ORIGINAL

OFFICIAL TRANSCRIPT
PROCEEDINGS BEFORE

SUPREME COURT OF THE UNITED STATES

DKT/CASE NO. 81-485 & 81-903

TITLE HILLSBORO NATIONAL BANK, Petitioner v. COMMISSIONER OF INTERNAL REVENUE; and UNITED STATES, Petitioner v. BLISS DAIRY, INC.

PLACE Washington, D. C.

DATE November 1, 1982

PAGES 1 thru 54

ALDERSON REPORTING

(202) 628-9300
440 FIRST STREET, N.W.
WASHINGTON, D.C. 20001

IN THE SUPREME COURT OF THE UNITED STATES

HILLSBORO NATIONAL BANK,
Petitioner
v. No. 81-485
COMMISSIONER OF INTERNAL REVENUE; and
UNITED STATES,
Petitioner
v. No. 81-930
BLISS DAIRY, INC.

Washington, D.C.

Monday, November 1, 1982

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:40 a.m.

APPEARANCES:

HARVEY B. STEPHENS, ESQ., Springfield, Illinois; on behalf of Petitioner Hillsboro National Bank.

JAMES SILHASEK, ESQ., Phoenix, Arizona; on behalf of Respondent Bliss Dairy, Inc.

REX E. LEE, ESQ., Solicitor General of the United States, Washington, D.C.; on behalf of the Commissioner of Internal Revenue and the United States.

- - -

C O N T E N T S

ORAL ARGUMENT OF	PAGE
HARVEY B. STEPHENS, ESQ., on behalf of Petitioner Hillsboro National Bank	3
JAMES SILHASEK, ESQ., on behalf of Respondent Bliss Dairy, Inc.	10
REX E. LEE, ESQ. on behalf of the Commissioner of Internal Revenue and the United States	23
HARVEY B. STEPHENS, ESQ., on behalf of Petitioner Hillsboro National Bank - rebuttal	50

P R O C E E D I N G S

CHIEF JUSTICE BURGER: We will hear arguments next in Hillsboro National Bank against the Commissioner of Internal Revenue and the consolidated case.

ORAL ARGUMENT OF HARVEY B. STEPHENS, ESQ.,

ON BEHALF OF PETITIONER

HILLSBORO NATIONAL BANK

Mr. Chief Justice, may it please the Court:

The question presented in the Hillsboro National Bank case is simply, should payments made to some of the bank's shareholders by a third party be included in the bank's income.

The facts underlying this case are these. In July of 1971 the Hillsboro National Bank paid the personal property tax for all of its shareholders, all 149. This was its custom for a number of years. The amount of the tax that was paid was $30,000, approximately. It was paid out of the general funds of the bank.

In the subsequent year, in its 1972 income tax return, it took a deduction for the amount of the tax that it had paid. This deduction was in accordance with the provisions of 164(e) of the Internal Revenue Code. At the time it paid the tax it did not protest the payment of these taxes, as was provided under the

Illinois statute, nor at any time thereafter did it ever contest the validity of the personal property tax.

Prior to the time of the payment of the tax, the people of the State of Illinois had adopted a constitutional amendment that stated that individuals should not pay ad valorem taxes on personal property owned by them. This constitutional amendment was held unconstitutional by the Illinois Supreme Court in July of 1971. Consequently, in 1971 personal property taxes were levied against individual and corporate taxpayers. Hillsboro National Bank and all the other citizens of Illinois paid a personal property tax.

This Court in 1973 reversed the Illinois Supreme Court in the case of Lehnhausen versus Lake Shore Auto Parts. Now the question was presented to all the county treasurers throughout the state: What do they do with the money that was paid in 1972 for the 1971 taxes?

The Illinois General Assembly had attempted to solve the problem by passing a piece of special legislation which specifically referred to the pending case in this Court, directed the county treasurers to hold the money in escrow, and following the decision in this Court to either dispense the money to the taxing bodies or to refund that money if the tax was declared

invalid.

This special act was enacted after the Hillsboro National Bank paid the tax. It was not on the books and did not exist at the time they paid the tax.

Some time during 1973 the Hillsboro National Bank -- excuse me -- the Montgomery County treasurer decided that 132 of the 149 shareholders of the bank were individuals and issued refund checks of the amount of personal property tax directly to the shareholders. They did not consult with the bank. They did not even advise the bank that they were making the refunds or to whom or how they were made.

This brings us to the issue before this Court. Very simply, should these refunds to the 132 shareholders made by the county treasurer, totaling approximately $26,000, be included in the 1973 income of the Hillsboro National Bank.

QUESTION: What about the corporate shareholders?

MR. STEPHENS: No, the money was delivered to the taxing bodies because the corporate shareholders were held to be liable for the tax. So as far as corporate shareholders, trusts, executors, they made up the other 17 shareholders in this case.

We are faced then with an application of the

tax benefit rule. The tax benefit rule is a judicially created doctrine having its basis in equity and the annual accounting principle. Prior to this case, a case before it in the Seventh Circuit called First Trust, and a case in the Sixth Circuit of Tennessee-Carolina, all of the cases involving the tax benefit rule had three elements to them:

First of all, a deduction; secondly, a deduction which results in a tax benefit to the taxpayers; and thirdly, in a subsequent year there is an economic recovery which we believe has the effect for tax purposes of increasing the net worth.

The Commissioner now argues in this Court, though, that this third requirement, that is of an economic recovery, should be ignored and we should substitute a new element, a rather ambiguously stated argument, and I quote from his brief: "The premise upon which the deduction was taken is no longer valid."

In order to get to that result, he relies on three earlier opinions of the Board of Tax Appeals. Each one of these cases, there is an economic recovery. The first case, South Dakota Concrete, involves an embezzlement loss and a deduction for it in year one, the recovery of the embezzlement in a subsequent year.

The second case, Block, involves a deduction

on an income tax return for estate taxes that were paid, federal estate taxes. The federal estate taxes were subsequently refunded. There was an economic recovery.

The third case is Barnett. It involves the situation where a person leased out some mineral property, they took a depletion allowance against the advance royalties. For tax purposes it was considered that the property had been expended. The property was returned to him, the lease cancelled. When the minerals were given back to him, they also received back the depletion allowance.

Each case, there is an economic recovery. In this case, in the Tax Court and in the Court of Appeals they relied on the notion that the taxpayer-shareholders, through some sort of constructive dividend theory, it should be attributed to the taxpayer. However, in the briefs in this case the Commissioner now takes the position and urges that even if no one had received a recovery, no one, the Court's decision in Lehnhausen by itself required the inclusion of the tax payments in the bank's income.

That means quite simply that if the county treasurer did not establish the escrow, but instead immediately distributed all the funds to the taxing bodies and had not established the escrow, so that there

was no money to be refunded and no money was refunded, the Commissioner now argues in this Court that because the premise, agreeably and concededly valid, on which the deduction was taken in 1972 has become invalid by subsequent action, that you must restore that income.

This is contrary, I urge, to the longstanding history of the tax benefit rule.

QUESTION: Could I ask you, why was the deduction allowed in the first place, paying a tax on behalf of someone else?

MR. STEPHENS: It is specifically provided for under Section 164(e).

QUESTION: It's a statutory --

MR. STEPHENS: It's a statutory provision that allows corporations to pay taxes for its shareholders.

QUESTION: And the shareholders need not treat that as a dividend?

MR. STEPHENS: The shareholders are precluded from treating that as income and also precluded from taking a deduction for the tax.

It was passed out of the longstanding history going back -- remember, national banks can only be taxed in certain ways. Consequently, one of the ways that was developed early on was the idea of taxing the capital stock, and therefore the Internal Revenue Code

eventually, after some cases to the contrary, was -- the provision of 164 --

QUESTION: How did the shareholders treat this return of the tax to them?

MR. STEPHENS: It was treated as income to them. That is not specifically in the record. It was on a stipulation of facts. But that's how it was treated.

QUESTION: So the taxpayers paid the tax on it.

MR. STEPHENS: They paid tax when it was received, yes, sir.

QUESTION: Mr. Stephens, suppose the Commissioner is right in your case. Does it make any difference to the bank whether it is thrown into fiscal '72 or fiscal '73?

MR. STEPHENS: In order for the tax benefit rule to apply, you would have to look at the two different years. I would argue, Your Honor, though, it makes no difference if it's '72 or '73, because the bank paid out the money on the basis of a valid premise, they have received nothing bank for it, their books have not been adjusted. And so I would say that if this Court had ruled in December of '72, before the corporate tax return for that year was paid, that they would be

entitled to the deduction, because there had been no recovery. They had paid the money out.

I would like at this time to reserve the remainder of my time for rebuttal.

CHIEF JUSTICE BURGER: Very well.

Mr. Silhasek.

ORAL ARGUMENT OF JAMES SILHASEK, ESQ.,

ON BEHALF OF RESPONDENT BLISS DAIRY, INC.

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

As Mr. Stephens has set forth, the tax benefit rule requires that an item properly offset against gross income in determining the true liability for a particular year is includable in the gross income when it is recovered in a subsequent year. In effect, there are the three elements, that is: an item that was previously deducted, that resulted in a tax benefit, and it was subsequently recovered in a later year.

The Government has sought to resurrect the early applications of the tax benefit rule, which held that an end of need constituted a recovery. That rule was laid to rest by this Court in the Nash decision. As such, an actual recovery is required for the application of the tax benefit rule.

In the case involving Bliss Dairy, there was

an amount that was previously deducted by the corporation that resulted in a tax benefit. That amount was not, however, recovered during the taxable year in issue as a result of the liquidation of the corporation or, for that fact, ever recovered by the corporation.

The attempt to apply the tax benefit rule to a liquidation under Sections 333 and 336 of the Internal Revenue Code is not only prevented by the concise words of the statute --

QUESTION: Who got the benefit when the corporation was liquidated?

MR. SILHASEK: No one received the benefit, Your Honor.

QUESTION: Had this second event not occurred, would the stockholders have received more or less?

MR. SILHASEK: It really, in this situation, as I'll explain it, it really doesn't make that much difference, because the stockholders, when they received the assets, fair market value, the fact that it was depreciated or expensed made no difference to them.

QUESTION: Let me put the question another way. Would the treatment of the stockholders have been different?

MR. SILHASEK: No, it would not have. It would not have been an expense, because their basis in

the assets that they received, for which they can deduct, is determined by their basis in the stock they had in the corporation. It makes no difference as to the fair market value of the asset or if it was expensed by the corporation.

Again, it's not only --

QUESTION: Mr. Silhasek, I'd like to ask you, if I may, what weight we should give to the failure of the 94th Congress to enact a change to Section 1245 to apply it to recapture of Section 162 expenses?

MR. SILHASEK: They have had that opportunity, and again, they have avoided it. And just as recently as last Thursday, the Chairman of the Senate Finance Committee said he was going to propose more legislation. But they have had that opportunity on several occasions and have not passed any legislation that would have affected the outcome of this case.

QUESTION: Should we give any weight to that, one way or another?

MR. SILHASEK: I believe so, because in looking at the entire view of this transaction there really is not an avoidance, a tax avoidance, or a benefit that was recovered or recaptured by either party.

In this particular case, the corporation made

purchases of cattle feed during its fiscal year ending June 30, 1973. The corporation, in accordance with the cash method of accounting, properly deducted the amount expended for the cattle feed as a business expense on the tax return filed for that fiscal year.

During the next fiscal year, the corporation adopted a plan of liquidation pursuant to the provisions of Sections 333 and 336.

QUESTION: Right away, at the beginning of the next fiscal year?

MR. SILHASEK: Yes, Your Honor. Under 333, when you adopt a plan, it has to adopt a plan of liquidation and totally distribute its assets within a 30-day period.

QUESTION: Well, they did it right at the beginning of the taxable year.

MR. SILHASEK: Yes, Your Honor, they did, although they purchased the feed -- that was expensed throughout the taxable year. It was not a purchase made immediately before liquidation or anything of that nature.

As a result of the plan, the corporation distributed all of its assets to its shareholders in redemption of all the stock issued and outstanding by the corporation and went out of business. Simply

stated, the corporation received no consideration upon distribution of its assets to its shareholders upon liquidation. The corporation only received its stock in return for the distributed property, the value of which upon the cessation of business and distribution of the assets was nil.

There is no reason why the tax benefit rule should override the specific language of the statute. Section 336 of the Internal Revenue Code in effect during the year in question specifically states that there is no gain or loss recognized to a corporation on distribution of property in partial or complete liquidation. There are certain statutory excepts to the statute, but none of them are applicable in this case.

The language and intent of the Congress is clear with respect to this statute. Congress has had, as we mentioned, the opportunity to amend this statute as recent as the enactment of the Tax Equity and Fiscal Responsibility Act of 1982.

QUESTION: Is there any doubt that what the Internal Revenue Service has construed the statute contrary to your submission?

MR. SILHASEK: Any doubt in my mind?

QUESTION: That they have been construing it contrary to your submission?

MR. SILHASEK: Not -- this is the first time that this case has ever come up in this situation, outside of Tennessee-Carolina, Your Honor. They have never attempted to apply the tax benefit rule in a 333 liquidation where there's been a distribution of assets to the shareholders that were subsequently expensed.

QUESTION: Well then, this subsequent Congressional history is irrelevant, too, then.

MR. SILHASEK: They have attempted to apply this in other types of liquidations, but they have had this problem --

QUESTION: So this is consistent. This position is consistent with their position in other contexts.

MR. SILHASEK: There are other cases. They have not reached the Court, Your Honor, but as the Government said in their brief, there are many cases depending upon the outcome of this case. So apparently they have applied it in many cases that are not of public record at this time.

QUESTION: And you must convince us, to win, that the statute just won't yield to this kind of construction, that it's just not within the realm of statutory construction to apply it the way the Service --

MR. SILHASEK: That is correct, Your Honor.

QUESTION: And I take it you think your case is different from the one that was just argued?

MR. SILHASEK: Hillsboro?

QUESTION: Yes.

MR. SILHASEK: As far as -- it's totally different factually, but as far as the application of the tax benefit rule it's the same, because there was no recovery in this situation. There was a deduction, there was a tax benefit, but the amount was never recovered.

QUESTION: But you're relying on this being a liquidation.

MR. SILHASEK: Specifically on the statute, yes, Your Honor.

QUESTION: Which is different from Hillsboro.

MR. SILHASEK: That's correct, Your Honor.

The Government has asserted that the non-application of the tax benefit rule in this situation would result in a double deduction. However, a complete view of the entire transaction clearly reflects that there was not a double deduction.

It is true that the feed was written off by the corporation, with the writeoff equaling the amount that the corporation paid for the feed. In the

subsequent year a portion of that feed was distributed to the shareholders in liquidation and the shareholders received a basis in that feed equal to the basis they had in the stock of the corporation.

QUESTION: So it's just as though the stockholders had bought the feed from them.

MR. SILHASEK: Similar to that, Your Honor.

QUESTION: If they'd have bought it -- suppose this corporation hadn't gone out of existence, but the corporation had sold some feed to one of the stockholders.

MR. SILHASEK: If they had sold it to one of the stockholders, in that situation there possibly would have been gain to the corporation.

QUESTION: Possibly, but there might not have been, either.

MR. SILHASEK: They would have had to pay a fair, a full -- the difference is, though, in purchasing that feed they would have paid the full market value for that feed.

QUESTION: But the stockholders could have deducted it.

MR. SILHASEK: They could have deducted it, but they would have paid substantially more, that is correct.

QUESTION: But they nevertheless have paid for the feed by turning in their stock, which was worth a certain basis.

MR. SILHASEK: That's correct. The basis that the shareholders received in the feed was not a stepped-up basis, that is stepped up to the fair market value, but was the basis as it relates to the basis they had in their stock. It is only by the fact that they acquired a basis in the feed that they were able to deduct the stock.

It is not a situation where the fair market value of an item is deducted once and then again the fair market value of the item is deducted. The second deduction emanates from the fact that the shareholders received a new basis in the asset.

QUESTION: Do we know what that basis is? There isn't anything in the record on it, is there?

MR. SILHASEK: No, Your Honor. It was not a stipulated fact.

QUESTION: I mean, it could have been, I suppose, either, at one extreme they could have had a $1,000 investment in their stock, or a zero investment, in which case there'd be no basis at all.

MR. SILHASEK: Your Honor, in the lower court we were only concerned with the effect of the statute,

the Government's position, to override Section 333 without taking into consideration the effect on the shareholders. In their brief for certiorari, they raised this point concerning the double deduction, I think it was only briefly mentioned, that in the early cases -- that there would be some inequity because of the possibility of a double deduction.

QUESTION: But am I correct that there's nothing in the record to tell us what the basis of the shareholders in the feed that they acquired after the liquidation?

MR. SILHASEK: That's correct, Your Honor.

QUESTION: It could be zero.

MR. SILHASEK: I'm sorry. There is no basis in their stock. It is in the record what their basis in the feed was, because as a result of the liquidation their basis is determined by Section 334(c), which has the basis in their stock subject to certain adjustments. That is, if they receive cash, if they recognize gain, or if they have to assume any liabilities of the corporation.

So it is in the record what their basis in the stock was.

QUESTION: Well, what was it?

MR. SILHASEK: Approximately $55,000, Your

Honor.

QUESTION: I see. That's the basis in the stock or the basis in the --

MR. SILHASEK: Excuse me. The basis in the feed that they received.

QUESTION: If that feed had been consumed entirely in the prior year, what difference would it have made to the stockholders on liquidation?

MR. SILHASEK: It would have meant -- probably made no difference, because upon liquidation their basis in the assets that they received is, they take the basis in their stock and distribute it over the assets that they received. So if they received one bail of hay or if they received a whole truckload, whatever their basis in the stock was is distributed over those assets.

QUESTION: Are you saying that the tax benefit rule shouldn't apply because there was no benefit?

MR. SILHASEK: No benefit to the corporation upon liquidation, that is correct, Your Honor.

QUESTION: How about benefit to the tax -- to the stockholders?

MR. SILHASEK: I see no benefit to them either, because they would have written off -- when they received that feed, what they wrote off was the basis they had in the stock. It's similar to a reverse of

incorporation, where stockholders form a corporation. They may put in assets that have a very low basis and receive stock having a fair market value equal to the fair market value of the assets that they use for incorporation.

They recognize no gain at that time, even though they have received something substantially increased in value, and that's because of the statute involved. If they were to sell their stock, however, the basis in their stock is the same as the basis they had in their assets. Therefore, they would recognize gain based on the difference between the fair market value of the stock and the basis they had in the assets.

As a part of the complete view of the transaction, we should examine the statutory pattern of a liquidation under Section 333. Again, the purpose of that statute was to allow people to disinvolve themselves with the corporate entity. They had formed a corporation; to allow them to get out of a corporation by distribution of assets.

It must also be noted that there is a possibility that they would not have received cash sufficient to pay tax on any gain. So what the statute provides is that upon liquidation, under this type of

liquidation, they get the assets out even if they had appreciated substantially in value, but the basis remains the same as the basis they had in the stock. So if there's a subsequent sale, it is that time that the gain is recognized upon the sale of those assets received by the shareholders.

In our instance, these assets were of the type that the shareholder could expense them rather than having to sell them as if they were an asset that was not subject to expensing, because of the type of business they were engaged in.

Reliance by the Government on cases involving liquidations under Sections 331 and 337 is misplaced because those cases do not in fact involve the application of the tax benefit rule to the liquidating distribution. They provide for the application of the tax benefit rule to sales made by the corporation prior to liquidation.

Under Section 337 there is no gain or loss on sales or exchanges of corporate property that accrue within a 12-month period following the adoption of a plan for liquidation, but prior to the actual liquidating distribution.

The courts have allowed the application of this tax benefit rule or tax benefit principles even

though it is contrary to the specific language. Basically, I feel they have allowed it because of two things: One, there was an actual recovery in those instances; Two, they have looked to the purpose of that statutory language and held that the purpose of that language was really to prevent the results that occurred under the Court Holding case, rather than to override any type of application of the tax benefit rule.

The cases of South Lake Farms and Tennessee-Carolina involved liquidations wherein there was a distribution rather than a sale of assets. While those cases involved similar factual situations, the courts obviously reached a different result.

CHIEF JUSTICE BURGER: Your time has expired now, Mr. Silhasek.

Mr. Solicitor General.

ORAL ARGUMENT OF REX E. LEE, ESQ.

ON BEHALF OF THE COMMISSIONER OF INTERNAL REVENUE AND THE UNITED STATES

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

No one in these cases is contesting the tax benefit rule as a general principle necessary to our federal income tax system, based as it is upon annual accounting. The only issue is what type of event serves

to trigger the rule.

The answer to that question, we submit, is supplied by an examination of the purpose of the rule. The triggering event ought to be key to the reason why we have a tax benefit rule. Simply put, the tax benefit rule requires a taxpayer to include in Hillsboro the amount of deduction taken for costs and expenditures that are ultimately not incurred.

In a tax system based on --

QUESTION: Would that apply, Mr. Solicitor General, if let us say a tax had been paid and that had been deducted, and then later there was a recovery, a refund on that tax paid. Then that refund becomes income

MR. LEE: In a later year, in a later year.

QUESTION: A subsequent year.

MR. LEE: And offsets what happened during the earlier year.

QUESTION: That's the element --

MR. LEE: Precisely. And it is not that it is income because of the recovery. It is rather that it disproves the earlier event, it shows that the earlier deiuction that was taken by the taxpayer.

QUESTION: If that's the case, if it's not -- well, why doesn't the Government simply require the

person to make out an amended return for the later year?

MR. LEE: I asked exactly that same question.

QUESTION: Well, you probably know as little about tax law as I do.

(Laughter.)

MR. LEE: But I have the answer from those who know more than either of us, and the answer is that the Government cannot require an amended return. And the other answer is that in some instances --

QUESTION: General, wait. What do you mean by that? Doesn't the Government do this every day when it audits a person's return?

MR. LEE: Yes, but what it does is to require the correction at a later point in time.

And in addition, there are some instances where it is not in fact income. For example, assume in the Bliss Dairy case that what Bliss Dairy had done was to expend $150,000 for feed and then had simply given some of it to the president of the corporation or to his brother-in-law to use for their personal purposes, to feed their personal cattle. That would not have been income to anyone and yet it would have been shown at that point in time that it was an expense that was not in fact an expense of that corporation for cattle feed

purposes.

QUESTION: Well, Mr. Solicitor General, in both these cases why didn't the Government merely throw or limit the deduction that was taken in the original year? Does it make a difference to the Government which year?

MR. LEE: The reason is, and this goes, Justice Blackmun, right to the heart of the tax benefit rule, the problem is the annual accounting concept that was declared in 1931 by this Court in Sanford & Burnett against Brooks, the notion that we do not assess tax on the basis of a transactional approach and wait until all of the assets of the transaction have been finally completed. Rather, at the end of each year we determine, what are the income, what have been the expenses, and then assess the tax within that year.

In some instances, however, it later develops that deductions that were taken because of later events we know were not in fact deductions to that taxpayer. If they occur within the same year, then both transactions are a wash. The later event simply nets out the former.

The problem arises when you have a circumstance where the later event occurs in a subsequent year, and that's where the tax benefit rule

--

QUESTION: Why is that a problem at all if the statute of limitations hasn't expired? What bothers me is a statement in your brief: "The proper remedy for taking account of such changed circumstances is not to amend or modify the original return, but rather to reflect the change in the return covering the later period."

Why is that so?

MR. LEE: Well, in some instances, as I indicated -- in some instances, I suppose that that would solve the problem. In other instances, there is not an income item that occurs in the later year.

QUESTION: It seems to me again that what you're saying is that precision in annual accounting for income tax purposes is a secondary consideration, not a primary one.

MR. LEE: Well, that is correct, and that what is the primary purpose is determining -- but because of the annual accounting concept, there are these later balancing entries or correcting entries that may from time to time be necessary.

Now, in the great majority of instances it is true that there will in fact be a recovery, and the later disproving event is in most instances accompanied

by a recovery. But that is purely fortuitous where it occurs, because the recovery itself is really irrelevant to the reason that we have a tax benefit rule.

The reason that we have the rule is in order to prevent the distortion that would otherwise result, Justice Blackmun, just as you have stated, from the application of the annual accounting principle.

QUESTION: I can understand that statement, but it seems to me that there's a lot less distortion if you put it in the original --

MR. LEE: In the earlier period.

QUESTION: -- taxable year.

MR. LEE: In the earlier period.

That is not the way that the tax benefit rule has developed. In fact, it achieves roughly the same result that would have occurred if the two events had fallen out in the same year. There are some differences.

QUESTION: It might not, depending on the taxpayer's particular situation.

MR. LEE: That is correct, that is correct. It is not always exactly the same.

QUESTION: I guess I'm a firm believer in accuracy rather than theory.

MR. LEE: And it would in fact -- Alice Phelan

Sullivan Corporation, for example, is one instance where there is a difference because of a different tax rate. But the way the rule has developed is that what we do is we come to an end, we bring an end to each tax accounting period and then it back into income in the later period.

But the crucial event -- or the crucial question here is --

QUESTION: Well, why shouldn't -- if you say you're going to bring it back into income, why shouldn't it be income if you're going to bring it into income?

MR. LEE: It is income, in the later period.

QUESTION: How did this, how did Hillsboro, get any income in this later period?

MR. LEE: Because --

QUESTION: I thought you said a moment ago the whole point of it was not to recover income, but to recover a deduction.

MR. LEE: To recover a deduction, but we do that --

QUESTION: And therefore you have to treat it as income in the later year?

MR. LEE: That's right.

QUESTION: Even though it isn't income?

MR. LEE: That is correct. We do that by

including in income in the later period the amount of the deduction that we now know was improperly taken in the earlier period.

QUESTION: Why don't you merely reduce the deduction in the original year?

MR. LEE: If it were feasible, the Government could require that we go back and reopen the period. Then it could be done in that way. In fact, that is not the way the tax benefit rule --

QUESTION: But don't they do that all the time?

MR. LEE: Well, they do, Justice Blackmun, in the sense of going back and requiring an audit. But this is not the same circumstance, according to tax procedure as I understand it, as regards this kind of situation, because all accounts are closed as of 12/31, or whenever the --

QUESTION: They're closed until they're audited.

MR. LEE: Well, that's right. But subject only to an audit. It's not that we are contending that there was anything improper that happened in 1972. As of the end of 1972, any event that occurred in 1972 as to Hillsboro was proper. It's only that in subsequent years, because of events that occurred in subsequent

years, we now know that the deduction was not proper.

Now, let's take the Hillsboro facts and I think it may help to clarify just a bit. I assume that no one would quarrel with the proposition that if all the events had occurred in 1972 the bank would not have been able to claim a deduction for state tax. The bank would have paid the money into the state treasury in '72 and the state would have paid it back to the shareholders. The dividend character of the three-cornered transaction is apparent and it is well established that dividend distributions are not deductible.

The fact that the two events occurred in separate years should not lead to a different result. In either case, we now know what we did not know in 1972, and that is that this is not something that the bank owes and it is not a deductible item.

QUESTION: It never was anything it owed.

MR. LEE: Well, but it is -- all right. We now know what we didn't know earlier, and that is that it is something that no one owes. It is simply not a deductible item, not something for whose payment the bank is entitled to a deduction.

QUESTION: The statutory permission for a deduction just wasn't satisfied.

MR. LEE: That is correct, that is correct.

QUESTION: Let me see if I can get something that's at least simple to me. In 1972 we'll say $100,000 was allowed as a writeoff for bad debts, uncollectable. Then through some circumstance someone, even if he has no longer a legal obligation to pay because of a statute of limitation, pays the debt in a subsequent taxable year.

That invokes the rule, does it not?

MR. LEE: That invokes the tax benefit rule.

QUESTION: How is that different from what we're dealing with here?

MR. LEE: It is not different at all, Mr. Chief Justice, not at all. Now, my friends to my left will tell you that it is different because it involves a recovery. And my comment is that a recovery is totally -- I cannot think of a more irrelevant criterion for the reason that we have the tax benefit rule than whether there has or has not in fact been a recovery.

Because what we're looking for is whether we now know in a later period, period two, three, four or 26, something that we didn't know in the earlier period which indicates that in fact, subject to Sections 164 and 461, the bank was not entitled to a deduction for that expenditure.

QUESTION: General, is it the Commissioner's position that in the hypothetical of the Chief Justice regarding the recovery of some money that had been written off as a bad debt, it would be treated under the tax benefit rule just as these matters have been treated that are now before the Court?

MR. LEE: That is correct, that is correct.

QUESTION: May I also ask, in view of your latest, if you agree with the hypothetical that your opponent suggested, that if instead of refunding the money to the shareholders the State of Illinois or the county just kept the money, even though not entitled to do so, that would still -- the tax benefit rule would still apply?

MR. LEE: That is correct. Now, there would be a claim, of course. But the fact is, the crucial criterion is, is there a later disproving event.

QUESTION: Now, what in the Dairy case, what is the difference in the facts at the time the deduction was taken and the facts as they later materialized?

MR. LEE: Let's turn to the Dairy case --

QUESTION: Mr. Solicitor General, before you go on, Judge Pell characterized the result of this transaction as double taxation. That is certainly different, if true, from the classical situation where a

bad debt is charged off one year and collected the following year.

Do you agree that the result for which you contend will be double taxation? The bank has to increase its taxes, the stockholders also have to pay a tax on what they received.

MR. LEE: Clearly, it's double taxation, just like dividends are always double taxation.

QUESTION: Sir?

MR. LEE: Just like dividends are always double taxation.

QUESTION: That's not true, not in the bank stock situation, not under 164. There's only one tax.

MR. LEE: It is double taxation only in this sense --

QUESTION: Well, that could be why this case is different from the established and rule that you rely on. It could be.

MR. LEE: Well, it is not double taxation in this sense. The bank in 1972 took a deduction for an expenditure it was ultimately determined no one owed. At the time -- the triggering event that determined that it was no owed was the return of the money to the shareholders.

The shareholders include that within their

taxable income and the bank, under the tax benefit rule, includes the amount of the earlier deduction within its taxable income. So that it's only double taxation in the sense that there is a tax on the shareholders and there is also a tax on the bank.

But that would also be true in the event that the bank simply declared a dividend on its earnings and profits.

Now, let me turn to Justice --

QUESTION: Mr. Lee, before you return to Bliss, if I may, you've argued, as I understand it, that if we reverse in Hillsboro we will be giving the corporation a deductible dividend.

MR. LEE: That is correct.

QUESTION: All right. Isn't that exactly what Section 164(e) always gives the corporation, a deductible dividend?

MR. LEE: Not really, because in that circumstance it is not permission to distribute funds from the corporation to the shareholders which they can then use for their purposes. But if you regard that as a deductible dividend, then that is one statutory exemption to the general rule, applicable only to that circumstance.

QUESTION: And also, if I understand you

correctly, if the refund checks in Hillsboro had been stolen before they got to the shareholders, your position would be the same, is that right?

MR. LEE: That is correct. That is correct.

QUESTION: Still a tax?

MR. LEE: That is correct, for the reason stated. We now know what we did not know earlier, that it was not a proper deduction, and the shareholders would then have a claim against whoever had stolen them. But the tax benefit rule still operates.

Now, let me return to Justice Stevens' question about Bliss Dairy. Bliss purchased approximately $150,000 worth of cattle feed and claimed a deduction for the full $150,000, on the assumption that the entire amount of feed would be consumed in its business.

In fact, it was not. The reason was, Bliss used only $94,000 worth of the feed in its business because it went out of business before it used all the feed. We now know what we did not know at the end of fiscal 1973, and that is that Bliss' feed expense, Bliss as a corporation, feed expense for 1973 was not $150,000, it was $94,000.

Now, I need to make two points. The first is, Mr. Silhasek is right when he says that there was an

allocation of the basis, the shareholders' basis in their stock, among the various assets. I know of no indication in this record as to how much of that basis went to the feed, though that I think is immaterial. The crucial point, the first aspect of my response, is that insofar as the feed itself is concerned there was a stepped-up basis and that is undeniable. Insofar as the feed is concerned, the corporation paid for it once and the corporation and the shareholders deducted it twice.

QUESTION: Yes, but Mr. Solicitor General, is it not true that if there were no basis in the stock -- say they got the stock at $1,000, some nominal amount, so that there would be not a stepped-up basis but a stepped-down basis -- your theory would be precisely the same?

MR. LEE: That is correct.

QUESTION: So really, this is totally irrelevant. Your whole point is that they were expensed items that were not used up before they went out of business.

MR. LEE: That's exactly right.

QUESTION: So inventory always has to be charged back.

MR. LEE: That is correct, and that's my second point. But I want to make the point that in the

usual instance there will in fact be a double benefit because of the fact that you do get a stepped up basis in the feed.

QUESTION: Well, how do we know that? How do we know that more often the stock has gone up rather than down in value?

MR. LEE: We don't know in this particular case.

QUESTION: Well, I mean in any case, in the generality of the universe.

MR. LEE: Well, if there is a fair market value of the feed at the time of distribution there will be some allocation that will be made to the expensed items. But simple because -- you allocate the basis, and if the stock is zero then you're right, there is none.

QUESTION: Well, supposing there's $55,000 worth of feed and that's the only corporate asset and that's the exact amount they paid for the stock.

MR. LEE: Then they would --

QUESTION: Then they'd be paying $55,000 for it just as though they bought it.

MR. LEE: That is correct, that is correct.

But in any event, the crucial point is that we now know what we did not know before, and that is that

the corporation did not use this as an expensed deduction in the amount of $155,000, but the feed expense was in fact only $94,000.

Now I come to the common argument that both of the taxpayers have against the application of the tax benefit rule, and it is that the tax benefit rule should be key to recovery. Quite frankly, I can think of nothing that would be more irrelevant to the reason that we have a tax benefit rule than whether there has or has not been a recovery.

As the Seventh Circuit observed in the First Trust case, what is required is either a recovery or some other event that disproves the earlier assumption. Neither counsel in this case nor the Ninth Circuit nor anyone else has been able to suggest any possible bearing that recovery or nonrecovery has on the underlying objective of the tax benefit rule.

Bliss has a second argument and it's based on Section 336, and I want to turn to that now.

QUESTION: May I ask you a hypothetical question. Supposing a football team hires a player on a five-year contract, pays him a lump sump on the assumption he'll play for five years, and then at the end of one year he gets killed, he can't play it out. Do they lose the benefit?

MR. LEE: No, because I think what they have done is they have purchased his services for however long he lives.

QUESTION: On the assumption that he'll be playing for five years.

MR. LEE: Well, I would regard that -- I'm not sure how that would come out, but I would argue that that is a purchase of his services for as long as he lives, and that it would not --

QUESTION: They made the payment because they expected to use his services before -- say they go out of business and then he's still around, as with the case of the feed.

MR. LEE: Your question correctly shows --

QUESTION: In that case then there'd be a tax benefit recovery?

MR. LEE: Your question shows that you understand what we're saying. I would apply it differently in that kind of circumstance, but it would be arguably applicable to that kind of circumstance.

QUESTION: Why would you apply it differently?

MR. LEE: Well, because you could say that what they had purchased was not his services for five years, that it was his services for five years or

whenever he dies or becomes incapacitated, whichever comes first.

QUESTION: Well, say it's just two seasons, like the feed they expect to use up in 18 months or something like that.

MR. LEE: Well, except there may be slightly different assumptions in the case of feed and the case of football players.

QUESTION: Why? They're both expense items. They both, they expect to use it within a foreseeable period of time but beyond the end of the taxable year.

MR. LEE: That may well be. Certainly I would not be embarrassed to defend the Commissioner in this Court under --

QUESTION: Well, do you think, in Justice Stevens' example do you think that in any event could the football team deduct the entire payment in one year?

MR. LEE: Well, I'm just not sure.

QUESTION: They basically depreciate those contracts, don't they?

MR. LEE: I think they do. I think they do, in which case it may not be the best example for this circumstance.

But let me get to the 336 argument. Bliss'

argument is that once it decided to terminate its business it distributed all of its assets, including the unconsumed feed, to its shareholders in a liquidating transaction governed by Section 336 of the Code, which provides that no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation. And Bliss' argument is that this statute precludes the application of the tax benefit rule.

The fallacy in that argument is that the gain which Section 336 immunizes is a gain from the sale of appreciated assets and, for reasons that are spelled out more fully in our reply brief, particularly the reference to the First Bank of Stratford case in connection with the adoption of the companion provision to Section 336, Section 311, makes very clear that that's the kind of gain to which Section 336 applies. This is also borne out by, interestingly enough, a Ninth Circuit case, the West Seattle case.

The amount which the Commissioner seeks to include in Bliss' income does not result from the disposition of an appreciated asset. It was not a gain in the Section 336 meaning of that word. On the contrary, the income at issue in this case is the ordinary business income of Bliss' prior taxable period

that had gone untaxed as a result of the offset provided by Bliss' cattle feed deduction, a deduction that was based on anticipated expense that Bliss in fact never incurred.

QUESTION: General Lee, certainly the literal language of the statute would support the taxpayer argument in Bliss.

MR. LEE: That is correct.

QUESTION: And Congress has had an opportunity to correct it and hasn't done so.

MR. LEE: To the same extent, Justice O'Connor, the literal language also applies to the companion provision of Section 336, which is Section --

QUESTION: And there has been a judge-made exception to that.

MR. LEE: A rather consistent judge-made exception --

QUESTION: Yes, right.

MR. LEE: -- that is uniform, well accepted.

QUESTION: At the urging of the Service.

MR. LEE: Oh, that's right. We have been, I submit, Justice White, in answer to your question, consistent in this position.

QUESTION: This is an administrative interpretation.

MR. LEE: This is an administrative interpretation.

QUESTION: Validated by the Court.

MR. LEE: That is correct. But more than that, we also have two companion provisions, Sections 336 and 337. The sole purpose, as I think every tax lawyer acknowledges, for the adoption of Section 337 was to prevent inconsistencies that would otherwise come into transactions that are governed by Sections 336 and 337, that is those in which pursuant to a corporate liquidation the sale of assets is made either by the corporation or by the shareholders. It was to eliminate that inconsistency that Section 337 was adopted.

It is well settled that, notwithstanding the clear no-gain language of Section 337, the tax benefit law applies. If Bliss Dairy were to win this case, so that the tax benefit rule were not applicable to Section 336 provisions -- transactions -- but were applicable to Section 337 provisions, a close relative, indeed arguably the same kind of inconsistency that Congress sought to eliminate through its passage of Section 337, would creep back in under the guise of the inconsistent application of the tax benefit rule.

QUESTION: Mr. Lee, it seems that you're arguing for a rather broad rule here and it concerns me

a little bit, because normally somebody, for example, who takes property from a decedent gets a step up to fair market value. And if your theory were applicable then a decedent who had expensed an asset under Section 162 and then died, does that mean that it would have the effect of no stepped-up basis and there is going to be a tax consequence?

MR. LEE: I do not understand our position to be that this has anything to do with a stepped-up basis on estate taxes, estate tax cases. This is strictly in income tax matters. That is governed by statute and it's governed by a statute that does not have the limited interpretation of the word "gain" that Section 336 does by virtue of its --

QUESTION: But your theory, if broadly followed, would lead to some surprising consequences for decedents' estates or donors of property.

MR. LEE: If it were applied to donors' property or decedents' estates, which so far as I know the Commissioner has never urged.

QUESTION: Well, it's the foot in the door, I suppose. You'll be back.

MR. LEE: But let me tell you about --

QUESTION: General Lee, before you sit down -- I notice the white light has gone on -- somewhere would

you comment on Nash?

MR. LEE: Yes. There is nothing in Nash that is inconsistent with the position that we're taking. In Nash the Court rejected the Government's argument that when a partnership incorporates the amount of its reserve for bad debts should be included in income. In Nash there was no later inconsistent event, no disproof of the earlier assumption. The fact of incorporation proved nothing about the collectability or noncollectability of the existing accounts receivable in the portfolio of the partnership, and as a consequence it simply showed nothing about the earlier collectability.

And indeed, one of the concerns in Nash was the possibility of the double deduction, which was also the concern of the Tennessee-Carolina court in the Sixth Circuit, and there is at least the possibility of such in the Bliss Dairy kind of circumstance.

Now, finally, if recovery is essential we still are entitled to win.

QUESTION: Before you leave Nash, isn't it true that at the time they set up the reserve for bad debts they assumed the corporation would continue in business for such time as would be necessary to see who paid their bills and who didn't?

MR. LEE: Yes, but I think the assumption, Justice Stevens, is not the assumption that the corporation would continue; the assumption is about the collectability of the debts. And there is nothing about that assumption --

QUESTION: Well, but if you say that, the assumption here is about using the feed to feed the cattle, and presumably that's what they did with the feed.

MR. LEE: I simply take a different view as to what the relevant assumption is.

If recovery is required, there is recovery in both of these cases. This case is identical to Tennessee-Carolina. There is no basis for distinguishing the two, that is, Bliss Dairy. And in Tennessee-Carolina the Sixth Circuit did hold that there was a recovery.

And indeed, in circumstances that I think are indistinguishable, the First Trust case held that there was a recovery in the Hillsboro type of situation, and the Tax Court in Hillsboro itself held that there is a recovery.

QUESTION: What is the recovery?

MR. LEE: The recovery is a recovery to the shareholders, who in turn own the bank.

QUESTION: But in Bliss I gather under your submission the recovery is not limited to the extent that the shareholders get a basis?

MR. LEE: That is correct, that is correct. It is not.

QUESTION: You go beyond that.

MR. LEE: That is correct, and that was precisely the rationale in Tennesee-Carolina.

QUESTION: If it was so limited, Mr. Solicitor, would not that rather eliminate the double taxation problem?

MR. LEE: Well, that is not our preferred view of the case.

QUESTION: Mr. Solicitor General, the recovery, you say, to the shareholders, who in turn own the bank, but your rule would be exactly the same if they had all sold their stock and you had an entirely different group of owners, because it would then go to former shareholders.

MR. LEE: That is correct. That's why I say it is not --

QUESTION: There really isn't necessarily any recovery.

MR. LEE: Well, but what I'm saying is that you can find a recovery.

QUESTION: If you try hard enough.

MR. LEE: If you try hard enough.

(Laughter.)

MR. LEE: And the Tax Court did find a recovery in these kinds of cases. But tying the rule to recovery leads you to try very hard, as did the Tax Court and as did Tennesse-Carolina. Much better is to key it not to recovery, which is irrelevant to the purpose of the tax benefit rule, but rather, to the question of whether in fact the benefit was not taken.

And for this reason, we submit that the judgment of the Ninth Circuit should be reversed, and the Seventh Circuit.

QUESTION: Mr. Stephens, let me put this question to you. A jewelry company sends a courier periodically to Israel to the diamond market. And he buys a million dollars worth of diamonds; each diamond in a packet is appraised with the price on it. On the way back, the courier is kidnapped and the jewels stolen in 1982, this year.

Next year, the police, Interpol and whatnot, apprehend the thief and he's got $800,000 of the diamonds left and the $800,000 comes back. What about

that? What do you say is the status of that $800,000 recovery?

ORAL ARGUMENT OF HARVEY B. STEPHENS, ESQ.

ON BEHALF OF THE PETITIONER -- REBUTTAL

MR. STEPHENS: That $800,000 is taxable to the jewelry company in the year of recovery because, as Your Honor correctly points out and we believe is relevant, there was a recovery, an economic recovery by the company. It wasn't a recovery of the full amount of the diamonds that was taken. The amount that would be included in the tax is only the amount of the recovery.

QUESTION: Now let me change it a little bit. In 1982 no settlement is made with the insurance company. In 83, the insurance companies pays a million dollars to the company for its loss.

MR. STEPHENS: Then that would be added to the income, because again, it would be a subsequent recovery. And that, in point, is what happened, I believe, in Dodson versus U.S. which is a case in this Court, earlier applying the tax benefit rule.

QUESTION: Could the Service insist on amending the 82 return in the Chief Justice's example?

MR. STEPHENS: The premise upon which the 82 -- wait a minute. In the 82 return is when we got the $800,000.

QUESTION: No, the loss is in 82 and the recovery is the next year.

MR. STEPHENS: Okay. The premise on which the casualty loss deduction was taken was valid in that year.

QUESTION: All right. But it now turns out that it was not.

MR. STEPHENS: No --

QUESTION: May the Service go back and recover it in the previous year or not?

MR. STEPHENS: I would say that they could not, because the recovery occurred in 83, and remember, they were stolen. That premise was a valid premise in the year --

QUESTION: There was a loss in that year.

MR. STEPHENS: And there was a loss. And we have argued here that the tax that we paid for our shareholders was paid in 1972. And in response to Justice Blackmun, I said that if the Supreme Court had ruled in December of 1972, if there was no economic recovery to us, which I believe that there was not because our balance sheet was not changed in any way, we would still be entitled to that deduction.

QUESTION: So you don't -- you say the Service could not reopen the 82 return in the Chief Justice's example, --

MR. STEPHENS: I believe under the procedures it could, but this is not the proper --

QUESTION: But they would lose their case if they attempted to make an assessment for 82 based on the recovery of the $800,000 in 83.

MR. STEPHENS: Well, obviously, from an accounting point of view they would not lose the case, Your Honor, because if they show $1,800,000 deduction and an $800,000 recovery, they only have a million dollar loss.

QUESTION: Let me tell you my hypothetical one step beyond. In 83, perhaps from the shock of this loss, the principal officers decide to liquidate the corporation. They have eight stockholders. They distribute $100,000 worth of diamonds to each one of the stockholders along with whatever other assets are liquidated. What about that?

MR. STEPHENS: Well, in that situation, --

QUESTION: In other words, how is that different from the feed, except that you can't eat the diamonds.

MR. STEPHENS: You're saying you're distributing the diamonds. I would think what you mean, Your Honor, if I may, they are distributing the loss that incurred or the right for the insurance recovery.

QUESTION: No, I mean physically. A packet full of diamonds.

MR. STEPHENS: Physically distributed the diamonds. I would think since they wouldn't have been expensed before, they would not apply, and the diamonds would be taken to the -- you would apply the tax basis that would be apportioned to the assets it's received. There's a possible capital gain and loss depending upon the original investment of the shareholders in the liquidation.

I call the Court's attention to the fact that the Commissioner argues that recovery is irrelevant but in every case except the Tennessee-Carolina, and in our case here and in First Trust, there was recovery. And in point of fact, the Solicitor has said oh, we can find recovery here.

This Court, in Commissioner versus First Security Bank of Utah, made the following statement: We know of no decision of this Court wherein a person has been found to be taxed -- to have taxable income when he did not receive -- that he did not receive, and that he was not prohibited from receiving. End of quote.

If this Court should adopt the position of the Commissioner, that broad statement will no longer be true because no income has been received by the

Hillsboro National Bank. They paid a tax. They did not receiver it. In First Trust, the checks -- a small distinction -- but the checks were made payable to the bank and the shareholders. The bank actually had to endorse the checks.

The lower Illinois courts, though, in keeping with the Commissioner versus First Security Bank, held that the bank was prohibited from receiving the refunds.

I urge that this Court reverse the judgment of the Seventh Circuit. Thank you for your courtesy.

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

(Whereupon, at 11:43 a.m., the case was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represent an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of the United States in the Matter of:

#81-485 HILLSBORO NATIONAL BANK vs. COMMISSIONER OF INTERNATIONAL REVENUE; AND UNITED STATES VS. BLISS DAIRY, INC. # 81-930

and that these attached pages constitute the original transcript of the proceedings for the records of the court.

BY _____

(REPORTER)