OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: NEWARK MORNING LEDGER CO., AS SUCCESSOR

TO THE HERALD COMPANY Petitioner v.

UNITED STATES

CASE NO: 91-1135

PLACE: Washington, D.C.

DATE: Tuesday 10, 1992

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IN THE SUPREME COURT OF THE UNITED STATES

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NEWARK MORNING LEDGER :

CO., AS SUCCESSOR TO THE :

HERALD COMPANY, :

Petitioner :

v. : No. 91-1135

UNITED STATES :

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Washington, D.C.

Tuesday, November 10, 1992

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 9:59 a.m.

APPEARANCES:

ROBERT H. BORK, ESQ., Washington, D.C.; on behalf of the Petitioner.

LAWRENCE G. WALLACE, ESQ., Deputy Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Respondent.

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PROCEEDINGS

(9:59 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument first this morning in Number 91-1135, the Newark Morning Ledger v. The United States.

Mr. Bork.

ORAL ARGUMENT OF ROBERT H. BORK

ON BEHALF OF THE PETITIONER

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

Newark Morning Ledger is here seeking a reversal of the judgment of the Third Circuit which denied a depreciation deduction on the Ledger's tax returns.

Now, the Ledger paid $68 million for the subscriber relationships of those eight papers when it acquired them, and there were -- these were enormously valuable, 460,000 subscribers, because of the subscription income they produced.

Now, these assets, the subscriber relationships, are wasting assets because they have limited lives, and for that reason Ledger seeks to depreciate them. There is no question here that Ledger proved the lives of these particular subscriber relationships and proved their value.

QUESTION: Suppose that no new investment is required to solicit new subscribers. I don't think that's the fact, but a hypothetical case. Would the case be any different if the new subscribers just automatically came without any promotion or subscription drives? Would your case be just the same?

MR. BORK: I don't -- it might not be just the same, Your Honor, but in fact you're addressing the Government's argument that these are self-regenerating assets, that they just continue, we'll have -- no matter what we do, we'll always have 460,000 subscribers. The district court found as fact that these are not self-regenerating assets, and that factual finding was not disturbed by the Third Circuit, so I think it is -- that's a question --

QUESTION: What about the hypothetical case?

MR. BORK: If we did nothing and got no new subscribers, is that the question?

QUESTION: Yes.

MR. BORK: No, we would have a wasting assets. We would have what we -- the paper would be gone at the end of the subscriber relationships.

QUESTION: But -- I recognize the finding isn't challenged. I just find it hard to grasp the case because our common knowledge tells us that many businesses will have renewed patronage just because of their reputation and the quality of their product.

MR. BORK: Well, I suppose there would be some renewed patronage in that way, but the fact is that all newspapers, particularly in this era of declining readership, but all newspapers, including Newark Morning Ledger, spends a great deal of money and effort trying to get new subscribers to replace the ones that disappear, so they just don't automatically -- new subscribers just don't automatically appear, and the district court so found they do not.

QUESTION: Mr. Bork, I didn't understand the Government's argument to be that these regenerate themselves. Rather, I thought their argument was they really don't regenerate themselves.

You have to make expenditures to retain your subscribership, but the Government does not require those expenditures to be capitalized because those expenditures are not going towards maintenance of a capital asset, and it's consistent with that not to allow you a depreciation on that so-called asset.

MR. BORK: Those expenditures would have to be capitalized but for section 173 of the code, which makes a special case for newspapers, and it's --

QUESTION: So you think in other businesses that have similar arrangements they would have to be capitalized?

MR. BORK: You mean if they are getting new -- if -- take in the case of a machine, suppose this were a printing press we're talking about. We have to -- you'd have to have maintenance on the machine. Suppose it has a 10-year life, you would amortize the cost over 10 years, but you would also have maintenance on the machine to make it last 10 years, and that would be expensed.

However, if you put -- if you did things to the machine to make it last 15 years instead of 10, the additional time would have to be capitalized, but the maintenance of the machine is not.

QUESTION: Under 173 some may be capitalized, may they not be? Aren't there regs under 173 that allow some capitalization?

MR. BORK: I wasn't aware of that, Your Honor. It seemed to me that -- I know that we take them as expenses, the cost of maintaining and acquiring new -- old subscribers and acquiring new subscribers.

QUESTION: May I ask you a different -- no, go ahead.

QUESTION: Before we get off that, but what -- isn't it the case that the maintenance that is put into this is precisely the kind of maintenance you're talking about? It's the kind of maintenance that is designed to make it last forever.

MR. BORK: Oh, no.

QUESTION: It is designed to make it last not just 5 years, whatever the normal period would be, but as long as the newspaper is in business.

MR. BORK: We're talking about individual subscriber relationships which have been valued here. The maintenance that is put in to maintain existing subscribers is to maintain them for the limited life which has been estimated, not to extend them beyond that. The cost of acquiring new subscribers is a separate asset all together. The subscriber is a separate asset.

For example, if you had -- one of the more illogical contentions in this case by the Third Circuit and by the Government is that we could depreciate the subscriber relationships if they were in fixed-term contracts.

Now, I hope this goes to the question we're discussing. Assume that Newark Morning Ledger had 460,000 fixed-term contracts with its subscribers. Those, the Government will admit, could be capitalized and depreciated.

Then, Newark Morning Ledger begins to expend moneys and effort to get new subscribers under fixed-term contracts. At the end of the life of the fixed-term

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contracts that it purchased, when they're all gone, let's assume that Newark Morning Ledger would still have 460,000 fixed-term contracts with subscribers.

Those are a different asset all together, so there's no question of a double deduction or anything of that sort. They purchased and capitalized the existing subscriber relationships as they tried to get new subscriber relationships, those were expensed under 173 -- different assets all together.

QUESTION: Is it true that -- leaving aside the question of fixed-term contracts that you've just been addressing, is it true that in principle, if it is possible to predict an average definite life for your subscriber base which is in issue here, that in principle the same thing could be done with respect to your basis in newsstand sales, and the same thing could be done with respect to the value of your advertising base?

MR. BORK: The same thing -- we found it impossible to do it with respect to either newsstand sales or advertising, which is much less -- fluctuates much more, and is much less certain, and the issue here --

QUESTION: Is it because there was just not a fact base upon which the expert could testify, or because there was something in principle that made it impossible to develop that fact base?

For example, couldn't people have gone out and surveyed the people buying papers at the newsstand and found, based on their answers, that, you know, most of them buy the paper 5 days a week and have done so for the last 20 years, or whatever the case may be, and if you got a sufficient factual base, couldn't the same kind of prediction be made?

QUESTION: Yes -- allow me to correct something I just said before I answer your question, Mr. Justice Souter, and that is I think we could have done it on the advertising. It would be must less certain.

On the newsstand sales, that -- maybe if you did an intensive study and it turned out that newsstand purchasers were the same people, maybe you could do such a thing. However, there's nothing wrong with that.

In fact, that's a healthy development, because then you would know that they had limited lives and that you would have a wasting asset, and you would depreciate it, which fits the basic premise of the tax code of matching your expenses with your revenue to come up with net income, so if it were possible to do these additional things, that would be good from the point of view of the tax code.

QUESTION: It might well be wholly consistent with the code, but the effect of it when you were all done would be that there would be little or nothing left of what we speak of as goodwill, and that may be okay.

MR. BORK: That would vary from case to case. These are -- you know, these are fact-bound cases, and there would be cases in which there would be a great deal of goodwill and cases, I suppose -- there are cases in which there is no goodwill.

QUESTION: But the more intensively you study each situation, the less total goodwill you would end up with under your theory.

MR. BORK: If, by new statistical techniques, Chief Justice, and computers and so forth and the things that are developing, and new accounting techniques, it became possible to give determinable lives to these other assets, that's right, they would no longer be goodwill, because, as the Government concedes, and has conceded in its regulations and in its revenue rulings, the defining characteristic of goodwill is that it does not have a determinable life.

If you can take some body of relationships and give them a determinable life, they are not goodwill, and there's nothing wrong with that, because what that does is give you a more perfect match between the cost of producing the income -- the revenue, in order to get the net income.

QUESTION: Mr. Bork, does something which does not have a determinable life acquire a determinable life simply by being aggregated with other items that do not have a determinable life and subjected to statistical probability?

I mean, the fixed contracts you gave as a hypothetical before, if you had fixed contracts with subscribers, each one of them would have individually a determinable life -- 5 years, 2 years, 1 year.

Each of these subscriptions that we're arguing about today do not have any determinable -- if you had to make a judgment as to one individual subscriber, what the determinable life was, you'd have to say, gee, I don't know.

MR. BORK: Your Honor, we did that. We did that. We did individual subscribers, and let me describe the process.

This is a process the Government uses in its cases, too, so it's not a -- there's nothing unique about it.

We took samples from the 460,000 subscribers, a statistically significant sample -- and there was no objection by the Government to that technique, and they couldn't because they use it themselves in other cases -- took samples and then determined what percentage of subscribers had been subscribers from zero to 1 year, 1 to 2, and so forth, up to 40 years, and then over 40, and so we in effect had through the sample technique a determination of each individual subscriber's life. These are particular subscribers. This is not one big lump of assets.

QUESTION: In the sample.

MR. BORK: Well, that's right, but the sample is statistically accurate.

QUESTION: But for the rest, you're making a statistical generalization. You don't -- you couldn't really point to an individual subscriber and say, the life of this subscriber is, except for the few that you did in the sample.

MR. BORK: Well, that's true, Justice Scalia, but the fact is, that's the way these cases are tried. That's the way the Government does these things, too, and if the sample is inadequate so that it doesn't accurately reflect the whole, then that could be objected to. That was not objected to here. The sample was fine.

QUESTION: Mr. Bork, I had thought maybe your theory could be applied just to the situation where the subscriber has to take an affirmative act to stop the subscription, the kinds of lists where there's an inertia factor, if you will, rather than -- is that important, do you think, in making it possible to make a statistical analysis here --

MR. BORK: I think it is important, Justice O'Connor --

QUESTION: That inertia factor?

MR. BORK: I think it is important. That's the reason that distinguishes these subscriber relationships from the people buying at newsstands.

QUESTION: Is that why it's a little closer to a fixed contract?

MR. BORK: That is why it is the same as a fixed contract under the regulation. I should say that we are really relying upon the plain language of the statute and the plain language of the regulation.

QUESTION: Do you think the regulation, that last sentence saying you can't depreciate goodwill, is consistent with the statute?

MR. BORK: Oh, yes. The statute doesn't even mention goodwill. From our point of view, it's certainly consistent enough, because we don't want to depreciate goodwill, but it's quite clear from the face of the regulation -- I should say this with apologies. We misprinted the regulation in our brief. However, none of the relevant language was misprinted, and -- there we are.

But none of the relevant language is misprinted.

But the regulation says that an intangible asset is depreciable when it is known from experience or other factors that its life is limited and the length of that life can be estimated with reasonable accuracy.

Now, that makes an at-will contract the same as a fixed-term contract.

QUESTION: But why is it that you can define the asset in the way you choose, just because a portion of the asset has a useful life, i.e., the current subscribers?

MR. BORK: I'm not --

QUESTION: It seems to me that when you purchase a business, one of the things you purchase is goodwill in the sense of -- the classic sense of renewed patronage --

MR. BORK: Well --

QUESTION: And simply because a statistician can take out of the continuous patronage pool the existing subscribers, I don't know why that makes it a separate asset.

MR. BORK: Well, it is quite obviously -- we paid $68 million for this asset, so that I would say that that's a separate asset, but --

QUESTION: Well, I have trouble with that, because it seems to me that if you knew the newspaper was going to last for only 20 years you might have paid less than $67 million.

MR. BORK: Oh, sure. There is going concern value, and there is goodwill, and there are other things, but this is a defined asset, and we rely here, Justice Kennedy, on the regulation and the Government's explanation of this regulation.

You see, the fact is that this regulation we're dealing with now first came into effect in a slightly different form in 1919, not in 1927, as the Government says, and it said that if an intangible asset is known from experience to be of value for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, and I think this becomes important.

Then it said, there can be no such allowance in respect of goodwill, trade names, trademarks, trade brands, secret formulae, or processes. Now, every one of those is an intangible with no limited life.

Now, when Prohibition was upon us, the IRS thought that the goodwill of a brewery or a distiller had a limited life, because Prohibition was going to cut the business off. The court later said that it still wasn't -- goodwill still couldn't be depreciated because it didn't fit the statute in terms of being exhausted or worn out, it was cut off by law.

But the IRS, when it allowed for the time being the depreciation of goodwill, said that the principle of depreciating assets whose -- depreciating intangibles whose life is limited overrides the statement in the regulation that goodwill is not depreciable. The rule of limited life requiring depreciability was said to be controlling.

Now -- and in fact the current revenue regulation -- ruling states that it was issued to remove any implication that customer and subscription lists are as a matter of law indistinguishable from goodwill. It further states that the depreciability of assets of this nature is factual issue, so what we have here is a continuing course of a code, a regulation beginning in 1990 and up to date, a revenue ruling which is now in force, all of which contradict the Government's per se approach in this case.

QUESTION: May I ask you a question that keeps troubling me, Mr. Bork?

You start out with 460,000 paid subscribers and then in a period of years -- what is, 5 years? Whatever period -- there will be a turnover, and you assume those 460,000 have been replaced by another 460,000, so the original 460,000 is a wasted asset and the others are brand-new.

But say you had exactly the same situation with your newsstand circulation. You had 460,000 people on your paid circulation from newsstands, and you could statistically find out that there's a turnover in 3 years of those.

Why can't you -- why wouldn't your theory require also treating the people who were there at one time and had been replaced by others as a wasting asset in that branch of the business?

MR. BORK: Well, I suppose it could, Justice Stevens.

QUESTION: In fact, it would, wouldn't it --

MR. BORK: But I suggest --

QUESTION: Not just could? It seems to me it would have to --

MR. BORK: Yes, but I think that's --

QUESTION: If you have the accounting technique to prove it.

MR. BORK: That's right, and I think that's my point.

QUESTION: But you wouldn't know what the base was.

MR. BORK: Well, I'm assuming -- I think Justice Stevens is assuming --

QUESTION: That you would capitalize what?

MR. BORK: That we know who the -- who's buying papers at the newsstand.

QUESTION: Well, I know, but what figure would you be depreciating?

MR. BORK: The figure of the regular newsstand purchases.

QUESTION: How you would value this asset that you're talking about?

MR. BORK: Well, first you'd have to do something we currently can't do. First you'd have to study it and find out what the lives were of the people who buy at newsstands.

QUESTION: Well, I know, but say this is a depreciable asset, how much are you going to depreciate each year?

MR. BORK: Well, it depends on the life. If it's --

QUESTION: Well, I know, but you have to have something to subtract from.

MR. BORK: Oh, yes, that's right.

QUESTION: So what do you do, capitalize the expenses?

MR. BORK: No, you'd capitalize the income from the people who purchased -- the present value of the income, and you'd amortize that, but we're currently unable to do that.

But my point is, if we were able to do that, that would be good from the point of view of the tax code, not bad, because it would match costs and revenue to produce net income more accurately than we can now do it.

QUESTION: It would only match costs when you sell a business. It wouldn't match it in an ongoing business, because you'd expense the costs of developing those sales --

MR. BORK: That's right.

QUESTION: As either the paid subscribers or the newsstand sales are expensed, as you develop them. It's only when you sell to a new buyer who will pay a premium for it, and then your premium is really what you're going to amortize.

MR. BORK: The seller when he sells will pay the tax on the sale, and the purchaser, just as a printing press, will take what he paid for it and use it as the basis for amortizing.

QUESTION: But I would suppose in future purchase transactions they would always negotiate an allocation for these various items and have some basis, and then try and defend it later with expert testimony as to what -- you know, capitalizing it and so forth.

MR. BORK: Well, I think you're positing a case where perhaps some fraud is involved. That is not what happened in this case. We did not negotiate.

QUESTION: No.

QUESTION: You didn't -- this sale didn't negotiate the value of the customer lists.

MR. BORK: They --

QUESTION: You allocated -- the company allocated what it thought was a fair allocation.

MR. BORK: Yes. It had accountants and statisticians, and I might say --

QUESTION: Of course, if they'd bought assets instead of stock, they would have had to make an allocation.

MR. BORK: Yes, true. But what I'm trying to say is that none of that was challenged. I mean, the --

QUESTION: I understand.

It does seem to me that your position -- it may well be right. I'm not -- that doesn't go to that, but your position it seems to me will, in time, given the techniques that are available now for computing all sorts of things, would mean that goodwill would seldom be -- there would seldom be any goodwill left in the sale of the business.

MR. BORK: I really can't --

QUESTION: I think in this case if you'd had the -- because you're pushing a little bit. If you wanted to push your theory all the way, you could really have capitalized your newsstand sales and your advertising relationships, too.

MR. BORK: Well, I think if we could have, Justice Stevens, we would have, but we didn't.

(Laughter.)

QUESTION: Well --

QUESTION: That's the next case.

QUESTION: Only a small amount of goodwill -- relatively small amount of goodwill was left over in this transaction.

MR. BORK: $22 million.

QUESTION: Yes.

QUESTION: Mr. Bork, do you think that the Commissioner of Internal Revenue is entitled to some deference here in saying we're not going to treat this like an annuity, we're going to treat it like a nonwasting asset?

MR. BORK: I think not, Justice O'Connor, the reason being that the commissioner's position has been all over the lot in these cases, and his litigating position is different from his position under the revenue ruling and under the regulation, so I don't there's any -- the commissioner is entitled to any deference here.

In fact, I think if deference is owed here, it would be to the tax court, which has a great deal of expertise in this field, and this Court, as I believe, has from time to time recognized some deference to the tax court, and the tax court uniformly rules our way.

QUESTION: Well, you say the tax court is entitled to deference in a way that the commissioner is not in the case of an Internal Revenue matter?

MR. BORK: Well, the commissioner -- no, no. I say the commissioner is not in this case, Chief Justice, because the commissioner's position has changed, and because his position runs contrary to the regulation and the revenue ruling.

QUESTION: Is it the Government's position --

MR. BORK: Before -- may I continue to answer that for a moment?

QUESTION: Of course.

MR. BORK: In the court -- in the district court, the commissioner -- the service took the position that this was a factual issue, just the position we took. It wasn't until they lost and went on appeal that they switched to a statement that no, this is goodwill as a matter of metaphysics, or it's the essence of goodwill, and begin to argue a legal position.

So I don't -- that's an additional reason, I think, why deference is not required, since they took an inconsistent position in the district court with the one they took in the court of appeals and the one they take here.

QUESTION: But it would be unusual in this case, which came up not through the tax court but through the district court, to say that some other decision of the tax court is entitled to some special deference.

MR. BORK: Well, I think it's entitled to some deference, Your Honor, simply because they analyzed the same problem, the same statute, the same regulation, and arrived at the result that if you can give a wasting, intangible asset a determinable life with reasonable accuracy, then it is not goodwill.

QUESTION: Well, you say it should be accepted because it's sound analysis. I presume that's true of any decision.

MR. BORK: Well, that's right. Well, I think something is due to something -- if you don't want to call it deference, I won't call it deference, but some persuasive force, I think, is -- should be accorded to the tax court when it faces these things and has a good deal of expertise in these matters.

QUESTION: May I state the question just a little differently that troubles me, and I'm -- as I'm really not sure of the answer at all, but you describe the wasting asset as the relationship between the newspaper and the existing subscribers, so that even though you have 460 subscribers today, and 460 different subscribers 5 years later, you still say that's a wasted asset.

I think normally when one buys a business, you say you get the same number of customers 5 years later, it's a little difficult for me to perceive that as a wasting asset --

MR. BORK: Justice Stevens --

QUESTION: Whether it's newsstand or subscriptions.

MR. BORK: Justice Stevens, if we bought a machine, a printing press, and it had a 10-year life, and you looked at the end of the 10 years -- and we still had the printing press -- you wouldn't deny depreciation on the machine we bought, because we --

QUESTION: No, you wouldn't, but you would have capitalized that. You would have capitalized that machine when you bought it, and it's rather strange that you have a wasting asset when you buy a business, but you don't when you just continue to operate it.

MR. BORK: You don't, because of -- well, for a couple of reasons, one if it's just maintenance, then it's expense rather than capitalization, and the other is, in the newspaper business section 173 says that the cost of acquiring new subscribers is to be expensed rather than capitalized.

QUESTION: So you're forbidden to capitalize it.

MR. BORK: I believe so, but I'm not -- I don't have the --

QUESTION: I mean, you may -- you may expense it, but --

MR. BORK: You may -- I'm not sure whether --

QUESTION: In which event, if you do, you don't capitalize it.

MR. BORK: Oh, if you do, you don't capitalize it, no.

QUESTION: But you think it forbids you to capitalize.

MR. BORK: That, I must confess, I'm not entirely sure about.

QUESTION: I suppose you'd rather expense it than capitalize it.

MR. BORK: I certainly would, Your Honor.

QUESTION: Even though it was a wasting asset -- became a wasting asset.

MR. BORK: Well, but the code allows it, and I don't think we're -- I don't think we're -- I don't think we're forced to say the code is wrong about what we're entitled to do.

QUESTION: Is it your view -- and this came from your reference to the tax court cases -- that neither the Government nor the tax court has any definition of goodwill, other than residual value?

MR. BORK: There is no definition of goodwill that's agreed upon by anybody. The statute -- the code does not mention goodwill in the wasting asset thing. The regulation does not define it.

I think if you read the regulation, it's clear -- the regulation breaks in two. The first part says, a wasting asset with a determinable life is depreciable, and it gives examples.

Then it says, wasting assets with a life that can't be determined is not depreciable, and it says goodwill.

QUESTION: So the Government simply must resort to the idea that continued patronage is the essence of goodwill as an ipse dixit.

MR. BORK: I think it is an ipse dixit. I don't know where it comes from, except just general description that people -- but they use different descriptions.

But the fact is, there is a simple bright line test in the regulation which says, determinable life, depreciable, nondeterminable life, nondepreciable. The

Government throws in a wild card, says, but ah, there's goodwill, which is neither of those two things, but it trumps everything else. That produces chaos.

We have a bright line test which the Government is trying to muddy to win this case.

QUESTION: Mr. Bork, may I ask you how your expert dealt with this distinction between the classic case of the machine with the 10-year life and the subscriber base that you're talking about?

In the machine with the 10-year life, we assume it's got a 10-year life because we assume that people will do simple ministerial things like oiling the machine and feeding it with whatever it takes to keep it going.

In the case of a subscriber base for a paper, however, the variables are a lot more subtle, because they include, among other things, the kind of editorial behavior of the paper.

I mean, if they make a guess about how racy the ads may be and still keep subscribers, that's going to cost money. If they change from a Clinton position to a Perot position, that may cost them subscribers.

How does the expert deal with all of these, I would suppose potentially unpredictable value choices that the owner of the paper may make in making the prediction about how long the asset will survive?

MR. BORK: Well, I think he assumes that the business will run pretty much as before, but let me say to you, Justice Souter, I think that same argument would apply to the printing press.

If a paper is running along with a half-million subscribers and makes a bad guess about what will appeal to subscribers so that it loses subscribers, loses half of the, the printing press is less valuable, and it --

QUESTION: Yes, but there's still a market for printing presses, and --

MR. BORK: Well --

QUESTION: And you can't say that there is a market for subscriber bases as opposed, perhaps, to subscriber lists in a given community.

MR. BORK: Well, there is a difference of opinion about whether there is a separate market for a subscriber base, but that's because people do purchase a paper and purchase the -- pay money for the right to go to those subscribers.

QUESTION: But then they're just buying names.

MR. BORK: Names and information.

QUESTION: Yes, but you're depreciating more than just names.

MR. BORK: Oh, that's right.

QUESTION: Yes.

MR. BORK: But I'm saying, as to a machine, a printing press that you had to pull out of a plant and sell on the open market would not be nearly worth as much as it would be in an ongoing newspaper, so that you have the same kind of variables determining the value of tangible assets as you do this intangible asset.

QUESTION: Mr. Bork, I take it you would be perfectly willing to win this case on the basis that it's limited to a situation where you buy a customer list.

MR. BORK: Well, we buy more than a specially defined customer list. We buy not just the names, we buy people who have already subscribed and are known as seasoned subscribers --

QUESTION: Yes.

MR. BORK: And they're very valuable, so it's not just a list that we can go out and talk to people.

QUESTION: Well, I know, but you would be glad to limit this case to where you do buy whatever it is you call it, a customer list, or seasoned customers, where you actually pay money for it.

MR. BORK: Oh, yes. Oh, yes. That's what we did.

QUESTION: Well, I know that's what you did, but I take it your argument would be that even where you are not buying a company, you just have an on-going business with seasoned customers, that your theory could apply to that.

MR. BORK: It applies only when you purchase the asset, Justice White.

If we are maintaining -- if we didn't sell the paper, we just maintained the customers by continually -- then those are expenses. We can't --

QUESTION: Well, that would be a newspaper. That's because of the provision --

MR. BORK: Oh, yes.

QUESTION: Suppose you bought assets, and you actually negotiated a figure for the customer list, as you call it. I suppose there would be no question that you could depreciate that.

MR. BORK: I think that's right, Your Honor.

You know, we have the same -- the cases discuss the very similar circumstance in which a bank buys another bank and wants to capitalize and depreciate the core deposits, which are at-will relationships, and the courts uniformly find that those deposits can be capitalized and depreciated.

QUESTION: Thank you, Mr. Bork.

MR. BORK: Thank you.

QUESTION: Mr. Wallace, we'll hear from you.

ORAL ARGUMENT OF LAWRENCE G. WALLACE

ON BEHALF OF THE RESPONDENT

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

Petitioner's complaint is that the commissioner disallowed it to take depreciation deductions for the value of its customer base when both as a matter of fact shown in this record and as a matter of assumed economic behavior under the statute and the regulations, the customer base has not been depreciating.

Petitioner's own statistical expert testified -- and this is reproduced on page 94 of the Joint Appendix -- that in the years under examination here the circulation of the papers remained constant. There was some turnover in the particular subscribers, but the circulation remained constant.

And under the statute and the regulations, it is not the case that everything measurable is ipso facto amortizable. As the Court of Appeals for the Fifth Circuit stated in the Houston Chronicle case, which petitioner in its brief says is the landmark decision in the area although petitioner did not refer to the case in the oral argument, in order to be depreciable there must be a value separate and distinct from goodwill that is eroding predictably over a period of time.

Now, the value in what petitioner refers to as its customer relationships, the property that petitioner has -- because it's only property that under 167 -- section 167 of the code -- that can be depreciated. The property is not the tangible property in the persons of the subscribers. Of course, persons are mortal, and erode over time. The -- it's an intangible asset that was paid for that is symbolized by the subscription list, and the intangible asset was the expectancy of continued patronage that it symbolized.

QUESTION: Is it really only that? I mean, isn't -- if a newspaper goes out of business and does not sell its business to anyone else, certainly somebody out of the blue can't come up the next day and begin delivering me newspapers, and then bill me for those papers.

Isn't what they were selling the right to deliver papers with the expectation of being paid for those papers unless and until the recipient says, deliver them no more? Isn't that a contractual right, something beyond mere goodwill?

MR. WALLACE: Well, the value that was measured here was a projection of the expected duration of continued patronage by these particular customers. Of course there was an on-going business here for which a premium was paid over the ascertainable cost of the tangible and depreciable, intangible assets, and the ongoing business included this so-called relationship with customers, the habitues of the paper.

QUESTION: It's not just a relationship with customers, it seems to me. You have a relationship with customers who buy off the newsstands, but you have a contractual right with respect to these subscriber customers. You have a contractual right to drop a newspaper on their doorstep and receive a payment for it --

MR. WALLACE: Even --

QUESTION: Unless and until they cancel the subscription. That's a contractual right.

MR. WALLACE: Even when there's a contract for a term, if it's one where regular renewal is anticipated, the commissioner does not allow depreciation for that term contract because that is just a symbol of an expectancy of continued patronage.

QUESTION: Even if you have thousands of such contracts and you can show statistically that a certain percentage of those thousands will invariably be renewed?

MR. WALLACE: Well, that's exactly the point, that the likelihood of renewal of a continued -- that it's really just an evidence of a continuing patronage, even though the particular contract may be for a few months time or a year's time.

If someone buys an apartment building and there are many tenants there with 1-year leases or portions of remaining 1-year leases, a large percentage of which are going to be renewed or going to stay on as month-to-month tenants, the commissioner doesn't allow depreciation for the remaining term of the existing leases of the tenants who are in the building.

QUESTION: What if it's a lease that continues from year to year unless affirmatively cancelled? Let's assume it's a year-to-year lease.

MR. WALLACE: Well, that's what most tenants have a right to do when their lease expires, is to stay on until they give notice that they're moving with a month-to-month notice provision. I mean, it's -- that's not depreciable.

QUESTION: Well, there just isn't any depreciation. If you call it an asset, it isn't depreciating --

MR. WALLACE: That's correct --

QUESTION: Because it's constantly renewing.

MR. WALLACE: And that's the same situation we have here. I mean, there are innovations in the elaboration of proof that can be offered, but it was never assumed that the old customers resorting to the old places, as goodwill is sometimes described, were immortal, and --

QUESTION: So that the phrase is wrong? So that it should be that new customers will come to the old place?

(Laughter.)

MR. WALLACE: Well, it's an expectancy of continued patronage in whatever forms.

QUESTION: Well, is the mistake of the taxpayer here trying to make divisible what's really a single asset? Is that your position?

MR. WALLACE: That is part of our position, and we've pointed to cases in which owners of land or stocks have tried to give themselves a term of years' interest in what they own in order to try to depreciate over that term of years, and that has been disallowed in the case law.

QUESTION: But there is a finding of the district court that the customer base is not self-renewing.

MR. WALLACE: Well, it's not self-regenerating. The finding was not elaborated upon. It was characterized that way. It's not self-regenerating in the sense that a forest is self-regenerating because the trees sprout up again from the seedlings.

QUESTION: Well, I don't know about the behavior of these newspaper subscribers, but --

MR. WALLACE: No business has --

QUESTION: But the experts said that they could value this and that these people would not be subscribers after more than -- well, 14 to 21 years.

MR. WALLACE: Well, of course it can be valued, there was evidence of that, but not everything measurable is amortizable, as I said. It has to be separate and distinct from goodwill, and the essence of goodwill is the expectancy of continued patronage.

Their actuarial analysis of the old customers has been available as long as we've had a life insurance industry.

QUESTION: Well, Mr. Wallace, isn't it possible to say that when proof and findings such as were made here, then it takes it out of the definition of goodwill and puts it squarely within the meaning of a statute as a wasting asset? I mean, it seems to me that's the argument you need to address.

MR. WALLACE: Well, as a matter of fact, the customer base was not a wasting asset, as I pointed out.

QUESTION: Well, was that a finding here in the district court that it was?

MR. WALLACE: The district court said that it was irrelevant whether the subscribers were in fact increasing, so the district court did not make a finding. He said that the Government offered proof that in fact the subscription list was increasing overall in these newspapers, but that that was irrelevant.

QUESTION: Well, Mr. Wallace, I thought the $68 million was the value to the paper of just the existing seasoned customers, whether or not they ever got any subscribers at all to replace them. They just -- what value is it to sell papers to this particular group of 400,000 plus subscribers?

MR. WALLACE: That was projected income --

QUESTION: Isn't that right?

MR. WALLACE: That was -- not exactly. I'd have to qualify. That was projected income to be received from these --

QUESTION: From those 400,000 people.

MR. WALLACE: On the assumption that the newspaper would still be in business to receive it, but if it didn't do anything to generate additional customers, it would be unlikely to be able to receive it, and it would be unlikely to continue to have advertisers, which are the major source of income for a newspaper.

It was a portion of the expectancy of continued patronage that the newspaper was looking forward to over the life that these customers and others would be patrons.

QUESTION: It nevertheless measured its value by the expected income from these 400,000 subscribers, isn't that right?

MR. WALLACE: It tried to break away from the overall expectancy of continued patronage what they would expect to receive from the particular customers at the particular time.

I think some light could --

QUESTION: I suppose you can say if you can give a value to goodwill it must be because they're going to have just -- they expect to keep the same number of customers or more over the years.

MR. WALLACE: Well, their goodwill depends on the same number -- the same persons.

QUESTION: In which event, there's no depreciation.

MR. WALLACE: Well, that's right, there's no depreciation of goodwill in whatever form it takes. Sometimes goodwill is dependent primarily on location of the business.

QUESTION: That means that we, if you're going to prevail in this case, have to define goodwill in a way other than the residual value which you yourself set out at page 3 in your brief.

It seems to me that you want us to say that the essence of goodwill is renewed patronage, and make that a rule of law, and there's obviously some common sense appeal to that, but --

MR. WALLACE: And it is recognized --

QUESTION: But it seems to me it is not consistent with the residual definition that you yourself embraced in the case.

MR. WALLACE: Well, we don't -- there's some confusion between the residual method of allocating the purchase price and after you've allocated the purchase price to all the other assets that can be identified, the premium left over is what is associated with goodwill and with going-concern value, both of which are nondepreciable.

QUESTION: So you say we have to define going-concern value?

MR. WALLACE: Going-concern value is an accounting concept that is associated largely with the fact that facilities are in place, and particularly with the fact that there's a trained work force --

QUESTION: Well, what is the definition of goodwill that you want us to apply, other than the residual method of determining?

MR. WALLACE: Yes. Yes, the expectancy of continued patronage. That is --

QUESTION: Is the essence of goodwill and may not be depreciated.

MR. WALLACE: That is the essence. The commissioner's regulations, the most recent regulations on goodwill, which happened not to be in effect at the time of this acquisition but which petitioner relied on in his opening brief, we describe in some detail in footnote 23 on page 27 of our brief, and we show that under the regulations it's the Class III assets which are the ones that are residual after goodwill and going-concern value are allocated, so they have to have a meaning other than residual.

In the commissioner's own regulations, the terms of the commissioner's regulations show that the residual way of defining what goodwill is is inconsistent with the terms of the regulations as we point out in our analysis of the regulations and in the last sentence of that footnote, and petitioner did not choose to respond to that in petitioner's reply brief. Goodwill is looked upon that way.

I think it might be illuminating if I could give the Court some rather simply hypothetical examples of purchases of businesses which show that the actual expectancy of continued patronage will be roughly the same, even though the circumstances of the business vary dramatically and the rate of customer turnover that would be expected, and one example that I could give would be three separate purchases of three separate, similar, prospering fast-food restaurants.

In case A, the restaurant is in a residential area of a small to medium-size city such as these newspapers are published in, with a relatively stable population, and the customers consist in large part of young to middle-aged parents with their children, of young adults and teenagers who come in on their own, and the expectancy would be that, in another 10 or 15 years, many of these teenagers would be coming in as parents with their own children, many of the children presently coming in with their parents would be coming in as teenagers or young adults on their own, et cetera.

Case B would be a similar prospering fast-food restaurant located directly across the street from a college campus with dormitories, and it can be shown that more than 90 percent of the existing customers will turn over within a 4-year time, yet the purchaser's expectancy would be that 5 years from now he would have roughly the same number of college students eating in the restaurant.

Case C would be a similar fast-food restaurant prospering that is located in a service area along an interstate highway or at an airport, or across the street from the entrance to a resort such as Disney World. Most of the customers are seen for the last time when they walk out the door, or will come back only very seldom, but the expectancy is that the business will go on much as it has historically.

Now --

QUESTION: Well, Mr. Wallace, it seems to me that none of those examples involve the kind of thing we have here, which is a contractual arrangement to have a newspaper delivered at the door unless and until the customer says I don't want it any more, or a relationship that you might have as a depositor in a bank -- I want you to keep my assets until I terminate it.

MR. WALLACE: Until I withdraw them.

QUESTION: Now, none of your examples have dealt with that kind of situation, which seems to me to be able to be analyzed for its expected life in a different way than in the examples you pose.

MR. WALLACE: Well, only -- only in a very limited way. I mean, any individual can withdraw his funds from a bank account at any time. One of the amicus briefs said that a premium is paid for a bank location that has a large volume of core deposits, but is that premium paid because the purchaser thinks that this is a wasting asset, or because it's an indicium of the level of business that can be expected to be done at this particular bank location?

I mean, of course it's less daunting for the purchaser of a business to be faced only with the task of maintaining an existing level of patronage than to try to build up a level of patronage that is not already existing in the business.

It's an expectancy of future patronage that is symbolized, rather than a separate value. Any of these subscribers could, the day after the purchase, call up and say I don't want the paper to be delivered any more, and they would have no obligation except to pay for papers that they've already received.

That's not terribly different from the people who have an appointment at the beauty parlor for -- each week, and the beauty parlor is purchased. These people have the choice of whether to return or not to return. Even though it's not a contractual obligation, it's their habitual place to get a repetitive service done.

QUESTION: I --

QUESTION: Mr. Wallace, are you saying in essence that the fallacy in the argument on the other side is assuming that the value comes from the probability of certain people returning as opposed to the probability of certain people buying, and that if in fact the real value here is a probability of buying, which may or may not coincide to some degree with returning, then their whole analysis falls? Is that fair?

MR. WALLACE: Well, I would agree with that --

QUESTION: All right, then why didn't the -- and perhaps the Government did, but did the Government oppose, then, the relevance of the expert testimony, or perhaps, indeed, even the foundation for the expert testimony, about there being a probable -- I was going to say life expectancy to the asset.

Why didn't the Government say the expert's testimony is entirely irrelevant because we're dealing with something, i.e., the probability of customers coming, which does not have a clearly determinable period?

MR. WALLACE: Well, we didn't -- we in effect did. We said that we don't object to the proof as proof of what is being shown, which is how long these particular subscriber relationships may be expected to last, but that they do not show a wasting asset separate and distinct from goodwill. That was our legal position.

The problem isn't a failure of proof here, or that the proof was inadequate, it was that it didn't prove a depreciable wasting asset that was predictably diminishing over time. The customer base is what people are interested in.

QUESTION: Well, was that your position in the district court?

MR. WALLACE: So far as I'm aware, because --

QUESTION: Well, the -- your opposition suggests that the Government changed its position between the district court and the court of appeals.

MR. WALLACE: Well, I'm sure we refined it, as we often do, but we certainly did not take the position that they would be entitled to a depreciation deduction if they could show that the particular subscribers on the list would last over a particular period of time.

Many businesses can make a list of customers. Some of them could compile them from their charge account lists. Others have records of them at a medical clinic or what-have-you.

QUESTION: One question I'm not sure I understood in your dialogue earlier with Justice Scalia. We were talking about contractually based relationships, and in the court of appeals the court seemed to assume that you had agreed that if these relationships were contractually based, that then they would be depreciable assets, and then the question is, why doesn't that concession undermine your hypothetical examples and all the rest?

MR. WALLACE: Well, I am not aware that we conceded that contrary to all the case law --

QUESTION: Well, what the court of appeals said was, the service does not dispute that the value of the paid subscribers would constitute -- would not constitute goodwill if Morning Ledger's expectation of continued patronage were contractually based. Now, is that an incorrect statement of -- they say you didn't dispute it.

MR. WALLACE: If we -- we -- well, because it was not contractually based we didn't perhaps caution the court about the refinement between contracts that are expected to be renewed regularly, which are not depreciable, and term contracts that are.

QUESTION: But if the proper definition of the asset is given in terms of the probability of customers buying, as opposed to the probability of customers returning, or indeed, having to return, then you would not make that concession, would you? You would not concede that the existence of the contract should make any difference. That's just one incidental reason for which they might buy, and others will buy for other reasons.

MR. WALLACE: Well, the fact is that sufficiently long-term contractual obligations can be valued as a particular asset in situations where they don't represent just the normal short-term contracts that are expected to be renewed.

This is a difficult area of litigation. We've cited some of the cases for it. It's a difficult distinction to draw, but --

QUESTION: Your objection is not to the valuation rather than in principle to the depreciability.

Suppose it could be established that had -- you're in a town with one newspaper, and it could be established that if that newspaper just folded up and a new newspaper opened up the next day, it would acquire almost -- it would acquire 95 percent of the people who had subscribed to the previous newspaper, but it would not acquire the last 5 percent. Would not the value of the subscription list be a reality? Wouldn't it be worth 5 percent of the subscriptions?

You're saying that this contractual relationship had zero value. It seems to me it has some value, although it may not be the value of 100 percent of the subscribers of the newspaper. You might get 95 percent of them, even if you didn't have the right to drop your newspaper on their porch the next day and get paid for it.

MR. WALLACE: Of course it has value, and a subscription list that is sold separately from an on-going business that is to be continued can be evaluated for its value as a marketing tool by the purchaser, and it has value to the purchaser of the on-going business, but that value is put into its capital account and it is offset against the price received when the asset is sold, when the business is sold. It is not a depreciable wasting asset that predictably erodes in a determinate way over a period of years.

QUESTION: Oh, I can show that those 5 percent of subscribers that I would not have gotten if I had not had the right to drop the newspaper on their stand, they're just lazy. They would not have subscribed on their own. They're maybe elderly, and they wouldn't take the trouble to do it any more, but if they had the subscription they'd continue to pay for it.

I can show that that 5 percent I would not have had, and that that 5 percent will be gone in 3 years. I don't know why I shouldn't be able to depreciate that. It's a contractual value that I acquired from the outgoing newspaper.

MR. WALLACE: Well, it's contractual only in the sense that you have to hear from the subscriber to cut off the service of the particular subscriber, if, in fact, that would even be a transferable obligation to someone who wasn't carrying on the same business. I rather doubt that it would be legally transferable to a purchaser of it.

QUESTION: In your hypothetical regarding the fast-food chain across from the college, if it had been announced that the college was closing in 4 years, I take it an accountant would be required to depreciate the so-called goodwill, or the customer list, over 4 years.

MR. WALLACE: Well, it might depend on what was going to happen to those campus facilities, and I rather doubt that the purchaser in those circumstances would have paid a premium that could be attributed to --

QUESTION: Well, he might have paid for 4 years of revenue, and if it's measurable, it can be depreciated.

MR. WALLACE: The valuation of the rest of the assets that were bought would probably preclude any premium left over for goodwill for an expectancy of future patronage in a situation where the expectancy does not look good. It's only where a premium is paid that there's any asset of goodwill to start with.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Wallace. The case is submitted.

(Whereupon, at 11:01 a.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

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

Newark Morning Ledger V U.S.

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BY Ann-Marie Federico

(REPORTER)