OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: PORTLAND GOLF CLUB, Petitioner v.

COMMISSIONER OF INTERNAL REVENUE

CASE NO: 89-530

PLACE: Washington, D.C.

DATE: April 17, 1990

PAGES: 1 thru 51

ALDERSON REPORTING COMPANY

1111 14TH STREET, N.W.

WASHINGTON, D.C. 20005-5650

202 289-2260

IN THE SUPREME COURT OF THE UNITED STATES

- - - - - - - - - - - - - - - - -x

PORTLAND GOLF CLUB, :

Petitioner :

v. : No. 89-530

COMMISSIONER OF INTERNAL :

REVENUE :

- - - - - - - - - - - - - - - - -x

Washington, D.C.

Tuesday, April 17, 1990

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:12 a.m.

APPEARANCES:

LEONARD J. HENZKE, JR., ESQ., Washington, D.C.; on behalf of the Petitioner.

CLIFFORD M. SLOAN, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Respondent.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

C O N T E N T S

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

P R O C E E D I N G S

(10:12 p.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument first in No. 89-530, the Portland Golf Club v. the Commissioner of Internal Revenue.

Mr. Henzke.

ORAL ARGUMENT OF LEONARD J. HENZKE, JR.

ON BEHALF OF THE PETITIONER

MR. HENZKE: The issue in this case involves the deductibility of the unrelated non-member business expenses of an exempt social club. Specifically, whether the government is correct that there is a per se rule requiring an exempt social club to intend to report a tax profit on its tax return in order to deduct a loss on such business.

Here, Petitioner is a tax-exempt social club. It is a golf club. It has operated one of the finest golf courses in Oregon for the past 75 years. In addition to its golf course, it operates a food and beverage business for members and also for non-members whose private parties are sponsored by members.

Virtually all the private party business is categorized as an unrelated business by Section 512(a)(3) of the Internal Revenue Code. In the years at issue, this food and beverage unrelated business produced tax losses when -- when computed according to a method stipulated by

the government to be reasonable. These losses were used to offset other unrelated business income -- unrelated business income from another activity, the investment income.

The government disallowed the deduction which produced the losses on the basis that the food and beverage unrelated activity was not entered into with an intent to earn a profit. We contend that no profit motive is required because the plain and ordinary meaning of the terms in Section 512(a)(3) do not require a profit motive.

The resolution of this case, in our view, depends completely on the terms of Section 512(a)(3). Accordingly, I would like to take a few minutes to analyze the operation of this statute.

Section 512(a)(3) of the Code divides the activities of a social club into two parts, and for our convenience today I would like to call these parts categories or baskets.

Section 512(a)(3) creates two categories for the activities of an exemption -- social club called the Exempt Category and the Unrelated Business Category. Section 512(a)(3) then defines which club activities are to go into each category.

Section 512(a)(3)(b) narrowly defines the exempt category to consist of those activities which are member-paid social or recreational goods or services. Goods or

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

services that the members pay for; that's the exempt category.

On the other hand, Section 512(a)(3)(a) provides that all the remaining activities --

QUESTION: Mr. Henzke, where will we find these sections? In your brief?

MR. HENZKE: The Section 512(a)(3)? Well, it's in the --

QUESTION: Well, in the --

MR. HENZKE: -- appendix to the --

QUESTION: -- the one you -- the appendix to your petition?

MR. HENZKE: Yes. No, the appendix to the brief.

QUESTION: The appendix to the brief.

MR. HENZKE: Yes. At pages a-1, a-2 and a-3.

QUESTION: The -- the blue brief?

MR. HENZKE: The blue brief, yes. At the very end.

QUESTION: Oh, I've got the wrong case.

MR. HENZKE: As I was saying, Section 512(a)(3)(a) defines all the remaining activities, all the activities except the exempt category, as fitting into the unrelated business category. The tax treatment of the income and deductions of an activity is determined by which category Section 512(a)(3) assigns that particular category.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

The income of an exempt category is exempt, and the deductions -- and the expenses are not deductible. The income of the unrelated business activity is taxable and the deduction -- and the expenses are deductible if those expenses are of the type allowed to a business by Chapter 1 of the Code.

Now, the government maintains that after Section 512(a)(3) assigned Petitioner's unrelated food and beverage business to the unrelated business category it must then meet a profit motive test under Section 162 of the Internal Revenue Code. However, the profit motive test is generally a precondition to the existence of a business. The existence of a business is a requirement for Section 162 to apply.

In this respect, the profit motive test is similar with respect to Section 162 as the rules of Section 512(a)(3) are with respect to that statute, where the rules of Section 512(a)(3) establish the preconditions for determining whether an activity is an unrelated business.

Once the Section 512(a)(3) precondition for an unrelated business are met, it would be contradictory to attempt to apply the profit motive precondition for a Section 162 business. The government's interpretation --

QUESTION: So are you -- are you saying that there's a presumption in -- in this section of the statute

that any deduction is for a profit motive and that any unrelated business is also for a profit motive, or that profit motive is simply irrelevant?

MR. HENZKE: Well, profit motive is simply irrelevant for a -- to determine whether an activity goes on the unrelated business side -- category under Section 512(a)(3) because Section 512(a)(3) does not contain any profit motive requirement and it sets forth specifically what the requirements are for being an unrelated business under Section 512(a)(3). And since there is no profit motive requirement in Section 512(a)(3) of the Code, then profit motive is really basically irrelevant.

Now, you could have a situation where if the club was, for example, providing food and beverages to non-members who were, for example, maybe their friends and they were providing them, say, at half cost, that in actuality what they're doing is they're really having the members pay part of the cost for these nominally non-member functions. So it may be then what would nominally be an unrelated business under Section 512(a)(3) -- in other words, you would say, first of all, if you looked at it, well, this looks like a non-member function. It's really a member function.

But once you determine that it is a -- an unrelated business activity, then it does not need a profit

motive.

QUESTION: Well, doesn't the statute refer to deductions allowed by this chapter? So doesn't that incorporate of necessity any provisions in the chapter that might determine what deductions are proper?

MR. HENZKE: Your Honor, it does incorporate many requirements of provisions other than Section 512(a)(3).

QUESTION: All right. And the SG, the Solicitor General, says, and that includes Section 162.

MR. HENZKE: And we agreed with that -- with that contention.

QUESTION: And that section has been interpreted as incorporating a profit motive.

MR. HENZKE: I would -- I don't think it's been interpreted as incorporating a profit motive in the --

QUESTION: For a trade or business.

MR. HENZKE: For a -- it incorporates a trade or business. But the profit motive test is a precondition to determine if a Section 162 business exists. Now, once you have a Section 162 business, then there are other requirements of Section 162 which you -- which you must apply.

For example, the necessary test or the ordinary test. For example, if you have a business, it doesn't mean every single deduction is going to be deductible. A

particular expense may be a non-ordinary expenses, that is, a capital item. So it would not be deductible.

QUESTION: (Inaudible) the profit motive in this case?

MR. HENZKE: Because Section 512(a)(3) itself decides what is a business and --

QUESTION: And once you've got a business you've got a business?

MR. HENZKE: You've got a business, right. Now, even in our case, once you have a business some of the items of deduction in that business may be non -- items of expense, rather, in that business may be non-deductible.

For example, if you have a capital expenditure, it -- then it's non-deductible because it does not meet the ordinary test of Section 162. Or you may have, for example, a lavish expense which then does not meet the necessary test of Section 162.

But you -- you -- Section 512(a)(3) sets forth the preconditions for determining whether a business exists, an unrelated business exists, under Section 512(a)(3). You then, after you have that precondition -- set of preconditions -- you can't go to Section 162 and say, well, let's test this again to see if the preconditions, the profit motive test, of Section 162 will apply here, because what you're going to have then is a contradiction. You

can't have two sets of preconditioning -- preconditions governing one particular category or activity. It has to be --

QUESTION: Well, you want to --

MR. HENZKE: -- be one or the other.

MR. WAGNER: You want to explain it -- get down to what the government's contention really is.

MR. HENZKE: Well, I --

MR. WAGNER: How it works out. How it works out.

MR. HENZKE: I think the -- the government's -- the government confuses the preconditions for a Section 162 business with what happens after it's determined you have a business.

QUESTION: Yeah, but the problem here is whether -- is whether certain deductions can be taken against investment income. Is that right?

MR. HENZKE: That's right. That's right, Your Honor.

QUESTION: And -- but it isn't for the purpose of determining whether or not you've got a gain or loss on your non-member activities. You can deduct both the direct expenses and the indirect expenses.

MR. HENZKE: That's right. I don't think the government would disagree with that.

QUESTION: Yes.

MR. HENZKE: Nor does the government disagree that we properly computed the direct and the indirect expenses.

QUESTION: But the only issue is whether that loss can be taken against other unrelated income?

MR. HENZKE: That's right. And -- and the government, I think, would contend that the deductions that make up that loss -- because it is a loss -- become non-deductible because it's not for profit.

And our contention is, no, they -- they're business because Section 512(a)(3) says these are business activities. And you can't -- after you make that determination under Section 512(a)(3) you then can't go to Section 162 and say, well, let's see what preconditions are necessary to see what a business -- whether a business exists under Section 162.

In our view, the government is confusing the precondition for Section 162, namely, the profit motive, with the requirements of Section 162, which are the ordinary, the necessary, the paid or incurred and other requirements in the statute.

QUESTION: If it was -- if there was a precondition of a profit motive for a trade or business under this section, I don't suppose you'd allow any deductions, because it wouldn't be a trade or business at all.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

MR. HENZKE: Not in -- not in this particular case. In some cases, of course, the club would have taxable income on the return and, therefore, it would be a trade or business under the 162 precondition.

But, of course, there is no -- for -- there's no profit motive precondition in Section 162 of the Code.

QUESTION: Well, if you had -- if you had made money on these member -- non-member transactions, you would have been required to report any gain from it?

MR. HENZKE: If we had made money in the sense that we had taxable income --

QUESTION: Yes.

MR. HENZKE: -- we would then have to pay tax on that taxable income. Yes, sir.

QUESTION: Whether or not you had a profit motive?

MR. HENZKE: Well, I -- whether or not we had a profit motive, right. If we accidentally made money, even though we didn't have a profit motive, I suppose that could happen in a social club. Yes, we would have to pay taxes because that is an absolute rule of Section 512(a)(3), that you have to -- it's taxable income; you have to pay tax on it.

Maybe an illustration would help clear up this difference between the preconditions of Section 162 and the requirements of Section 162. The preconditions aren't

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

incorporated into Section 512(a)(3); the requirements are.

In our view, under the -- what the government is doing, it's applying the profit motive test to the items of expense that are in the unrelated business activity on an item-by-item basis. For example, under the government's test, they would take the appetizer, the food that goes into the appetizer at a non-member banquet, unrelated function and they would say, we are going to apply the profit motive test to the cost of the food, the expense for the food in that appetizer.

Well, obviously, that can't be done. I mean, you can't have a profit motive with respect to an item of expense. You can't say that the appetizer food is -- has a profit motive, or doesn't have a profit motive and the dessert, the food that goes into the dessert, does have --

QUESTION: Well, they don't refer to --

MR. HENZKE: -- a profit motive.

QUESTION: They don't really say that, do they?

MR. HENZKE: Well, that's what they're doing, I think, Your Honor, because they are saying that after --

QUESTION: Well, it is certainly logical to say that running the restaurant and all the other non-member activities is one major function of the club and the interest on their investments is another one. You don't have to divide it into salad and appetizers and shrimp

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

cocktails, do you?

(Laughter.)

MR. HENZKE: But, Your Honor, I think that what they're saying is that we will -- we agree that this is an unrelated business under Section 512(a)(3) of the Code. But we are now going to examine -- we're going to apply the test under Section 162. And the test under 162, for example, is -- is whether it's a necessary expense.

QUESTION: They're doing it for purposes of deductions, not for purposes of including the gross income.

MR. HENZKE: Well, the gross --

QUESTION: To the extent you'd include --

MR. HENZKE: Of course, you don't include the gross income just as gross income. You have to take the -- deductions from the gross income and then you get net unrelated business taxable income, or unrelated business taxable income. So, the statute is defining unrelated business taxable income, and then you have to determine what is the gross income and what are the expenses and then you come up with what the taxable income is.

QUESTION: But you seem to be interpreting this section as saying that anything goes so far as the deduction of the related expenses so long as it's related.

MR. HENZKE: Well, --

QUESTION: It seems to me there has to be some

control, as Justice O'Connor points out, initially under Section 162.

MR. HENZKE: Well, there is -- there is a great deal of control. We would apply the ordinary test. In other words, it can't be a capital item. Even if it's in -- the item, the expense, is in the unrelated business activity. It's been classified. It's been put in the unrelated business basket. But still, it has to -- it will not be deductible if it doesn't pass the ordinary test, the necessary test, the paid or incurred test, the incurred -- paid or incurred in a taxable year test, the substantiation test -- all the other requirements of a Section 162 trade or business.

But we do make one exception. We say, but we don't have to meet the preconditions for a business under Section 162 because the preconditions for an unrelated business under Section 512(a)(3) is in Section 512(a)(3) and you can't apply two different preconditions for a business.

QUESTION: Well, you have to allocate some fixed costs to the unrelated income, don't you?

MR. HENZKE: Oh, there's no question about that. But there's no dispute here that we properly allocated the fixed costs to the unrelated business income. It's stipulated that the method we used --

QUESTION: Was that stipulated for purposes of this case or is there a revenue ruling that covers this area generally? Or was it just stipulated in this case that that's a proper allocation?

MR. HENZKE: It's stipulated in this case that this was a reasonable allocation. But the allocation method that was used is the gross-to-gross method, the gross-to-gross allocation method. And that is the normal allocation method made by -- under Section 512(a)(3) and actually by most exempt organizations under Section 512(a)(1) also. That -- that allocation method has been approved by the claims court in the Disabled American Veterans case.

I think a comparison of Section 512(a)(1) and Section 512(a)(3) confirms our interpretation of the statute.

QUESTION: May I ask you, what -- what do you say about the government's main argument that -- that the theory you urge would frustrate the whole purpose of the provision, which is not to let people who are spending money on their own entertainment in -- in effect to get tax deductions for it by allowing their investment income that is used for that activity to be tax-free.

MR. HENZKE: In -- in our view, Your Honor, the statute does not tax gross investment income. I mean, I think it's undisputed in this case that the tax -- that the

Section 512(a)(3) taxes gross investment income less expenses and gross unrelated business food and beverage income less the related expenses.

Now, the entertainment -- talking about -- taking entertainment costs and deducting them from the investment income, in actuality the entertainment-type expenses are covered by the categorization, the division process, in Section 512(a)(3), because you see, the member expenses are actually a type of quasi-personal expense. And that is why Congress placed them in this exempt category.

Now, if you look at the legislative history of Section 512(a)(3) of the Code, you'll see that Congress did not want those expenses to be offset against the investment income so they -- they provided specific rules to make sure that those losses on the member business were not offset against the investment income. That was the thrust of Section 512(a)(3).

And of course, there is no dispute in this case that none of the member expenses -- the member losses in our case -- are being offset against the investment income.

Now, why didn't Congress go further and say that, well, you may have some -- some expenses that we didn't catch in this division category that are being offset against the investment income and might be said to be somewhat member related? Why didn't they go further?

Well, I think the -- the practical reason is that in 1969 tax-exempt social clubs were only allowed to have 5 percent of their total gross receipt represented by all active non-member income, including non-member food and beverage income. So that it really was not a -- a major problem in Section -- in 1969, the thought that maybe there would be some losses on the non-member side and they would be offset against the -- the investment income.

So Congress certainly -- there was nothing in the legislative history that indicates that they thought that losses on unrelated business -- food and beverage business -- should not offset the investment income.

QUESTION: How does this gross-to-gross allocation method work? Would you explain it to me? Suppose -- suppose I have a club that -- it -- it originally serves only members, and are there are 100 -- there are 100 members. And then -- then it decides it will serve non-members as well, and it serves one non-member.

Now, what is the effect, under your system, of serving that one non-member? What would go along to be deducted from what would otherwise be the profit from the sales to the non-member?

MR. HENZKE: All right. Assume, then, that the -- for simplicity, that you had one dollar of non-member income and $99 of member income in that situation.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

QUESTION: Right.

MR. HENZKE: All right. And the fixed expenses of the club were -- that -- that would be your gross receipts. The fixed expenses of the club were $1,000. So, under that, then 99 percent of the fixed expenses would go -- would be allocated to the non-member business and 1 percent of the expenses would be allocated to the member business.

Now, you have to realize it will never be more than 15 percent because there's a 15 percent limit now under the current Code.

QUESTION: On the non-member business?

MR. HENZKE: On the non-member business, yes. Right.

QUESTION: And the government has stipulated that that's an appropriate allocation in this case?

MR. HENZKE: That's right, Your Honor.

QUESTION: That -- that seems to me very strange. They've done it, so I suppose we're stuck with it. It just --

MR. HENZKE: Well, it really --

QUESTION: -- doesn't seem to me that one -- that one member uses one percent of the fixed costs. That's just contrary to common sense, it seems to me.

MR. HENZKE: Well, the reason --

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

QUESTION: But that seems to be what the government seems to have done.

MR. HENZKE: There is a reason for using this gross-to-gross method even if it's not perfectly accurate. And that's the fact that there are 50,000 social clubs -- tax-exempt social clubs -- in the country. Most of them are very small, and if you used a more complicated method, like the actual-use method here, under which we actually had a profit -- net income of $45,000 -- if you used that method, you would -- of course, it would be too complex to -- to --

QUESTION: So all of the clubs in the country are, therefore, understating -- or, overstating the costs that are allocated to non-member activity?

MR. HENZKE: Well, they're under -- some of them may be -- the gross-to-gross method may be accurate. Some it may overstate; some it may understate. It just depends. The more non-member business you have, the greater will be your fixed expense deductions. The less non-member business you have, the less. I mean, if you have 1 percent non-member business, then you have one percent allocation.

QUESTION: But when you say non-member business, you mean income from non-members.

MR. HENZKE: Right.

QUESTION: You would count member dues as part of

the member business?

MR. HENZKE: That's -- that's correct. Yes. That's correct. But not initiation fees. Not initiation fees.

QUESTION: And -- and you count expenses -- income received from guests of members as member expenses and not non-member expenses, do you not?

MR. HENZKE: That -- that will vary. If the -- if the member pays the bill, generally that is -- that is a member expense or -- and member income to the club. If the non-member pays the bill, in general, that is an unrelated business, a non-member item of income.

QUESTION: Well, can a non-member pay a bill? I mean, is that the custom at the club, that the non-member can pay the bill just as readily as the member?

MR. HENZKE: Well, the mechanics of it will differ, but the non-member can bear the economic -- burden of the bill, yes. Yes. If he's sponsored by a member.

I'd just -- I'd like to take a couple of minutes to talk about our alternative argument that Petitioner had a profit motive. The unanimous tax court in the North Ridge Country Club opinion applied here, assumed that Section 512(a)(3) required a profit motive, and the court found that both clubs had a profit motive based on all the facts and circumstances.

I don't have time to go through all those facts and circumstances, but I think that significant here is that the gross receipt here exceeded the variable cost by $50,000 in the two years in issue, and that they -- under the actual use method, which took into account the fixed expenses, we had a profit here of $45,000 in two years.

So we submit that the government is wrong in saying that taxable income is a per se requirement for having a profit motive. With this kind of real economic profit, we submit that we had a profit motive even if you determine under Section 512(a)(3) that a profit motive is required. And we think that the tax court rationale for making that determination on a facts and circumstances basis is consistent with this Court's decision in the -- in the Groetzinger case.

QUESTION: (Inaudible) you want to claim these -- you want to claim these overhead expenses as -- as deductible and yet you want to disregard them to show that you have a profit motive.

MR. HENZKE: Well, because the definition of -- of profit, for purposes of computing your tax, is different from the definition of profit for purposes of profit --

QUESTION: It's cash flow.

MR. HENZKE: -- motive.

QUESTION: It's cash flow.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

MR. HENZKE: It's cash flow, right. Or cash return, as some of the commentators in some of the opinions have called it.

QUESTION: Thank you, Mr. Henzke.

Mr. Sloan.

ORAL ARGUMENT OF CLIFFORD M. SLOAN

ON BEHALF OF THE RESPONDENT

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

In 1969 Congress enacted a provision addressing the tax treatment of the income of social clubs and in that provision Congress treated social clubs differently from other tax-exempt organizations.

With respect to other tax-exempt organizations, Congress imposed a tax only on the income from an unrelated trade or business. With respect to social clubs, Congress imposed a tax on all income except for what was called the exempt function income which was primarily the payments from members for the purposes of the club. Congress was explicit in the legislative history about the reason for this different treatment.

With respect to other tax-exempt organizations, the concern was a concern about unfair competition. It was a concern that if a tax-exempt organization engaged in a trade or business in competition with a taxable entity, the

tax-exempt organization would have an unfair competitive advantage.

With respect to social clubs, Congress explicitly stated in the legislative history that there was that concern, but there was another concern as well. And the additional concern had to do with the entire reason for the exemption for social clubs in the first place.

The reason for the exemption for social clubs was so as not to penalize individuals for coming together and pooling their resources for their pleasure and recreation activities. But Congress specifically noted, to the extent that outside income was not taxed, it represented a tax subsidy. And in the words of Congress, such a subsidy would be a distortion of the purpose of the exemption.

Well, in the legislative history Congress specifically identified investment income as the kind of income that it sought to tax of social clubs, and it specifically identified the failure to tax investment income as the kind of tax subsidy that it sought to prevent.

For the tax years in question, Petitioner received more than $33,000 in income from its investments. Yet, Petitioner claims that it is entitled to pay no taxes on that investment income because Petitioner claims that what Congress actually did in 1969 was create a special favorable tax rule for social clubs in which, unlike other taxpayers,

social clubs can deduct losses from an activity and apply those losses to another activity and offset the income and eliminate any tax on it without any showing that the activity generating the losses was engaged in for profit.

Alternatively, Petitioner suggests that it should be able to claim that certain expenses are directly connected to the production of income for the purpose of claiming deductions and at the same time deny that they are related to the production of income at all for the purpose of evaluating the profit motive.

QUESTION: Well, Mr. Sloan, do you -- do you agree that -- that these sort of indirect expenses are deductible for the purpose of determining whether there's a profit or loss on non-member activities?

MR. SLOAN: For it -- well, let's see. I'm not sure that I completely understand the question. In terms of whether they are deductible?

QUESTION: I'm talking about the overhead items.

MR. SLOAN: Right. The allocation of indirect costs.

QUESTION: Right.

MR. SLOAN: Yes, we think that those costs that are allocated should be considered in evaluating whether the club had a profit or not. Yes.

QUESTION: On the -- on the non-member activity?

MR. SLOAN: On the non-member activity. Yes.

QUESTION: And if it's -- and if there's a profit, there's a tax?

MR. SLOAN: Yes.

QUESTION: And if there's a loss, there's no tax but you say that can't be set off against other non-member income?

MR. SLOAN: That's right.

QUESTION: Because?

MR. SLOAN: Because the activity was not engaged in for profit.

QUESTION: Is there a regulation to this effect?

MR. SLOAN: There's a revenue ruling to this effect in 1981.

QUESTION: I didn't ask that. Is there a regulation?

MR. SLOAN: No, there is not a regulation to this effect.

QUESTION: Has there ever -- has there been a proposed regulation?

MR. SLOAN: No. The proposed regulation to that explicitly addressed this particular issue. The revenue ruling is the only administrative guideline --

QUESTION: How long -- how long has the Service taken this position that you're urging?

MR. SLOAN: Well, the revenue ruling was issued in 1981, and certainly since 1981.

QUESTION: Consistently?

MR. SLOAN: Yes.

QUESTION: And before that?

MR. SLOAN: Before that the issue doesn't appear to have been firmly resolved. There's absolutely nothing to indicate that the Service had taken a contrary position. The revenue ruling -- the fact of the revenue ruling indicates that perhaps it was intended to resolve the issue. But there is no administrative document that specifically addresses the issue one way or the other before 1981.

QUESTION: And the act was passed in 1969?

MR. SLOAN: That's right.

QUESTION: And with what tax years are we concerned here?

MR. SLOAN: The tax years are 1980 and `81.

QUESTION: So that the rev. rule came down just about the time of these tax years?

MR. SLOAN: Well, that's -- that's correct, Your Honor. But it should also be pointed out that there is no suggestion that this revenue ruling is addressed solely to this case. This has been a regularly recurring pattern with social clubs and has come up in a number of cases. And so -- in -- in some of the other cases there is completely

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

different timing as to --

QUESTION: Mr. Sloan, do you accept the Ninth Circuit's definition of profit explained in that North Ridge case, which is that the production of gains in excess of all direct and indirect costs --

MR. SLOAN: Yes.

QUESTION: -- indicates a profit?

MR. SLOAN: Yes, we do. We accept that.

QUESTION: Well, you accept it for one purpose but not for the other. Just -- just as in your opponent's second argument he would accept it for one purpose but not for another.

MR. SLOAN: Well, for what purpose do we not accept it?

QUESTION: You accept it for -- for purposes of deciding whether it's a profit-motivated business but you reject it for purposes of deciding whether it's a -- it's a proper deduction from the business. You -- you want to segment the business for purposes of the deduction but insist that it be looked upon as an inseparable whole for purposes of whether there's a profit motive.

MR. SLOAN: Well, that --

QUESTION: Now, isn't that a fair characterization? I mean, because I could say there's a profit motive. You know, I want to make as much money as

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

I can from -- have these facilities lying fallow, the marginal costs are negligible. Whatever I make on the sandwiches I sell to non-members is -- is gravy.

That's a profit motive if you look at it one way. But you insist, no, you have to look at the whole business. You have to consider the -- all the club facilities that go behind selling this one sandwich and you say that's no profit motive.

Well, you know, in a real sense it is a profit motive. For that purpose, you want to segment the two -- the -- the -- or you want to merge the two. But then for the other purpose of whether you can take the deduction, you say, oh, no, that these two things are entirely separate.

MR. SLOAN: Well, we're not saying that they're -- that they're entirely separate in terms of the profit motive. We allow them to offset their -- the expenses up to the level of the last penny that they get from the sale of the food and drinks to non-members. They don't have to pay any tax at all on that.

But that is not from segmenting the activity. That is from a basic principle that's been long-established that a taxpayer can offset the expenses of a not-for-profit activity. So, that's perfectly consistent with our view. Our view is in both instances and the justification in both

instances is because the activity is not for profit.

Now, we do agree -- we completely agree -- that you have to take into account both the direct costs and the indirect costs for the purposes of evaluating the profit motive. But I don't see -- respectfully, I don't see the inconsistency.

QUESTION: When you compute if they're making a profit from their -- sandwich business, they wouldn't be making a profit if -- if they're simply getting back more than marginal costs. They would have to get back more than --

MR. SLOAN: Than the combination of the direct costs --

QUESTION: -- the combination of the marginal and direct?

MR. SLOAN: -- and indirect costs, which is exactly the test that Justice O'Connor was mentioning that the Ninth Circuit said in the North Ridge case, which we completely agree with. And that's why we're not taxing at all their receipts from the sales --

QUESTION: That's very generous of you, of course, because that never happens, does it?

(Laughter.)

QUESTION: Does it ever happen?

MR. SLOAN: Well, it -- it doesn't happen in the

way that they have been allocated and so -- it may be that the Commissioner is unduly generous in allowing -- in stipulating to this allocation method. But all that that goes to is whether there should be a tax imposed on the receipts from the sales to the non-members. That doesn't go to whether somehow some special additional rule is created that allows you to offset the investment income altogether. That -- that's an entirely separate issue here.

QUESTION: Well -- well, but I -- I wonder if there isn't an inconsistency there. Once you allow them to allocate in this way, isn't that a concession by the Revenue that this is either a profit or a loss, depending on how it comes out. You've accepted this -- this method of allocation.

MR. SLOAN: We have accepted this method of allocation, Your Honor, and in the record -- not only for these tax years in -- not only for the specific tax years in question, but for 1975 to 1984 there is regularly nothing but losses which are shown by Petitioner for this activity and for this allocation method.

So there's no question -- there's never been any suggestion here that Petitioner intends to have receipts which exceed the combination of the indirect costs. Petitioner's intent here is clear. It's to have cash coming in in excess of the direct costs, but not to be in excess

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

of the direct costs and the indirect costs as they -- as they have been allocated here.

Now -- so when you look at this repeated pattern and there's no suggestion that they have any intention of having a profit under this standard, it's clear that they're engaging in it for not-for-profit purposes.

Now, the question arises, and perhaps this is what Justice Scalia's question was going to to some extent, why then would they do it? Why would an entity continue to have losses? Somehow that seems counterintuitive. And the answer to that question relates to the unique role of social clubs in terms of their dual uses. That they have -- their primary activity is a not-for-profit activity, and then they have this incidental other activity to generate some cash in excess of the direct costs, which will help defray the costs of the --

QUESTION: Well, I don't know why that's -- why that's confined to social clubs. Any business does that.

MR. SLOAN: Well, it is -- it is not like any business because any business has a profit motive. Any business certainly has a -- has an incentive to maximize its off-use facilities and so on. But no business in the situation where it has a not-for-profit purpose the way that the social club does or tax-exempt organizations as its primary purposes. And so it arises in that context.

Really what it's analogous to is not to the situation of other businesses, which have a profit motive for all of their activities, but to situations -- the dual-use cases in which a taxpayer has property for a particular not-for-profit purpose, usually recreation, and the property is something like a yacht or a vacation house or a horse or a horse farm and on particular days of the year the taxpayer seeks to rent out that property and generate some additional cash to help defray the costs of the not-for-profit purpose.

And the courts have said in that circumstance it's clear that in order to look at profit motive it -- it is not sufficient to look solely at the cash coming in in excess of the direct costs, but the whole picture has to be considered, including proper allocation of the indirect costs. That's what distinguishes the -- the social clubs, this dual-use character.

QUESTION: I don't -- see, where is there room under the Section 512(a)(3) for insisting on this profit motive? The -- the -- as you described it, (3)(a) says that you figure all your gross income and then take out the exempt income and -- but after you've taken out the exempt income you can deduct from the gross income that's left all of the deductible expenses.

MR. SLOAN: We take --

QUESTION: And it doesn't separate out investment

income from other kind of income. You just add it all up and you take your -- how do you --

MR. SLOAN: Well, because of the phrase "deductions allowed by this chapter," Justice White. The statute doesn't -- does not suggest some kind of mechanical mathematical formula in which you just add together the income and then subtract the deductions. It's a specific requirement.

For deductions there are two requirements. They have to be directly connected to the production of the income. But they also have to be deductions allowed by this chapter. And so the very -- the structure and the text of the statute points to other provisions in Chapter 1 for determining whether a deduction is allowed.

And in this case, Petitioner claims that its deductions are allowed under Section 162 of the Code. And so one would look to Section 162. In Section 162, it is clear, requires a profit motive for a trade or business. Now --

QUESTION: Well, yeah, but it -- this doesn't require a trade or business, (3)(a).

MR. SLOAN: No, it -- it doesn't require a trade or business because, again, Congress, consciously broadened --

QUESTION: Exactly.

MR. SLOAN: -- the tax and it includes --

QUESTION: Exactly.

MR. SLOAN: -- gross income --

QUESTION: Exactly.

MR. SLOAN: -- which isn't limited to a trade or business. But there are obviously forms of income which are not a trade or business, and there's nothing in the text of the statute to suggest that Congress meant somehow by broadening the scope of this tax to say that anything that fell within that tax was automatically a trade or business or to suggest that gross income --

QUESTION: Well, there's just nothing -- there's no necessity to have a trade or business in (3)(a).

MR. SLOAN: There's no necessity to have a trade or business to be taxed. Then if one wants to claim a deduction, one has to show that the -- that the deduction is authorized by a provision of Chapter 1 of the Code. Now, the provision the petitioner is invoking is Section 162. To invoke that provision, one must be a trade or business.

Now, the fact that Section 162 generally requires a profit motive is clear. This Court has reiterated that point recently in the Groetzinger and the American Bar Endowment cases, numerous courts of appeals decisions have held it. And the fact that that was the general rule of Section 162 should be sufficient to address Petitioner's,

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

claim because Petitioner and other social clubs should be fully applicable to that requirement because that is the applicable provision under Chapter 1 of the Code that they are invoking for the deduction.

The petitioner makes this plain meaning argument that because it -- something -- it comes within the scope of the tax it is automatically a trade or business. And, as we've discussed, the tax and the structure of the provision do not support that because they point elsewhere for the rules of deduction. They point to the other provisions --

QUESTION: Well, they do -- Section 512(a)(1) does refer to unrelated business taxable income.

MR. SLOAN: That's --

QUESTION: And so what we're saying in that section, we're dealing with a business.

MR. SLOAN: Well, it -- it uses the term -- Chief Justice Rehnquist, it uses the term "unrelated business taxable income." Congress uses that term in two very different ways. In Section 512(a)(1) it is using it for almost all tax-exempt organizations, and it refers only to income from an unrelated trade or business. And that term had been in the statute since the 1950s.

QUESTION: Well, it uses the same thing in 512(a)(3)(A).

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

MR. SLOAN: That's right. And in 512(a)(3)(A) in 1969 Congress says, this term that we've been using in 512(a)(1) to refer only to an unrelated -- income from an unrelated trade or business, which is basically the tax that we're imposing on non-exempt income, it's going to mean something entirely different for social clubs. It's going to -- it's going to have a much broader scope and it's going to refer to gross income of all kinds, not only to a trade or business.

And -- and Congress specifically included in that provision that deductions must be allowed under Chapter 1. And so it points to the other provisions of Chapter 1.

Now, Petitioner claims to be making a plain meaning argument based on the fact that the term "unrelated business taxable income" is used and even though it had been used in an entirely business context. But Petitioner pulls back from the reach of its plain meaning argument. In Petitioner's words, the statute shouldn't be read too literally, even though it is making a plain meaning argument.

And Petitioner suggests this economic gain test where if non-members pay a nominal fee for a function in which members participate and the fees from the non-members do not exceed the direct costs of providing that activity, then that situation is not entitled to the trade or business

situation -- to the trade or business treatment.

Now, under Petitioner's plain meaning argument that clearly should be the result because the fees from the non-members are taxable income. They're gross income, they're not from members, so they're unrelated business taxable income. And, therefore, under Petitioner's view, they should be automatically a trade or business and entitled to very large Section 162 losses. But Petitioner pulls back from the reach of that because that exactly would be clearly contrary to Congress' intent.

The problem with Petitioner's suggestion of this economic gain test is that it is anchored nowhere either in the specific provision relating to social clubs or in the other provisions of Chapter 1 to which the social club provision specifically points. And there is no need to create a new test out of whole cloth in order to address that kind of situation because there is a readily available test that fully addresses that situation, and that test is the profit motive which other taxpayers have to meet under Section 162.

QUESTION: It sounds like you're really relying on a general rule that -- that if you have more expenses than you have income from a nonprofit activity, you can't apply that -- those excess expenses to any income from any other source.

MR. SLOAN: That's correct, Justice White, because there's no --

QUESTION: Now, what authority do you have for that?

MR. SLOAN: Well --

QUESTION: I say you -- you cite -- you cite Boris Bitker and you cite two court of appeals cases.

MR. SLOAN: Well, that --

QUESTION: Do you have anything from a -- you have no regulation for it, no regulation for it. You have nothing expressed in the Code for it. And you have no -- no decision from this Court on it.

MR. SLOAN: Well, I think, for example, the Five Lakes Outing Club that is cited in our brief at footnote 6 would be --

QUESTION: Yes. Eighth Circuit. Uh-huh.

MR. SLOAN: That's right. But part of the reason for that, Justice White, is that there is no provision or no authority in the Code for taking losses from a not-for-profit activity and applying those to other activities.

QUESTION: Well, there's no -- no -- there's no provision in the Code preventing it either.

MR. SLOAN: Well, it --

QUESTION: You put the -- you say that --

MR. SLOAN: It's -- it is a --

QUESTION: That's just bootstrapping.

MR. SLOAN: No. It is the taxpayer's burden generally to show that a deduction is authorized under a particular provision and -- and --

QUESTION: Well, he says that --

MR. SLOAN: -- and that requirement --

QUESTION: He says, I'm trying to figure out what my -- what my taxable income is. I've had these expenses, I'm out of pocket. Why should I have to pay tax?

MR. SLOAN: He should -- well, he doesn't have to pay tax on that activity. That's the key.

QUESTION: Well, I know, but he -- he says, I've got some other income, but if I -- but I'm still out of pocket because I've had more expenses than I've had income.

MR. SLOAN: Because the -- the reason that that principle is allowed with respect to a profit-making activity is because in that circumstance there is a reasonable expectation that at some point -- the theory is that at some point the taxpayer is going to turn it around and there's going to be a profit on it. Maybe it's down the road, maybe it's very distant down the road. But at some point there's going to be a profit on the activity and that that will be taxed along with the income from the other activity. And that's one of the justifications for allowing the loss.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

But when one is engaged in a not-for-profit activity, there is no expectation that it's ever going to generate any kind of a profit. And the losses that are -- that are incurred are not deductible. It's --

QUESTION: So you -- so you say that it's -- there's just this general principle that we ought to accept that you can only -- in a nonprofit activity you can only apply expenses to that income?

MR. SLOAN: That's correct.

QUESTION: Well, it seems to me you're relying on a -- on a broader principle, and that is that the burden is on the taxpayer to justify any deduction.

MR. SLOAN: That's -- that's exactly right, Chief Justice Rehnquist. The burden is on -- is on them and they haven't pointed to any provision which would -- which would authorize --

QUESTION: You have a defense to each of their arguments as to why they could get a deduction.

MR. SLOAN: That's right. That's right. But we --

QUESTION: Except that you come -- you come here having stipulated that the deductions are proper as to the non-member income.

QUESTION: That's right.

MR. SLOAN: Not that the deductions are proper as

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

to the non-member income, but the allocation of costs as to the non-member income are proper. And that -- and then --

QUESTION: Well, all deductions other than the one in question.

MR. SLOAN: Well, that's -- that's correct. All offsets of expenses up to the level of the last -- it's not all deductions except for the one that's in question. It's a very clear and logical principle that, to the extent that their incurring expenses in getting this money will allow them to offset their expenses against that money, it's consistent --

QUESTION: But why if they're not engaged in a business for profit they -- they -- to offset, don't they have to point to some section that authorizes a deduction?

MR. SLOAN: Well, as -- as we had suggested, and as the Five Lakes Outing Club suggests, there is a well-recognized interpretation that the Commissioner has given that is consistent with the intent of the Code not to tax gross income but to tax net income, of allowing an offset of expenses up to -- up to the level of the receipts.

QUESTION: But that's not a deduction, you're saying?

MR. SLOAN: That's right. It's an offset of expenses that the Commissioner permits. Now, it's conceivable that one could argue that the Commissioner is -

- is being too generous in that respect. It is, as the Five Lakes Club suggests, a long-standing principle and judicially recognized, as is stated in their case.

But again, that goes to the point about whether a tax should have been imposed on the sale of food and drinks to non-members, whether that offset should have been disallowed altogether. And it suggests that perhaps the Commissioner, if anything, was being too generous in that respect.

But that does not allow and that is no justification for creating a special rule that allows the offset of the investment income.

QUESTION: Well, I suppose they'd say it's a matter of consistency, not generosity.

MR. SLOAN: Well, but I -- respectfully, I think that our position is entirely consistent here because what we are allowing -- and it is -- has been applied in numerous other situations -- is an offset of expenses up to the level of the receipts. We're saying, okay, we're not going to tax you up to -- up to that level. But we're not going to take the further step of allowing you to use claimed losses in order to offset other income and eliminate -- and eliminate tax on that other income.

QUESTION: But, Mr. Sloan, under your reading of the Code it would be open to the Commissioner to take the

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

position that, absent a profit motive, no expenses are deductible and you might be back here next year with that position.

MR. SLOAN: Well, it --

QUESTION: Apparently you would defend that as a proper reading of the statute.

MR. SLOAN: I -- let me answer it in this way, Justice O'Connor.

We have no quarrel with the long-standing interpretation of an offset of expenses, and we're not suggesting --

QUESTION: I know, but your legal position would leave open that position --

MR. SLOAN: That's correct.

QUESTION: -- to be taken by the Commissioner in another case on another day.

MR. SLOAN: That's correct, Justice O'Connor. But there is absolutely no suggestion that the Commissioner intends to take that position or has taken that position. And it's precisely because of a concern about taxing gross income as opposed to net income in the circumstance.

So it's important to realize that Petitioner's arguments, either its primary argument that it should be excused from the generally applicable profit motive requirement, or its argument that it should be able to claim

that certain expenses are directly connected for the purpose of claiming a deduction and then say that they're not related at all for the purpose of evaluating their profit motive, would go -- would clearly be contrary to Congress' legislative purpose and go a long way toward nullifying the tax on investment income that Congress thought it was imposing in 1969.

It is relatively easy and common for social clubs to structure their sales to non-members in exactly the way the petitioner has here and to eliminate any tax on their investment income.

Now, if the text of the statute required this result, it might be an example of an unintended tax loophole by Congress. But far from compelling that result, the text of the statute points in exactly the opposite direction and in the direction entirely consistent with the purpose that Congress explicitly stated in passing the provision in 1969.

QUESTION: Mr. Sloan, will you just clear up one thing to be sure I have it straight? If the old fashioned definition of unrelated business taxable income had not been -- if that term had not been specially defined -- redefined for clubs, is it correct that the interest income would not have been taxable because the interest income in itself would not have been an unrelated business income?

MR. SLOAN: That's correct. That -- that is

correct. That was exactly what Congress was trying to do in 1969. It's explicit under the statute that investment income that is not included in the taxable income of a tax-exempt organization and is included for a social club. That -- that's explicit under the statute and in the legislative history.

QUESTION: And that's really the big distinction between the two definitions of unrelated business taxable income. One includes interest and the other doesn't.

MR. SLOAN: Well, that certainly is the primary distinction and it's one that Congress was focusing on in 1969. Congress, by using the words gross income, included all forms of income --

QUESTION: Yeah.

MR. SLOAN: -- except for the exempt function income. But that is the principal difference.

QUESTION: Well, if you didn't allow -- there wouldn't be much of a problem if you didn't allow these -- not only the direct costs but the overhead deduction?

MR. SLOAN: Well, there -- there wouldn't be --

QUESTION: But (a) -- (a)(3) says directly connected with the production --

MR. SLOAN: And as recent --

QUESTION: -- and yet you seem to allow indirect deductions.

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

MR. SLOAN: We stipulated to it in this case that those indirect costs were properly allocated and that they were directly connected.

Now, as we suggest in footnote 24 of our brief, there may be room to question that and -- but we are not in a position in this case, having stipulated --

QUESTION: Yeah.

MR. SLOAN: -- to it to --

QUESTION: But if you lose this case, you won't be out much money if you -- if you don't allow these deductions.

MR. SLOAN: Well, if -- as applied to social clubs across the country, we would be out a lot of money and we would be in a situation where --

QUESTION: Not if you didn't allow these --

MR. SLOAN: Oh, I see. If you change the allocation method.

QUESTION: Yes.

MR. SLOAN: Well, if you change the allocation method and, for example, didn't allow any costs to be allocated altogether, then that -- that suggests that Petitioner should have been taxed on that income.

QUESTION: Thank you, Mr. Sloan.

Mr. Henzke, you have three minutes remaining.

REBUTTAL ARGUMENT OF LEONARD J. HENZKE, JR.

ON BEHALF OF THE PETITIONER

MR. HENZKE: May it please the Court:

I'd like to first address the question of whether the -- the government is correct in stating that since the burden of proof is on us, then the burden is on us to somehow come up with some specific provision in the regulations or something which allows us to take this deduction.

I think that the government's contention confuses what is a factual burden -- a burden of factual -- burden of proof is on us. But we contend that the plain ordinary meaning of Section 512(a)(3) allows us to take these deductions because it says that all -- everything that's not exempt function income and deduction is to be put in this other basket, the unrelated basket. And once you get the unrelated basket, all the items of income and -- income and deduction are to be aggregated. And --

QUESTION: (Inaudible) rely on -- don't you rely on 162 for what expenses you can deduct?

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

QUESTION: Well, if there's a general rule -- if there's a general rule that you -- that nonprofit activities shouldn't generate a loss to offset against other income -- is there a general rule like that or not?

MR. HENZKE: There is -- there is no general rule

of that kind, any kind whatsoever, Your Honor.

QUESTION: Well, there's two courts of appeals that say there is.

MR. HENZKE: But -- but the tax court and the Sixth Circuit said that the proposed regulations, which were in effect until 1986, specifically authorized the aggregation --

QUESTION: Well, is a proposed regulation in effect?

MR. HENZKE: Well, it was -- it was outstanding.

QUESTION: I just heard from the government that their position -- present position they've followed consistently.

MR. HENZKE: That is incorrect, Your Honor. Prior to 1981, routinely deductions -- losses on food and beverage income were offset against investment income.

QUESTION: Do you have you any evidence of that?

MR. HENZKE: Well, in this -- in this particular case it was done routinely until Revenue Ruling 81-69 was -- was promulgated. And certainly the Sixth Circuit and the tax -- tax court both stated that the proposed regulation, which was outstanding then, allowed this kind of offset.

And the -- as we've said in our brief, the government's own manual for instruction of -- of revenue agents continually cited proposed -- those proposed

regulations as being the proper way to interpret the Code from 1969 through 1981.

QUESTION: So -- a manual?

MR. HENZKE: The government's manual, which is -- is produced by the National Office of the Internal Revenue.

QUESTION: Is that before us? I mean, is that available?

MR. HENZKE: That is available. Yes, Your Honor. It's a public document.

QUESTION: Mr. Henzke, how does the Service handle sales under -- under 512(a)(1) by -- by a non -- non-social club? Suppose a museum sells sandwiches and in fact it's -- it's a loss operation if you take into account all the expenses. Is that considered a trade or business?

MR. HENZKE: Your Honor in -- in Section 512(a)(1) the -- the situation is sort of reversed. Everything is exempt unless -- unless the statute specifically says it is non-exempt and non-deductible. So, in Section -- in Section 512(a)(1) you have to show --

QUESTION: That it's a trade or business.

MR. HENZKE: -- that it's a trade or business.

QUESTION: Do they require, for purposes of trade or business, the same thing that they want to require of you here? That is, that the museum would be making a profit if

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

you took into account the overall costs and not just the marginal costs?

MR. HENZKE: They would -- they would not allow the loss to be taken if there was not a profit motive, because under Section 512(a)(1) the --

QUESTION: What I'm asking is, would they consider it to be a profit motive if all you're trying to do is make a marginal cost and -- and it's a loss operation, net? Would they --

MR. HENZKE: I don't think there has been any case or any authority which has addressed that point, Your Honor, up to this point.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Henzke.

The case is submitted.

(Whereupon, at 11:13 a.m., the case in the above-entitled matter was submitted.)

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

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: 89-530

PORTLAND GOLF CLUB, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE

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

BY Lora M. May

(REPORTER)