In the

ORIGINAL

Supreme Court of the United States

UNITED STATES,	)	
	)	
Petitioner	)	
	)	
v.	)	NO. 80-1251
	)	
VOGEL FERTILIZER COMPANY	)	

Washington, D. C.

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IN THE SUPREME COURT OF THE UNITED STATES

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Petitioner

v. No. 80-1251

VOGEL FERTILIZER COMPANY

Washington, D.C.

Tuesday, November 3, 1981

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:50 o'clock a.m.

APPEARANCES:

STUART A. SMITH, ESQ., Office of the Solicitor General, U.S. Department of Justice, Washington, D.C. 20530; on behalf of the Petitioner.

RONALD C. JENSEN, ESQ., 1500 Woodmen Tower, Omaha, Nebraska, 68102; on behalf of the Respondent.

C O N T E N T S

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P R O C E E D I N G S

CHIEF JUSTICE BURGER: We will hear arguments next in the United States v. Vogel Fertilizer Company. Mr. Smith, you may proceed whenever you are ready.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF THE PETITIONER

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

This federal income tax case is here on write of certiorari to the United States Court of Claims. It involves a definition of controlled group of corporations and component members. A technical area of the tax law that we believe appropriately lends itself to elucidation by means of the Commissioner's Treasury Regulations.

And at the outset I would like to point out to the Court that there is a regulation that specifically addresses the facts of this case, with an explicit example that governs this case.

As we shall point out later in our argument, the Court of Claims admitted in its opinion that the Commissioner's regulation was not unreasonable. But it went on to hold that the regulation was invalid because it believed that its interpretation of the statute served better purposes and was more reasonable.

At the outset, I think it bears repeating that

under an unbroken line of decisions of this Court, the question in this case is not whether the Court of Claims has reached a more reasonable interpretation of the statute, but rather, the question is whether the Commissioner's regulation is a reasonable interpretation of the statute. We think it is, and with this admonition in mind, I think we can turn to the particular statute at hand.

It is Section 1563(a)(2) of the Internal Revenue Code of 1954, pertinent parts of which are set out at the bottom of page 6 of our brief.

At the outset, I think it's important to point out to the Court what the purpose of this statute was, which I think is beyond dispute. The corporate income tax is made up of two levels, a basic rate and a surtax. For example, a 30% normal rate and a 25% surtax, and the rates keep changing, but normally, it's on the first $25,000 there is the normal rate, and then the combined normal rate and surtax on the remainder of taxable income.

Because of this split in brackets, it has been attempted by various business organizations to split income among many different corporations which are essentially part of the same economic enterprise, to reduce the overall tax burden of a business. And because of that, the Commissioner has, in the past, had a number of statutory weapons at his disposal; for example, Section 269 and 1551 of the Code,

which required a judicial inquiry as to whether these corporations were formed or split up for the purpose of reducing taxes or getting an additional surtax exemption.

Because of the difficulty of probing and deriving these factual -- entry of these factual increase, Congress finally adopted this statute in 1964 and amended it in 1969 to establish a precise mathematical test. And if you are a controlled group of corporations, then the component members of the group must either share the corporate surtax exemption or pay a 6% penalty, if they're going to each claim a separate surtax exemption.

Now, the particular controlled group involved in this case is the so-called brother-sister group, and it is defined, as we point out here for pertinent parts of the statute, in two different subparagraphs of Section 1563(a)(2). The provision says two or more corporations -- that is a brother-sister group -- if five or fewer persons who are individuals own stock possessing (A) at least 80% of the stock of each corporation, and (B) more than 50% of the stock of each corporation, taking into account the stock ownership of each such person, only to the extent such stock ownership is identical with respect to each such corporation.

Basically, --

QUESTION: Mr. Smith, what do you think the reasoning behind the Court in the case of United States v.

Cartwright was, where it struck down a Treasury regulation.

MR. SMITH: I think the reasoning behind the Court in United States v. Cartwright was that the regulation was unreasonable and inconsistent with the statute. We think the regulation at issue here fully implements the plain language of the statute and is consistent with the congressional purpose of eliminating multiple surtax exemptions for corporations controlled as a single economic entity.

QUESTION: Maybe your reading of the statute -- the Court of Claims' reading of the statute -- would make more sense than Congress made, but how do you get away from the 80%?

MR. SMITH: Well, I think -- let me turn to the facts of the case and I think our position will become clear.

In this particular case, we have two shareholders; Arthur Vogel and Richard Crain, and two corporations, Vogel Fertilizer and Vogel Popcorn.

QUESTION: Does Vogel own 80% in each?

MR. SMITH: Arthur Vogel owns 77.49% of Vogel Fertilizer. Richard Craine owns the remaining 22.51% of Vogel Fertilizer. For Vogel Popcorn, Arthur Vogel owns 87.5% of the stock of Vogel Popcorn.

Now, just looking at the plain words --

QUESTION: If you add those two together and

divide by two, then you do have 80 -- is that the way it's supposed to work?

MR. SMITH: Yes, exactly. We think the 80% test of the statute, which is the only part of this statute that's at issue here, everyone agrees that the 50% part of the statute is met, but --

QUESTION: But you didn't mention that Crain owns nothing of Popcorn.

MR. SMITH: No, Crain owns nothing of popcorn.

QUESTION: You think that's wholly irrelevant?

MR. SMITH: Well, that's the issue here, as to whether Crain has to own any shares in Popcorn.

QUESTION: Your position is that it's wholly irrelevant.

MR. SMITH: It's our position here that that is irrelevant on the face of the statute. And just reading the statute, the question is whether five or fewer persons -- and here we have Arthur Vogel and Richard Crain -- own stock, -- who are individuals, which they are -- own stock possessing at least 80% of the stock of each corporation.

Now, Arthur Vogel and Richard Crain own 100% of Vogel Fertilizer, and Arthur Vogel, who is also a person in that group, owns 87.5% of Vogel Popcorn. In our view, the plain language of the statute, the literal language of the statute, supports the result that Subparagraph (a) applies

here.

QUESTION: We'll resume there at 1:00 o'clock, Mr. Smith.

(Whereupon, at 12:00 o'clock p.m. the oral argument in the above-entitled matter was recessed for lunch, to reconvene at 1:00 o'clock p.m. the same day.)

AFTERNOON SESSION

(1:00 p.m.)

CHIEF JUSTICE BURGER: Mr. Smith, you may continue where you left off.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF PETITIONER - Resumed

MR. SMITH: Mr. Chief Justice, and may it please the Court, when the recess occurred, we were discussing the text of Section 1563(a)(2), which is set forth in pertinent part at the bottom of page 6 of our brief. The statute defines a brother-sister group, which consists of, quote, "two or more corporations, if five or fewer persons who are individuals own stock possessing (A) at least 80% of the stock of each corporation, and (B) more than 50% of the stock of each corporation taking into account the stock ownership of each such person, only to the extent such stock ownership is identical with respect to each such corporation."

The statute has two parts, an 80% test and a 50% test. Perhaps the best way to attack the statute on the facts of this case is to first put out of the way the 50% test, the applicability of which is undisputed here.

QUESTION: Let me ask you one question, Mr. Smith, if I may. With the 80% rule in the statute itself, doesn't -- isn't that made almost superfluous by the regulation?

MR. SMITH: No, because the 80% rule, or part of the statute, is still important in order to insure that the corporations be closely held. The 50% test was added to the statute in 1969 at a time when the number of shareholders went from one to five in order to retain commonality of ownership or overlap. And I think the best way to illustrate that is on the facts of this case.

Here we have two shareholders, Arthur Vogel and Richard Crain, and two corporations, Vogel Fertilizer and Vogel Popcorn. Now, Arthur Vogel owns 77.49% of Fertilizer, and Richard Crain owns the remaining 22.51%. Arthur Vogel owns 87.5% of Popcorn, and the remaining shares of Popcorn are owned by a trust. Crain doesn't own any shares in Popcorn.

QUESTION: So Crain is, in effect, drawn into the net by his interest in Vogel.

MR. SMITH: Crain is drawn into the net by his interest -- well, when you say Vogel, his interest in Fertilizer. The statute applies because of Crain's interest in Fertilizer. And I think that the words of the statute support our submission that the statute applies.

Let me first put out of the way the application of the 50% test in subparagraph (B). The italicized words which we have italicized at the bottom of page 6 of our brief, the taking into account the stock ownership, works as

follows.

You find out -- you take into account the stock ownership of each such person as to the extent it is identical. In this particular case, the identical stock ownership is 77.49%. Arthur Vogel owns that amount in Vogel Fertilizer, and indeed, he owns 87% of Vogel Popcorn. So using 77%, to round the figures, as the identical stock ownership, subparagraph (B) of the statute which demands that five or fewer persons own more than 50% of the stock of each corporation is met. Because indeed, Arthur Vogel is one person; one is less than five, and the required overlap is met.

QUESTION: A and B are conjunctive, are they not?

MR. SMITH: What is conjunctive, Mr. Chief Justice?

QUESTION: A and B of this --

MR. SMITH: A and B of the statute have to work in tandem. But our submission is that the Court of Claims has confused the application of A and B by requiring some overlap in A, when the words of the statute, if I may suggest, simply don't speak to any overlap.

QUESTION: But they do have to subsist together. I mean --

MR. SMITH: They do have to subsist together, but in our view they subsist together to the extent that we're talking about the same group of five or fewer persons.

Here, the group is Arthur Vogel and Richard Crain; two persons, ergo, less than five.

QUESTION: But you have to have the two to satisfy A. And you have two here, you say, to satisfy A.

MR. SMITH: We have two that satisfy A.

QUESTION: But only one that satisfies B.

MR. SMITH: Right, exactly.

QUESTION: And what are the two, to be precise, that satisfy A?

MR. SMITH: The two that satisfy A are Arthur Vogel and Richard Craine, because going back to the words of the statute, if five or fewer persons who are individuals own stock possessing at least 80% of the stock of each corporation.

QUESTION: And 77 or whatever it is --

MR. SMITH: Well, actually, for Fertilizer it's 100%, because --

QUESTION: I know, because as you say, 77 plus 22 is 100, so that's more than 80.

MR. SMITH: And for Popcorn, Arthur Vogel satisfies it in its entirety, because he owns 87%. You don't have to look to anything else.

In our view, this is the language of the statute.

QUESTION: But if he only owned 40% of Popcorn, the statute would not be satisfied.

MR. SMITH: That's right.

QUESTION: How do you account for the word "and" between A and B in the statute?

MR. SMITH: Well, they simply talk about both tests that have to be met. Our submission here is that based on the literal language of the statute, the only thing that is required is that five or fewer persons own at least 80% of the stock of each corporation.

QUESTION: Why didn't the Court of Claims agree with you?

MR. SMITH: The Court of Claims did not agree with us because they looked to the phrase "each such person" in subparagraph B, and they somehow felt that each such person really spoke to five or fewer persons, and that somehow, that meant -- and I must confess that it really is as the Second Circuit characterized it in Allen Oil Company, a convoluted reading of the statute. Because what they have done is take a kind of hybridized overlap and attributed that to subparagraph A, when in fact, subparagraph A has no overlap at all.

The overlap aspects of the statute are completely carried by subparagraph B. If there is 50% overlap, that satisfies the overlap aspects of the statute.

QUESTION: Of course, it's not hard for an ordinary person to convolute the Internal Revenue Code.

MR. SMITH: Indeed. Both ordinary and extraordinary people engage in that on a daily basis.

QUESTION: When we're construing a statute of this kind we -- must the courts construe it most strictly against the taxpayer or most strictly against --

MR. SMITH: I'm not sure that there are any such doctrines of strict construction against one party or the other. Let me simply say, Mr. Chief Justice, that in our view, the plain language of the statute supports the Commissioner's interpretation.

QUESTION: Even if it was ambiguous, there is some rule that you pay some deference to the Commissioner's --

MR. SMITH: Oh, indeed, here. And indeed, we don't even think it's ambiguous. But to the extent that one could convolute, we think that here we have a Treasury regulation --

QUESTION: I don't know what you mean by convolute. What do you mean by convolute?

MR. SMITH: To the extent that if one could mis -- you know, engage in another interpretation. We think here, as Mr. Justice White has pointed out, there are Treasury regulations that elucidate the statute, provide for an example that speaks to the very question in this case, which we think --

QUESTION: And how old is that regulation?

MR. SMITH: That regulation came out in temporary form, Mr. Justice White, in March of 1971, two years before the taxable years at issue. And indeed, the taxpayer here -- there's no dispute about this -- filed their return on the basis of not claiming separate surtax exemptions, following the regulation.

QUESTION: Mr. Smith, before lunch I think you started your argument by saying that the purpose of the statute was to prevent the split-up of a single economic entity or enterprise. What is a single economic entity or enterprise in this case?

MR. SMITH: Well, it's really what is defined by the statute in objective mathematical terms. It's that --

QUESTION: What is it in economic terms?

MR. SMITH: Well, I think --

QUESTION: The Popcorn business or the Fertilizer business?

MR. SMITH: Well, it's not the lines of business. It's simply the percentage of shareholdings and overlap. It's a particular kind of closely-held group of corporations in which there is the requisite overlap, and we think they are met in this case. And I think that the best way to illustrate your point is perhaps by pointing that the Court of Claims agreed here, and indeed responded, it concedes, that the statute would be met in this case if Richard Crain

owned one share of stock in Vogel Popcorn.

Because in their view, you can't really count Crain's interest for purposes of the 80% test unless he owns some de minimus; indeed, one share, of Vogel Popcorn. And we think that really turns the legislative purpose on its head. What Congress was --

QUESTION: Isn't a fair way to state the issue as to whether the five or fewer persons referred to in the statute have to be the same persons for both A and B?

MR. SMITH: That is indeed the way --

QUESTION: That's the issue.

MR. SMITH: That's the issue. And we don't think that the --

QUESTION: And there's only one mention of five or fewer persons that applies to both A and B, isn't there?

MR. SMITH: Well, five or fewer persons -- it seems to me that you have to read A and B as separate parts of the statute.

QUESTION: But referring to different groups of five or fewer --

MR. SMITH: Well no, no. I think that the five or fewer persons is the same group. But the question is really whether each member of the five or fewer persons has to own stock in A and B, and we don't think that the words of the statute support that. We're taking about five or fewer

persons who are individuals who own stock, possessing at least 80% of the stock of each corporation, and that's concededly met here.

QUESTION: Mr. Smith, what can Crain do to get out from under this?

MR. SMITH: What could Crain --

QUESTION: He doesn't own any of the stock, Popcorn stock, does he?

MR. SMITH: He doesn't own any of the stock of Popcorn, indeed.

QUESTION: What did he do wrong?

MR. SMITH: Crain didn't do anything wrong, Mr. Justice Marshall. The only way that the numbers would have to be changed, Crain would have to sell some of his shares. Well basically, you'd have to have a situation where perhaps six shareholders -- . What Congress was interested in was making sure -- to attack and to prevent income spreading among --

QUESTION: What is it that Crain did that Congress tried to stop him from doing?

MR. SMITH: I think that's really looking at the case in an inappropriate way, and in a way that --

QUESTION: Well, another way if you don't want to answer the question.

MR. SMITH: No, I do want to answer the question,

but I don't think it really helps the analysis to talk about as a guilty party.

QUESTION: Well, assuming I think it might help it.

MR. SMITH: Well, I think that, you know, on the fats of this case, with Crain owning 22% -- if Crain is going to insist on owning 22% of the shares, then he has to acquiesce in Congress's decision that these two corporations are not going to share -- are not going to be eligible for separate corporate surtax exemptions because these are members of a brother-sister controlled group, as the statute is defined.

The shareholdings could be re-arranged perhaps in a way to provide for more than five shareholders. Crain could presumably --

QUESTION: But there's only one, that's Fertilizer.

MR. SMITH: Well, Crain could sell his stock to five other people. And then there would be six shareholders.

QUESTION: Well following up on Justice Marshall's thought, supposing originally Crain owned this interest in the company in which Mr. X owned the other 77%. And then he'd have the full exemption. Then Mr. X sells out to Mr. Vogel and Mr. Crain loses a big part of his exemption.

MR. SMITH: That's true, that is true. But as we point out in our reply brief, you know, because the respondent makes much of the fact that our construction of

the statute would visit surprises on fellow shareholders, the tax laws are replete with instances where that could be the case. You could have a Subchapter S corporation in which you have the maximum number of shareholders, and then one of the shareholders decides to sell some stock to someone else, which thereby increases the number of shareholders beyond the maximum. And the corporation then loses its status.

I don't think that the fact that that might happen necessarily casts doubt on what we think is really the plain language, our interpretation, which is really supported by the plain language of the statute.

QUESTION: Does the Court of Claims and the Tax Court hold that each one of the five has to be an owner in each of the corporations?

MR. SMITH: Yes, yes.

QUESTION: Would that make the 50% requirement superfluous?

MR. SMITH: No, it wouldn't make the 50% requirement superfluous, Mr. Justice White, because they said they would satisfy it if Richard Crain owned one share of stock of Vogel Popcorn. That wouldn't do anything to the 50% test. That --

QUESTION: I know, if each of the five have to -- if each of the five have to own --

MR. SMITH: Identical amounts --

QUESTION: No, not identical amounts. But if all five of them have to own something in, say, Popcorn, and if they all add up to 80%, then certainly --

MR. SMITH: Oh, that would indeed -- yes --

QUESTION: Well, isn't that the result of it? In any case. If each of them, if all five have to own some shares in both -- in all the corporations, if each of the five has to own --

MR. SMITH: Yes.

QUESTION: And certainly in one of them; say in Popcorn, the five would have to own over 80% to satisfy that test, wouldn't it?

MR. SMITH: To satisfy the subparagraph A test?

QUESTION: No, the 80% test.

MR. SMITH: Yes, that would, in effect, make it superfluous.

QUESTION: Exactly.

MR. SMITH: Yes, but I don't think that's what the Court of Claims is saying here. I think what the Court of Claims is --

QUESTION: Yes, but it's what the result is. In any case, under their rationale that you satisfy the 80% test, you would always satisfy the 50%.

MR. SMITH: Right.

QUESTION: Well, that's not true. If you have A owning 80% and B 20% in one, and vice versa in the other, you wouldn't meet the 50% test.

QUESTION: Why?

QUESTION: Mr. Smith will explain it.

MR. SMITH: Mr. Justice Stevens is right.

QUESTION: Oh, that's because of the provision that --

MR. SMITH: Yes, that they have to be taking the identical shareholding --

QUESTION: The lowest amount.

MR. SMITH: So it would be 20 and 20, so that would only be 40; it would be less than 50%.

QUESTION: I see. But if they own the same amounts.

MR. SMITH: Right.

Now, I think that it's relevant that the fact that respondent concedes and the Court of Claims concedes that if Richard Crain owned one share of stock in Vogel Popcorn that the result would be different, really, it seems to me, proves the validity of the interpretation that we are urging here.

QUESTION: Mr. Smith, I'd like to talk to you a little bit about, or have you explain to me a little bit about the legislative history. I guess the section was

originally enacted in 1964 as just an 80% test.

MR. SMITH: That's right, Justice O'Connor.

QUESTION: Without the 50% requirement.

MR. SMITH: Right, because at that point, the share -- it had to be one shareholder owning 80% or more of each corporation. That was the requirement. The overlap and the closely held aspects of the statute were merged in the single 80% test.

But when Congress in 1969 determined that it was very easy to avoid application of the statute because you could simply just sell a few shares to another shareholder and then you would have two shareholders. So they expanded the shareholder group to five.

QUESTION: From one to five. But didn't change the other language of subsection A, which would indicate that the common ownership was required?

MR. SMITH: Well no, because I think, as we pointed out in our reply brief in the footnote, the common ownership aspect of the statute was taken up by the 50% test of subparagraph B. And that's the import of the language, taking into account the stock ownership of each such corporation only to the extent that such stock ownership is identical. And once the 50% common ownership requirement was taken into the statute, in our view the only thing left of the 80% test was the closely held tack that the

corporation --

QUESTION: Would you concede that originally, as the statute was originally drafted, that in effect the 80% requirement was a common ownership requirement?

MR. SMITH: I would concede that, but I would also suggest to you and the Court that once the statute changed, the statute had to be construed in a different sort of way; that the common --

QUESTION: But subsection A did not change other than to say expand from one to five, right?

MR. SMITH: Yes, indeed, but once adding subsection B, it's clear that the legislative history, the Treasury studies, indicate that the aspect of common ownership that the statute was attacking was going to be covered completely by the 50% test, because if that were not the result, then it would be an 80% common ownership test and everyone agrees that that is not the case here; it's only a 50% common ownership.

QUESTION: Mr. Smith, at page 6 of your brief in the second full paragraph in the summary of argument you say, "Congress sought to provide an objective mathematical test to eliminate income splitting among corporations, operated as one economic entity."

Doesn't that make the Court of Claims' concession that if Smith had owned one share in Popcorn -- fit in with

that? It's a mathematical test?

MR. SMITH: Indeed, because in our view, if Crain had owned one share of Popcorn, that really wouldn't have enhanced Vogel's ability to control these corporations as a single economic entity. And in our view, the statute really wasn't intended to turn on such minute differences, and it supports, I think, the Commissioner's regulation which implements the plain language of the statute.

I'd like to save the rest of my time.

QUESTION: Mr. Smith, every test like this can turn on one share being in somebody else's hands, can't it, no matter where you draw the line?

MR. SMITH: Oh, that's true, but I don't think -- there are lines here. 80% test and, of course, if 79.9, it wouldn't fit the statute. But I think our point simply is here, if Congress was attacking and trying to define enterprises controlled as a single economic entity, it really forced that purpose to say well, we're going to make the statute apply if Crain owned one share of Popcorn. That really doesn't add anything to Vogel's ability, and that's really what the focus of the statute is on.

CHIEF JUSTICE BURGER: Mr. Jensen?

ORAL ARGUMENT OF RONALD C. JENSEN, ESQ.

ON BEHALF OF THE RESPONDENT

MR. JENSEN: Mr. Chief Justice, and may it please

the Court:

Your Honors, the issue in this case can be very simply stated. Must Vogel Fertilizer Company be considered a member of a brother-sister controlled group under the specific definition and the specific statutory language of that term, as provided by Congress?

QUESTION: Mr. Jensen, where does this brother-sister terminology come from?

MR. JENSEN: The specific origin of the brother-sister I'm not sure. I assume it comes from the fact that you have two corporations side by side as opposed to a parent subsidiary.

QUESTION: So one's brother and the other sister?

MR. JENSEN: One's a brother and the other's a sister.

QUESTION: Which is which?

MR. JENSEN: I could not tell you the gender.

QUESTION: The dominant one is the female --

QUESTION: Perhaps they should all be gender and neutral.

MR. JENSEN: I would agree with that, Your Honor.

QUESTION: Isn't the term right in the statute itself?

MR. JENSEN: The term is right in the statute itself. Both the parent subsidiary term and the

brother-sister terms are there.

QUESTION: Perhaps it came from a case in which there happened to be a brother and a sister embarking on this kind of a program.

MR. JENSEN: Where?

QUESTION: I said perhaps it came from such a case.

MR. JENSEN: Perhaps it did come from that. That's right. Or some more obscure relationship.

Your Honors, it appears that the sharpest division between the government and the taxpayer comes in defining the functions and the interactions of the 80% and the 50% tests, and how these functions advance the design of the statute.

Now, if I may just reiterate and summarize for you what I believe the differences are, I think this would help very much.

The taxpayer's interpretation, our interpretation of the statute is as follows. We apply the 80% test first, and that follows from words located in the statute, if for no other reason. And the 80% test is a test of financial interest. This test is designed to require an aggregate ownership representing substantially the entire financial interest in all the corporations involved. This is where we get to the economic entity idea. We are trying to find the entire financial interest.

Now, why is a financial interest necessary? It's necessary because the conduct sanctioned by this particular statute is the exercise of control over more than one corporation by a small group of persons for their own substantial financial interest in the corporations. With this function, commonality is required.

Now, the 50% test, I believe that both the government and myself agree, is one of control. It identifies the degree of control necessary to allow the corporations to be operated as one economic entity.

Now, we believe that our interpretation of the particular statute gives both tests a separate and distinct function. The government, on the other hand, interprets the statute in such a manner that both of the tests, the 80% and the 50% tests, are tests of control.

The 50% test, which they would apply first, determines whether the corporations have a commonality of control through common stockholders. We don't really have any argument with that particular definition. But their 80% test ensures only that the stock is closely held. The exemption is saved under their interpretation if there are shareholders outside the 50% five or fewer group that own more than 20% of its stock.

Now, I would submit that under the government's interpretation, 1563 as a scheme wherein the 80% test has no

separate meaning by itself and is redundant. If Congress had meant and intended both tests to be tests of control, what does 80% add that 50% doesn't already have? You can control a corporation with both of those items. Congress must have meant more than this.

QUESTION: With either you can control.

MR. JENSEN: With either you can control, yes, that's correct. Congress must have meant the 80% test to mean more than this, and it does mean more than this if it is given a financial interest function. Again, a financial interest test is necessary because of the conduct the statute is meant to be reached, and that's --

QUESTION: Are you saying that if one person does not own 80% or more in each corporation, you never get to the B part of the statute?

MR. JENSEN: Not necessarily just one person, but if any -- you have to have commonality among the five. To count one person's stock in a corporation, he has to own stock in both corporations.

QUESTION: But if it's less than 80% in either one of the corporations, you never get to B.

MR. JENSEN: That is correct. And that is how, in our particular case with the 77% and 23%, you cannot count, we say, the 23% because Mr. Crain does not own any stock in the second corporation. Therefore, he only has 77% in the

first corporation; no brother-sister group.

QUESTION: Even though there is 87% in Popcorn.

MR. JENSEN: Even though there is 87% in Popcorn.

QUESTION: Would your answer be the same if it was 100% in Popcorn?

MR. JENSEN: My answer would be the same if it was 100% in Popcorn.

QUESTION: But you must concede that Congress said that this rule they are imposing wouldn't be triggered until the 80% requirement is satisfied.

MR. JENSEN: That's right, you have to meet the 80% test first and then go to the 50% test. You have to meet both.

QUESTION: So it does add something to the 50%.

MR. JENSEN: The 80% test?

QUESTION: Yes.

MR. JENSEN: They are both tests of overlapping interests, but they are separate tests in that the --

QUESTION: Well, you don't necessarily satisfy the 80% requirement just because you satisfied the 50% requirement.

MR. JENSEN: Well, that is correct. You can fail one test or the other; it doesn't necessarily mean --

QUESTION: All right, I misunderstood you.

QUESTION: Mr. Jensen, suppose he had 80% in both.

MR. JENSEN: Mr. Vogel?

QUESTION: Yes, sir. Then what? Would that be any different?

MR. JENSEN: If he had 80% in both, then he would meet both tests. Even under our position, he would meet both tests.

QUESTION: I have a little trouble with that.

MR. JENSEN: Well, this is the arbitrary line that Congress has picked in their own wisdom, and if 80% is 80% in the test, then 80% meets the rule. That just follows. But 79% is not 80%.

QUESTION: Well then, I gather, Mr. Jensen, that if he had 80% or 85% in Fertilizer and only 77% in Popcorn, the fact that the other chap had 22% in Popcorn wouldn't satisfy the test.

MR. JENSEN: That's correct.

QUESTION: Because he would have also to have some stock in Fertilizer before --

QUESTION: That's right, before his stock could be counted at all.

Now, if I might present an example, I think that this will bring the unreasonableness of the government's 80% test in view. Let's suppose that one of you owns 70% of corporation number one, in which I own 30%. Tax time rolls around. Of course, the Tax Court, as you probably already

well know, says that there is a surprise visited upon me, and perhaps upon you, in that the surtax exemption is lost or is at least shared if you, all of a sudden, I all of a sudden find out, that you own not just one other corporation as the Tax Court says, but four other corporations. And let's assume that in those four other corporations you own 70% of each one, including the one I am in, the fifth one, and there is a different 30% shareholder in each corporation.

So we have 70% going across, if I can draw a schematic here, and 30% going down, with each different shareholder. Now, not only is the corporation in which you and I own stock -- not only does that corporation lose its surtax exemption or at least shares its surtax exemption under the regulation, but also those other corporations lose their surtax exemption.

Now which one, which corporate group, which brother-sister controlled group are we in? What we have is five corporations with six shareholders, and the statute says you can only count five shareholders. Are we in the brother-sister controlled group comprising corporations one through four, leaving the fifth one out? Are we in corporations one through three, leaving four and five in a separate group? Are we not in a brother-sister controlled group at all, but two through five, corporations two through five are in a separate brother-sister controlled group?

This type of arbitrary determination I believe illustrates the unreasonableness of the regulation. Now, the regulation does have, in a separate part, a provision dealing with overlapping interest like this, but it simply provides that the corporations are to get together and somehow allocate among themselves the exemption at the time they file their tax return, or suffer the allocation subsequently made by the Commissioner at tax audit time.

But how can the parties make this allocation if, prior to audit, they don't even know who is in the group? And what policy reason is served by treating identically-owned corporations; that is, 70-30 corporations, in each one in a different manner?

Thus, I submit that the regulation's 80% test draws a totally artificial line, and creates an unreasonable design not intended by Congress, by arbitrarily excluding a corporation with a pattern of ownership that is identical to every other corporation.

Again, from a policy standpoint, either all of the corporations owned 70-30 should be in the group or none should be, and we, of course, submit that none should be. There is no indication anywhere that Congress ever intended to lay such a trap for the expanded group of unknowing minority shareholders.

Now, if I might turn for a second to the proper

test that the government has allocated or said that should be applied to this particular example, this particular reg. Your Honors, the regulation in question is, without a dispute, without any dispute whatsoever, an example of an interpretive regulation rather than a legislative regulation. That is, I define a legislative regulation as one written in direct response to a specific delegation of authority by Congress. That's the difference between this case and the Portland Cement case, for example.

This regulation, on the other hand, is written under the general auspices of Section 7805. Now, I well understand the general reluctance and the general wisdom of this Court to not overturn contemporaneous constructions of a statute by those charged with its administration, and who -- and those people who are presumably well aware of congressional intent.

I believe that the test should be in such a case, though, whether that regulation implements the congressional mandate in some reasonable manner.

As recognized by the Court of Claims in this case and supported by this Court's recent decision last summer in Rowan Companies, the rule of deference, however, is not appropriate in this case when the Treasury is interpreting a definition specifically set forth in a statute, such as we have here.

Because we can't in this case measure the Commissioner's definition word for word against a statutory definition of the term brother-sister controlled group, the proper test that we ultimately get to to determine whether the congressional mandate has been fulfilled is to look to see whether the regulation in question harmonizes with the plain language of the statute, its origin and its purpose. We submit that it fails on all three counts.

The regulation, going to the plain language of the statute first, the regulation, of course, clearly adds four very important words to its otherwise word-for-word recitation of what the statute says, and those words are singly or in combination.

Thus, I'd submit that on its face, the regulation adds to the statute words that Congress did not write. Without a doubt then, this regulation can hardly be said to harmonize with the statutory defintion as required by the Rowan case.

The government, of course, has advanced the theory that its regulation, inspite of this lack of harmony, correctly interprets the statute under some type of a natural reading theory. While this type of analysis may have initially its appeal, the problem with such a natural reading, as you have alluded to, is that it ignores the well-established and commonly-used guidelines of English

grammar and usage in interpreting the statute.

Of course, Congress could have emphasized that the 80% test required common ownership by reiterating the phrase "each such person in the 80% test as well as in the 50%", but it really didn't mean to do that. First of all, it was not abandoning the principle of common ownership as found in the 1964 statute. Second of all, it was not ignoring the English language in the structure of the statute.

These two factors we believe effectively cause such phrase to be part of the 80% test without the need for Congress to reiterate the phrase in the statute.

Now, this particular interpretation, I want to emphasize, does not import the entire identical interest clause into the 80% test. It merely illustrates the use by statutory analysis of what persons should be in the 80%. And once you have that group determined, these two tests then work separately to fulfill their purposes as Congress intended.

QUESTION: Mr. Jensen, just as a matter of curiosity, were you or your office counsel for these corporations at the time the 1973 and 74 returns were filed?

MR. JENSEN: We were counsel, but we did not prepare the returns in question. That was done by the --

QUESTION: It was only after the Fairfax case was decided in the Tax Court that a different direction was

taken by the taxpayer.

MR. JENSEN: That is correct, Your Honor.

QUESTION: Do you think that fact indicates a bow in the direction of the reasonableness of the regulation?

MR. JENSEN: No, Your Honor. I believe that it shows effective tax planning on behalf of the taxpayer. When you have a regulation out there with no authority to the contrary, I think you are well advised to follow the regulation in most cases. But as soon as you have some authority to the contrary, it is more than proper to take a position that the regulation is not a correct implication of Congress's intent.

QUESTION: Well, somebody has to blow the whistle. Why didn't you?

MR. JENSEN: Well, just from knowing the people who prepared the tax returns, I would suggest to the Court -- although this is not a matter of the facts -- that they are conservative tax planners, and they would follow the regulation unless there was authority to do otherwise.

QUESTION: Accountants frequently would rather get refunds than have their clients slapped with a deficiency notice, wouldn't they?

MR. JENSEN: Definitely, that is correct.

QUESTION: Yes, but there is nothing to that effect in this record.

MR. JENSEN: No, I agree with that, Your Honor. And we are also not talking about a large amount of taxes.

QUESTION: You spoke of some authority. You don't have all authority, though, do you?

MR. JENSEN: No, I would agree with that.

QUESTION: You have the Tax Court and a majority of a three-judge panel of the Court of Claims.

MR. JENSEN: And we also have the Fifth Circuit.

QUESTION: Judge Smith went the other way in your case.

MR. JENSEN: That's correct.

QUESTION: Mr. Jensen, is the Tax Court's interpretation of the statute the same as the Court of Claims' interpretation?

MR. JENSEN: I believe the Court of Claims expanded somewhat on the Fairfax decision, the original Fairfax decision, but as a whole, they follow along the same line.

QUESTION: Do you think they would decide all the same cases in the same way?

MR. JENSEN: Yes.

QUESTION: How about the reliance on "each such person" in B? Did Fairfax rely on that as the Court of Claims did?

MR. JENSEN: Yes, that's where that analysis first

came to rise, is in the Fairfax case. They first decided that particular way.

Your Honors, it is felt that the Court of Claims was correct in finding that by addition of the phrase "singly or in combination" to the statutory language, otherwise identically traced by the regulation, the government has expanded the scope --

QUESTION: Mr. Jensen, let me interrupt you again. I have not looked at Fairfax. Was that a single judge ruling or was it reviewed by the Court?

MR. JENSEN: It was ultimately reviewed by the Court.

QUESTION: And was there a division in the Tax Court?

MR. JENSEN: There was a division of the Tax Court from time to time.

QUESTION: Do you remember what the extent of that division was?

MR. JENSEN: I can tell you --

QUESTION: Never mind if you don't. I can look it up.

MR. JENSEN: Your Honor, I believe the first decision was a different division than a later decision by the Tax Court in below or in one of the other Tax Court cases. I think it was -- we, of course, were always in the

majority with the Tax Court, but there was always a split between the judges.

If I remember right, in Fairfax I think there were three in the first dissent.

Are there anymore questions? Thank you.

CHIEF JUSTICE BURGER: Do you have anything further, Mr. Smith?

ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF PETITIONER -- REBUTTAL

MR. SMITH: A few points. To answer Mr. Justice Blackmun's question, there was quite a sharp dissent in Fairfax by Judge Simpson joined by Judges Raum, Tannenwald and Wilbur.

QUESTION: How many members of the Tax Court are there?

MR. SMITH: Well, there are 16 when the Court is at full strength. I'm not sure whether 16 judges were on this particular case.

And, of course, that decision was reversed by the Fourth Circuit, as was the Tax Court reversed by the Eighth and the Second Circuit, too.

I simply want to re-emphasize to the Court that we think that based on the Court of Claims' concession here that the Commissioner's regulation was not an unreasonable interpretation of the statute -- and I think I have

demonstrated to the Court that the plain language of the statute supports the Commissioner's interpretation -- that we think under the decisions of this Court, that the regulation should be approved as a valid interpretation of the statute.

QUESTION: Do you think you ought to win without the regulation?

MR. SMITH: I think we ought to win without the regulation because I think the plain language of the statute supports us, and I think the legislative history supports us. And I simply want to say in closing that at the time -- and this really goes to the point that Justice O'Connor and I were exploring -- at the time that Congress amended the statute in 1969 to expand the shareholder group from one to five, it did in our view make the 50% test accomlish the common control purpose of the statute and leave the 80% test simply to represent -- to carry the closely-held character of the corporations.

And at the time that Congress was expanding this group from one to five, the House Ways and Means Committee ratified the Treasury's statement that it intended to adopt the same test here that it did in Section 1551, which has a comparable mathematical test, although there is also a factual inquiry that has to be made in that statute as to whether the corporation was formed to receive the transfer.

And at the time, in 1969, there was on the books for at least two years a Treasury regulation under Section 1551; precisely, 1551-1G, Example 4, which we cite in our brief, which sets forth an example which demonstrates that under Section 1551, that not every member of the five or fewer persons has to own stock in each corporation for the 80% test to apply.

And presumably, the same Treasury that was recommending the expansion of the test knew what the regulation said, and basically so did the tax-writing committees of Congress. And it seems to us with this legislative history and with the peculiar result that would be reached under the respondent's interpretation where a single share of stock would cause a different result, based on the plain language we think the Court of Claims was wrong.

QUESTION: Mr. Smith, wouldn't you agree that at the time that the Treasury Department was talking to the Congress, when this act was passed, that their explanation was far from clear and didn't set forth the position that was subsequently adopted in the Treasury regulation?

MR. SMITH: I think I would agree that I would prefer -- my case would be stronger -- if the Treasury studies adopted -- had the same language as the regulation. But the regulation came not far down the road as a contemporaneous construction of the statute, and given the

history, Justice O'Connor, of the similarity that Congress was attempting to use in this statute as in Section 1551, I think it's fair to conclude that what Congress intended to do was to adopt the same test that existed in the 1551 regulation.

QUESTION: Well, I do have concerns about that. It looks somewhat as though the Treasury Department had second thoughts after the Act was passed and then adopted the regulation, and that it didn't have the same thoughts when it was talking to the Congress.

MR. SMITH: I don't think that it's fair to conclude that on this record. There is really nothing to indicate that the regulation was an afterthought. Many regulations, as common practice, follow the enactment of the statute by some time after studies and, you know, they're proposed and then circulated for comment and then come out in final form.

I will say that on pages 27 and 28 we set forth a portion of the Treasury proposals, and they talk about, to a large extent, a group of corporations in which five or fewer persons own, to a large extent, in identical portions at least 80% of the stock of each of the corporations. And it goes on then to describe the 50% test in terms of the stock of a particular person.

So I think one could derive, as indeed some of the

decisions have which we have held for the regulation, the fact that the Treasury studies are not inconsistent with the regulation that ultimately came out, pursuant to the Commissioner's authority to prescribe all need for rules.

Thank you.

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

(Whereupon, at 2:00 o'clock p.m. the oral argument in the above-entitled matter ceased.)

CERTIFICATION

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UNITED STATES v. VOGEL FERTLIZER COMPANY No. 80-1251

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BY Suzanne Young