OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: COMMISSIONER OF INTERNAL REVENUE, Petitioner v. KEYSTONE CONSOLIDATED INDUSTRIES, INC.

CASE NO: 91-1677

PLACE: Washington, D.C.

DATE: Monday, February 22, 1993

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IN THE SUPREME COURT OF THE UNITED STATES

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COMMISSIONER OF INTERNAL :

REVENUE, :

Petitioner :

v. : No. 91-1677

KEYSTONE CONSOLIDATED :

INDUSTRIES, INC. :

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Washington, D.C.

Monday, February 22, 1993

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

APPEARANCES:

CHRISTOPHER J. WRIGHT, ESQ., Assistant to Deputy Solicitor General, Department of Justice, Washington, D.C.; the on behalf of the Petitioner.

RAYMOND P. WEXLER, ESQ., Chicago, Illinois; 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. 91-1677, the Commissioner of Internal Revenue v. Keystone Consolidated Industries.

Mr. Wright.

ORAL ARGUMENT OF CHRISTOPHER J. WRIGHT

ON BEHALF OF THE PETITIONER

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

Under the funding rules established by ERISA, Keystone Consolidated Industries owed $9.6 million to the pension trust it sponsored in 1983. Keystone lost $21 million that year and decided not to pay the pension trust in cash. Instead, it contributed five truck terminals to fulfill its funding obligation to the pension trust. The next year it contributed real estate to partly satisfy its funding obligation to the plan.

Now, Keystone recognized that these transfers of property were sales or exchanges for purposes of the income tax laws, but Keystone maintains that they are not sales or exchanges for purposes of 26 U.S.C. 4975(c)(1)(A). Subsection (c)(1)(A), the provision at issue in this case, bars any direct or indirect sale or exchange between an employer and the pension plan it sponsors.

QUESTION: Mr. Wright, can I just get one question out of the way early? Would the trustee of the fund have been empowered to refuse to accept that kind of payment and insisted on cash?

MR. WRIGHT: Yes, the trustee could have. First --

QUESTION: So, this was acceptable to the trust to accept the assets in this form.

MR. WRIGHT: In this case, the trustee, who is also a director of Keystone Consolidated Industries, accepted the property.

QUESTION: You mentioned the director. Is there any claim that the -- I mean, does that make a difference in the legal issue whether the director is one who might not be totally independent or something like that?

MR. WRIGHT: No. There might also be a fiduciary duty breach action in a case of this sort. In fact, many such breaches were alleged and found by the district court in some related litigation, but this issue --

QUESTION: But do we -- for the purpose --

MR. WRIGHT: -- the issue before this Court, did not focus on the --

QUESTION: For the purpose of the legal issue we have, is it correct that we should assume, A, that the trustee has -- is an independent person and, B, has the authority to refuse to take anything except cash?

MR. WRIGHT: Yes. Yes, and it's probably the case that the trustee probably should have refused to accept this property.

QUESTION: That we shouldn't --

MR. WRIGHT: But they did not.

QUESTION: All right.

QUESTION: Mr. Wright, I take it there's no question of the valuation of these properties.

MR. WRIGHT: No. We do not contend that the property was overvalued here.

QUESTION: So that that possibility of abuse is not in the case.

MR. WRIGHT: It's not in this particular case. That's right.

QUESTION: I suppose you would prefer or Congress would prefer, according to your theory, that the properties be sold first and the proceeds contributed to the --

MR. WRIGHT: Exactly, Your Honor, and --

QUESTION: Any why is that? To put the capital gain, if there is such, on the taxpayer rather than on the --

MR. WRIGHT: No, Your Honor. The capital gain -- Keystone acknowledged that this is a sale or exchange under the capital gain provision. We agree with that. Under anyone's interpretation, the tax consequences of this contribution to Keystone are the same here.

If I may return to your earlier point, however, one of the key things I'd like to make clear here this morning is that subsection (c)(1)(A) and the other prohibited transaction rules are phrased categorically. There is no question that even if a sale is for fair market value and everyone agrees, the language of the statute which prohibits any direct or indirect sale or exchange between an employer and a pension plan prohibits that transaction.

QUESTION: What I'm trying to get at is why would the Congress so provide.

MR. WRIGHT: Oh. I think Congress made that clear. It was replacing the arm's-length transaction rule, which had prevailed prior to ERISA, with this categorical rule because transactions of this sort are inherently susceptible to abuse.

You have already suggested one of the ways that abuse occurs and, in fact, did occur in the Wood case, the Fourth Circuit case where the court reached the conclusion that the Government agrees with. In that case, the employer intentionally overvalued the property it contributed to its plan.

QUESTION: While I have you interrupted, was either this case or the Wood case in the tax court reviewed by the full court?

MR. WRIGHT: No, no. No, Your Honor.

QUESTION: Mr. Wright, I take it that the IRS manual until 1989 indicated that a transfer such as this was allowable.

MR. WRIGHT: Not exactly, Your Honor. What the IRS manual said was that -- and let me make clear that this is, of course, an in-house manual intended for auditors, and everyone agrees it has no legal binding authority.

What the manual said was -- first, it had a sentence that said that if the terms of a plan allow, a pension plan may accept property. It then had an example. It said, for instance, a profit sharing plan may accept stock from the employer.

Now, those --

QUESTION: Did the terms of this plan allow the transfer?

MR. WRIGHT: Not as far as I know, Your Honor.

And, in fact, another point that I want to make clear today is that there is a big difference in the pension area between defined benefit plans, the sort of plans Keystone sponsored, and defined contribution plans like profit sharing plans, the plan discussed in the example in the manual.

QUESTION: Well, was there anything in this plan that addressed the subject of the nature of the annual contribution?

MR. WRIGHT: Not as far as I know, Your Honor. We would take the position that if a defined benefit plan allowed contributions of property to fulfill funding obligations, that that provision of the plan would be contrary to the terms of ERISA.

QUESTION: Well, the manual didn't really refer to that distinction.

MR. WRIGHT: No. No, Your Honor, it did not, but the example --

QUESTION: And so, if anyone -- if any taxpayer were looking at the IRS' own manual, they would have thought that if the pension accepted this property, it would have been all right?

MR. WRIGHT: Well, Your Honor, I think that if anyone went through the IRS manual, they should have been alerted by the example which discussed a defined contribution plan, and they should have -- it is our position that contributions of property may well be permissible to defined contribution plans. Those plans differ from --

QUESTION: Why is that, Mr. Wright? Because there's no sale or exchange?

MR. WRIGHT: Yes, Your Honor. A --

QUESTION: There is no sale or exchange because there's no obligation to contribute.

MR. WRIGHT: Exactly.

QUESTION: Isn't there an obligation to contribute some way or other than in the plan, i.e., the trust instrument itself?

MR. WRIGHT: In a defined contribution plan?

QUESTION: Yes.

MR. WRIGHT: Frequently, no, Your Honor.

QUESTION: They're just making gratuitous gifts?

MR. WRIGHT: They are not gratuitous gifts because they're deferred compensation to the employees, but as far as the plan is concerned, they're gratuitous gifts.

QUESTION: But they're deferred compensation because they're obligated under some contract --

MR. WRIGHT: No, Your Honor. The way defined contribution plans are frequently established is that the employer basically sets up individual accounts for each participant. Now, the plan may call for -- it may call for no contributions at all. It may simply set up a mechanism for distributing whatever contributions are made. It may also call for a percentage of profits to be contributed each year.

But these plans also almost always allow for excess contributions if the employer wants to contribute more than it has promised, if in fact it has promised anything. Those sorts of contributions are not required by any contract with the pension plan or any contract at all. And so --

QUESTION: Is it characteristic in those cases that there is no provision in the plan for crediting any excess contributions to -- let's say, to a future year's obligation, if there would be an obligation?

MR. WRIGHT: Your Honor, in a defined contribution plan, there is no future year's contribution. Section 412 of title 26, which sets out the minimum funding rules, applies only to defined benefit plans, the sorts of plans Keystone sponsored. It has no bearing on individual account plans.

Let me add in this connection --

QUESTION: But the contract can provide, I mean, whether the statute provides it or not. The contract can provide for future year payments.

Let's assume one that says you shall make this much of a contribution every year, and you may, in addition, make whatever beyond that you wish. So, in year one, the employer makes the minimum plus a lot. I think the question asked is whether that excess can be credited to the next year's. That would be entirely up to the terms of the contract, wouldn't it?

MR. WRIGHT: That would be, Your Honor. Now, I'm told that in many of these plans, what's -- if something is mandated, what's mandated is a percentage of profits each year. So, in that particular situation, presumably you wouldn't be able to credit those for future years.

But let me say in this connection that defined contribution plans are not some tail wagging the dog here. They actually outnumber defined benefit pension plans and are a very important part of the pension scheme here.

QUESTION: Well, in --

QUESTION: Mr. Wright, (c)(1)(A) talks about prohibited transactions, and there's a tax imposed on them of 5 percent. Are there any other consequences of prohibited transactions other than that they are taxed at a rate of 5 percent?

MR. WRIGHT: Well, if Keystone -- there's an additional tax if Keystone doesn't ultimately correct the transaction. It's actually a 100 percent tax, but

Keystone can correct the transaction even after it loses in this Court. So, in fact, it's very unlikely that the 100 percent tax will ever get levied.

There could be a fiduciary breach action, as I think I've already indicated, against the fiduciary alleging that it should not have accepted the property.

QUESTION: That would -- that could be based on the fact that that was a prohibited transaction under the Internal Revenue Code?

MR. WRIGHT: It certainly could, and even independent of that, it could be based on the fact that the fiduciary simply shouldn't have accepted this sort of property.

In this particular case, the truck terminals were quite illiquid, although the -- I think the reason Keystone didn't sell them and contribute the proceeds, which is what the Government thinks an employer should do, is because it was trying to sell them. They were hard to sell. In fact, the pension trust tried to sell them immediately, but it took 3 and a half years for the plan to sell one of the truck terminals.

And, of course, in addition, two of the truck terminals were subject to exclusive listing agreements calling for the payment of 5 percent sales commission to brokers. Real property is not easy to sell.

And, Justice Blackmun, I was trying to get this out as a second example of what Congress was clearly concerned about in this area. Besides the more easy to understand, straight abuse of overvaluing the property, what Keystone, in effect, did here was find a buyer for its truck terminals and transfer the transaction costs of sale to the pension trust along with them.

QUESTION: May I ask? There are multiple terminals here. I want to be sure I understand your position. Supposing the funding obligation was $100,000 and they had five terminals, each worth $100,000 fair market value, and they transferred all five of them. Would the four that were not necessary to discharge the obligation also be sales or exchanges within your --

MR. WRIGHT: Yes, and let me say that that's a harder issue that's not presented in this case. But the Fifth Circuit said in this case -- in the Fifth Circuit, we concentrated on defined benefit plans, and we said, look it, this is an easy case. The contribution here fulfills a funding obligation. Under the black letter law for 50 years in the tax area, it's a sale or exchange. And the Fifth Circuit said, well, any contribution to a defined benefit plan necessarily satisfies a funding contribution, if not this year, next year. It totally overlooked defined contribution plans.

Now, those excess contributions are admittedly a more difficult case for us. They do, in fact, satisfy in effect a future funding obligation. On the other hand, at the moment the contribution is made, the plan does not actually have a right to go in and sue for the truck terminals.

Now, the Department of Labor -- under the division of authority, it's the Department of Labor that actually has the primary responsibility among the three agencies that administer ERISA for construing this provision. And it has issued -- in 1981, that is, 2 years before the transactions at issue, it issued an opinion letter in a case indistinguishable from this one in all respects saying that the contribution of property to a defined benefit plan to satisfy a funding obligation is a prohibited sale or exchange.

In 1990, it issued an opinion letter discussing a voluntary contribution to a defined contribution plan of the sort I have talked, a contribution that fulfills no current or future funding obligation.

QUESTION: How did it deal with section -- what is it -- 4975(f)(3)?

MR. WRIGHT: It explained that the -- that provision, which prohibits any contribution of mortgaged property, serves the following role. In the situation at issue in the 1990 transaction, the excess contribution to a defined contribution plan, that contribution is not prohibited by subsection (c)(1)(A), but subsection (f)(3) serves the additional purpose of prohibiting transfers of mortgaged property to any sort of pension plan under any circumstances.

And that's why, contrary to what the Fifth Circuit said, our interpretation of this provision does not render (f)(3) or any other provision superfluous. It prohibits contributions to mortgaged property -- of mortgaged property under any circumstances. So, that's the role it played.

QUESTION: Mr. Wright, do you take the position that the DOL opinion letter is a formal interpretation of section 4975?

MR. WRIGHT: Yes, Your Honor, it is.

And let me say that -- I meant to say in response to your earlier question that as between the formal published letter of the Department of Labor, which is intended to inform people how the agency that administers the prohibited transaction provision interprets it -- these are now available on Lexus and Westlaw, and they have long been published by a number of private parties. And the IRS manual, an in-house manual that is not intended to inform the public -- it is surely the Department of Labor opinion letter that is controlling and is what Keystone should --

QUESTION: And when did that opinion letter issue again?

MR. WRIGHT: 1981, 2 years before the transfers at issue here.

QUESTION: Mr. Wright --

QUESTION: In the case where an excess amount of property is contributed, an amount of property over and above the employer's obligation, does the employer have a deduction for that additional amount?

MR. WRIGHT: Yes, Your Honor, and it has a deduction because it's a transfer of property. Sometimes employers argue that that is a gift, but usually, certainly in the case of large employers like Keystone, the IRS almost always maintains that, in fact, what happens is it's a transfer of property between the employer and the employees. Even if the pension plan has absolutely no right to the money and no right to insist upon it, it's nevertheless a form of deferred compensation to the employees, and it is deductible.

QUESTION: One other question. In tax law generally, quite apart from the pension benefit plan, if I simply make a gift to someone -- I give a car to my son -- that's not a sale or exchange, is it?

MR. WRIGHT: No, Your Honor.

QUESTION: Suppose there's a mortgage on the property that he assumes. Is that then become a sale or exchange?

MR. WRIGHT: No, Your Honor. In some certain circumstances, there are tax consequences. In the unusual case where the basis in the property is actually less than the mortgage, then there is some gain to the transferor, but in a normal case where the property is worth much more than its mortgage and the basis is worth more than the mortgage, that -- that's simply a gift.

The example we've used is that if a father gives 80,000 -- property worth $80,000 to a child, that's a gift. If the parent gives a $100,000 property with a $20,000 mortgage to a child, we think that it's the same. The same result holds under the ordinary, everyday way of looking at the transaction which, as recently as the Solomon case, this Court said applies.

QUESTION: I take it that's a further argument on your behalf of why (f)(3) is necessary in the statute?

MR. WRIGHT: Well, that's a further response to Keystone's latest argument as to why (f)(3) is rendered superfluous under our view of the statute, and once again, it's not in our view -- any old contribution of mortgaged property is not a prohibited sale or exchange, but it is prohibited by subsection (f)(3).

Let me say that subsection (f)(3) performs a rather modest role, I'll acknowledge, under our view of the statute, but that's not surprising. Congress simply wanted not to allow employers to use one particular trick of mortgaging property to raise cash and then transferring the property to the pension plan to have to pay it off.

Let me add that I'm more than willing to acknowledge that there is a lot of overlap in ERISA. After all, there are two prohibited transaction provision added by ERISA, one in title 26 and one in title 29, both of which prohibit any direct or indirect sale or exchange between an employer and a pension plan.

There is also overlap between subsection (c)(1)(A) and (f)(3). A contribution of mortgaged property to fulfill a funding obligation would be prohibited under either provision, but to say that there is overlap is not to say that there's superfluity.

And let me say that the essence of Keystone's argument, as I understand it, is that they first acknowledge that sale or exchange has for 50 years been construed very expansively, certainly to cover the situation in this case. In fact, no court has ever held that the transfer of property to satisfy an indebtedness is not a sale or exchange.

Then they acknowledge that ERISA is drafted very expansively, but --

QUESTION: Have you completed your explanation to me why the portion of the -- say, an excess is involved -- why that's a sale or exchange?

MR. WRIGHT: Oh, I'm sorry.

QUESTION: I'm not sure you really did complete your answer.

MR. WRIGHT: We -- on reflection, the Department of Labor had issued these two opinion letters, which set out the easier cases. And then the hypothetical you've suggested, which is a contribution of property to a defined benefit plan in excess of what's owed in the current year, the Fifth Circuit said, well, look it, that really satisfies a funding obligation for the future, and therefore, we can't -- this is a sale or exchange. The plan is giving something up. It's giving something up in the future. On reflection, the Department of Labor thinks that the Fifth Circuit is probably right in that respect.

Let me add that Keystone at page 22 of its brief says that the Fifth Circuit was wrong in that respect, that such a transaction would not be a sale or exchange, which totally undermines its argument that (f)(3) is superfluous. Under that view, it's not superfluous even ignoring defined contribution plans.

But I was trying to say that, as I understand the essence of their argument --

QUESTION: No, but it's superfluous if you take your view of the law.

MR. WRIGHT: Excuse me?

QUESTION: It's superfluous if you take your view of the transaction it seems to me.

MR. WRIGHT: No, Your Honor. A contribution to a defined contribution plan in excess of what's owed in the current year is not necessarily a sale or exchange. A contribution to a defined benefit plan probably always is, although that's a -- that question isn't actually here today.

QUESTION: Mr. Wright, what if it is not in excess of what is owed, but is -- it's a contribution to a defined contribution plan?

MR. WRIGHT: It's a sale or exchange. It's prohibited by subsection (c)(1)(A).

QUESTION: What if the obligation is only an obligation to the employee, not to the plan? Is that not a defined contribution plan then?

MR. WRIGHT: I'm not aware of any --

QUESTION: The employer makes a deal with his employees. I will -- you know, I will contribute a certain percentage of profits every year to this plan. He makes a deal with his employees.

MR. WRIGHT: It's not prohibited by (c)(1)(A) --

QUESTION: It's not prohibited.

MR. WRIGHT: -- because (c)(1)(A), while drafted very expansively, any direct or indirect sale or exchange --

QUESTION: To -- but to the plan.

MR. WRIGHT: Right, exactly.

QUESTION: And this would be a sale or exchange with the employees.

MR. WRIGHT: ERISA doesn't prohibit that.

QUESTION: Mr. Wright, in giving examples of transfers that were -- would not be in satisfaction of an existing obligation to the plan, I think all of your examples are of transfers by the employer. Could there be transfers by other disqualified persons?

MR. WRIGHT: Yes, absolutely. There are other kinds of disqualified persons, fiduciaries, accountants and lawyers who provide services to that plan. Now, frankly, it is usually employers who contribute property to pension plans, but these provisions also prohibit other employers -- other parties from doing that.

(f)(3) actually has some role here. There has been -- there could be abuse by fiduciaries, for instance, doing the same trick, mortgaging property to raise cash and giving it to a pension plan which is stuck with the obligation of paying it off.

QUESTION: Or unions?

MR. WRIGHT: Excuse me?

QUESTION: Or unions?

MR. WRIGHT: Yes. Well, that's true too.

QUESTION: Let me make sure I understand one thing. Assume a plan invests all its money in government bonds, and the employer has an excess of government bonds and rather than selling them, he wants to transfer those. That would also be prohibited, too?

MR. WRIGHT: Yes, Your Honor. Let me say in that respect that, unfortunately, as in many areas of ERISA, there are, of course, exceptions. And, in fact, subsection (d) sets out 15 exceptions to the prohibited transaction rules. We think that's significant, first, because if Congress wanted to allow what Keystone did, it would have allowed an exception.

Now, in answer to your question, subsection (d)(13) allows employers to contribute certain kinds of property, certain kinds of stock and, in fact, even certain kinds of real property in specified circumstances. Your example may well fall into that situation, but let me note in this respect that Keystone's situation does not fall into exception (d)(13) where Congress did allow contributions of property to --

QUESTION: Does (d)(13), which is not set out in the brief, have -- apply to transfers of encumbered property?

MR. WRIGHT: It doesn't speak of encumbered property, Your Honor.

QUESTION: So, there is still a flat rule against encumbered property.

MR. WRIGHT: Yes. Yes, Your Honor.

QUESTION: You're telling me more about this than I want to know, Mr. Wright. You really are.

(Laughter.)

MR. WRIGHT: I'm afraid of that.

But let me make one last point. Keystone acknowledges that sale or exchange has a very broad meaning under the tax laws. It acknowledges that ERISA is written expansively, but it says for those reasons, subsection (c)(1)(A) should be construed narrowly to minimize the overlap between (c)(1)(A) and (f)(3). Well, in our view that's perverse to read (c)(1)(A) narrowly because Congress drafted it broadly.

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

QUESTION: Mr. Wright, I don't want to spoil your hopes in that respect, but --

(Laughter.)

QUESTION: You've just tantalized me with one possibility here. Is it possible that the flat prohibition on transfers of encumbered property could have been put in there to trump one of the exceptions?

MR. WRIGHT: I hadn't thought it through that far, Your Honor. I'm not sure whether the exceptions could apply there.

Let me add also, to make it even more complicated, that there's yet another -- there's a general exemption provision in (c)(2). An employer like Keystone suffering from financial problems can go to the Secretary of Labor and say, "We're in hard shape. We want to contribute property. It's not going to harm the plan for the following reasons," and the Secretary of Labor can authorize it. I believe the Secretary of Labor could authorize a contribution of mortgaged property.

QUESTION: Even encumbered?

MR. WRIGHT: But, of course, again Keystone bypassed the statute, and it's asking this Court to authorize it and other employers to do so in the future.

Thank you.

QUESTION: Thank you, Mr. Wright.

Mr. Wexler, we'll hear from you.

ORAL ARGUMENT OF RAYMOND P. WEXLER

ON BEHALF OF THE RESPONDENT

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

I hardly know where to begin. I think I'd like to begin with where Mr. Wright began which has some implication in answer to a question that there was an allegation of a breach of fiduciary duty on the trustee's behalf for having accepted this property. That's simply untrue. The answer to the question is the trustee could have and it was -- within his duty as a fiduciary could have rejected this property if he thought it was an inappropriate contribution.

Second, I'd like to respond to Mr. Wright's comments to Justice O'Connor regarding the IRS manual and his statements regarding the Department of Labor advisory opinion. When ERISA was passed in 1974, there were three agencies involved in the enforcement and regulation of ERISA: the Department of Labor, the Internal Revenue Service, and the PBGCA -- the PBGC. Sorry.

The -- originally the IRS was given regulatory authority under 4975, the section at issue here. It was also given regulatory authority under section 412, which is the section that places the obligation on an employer with respect to a defined benefit plan.

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In 1978, pursuant to reorg plan 4, which is cited in both briefs, the IRS and the Department of Labor divided up responsibility for various portions of ERISA. Under that division of authority, the Department of Labor was given regulatory authority under 4975, certain portions of it, including the two that are relevant here, (c)(1)(A) and (f)(3). The IRS retained regulatory authority under section 412, the obligation setting section.

With that background in mind, let's talk about what the three agencies have done.

The Department of Labor has never issued regulations under 4975(c)(1)(A) or (f)(3) indicating that noncash contributions to defined benefit plans were intended to be a prohibited sale or exchange.

QUESTION: Did it issue an opinion letter? Do you agree --

MR. WEXLER: Yes.

QUESTION: -- that an opinion letter issued before this transaction took place?

MR. WEXLER: The sole position administratively of the Department of Labor is the two private advisory opinions, one issued in 1981, 3 years before, approximately, these transactions occurred, one issued in 1990, 2 weeks after my client filed a motion for summary judgment in the tax --

QUESTION: Well, do we owe deference to the DOL opinion letter of 1981?

MR. WEXLER: I don't think so, Your Honor --

QUESTION: Why not?

MR. WEXLER: -- for two reasons. One, under the Department's own procedures, private parties are not entitled to rely upon opinions. Only the parties in the opinion are entitled to rely on them. So, in a sense, what the IRS is stating is that this taxpayer ought to be bound by an advisory opinion, with respect to which, under the Department's own rules, this taxpayer could not rely upon.

Second, and perhaps more important, the Department of Labor '81 advisory opinion contains within it a false assumption, and that assumption is that code section 412 imposes a cash obligation upon the taxpayer. The way that advisory opinion analyzes the issue, it states that the transfer of property to a plan that has a legal right to receive cash is tantamount to a sale.

Whether or not there is a cash obligation is answered by code section 412. That is the code section that the IRS, not the Department of Labor, has regulatory power over.

And that would lead you then to ask what is the

IRS' administrative position. Like the Department of Labor, the IRS has issued no regulations whatsoever indicating that a transfer of noncash property to a defined benefit plan is a prohibited sale or exchange.

However, the IRS has not been silent. First, in 1978, a taxpayer in a private letter ruling asked the IRS to rule on this issue. The IRS stated that it was an issue that could not be reasonably resolved without the issuance of regulations. What the IRS is really asking this Court to do is to issue the regulations that they have not --

QUESTION: Well, are you making an argument that somehow the taxpayer here did not have fair notice of the coverage of 4975?

MR. WEXLER: I would so argue, but I'm really making an argument --

QUESTION: You have not made that argument really.

MR. WEXLER: No. I'm really making an argument that the Department of Labor 1981 advisory opinion is not the type of administrative agency position that courts tend to offer deference to. It seems to me that we have an opinion that is wrong, that is a private opinion. We have the IRS, through its manual, telling agents that the rules are exactly the opposite, and we have the PBGC, which really had no administrative position at all. They have had nothing to say on this issue at all until they filed the amicus brief in this Court.

The cases that the Government cites in its brief that would indicate that courts ought to pay deference to the administrative position of agencies all either involve published regulations or published rulings, and in none of those cases does it involve issues on which there are differences of opinion between the various agencies involved.

I would, however, to continue to respond to your question, state that we have a disagreement with Mr. Wright -- a terrible name for an opponent to have, Mr. Wright --

(Laughter.)

MR. WEXLER: -- a disagreement with the Government on whether or not the excise tax of 4975 is in the nature of a penalty. And I think that this Court has made it clear that the law is that people are not -- people or corporations are not to be subjected to penalties unless the plain words of the statute impose those penalties. I think underlying those cases is the notice issue that you indicate. We would submit that it is crystal clear in our mind that 4975 does, indeed, impose a penalty.

QUESTION: Is that something different than an ordinary tax then?

MR. WEXLER: Yes. It is a 5 percent per year penalty in addition to a 100 percent penalty if the transaction is not corrected.

QUESTION: Well, the statute refers to it as a tax. Why do you say it's a penalty rather than just a tax?

MR. WEXLER: Because it -- because of the magnitude and because of the purpose of the statute. The purpose of the statute is to prohibit conduct by providing pecuniary punishment, and a tax that has that purpose is in the nature of a penalty, not in the nature of a tax.

In the Acker court -- case, which is the leading case in this area --

QUESTION: The what case?

MR. WEXLER: The Acker, A-c-k-e-r. This Court held -- the question was whether the additions to tax for failure to file estimated tax returns, as well as for failing to pay estimated taxes -- whether those taxes were in the nature of a penalty. And what this Court held -- and I would point out to the Court footnote 4 in the main opinion and the single footnote in the dissenting opinion -- concluded that those taxes were in the nature of a prohibition for violation of a statutory order.

The same, exact thing is true of the 4975 tax. That is a pecuniary punishment. In this case, the assessed tax is $13 million.

QUESTION: Is that 100 percent?

MR. WEXLER: It is 5 percent for a number of years, plus 100 percent.

QUESTION: Of course --

QUESTION: 5 percent for every year plus 100 percent over that.

MR. WEXLER: Correct. The maximum criminal penalty provided in ERISA for knowing violation of ERISA provisions is only $100,000, so that the tax which we are describing as being in the nature of a penalty is more than 100 times greater than the maximum criminal penalty provided --

QUESTION: Is that because Keystone has never agreed to correct the situation?

MR. WEXLER: Keystone has made an effort to determine. The problem is that the issue of correction also is an IRS issue, not a Department of Labor. The IRS regulations are not written in contemplation that a contribution of property would be a prohibited sale or exchange. Therefore, they don't have any provisions that would tell us how to correct. But I promise you, we did try to find out what the IRS thought we ought to do in order to correct, and we had no response.

QUESTION: Mr. Wexler, the consequence of the argument you're now making, however, is not that the section should be interpreted the way you want to interpret it. We would interpret it, the way the Government wants it, to make this a prohibited transaction, but you just wouldn't have to pay the 5 percent penalty. Right?

MR. WEXLER: One could reasonably conclude --

QUESTION: It would be a prohibited transaction, and you would have to undo it. I mean, that's no justification for interpreting the statute the wrong way.

MR. WEXLER: No, no, no, but I think that if the statute is penal in nature, then it is a statute that ought not assess a tax unless it is fairly clear on the face of the statute that the tax is owed.

QUESTION: So, the consequence is you don't owe the tax, but in addition to that, should we make nonprohibited what are prohibited transactions just because they haven't been made prohibited clearly enough?

MR. WEXLER: Let me talk then about why we believe that they are not prohibited transactions. Justice Stevens asked a question which I believe Mr. Wright has answered absolutely inconsistent with the Government's position both in its brief here and in the

Fifth Circuit. The question asked was whether in a defined benefit plan, if a year's minimum funding requirement was $100,000 and the taxpayer contributed property, five separate parcels that were each equal to $100,000, which parts of those would be a prohibited sale or exchange and which would not.

It is the Government's position that the first piece, the first $100,000 worth would be a prohibited transaction. However, it is the Government's position that the other four pieces would not be prohibited transactions. And even though for income tax purposes, all five of those are treated as sales or exchanges for income tax purposes and in each of the five cases, the taxpayer would have to pay a capital gain on his income tax return, just as -- the way Keystone did.

The problem with the -- the reason the Government reaches this position is exactly because of the existence of (f)(3). (f)(3) states that a transfer of property subject to a mortgage will be treated -- shall be treated I believe the words are -- as a sale or exchange. The necessary implication on the face of the statute is that if it is not, it is not intended to be a sale or exchange. Thus, the Government is looking for some meaning for (f)(3) that is consistent with a transfer of noncash property being a prohibited sale or exchange when it is an exchange for a minimum funding.

And the distinction that you have drawn is exactly where they draw the line. What says the Government is that the first piece is an exchange for a cash obligation, the minimum standard requirement for that year. Therefore, that's a sale or exchange. However, the other four pieces are not for that year's cash obligation. Therefore, those are not prohibited sales or exchanges under (c)(1)(A), and that is the slice that (f)(3) was intended to pick up.

We would submit two answers to this. One, hard to believe that this is what Congress had in mind without a single word in the legislative history speaking of this differentiation about the two types of contribution under code section 412. Moreover, we would suggest that code section 412 does not impose a cash obligation on the taxpayer. What the words of 412 state specifically is that the employer must satisfy a minimum funding standard, and that is specifically defined by 412(a) with the following language: a plan -- and I will quote -- shall have satisfied the minimum funding standard for such year for a plan year if at the end of such plan year the plan does not have an accumulated funding deficiency. Then in 412(b) the code states how you determine whether there is an accumulated funding deficiency.

One of the things that happens in making this determination is there are credits provided to and charges against the plan's assets. One of the credits is for the amount contributed by the employer. What the IRS alleges -- and I would point out to page 5 in their brief -- is that the allowance -- or the statement in 412(b) that provides a credit for the amount -- and the IRS puts the words amount in quotes -- of contribution by the employer, that is the item that provides the monetary obligation or the dollar obligation. That is the beginning point of their substantive argument.

What the IRS fails to point out and totally ignores are the two words immediately following the word amount, which they put in quote, and those amounts -- those words are the amounts considered contributed. We would submit that the IRS is absolutely incorrect. The two words I have just added, which are in the code, make it clear that Congress must have thought that something other than cash was going to be contributed in discharge of the minimum funding standard, otherwise the words amount considered contributed would have no meaning.

QUESTION: This is in section 412 you're speaking?

MR. WEXLER: (b).

QUESTION: 412 --

MR. WEXLER: (b)(3) I believe.
QUESTION: Well, now the Government's petition sets out section 412(a). I don't see it sets out section 412 --
MR. WEXLER: 412(a) -- it doesn't. 412(a) --
QUESTION: Where is 412(b) set out in your brief?
MR. WEXLER: It is not set out in our brief. It is discussed in the Government's reply brief that was filed in response to our argument that there was no cash obligation. They then quote in their reply brief at page 5 portions of (b)(3).
QUESTION: If you're going to rely on some section of the statute, you ought to set it out.
MR. WEXLER: My colleague advises me on pages 7 and 8 of our main brief.
QUESTION: 7 and 8.
QUESTION: Of your main brief?
MR. WEXLER: Yes, our only brief.
The point being is that if 412 -- if I can try to respond to Justice Kennedy's -- or Justice Stevens' question a little more. A defined benefit plan requires an employer to fund benefits over the life of the employee such that when the employee retires, there is sufficient assets in the plan in order to pay retirement benefits.

The IRS' argument that attempts to distinguish between what they call voluntary contributions, which are the four additional pieces of your five $100,000 pieces and the initial $100,000, draws an economic distinction that doesn't make any sense, and the reason is both contributions are in discharge of the employer's obligation: one, the minimum obligation for the year; the other, the overall obligation, which is the employer's full obligation to fund the plan. The question -- the difference is one of timing, not of economic substance.

The reason the IRS is forced to draw this distinction, which, as I pointed out, is not mentioned at all in the legislative history, is because of the existence of (f)(3). They need to find some contribution that is a prohibited sale or exchange under (c)(1)(A), but does not render (f)(3) totally meaningless.

QUESTION: But they don't need that for that purpose. They have defined contribution plans instead of defined benefit plans.

MR. WEXLER: Except for the fact that --

QUESTION: Why doesn't that suffice?

MR. WEXLER: -- there was no indication -- there's not a single word -- and I mean a single word -- in the legislative history that indicated that (c)(1)(A) was intended to apply different rules to defined benefit as opposed to defined --

QUESTION: That doesn't carry a lot of weight with me, but it does eliminate your argument that they -- I agree that there's some difficulty in figuring out what happens to the four extra parts. But however that argument comes out, even if you disagree entirely with the Government on that and say that all five parts are considered sales and exchanges, there's still an explanation for (f)(3).

MR. WEXLER: But it is a strained explanation. Plus, it is inconsistent with the intellectual underpinning of their initial argument. The way they get any of these transactions to be prohibited sales or exchange is by application of income tax cases. And it is true that in income tax cases, these are treated as sales or exchanges.

The problem is if Congress had in mind income tax consequences in (c)(1)(A), the very same income tax cases that hold that mandatory contributions are sales or exchange also hold that voluntary contributions to a defined benefit plan are sales or exchange and also hold that contributions --

QUESTION: Sales or exchanges to whom? I mean, the point -- they're not claiming that they're not sales and exchanges. They're just claiming that they are not sales and exchanges to the plan, which is the only prohibited sale or exchange.

MR. WEXLER: In order to reach that argument, they have concluded that there is an underpinning in the income tax sales or exchange cases that looks at to whom the sale or exchange is between. It seems to us there are two real problems with that.

Problem one is none of those cases talk at all about who the sale or exchange is between. What those cases do is they conclude that the transferor has recognized the benefit of economic gain and, therefore, should pay an income tax.

QUESTION: Of course, the tax cases don't --

MR. WEXLER: Moreover --

QUESTION: -- go into to whom it is because it's irrelevant for taxation, but you have to make the decision for purposes of ERISA.

MR. WEXLER: However, if a mortgage -- if a property is transferred to a pension plan subject to a mortgage, it is crystal clear who that sale or exchange is between. That sale or exchange is between the party who is being relieved of the liability, by analogy the employer in our case, and the party assuming the liability, namely the plan. Therefore, if that were the concept that Congress had in mind, (f)(3) has defined the single transaction that is clearly between the plan and the employer, not between the employer and the employees.

QUESTION: I don't agree with what you just said if the mortgage is in a lesser amount than the equity in the property. I just don't agree with it.

MR. WEXLER: The -- when a mortgage is assumed, the party assuming it pays the liability. So, in a sense it is no different than if a liability, absent property, were transferred to a plan.

Or to put it another way, whether or not a sale or exchange, when mortgaged property is transferred to a plan, is between the plan and the employer or the employer and the employee, it would seem to us to indicate the clearest example where you have a transaction that 4975 is trying to operate on, the reason being that 4975, by and large, is talking about transactions from which assets that are in a trust are extracted from that trust. It's not a funding section.

The reason that they have made the mortgaged property into a sale or exchange is because that is a transaction that can occur in a funding context, but which results in the extraction of assets from the plan.

QUESTION: Well, Mr. Wexler, you don't say that the only kind of sale or exchange, as described in 4975(c)(1)(A), is one that meets the definition in (f)(3), do you?

MR. WEXLER: No. What our position is is that the income tax cases that hold that transfers to defined benefit, to defined contribution, voluntary, mandatory, that contributions of that nature of property to a plan are sales or exchanges, was affirmatively not intended to be included in (c)(1).

QUESTION: So, our -- we simply have to figure out or courts have to figure out what the term sale or exchange in 4975(c)(1)(A) means.

MR. WEXLER: Exactly. That's exactly, precisely the issue.

QUESTION: I suppose there wouldn't be any question about whether or not you could satisfy any funding obligation by furnishing of goods or services.

MR. WEXLER: Correct, because that is prohibited under a different section.

QUESTION: Yes, but that's just because you really know what furnishing of goods or services is.

MR. WEXLER: Correct.

QUESTION: And the same with leasing --

MR. WEXLER: Correct.

QUESTION: -- under (1)(A).

MR. WEXLER: Right. The same with -- I mean, I'll give you an -- the same with the prohibition under (a)(2)(B), the very next subsection. The very next subsection in 4975(c) is called (a)(1)(B) instead of (c), and what that provides is a prohibition against the lending of money back and forth between a plan and an employer.

What the legislative history of that section stated was that one of its purposes was to disallow an employer from funding his obligations with a promissory note, the reason being a promissory note would then create the prohibited lending.

We would submit that that sentence is also, just like (f)(3), irreconcilable with the theory that Congress intended in (c)(1)(A) to include to prohibit noncash contributions, the reason being a promissory note is clearly a noncash contribution.

QUESTION: So, under (1)(A), leasing would be prohibited, but transferring fee title would not be.

MR. WEXLER: Correct, or transferring mortgaged property would not be permitted.

QUESTION: Well, Mr. Wexler, what if the employer just outright sold to the plan a piece of property?

MR. WEXLER: That would be prohibited.

QUESTION: And yet, it would be prohibited because it's a sale or exchange?

MR. WEXLER: For consideration I would assume. That's why I started out talking about 412.

QUESTION: And yet, you continue to take the position that a transfer to meet a funding obligation --

MR. WEXLER: Is not intended to be.

QUESTION: -- is not.

MR. WEXLER: And the reason is is that 412 does not impose a cash obligation. I would suggest that if 412 had a rule that said that all contributions to a defined benefit plan must be made in real estate, we would not be here because we would have a clear allowance of what we want.

I would also state that if 412 had a rule that said all contributions must be made in cash, we would not be here either, and the reason is we wouldn't have a case because in discharge for cash, it's clearly a sale.

The problem is 412 is intended to provide flexibility on funding to plan employers.

Mr. Wright indicated that there are, by and large, way more defined contribution plans than defined benefit plans. I would suggest that the congressional policy is to favor defined benefit plans, the reason being they are the only kind of plans that -- where the investment risk of the assets rests with the employer, not the employee. As pointed out in Professor Zelinsky's article, which we cite in our brief, one could argue that, as a matter of policy, Congress would not be interested in passing anything that would restrict funding of defined benefit plans because it would tend to discourage those plans when policy is exactly the opposite.

QUESTION: Could I -- why didn't the company just sell their terminals and contribute the cash?

MR. WEXLER: I can't answer that question, but I would suggest that transferring the terminals to the plan is more like not selling them than it is like selling it. Once they were transferred, it was up to the fiduciary to determine whether it was a good investment or a bad investment, a short-term investment or a long-term investment. The real estate that was contributed in the second year was sold at a gain by the trustee within the year it was contributed. The truck terminals were held.

It would seem to us that in order for this Court to reverse the decisions entered in this matter by the tax court and the Fifth Circuit, this Court will have to find as a matter of law in the Government's favor on three conceptual issues.

First, this Government -- this Court would have to find that 412, we think, imposes a cash obligation.

Second, this Court would have to find that when Congress passed (c)(1)(A), they intended to implant income tax consequences with respect to certain contributions, but specifically intended to ignore income tax consequences with respect to other transactions. The reason is that we think if you don't do that, you have read (f)(3) out of the law.

And item three, this Court would have to conclude, as a matter of law, that section 4975 does not impose a tax that is in the nature of penalty. It is --

QUESTION: Why?

MR. WEXLER: Because if it is in the nature of the penalty, this Court's precedents would indicate it has to be narrowly construed. We would suggest that that's a standard --

QUESTION: Yes, but what if we think the -- what if we think (c)(1) is clear?

MR. WEXLER: You would have to come to that conclusion. I would agree with you actually. You could come to that conclusion, which I think is a wrong conclusion because I think the words of the statute don't say that. But if you came to that conclusion, you could then defer and not deal with the penalty issue.

It is, nevertheless, our position that it would be incorrect, as a matter of law, for this Court to find in favor of the IRS on any of these three issues, much less all three.

We would submit that if the Department of Labor and the Internal Revenue Service have come to the conclusion that, as a matter of policy, noncash contributions should not be made to defined benefit plans or that some should and some should not, we would suggest that that is an issue that ought to be addressed to Congress, not to this Court.

Thank you.

QUESTION: Thank you, Mr. Wexler.

Mr. Wright, you have 4 minutes remaining.

REBUTTAL ARGUMENT OF CHRISTOPHER J. WRIGHT

ON BEHALF OF THE PETITIONER

MR. WRIGHT: Mr. Wexler acknowledged that sale or exchange has for 50 years been construed by the courts to include a transfer of property to satisfy an indebtedness. In subsection (c)(1)(A), Congress didn't merely prohibit sales or exchanges. It prohibited any direct or indirect sale or exchanges. Whatever hard cases there are in the future, a transfer of property in fulfillment of a funding obligation is certainly a form of direct or indirect sale or exchange.

QUESTION: Can I just be sure of one thing in my mind? Is it your position that a transfer of property, real property, to a defined contribution plan is also a sale or exchange?

MR. WRIGHT: If it fulfills a current -- if it fulfills a funding obligation to the defined contribution plan, it is.

QUESTION: Then why isn't (c)(3), or whatever the number is, superfluous?

MR. WRIGHT: It is not superfluous because there are contributions made to defined contribution plans that do not fulfill any current or future funding obligation.

QUESTION: -- say, Mr. Wright, the language, sale or exchange or leasing, the words leasing coming after sale or exchange, does seem to me to indicate that they're talking about a person-to-person transaction, not just the regular contribution that the employer makes.

MR. WRIGHT: Well, those are certainly also prohibited, but sale or exchange is a phrase that's used throughout title 26. It has a well-settled meaning. It had a well-settled meaning in 1974. We think that Congress relied on that meaning when it used that language.

QUESTION: It seems to me strange to use that highly technical meaning which would cover any contribution to the plan which elsewhere is referred to as contributions in the statute.

MR. WRIGHT: Well, Your Honor, sale or exchange has a settled meaning, and I'm not sure it's fair to characterize it as technical. As Professor Bittker explains in his treatise, transferring property to satisfy a debt is just the same as selling the property and saying, oh, by the way, instead of giving me cash, please credit my accumulated funding account, which admittedly doesn't say it has to be satisfied in cash. But I wonder what would have happened if Keystone had tried to give this property to one of its other creditors that it owed obligations to.

QUESTION: Mr. Wright, what's your response to the argument that 412(b)(3) does say that the funding standard shall be credited with the sum of the amount considered contributed?

MR. WRIGHT: Employers make large payments to pension plans, not all of which actually go into the plans to pay pension accounts. They also agree to pay certain administrative money. So, when an employer makes a payment to a pension plan, all the money doesn't necessarily go into the plan. Some of it goes elsewhere.

And let me also say with respect to 412 --

QUESTION: Well, but I mean, it seems to me that that's a simple bookkeeping entry.

MR. WRIGHT: Well, and --

QUESTION: The amount contributed -- it's either contributed or it isn't.

MR. WRIGHT: The amount considered contributed to the plan. Well, you know, the other thing about section 412 is that we're faulted, on the one hand, that there are so many prohibitions on this kind of transaction, that there's a danger of superfluousness. On the other hand, the fact that in certain other provisions of the in tax -- income tax code, it doesn't make clear that these transactions are prohibited. Well, that's found to be significant too. We think two prohibited transaction provisions saying that any direct or indirect sale or exchange is prohibited is arguably more than enough. It's certainly enough.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Wright.

The case is submitted.

(Whereupon, at 11:00 a.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

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Commission of Internal Revenue ✓

Keystone Consolidated Industries

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BY Leona M. May

(REPORTER)