaning of 446(e) of the Code. And the principal one is that income escapes tax because of the change, or that there is a double deduction or, in this case, a double increase in cost of goods sold. And either actually or potentially.

And as we explain at length in our reply brief, there is no possibility, by Thor's procedures, that any income could have escaped or had double reduction.

We secondly point out that change of method is a specific term meaning a change of the basis of valuation which was -- lower-of-cost-or-market -- which was not changed. Or a change in a inventory method such as from FIFO to LIFO or to change a cost accounting method, which Thor also did not change. It does not reach down into the component techniques of calculation within the basis evaluation, and within the method used.

Also in 1964 the regulations made this clear, and as we point out in the brief, it was only the later amendments of 1970 where the regulations stretched, we believe, the statutory standard to try to define change of method to include a change of a component of the method. And we do not believe that, as we said in our brief, that that regulation applies to 1964; and, in fact, we argue that it goes beyond the statutory intention.

QUESTION: Are you saying that the taxpayer has used consistently the lower-cost-or-market method for valuing inventories?

MR. BERENS: Yes. And the record is clear on that, Mr. Justice Powell.

QUESTION: All right. And when you use the term "net realizable value", that's not inconsistent with the cost-or-market method?

MR. BERENS: As we conceive it, based on generally accepted accounting principles, it is part of the lower-cost-or-market system. It does not meet the specific requirements of -- or, as interpreted by the Commissioner, of the market regulations, of the market regulations, the lower-cost-or-market.

We -- I misstated that. The Commissioner argues it does not meet the definitions within the lower-cost-or-market method of the regulations. As our brief points out, we submit that it's there interpreted to fulfill the statutory intent. That is, to constitute a best accounting practice, that they do authorize this type of writedown.

QUESTION: I want to be sure, incidentally, Mr. Berens, do I correctly understand that you are not attacking specifically any of the regulations involved here?

MR. BERENS: No, Mr. Justice Blackmun, we cannot attack them because they're an omission. They don't deal explicitly with the problem. We say this application, if they are interpreted to preclude this type of writedown, we object to that, but we do not say that any provision of the regulations is invalid. And I stress because it --

QUESTION: But you say -- you just talked about an interpretation of the regulation with which you disagree.

MR. BERENS: Yes. The Commissioner's interpretation of the regulations, we believe is improper; but the regulations are not invalid. They are basically silent on the writedown of --

QUESTION: But you think his interpretation of that particular regulation is contrary to the statute?

MR. BERENS: Yes.

QUESTION: Yes.

QUESTION: I'm sorry, you say you took the regulation was or was not contrary to the statute?

MR. BERENS: No, the regulation -- you express it in a different way, Mr. Justice Stevens, and makes it a hard -- I'll have to answer it a little differently. The regulation, as far as it goes, is not contrary to the statute. The regulation, we concede, is silent on the writedown of excess inventory.

QUESTION: Well, is 1471.4 silent on it? I thought it allowed the writedown of excess inventory if there was an extraordinary circumstance that produced the excess. And I thought you then argued about whether or not there was an extraordinary circumstance in the Tax Court.

MR. BERENS: We never argued that there was an extraordinary circumstance. That was from the Tax Court's opinion. We argued, and we argue here, and I have not stated this very well, that if you -- that the language of -4, dealing with the writedown of market, construed broadly, where it says if normal conditions of the market do not exist, that you may use the best available evidence. We say that that covers excess inventory, while, at the same time, conceding that excess inventory is not specifically provided for by name in that regulation.

We also parallelly argue that under the --

QUESTION: Well, let me stay with that for just a moment. I guess I was wrong in using the word "extraordinary". It's where there are abnormal market circumstances on some items like this.

MR. BERENS: Yes. Yes.

QUESTION: And do you contend that the existence of an excess inventory is evidence -- do you contend there were abnormal market circumstances in your case?

MR. BERENS: We contend that there is inherent abnormality in the market for replacement parts. That there's not a normal pricing effect of supply and demand, as was testified both by Mr. --

QUESTION: But the answer the Court of Appeals gave, as I remember, was that you regularly produce an excess because this is the normal way you do business. But that, nevertheless, is abnormal?

MR. BERENS: The market does not operate in the normal way for replacement parts. We think the Court of Appeals is misapplying this concept in that point. The regular goods, you can move them, if they are slow moving, by lowering the price. With replacement parts, there is essentially no elasticity on them, you cannot lower the price and move them. So, although you produced them intentionally, you still -- if you could be perfect, you would produce exactly the right amount that's eventually needed, but you can't be; and so you produce intentionally the excess.

That production side is not what makes it extraordinary. What makes it -- I don't want to use the word "extraordinary" -- what makes it an unnormal situation is the nature of the goods, the replacement parts.

QUESTION: Wouldn't your reasoning apply to any goods which a manufacturer makes expecting not to be able to sell 100 percent of his production?

MR. BERENS: I would say it would, and it certainly would apply to the retailer who buys quantities of goods, some of which he knows are going to turn out to be obsolete and unsalable; which ones he doesn't know. But the lower-of-cost-or-market system is designed to handle that situation.

Two of the important decisions of this Court in the area of tax accounting, Kansas City Structural Steel, which condemned -- one of them being Kansas City Structural Steel, which condemned the taxpayer's base document, that because it misrepresented the facts it merged the inventory results of one year with that of another. That method is designed to do that.

Really, that objection that this Court found to that method, we think applies to the scrapping method. It delays recognizing a loss that has occurred to some year after it has really occurred. And in that sense it misrepresents the facts.

In a case that I embarrassingly must admit was not cited in our brief, United States Cartridge vs. United States, a decision of this Court, and we overlooked it until two days ago, Volume 284, there was --

QUESTION: What page? Don't bother.

MR. BERENS: I think page 269, Mr. Justice Brennan.

There a munitions manufacturer at the end of World War I was terminated by the government. In 1918. He immediately wrote down his inventory to salvage value of about $230,000. While settlement negotiations were going on, the Commissioner contended that the writedown should be postponed until the eventual payments by the government became known, which occurred in 1921 or '22. And the total payments amounted to $730,000, a difference of 500,000.

This Court, in a unanimous opinion at that time, stressed that -- the taxpayer was in the lower-of-cost-or-market -- stressed that the annual accounting period applied inventory as events happened, and that the taxpayer was entitled to write it down as he saw the situation in 1918, of 230,000. Because, even though there was a prospect of later recovery, which indeed occurred, this should be taken into income in the later year as it became a closed event.

I think, Mr. Justice White, this is quite parallel to the line of questions you were addressing to me earlier.

QUESTION: So how did you run into 284 U.S.? You just didn't stumble on it in the --

MR. BERENS: Well, we were reading some of the cases in Respondent's brief, and one, the Commissioner said it was bound by U.S. Cartridge, and that's the first time that it had crossed, apparently, anyone's eye in our office.

QUESTION: Maybe an associate was looking for a partnership.

[Laughter.]

MR. BERENS: I wish he would have found it earlier.

I see my time is up, and I have not even touched the bad debt issue.

MR. CHIEF JUSTICE BURGER: You covered that in your brief, though.

MR. BERENS: We will have to stand on that, Mr. Chief

Justice.

MR. CHIEF JUSTICE BURGER: Very well.

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:

In the government's view there is a fundamental issue at stake in this case, which is familiar to all of us, I think, in computing our tax liability, and that is that a deductible loss can only be established by a closed and completed transaction, fixed by an identifiable event and not by fluctuations in value.

We all know this to be the case when we buy a share of stock, a house, it goes up in value or down in value; those are paper losses, so to speak, and are irrelevant in computing our tax liability, and only when we sell or exchange or otherwise dispose of the asset does the loss become fixed.

Well, this case involves inventories, which is somewhat technical in nature; the same principle applies. Because inventories really are simply a device of computing the cost of goods sold and its basis, and thereby measuring a given year's income within the annual accounting system, which is central to our tax system.

The Court recognized as much in the Catto decision, in Volume 384 U.S., where it said: the general and long-standing rule for all taxpayers, whether they use cash or accrual method of accounting, is that cost incurred in the acquisition of inventory may not be currently deducted, but must be deferred until the year of sale, when the accumulated cost may be set off against the proceeds of sale.

In that particular case, a portion of the regulations at issue here were under scrutiny. That is 1.471-6, as they applied to livestock raisers. Here we are principally concerned with -2 and -4 of 1.471. And I think that, with the Court's indulgence, the best way to explain the Commissioner's position is to look at the details of these regulations. Because these regulations have been around since 1922, they were promulgated pursuant to an express statutory command of Section 471, which is essentially the same now as it was back in 19- -- the Revenue Act of 1918, and they are essentially the same. If you read the old cases and you look at the footnotes, Article 1582 is virtually the same as these regulations set out in our Appendix.

Now, the new management of Thor Power came in in 1964, and made three large-scale reductions to its closing 1964 inventory. And by doing that, it increased its cost of goods sold and thereby decreased its taxable income. There was a $2.75 million writedown of closing inventory to reflect items that were scrapped, obsolete. There was also a $245,000 writedown to reflect some spare parts stocked for unsuccessful products, and shortly thereafter these parts were sold at reduced prices.

The Commissioner did not question these two write-downs, and they are not involved in this case. Why? Because in our view there was an identifiable event that established a closed and completed transaction. That is, the scrapping or the reduction of price of the spare parts.

Now, here we have a $926,000 writedown, which is essentially an amalgam of three other writedowns, but I don't think we have to go into the nature of those three other writedowns, we essentially have $926,000 deduction which, in our view, is qualitatively different from those other two writedowns. Why? This writedown was based on the fact that the taxpayer had estimates that this inventory was in excess of a year's demand of its customers.

Now, I think the important thing to point out at the very beginning is why this was the case. This taxpayer, like all manufacturers, manufactured machinery and had a stock of spare parts. Now, economically it doesn't make sense, and counsel, I think, agreed, and the testimony is to this effect as well. It doesn't make sense to manufacture a machine and then destroy the dies or the tools and then, when your customers who have this machine need spare parts five years down the road, to re-tool for those spare parts. So all the spare parts are made at once, and they are made pursuant to some estimate of what you think, how long your machine will be in circulation.

Now, this is described as excess inventory. But I want to stress the fact, it's not excess in the sense of a farmer having a warehouse of oranges that are going to rot or, you know, that's kind of a glut on the market, it's a storehouse of goods which is in excess of what you think you can sell for one year. That doesn't mean that --

QUESTION: Mr. Smith, --

MR. SMITH: Yes?

QUESTION: -- I assume you would agree that no manufacturer can perfectly, with perfect accuracy, estimate the amount of spare parts he's going to need.

MR. SMITH: Absolutely, and I think this was --

QUESTION: He's going to be high on some parts and, if he's had bad staff work, he's going to be low, perhaps, on some others.

MR. SMITH: Absolutely, Mr. Chief Justice. I think it was a perfectly reasonable business sense. And I think it goes to the point that Mr. Justice Stevens explored with counsel earlier, and that is, this was not an abnormal situation, this was quite a normal situation. In fact, on page 51 of our brief, we quote the testimony of Thor's president, who conceded that, "any business which is involved in the manufacture and

sale of products inevitably must have excess inventory."
So I think that's, you know, we don't dispute that fact.

The point I simply want to make is that this was not a glut of goods that had no utility, it was simply a stock of goods that was in excess of a year's demand.

So what did the taxpayer do? He said, well, okay --

QUESTION: Which might turn out to be excess at some point.

MR. SMITH: Might turn out to be excess at one point. And that's basically our point, because "at some point" is not at the end of 1964. The tax system works on an annual accounting system. At the end of 1964 these things were simply estimates.

And the Commissioner's regulations, which I would like to now turn to, do not provide -- in fact they explicitly prohibit the reduction of inventories based on these kind of estimates. If there's one principle that underlines all of these regulations and has done so for 60 years, it's that inventory adjustments must turn on objectively verifiable data, and not estimates.

QUESTION: Can I ask you a sort of fundamental question about your view on the statutes and regulations? They argue, in effect, that there's an omission in the regulations. They argue alternatively that they complied with the regulations, and also that the regulations are defective by not providing for this particular problem.

Is it your position that, reading 471 which is their central section, that where it says "by such taxpayer on such basis as the Secretary or his delegate may prescribe" so forth and so on, that they must conform to a regulation by the Secretary authorizing the particular procedure they are using, and then there is no room for --

MR. SMITH: Absolutely.

QUESTION: In other words, you say if there's not a regulation authorizing it, they're through. And they say --

MR. SMITH: Exactly. Exactly. They alternatively argue that the regulations are silent and somehow they should be allowed to sneak through, so to speak.

But we say no. In fact, the regulations, in our view, explicitly prohibit these writedowns. 1.471-2(f)(1), (2) and (3), if I may burden the Court with all these numbers.

QUESTION: Right. You didn't burden the Court of Appeals with those, as I understand it.

MR. SMITH: [Laughing].

QUESTION: Mr. Smith, in this connection, was 2(f) argued to the courts below?

MR. SMITH: Absolutely; I believe so. Yes. Yes.

QUESTION: You're sure about that?

MR. SMITH: Yes. I think the Court of Appeals had the benefit of -- in fact, there's a good deal of accusations in the petitioner's brief about public counsel's post-hoc justifications. But, while, you know, that may be complimentary, maybe that is personally complimentary, I think, you know, basically all of these considerations were put to the Court of Appeals, including the change of accounting method as well.

Anyway, with that in mind I would like to turn to these -- to the regulations, because I think that they justify -- they not only justify, they differentiate the treatment by the Commissioner of these three writedowns. But they require, and they have required it since 1922.

Now, the taxpayer's argument pretty much principally rests on the notion that their accountants told them that this was an acceptable accounting practice.

QUESTION: Well, where is it -- tell me, you just say these regulations forbid it. Now, are you --

MR. SMITH: Yes, I'm going to explain -- I'm not just going to leave that statement hanging, unsupported.

QUESTION: Mr. Smith, --

MR. SMITH: Yes?

QUESTION: -- before you go on, didn't the Tax Court find that generally accepted accounting practice required what was done by this taxpayer, and that the SEC also would have required it in the registration statement?

MR. SMITH: That may well be that the SEC might require it. In fact, you know, it may well be that all sorts of bodies or statutes may require such things, and that the account -- well, I mean, our basis point is that accountants are concerned with projecting data to a reader in a way that doesn't really take into account measuring taxable income. I think a prospective investor might want to know that Thor Power Tool had a feeling that it wasn't going to be able to sell all these things down the road at some point, and it may have to get rid of them, they may be worthless. That may affect his decision to buy a bond or a share of stock or whatever.

But the Commission of Internal Revenue is interested in measuring taxable income. I think that's quite a different matter. And the fact that there might be such other requirements by the accountants or by other governmental agencies, I think is quite beside the point for purposes of determining whether --

QUESTION: Well, what prompted my question was not that I was suggesting there may never be a variation between tax requirements and accounting requirements, that was your suggestions, as I understood it; the taxpayer has sort of more or less pulled this out because it wanted it. And that it was not in accord with generally accepted accounting practice or with what other governmental agencies required.

MR. SMITH: Oh, no, I didn't mean to suggest that, although I think to fill out the story, the chronology is important as well. I mean, this wasn't a situation where the accountants came in and insisted on this method. It sort of went quite the opposite: management --

QUESTION: I thought they wouldn't have certified without this --

MR. SMITH: Well, there was testimony to that effect. But all I want to point out is that management made the writedown and then asked the accountants for an opinion as to its validity. And in fact the record indicates, and we sort of quote it in our brief, the accountant's opinion was --

QUESTION: What page?

MR. SMITH: Page 8. I mean it's a standard -- it was a standard caveat that the accountants kept appending to their opinions: "while the inventory reserves provided the best current judgment of the company's management, it is not possible to evaluate these reserves prior to ultimate disposition of the inventories involved."

In other words, he -- I mean, I think it's conceded this is an estimate, and our point simply is, while that may be a perfectly reasonable thing for an accountant to do, the Commissioner of Internal Revenue's regulations specifically prohibit those kinds of estimates --

QUESTION: That may be, but my brother Powell's question was -- it went to what the Tax Court found.

MR. SMITH: I think the Tax Court did find that the --

QUESTION: And the Tax Court did find that, and that's in conformity with Section 446, the law enacted by Congress.

MR. SMITH: Well, it's in conformity with one's requirement, Section 446 --

QUESTION: Well, which one do you think should give way?

MR. SMITH: Well, I don't think that --

QUESTION: The Tax Court finds that accountants won't certify as -- if they wouldn't certify, if the taxpayer uses your method, then how can it possibly accord with best accounting practices?

MR. SMITH: Well, Mr. Justice White, if I may just sort of answer your question in a slightly different way, I don't think there's a choice here that you have to say which requirement has to give way. There are two requirements. There is the requirement that it conform to the best accounting practice; also a requirement that it clearly reflect income. I don't think there's any dispute here that this was accepted --

QUESTION: And the Tax Court found that it did both.

MR. SMITH: The Tax Court did not find that -- I think the Tax Court found that it clearly reflected financial income. I think that's all counsel has said here this morning.

But we're talking about whether it clearly reflected taxable income, and I think that the answer to that question necessarily has to be made by reference to the Commissioner's regulation.

QUESTION: You say that your method, the method that you insist on, would be accepted in the accounting field as the --

MR. SMITH: It may not be; it may not be.

QUESTION: Well, if it isn't, then the statute isn't satisfied either?

MR. SMITH: Well, then I must say, I can't imagine -- I think it's true, as Mr. Justice Stevens indicated, there is no one -- I don't think in this area there is any one accounting method --

QUESTION: But you answered Mr. Justice Powell, though, that there was a finding that -- or at least testimony that accountants would not have accepted any other basis.

MR. SMITH: I think that's right. There was testimony to that effect.

But the point is, the Commissioner of Internal Revenue has --

QUESTION: Well, Mr. Smith, let me --

MR. SMITH: Yes.

QUESTION: -- get something straight.

MR. SMITH: Sure.

QUESTION: Earlier we, your opponent and I, had a colloquy in which we agreed there could be more than one best accounting method. Now, as I understand it, the SEC, for SEC purposes, they would require disclosure of the fact that the inventory on the books would be somewhat larger than its real value, say.

MR. SMITH: Right.

QUESTION: Not unlike the case where you might have a piece of real estate, that's on its books at one figure, but there's reason to believe its market value is much lower. I assume the accountants wouldn't certify unless there was disclosure of this fact, that there's great difference between the market value and the other.

MR. SMITH: That's correct.

QUESTION: That wouldn't necessarily mean, of course, you could take deduction for --

MR. SMITH: Exactly. I think if there was disclosure --

QUESTION: Let me get to the hear of the thing.

MR. SMITH: Yes.

QUESTION: Is there, however, any finding one way or another on the question whether accounting in conformity with the Commissioner's regulation would be or would not be a best method ofaccounting, an acceptable method?

MR. SMITH: There is no such finding in that regard.

QUESTION: Is there testimony by the experts that they put on the stand that that would not be an acceptable method of accounting?

MR. SMITH: No. No, I think the testimony simply says that the taxpayer's method would be a good method of accounting.

QUESTION: That would be an acceptable method?

MR. SMITH: Yes. I think the way, perhaps, to resolve this in a procedural sort of a way -- I mean it never, quite frankly, occurred to me. But if the statute requires these two things, the taxpayer has the burden of proof in the Tax Court, and it's the taxpayer's job to demonstrate that its inventory, you know, its claimed reduction is proper, and if it doesn't meet both tests I think the deficiency is approved. I think that --

QUESTION: In a way I think your argument may be that the taxpayer is really challenging the regulation in --

MR. SMITH: Oh, I think that --

QUESTION: -- requiring a method of accounting that's not a best method of accounting within the meaning of the statute. Even though it's been on the books for some 40 years or so.

MR. SMITH: Well, I don't want to confront the accounting testimony, I don't think I have to.

QUESTION: I don't blame you.

[Laughter.]

MR. SMITH: I don't think I have to do that. I think that --

QUESTION: Mr. Smith, one thing that makes me keep coming back and taking your time is that you refer to testimony, and of course that's there; but I started out with the point, and I finally found a sentence in the Tax Court's opinion that says -- this is on page A-19 of the Petition for Certiorari, five lines from the bottom. It says "A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was required in order to produce a certified balance sheet."

Now, I would say I don't think that decides the case, I'm just trying to --

MR. SMITH: I think you're right. I think that's right. That was --

QUESTION: I'm trying to make clear that this taxpayer --

MR. SMITH: This method of accounting was perfectly acceptable -- the Tax Court goes on to say --

QUESTION: -- was required.

MR. SMITH: What? Yes.

QUESTION: The Tax Court said it was required, not just --

MR. SMITH: Yes, but the Tax Court went on to say, Mr. Justice --

QUESTION: That still leaves the second --

MR. SMITH: Exactly. The Tax Court went on to say, if you turn the page over, "However, petitioner must also show that the method clearly reflects taxable income." And our point is that he hasn't done that.

And the reason he hasn't done that is that he hasn't conformed with the regulations. I think, although the counsel has denied that he's taxable under the regulations, he really does, because --

QUESTION: Do you have to get to the regulations if you take 446(b) entitled "Exceptions", which I take it means that it's exceptions to Rule 446(a). One of the exceptions is, "or if the method used does not clearly reflect income".

MR. SMITH: Right. Then the Secretary makes the computation.

QUESTION: And that's the end of it, whether it conforms --

MR. SMITH: Yes, but I think, you know, I think you have to get to the regulations only to determine whether, you know, it clearly reflects income, because the regulations, I think, you know, provide a detailed panoply of rules as to what will, you know, meet the clearly reflected income standard.

QUESTION: But even if it conforms to entirely proper accounting practice, and even if the accounting profession would say, This is the only way to do it; if the

Commissioner can properly determine that it does not clearly reflect income, you win, I would think.

MR. SMITH: That's absolutely the case. And the reason we win, in our view, is because this doesn't meet the requirements of the regulations.

QUESTION: May I follow up on Mr. Justice Rehnquist's point, with which I do not necessarily disagree. Do you perceive that there's any sort of a presumption in favor of what a taxpayer does when it is in accord with generally accepted accounting practice, and, moreover, his balance sheet won't be certified unless he does what was done?

Is there any sort of presumption in favor --

MR. SMITH: Well, I don't think it's a presumption -- I wouldn't characterize it as a presumption.

QUESTION: But doesn't it --

MR. SMITH: I would simply say it meets that one leg of the statute.

QUESTION: But doesn't it put the burden on the Commissioner to demonstrate why the taxpayer was wrong?

MR. SMITH: Oh, no. Oh, No, I don't think so.

QUESTION: You don't think so.

MR. SMITH: I think the Commissioner -- I think the taxpayer has a -- you know, these are statutes in which the courts have traditionally characterized the taxpayer's burden as a heavy one, and the Commissioner's discretion is a broad one.

QUESTION: Even in view of the conjunctive language in 471?

MR. SMITH: Yes. I think that's right. And I think, you know, I think, to follow up on your point, I mean I think the taxpayer -- and to get into the regulations -- the taxpayer has plucked out a sentence out of the regulations, which says here that --

QUESTION: What are you reading from?

MR. SMITH: I'm in 471-2(b).

QUESTION: Page?

MR. SMITH: Page 85, I'm sorry, of the Appendix to our brief. "inventory rules must give effect to trade customs which come within the scope of the best accounting practice", and then down below it says "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting income." I think that's what the regulations provide.

So I think, you know, that's it. I mean, you know, what that sentence does, the taxpayer would have that sentence stand as a kind of universal standard in derogation of the rest of these detailed rules that have existed, you know, for almost sixty years.

QUESTION: But, of course, one starts with the statutory language and the regulations can rise no higher than that.

MR. SMITH: Sure.

QUESTION: My question really was whether or not the statute itself does not put the burden on the Commissioner in this type of situation, where the taxpayer has met the first requirement of the statute?

MR. SMITH: No, I don't think it does, Mr. Justice Powell. In fact, you know, the portions of the Code in which the -- I mean, the general rule is that the taxpayer has the burden of proof of --

QUESTION: Yes, I'm familiar with that.

MR. SMITH: Yes. And I think that the portions of the Code has a few sections which specifically put the burden of proof on the Commissioner by, you know, in accumulated earnings tax case, if the taxpayer files a statement of reasonable cause for accumulation, then the Commissioner has the burden, that's by statute, in a case where the Commissioner asserts the 50 percent fraud penalty, the Commissioner has the burden. Tax Court rules provide that when the Commissioner raises new matter by answer, it has the burden -- I mean, I think that those are unusual circumstances, and I think that the general rule has to apply here.

Simply qualifying under one provision, you know, under one requirement of the statute, I don't think shifts, you know, provides any shifting of burden of proof.

QUESTION: May I ask you just one more question, and then I'll be very quiet.

MR. SMITH: Surely.

QUESTION: How does a taxpayer in a business that involves a substantial number of items comply with what I understand your point is, and that is, that there must be a realization of a loss estimated to exist in inventory before it may be taken in the taxable year in question?

How does one comply? You have here --

MR. SMITH: Well, there are several ways. In fact, counsel averted to one of them, scrapping; scrapping of goods and --

QUESTION: Suppose you have a million bits and pieces of inventory, you can't selectively scrap -- perhaps you could, but you'd still have a very large number of items that perhaps properly should be written down. On a cost-or-market inventory basis, what does one do?

MR. SMITH: Well, what one does is look at the regulations which provide for a way of fixing the proper amount of the writedown. The regulations provide -- let me give two examples. If you look at page 85-86, there is a provision for a writedown for damaged or imperfect goods, goods that have been shopworn, et cetera, and the regulations provide that they shall be valued at bona fide selling prices less direct cost of disposition, whether you're on the cost or lower-cost-or-market method. And the regulations go on to say, a little further down, I suppose two-thirds of the way down on page 86, "Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date."

Now, if I may drop down a few more -- well, actually, "The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications avoce, and he shall maintain such records of the disposition of the goods as will enable a verification."

The regulations, the hallmark of the regulations, the touchstone, is independent means of verification.

Now, going on to page 87, if I may, the lower of cost or market -- and this sort of, in a way I'd like to clear up what I think is a fundamental sort of misconception advanced by counsel; and that is that somehow market means net realizable value. Market and the lower cost of market doesn't mean net realizable value, it means replacement value. And the reason it means replacement value is simply because, as I said earlier, the whole process of inventories is to determine basis.

In other words, if you buy something for $100 and then, two years down the road, you find out that you can buy it for $50, well, if you -- you know, the Commissioner will then say if you're on the lower of cost or market, then if you went out and bought one today you'd only pay $50 for it, but we'll allow you a $50 writedown. But again it has to be on the basis of independent verifiable data. If I may ask the Court to look at one more of these detailed provisions, on page 88, subparagraph (c) on the lower of cost or market, it says "Where the inventory is valued on the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared".

In other words, the Commissioner's regulation -- I mean, I think it's -- I don't think that it's incomprehensible to infer that there's a tremendous amount of abuse in the keeping of inventories; and the way the Commissioner has tried to set up these requirements for almost sixty years is to provide for independent verifiable evidence of inventory reductions. And --

QUESTION: Well, Mr. Smith, what if --

MR. SMITH: Yes?

QUESTION: -- what if the taxpayer came in to the Tax Court or came in to the Commissioner and said, "Look, my net realizable value is scrap value. Here's what I could get if I actually scrapped it." And suppose you said, "Well, we agree with you that if you scrapped it right now, that is the net realizable value." That amount would be the amount you say is the net realizable value.

Now, let's assume you agreed with him. You still wouldn't let him write it down, would you?

MR. SMITH: Well, it has to be scrapped.

QUESTION: I know, but you -- but --

MR. SMITH: In other words, I'm saying that there are, you know, there are --

QUESTION: But suppose he gets offers from people who are buying the scrap, and he comes in and says, at page 86 he says, "Now I here have some bona fide offers for my inventory." Scrap value.

MR. SMITH: Well, if I may just modify your example in one respect, --

QUESTION: No, don't modify it at all, just take my example for a minute.

[Laughter.]

MR. SMITH: Well, I would say that the writedown would be permitted if the goods were damaged, imperfect, shopworn, unstylish, broken --

QUESTION: So you just don't permit, on page 86, don't permit writing down for just excess inventory.

MR. SMITH: Exactly. Exactly.

QUESTION: Well, why did you cite that to us as an example of what the taxpayer could have done here?

MR. SMITH: Excuse me?

QUESTION: Well, you indicated to us the he might have used this method, on page 86.

MR. SMITH: I said if the goods were damaged or shopworn, et cetera.

In other words, what I am simply saying is that these are detailed technical rules and they --

QUESTION: So tell me again now, Mr. Smith, I asked a long time ago: What specific provisions in these regulations prohibit what the taxpayer does?

Certainly 86 doesn't now, you've just conceded it.

MR. SMITH: Yes. Well, page 87 --

QUESTION: So 86 is irrelevant?

MR. SMITH: Yes -- well, no, let's put it this way: 86 is not irrelevant, 86 simply --

QUESTION: Well, it doesn't cover this.

QUESTION: It doesn't apply in this case.

MR. SMITH: Well, it refutes -- I mean, it's relevant only because petitioner has claimed to come within it.

QUESTION: Your time is running -- where is the prohibition on this?

MR. SMITH: Yes. The prohibition is at the top of page 87, paragraphs (1), (2) and (3), "Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof". And we set forth in great detail in our brief, at pages 41 to 44, and cite a number of cases which, incidentally, antedate --

QUESTION: But is this the only provision, you say?

MR. SMITH: No. (2) and (3) as well expressly prohibit it. We think that what the taxpayer did here on the basis of the estimates is described by each of those subparagraphs. He deducted from the inventory a reserve for price changes, or an estimated depreciation; in other words, that these were estimates and not independently --

QUESTION: Is there anything else in the rules?

MR. SMITH: No, there's no express prohibition. Everything else -- we have invoked the regulations in every other respect to refute the taxpayer's claim to the inventory writedown. In fact, you know, attacking the taxpayer's principal claim is that somehow this is a lower-cost-or-market, and we say this is where --

QUESTION: Mr. Smith, didn't the government allow them to writeoff any inventory of any items that had been unsold for at least a year?

MR. SMITH: Excuse me?

QUESTION: There were some items on which there had been no sales for at least a year. Did not the Commissioner permit them to write those off at 100 percent as obsolete?

MR. SMITH: There were two -- as I said earlier, there were two specific writedowns, one of them for obsolete goods, you're right, and the other one was for spare parts --

QUESTION: And wasn't the test of obsolescence no sales of a particular item for a year?

MR. SMITH: I think that -- you know, they were scrapped. They were scrapped as obsolete. In other words, they met the scrapping requirement, the one that the taxpayer feels so unhappy about.

QUESTION: Do you know whether or not the Commissioner allowed writeoff for obsolescence merely on a showing that an item had not been sold for a year?

MR. SMITH: I don't think there's anything in the record that indicates that, and I would suggest that that wouldn't be the test of the regulations; simply because something wasn't sold for a year, I don't think indicates that it's without utility or value, to the taxpayer.

QUESTION: And under what part of the regulation was that particular writedown for obsolescence permitted?

MR. SMITH: Permitted? I would suggest to the Court there's nothing in the regulations, as such, that permits a writedown for obsolescence, or scrapped as obsolescent. But that it seems to us that the statutory basis for that is Section 165 of the Code, which simply permits a loss when something becomes valueless, like when you had a casualty and your house was --

QUESTION: When you realize loss.

MR. SMITH: Yes, and it's sort of of no value to you. Exactly. Or whatever you can get for it.

I think my time has expired. If there are no further questions.

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

[Whereupon, at 11:05 o'clock, a.m., the case in the above-entitled matter was submitted.]

- - -