ORIGINAL

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THE SUPREME COURT OF THE UNITED STATES

CAPTION: COMMISSIONER OF INTERNAL REVENUE, Petitioner V. DONALD E. CLARK, ET UX.

CASE NO: 87-1168

PLACE: WASHINGTON, D.C.

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IN THE SUPREME COURT OF THE UNITED STATES

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COMMISSIONER OF INTERNAL REVENUE, :

Petitioner :

v. : No. 87-1168

DONALD E. CLARK, ET UX. :

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Washington, D.C.

Monday, November 7, 1988

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:02 o'clock a.m.

APPEARANCES:

ALAN I. HOROWITZ, Assistant to the Solicitor General, Department of Justice; Washington, D.C.; on behalf of the Petitioner.

WALTER B. SLOCOMBE, Washington, D.C.; on behalf of the Respondent.

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P R O C E E D I N G S

(10:02 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument first this morning in No. 87-1168, Commissioner of Internal Revenue v. Donald E. Clark.

Mr. Horowitz, you may begin whenever you're ready.

ORAL ARGUMENT OF ALAN I. HOROWITZ

ON BEHALF OF THE PETITIONER

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

This case presents a statutory question concerning the operation of the reorganization provisions of the Internal Revenue Code. For transactions that fall within the statutory definition of a reorganization, the Code provides an exception to the general rule that the entire amount of gain or loss must be recognized upon the sale or exchange of property.

On the theory that the reorganization represents a recasting of interests in a continuing enterprise, not a sale, the Code provides for deferral of the gain or loss that would otherwise be recognized on the transaction.

When the reorganization is purely stock for stock, no gain or loss is recognized at all. However, when the transaction also involves, in addition to an exchange of stock, the payment of cash or other property, what is commonly known as boot, Section 356, the provision at issue here, comes into play.

Section 356(a)(2) provides that the gain on the transaction is to be recognized up to the amount of the boot, and it further provides that if the exchange has -- and I quote -- "the effect of a distribution of a dividend", then it is to be treated as a dividend to the extent of the recipient's share of the undistributed earnings and profits of the corporation, and it is generally recognized, and Respondent does not dispute here, that the corporation whose earnings and profits are examined in this connection is the acquired corporation.

The facts of this case are as follows. Respondent Clark was the sole shareholder of Basin, a closed corporation that by March 1979 had accumulated more than $2.3 million in undistributed earnings and profits. N.L. Industries, a major corporation whose more than 32 million shares were traded on the New York Stock Exchange, sought to acquire Basin from Clark in the transaction that ultimately yielded Clark more than $10 million in gain.

N.L. offered Clark two alternatives as

consideration for his stock in Basin: either a complete stock for stock deal, in which he would receive 425,000 shares of N.L., or another deal in which he would receive 300,000 shares of N.L. and in addition $3.25 million in cash.

Clark chose the latter alternative including cash, explaining that he needed cash to pay outstanding bills and that his whole livelihood had been tied up in Basin, and he didn't want everything tied up in N.L., where he would run the risk that something would happen to N.L.

Under Section 356, therefore, Clark was required to recognize and pay tax on $3.25 million of his gain.

QUESTION: If the first alternative had been chosen, then what? Would you be here?

MR. HOROWITZ: No. There would be no tax at all. It would be tax-free -- a completely tax-free transaction.

The bulk of the gain still remained tax-free, however. The question here is whether the cash that was received by Clark should be treated as a dividend, and therefore taxed at ordinary income rates, to the extent of the $2.3 million in earnings and profits that Clark had allowed to accumulate in Basin.

It is the Government's contention that the boot distribution to Clark in this case clearly had the effect of the distribution of a dividend. A dividend, as defined by the Code in Section 301 --

QUESTION: Mr. Horowitz, is that the basic principle of boot, really? Why do we have the boot principle worked into the decisional process at all?

MR. HOROWITZ: Well, the idea is that -- the idea of not recognizing gain in the reorganization is that it's kind of paper profits, and that the -- since the taxpayer is continuing his operation of the same corporation in a different form, as long as he keeps it in stock, it's the same as if his own stock had appreciated. He doesn't have to pay tax on it. He hasn't realized anything.

But once he takes cash out of the transaction, then it becomes a taxable transaction, and he needs to pay tax on it. The Code usually doesn't let people take out $3.25 million without paying any tax on it, when it actually represents gain from his initial investment.

So, there's no question that the boot is taxable here. The only question is whether $2.3 million of it is taxable at ordinary income rates or at capital gain rates, and that turns on whether it had the effect of the distribution of a dividend.

A dividend is defined in the Code as a distribution by a corporation with respect to its stock of its earnings and profits, and this Court has described the fundamental test of dividend equivalency as whether the distribution to the shareholders is on a pro rata basis.

Here there is no question that the distribution was made on a pro rata basis to the shareholders of Basin. That is, Clark was the only shareholder of Basin.

Now, of course, the distribution here, which was made in the course of a multi-corporation reorganization, is not literally a dividend. That would be impossible, because a dividend is a transaction between a single corporation and its stockholders.

With that constraint, however, it is as close to an ordinary dividend as could be, and therefore, it had the effect of a dividend. Remember, the reason why Section 356(a)(2) needed to be enacted with the terms "have the effect of a dividend" is because any money that would be distributed in the course of reorganization would not literally be a dividend.

Let's look at what happened here.

QUESTION: Mr. Horowitz, it seems to me that possibly the Government's approach in this case divorces the boot payment from the context of the reorganization in which it occurred.

MR. HOROWITZ: Well, I --

QUESTION: I think you need to keep in mind, don't you, that this whole thing arose out of a reorganization.

MR. HOROWITZ: Well, we certainly don't dispute that, Justice O'Connor. But as I was saying, the text of Section 356(a)(2) is that you need to look at whether it has the effect of a distribution of a dividend, because in no reorganization would the distribution itself literally be a dividend, because that's a single corporation transaction.

So of course the distribution occurred in the course of the reorganization, and for that reason, it is not literally a dividend. The Code directs you to look at whether it has the effect of the distribution of a dividend, and in order to do that, you must compare it with an actual distribution of a dividend. And that requires a comparison to a transaction that necessarily takes place outside of the reorganization, because dividends are --

QUESTION: How much of a -- how much of a split of opinion is there on this question? The Tax Court was unanimous, wasn't it, in thinking that it was taxable as a capital gain?

MR. HOROWITZ: Well, it was -- it was a review decision of the Tax Court, so -- Judge Tannenwald wrote an opinion which was circulated to the other judges and no one dissented.

QUESTION: I missed what you said there, Mr. Horowitz. What happened in the Tax Court?

MR. HOROWITZ: I said it was a review decision, so there was --

QUESTION: And it wasn't --

MR. HOROWITZ: -- it was written by one judge and circulated to the other judges with no dissent.

QUESTION: It was a review decision?

MR. HOROWITZ: Yes. Yes, it was.

QUESTION: And it was unanimous, was it not?

MR. HOROWITZ: It was unanimous, although I should say that I'm not sure if the Tax Court was sitting here today they would still vote unanimously on it. In reading Judge Tannenwald's opinion, I think there are some things that are not apparent from the face of that opinion that we rely on somewhat, and that wouldn't have been apparent to the judges who were reading it.

For example, the fact that there was a long --

QUESTION: The Court said that there --

MR. HOROWITZ: -- line of Court of Appeals authority.

QUESTION: The Court of Appeals was unanimous also?

MR. HOROWITZ: The Court of Appeals was, yes.

QUESTION: So you have a unanimous array of judges against you so far.

MR. HOROWITZ: In this particular case, the array of judges is unanimous. On the other hand, as we point out in our brief, there's a long line of earlier authority which directly supports the Government. So, there are many judges before who have ruled our way, and in fact, dating back to 1934, it's a pretty well-established proposition that a pro rata boot distribution would have the effect of a dividend.

It's only in this case and in one other case back in 1972, in the Eighth Circuit, on very unusual facts, that there's been any deviation from that rule. And I should also add that it is a rule that was acknowledged and cited approvingly by this Court in the Bedford case back in the Forties, although that was not the holding of the case. But the Court cited the lower court cases on which we rely, and then extrapolated from those--

QUESTION: This kind of a transaction?

MR. HOROWITZ: I think the Commissioner--

QUESTION: Is there some suggestion that -- isn't there some suggestion in this case that he's changed his mind?

MR. HOROWITZ: I don't think so. There's a few red herrings that are floating around on this case. One of them is the so-called automatic dividend rule, which is something that came out of that Bedford decision, in which the Court had -- the Court, in approving this lower court decisions that had held that a pro rata distribution to the shareholders of the acquiring corporation would always have the effect of a dividend.

The Court used some loose language there, and after the Bedford decision came down, some people read it as establishing the so-called automatic dividend rule, which is that every distribution, boot distribution made in the course of reorganization would be a dividend, even if it was made on a non pro rata basis.

That view has been rejected by the Courts and by the Commissioner, although in that respect you might argue the Commissioner changed position, because originally he tried to make some hay out of that, I think, in some way.

QUESTION: Mr. Horowitz, isn't it possible to view the issue in this case as whether or not there was a pro rata distribution depending on whether you look at it before or after the acquisition?

MR. HOROWITZ: No, I think there's no question that there was a pro rata distribution. Now, if you look at it from after -- if you look at it the way the respondents do, they construct a scenario in which it would not be a pro rata distribution, but I don't think that changes what is a fact, which is that the money was distributed on a pro rata basis to the shareholders of Basin.

QUESTION: But it wasn't distributed by the acquired corporation to its shareholders, it was distributed by the acquiring corporation.

MR. HOROWITZ: Well, it was distributed by a corporation that, within the assumptions that underlie the reorganization provisions, and that support the view that gain will not be recognized, it is a successor corporation to Basin, a continuation of the original corporation of Basin. So it's not like it's another corporation.

QUESTION: How would you vary the facts in this case so that the Government would concede there was not a pro rata distribution?

MR. HCROWITZ: If there were more than one shareholder of Basin, and the money went to some, and not to others.

If you look at some of the revenue rulings that are cited in the briefs, you'll see cases where some shareholders hold common stock of the acquired corporation, some hold preferred, some hold a combination of both. And the terms of the organization are such that each shareholder doesn't get the same thing because of those differences. That would not be a pro rata distribution.

This case is a typical one, though, no question about it. Many of these organizations --

QUESTION: Wouldn't you also concede there was no pro rata distribution if they, in an all stock transaction with a contractual provision that 30 days later, some of the stock would be redeemed?

MR. HCROWITZ: Well, I'm not sure what the temporal limitation would be on it. I'm sure if the contractual provision was for 15 minutes later, the stock would be redeemed, the Commissioner would -- well, what you're suggesting is I think a transaction where there's no boot at all, that is, a pure stock to stock.

QUESTION: Well, I think the Government might argue it was boot, because it was contemplated from the outset that the selling shareholder would end up with the same number of dollars that he did here, only he just had to wait 15 days.

MR. HOROWITZ: Right. I think there would be some point at which the Government would challenge that, try to collapse, transact something, which it wouldn't but I don't think that goes to whether it's a pro rata distribution. It goes only to whether it's a distribution at all in the course of reorganization. If there is one, we would argue that it was pro rata.

QUESTION: May I ask just one other question? What happened to the balance sheet of the merged corporation when this money is treated as a dividend? Does the earned surplus account subtract this amount from it?

MR. HOROWITZ: Yes. The earnings and profits would be taken out from Basin, and wherever Basin's earnings and profits went -- in this case, into the subsidiary.

QUESTION: Mr. Horowitz, do I understand you to be saying that if Clark had a partner in Basin, and they both sold out, and Clark's partner took it all in N.L. stock, but Clark took it just the way he did here, Clark would -- neither of the two would be receiving a dividend?

MR. HOROWITZ: Certainly the first person is not receiving a dividend.

QUESTION: Certainly the first one?

MR. HOROWITZ: And the cash, the second person is getting cash, and it would not be a pro rata distribution to him. So it would not -- it probably wouldn't be a dividend, although then you'd have to see --

QUESTION: It doesn't seem to me to make a whole lot of sense.

MR. HOROWITZ: Oh, it does make a whole lot of sense, Justice Scalia. The whole -- the earmark of a dividend is what we ordinarily think of a dividend when AT&T takes its earnings and profits and sends a check to all its shareholders. That's what a dividend is -- it's when all the shareholders take money equally out of the corporation, and that's what's happened, essentially, in this case.

When it doesn't -- when it's not distributed on a pro rata basis to the shareholders, then you've got something else, because there's no basis for issuing a dividend to one shareholder and not to another. So the hypothetical that you posit is -- on its face looks like something quite different from a dividend. This case does not.

QUESTION: Counsel, you're asking us to rule for you on the assumption that the redemption was prior to and apart from the merger, are you not?

MR. HOROWITZ: Well, the way I --

QUESTION: Isn't that the way you want us to look at the transaction?

MR. HOROWITZ: Well, first of all, now, I think the answer -- it's a long answer. First of all, we don't necessarily say that you have to hypothesize a redemption. That is Respondent's construct. They argue that somehow you'd have to trade a recemption, and what the statute says is whether it has the effect of a dividend, which the dividend is a much simpler transaction than a redemption. And we say that you look at a dividend.

Now, the simplest way of looking at is true, as if Basin had in fact distributed this as a dividend before the reorganization, because Basin ceased to exist as an independent entity after the reorganization. But our position does not depend on looking at it before the reorganization. This is explained in some detail in my reply brief, pages 7 to 9.

But you could also structure the transaction somewhat differently the way the Minnesota Tea case that was before this Court was structured, and that is, Basin could have been kept as a shell corporation. All of the assets of Basin could have been sent to N.L. in the reorganization with Basin remaining as a shell. And in that case, the consideration paid for the organization would have gone into Basin as a holding company. It would have held the shares in N.L. and it would have taken the money.

It still would have all been to the benefit of Clark, which would remain the sole shareholder of Basin. In that case, if Basin then distributed the money as a dividend to Clark, which is what happened in the Minnesota Tea case, it would clearly be a dividend. There would be no argument that it wouldn't be a dividend. Yet everybody would end up in exactly the same place as they are now.

So, whether you compare what happened here on the reorganization to a pre-reorganization distribution by Basin, or if you compare it to the post-reorganization transaction,that I just described, in either case there, it is exactly comparable to a dividend.

QUESTION: But in either case, that's a hypothetical construct, compared to what really happened?

MR. HOROWITZ: Well, again, the statues require some degree of hypothetical construct, because it asks the question: is this equivalent to a dividend? And the dividend is a transaction that occurs outside reorganization. It's a transaction that occurs between a single corporation and a shareholder. So, the statue, in requiring a comparison, requires you to look at some other transaction, and to see whether the effect is the same.

QUESTION: I take it the taxpayer uses a hypothetical construct as well?

MR. HOROWITZ: The taxpayer uses a -- what I might call a double hypothetical construct. They look --

QUESTION: So you're saying his is more hypothetical than yours?

[Laughter]

MR. HOROWITZ: Yes. That's not, that's not the basis for deciding the case in our favor, but I should point it out.

They look at a post-reorganization.

QUESTION: Well, might it be a basis for deciding the case?

MR. HOROWITZ: It's one argument. It is not, I think, the main argument that we have. But just to talk briefly about what the taxpayer says; they look at a post-reorganization redemption of stock. That is probably analogous to our looking at a pre-(inaudible) reorganization dividend. It's a transaction that never occurred. There was never a redemption.

Why I say it's doubly hypothetical is because the redemption that they hypothesize is the redemption of stock that never existed. They posit a redemption of the 125,000 shares of stock that Clark declined to take in the reorganization, the exact option that he refused to take, and those shares never existed. They were never issued by the corporation, they're completely imaginary. So, to that extent, I think their claim is more hypothetical than ours.

But I would like to focus on the statutory language which says, which asks the question: does it have the effect of the distribution of a dividend? We think that we have clearly shown that it does, at least if you look at it, if you looked at what would have happened if Basin has distributed the dividend. We think there's no denying that it has the effect of the distribution of a dividend.

Now, Respondent's argument is that it may also have the effect of some other transaction that they're able to dream up, one that is not a dividend. But that doesn't get around the statutory problems. Statute says that if it has the effect of the distribution of a dividend, it's to be treated as a dividend, and the statute doesn't care whether it could have the effect of some other transaction which they hypothesize.

So, we think whether or not you think that the Respondent's hypothetical way of looking at it is as good as ours or not, it does not help them in dealing with the statute.

QUESTION: The Fourth Circuit relied rather heavily on Section 302. Does the Government think that has no applicability?

MR. HOROWITZ: Well, Section 302, the question of whether the parties think that Section 302 applies is another one of the red herrings, I think, that's been raised in this case. There's no dispute on that point. If there's a question of needing to look at the substantially disproportionate criteria that are in Section 302, because there is a non pro rata distribution, the Government is willing to look at it as the taxpayers are.

I think this is most clearly illustrated, actually, if you look at the Respondent's brief, if you look at the cases that they cite for their proposition that Section 302 must apply. They're exactly the same cases that the Government cites in its brief for the proposition that a pro rata payment to the shareholders of the acquired corporation, a payment exactly the same as what happened here, is in fact a dividend.

So, what they're doing is kind of arguing about some side point that has nothing to do with what's really going on in this case.

QUESTION: Do you say that 302 is irrelevant in any case, where we are construing this statute that is before us, or just in this one?

MR. HOROWITZ: No, there are criteria in Section 302 for determining when you have a non pro rata distribution, one that results in a reduction of interest by the shareholder. There are criteria in Section 302 for determining whether that should have the effect of a dividend of not. And we're willing to look to Section, when you have a problem like that, we're willing to look to Section 302 for guidance just as the Respondents are.

But here you don't have that. You have a 100 percent pro payment, pro rata payment to the shareholders of Basin. Under 302, that's considered a dividend. That's what this Court said in Davis.

If you don't look at 302, it's also a dividend. So it's --

QUESTION: May I just restate what I think you're -- I just want to be sure I understand it.

You're saying that 302 is relevant, but only for the purpose of determining whether distribution is pro rata or not, in effect? It's close enough to being pro rata to be treated as a dividend?

MR. HOROWITZ: Close enough to pro rata, that's right.

QUESTION: That's the sole function of 302?

MR. HOROWITZ: That's right, that's right. It's called "substantially disproportionate" in the statute.

QUESTION: So that's your answer to their reliance on the 84 legislative history?

MR. HOROWITZ: Yes. Their '84 legislative history is just a statement about what the Courts have done. The Commissioner himself has said that he's willing to rely on Section 302 for guidance. So, again, I say that there's not a real controversy over that that impacts on this litigation.

QUESTION: Well, do you say that the reorganization in this test meets the language of Section 302 that the shareholder relinquishes more than 20 percent of his corporate control and less than 50 percent shell at the transaction?

MR. HOROWITZ: No. We don't think it meets that.

QUESTION: So you said. But you said that's not the only way you can conclude that something is essentially equivalent to a dividend?

MR. HOROWITZ: Well, the language you described, this is describing something that would not be equivalent to a dividend, Justice Rehnquist. Here we say there's no change in control, because it's a completely pro rata distribution.

I think as Justice Stevens said, those numerical tests in Section 302 are to decide when something is close enough to pro rata that it should be treated as pro rata.

If the interest goes down below 80 percent, that's already considered by the statute as not a pro rata distribution, and therefore not a dividend. But here we have a pro rata distribution, so it's not necessary to get into that.

QUESTION: You say when something is concededly pro rata, you don't get the Section 302?

MR. HOROWITZ: That's right. And if you did look at Section 302, you would get the same answer, because there's no reduction in interest.

Let's look at what happened here with the two transactions, and I think it should be clear enough that this has the effect of a dividend.

We start out with Basin having $2.3 million in earnings and profits. That $2.3 million was distributed on a pro rata basis to the shareholders of Basin. The only difference between that and the prototype dividend, where the distribution was actually made by Basin, is that the distribution was made by a corporation that's a continuation of Basin in a recast form.

The effect is certainly the same. At the end of the day, whether the dividend was paid directly by Basin outside the reorganization, or paid in the course of the reorganization as it was here, $2.3 million has disappeared from the corporation and ended up in the pockets of Clark, Basin's sole shareholder.

I'd like to make -- there are several points we make in our brief that are critical of the hypothetical redemption scenario that is posited by the Respondents. For one thing, it does not have -- it does not fit the statutory language of having the effect -- the reorganization transaction does not have the effect of the transaction that they posit, because many of the categories that are relevant for tax purposes would come out quite differently -- the amount of the gain, the amount of the basis, the amount of continuing earnings and profits accounts.

There's one, that stuff is in our brief. There's one thing that I would like to focus on here in oral argument, though, and that is the question of the earnings and profits that is required to be compared by Section 356(a)(2). The statute says that the amount of the boot that is to be treated as a dividend is limited by the earnings and profits of the corporation. Now, as I said before, the corporation there has been recognized by the Courts and not disputed by Respondent as being the acquired corporation.

Now, it's almost a tautology that when you have a dividend, and you compare the distribution, the dividend is a distribution out of the earnings and profits of a corporation. The earnings and profits that you look at there are those from the same corporation that's making the distribution to its shareholders.

But what you have here, with the hypothetical redemption scenario that the Respondents have posited is they assume that the distribution was made by N.L., by the later, combined corporation, yet they want to compare that against the earnings and profits of Basin, a corporation that had no connection to N.L. at that time, in determining whether that's a distribution.

QUESTION: I thought you answered Justice Stevens that you would subtract this distribution from the balance sheet of N.L.

MR. HOROWITZ: Well, a distribution comes out of the earnings and profits of Basin when you combine the corporations, and in the merger those accounts are carried over into the new corporation. So the bottom line would be that it would have disappeared from the new corporation, although as it happens here, because of the way they structured it, the Basin earnings and profits would have gone into the subsidiary, N.L.A.C., that was specially created by N.L. for the purposes of holding this new corp. So it wouldn't have even gone into the N.L. earnings and profits.

But that change would be as a consequence of it having first come out of Basin, and then later the accounts being transferred over.

QUESTION: May I ask it, I know it's not apt to happen with the corporations of the relative size of these two, but suppose the acquiring corporation had a deficit that was as great as or greater than the earned surplus of the acquired corporation.

Would there be -- would that have the effect of a dividend then? Do you understand my --

MR. HOROWITZ: Yes, yes, I think if the acquiring corporation had a deficit.

QUESTION: Had a deficit, so that after the transaction, this would have just in effect doubled the deficit, you'd say, I suppose?

MR. HOROWITZ: Yes, I think so.

QUESTION: Or was it that it was still treated as a dividend?

MR. HOROWITZ: Because what is happening is that the shareholders of the original corporation are taking their earnings and profits out, and getting them in their pocket. That's what they're ordinarily part-paid dividend -- to treat as a dividend. The fact that they're going into a worse corporation is kind of irrelevant to that.

QUESTION: What about the other way around -- the acquired corporation has no accumulated earnings and profits?

MR. HOROWITZ: Then there's no dividend.

QUESTION: Well, but the accuiring corporation does, and it pays the stockholder cash.

MR. HOROWITZ: Well, even so.

QUESTION: As boot?

MR. HOROWITZ: As boot, that's not --

QUESTION: So you wouldn't have it?

MR. HOROWITZ: The facts make it clear that it's measured by the E and P, and there's no -- because there's no suspicion that there's a ballout there of the earnings of the acquired corporation, because they didn't have any.

I'd like to reserve the remainder of my time.

QUESTION: Thank you, Mr. Horowitz.

We'll hear now from you, Mr. Slocombe.

ORAL ARGUMENT OF WALTER B. SLOCOMBE

ON BEHALF OF THE RESPONDENT

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

The central fact in this case is that there is no dispute that if Mr. Clark had not taken the cash, he would have received an additional 125,000 shares of N.L. stock. So, the effect of the exchange in which he got the cash was that he got about 30 percent less N.L. stock than he would otherwise have received.

The question here is whether the Fourth Circuit was right in affirming.

QUESTION: But, Mr. Slocombe, let me interrupt right there. If that's the central fact, would your position be different if the acquiring corporation had not given him an option, but had simply said: this is our proposal: X shares of stock and X cash?

Does your case depend on there having been an option, or --

MR. SLOCOMBE: No, it doesn't depend on there having been an option.

QUESTION: Okay.

MR. SLOCOMBE: But the existence of the option makes clear what was really going on.

QUESTION: Which just helps with the arithmetic. I don't see it helps with the legal analysis at all.

MR. SLOCOMBE: Our view is that in another case where a shareholder of a small corporation -- that corporation was being absorbed by a big corporation -- they would normally be able to show that if they hadn't gotten the cash, they would have gotten more stock. But the burden would be on them.

QUESTION: They couldn't show it if the buyer didn't offer it. They said: the amount of shares we'll issue is this ceiling, and that's it. The rest is going to be cash.

MR. SLOCOMBE: It would be, in other cases --

QUESTION: Do you think that's a different case?

MR. SLOCOMBE: -- it would be a factual problem that doesn't exist here.

QUESTION: Pardon me?

MR. SLOCOMBE: In other cases, there would be a factual problem that doesn't exist here. But in this case, the effect of receiving the cash is clear.

QUESTION: I don't know why that's a different case. That's what I'm -- that's -- if you say this is a central fact, you'd better explain it to me.

MR. SLOCOMBE: Because there will be a problem of showing the effect. The statute makes the test the effect of the exchange, not the effect just of the cash, but the effect of the exchange, and therefore, the inquiry has to be what difference in the world did receiving the cash in this exchange make?

And here, the answer is clear. In other -- it's not an unusual situation of which there are alternatives. And in other cases, the taxpayer would have a different burden, a different -- they always have the burden of proof; he'd have a different problem showing the factual situation, showing the effect.

But that's the inquiry that the statute makes critical -- what's the effect of the exchange.

QUESTION: And you say the effect might be different if he didn't have an option?

MR. SLOCOMBE: If the taxpayer couldn't show that the effect of the exchange was to reduce his ownership in the continuing corporation, then we would have a different case, yes.

QUESTION: But it always is that. It seems to me that you're just balking at two unreal hypotheticals instead of one.

I mean, the fact is that he didn't accept the offer --

MR. SLOCOMBE: Yes.

QUESTION: -- and you're willing to leap over that fact. But you could also say in a case where no offer has been made, the same thing. Not only didn't he accept the offer, but also the offer wasn't made. But you could likewise say, nonetheless, had there been an offer, and had the offer been accepted, he would simply be reducing the amount of his stock in the new corporation, in the acquiring corporation. Isn't that true here?

MR. SLOCOMBE: I believe in the normal case it would be the fact, and you'd be able to show it, that if the taxpayer, the shareholder hadn't received the cash, he would have insisted on more stock, yes.

But he'd have to show that, but that's what he'd have to show. He'd have to show that there was an effect on his continuing ownership in the corporation. Here we've met that burden, and shown what the effect was.

But the task, the issue, the factual situation isn't any different, but what the taxpayer would have to show is to show what we showed here in the Tax Court, and in this trial.

QUESTION: Well, just so that I understand, he could always show the effect on the corporation just by comparing the percentage of stock in Justice Stevens' hypothetical, where he's not given a choice.

MR. SLOCOMBE: If he's not given a choice, he's got a harder problem, because he'd have to show what would have happened if he hadn't taken the choice.

But the whole concept of a reorganization is that there's a continuing enterprise. There's no excuse that if he'd sold it all for cash, that would have been a capital gain. There's no dispute that if he'd taken all stock and at some appropriate point in the future, so that it didn't destroy the reorganization, had sold 30 percent of it, that would have been a capital gain.

The issue is, what is the effect of getting the cash at the time of the reorganization as a part of the overall exchange to give him a dividend? And in this case, it is clear what I think would also be the fact in most similar cases. We have a large corporation merging, absorbing a smaller corporation. The people who get, the people who own the smaller corporation, would insist on more stock if they couldn't get cash.

But the point is that the effect of taking the cash out is to reduce, clearly here, to reduce the amount of ownership he has in the continuing enterprise, and this Court has defined dividend not in terms of what's pro rata or not, but in terms of the impact of the distribution on ownership. In Davis, this Court said that a dividend results when a distribution produces no change in the relative economic interests or rights of the shareholders whereas conversely, there is no dividend if a distribution results in a meaningful reduction in the proportionate interest of the shareholder in the corporation.

But where there's a reorganization, our position is, and what the Fourth Circuit held, was that the corporation there means the only corporation that's going to continue to exist. Basin went out of existence at the moment of the reorganization. Insofar as the IRS test focuses on ownership at all, it focuses on ownership in Basin. But Basin didn't exist anymore. There is a continuing -- but there was a continuing ownership. Clark's continuing ownership was reduced as a result of receiving the cash.

QUESTION: But that's just as much a hypothetical -- an interest he never got was reduced. But it seems to me this is a standoff on your two hypotheticals, because he never got the 425,000 shares.

MR. SLOCOMBE: He never got 425,000 shares.

QUESTION: So how can you say he reduced that ownership?

MR. SLOCOMBE: Because we have nere a clear indication, as your question earlier --

QUESTION: But if he accepted tnat offer and changed his mind and --

MR. SLOCOMBE: We know how much he would have gotten.

QUESTION: Sure, it helps on the arithmetic, but he never got it, so how can you say it's been reduced?

MR. SLOCOMBE: Because to ask about the effect of an exchange necessarily involves asking what difference does it make that this event took place rather than some other event? Our view is that Section 356(a)(2) really is concerned with situations as is 302 in which the money comes out and there is no change in the continuing ownership interest.

302 is relevant here not just because of the numerical calculations of what is substantial, once you decide that there's been some reduction. How much reduction is enough? It's also relevant because both sections are trying to deal with the same basic question: when has getting money from a corporation sufficiently reduced the shareholder's interest in the continuing business that it has the effect of going out

and selling some of that stock, so that it should be treated as a capital gain?

Now, 302 is relevant to 356 for determining the character. The particular rules for the amount, how the basis is calculated and that sort of thing are determined in detail in Section 356 separately from the characterization issue.

Now, the IRS has in fact changed its position; not with respect to this exact particular case, but it is following a position in very similar other cases which is not the same as what it's following here. Even in this case, it's said in a ruling that 302 applies, but as to very similar cases.

For example, there's a Revenue ruling, 75-447, which is cited in our brief, in which there is a pro rata distribution of cash by a corporation to two shareholders, each of whom owns 50 percent, and then the corporation sells additional stock to a third person, so that they end up instead of each owning half, they now only each own a third.

Service has held that ought to be held as an integrated whole. You ought to look at the continuing ownership interest in that situation, and they said the reason for that is that a correct analysis requires that effect be given only to the overall result and proscribed to the fragmenting of the whole transaction into its component parts.

And they go on to explain that the approach is needed because making the computations in this manner properly reflects the extent to which the shareholder involved in each situation actually reduces his stock holding as a result of the whole transaction.

In the real, practical world, what happened here was Mr. Clark chose in effect to trade 70 percent of his Basin stock for N.L. stock and 30 percent for cash. Because it was in the context of a reorganization, special separate rules for computing the gain, it was recognized. But that's what really happened.

And there's nothing surprising that in a system as -- that was in existence at that time, it doesn't exist anymore. But in a system where there was a differential between capital gains and ordinary income, you would expect that when there is a substantial diminution of ownership interest, then capital gains is the appropriate treatment.

QUESTION: I take it by that, then, that you are comparing his position in the acquired corporation with his position in the acquiring corporation, and I -- which was I guess what the District Court did in Shimberg, and everybody seems to agree that that's wrong.

MR. SLOCOMBE: Everybody seems to agree that it's wrong.

QUESTION: But isn't that what you just said?

MR. SLOCOMBE: No. What I just said was that he had a relative ownership in the combination of Basin and N.L. before the transaction. The whole idea of a reorganization is that not just N.L. goes on after the reorganization, but Basin goes on inside N.L., as a different entity. Both as to N.L. and as to Basin, it emerges from the transaction. His relative ownership was 425,000 shares' worth of N.L. before the transaction. The market shows that.

After the transaction, his relative ownership was 300,000 shares' worth. It is true in practice that it will normally be the case if the taxpayer can bear the burden of proof and show the relevant facts the -- in any situation where, so to speak, the whale swallows a minnow, then capital gain treatment for the boot will be appropriate.

But it's because of the effect on the continuing ownership, not simply because he's going from 100 percent down to, I'm sorry, from 100 percent down to 1.3 percent, or 0.9 percent, which he would in either event. We're not arguing that it's an automatic rule.

I think, rather, if the -- we're arguing the importance of effect on ownership. And indeed, the IRS test also relies on effect on ownership. They said: we don't want an automatic dividend rule. That's what people said, Bedford said, and all the commentators, all right-thinking people, said an automatic dividend rule is wrong. We don't want that. We only want it in pro rata cases.

The difficult with that argument is that knowing that the distribution from a corporation is not pro rata doesn't tell you whether it's a dividend or not. If only one of three shareholders of a corporation gets something from the corporation -- gets a check from the corporation in respect to his or her stock, and there's no effect on ownership, that's still a dividend. That's not entitled to capital gains transaction. Other shareholders may have a quarrel with it.

QUESTION: Well, yes. You don't ordinarily have a situation where one shareholder gets a check like that, and the others don't.

MR. SLOCOMBE: The Service will certainly take the position that where money is coming out to a dominant shareholder, maybe money that was claimed to be salary and is held to be unreasonable, they'll say that's a dividend. It's taxable to him as a dividend, even though the other shareholders didn't get an equal -- didn't get a proportionate amount.

It's unusual, but there's no question if that's all that happens that the dividend -- now in their reply brief, the IRS sets up a hypothetical where one person has 70 percent and the other has 30 percent. And Mr. 70 Percent gets all stock and Mr. 30 Percent gets all cash, and they say that shows we're not in favor of an automatic dividend rule. That shows what we mean by disproportionate distribution.

But in their reply brief, they explain why it is that Mr. 30 Percent is treated as getting a capital gain there, and it is because the effect is to terminate his interest in the continuing corporation. They concede that even with the disproportionate distribution, you have to look to what was the impact of getting the cash on his interest in the continuing corporation.

Disproportionate test, therefore, is simply a way of highlighting the effect on continuing interest.

QUESTION: Excuse me -- but taking boot is always going to reduce your interest in the -- in the acquiring corporation. That will always be the effect, won't it? So wouldn't this whole provision be a dead letter, then?

MR. SLOCOMBE: A very important class of cases where it wouldn't be the case. First of all, there are classes of reorganization where only one corporation is involved. There are reorganizations where there are overlapping ownership, and there are reorganizations where two relatively equal companies are merged.

And in all of those cases you can have a situation where the reduction will exist, but it will not be sufficient to produce -- there may not be any reduction at all. But even where a reduction exists, it may not be enough to be meaningful.

When the Service has held, this is not the result of this case, but of lots of rulings in the past, the Service has held that a minority shareholder going down by as little as a few percent, three or four percent, that's meaningful for a minority shareholder.

But for a majority shareholder who continues to be able to control the corporation, he can go down quite a bit, as long as he doesn't go below a control level, and that reduction is not meaningful and that would be treated as a dividend.

So 356(a)(2) would continue to be a meaningful provision of the code if the Fourth Circuit opinion were affirmed here. It doesn't make it a dead letter. It makes it not apply in situations where the effect is not that of a dividend but that's what it says. It doesn't mean there are no cases in which it would apply.

QUESTION: Well, you acknowledge that it would -- it would not apply where a small corporation -- the minnow and the whale.

MR. SLOCOMBE: Yes.

QUESTION: It would not apply in those cases?

MR. SLOCOMBE: It would not apply, subject always to the requirement that the burden of proof is on the taxpayer, and he has to show what the effect of the exchange is. I agree in the normal situation he would be able to show it.

Moreover, the problem -- at some point in their brief, the IRS suggests that they have an intuition, they use the word intuition, about what's going on here. The taxpayer was trying to bail out, bail out earnings.

The Tax Court as the trier of facts specifically found that there was not the slightest evidence of that. This is not a situation where something different is going on, and it would be open to the Government to prove something quite different was going on.

QUESTION: Precisely. Did the Tax Court find --

MR. SLOCOMBE: With respect to that?

QUESTION: Yes.

MR. SLOCOMBE: That there was not the slightest evidence that Mr. Clark was using this as an opportunity to bail out accumulated earnings.

And I raise the point because the suggestion is made that that what was really going on. That's a factual assertion -- the Tax Court specifically found contrary to that factual assertion.

QUESTION: I mean, the man wanted cash. Do you think anybody says: Gee, I want that portion of cash that's return of capital or I want that portion of cash that's growth and therefore dividends. Is that at all -- it doesn't seem to me to make any sense to even ask that question.

MR. SLOCOMBE: Justice Scalia, he said more than just I want cash. He said: I want cash because I don't want to own so much N.L. stock. I don't want to be that tied to N.L. I want, in effect, to get some of my money out in return for less N.L. stock.

QUESTION: I understand.

MR. SLOCOMBE: So that's a meaningful inquiry, yes.

QUESTION: Some of my money out of what?

MR. SLOCOMBE: Out of the continuing business.

He knew he was going to have because it qualified as a reorganization, he knew he was going to have an interest in N.L. otherwise the whole thing would have been taxable, and it would all have been taxable as a capital gain.

He said: I want not to hold so much N.L. stock and the Tax Court found that that was what was going on.

Another aspect of the problem which is relevant --

QUESTION: Would the case have come out differently if instead he said: I want to buy a Caribbean Island?

MR. SLOCOMBE: No. What he wants to do with the money is not relevant. Why he wants not to own the N.L. stock, I believe, is relevant, and the Tax Court thought it was relevant.

Money is money. That's one of the problems with the system that taxes capital gains and ordinary income at different rates. You're always trying to decide what the character of that income would be, and it's all money.

The issue is not what he wanted to spend the money on, but why he chose not to take so much N.L. stock.

QUESTION: Well, would the case have come out differently in your view if he had said: not that I don't want to be involved to that extent with N.L. but that I have a pressing need for cash right now?

MR. SLOCOMBE: No.

QUESTION: Well, then it does seem that -- what is the relevancy of the inquiry?

MR. SLOCOMBE: The relevancy of the inquiry is that the charge is made in the Petitioner's brief, and the charge is specifically refuted in the record.

QUESTION: If I understand you correctly, you are saying that if the record showed that a couple of years ago, he'd said, I've got this $2 million of accumulated earrings in this corporation that I own. I want to get it out without paying a dividend. How can we structure a transaction to accomplish this result? -- and they went ahead and structured this transaction, you'd lose.

MR. SLOCOMBE: No.

Every corporation's value is in the sense only the value of its past accumulated earnings --

QUESTION: But if you win on the facts that I've given you, then this testimony -- it doesn't really add or subtract anything?

MR. SLOCOMBE: It isn't crucial. But it underscores what was really happening here, as opposed

-- the Government accuses us of wanting to do this and analyze this case on a hypothetical basis. It's not hypothetical what was actually going on here, and the record makes clear what was actually going on.

QUESTION: Well, it's hypothetical when you say you reduced your ownership because you didn't take some stuff you never got. I mean, they're both hypothetical.

MR. SLOCOMBE: Yes, and that's because whenever you ask about effects, you're asking about something which didn't happen. The only way you could meaningfully answer the question about effect is effect compared to what? The Government says take the -- if he'd taken the money straight out of the corporation, and that's all we will ask about -- that will always be a dividend, no matter whether it's pro rata or disproportionate, that will always be a dividend unless you show that something else was going on.

The something else here that was going on was the reduction in his continuing ownership in the corporation. The practical effect of the decision, overturning the Fourth Circuit, would be to create a good deal of confusion in the area.

The IRS is not clear in this situation about when or how much of the 302 analysis applies. They don't say how much disproportion is enough. Surely if there had been a one percent shareholder who had gotten all the stuff, I assume that the Commissioner would take the same position, that Mr. Clark's 99 percent was divided, still divided 70-30. That was still a dividend.

As the Fourth Circuit points out in their opinion, there are circumstances in which this approach, the IRS approach, would be subject to manipulation, because it makes in an overlapping ownership situation, because it makes a great deal turn on which corporation survives the reorganization.

Indeed, the IRS recognized this at trial, and in their trial brief they said they didn't want to win too much. They wanted to make sure they limited the effect of their victory to cases just exactly like this one.

That suggests to me that there's something wrong with the test they're proposing. It doesn't work in the generality of cases to go with the evil which Congress said in the 1924 legislative history was what they were going at which was situations in which there was an evasion of the principle of taxing dividends because a reorganization, the form of a reorganization, was gone through. There was no substantial change in who controlled the corporation, and yet money had come out.

That, we submit, and that's what the Fourth Circuit found, and the Tax Court found, that Section 356(a)(2) is about, and that is what the statute ought to be limited to ruling as a dividend.

QUESTION: Mr. Slocombe, suppose your client had just dissolved the corporation, said: you know, I want out of this business, and I'm not going to do any more business in the future. Fold it all up. He just terminates it, and takes all the money out, doesn't sell it to anybody. What would happen to that?

MR. SLOCOMBE: Generally speaking, that would be a capital gain. That would be a complete liquidation of the corporation.

QUESTION: Of all the accumulated earnings as well as --

MR. SLOCOMBE: Just as if he sold it all for cash.

QUESTION: And you're saying that essentially it ought to be the same kind of treatment when instead of just dissolving it, he sells it away, and decides that instead of taking some stock in the new corporation, or in the acquiring corporation, to take cash.

MR. SLOCOMBE: To take less stock, and to take cash, yes. Because that is exactly what he did, and in effect, he was selling 30 percent for cash, and he was taxed on that.

QUESTION: What if he had taken all cash?

MR. SLOCOMBE: If he had taken all cash, there's no question that it would all have been capital gain. It would all have been realized at the time of the event, in 1979.

As Mr. Horowitz says, the Code sets up an exception for certain circumstances in which there is a reorganization.

QUESTION: So he could, in effect, take out all the earrings by selling the whole thing and get capital gains treatment on the whole thing, but if he just tries to take out some of the earnings, by getting just some cash to boot, you're saying the Government wants to, wants to treat that as dividends.

MR. SLOCOMBE: Right.

Obviously I don't accept the characterization take out some of the earnings. If he wants to --

QUESTION: Right.

MR. SLOCOMBE: -- if he wants to dispose of a part of his interest for cash, while otherwise the requirements of reorganization are met, yes.

QUESTION: So you sort of have a

greater-includes-the-lesser kind of argument going for you, don't you?

MR. SLOCOMBE: Yes, because remember the effect of selling out altogether for cash would be that he no longer has any continuing interest. In a sense, the system matches, matches the appropriate level of taxation to what's happening.

QUESTION: If he takes all stock, it's not taxable at all?

MR. SLOCOMBE: No. Yes, it is not taxable. It's all deferred. It will be taxed eventually.

QUESTION: Yes, but at that point, it's not taxable, and if he takes all money, it's taxable only at capital gains rates?

MR. SLOCOMBE: Yes.

QUESTION: So it's only -- the Government says only in this situation where it's some stock and some boot that you have to pay ordinary income.

MR. SLOCOMBE: Yes. Mr. Horowitz in rebuttal will undoubtedly say that if he he had sold it all, the computations would be different.

Section 356 provides special rules for how you compute the amount of gain when there's boot, and they're somewhat different from the regular rules, and they're less favorable to taxpayers, because you don't get credit for any of the bases.

But the basic proposition is yes, that you -- the disposition of your interest in a corporation, of your property interest, is generally taxed as capital transaction. The point that we are making here is that this was in effect not a pulling of earnings out of a continuing corporation without affecting interest, but a trading of a reduced ownership interest in the continuing corporation for cash at the time of the reorganization.

Thank you.

QUESTION: Thank you, Mr. Slocombe.

Mr. Horowitz, you have four minutes remaining.

REBUTTAL ARGUMENT OF ALAN I. HOROWITZ

MR. HOROWITZ: Mr. Slocombe is now taking the position that the Court should basically ignore Section 356(a)(2). Obviously, if the entire corporation had been sold for all cash, it would all be capital gain.

However, it would be more than $10 million of capital gain that he would have to recognize on the sale. Respondent got a $7 million tax break by structuring this as a reorganization. $7 million of his gain is not recognized.

That's because it was a reorganization. That's because the assumption is that there is a continuing enterprise going on here, not getting rid of his old enterprise and turning it into cash, and the corollary to that is what Congress recognized in 356(a)(2), which is if you've got a continuing enterprise, you've still got these earnings and profits sitting around in the corporation, and if you take them out, you're going to have to consider whether what you've done has the effect of a dividend. And that's what's happened here.

As Mr. Slocombe himself said, the idea of Mr. Clark's notion was to get his money out, or some of his money out. What does that mean, his money? It's the money that he earned when Basin was operating as a corporation, and it's been sitting in Basin, and earning some profits. That's the money that he's got.

And this question of whether he bailed it out or not is not a factual issue, it's just an objective characterization of what's gone on by having the money come out.

One more point that I would like to make is this notion of whether the Government is bifrocating the transaction, or just looking at it in isolation, while Respondents arguably isn't. Obviously they're looking at it in isolation also, by focusing on this change of interest, this hypothetical change of interest, as

Justice Stevens says, if he had taken more stock or less stock.

What happened here is that he went from a 100 percent owner of a corporation down to a 1.3 percent, I guess it is, owner of another corporation.

Now, if you look at the whole transaction, obviously it can't make any serious difference whether he went from 100 percent to 1.3, from 100 percent to 0.9, or 100 percent to 1.15. None of that matters.

So, if you look at the whole thing, there's just this change of interest basically falls out. And if you try to apply the redemption provisions as they try to do, that difference becomes clear, because the reason why the Service, in these rulings that have been cited by Respondent does not require dividend treatment for a small change in interest by a minority shareholder, is because a minority shareholder -- that kind of distribution to a minority shareholder is not regarded as a dividend, because a minority shareholder doesn't have the power to declare a dividend to himself.

But here, Clark wants to treat himself as a minority shareholder by looking at the transaction from a post-Hope way. But of course he isn't, really. He started as a 100 percent shareholder who could have declared these earnings and profits out to himself from

Basin at any time, and that's essentially what's happened.

I think all of what the Respondent says about change in interest, etc., etc. would all apply equally if in fact Basin had distributed this as a dividend before the reorganization -- say, the day before. His interest in the continuing corporation would have ended up being less. It would all come out to be the same.

Yet, it would still have clearly been a dividend in the 316.

QUESTION: Yes, but you keep giving the example that if they had done it a little different -- if you had also sold 30 percent of the stock for cash, and then two weeks later entered into a statutory reorganization, you would get capital gain.

You don't have to change the facts very much to make the answer very easy. The problem is --

MR. HOROWITZ: Well, if you do it only two weeks later -- I mean, there's a question, when you have --

QUESTION: Well, whatever the period would be to get you, get the IRS off your back.

MR. HOROWITZ: Well, he didn't do it that way. I would just point out -- I don't want to get into an argument, but it would have been a different transaction if you look at 3739 of our brief.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Horowitz.

The case is submitted.

(Whereupon, at 10:55 o'clock a.m., the case in the above-titled matter was submitted.)

CERTIFICATION

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NO. 87-1168 - COMMISSIONER OF INTERNAL REVENUE, Petitioner V

DONALD E. CLARK, ET UX.

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BY Judy Freilicher

(REPORTER)