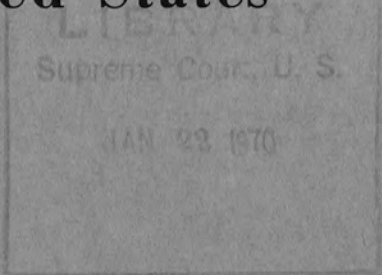


# Supreme Court of the United States

OCTOBER TERM, 1969



In the Matter of:

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 :  
 THE UNITED STATES, :  
 :  
                   Petitioner :  
 :  
                   vs. :  
 :  
 MACLIN P. DAVIS, et ux., :  
 :  
                   Respondents :  
 :  
 ----- X

Docket No. 282

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SUPREME COURT, U.S.  
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Place      Washington, D. C.

Date       January 12, 1970

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ORAL ARGUMENT:

P A G E

Erwin N. Griswold, Solicitor General,  
on behalf of Petitioner

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William Waller, Esq., on behalf of  
Respondents

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- - - -

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM

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	)	
THE UNITED STATES,	)	
	)	
Petitioner	)	
	)	
vs	)	No. 282
	)	
MACLIN P. DAVIS, ET UX.,	)	
	)	
Respondents	)	
	)	

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The above-entitled matter came on for argument at 1:30 o'clock p.m. on Monday, January 12, 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:

ERWIN N. GRISWOLD, Solicitor General  
of the United States  
Department of Justice  
Washington, D. C.  
On behalf of Petitioner

WILLIAM WALLER, ESQ.  
American Trust Building  
Nashville, Tennessee 37201  
On behalf of Respondents

P R O C E E D I N G S

1  
2 MR. CHIEF JUSTICE BURGER: Number 282, the United  
3 States against Davis.

4 You may proceed whenever you are ready, Mr.  
5 Solicitor General.

6 ORAL ARGUMENT BY ERWIN N. GRISWOLD,  
7 SOLICITOR GENERAL, ON BEHALF OF PETITIONER

8 MR. GRISWOLD: May it please the Court: This is a  
9 tax case, what we might call a regular tax case, not a  
10 criminal case nor a lien case, as the last two were, which  
11 comes here on a writ of certiorari to the Court of Appeals for  
12 the Sixth Circuit. The

13 The basic factual situation is simple; the statutory  
14 provisions are somewhat complex, but I think reduced to a  
15 relatively simple problem.

16 The case arises with respect to a family corporation  
17 which was set up in 1945 by Mr. Davis, the taxpayer here and  
18 his partner, a Mr. Bradley. At that time Bradley had 50 percent  
19 of the stock; Davis had 25 percent and Davis's wife had 25  
20 percent.

21 Now, they sought to borrow \$95,000 from the Recon-  
22 struction Finance Corporation, or a subsidiary, but found that  
23 they could do so only if the company had more capital. When  
24 Bradley was unwilling to increase his investment, and so it was  
25 worked out by Davis acquiring \$25,000 in preferred stock from

1 the company for which he paid cash.

2 Some years later Davis purchased Bradley's stock and  
3 transferred it in equal shares to his son and to his daughter.  
4 As a result of this transaction the stock was held four ways.  
5 Davis owned 25 percent, his wife 25 percent, his son 25 percent  
6 and his daughter 25 percent. And Davis himself owned all of  
7 the preferred stock.

8 In June of 1963 the IFC loan was finally paid off,  
9 and thereafter, on October 1, 1963, pursuant to a corporate  
10 resolution, Mr. Davis turned in his preferred stock and re-  
11 ceived \$25,000 from the corporation and this is the transaction  
12 which is at issue here.

13 Q Is there any question as to whether or not at  
14 the time of the reduction of the preferred stock there were  
15 earnings and profits?

16 A No; there is not question about that, Mr.  
17 Justice. There were adequate earnings and profits to cover  
18 this.

19 The point is, whether under the applicable provisions  
20 of the statute, the \$25,000 is taxable as a dividend, or whether  
21 it was received in exchange for the preferred stock, resulting  
22 in no tax, since the amount received, \$25,000 was the same as  
23 Mr. Davis's basis for the preferred stock.

24 Before going further I would like to make it plain  
25 that this is simply a matter of construing a rather specific

1 somewhat intricate statute. There is no suggestion of tax  
2 avoidance, or that Mr. Davis set up any sort of a scheme for  
3 artificially reducing his taxes. The fact is that he received  
4 \$25,000 from the corporation and that he turned in his pre-  
5 ferred stock.

6 The question is: what the tax consequences were and  
7 the circumstances of this case, and under the applicable  
8 statutory provisions.

9 It's clear, I think, that this is a situation where  
10 Congress had power under the 16th Amendment to impose a tax.  
11 For that purpose the basic fact is that \$25,000 was separated  
12 from the corporation and was received by Mr. Davis, to which I  
13 may add, as indicated in my response to Mr. Justice Stewart,  
14 that the corporation had earnings and profits in at least that  
15 amount.

16 This is not a case like Eisner and Macomber, the  
17 dividend case where the taxpayer received only pieces of paper  
18 and ended with more pieces of paper representing exactly the  
19 same interest that he had before. Here the shareholder re-  
20 ceived cash and had fewer pieces of paper than he had before  
21 that receipt.

22 And the question is how is receipt of the cash is to  
23 be treated for tax purposes. Basic to the consideration of  
24 that question is the provision of Section 318 of the Internal  
25 Revenue Code, which is set out at Pages 43 and 44 of the

1 Government's grey-covered brief, insofar as it is relevant to  
2 this question.

3 This is one of the two key provisions in the statute  
4 and I think that I should read it. Section 318 at the bottom  
5 of Page 43 of the Government's brief:

6 "For purposes of those provisions of this subchapter  
7 to which the rules contained in this section are expressly  
8 made applicable --

9 (1) (A) An individual shall be considered as owning  
10 the stock owned directly or indirectly by or for his spouse"  
11 (other than a spouse who is divorced or under a degree of  
12 separate maintenance, which is not applicable here, "and (2)  
13 his children, grandchildren and parents."

14 Now, under this statute Mr. Davis "shall be con-  
15 sidered," not "may be," or "in proper circumstances," but  
16 "shall be considered," as owning all the stock of the corpora-  
17 tion; every share, all the common and all the preferred.

18 Q Do you suppose that this statute really -- this  
19 attribution provision really means what it says, assuming the  
20 father is 75 years old and the son 50 years old and they haven't  
21 seen each other for 30 years; one lived in Europe and the other  
22 lived in California; do you suppose there would still be  
23 attribution?

24 A Yes, Mr. Justice, because I think the very  
25 purpose of the statute is to remove the questions of degree

1 which could be raised by that kind of question. It is true  
2 that some lower courts have said that Section 318 should not  
3 be applied where there is evidence of active hostility between  
4 the parties. That is not an issue here; there is no trace of  
5 evidence of hostility here, but I would take the ground that  
6 Congress felt that this was an area which should not be deter-  
7 mined by the facts in each particular case, but really friendly,  
8 and so on, to which there can be infinite variations, but that  
9 it's language as written should be taken as written.

10 Q You don't think "children" means minor child-  
11 ren or anything like that?

12 A No; I am sure that that does not apply. It  
13 covers parents, too, and is obviously, not limited to minors.

14 One can say, if they want to, "But he didn't own all  
15 the stock; some was owned by his wife, his son and his daughter;  
16 but the fact is that Congress had said specifically that the  
17 tax consequences of what was done here shall be determined by  
18 treating him as the owner of all of the stock. And for this  
19 purpose, I think that those last three words at the very bottom  
20 of Page 43, "shall be considered, without qualification," are  
21 significant.

22 No suggestion is made, either by the counsel for the  
23 respondent or in the courts below that the provision is not  
24 valid and I know of no basis on which such a contention could be  
25 successfully made. This is the way the Congress said the tax



1 consequences of this sort of a payment out of a corporation  
2 should be determined.

3 So, we start with the proposition that Mr. Davis is  
4 to be treated as holding all of the stock of the company, from  
5 which he receives \$25,000.

6 Let me point out next that Section 318(b) which is  
7 about four inches below the top of Page 44, and set out on  
8 Page 44 of our brief, specifically refers to Section 302 as  
9 being one of the provisions to which Section 318 applies. That  
10 is a cross-reference provision, but it says, "provisions to  
11 which the rules contained in subsection (a) apply, see (1)  
12 section 302 (relating to redemption of stock).

13 Now, let us then turn to Section 302. This is a long  
14 provision, beginning on Page 39 of our brief. We have set it  
15 out in full there, but most of it, happily, is not applicable  
16 here. The relevant portions are relatively simple.

17 Section 302(a) "If a corporation redeems its stock  
18 (within the meaning of section 317(b)), and if paragraph (1),  
19 (2), (3), or (4) of subsection (b) applies, such redemption  
20 shall be treated as a distribution in part or full payment in  
21 exchange for the stock."

22 Now, what that means is if you can bring yourself  
23 under paragraphs (1), (2), (3), or (4) then it will be treated  
24 as a capital transaction and not as a dividend. And the first  
25 one of those four paragraphs, 302(b)(1), 'Subsection (a) shall

1 apply if the redemption is not essentially equivalent to a  
2 dividend."

3 Now, I then refer to Subsections (b) (2), (3) and  
4 (4) only to say that everyone agrees with -- they are not  
5 applicable.

6 302(b) (4) relates to stock issued by railroad  
7 corporations and reorganizations.

8 302(b) (2) relates to a substantially disproportionate  
9 redemption of stock; and

10 302(b) (3) related to a redemption which terminates  
11 the shareholder's interest, and it is entirely agreed that  
12 (2), (3) and (4) are not applicable and this case turns on the  
13 construction of Section 302(b) (1).

14 We may complete the statutory picture, though there  
15 is no controversy about it in this case, by referring to  
16 Section 301 which provides that Section 302 does not apply and  
17 we contend that it does not. The distribution shall be treated  
18 as a dividend to the extent that it is a dividend under Section  
19 316; which means, essentially, whether there are earnings and  
20 profits and Section 316 says that it is a dividend if there are  
21 earnings and profits. The statutory path is, shall I say,  
22 disorderly and complicated, but I think it is relatively clear.

23 It's relevant, I think, that there is nothing in  
24 these statutory provisions about this purpose or about tax  
25 avoidance. These are simply a straightforward series of

1 provisions designed to say that in certain circumstances a  
2 payment made by a corporation to a shareholder is to be treated  
3 and taxed as a dividend.

4 As I have indicated and when we go through all these  
5 statutory provisions we find that the key passage, the clause on  
6 which everything turns, is Section 302(b)(1). It's awkwardly  
7 stated, I agree. Its meaning becomes clearer, I think, if we  
8 reverse the negative then it would say, "Subsection (a) which  
9 was treated as a capital transaction, shall not apply if the  
10 redemption is essentially equivalent to a dividend."

11 Now, what it says is that Subsection (a) shall apply  
12 if the distribution, if the redemption is not essentially  
13 equivalent to a dividend. That puts it backwards, I think, and  
14 to me it's clear and I don't think it alters the meaning a  
15 particle if it says that Subsection (a) shall not apply if the  
16 redemption is essentially equivalent to a dividend.

17 Either way, the question which we must consider is  
18 whether this redemption in this case under the circumstances and  
19 the statutory provisions, was essentially equivalent to a  
20 dividend.

21 And it is our contention that the transaction here was,  
22 in the light of the attribution rules of Section 318, essentially  
23 equivalent to a dividend. It was the payment of money out of a  
24 corporation to the person who, under Section 318 is to be treated  
25 as owning all of the stock of the corporation, without any

1 change whatever in his proportionate interest in the corpora-  
2 tion. Since he is taxes on the basis that he owned all of the  
3 stock of the corporation, before the payment and owned all of  
4 the stock of the corporation after the payment, such a payment  
5 by a corporation to a shareholder, without any change in pro-  
6 portion of interest, is, we submit, under many decisions of the  
7 courts, essentially equivalent to a dividend.

8 Section 302(b)(1) is the lineal descendant of a pro-  
9 vision which goes back to 1921. When it was first enacted at  
10 that time it was applicable only to stock which had been issued  
11 as a stock dividend and it was a part of the aftermath of  
12 Eisner and Macomber. The great scheme at that time was that you  
13 declared a preferred dividend on your common stock and then  
14 you immediately redeemed the preferred dividend and, as the  
15 theory was, that that wasn't taxable and the statute passed in  
16 1921 was designed to reach that type of a situation.

17 It was soon found, however, it wasn't limited to that  
18 kind of a situation. You could organize a corporation with  
19 serial preferred stock and then redeem the preferred stock year  
20 by year and seek to get around it and I repeat again, there is  
21 no suggestion that there was any tax avoidance scheme whatever,  
22 involved in this case.

23 In 1926 the statutory provision was expanded to re-  
24 cover redemptions without regard to the origin of the stock.  
25 However, that provision which became section 115(g)(1) of the

1 Internal Revenue Code, was worded somewhat differently than  
2 the present provision. It made a redemption taxable as a  
3 dividend if it was made "at such time and in such manner as to  
4 make the distribution and cancellation of redemption, in whole  
5 or in part, essentially equivalent to the distribution of a  
6 taxable dividend.

7 It was probably because of those words, "at such time  
8 and in such manner" that some of the lower courts used concept  
9 of business purpose and tax avoidance in construing that  
10 statute. They said, well if there wasn't legitimate business  
11 purpose or if there was no scheme of tax avoidance, then it was  
12 not at such time and in such manner. But there are no such  
13 words in Section 302(b)(1) of the '54 code which is the pro-  
14 vision now before the Court.

15 We have here the simple question of whether the pay-  
16 ment was essentially equivalent to a dividend. The taxpayer  
17 wants to treat this payment as if it were payment of a debt.  
18 He says he always understood that it would be paid off. His  
19 position is made clear at Page 3 of his brief in opposition in  
20 this case, from which I read a few sentences:

21 Again, moreover, there was a clearly identifiable  
22 date as of which the preferred stock was to be redeemed. The  
23 date of payment-in-full of the RFC debt. In this respect the  
24 preferred stock was like a subordinated debt. But there was no  
25 debt. There was preferred stock. Now, this was a payment with

1 respect to stock, which, under the attribution rules, did not  
2 in any way affect the proportionate ownership in the corpora-  
3 tion, which for tax purposes, pursuant to the express provision  
4 of the statute which represented Congress's statement as to  
5 how transactions of this kind should be treated for tax pur-  
6 poses.

7 For tax purposes his ownership was 100 percent, both  
8 before and after the transaction. Nor could this be treated as  
9 a partial liquidation of the corporation, for that requires some  
10 contraction of the business of the company. Here there was no  
11 contraction of the business; there was simply the payment of  
12 \$25,000 to the person who, by the clear and express provisions  
13 of the taxing statute is to be treated as the sole shareholder  
14 in the company.

15 Thus, the business purpose, is, we submit, irrelevant.  
16 Moreover, though there was a business purpose for issuing the  
17 preferred stock, there was no such purpose for its redemption. As  
18 the taxpayer himself testified in his deposition on Page 17 of  
19 the record, this was surplus money. The transaction was carried  
20 out for the benefit of the -- of Mr. Davis and not of the company.  
21 The distribution of surplus money to the sole shareholder of the  
22 corporation is precisely the kind of distribution to which the  
23 dividend rules of Section 301 and 316 are designed to apply.

24 Surely that would be the result if no stock had been  
25 surrendered, but Eisner and Macomber teaches that the presence or

1 absence of a piece of paper representing the same proportion  
2 of interest in the corporation, is irrelevant for tax purposes.

3 Here the important fact is that under the provisions of  
4 taxing statute Mr. Davis owned all of the stock of the corpora-  
5 tion before the transaction and he owned all of the stock of  
6 the corporation after the transaction. And the only substan-  
7 tial difference was that he had received \$25,000 from the  
8 corporation.

9 Q Mr. Solicitor General, would it make a dif-  
10 ference if the \$25,000 transaction had taken the form of a note?

11 A Yes, Mr. Justice, I think that if he had  
12 lent the money to the company and if the circumstances were  
13 such that the note would not be held to be, essentially an  
14 equity investment and a subordinated capital, it would have  
15 made a difference.

16 Q On this factual situation.

17 A On this factual situation, it seems to me it  
18 would have been somewhat difficult for the Government to con-  
19 tend that a note for \$25,000 was not legitimate debt.

20 Q Well, he wouldn't have got his loan, either.  
21 Because, I take it, that this condition was that he put this  
22 money at the risk of the business.

23 A It would have to have been a subordinated note,  
24 a note subordinated to the RFC's claim.

25 Q I thought at least to the risk of the business.

1           A        As I understand it, they could have got the  
2 loan by making a loan to the company. It would not have had  
3 as good a balance sheet; it would not have been as attractive  
4 with other creditors with whom they needed to deal after the  
5 RFC, and if he made it subordinate to all indebtedness then I  
6 think the Government would surely have come in and said that  
7 this is not a debt, but is stock.

8           Now, when I said that it would have been legitimate,  
9 I was thinking of subordination only to the RFC.

10          Q        That's what I meant; on the facts of this  
11 particular case.

12          A        On the facts of this particular case if it was  
13 subordinate only to the RFC, I think maybe the Government might  
14 have had some difficulty in contending this was an equity,  
15 rather than a debt investment. It would have had some other  
16 consequences.

17                 There is the fact of course here that it is not a debt  
18 and is not claimed to be a debt and we do not think that it can  
19 be given the consequences of a debt in that transaction, in  
20 that situation. Whatever might be the consequences if there  
21 had, in fact, been a note, rather than stock.

22                 In the decision below and in other cases and in the  
23 briefs here there is talk about the net effects test and then  
24 the strict net effects test and the flexible net effects test  
25 and I find these phrases confusing and perhaps question-begging.



1 My own view is that they are irrelevant. There is no such  
2 provision in the statute and the application of the statute  
3 becomes unnecessarily complex and confusing, if resort is made  
4 to such terms in the analysis of the problem.

5 The basic and underlying situation here is that  
6 Congress has provided that a person in Mr. Davis's situation is  
7 to be treated as the owner of all of the stock for the purpose  
8 of determining how he is to be taxed on the \$25,000 which he  
9 undoubtedly received from the corporation which had earnings  
10 and profits in at least that amount.

11 Q What is your judgment as to the standard  
12 necessary to determine the case under?

13 A The standard that's necessary to determine?

14 Q Yes.

15 A To determine --

16 Q Whether it's the equivalent of a gift.

17 A I think, in this case I would say that the  
18 standard is: what would have been the case if he had surrendered  
19 nothing; if he had simply owned stock in the beginning and had  
20 received \$25,000. No one would question that the \$25,000 was  
21 a dividend. Now, the mere fact that he gave up a piece of  
22 paper, not affecting his personal interest in the corporation  
23 does not keep that from being, essentially, equivalent to a  
24 dividend.

25 As the owner of all of the stock, his personal

1 interest in the corporation did not change a particle as a  
2 result of the transaction. He owned it all before; he owned it  
3 all after, but when it was completed he had \$25,000 in his own  
4 hands which he didn't have before, and we say that that was a  
5 dividend.

6 As I suggested at the time to Mr. Justice Black, if  
7 he, in fact, owned all the stock himself, there could be no  
8 doubt. I suggest that the \$25,000 was taxable to him as a  
9 dividend, since his proportionate interest was in no way  
10 changed and the presence or absence of pieces of paper in no  
11 way affected the substance of the transaction.

12 And the statute says that in his situation he is to  
13 be taxed on the basis that all of the shares are attributed to  
14 him.

15 I have said that I think that Section 302(b)(1) is the  
16 key here. Of course, it's equally plain that Section 318 is  
17 important. If the Court says, as I think it should, that  
18 Section 318 means what it says and Congress intended it to mean  
19 what it says and intended not to have individual, factual in-  
20 quiries on a general equitable basis in the construction of  
21 318. And then I think that the consequence for which we are  
22 contending follows. It may be somewhat literalistic, but this  
23 is an area, it seems to me, where the tax statute can well be  
24 construed the way it is written in order to both minimize  
25 repeated detailed, factual inquiries into the circumstances of

1 particular case with no standard set up by the Congress, and in  
2 order to clarify the application of the tax law.

3 It may or may not have been a wise provision for  
4 Congress to make. I think experience says that it was necessary  
5 and usual. It is the provision that Congress did make and it  
6 should be applied here.

7 And, accordingly, I submit that the judgment of the  
8 Court of Appeals should be reversed and the case remanded to  
9 the District Court for instructions to dismiss the complaint.

10 MR. CHIEF JUSTICE BURGER: Thank you, Mr. Solicitor  
11 General.

12 Mr. Waller.

13 ORAL ARGUMENT BY WILLIAM WALLER, ESQ.

14 ON BEHALF OF RESPONDENTS

15 MR. WALLER: Mr. Chief Justice, and may it please the  
16 Court: There is an old English saying about not being able to  
17 see the woods for the trees. And it seems to me that that is  
18 applicable here.

19 The Solicitor General's argument here would be  
20 exactly the same if on yesterday Mr. Davis had bought \$25,000  
21 worth of preferred stock in this corporation and today had sold  
22 it back and got his money back.

23 Now, true, he has given up only a piece of paper, but  
24 he has got back exactly the amount of money that he put out.  
25 He put out \$25,000 and got the piece of paper. Now he gives

1 back the piece of paper and gets the \$25,000.

2 And I respectfully disagree with the learned Solicitor  
3 General that Congress has power under the 16th Amendment, even  
4 if wanted to, to say that that is taxable income. I don't  
5 think Congress intended any such result, but if Congress had  
6 intended such a result I think that Eisner versus Macomber  
7 teaches that that would not be treated as income or gain; no  
8 more than if a race horse were involved. If you have a race  
9 horse --

10 Q What would it be treated as?

11 A Treated as a return of capital.

12 Q You mean as a sale?

13 A Sale. That's what this was; a sale of stock  
14 in the corporation, but the minutes provided, the director's  
15 minutes that Mr. Davis offered the stock back to the corporation  
16 for \$25,000. The offer was accepted; the stock was bought; the  
17 stock was redeemed. So, everybody was exactly in the same  
18 position after the transaction.

19 Taking the transaction as a whole, the two prongs of  
20 the transaction, Mr. Davis was in the same position. The corpora-  
21 tion had this temporary capital which it had needed in order to  
22 get the RFC loan. The RFC loan was paid off as had been intended  
23 all the time. The stock was redeemed; the corporation did not  
24 need the \$25,000 as the Solicitor General states; it was surplus  
25 money. The preferred stock was 6 percent preferred stock. This

1 was in 1963 when 6 percent was a good deal of money and any  
2 normal board of directors, having \$25,000 that was not needed  
3 in the business and at 6 percent preferred stock outstanding,  
4 would have redeemed the preferred stock. It was for the bene-  
5 fit of the corporation.

6 It may have been that Mr. Davis, he probably did want  
7 his \$25,000 back since the purpose for which he had turned it  
8 in to the corporation had been served, but he is at the end of  
9 this two-prong transaction, exactly where he started with his  
10 money back. That is a classic example of a return of capital  
11 and not other dividends.

12 As I stated, if the key transactions had occurred one  
13 day after the other, according to the Solicitor General's  
14 argument, this would be a dividend merely because of the  
15 existence of earnings and profits.

16 Q What would you say if one partner decided to  
17 put up all the money they needed for the new plant himself.  
18 They needed a new plant; the other partner said "No, I can't  
19 put up any more money to keep half ownership." And the other  
20 one says, "Well, I'll put it up as preferred stock." So, he  
21 puts up \$150,000 preferred stock. They build a new plant;  
22 they accumulate some money and they redeem his preferred stock  
23 later. What would you think. Would you say you would get the  
24 same results there?

25 A That's a return of capital also. That's a

1 return of capital.

2 I don't think it is a bit different that if it had  
3 been a subordinated note.

4 Q Well, of course, he deliberately chose to put  
5 it up in preferred stock and to put it at the risk of the  
6 business, rather than making it a subordinated note.

7 A Well, a subordinated note would also have been  
8 at the risk of the business, if it was subordinated as a usual  
9 subordinated note is. That is, that RFC loans --

10 Q But, nevertheless, it would have shown as a  
11 liability?

12 A Oh, yes; it would; that's true.

13 Q He preferred not to have that liability.

14 A He preferred not to do it because that made  
15 the balance sheet better off for his purposes in general. In  
16 other words, you didn't have that debt on the balance sheet. It  
17 all appeared to be equity capital, which it was.

18 Now, there have been a number of cases where this very  
19 same thing happened and the lower courts have uniformly held  
20 to the taxpayer that where there was a temporary advance of  
21 equity capital to a corporation for a limited purpose and for  
22 a limited time, with the understanding that the stock would be  
23 redeemed when that purpose had been served, that is a return of  
24 capital. They have used the phrase "business purpose."

25 Now, I think one court did say, and the Solicitor

1 General has used the argument that where there is a business  
2 purpose in issuing the stock in the first place, that the  
3 redemption of the stock is not a business purpose. But I don't  
4 think you can view the entire transaction of this kind as in  
5 isolation; view the redemption in isolation from the original  
6 issuance of stock. The transaction should be viewed as one  
7 transaction or a two-prongs, as I have said, of a transaction.

8 Now, I will have to agree that this net effect test  
9 is irrelevant. I believe the Solicitor General advanced that  
10 thought. The reason the net effects test, the strict net  
11 effect test, I think, has come into play was largely because  
12 the case that Mr. Griswold tried when he was in private prac-  
13 tice the Bedford Estate case, in which this Court reversed the  
14 Second Circuit. Thereupon, the Second Circuit Court of  
15 Appeals in the Bedford Estate case had nothing to do with a  
16 stock redemption. It involved boot in a reorganization case and  
17 the Second Circuit had held that this boot was a return of  
18 capital and not a dividend. This Court held that it was a  
19 dividend under the provision of the statute which used the  
20 words, "effect."

21 Whereupon, the Second Circuit Court of Appeals said,  
22 "Uh huh, the Supreme Court has now reversed all of our failure  
23 decisions in redemption cases," so from there on the Second  
24 Circuit has followed what they call this state net effect test,  
25 saying that the Bedford decision had overruled their prior

1 decisions, when it didn't do any such thing.

2 And, even as late as the Levin case year or year  
3 before last, the Second Circuit of Appeals repeated their  
4 statement that the Bedford case had overruled their prior  
5 decisions where they had followed the same, or a different rule  
6 regarding redemptions.

7 The Second Circuit, in the Snite case, which is  
8 cited in our brief, pointed out very clearly that the two  
9 situations are entirely different.

10 Now, the legislative history of this section 302(b)(1)  
11 states as specifically as it could be stated that what Congress was  
12 intending to do in 302(b)(1) was to revert in part to existing  
13 law under Section 115(g) of the old 1939 Goldwynne.

14 So, Congress said -- the Senate Committee said that  
15 they were restoring that to the House Bill which had left out  
16 the essentially equivalent test. They were restoring this  
17 essentially equivalent dividend test. But the Courts, going  
18 back to existing law so that a taxpayer who could not come  
19 within one of these so-called "safe harbor" provisions of the  
20 new code, the ones that we agree are not applicable here. If he  
21 could not come within one of them, he could still rely on the  
22 fact that his redemption was not essentially equivalent to a  
23 dividend.

24 Nothing can be clearer, it seems to me that the state-  
25 ment several times in the Senate Committee Report that that was



1 what was being done. The original House Bill had left out this  
2 essentially equivalent test and only provided these mechanical  
3 tests based on ownership of stock. The provisions being that  
4 if the shareholder's interest was terminated or if there was a  
5 disproportionate redemption, he could, by following these tech-  
6 nical rules, escape dividend treatment.

7 Now, those safe harbor provisions are where the owner-  
8 ship escaped dividend treatment. Now, those safe harbor  
9 provisions are referred to ownership of stock. And the House  
10 Bill had in it these attribution rules which, it said, should  
11 be followed in determining the ownership of stock.

12 Well, the Senate Committee kept that provision about  
13 determining the ownership, the attribution rules for determining  
14 the ownership of stock, but then puts back into the new 1954  
15 Code the old 1939 provision about essentially equivalent to the  
16 dividend.

17 We say that these attribution rules were not intended  
18 by Congress to apply to the essentially equivalent to a dividend  
19 test. They were intended to apply for the purposes of deter-  
20 mining ownership in those provisions where ownership of stock  
21 was mentioned; and there was no mention of ownership of stock  
22 in Section 302(b)(1).

23 So, while the lower courts said "No, this section  
24 was pretty broad." They said, for the purposes of this section  
25 we'll say that the attribution rules apply here, but even though

1 they do apply, this particular redemption is okay because of  
2 the business purpose rule.

3 Now, in one place, in one respect I think I must  
4 agree wholeheartedly with the Solicitor General and that is  
5 that these attribution rules either apply or they don't apply.  
6 You can't say that they apply where father and son love each  
7 other but they don't apply where they are estranged or where  
8 a man and his wife are estranged or where a partner and his  
9 partners are estranged. It would create interminable difficulty  
10 in finding out when the attribution rules do apply and when they  
11 don't apply.

12 But, I say they don't apply at all with respect to  
13 Section 302(b)(1) because that was the old test from the 1939  
14 Code when there were no attribution rules. And in every state-  
15 ment in the Senate Committee Report, saying what they were  
16 trying to do, it was specifically stated that they were rever-  
17 ting to existing law and no qualification based on these  
18 attribution rules.

19 So --

20 Q Mr. Waller, you say that the attribution, that  
21 Section 318 attribution provisions do not apply to this case?

22 A Do not apply.

23 Q Now, why is it?

24 A For this reason, Your Honor: The Section 318  
25 I think, is ambiguous in this respect, because it says "Section

1 318(a) shall apply in determining the ownership of stock for  
2 purposes of this section." Now, I would have to agree that if  
3 we didn't have any legislative history; if we didn't have a  
4 question of constitutional balance raised, that probably one  
5 would say that it applies for the purposes of the old section,  
6 including 302(b)(1).

7 But, if you look at the sequence of events by which  
8 this particular section got into the 1954 Code I think it's  
9 perfectly plain that what Congress was saying was that these  
10 attribution rules should apply in determining ownership of  
11 stock for the purposes of these provisions of the Section where  
12 ownership of stock is mentioned, namely: Section 2 and Section  
13 3, but not Section 1, I mean Subsection (1) of Section 2.

14 Q Now, I'm on Pages 43 and 44 of the Government's  
15 brief, in which --

16 A Look at Page 41 in the middle of the page.  
17 "Constructive Ownership of Stock. Except as provided in Para-  
18 graph (2) of this subsection, section 318(a) shall apply in  
19 determining the ownership of stock for purposes of this section."

20 Now, I say you should emphasize the ownership of  
21 stock because in the other provision of Section 302 the ownership  
22 of stock is mentioned, whereas in the essentially equivalent  
23 provision there is no mention of ownership of stock and owner-  
24 ship of stock is considered only by virtue of judge-made rules,  
25 and not because of any statutory provisions.

1 Q But, going back to 43 and 44, pages; and then  
2 look at 318(b) on 44. "For provisions to which the rules con-  
3 tained in subsection (a) apply, see Section 302," relating to  
4 redemption of stock and that implied that you are supposed to  
5 see the whole section.

6 A That's what I have --

7 Q And that's not inconsistent, I suppose, with  
8 your argument. It should be read as applying only to those  
9 parts of the section that refer specifically to ownership of  
10 stock.

11 A Yes; that's right. And I say there is suf-  
12 ficient ambiguity in the language that we can go through the  
13 Senate Committee Reports to find out what they meant. When we  
14 do go to the Senate Committee Reports, I think it's perfectly  
15 plain that Congress did not intend attribution rules to apply  
16 when determining whether a redemption is essentially equivalent  
17 to a dividend.

18 Q Has any court ever accepted this argument?

19 A No; no court has accepted it wholeheartedly.  
20 They have only said, "We think there ought to be exceptions  
21 where there is family estrangement and other things like that."

22 Q Well, that's not your argument here at all.

23 A That's right. I agree with the Solicitor  
24 General that it either applies or it doesn't apply; and I say  
25 that it does apply and he says that it doesn't apply.

1 Q Where is the legislative history in your  
2 brief to which you refer, identifying --

3 A My brief, starting on Page 10. Well, there is  
4 a part of it, the main part of it is pages 10 and 11. Then,  
5 it's referred to all through this brief. It's a very short  
6 brief, if Your Honor please; and it's referred to again on page  
7 14.

8 Q Are you arguing this as though the man has  
9 just loaned the money to the company?

10 A I'm not arguing that he just loaned it; no,  
11 Your Honor. I'm saying it was a purchase of preferred stock  
12 by Davis.

13 Q A purchase of preferred stock?

14 A Purchase of preferred stock from the corpora-  
15 tion.

16 Q With the agreement that they would buy it  
17 back?

18 A The agreement that they would buy it back when  
19 the RFC loan was paid off; would redeem it when the RFC loan  
20 was paid off. That was the general understanding. It wasn't  
21 in the form of a written agreement, but it was understood be-  
22 tween all parties involved that this was done solely for the  
23 purpose of getting the RFC loan.

24 Q What did the court find about that?

25 A Yes, it found that.

1 Q That's what it found?

2 A Yes.

3 Q On what page?

4 A Both lower courts. All right, sir; in the  
5 Appendix, the Court of Appeals opinion would be -- I think he  
6 quotes from the District Court. Pages 40 --

7 Q It begins at 39; doesn't it?

8 A Well, yes, but I was thinking about the place  
9 where -- the Court of Appeals quotes on Pages 45 and 46 of the  
10 Appendix.

11 "The subsequent acquisition of Bradley's stock,  
12 holdings by taxpayer, making the redemption distribution  
13 essentially pro rata because of the Section 318(a) attribution  
14 rules, neither impairs the legitimacy of the purpose underlying  
15 the issuance of the preferred stock, (to provide additional  
16 security required by RFC) nor alters the fact that the redemp-  
17 tion was simply the final (contemplated step taken to completion  
18 by this purpose)."

19 Q Then, what did the Court of Appeals hold?

20 A They held with us that this was a return of  
21 capital and not a dividend. The District Court held it was a  
22 return of capital and not a dividend; the Court of Appeals held  
23 that it was a return of capital and not a dividend, and we are  
24 here seeking to sustain the decisions below.

25 Q Mr. Waller, is there a difference between

1 this being a note, which we talked about earlier, subordinate  
2 only to the RFC and the preferred stock?

3 A Well, I wouldn't say there was no difference;  
4 because, of course, a note is different from preferred stock.  
5 There are lots of consequences attached to a note that do not  
6 attach to attach to -- but, so far as this particular situation  
7 is concerned, whether it's a return of capital or not, I say  
8 that's a return of capital.

9 Q Well, I mean as to this particular case. If  
10 it had been a subordinated note, it would be under the dividend  
11 clauses.

12 A If it had been a subordinated note the return  
13 would not have been a dividend and the Solicitor General would  
14 not even have made such a case, as he stated a while ago. He  
15 didn't quite go that far, but he said --

16 Q I don't think he went that far; I don't think  
17 he went that far.

18 A He didn't go quite that far, but he went almost  
19 that far.

20 Q Well, I was trying to get your view on it.

21 A He said, "I don't think the Government would  
22 have much case;" that's what he said, I think, in the vernacular.

23 Q Well, it's your position, then, there is no  
24 difference.

25 A I don't think, for the purpose of this case,

1 that there is any significant difference; that is correct.

2 Q You mean that the owner of this corporation  
3 had given \$25,000 to the corporation and then takes it back  
4 later would be no different from the fact that he issued stock?

5 A That's correct, Your Honor. In other words,  
6 it's a return of capital in either event. What the man has  
7 done, he hasn't made any money. Income is making the money;  
8 income is making some money; income under --

9 Q But, he's got the same corporation and all of  
10 his assets, but he's also taking \$25,000 out and he's still got  
11 the whole total.

12 A He just got his own \$25,000 back. Back what  
13 he put in. In other words, he's just exactly where he was to  
14 start with.

15 Q No --

16 A If he put it up in common stock and if he  
17 leaves these attribution rules out of it, why, it would have  
18 been the same thing.

19 Q Well, I know, but you say you are entitled to  
20 that, even with the attribution.

21 A I am saying I am entitled to win even with the  
22 attribution rules.

23 Q Right.

24 A I would say I would have a more difficult case  
25 if it were common stock than with --



1 Q Why; why; why? The RFC says, "You need \$25,000  
2 more in equity." He says, "Well, do you care whether it's  
3 preferred or common?" And they say no. And he says, "Well,  
4 I'll put it up in common." And when the loan was paid off he  
5 says, "I just want my \$25,000."

6 A I think if there had been a clear-cut agreement  
7 that it would be redeemed as soon as the RFC loan was paid off  
8 that I could substantiate the common even in the same way, but  
9 I'd rather do it with the preferred.

10 Q I don't see that there is any real difference in  
11 terms of your argument, between common and preferred. You have  
12 to argue for one as well as the other.

13 A I'll have to go back to the legislative history  
14 of the 1926 Act to explain that.

15 Q Well, I don't want to make you do that.

16 A Because -- in 1926 when the statute was amended  
17 the -- it was apparent from the reports of the legislative  
18 committees there that what they had in mind was taxing a pro  
19 rata redemption of common stock. In other words, that have got  
20 an equal amount of common stock and redeemed 10 percent of each  
21 one. That's essentially equivalent to a dividend.

22 Now, of course, that could apply here only by virtue  
23 of the attribution rules, because without the attribution rules,  
24 Mr. Davis owned only 25 percent of the common stock. His wife  
25 owned 25 percent and his two adult children, who were certainly

1 not his dummies in any way, even though there may have been  
2 family solidarity as distinguished from estrangement. They  
3 were the stockholders and they could have redeemed and the  
4 board of directors could redeem this stock if Mr. Davis hadn't  
5 wanted it redeemed, as far as that's concerned. They could  
6 have outvoted him.

7 So, the -- it's not correct to say that this redemp-  
8 tion was strictly for the benefit of Mr. Davis. It was for the  
9 benefit of the corporation to get rid of a 6 percent preferred  
10 stock in 1963. It wouldn't be today if anybody had some 6 per-  
11 cent stock outstanding today they'd want to keep it, of course.  
12 But in 1963 the situation was entirely different.

13 Q When was the money put in?

14 A The money was put in back in 1946, I believe it  
15 was.

16 Q And when was it taken out?

17 A In 1963.

18 Q '46 to '63?

19 A Yes. That's when the RFC loan was paid off. It  
20 took a long time to pay it off.

21 Q Who was hurt or helped by that transaction?

22 A The whole corporation was helped by it because--

23 Q Because there was money in there that could be  
24 used as though they owned it?

25 A Why, yes; that's correct. The corporation used

1 this money all that time. It had that for working capital all  
2 that time.

3 Q Then the man got it back.

4 A He got it back for his preferred stock. He got  
5 back for himself.

6 Q Well, the man himself didn't get anything; did  
7 he? If he put it into stock and let them have it and use it to  
8 would make it appear that they had this much value when they  
9 didn't have it.

10 A Yes, they had it all that time.

11 Q Well, they had it in their possession, but if it was w  
12 with the understanding he'd get it back, the exact amount, what  
13 good did it do the company?

14 A Well, because they had it all that time as  
15 working capital. All the time that the RFC loan was outstanding  
16 the corporation had it as working capital and it was redeemed  
17 only when the purpose had been served, when the RFC loan was  
18 paid off.

19 Q When was it paid off?

20 A 1963. The loan was paid off in '63 and at that  
21 time, shortly thereafter, the preferred stock was redeemed.

22 Q Did the company owe anybody else anything?

23 A They did not owe anybody else anything and the  
24 testimony was that the corporation had never borrowed any money  
25 since then from anybody. In other words, it was surplus money,

1 as the Solicitor General said. Didn't need the money. There  
2 it was, so there was --

3 Q Your argument sounds to me as though you are  
4 saying he actually made a conditional loan of his stock to the  
5 company.

6 A No, money, Your honor; not stock; money.

7 Q Well, he put money in there?

8 A Yes.

9 Q He actually put money in there and let it stay  
10 in there for seven years and then he got out exactly the same  
11 amount of money.

12 A That's right. So, I say he didn't have any in-  
13 come, because that's not income. He didn't make anything.

14 Q But, evidently he did or the company couldn't --  
15 didn't the company make money during that time?

16 A Oh, yes; and his common stock became more  
17 valuable as a result of it, and his wife's common stock and his  
18 children's common stock.

19 Q But, by reason of his being fortunate enough to  
20 or farsighted enough to get the other kind of stock, he didn't  
21 lose anything?

22 A He didn't lose anything; no, sir.

23 Thank you, Your Honor.

24 MR. CHIEF JUSTICE BURGER: Thank you, counsel. Mr.  
25 Solicitor General, do you have anything more?

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The case is submitted, gentlemen. Thank you very much  
for your submissions.

(Whereupon, at 2:30 o'clock p.m. the argument in the  
above-entitled matter was concluded)