Supreme Court of the United States

OCTOBER TERM, 1969

In the Matter of:

THE UNITED STATES OF AMERICA,

Petitioner

vs.

HILTON HOTELS CORPORATION,

Respondent.

Docket No. 528

Place Washington, D. C.

Date February 26, 1970

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

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BENHAM

IN THE SUPREME COURT FOR THE UNITED STATES

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vs

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No. 528

The above-entitled matter came on for argument at 11:05 o'clock a.m., on Thursday, February 26, 1970.

BEFORE:

WARREN E. BURGER, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice

APPEARANCES:

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Attorney for Petitioner

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: Number 528, United States against Hilton Hotels Corporation.

Mr. Walters, you may proceed whenever you are ready.

ORAL ARGUMENT BY JOHNNIE M. WALTERS, ASSISTANT ATTORNEY GENERAL, ON BEHALF OF PETITIONER

MR. WALTERS: Mr. Chief Justice, and may it please the Court: The relevant facts inthis case were stipulated and may be summarized in pertinent part.

In August, 1953 Hilton Hotels Corporation owned some 325,370 shares of the 366,040 shares outstanding of the Hotel Waldorf Astoria, leaving some 40,670 shares of Waldorf outstanding in the hands of others.

Contemplating a merger, Hilton retained consultants to do a study to determine a fair basis for exchange of Hilton shares for Waldorf shares. Hilton and Waldorf agreed upon a proposed merger, with Hilton to be the surviving corporation.

Under the proposed plan, Hilton offered to exchange 1.25 shares of its stock for each share of the Waldorf stock it did not already own. Prior to the agreement of merger, however, shareholders owning some 20,000 shares of Waldorf, filed with Waldorf an objection to the merger and demanded payment for their Waldorf stock.

Thereafter, on December 28 and 29, 1953, more than two-thirds of the stockholders of each of the two corporations

voted approval of the merger. And on December 31, 1953, the merger agreement and certificate of consolidation were filed with the Secretary of State of New York.

The applicable New York Law provided that in such a case the stockholder demanding payment for his Waldorf shares had no right to receive dividends payable on those shares after the close of business on the day preceding the date that the Waldorf stockholders voted approval of the merger. And, that upon that vote, the dissenting stockholder ceased to have any other rights of a stockholder of Waldorf, except the right to receive payment of the value of his stock.

Under the New York Law the dissenting stockholder or the corporation had the right to have the stock appraised in a court proceeding. Complying with New York Law, on January 7, 1954, Hilton offered to theWaldorf stockholders, $24.50 for each share of Waldorf stock it did not already own. Those stockholders who had dissented from the merger rejected the offer and began court proceedings under state law for a determination of the value of their shares.

Hilton again retained the same consulting firm to determine the value of those Waldorf shares on the day prior to the vote of approval of the merger.

In addition to paying those consultants, Hilton aslo paid almost $40,000 to lawyers in others in connection with the court proceedings to develop that value.

Hilton claimed a deduction as an ordinary and necessary business expense under Section 162 of the Code for all of the fees paid to the consulting firm, attorneys and others, including the fees that had been paid to the consultants prior to the vote of the merger.

The Commissioner of Internal Revenue disallowed the deduction; Hilton paid the asserted deficiency and commenced a suit for refund. The District Court held that the appraisal costs were deductible, but that the consultants' fees that were incurred prior to the merger were nondeductible capital expenditures.

Hilton conceded as to those pre-merger fees and the 7th Circuit affirmed the District Court allowing deduction of appraisal fees.

Q This was a taxable year 1955?

A This began in 1953, sir.

Q Well, the transaction began in '53; I would guess probably the taxable year involved was 1954?

A '54.

Q '54.

A Yes.

Q How on earth didit take 16 years to get here?

A Mr. Justice, I cannot answer that; it seems an awful long time.

Q It is an awful long time. This is a suit for

refund in the District Court. Is this explainable, just in terms of the delays in the Northern District of Illinois and in the Seventh Circuit Court of Appeals?

A Sir, that is part of it. I would assume that in a situation such as this, where you have large corporations involved, the administrative audits probably do not come until late in the statutory period and then all of the proceedings that follow that, keep eating up a little time.

Q Of course, it's only money.

A The sole issue here, then, is whether the fees paid to the consultant lawyers and others, in connection with the appraisal proceeding that followed the merger are deductible ordinary and necessary business expenses or nondeductible capital expenditures.

While we're concerned in this case with Section 162, that deals with business expenses and also with Section 263 again, as in the last case, we nevertheless, are concerned with the same basic principles that were involved in the Woodward case.

Section 162 provides a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in the carrying of the trade or business. It does not provide a deduction for a capital expenditure.

Section 263, on the other hand, prohibits deductions on a capital expenditure.

The origin and character ofthe claim with respect to which an expenditure is incurred determines or contributes to the determination of whether an expenditure is or is not deductible. The costs of acquiring an asset of capital stock are not deductible; they are nondeductible capital expenditures.

Q What about the legal expenditures in connection with the merger itself?

A They are capital items, sir.

Q They are not deductible?

A No, sir.

Q The lawyer fees for drawing up themerger plan and effecting it are nondeductible?

A That's right, sir.

Q Capital expenditures.

A That's right.

Just as the Seventh Circuit noted below, the expenditures incurred in connection with the corporate reorganization, such as the ones that Mr. Justice White just asked about, are nondeductible capital expenditures.

In considering this case alongside the Woodward case, there is only one additional item that we think we should mention. In Woodward the majority shareholder did not acquire title to the Quigley stock prior to the appraisal proceedings. Whereas, in this case, under the applicable New York Law, the merger and the acquisition were both accomplished prior to the

appraisal proceeding.

For this difference in timing is theonly that we think we need to address attention. The timing --

Q The Eighth Circuit decided this case first; didn't it? Am I right?

A Yes, sir.

Q The Eighth Circuit decision in Woodward was before this one?

A I don't recall, Mr. Justice, which came first, calendarwise. No, sir; it did not.

Q It did not?

A The timing of the appraisal proceeding with respect to title passage is immaterial. The appraisal proceeding in this case, too, was directly and functionally related to an integral part of the overall proceeding, which was a corporate reorganization.

This was not a causal relationship; it was part and parcel of the overall transaction, the corporate reorganization and acquisition of the Waldorf shares.

Thus, again we note that the tax law does not permit fragmenting of transactions. It requires the events that are functionally related be looked at together, even though they may be temporally separated timewise.

WE submit that such differences as exist between this case and the Woodward case are immaterial and the context of

these cases, the differences in timing of stock appraisals is not material.

And, likewise, the differences between the New York and Iowa statutes are not material. The Federal tax rules in the two cases should be the same. In neither case should the cost of these appraisal proceedings be deductible.

In Woodwoard the Eighth Circuit held that the appraisal costs were nondeductible, capital expenditures incurred in connection with the acquisition of capital stock.

In this case the cost of the appraisal, likewise, should be considered a part of the cost of acquisition of the Waldorf stock.

In either case, the appraisal costs were capital expenditures.

MR. CHIEFJUSTICE BURGER: Thank you, Mr. Walters.

Mr. Levenfeld.

ORAL ARGUMENT BY MILTON A. LEVENFELD, ESQ.

ON BEHALF OF RESPONDENT

MR. LEVENFELD: Mr. Chief Justice and may it please the Court: The Government concedes that Hilton's expenses in the appraisal proceedings are deductible under Section 162 if they are not capital costs.

My arguments will be first directed to demonstrate that the Government's contention is erroneous because the legal, contractual and economic positions of the second shareholders

change from that of stockholders to creditors when they objected to the merger and demanded payment for their stock.

I will then show that the merger and the appraisal proceedings were not functionally related, so the rules with respect to mergers are not applicable to the appraisal proceeding.

Underlying both arguments will be an analysis of state law, because without such an analysis, one does not know whether an acquisition has occurred.

Q Well, would they have engaged in this process of valuing the shares if they had not been going to acquire them? Would there have been any occasion for all this expense?

A The occasion for the expense was not the merger itself, Mr. Chief Justice; the occasion for the expense was the objection and demand for payment by the dissenters and the failure to agree on price.

Themerger would have been effected in any event, assuming two-thirds --

Q I was putting the emphasis on the acquisition as distinguished from the merger, to the extent that you --

A The acquisition was not by Hilton, Your Honor; the acquisition was by Waldorf. The stock ceased to be outstanding stock of Waldorf at the date of the objection and demand for payment. Hilton was not acquiring the stock.

At the time of the objection and demand for payment,

the New York statute specifically provides that the dissenters ceased to be shareholders.

Q Well, which was the surviving corporation?

A Hilton was the surviving corpoation.

But, prior to the merger, upon the dissent, the dissenting shareholders had to dissent prior to the vote for the merger.

Prior to the merger they became creditors of Waldorf. Hilton assumes the liability of Waldorf as a debtor to the dissenters by operation of law upon the merger. Hilton did not pay in its stock for the dissenting shareholders' stock.

There was a change of status of the dissenting shareholders from that of stockholder to that of creditor.

The only evidence pertinent in the appraisal proceeding was evidence as to values of shares, of the shares of the dissenting shareholders. There was no evidence introduced, or which could be introduced as to the value of the Hilton shares or to the effectiveness of the merger.

A debtor-creditor relationship was established between the dissenters and Waldorf and the debt of Waldorf was assumed by Hilton by operation of law on the merger.

The relationship of debtor and credit is established amply by the state law and case law citations in our brief.

After the demand for payment and the objection to the merger, the dissenters had none of the attributes of

stock ownership. Under state law they could not vote on any matters relating to the Waldorf or Hilton; they could receive no dividends from Waldorf or Hilton; they could receive no liquidation proceeds.

In addition, it has been cited by a Federal Court that once a dissenter elects to receive payment for his stock, he cannot bring a derivative suit in a capacity as shareholder, even while the appraisal proceeding is in progress.

In addition, the dissenters had all the attributes of sellers of stock, entitled to receive payment for stock. They became creditors of Waldorf and then Hilton. Had Hilton become a bankrupt they would have been entitled to receive distributions from Hilton as general creditors, parity to sue with other general creditors prior to any distribution to the stockholders of Hilton.

In addition, this was held in Southern Production Company versus Sobath, cited in our brief. In addition, the dissenters would have been entitled to the Federal protection of SEC Rule 10(b) relating to full disclosure with respect to the merger, because they would havebeen considered sellers of stock. And this protection would havebeen afforded to them even while the appraisal proceeding was in progress. This was decided in the Voege case, cited in our brief.

As prior counsel has brought out, this Court in Aspey versus Kimball, 221 U.S. would have decided, had Waldorf

been a banking corporation and had its shareholders been subject to additional liability. This Court decided that such additional liability could not have been imposed upon dissenters who had elected appraisal rights.

Q What happened to the stock? Was it held as Treasury stock or was it cancelled, or do you know?

A The -- as I read the statute, Mr. Justice, the stock became Treasury stock and Waldorf was obligated to pay for it, at its fair value.

Q What did -- how was the purchase price of the stock handled? I mean, taxwise; is that concededly a capital expenditure?

A That is concededly a capital expenditure.

Q Why do you concede that?

A I conceded that, Your Honor, because of the fact that it was unnecessary forHilton to exchange the one-and-a quarter shares for these shares that had ceased to become outstanding shares of Waldorf.

Q Why wasn't the expenditure for the actual price of the stock, why wasn't that as deductible as the miscellaneous expenses connected with the acquisition?

A My point, Your Honor, is that the miscellaneous expenses are not connected with the acquisition. They are not -- there is no functional relationship between the acquisition and these expenditures.

Q No functional --

A No functional relationship.

My point --

Q You mean that you would have incurred these expenditures anyway if you hadn't acquired the stock?

A It wasn't that; it was because we could not agree on price that we incurred these expenditures.

Q But you still wanted to buy the stock.

A We had already acquired thestock, Your Honor.

Q I suppose you could have -- could you have backed down on it?

A We could not have backed out of it, nor could have the dissenting shareholders.

Q But you knew in advance of the merger that if anybody dissented you would have to buy the stock.

A We knew that if they did exercise their rights we would have had to buy the stock.

Q But if, certainly absent some dissent and absent the acquisition of stock, you wouldn't have made these expenditures?

A That is correct, Your Honor, after the creation of an obligation on the part of Waldorf, assumed by Hilton to pay for the stock, the appraisal proceedings would not have been made.

The dissenters, when they dissented and demanded

payment, elected tosell their shares under terms set forth by the State of New York.

The State of New York determined who the parties to the sale were, the number of shares to be sold and the date of the sale.

In the State of New York, by statute also determines the purchase price of the shares. The State of New York determined that the purchase price of the shares was the value of the shares on the day before the meeting of Waldorf, approving the merger.

Neither party, neither the dissenter nor Hilton could vary the price to be paid for the shares. This is somewhat similar to the situation in Kieselbach versus Commissioner, 317 U.S., where this Court said that the purchase price of a condemnation proceeding is settled as of the date the property was taken.

The appraisal proceeding was not part of an acquisition process because the parties were not negotiating as to a mutually-acceptable terms as a condition to sale. This is not analogous to finding a buyer by paying a broker a commission. nor is it analogous to the parties bargaining as to the condition of sale as to purchase price. Without an agreement to purchase price, there wouldhave been no sale in the ordinary circumstance. In this circumstance the purchase price had been imposed upon by the State and the sale had been imposed upon

the party by the state once the election was made.

This is not in any way analogous to attorneys preparing documents to consummate a sale, without the signing of which there would be no sale.

This was a complete sale not subject to renegotiation by either party to the sale. The dissenters could not unilaterally cancel their dissent and resume their status as shareholders of Hilton. They were in the same position as a private seller who has sold his stock and he deferred payment and the payment could either have been a fixed purchase price or a formula purchase price or a price to be determined by an objective standard, such as the State of New York in this case said it would be; the objective standard being fair value.

After the demand for payment the shareholder -- the dissenters had no interest in Waldorf as shareholders. They were not interested in whether the price of Waldorf stock went up or down; they were not interested in whether the price of Hilton stock went up or down. They ceased to have any interest as equity owners and merely were creditors.

This --

Q Well, what if a buyer and seller sign a contract for the purchase of the assets of the company and they sign a contract; both sides are obligated and they accept to go through withthe transaction and they set the price of every item except one piece of real property over which they can't

agree, but they bothagree that a named appraiser will set the value and that's the price that will be paid and then the appraiser sets it and he charges a good stiff fee and they split it. What about the buyer there on that appraisal fee; doesn't he have to capitalize that expense?

A I would think, Your Honor, that that is part of the agreement as to purchase price prior to the consummation of the sale.

Q But he doesn't know what it is going to be.

A But they have agreed that it will be what is determined by the appraiser.

Q Well, your answer is: "Yes, it would be a capital expense."

A The answer is: it probably would be a capital expense.

The public policy in the State of New York in this, appears to be very correct, because if the Waldorf dissenters could resume their status as shareholders, and Hilton stock were tohave gone higher, they couldhave taken advantage of the increase in price of Hilton stock, while in any event, having a downward protection, because if Hilton stock went lower they could always have their demand for fair value of their stock.

The fact that the dissenters did not have this choice, demonstrates once again that they were in a position not as shareholders when the appraisalproceeding was commenced, but as

creditors, and the purpose of the appraisal proceedings was to determine the amount owed to them as creditors.

In summary on this point: the dissenters have sold their stock on the date they objected to the merger and demanded payment for their stock. They had no claim against Waldorf or Hilton as shareholders and they had only the right to receive payment.

And all of these events had occurred prior to the appraisal proceeding. The appraisal proceeding could, in no way, affect the acquisition. The appraisal proceeding was not an equitable proceeding to revise or modify the terms of the sale andit was not necessary to achieve an enforceable bargain, because an enforceable bargain had been imposed by the State of New York.

It was also not necessary to achieve the essential formalities of the sale because those formalities were taken care of by law. And it was not necessary to establish acceptable terms of acquisition because the terms of acquisition had been imposed by law.

The appraisal proceeding was not part of the cost of acquisition, because the share were acquired prior thereto and the appraisal proceeding had no effect on the acquisition.

Title involvement has always been a necessary element to determine whether an item is to be capitalized as being part of the cost of acquisition, protection or defense of title.

because one cannot acquire title or acquire anything without title being involved.

Title involvement, this necessary touchstone is absent from the appraisal proceedings, because title to the shares of stock of the dissenters passed from them long before the appraisal proceeding was started.

Most of the Government cases citing the application of the Winmill rationale involve title, so the cases cited by the Government are clearly not applicable. Andif the cases didn't involve title, they involved a recasting of sales price by a court with respect to a sale induced by fraud. Again, a bargaining process.

Or the cases involving the reaching of an agreement as to price prior to title being passed or the cases involved in taking the necessary steps to consummate the sale.

The more appropriate cases as authority for this case is the case of Petschek, decided by the SEcond Circuit, involving a confiscation proceeding. In that case the taxpayer's property was confiscated by a foreign government and the proceeding determining the award was based upon the value of the property confiscated.

There the Second Circuit held that the legal costs in the proceedings were deductible. Another relevant case is the Naylor case decided by the Fifth Circuit. In that case, an option was exercised to purchase the stock and the parties

agreed that title would pass, but the option price was set at the book value of the shares of stock at a certain date, and the taxpayer hired an attorney because a dispute arose as to book value.

The attorney's fees were held to be deductible because title had passed before the attorney was hired and he was hired merely to collect an express amount of the purchase price, which was a standard set by agreement among the parties of book value.

The Government's reliance upon title cases is misplaced and rather the Petschek case and the Naylor case are more appropriate.

The Government contends that the origin and character of the appraisal proceedings was in the merger. Essentially the argument is: had there been no merger there would be no appraisal proceedings. But the cause of the appraisal proceedings was not the merger; the cause of the appraisal proceedings was in the objection and demand for payment by the dissenters. Had their been no such objection or demand for payment there would be no appraisal proceedings.

The merger had been completed and the dissenters did not affect the merger. The acquisition of the dissenters' stock had been completed, and the dissenters could not affect such acquisition. It wasnot from the merger or as a part in the acquisition that the appraisal proceedings arose; it was from

creditor relationship relationship established between the dissenters and Waldorf, and the fact that they couldnot agree on the fair value of the dissenters' shares.

There was no functional relationship between the appraisal proceedings and the merger and the rules with respect to mergers should not apply.

The Government states that distinctions in state law should not govern Federal tax consequences. And the Government in its brief cites cases where there was no substantive difference in state law or where state law put different labels on the same property as authority for this statement.

However, we all know that in private contracts trying to accomplish similar ends, different tax consequences can depend upon title.

There is one case in the lower courts, other than Woodward, in which the appraisal proceedings -- the expense of the appraisal proceedings were held to be deductible. This is a District Court case, Boulder Building Corporation and it was decided under an appraisal statute at 18 Oklahoma Statutes Annotated 1.161(a) 1953.

I will quote this statute to you: "Holders of dissenting shares of a domestic corporation shall continue to have all the rights and privileges incident to their shares except as expressly limited by this section until such time as the fair value of such shares be agreed upon or determined by a

judgment."

There were no appreciable limitations under this statute.

I submit that underthe Oklahoma statute the dissenters remained shareholders and they could have resumed their status as shareholders, which is entirely different than the state law in New York when they have forever lost their status as shareholders.

The Government says: ignore title when you decide this case, but one must always be concerned with title if one is going to impose a capitalization because title acquisition is involved.

Hilton does not urge the use of theprimary purpose test in this case because the sole purpose of the appraisal proceeding was to determine the value of the shares, the amount of the debt owed by Hilton and there wasno element of title involved in the appraisal proceeding.

Q Well, again, it sounds to me on that argument that you could, if you are right, you should be able to deduct the price that was set in the appraisal.

A Your Honor, I think there is a distinction between setting a price and paying a price. We had agreed -- Hilton had agreed to pay a price. It was a price that was imposed upon it by state law and the state law had evolved a procedure to determine the price. We are questioning -- the

problem we have is to categorize the expenses in determining the price. There is no question that the price itself is -- was for an acquisition.

Title was not involved in the price determination procedure. The title was involved in the acquisition which had occurred before the price-determining proceeding.

In summary, the expenses of Hilton in the appraisal proceeding should not be capitalized because title was not involved in the appraisal proceeding and Hilton acquired nothing as a result of the appraisal proceeding.

In addition, the appraisal proceeding, having resulted from the demand for payment and the inability for the debtor-creditor to agree on price was not functionally related to the merger, so the merger rules should not apply.

It is respectfully submitted that Hilton's expenses in the appraisal proceeding are ordinary and necessary expenses deductible under Section 162 of the Internal REvenue Code.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Levenfeld.

Mr. Walters.

REBUTTAL ARGUMENT BY JOHNNIE M. WALTERS, ASSISTANT ATTORNEY GENERAL, ON BEHALF OF PETITIONER

MR. WALTERS: Mr. Chief Justice, and may it please the Court: I'll just mention one or two items briefly.

Again, we submit that these two cases bring to this

Court two instances where taxpayers would deduct the cost of determining the value of capital stock which capital stock had to be acquired in one instance by individual taxpayers; in the other by a corporation in connection with corporate action.

The fact that the timing of these costs came either before or after we submit, is immaterial. These costs were incurred at the part andparcel of the overall transaction in each instance.

Accordingly, we submit that the Court should decide these two cases alike. The Eighth Circuit held that they were capital expenditures in the Woodward case. In the Hilton case the Seventh Circuit held they were deductible.

We think that the Eighth Circuit is right and that the Seventh Circuit is wrong, but we submit most urgently that whatever this answer is we need one rule. These are not isolated instances. There are many, many corporate reorganizations, mergers and other items, actions taking place today where this is going to be a recurring event, so we need a rule for taxpayers and the government alike.

Q Are there other decisions in the lower courts where the courts have gone in opposite directions?

A Mr. Justice, there are several decisions --

Q Some in the District Courts.

A Yes, sir, where they have gone both ways, really.

We submit that the better view is that applying in the Woodward case, because we do not see how you can separate out this appraisal proceeding which is required to determine the value or the price of the stock from the overall transaction.

Now, as to the possible distinctions between the two statutes involved in these cases, again we say they are immaterial, because if you tread away the brush and look at the main transactions that we have here, it seems clear to us that these expenditures were incurred in the purchase of capital stock. We don't see how you canfind otherwise when you look at the whole picture.

We mentioned very briefly the point that Mr. Justice White has brought out in questioning, that if Hilton felt that the timing was as important as it is, then we submit that they could very well have justified, at least arguably, deducting the cost of price that they paid for the stock, too, because that came before the acquisition, also.

In fact, we submit that the concession by Hilton that the pre-merger expenses incurred, expenditures for the consultant constitutes nondeductible capital expenditures indicates that they, too, feel that the decision in the Woodward case is correct.

MR. LEVENFELD: Mr. Chief Justice, I would like a few minutes in rebuttal.

MR. CHIEF JUSTICE BURGER: I guess you have -- excuse me. We've got our two cases here, just let me get unsorted.

You have no rebuttal left. Mr. Walters was in rebuttal on this case; you have exhausted all your time.

(Whereupon, at 11:50 o'clock a.m. the argument in the above-entitled matter was concluded)