Supreme Court of the United States

In the Matter of:

JAMES G. NASH, et al.	Docket No. 678
Petitioner,	
vs.	
THE UNITED STATES,	
Respondent.	

Place Washington,

Date April 21, 1970

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1969

JAMES G. NASH ET AL.,

Petitioners;

vs. No. 678

THE UNITED STATES,

Respondent.

Washington, D. C.
April 21, 1970

The above-entitled matter came on for argument at 11:15 a.m.

BEFORE:

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

APPEARANCES:

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: Next case on for argument is No. 678, Nash against the United States.

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

ARGUMENT OF HAROLD I. APOLINSKY

ON BEHALF OF PETITIONER

MR. APOLINSKY: Mr. Chief Justice; may it please the Court:

This is an income tax case on a writ of certiorari to the United States Court of Appeals for the Fifth Circuit. The question is whether a balance, in a reserve for bad debts maintained by a partnership and stipulated by the parties to be reasonable, must be taken into ordinary income or not by the partnership when it incorporates its business under Section 351 of the Internal Revenue Code -- Section 351 providing that: "No gain or loss will be recognized if property is transferred to a controlled corporation." And it is agreed by the parties that the transfer, the incorporations here, are within the purview of Section 351.

Q What would have happened to this reserve if they had liquidated, Mr. Apolinsky?

A If the partnership had liquidated?

Q Just liquidated. Would it have gone into ordinary income then?

A No, Your Honor. Under the partnership concept

liquidating to the various partners, each one would have taken his pro rata part of the receivable with the reserve. And it would not have come into the income of the partners.

Q It wouldn't have entered their transactions, at all?

A No, sir. This would come straight through.

Q Each would have taken his pro rata part of the receivable and his pro rata part of the reserve?

A Yes, Mr. Justice.

Q The partnership, while it has to report as an entity, isn't a taxable entity, basically?

A That is right.

Q It is a group of individuals.

A That is right.

Now in this situation, this partnership operated 10 finance businesses: 2 in South Carolina and 8 in Alabama. It made loans to the public, and it used the accrual method of accounting, under which it would take into its ordinary income the profit on a loan, the receivable, in the year in which the loan was made and the receivable established.

It accounted for its bad debts by the use of the reserve method for the bad debts allowed under Section 166 of the Code. Actually, a tax payer can use either of two methods. It can use the direct charge-off method, which allows you to charge against income in the year that the account goes bad.

Or a tax payer can anticipate its losses -- as far as specific accounts are concerned -- and establish a reserve for bad debts, and, based on its experience, estimate the amount of the accounts receivable which will go bad and charge that amount against income, when it establishes its reserve.

The reserve is reviewed annually. And any additions to the reserve are, likewise, charged against income as a deduction. They are limited, of course, to the reasonableness of the reserve which, in our situation, is stipulated.

On May 31, 1960 the partnership had approximately $487,000 worth of receivables in these 8 Alabama offices and approximately a $73,000 balance in its reserve for bad debts, applicable to those 8 offices.

It then, on June 1, transferred to 8 separate corporations. It obtained a benefit, under the Alabama loan licensing statutes, by having separate corporate offices which could lend money. It transferred to those 8 offices the receivables applicable to the 8 corporations-- the furniture and fixtures applicable to the 8 corporations, cash applicable to the 8 corporations and liabilities -- taking back stocks and securities solely for the net value transferred to the corporations.

It continued the same businesses in the 8 corporations. What it did: The corporations then set up the reserve. They had an opening balance which they reflected in their reserve

for bad debts. In total -- and we are dealing here, in both briefs, with the total concept -- the total amount of the reserves reflected in the opening balance sheets of these 8 corporations was $73,000.

In 1962 the Commissioner of Internal Revenue issued his revenue ruling, 62-128, where he first expressed the position that the reserve being maintained by a partnership would be taken back into the ordinary income of the parnership when it transfers its assets, even though such transfer be under the tax-free rule, generally, of Section 351.

Thereafter, the Commissioner's agent examined the returns of the partnership, made a determination that the $73,000 of the reserve should be restored to the ordinary income of the partnership in its year, which ended in 1961.

This increased the distributive share of income to the partners, and, therefore, the partners' income increased in 1961. They paid their tax, filed claim for refund and filed suit in District Court.

The District Court, upholding the taxpayers' position that the reserve would not be restored to income, relying on the Ninth Circuit Court of Appeals case of Heinz Schmidt.

The Government appealed to the Fifth Circuit, where the Fifth Circuit said they disagreed with the Ninth Circuit, and agreed with the Tax Court and sustained the Commissioner's

position and, hence, this writ of certiorari.

We maintain that the clear legislative history of Section 351 precludes this inroad, this creation of income to the partnership when it incorporates its business under that Section. Section 351 came into the law in 1921, at the same time Congress first enacted the reorganization provisions and also enacted the tax-free exchanges of real estate provisions.

The Senate Finance Committee, in its report in 1921, recounted that the prior law, under the prior law before 1921, this would have been a taxable event -- a reorganization or the organization of a corporation as we have here would be a taxable event before 1921. And they said there had been no provision which had more seriously interfered with necessary business readjustments than these prior laws. Therefore, they put in these tax-free exchange provisions.

They said they specifically sought to eliminate "technical constructions which are economically unsound and interfered with necessary business readjustments."

In 1924 Congress considered the carryover basis sections of the Code, which are the corollary to tax-free exchanges -- the corporation taking a carryover basis. They had an opportunity to express their views again-- the House Ways and Means Committee -- as to the purpose of the predecessor of Section 351 of the Code. They said that this

Section 351 and the reorganizations sections were not intended to be exemptions from taxation; that they were recognitions that these changes were merely changes in form and not in substance and would not be given to recognition of income; that any recognition of income would be postponed until there was an actual sale or a taxable exchange.

Q What would be, under your theory that your clients as partners should not have added back into their income the amount theretofore set up as a reserve for bad debts, what would be the result vis-a-vis the newly-created corporation?

A We would say the result is what did happen in our situation. The corporation set up a reserve for bad debts. It had a balance ---

Q Which was identical?

A Identical.

Q In amount, I mean.

A In amount. It had $73,000 in it. Now that amount was not charged against corporate income for the first year as a reduction of income, which is the Government's position. The Government says, "Take it into the income of the partnership and give the corporation a new deduction in its first year for $73,000."

Q And you say, "Don't take into the income of the partnership and don't give the corporation a deduction the

first year."

A Yes, Mr. Justice.

Q I suppose, also, the basis of the stock received by the partners, in return for the transfer of the partnership assets, would be the amount of the assets, represented by the accounts receivable, less the reserve, would it not? It would be a net figure?

A That is right, the net figure.

Q So the basis of the stock in the hands of the partners would be lower. Therefore, on any subsequent sale or taxable transfer, their capital gain would be higher. Is that right? Is that what would follow?

A Yes, Mr. Justice.

Q And the corporation would never get a deduction?

A For that $73,000.

Q In the first year or any other time.

A Or any other year.

Q Because on your theory they haven't paid anything for that $73,000 worth of accounts receivable.

A That is right; that it was just a mere change in form.

The Government, in their brief, cast this pall of an expected double deduction; that the Code is to be construed to prevent double deduction. We took no double deduction. We set it up on the corporate books without deducting against corporate

income. Our tax payer considers his stock to be worth net.

The reserve for bad debts came into the Section, incidentally, in 1921, the same year that our predecessor of our tax-free organization Section 351 came in.

We have found no case -- nor has the Government cited any case -- since 1921 where any corporation has sought a second deduction or any tax payer has tried to take a second deduction.

Q I take it the Government would take the same position if the corporation had paid the partners cash for the accounts receivable in their face amount less the amount of the reserve?

A If they paid the partners cash in the face amount?

Q If they bought the accounts receivable, paid cash in the face amount, less the $73,000.

A They would take -- Well, that is a difficult question to immediately answer for this reason: They would say that, if you had a taxable sale of the receivables at net, face amount less the reserve, that there is no income. Because they seek to offset a return of the reserve to income by a loss on the receivables.

They say, however, in our situation, this is a tax-free exchange which precludes recognition of gain or loss. Therefore, there is no loss which can be recognized to the

transferring partners to offset the return of the reserve to income.

Their position in a taxable exchange would be that there would be no income, but, if we had a transfer of the receivables in exchange for cash in a non-taxable environment, then their answer would probably be the same.

Q They think it is different then if -- if the corporation and the partners had been valuing the assets to be transferred and specifically allocated a value to the accounts receivables at face amount less the amount of the reserve?

A Their result would not be any different.

Q Even though the corporation didn't purport to pay you any more than net amount?

A Had the corporation, instead of setting up the reserve, simply established on its books receivables at the net amount of $414,000 -- the net amount -- their answer would have been the same.

Q They still think you have realized income.

A They still think we have realized income. Now they cite -- which I think is a good case, and I wish I had cited it -- the Skelly Oil opinion, where they say that the Court will not permit any double deduction. I believe that, with that decision, it would be inconceivable that if a corporation tried to come into court later on, or a tax payer

tried to come into court to get a second deduction, that that would ever be allowed.

Q Let me test you position from another angle. Suppose -- and this is a large hypothetical, because it wouldn't happen -- suppose, after the corporate reorganization was completed, someone came along and offered to buy all of the receivables of the new corporations, which had just been transferred to it, for 100¢ on the dollar, then what would happen to the reserve?

A This is what would happen, Mr. Justice: The corporation would then have recovered the full amount of its receivables.

Q Well, they would be charged all of the bad debt loss; the reserve would then go into income, wouldn't it?

A Would go into income by the corporation.

Q This hasn't happened and never will happen, unless some fairy godmother comes along and buys these at 100¢ on the dollar?

A That is right. And if it happened quite soon after the incorporation, I think the Commissioner would come in and say, "The reserve wasn't reasonable in amount," and would probably seek to have the partnership pay some income tax on it. Because if the reserve is not reasonable, he has got other rules that they would apply and we would not argue with. But in our situation it is stipulated that the reserve

is reasonable.

Q But if somebody bought from the partners the accounts receivable for cash at their face amount, not the net amount, you would realize income.

A We would realize income.

Q You would have to add back to your income the $73,000?

A That is right. We would say that the tax benefit rule, which the Government espouses in their brief correctly but doesn't apply, would apply. The tax benefit rule, which they say is the basis for revenue ruling 62-128, says that, if you take a deduction in a prior year, it is of tax benefit in the prior year. And you subsequently recover the deduction, then you have to take into income the amount of the recovery in the year of the recovery.

Q That reserve really just makes you a cash-basis taxpayer for the amount of that reserve, I take it? That you pay on it if you collect some of them?

A If you collect those accounts in, then you do have -- in other words, you have a recovery of the reserve. We say, in this non-taxable situation with a mere change in form, that there is -- and this was the philosophy, I think, of the Ninth Circuit. The Fifth Circuit ignored Section, well, they mentioned it, but they did not give a lot of weight to Section 351. The Ninth Circuit didn't either, but they grounded

their opinion on the fact that there was no recovery; that the philosophy of the Government in using the tax benefit rule to take, to recover the bad debt in some future point should be based on the fact that there is a recovery in some later year of the amount of the reserve. And that, when you get back stock certificates representing the net value of the assets transferred -- the accounts receivable less the value -- that there was no recovery.

Q But, at least, if there is some recovery of these reserve accounts, the result of your position would be that the corporation would pay corporate tax rates rather than -- you would avoid paying an ndividual tax rate?

A You would not have an immediate recognition at the beginning. You could have a higher rate or you could have a lower rate, I imagine, either way at the time the corporation takes it back into its income, depending on the two rate structures.

Q Well, what is the result of the Government's position? Assume the Government prevails and you have to take-- the partners have to take this $73,000 into income. I suppose that $73,000 worth of accounts receivable could be recovered by the corporation for nothing?

A That is right. You see, what would happen ---

Q Should the Government concede that?

A I don't -- We are really ---

Q And the tax would then have been paid on those accounts receivable?

A If the partners took the $73,000 worth of receivables into income, then they would -- they say in their brief that the corporation would then be entitled to set up a $73,000 reserve for bad debts in its first year. Now if the corporation chose to do that and take a deduction of $73,000 in its first year and later recovered the $73,000 ---

Q The tax has already been paid on it.

A That is right. It has been paid, but, if you had a second deduction under their theory, you could have a second tax to pay on it. We say that would just really distort the income of the new corporation, giving it a whopping big deduction in the first year when it has no earnings, necessarily. It is not related to any business activity, and it creates an income item to the partnership.

I am going to reserve the balance of my time for rebuttal.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Apolinsky.

Mr. Zinn.

ARGUMENT OF MATTHEW J. ZINN

ON BEHALF OF RESPONDENT

MR. ZINN: Mr. Chief Justice; may it ---

Q Before you get under way, would you clarify -- perhaps for all of us, but at least for me -- what has

changed here, in your judgment, by this transfer except the form and structure of doing business.

A That is precisely all that has changed, Mr. Chief Justice, just the form in which the business is carried on.

Q There is no change in substance?

A That is correct. Although, as we pointed out in our brief, Section 351 transfers can apply where an entire business becomes a corporation or where a single asset, an account receivable or any other single asset, is transferred from an individual or partnership to a controlled corporation.

Q What business was this partnership engaged in?

A It was engaged in the business of financing, Mr. Justice.

Q Lending money?

A I believe so.

Q Is there any challenge to the question as to the amount they have tried to set aside for bad debts?

A No, Mr. Justice. If I understand your question, the reserve that was on the books of the corporation at the time of the transfer -- on the books of the partnership, excuse me, at the time of the transfer was reasonable, if the partnership continued in business. But the fact is that the partnership didn't continue in business. The partnership was terminated, and all of its assets, including its accounts receivable,

were transferred to the corporation.

Q Why did that change the situation with reference to the reasonableness of the amount?

A We think that when a partnership terminates, or when an entity terminates, the tax benefit principle requires that a deduction be restored to income. Because subsequent events have demonstrated that that entity is not entitled to the deduction.

Q Does the record show that? The subsequent events?

A If the partnership and corporation are considered to be separate entities, I don't think there can be much question that the partnership's need for the reserve ended.

The Ninth Circuit, in the Schmidt Case upon which petitioners rely, determined that the need had terminated.

Q But they merely changed the ---

A The form of the business, as the Chief Justice asked.

Q From a partnership to a corporation?

A That is correct. And Mr. Apolinsky, this morning and in his brief, has relied heavily on the legislative history of Section 351, which provides for the non-recognition for gain or loss. But he did not read the language of the statute to this Court, and I would like to do that.

It says: "No gain or loss shall be recognized if

property is transferred to a corporation or one or more persons solely in exchange for stock or securities and immediately after the exchange such person is in control of the corporation."

No gain or loss shall be recognized. Gain or loss is a statutory term. It can arise only when property is transferred. The reserve for bad debts is not property. It is merely a bookkeeping entry on the books of the partnership. It cannot be transferred.

And nothing in Section 351 bars the application of the tax benefit principle in this case.

Q Nobody is purporting to be transferring the reserve.

A They are transferring all of the receivables.

Q All anybody is saying is that, "We are transferring accounts receivable on their face amount less the amount of the reserve. We are transferring only the net amount, because everybody stipulates that these things that we have transferred are only worth so much."

A Yes; but Section 351 only prohibits the recognition of gain or loss. And restoring the reserve to income, under the tax benefit principle, is not a recognition of gain or loss.

Q That may be so, but ---

A I think the point is, Mr. Justice White, that there is no provision in the statute that precludes the

application of the tax benefit principle in this case. That principle is well-established. The need for the reserve here, we think, has terminated, because the partnership has terminated.

Q Just because there is nothing in the statute that prevents the application of the tax benefit principle doesn't mean that that principle is applicable in this case.

A I would, respectfully, disagree, Mr. Justice White.

Q Why? What possible benefit has come out of the transfer?

A The partnership has received the benefit of a deduction to which they are no longer entitled.

Q Well, they have received the benefit of it, because the Government agreed that the accounts receivable on the books weren't all collectable. And now you are saying that you must pay taxes as though all of these accounts receivable were collectable.

A That is correct.

Q And that you are no longer entitled to view this accounts receivable as worth less than face.

A That is right. I think the accounts receivable are separate from the reserve. Let me point out, Mr. Justice White ---

Q What so attractive about that? To say to

somebody, "You must treat as collectable these accounts receivable that we all agreed weren't collectable. And you must pay taxes on them."

A I don't know that there is anything attractive about it. As we tried to point out in our brief, we view the problem here as, initially, one of avoiding a double deduction.

Q What possible double deduction can anybody ever get?

A The concern we have, initially, Mr. Justice White, is that a deduction will be granted to the partnership -- as it was here -- and then that a second deduction will be be granted to the transferee corporation.

Q You wouldn't really think the Revenue Service would let that happen, would you?

A I think they would try not to, Mr. Justice White, but I don't think we can rule out that possiblity. Judge Dunaway, in his opinion in the Schmidt Case, specifically left open the question.

Q You mean because the corporation might try to take an improper deduction, we must make sure to charge somebody else more than we should?

A No, I don't think that is the case. It seems to me that we want to insure against a double deduction. The Code doesn't specifically tell us which way to do that.

Q You want to insure against it by taxing someone

on some income that they haven't received yet and never will receive.

A We say they have received it, Mr. Justice White.

Q But that is only by a fiction of the accrual basis accounting, anyway.

A But the deduction for the reserve for bad debts is a fiction, too, allowing deductions ---

Q It isn't a fiction at all. It is saying, "If you are on an accrual basis, you are going to have to pay as soon as you take in the income, the face amount of these receivables, whether you have collected them or not, except we won't make you take into income now a certain percentage of them, $73,000.

A That is right. But, nevertheless, there is a recovery. If we view the partnership as a separate entity, there is a recovery of that deduction. We think that the Code ---

Q If the incorporation had never taken place, these partners would never have paid a nickel on that $73,000, unless they had actually collected some of those accounts receivable.

A That is correct.

Q And now you are saying that, nevertheless, they should pay on that $73,000 although they haven't yet received any payment on that $73,000 ---

A That is correct.

Q --- and never will.

A That is correct.

Q That is interesting.

A In the case of the corporation that liquidates tax-free under Section 336 and distributes all of its assets to its shareholders in liquidation, it is clear that the corporation must restore the reserve to income, even though it didn't collect the amount of the reserve for bad debts. All it is getting back are pieces of paper, just like the partners are receiving here.

Q We have held that up in this Court?

A You haven't held it, but such holdings as there are are consistent with that.

Q Well, that may not be a very good holding either.

A Petitioners concede that, in their brief, that on a liquidation of a corporation, there is a restoration of the reserve to income.

Q Mr. Zinn, when this transfer occurred, I assume that in the 8 offices of the corporation -- the partnership, later the corporation -- they had typewriters, desks and a lot of office equipment. Let us assume, just hypothetically, that that equipment was worth at an original cost of $50,000 and had been depreciated down to $25,000. Would you say that now it is transferred to the corporation, that depreciation --

which is a hypothetical recognition or a prophecy, as is the bad debt deduction -- should now be charged back as income to the partners?

A No, we would not, Mr. Chief Justice. But that is because Section 1245 and Section 1250 of the Code specifically so provide.

Q The function of the bad debt loss is essentially, in principle, the same as the function of a depreciation for obscolescence, isn't it?

A They are similar, although some of the cases that we have cited, including the West Seattle Bank Case, draw a distinction between the two. So far as I can understand the distinction -- and it is rather murky -- it is that, with respect to accounts receivable and a reserve for bad debts, you cannot be certain that any particular account will become worthless. Whereas, you have some greater degree of assurance that wear and tear and obsolescence will gradually diminish the value of an asset.

Q That isn't necessarily true, as a matter of reality. In a period of rising costs it frequently occurs that assets long since depreciated down to zero become worth a great deal, and then the Government unliquidates them, recovers that, do they not?

A I agree that they would. And I think that they would recover it here but for the fact that we have specific

statutory provisions that apply. I think it would be helpful if I point out to the Court that, in the investment credit area, the Government wouldn't be taking the position that it is taking here, because Section 47(b) of the Code provides that: "Property shall not be treated as ceasing to be investment credit property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business."

Had a provision like that been included in the Code in Section 351, we wouldn't be here in Court today. But the fact is that Section 351 only prohibits the recognition of gain or loss. And we are not seeking to tax gain or loss in this situation.

Q Is your argument based on the fact that somehow somebody didn't put down here what they intended ---

A No, Mr. Justice Black.

Q --- and that the Government is going to get this payment, although it shouldn't happen? But nevertheless, the letter of the law doesn't prevent it?

A No; our position here is that the Internal Revenue Code does not tell us which way to handle this double deduction problem; that the Commissioner has determined that the proper way to handle it is to restore the bad debt reserve to income, under the tax benefit rule; that application of the tax benefit rule here is entirely consistent with all statutory provisions; and that, under decisions of this Court, so long as

the Commissioner's solution to the double deduction problem is reasonable, that that is the end of the case.

Q Is it your position that, in all truth and fact and justice, that this is not going to require a taxpayer to pay taxes on income that he did not receive as income?

A Yes ---

Q You admit that?

A Yes, but when he obtained the deduction for the reserve for bad debts, Mr. Justice Black ---

Q But he will have to pay tax on income that he did not get?

A We say he received it. Because he obtained a deduction when he set up the reserve for bad debts for a loss he did not suffer, for a loss that would be ---

Q Do you claim that this would be a double benefit occurrence?

A No; we are saying that, when he set up the reserve for bad debts, he got a deduction for a loss he had not yet suffered. And now, since the partnership is terminating and since the partnership never incurred those losses, he must restore the bad debt reserve to income.

Q Then what happens? Suppose they don't collect them? They still turn out to be bad?

A We think that the corporation would be entitled to take a deduction, because it would have suffered the losses.

Q You think it would be entitled to take a deduction later?

A Yes, because it suffered the losses.

Q That is your argument why it is fair for the Government to do it?

A That is right. The corporation is entitled to the deduction, because it suffered the losses. It actually suffered them. The partnership here did not suffer the bad debt losses, which it obtained through creation of the reserve. The reserve is an estimate of future losses, and the partnership never suffered those losses. And for that reason we don't think it is entitled to retain the benefit of a deduction.

Q Your argument is in fact that the taxpayer would get this deduction twice?

A No; our concern is -- The partnership has already gotten the deduction here.

Q That is right; you say it has already got it.

A There is a possibility that the corporation will get a deduction for the same accounts receivable.

Q As I had understood your argument, Mr. Zinn, it was this: The statute itself does not explicitly tell you or the taxpayer how this situation should be handled; and that your submission is that the way you handle it is a reasonable way of handling it under the statute; and that that should be the end of the case.

A That is correct.

Q And I further understand that neither you, on the one hand, or your adversary, on the other, are claiming that either there should be double taxation or a double deduction. You both recognize that, however this is worked out, that there shouldn't be a double deduction and that the same item should not be taxed twice,

A That is right. It is which way to avoid the double deduction.

Q As I understand it further, you are not saying that the way you decided to handle this is the only proper way of doing it. You are simply saying it is a reasonable way of doing it; and that, under the decisions, that should be the end of the case. Am I wrong in that?

A That is correct, except that I would add to that that we think our way is more consistent with the provisions of the Internal Revenue Code, particularly those of Sub-chapter C, which this Court recognized last term in Commissioner and Gordon are very, very technical.

Now we think that Mr. Apolinsky's arguments are very persuasive in terms of perhaps revising the Internal Revenue Code and making Section 351 read the same way that 47(b) reads; that if it is so long as the same business is continuing, no income will be recognized. But that is not what the Code says.

Q You don't claim it would be reasonable for the

taxpayer to be denied this deduction twice?

A No; we don't seek to deny it twice, Mr. Justice Black. We would allow it to the corporation.

Q Nor do you think it would be reasonable for them to get it twice?

A That is right.

Q You think once is all the deduction they should get?

A Yes; and that is all they seek.

Q Your scheme will do that; that is why you call it reasonable. You wouldn't call it reasonable if it didn't accomplish that, would you?

A I am not sure I follow you.

Q You wouldn't call it reasonable if it was making this taxpayer be denied the privilege of a deduction for a loss he had had.

A Oh no; but the petitioners here didn't suffer the loss that they are claiming. The corporation suffered the loss, and that is whom we want to allow it to.

Q Neither side of this case -- Your adversary is not claiming that he going to be taxed twice, and you are not claiming that it going to be deducted twice.

A It is just which way.

Q It is just which accounting method.

A Which way. Now, Mr. Apolinsky, has pointed out,

both in his brief and here this morning, that the corporation set up the reserve for bad debts on its books, and therefore, didn't claim it twice. I should point out to the Court that we have confirmed that, but that is extra record information. It does not appear in the record. I don't think it makes any difference, except as a matter of tidiness.

Mr. Apolinsky also mentioned this morning that, on a liquidation of a partnership, there would be no restoration of the reserve to income. There is no case law on that question. There is, as I have mentioned earlier, case law on the question of liquidation of corporations which indicate that there would be a restoration of the reserve. And it seems to us that there would be a restoration of the reserve if this partnership liquidated.

Q If someone bought from the partners the accounts receivable for cash, at the net value, face less the amount of the reserve, I suppose the partners would realize no income?

A They would realize no net income, Mr. Justice White, because, presumably, the restoration of the reserve in the hypothetical that you posited ---

Q Restoration? Would there be a restoration?

A Yes; we think there would be a restoration.

Q You mean they would have to take back into income the $73,000 even if nobody paid it?

A That is right. But then they would be entitled

to a loss deduction for $73,000, because the basis of the receivables in their hands would be the face amount of the receivables, we think, not the net amount.

(Whereupon at 12:00 p.m. the argument in the above-entitled matter recessed to reconvene at 1:05 p.m. the same day.)

(The argument in the above-entitled matter reconvened at 1:05 p.m.)

FURTHER ARGUMENT OF MATTHEW J. ZINN

ON BEHALF OF RESPONDENT

MR. CHIEF JUSTICE BURGER: Mr. Zinn, you may pick up where you left off.

MR. ZINN: Mr. Chief Justice; may it please the Court.

In the few minutes I have remaining I should like to discuss the two proposed solutions of petitioners to the double deduction problem here; that is the carryover solution and the adjustment of basis solution.

Section 381 of the Internal Revenue Code is the principle provision which allows for carryovers in certain transactions. That provision does not apply to transactions such as the one here, which is described in Section 351. It applies only to certain intercorporate transactions.

In addition to the absence in Section 381 of a specific congressional authorization for a carryover, it is well-established that a transferee, in a Section 351 transaction, is a new taxpayer and can adopt its own accounting and its own taxable year, including, in this specifice case, the specific charge-off method of accounting for bad debts.

We think, therefore, there is a real risk of a double deduction if this Court should hold that the tax benefit principle

is not applicable here.

Third, we point out that Congress has been quite specific when it wanted items to be carried over in a Section 351 transaction. Thus, Section 362 of the Code provides that the basis of property shall be carried over. But as I attempted to outline for the Court this morning, a reserve for bad debts is not property.

Similar carryover rules ----

Q Well, would you distinguish it in that respect from a depreciation reserve?

A No, a depreciation reserve is not property either. But, under Section 1016 of the Internal Revenue Code, a depreciation reserve is specifically provided to reduce the basis of the depreciable asset. That is under Section 1016(a2), Mr. Chief Justice. There is no specific provision that is comparable to that, allowing a basis reduction for a bad debt reserve.

I should also point out that, in attempting to analogize a Section 351 transaction, to bring it within the spirit, if not the specific language, of Section 381, that Section 381 applies only to transfers of entire businesses. Whereas, Section 351, as I mentioned before the recess, applies to a transfer of an entire business, as in this case, or to transfer of a single asset.

Q Let's assume that this wasn't a 351 transaction,

but the corporation was organized and assets were transferred to it for consideration, and the corporation bought these receivables for cash. I suppose its basis would be what it paid for them, wouldn't it?

A That is correct. In that case, the basis would be what you paid for it.

Q What do you think the corporation paid for it here? Assume this wasn't a taxable transaction -- wasn't a non-taxable transaction, but it did issue stock for the receivable?

A It issued stock and cash?

Q It issued stock for the receivables.

A But it was a taxable transaction?

Q Yes.

A Well then its basis would be the net value of ---

Q What is that?

A The face amount of the receivable less the reserve. That would be the corporation's basis. But that is not the corporation's basis in this case, according to the specific provisions of Section 1016(a) of the Code.

Q Do you think the Code requires the corporation, in this kind of a transaction, to take into its books the receivables at face?

A I don't know if I could go so far as to say "requires", Mr. Justice White. It seems to me that the

overriding principle that is applicable here is no double deduction -- a principle that this Court reaffirmed last term in Skelly Oil.

Q You mean that requirement is only a requirement if you are right on your other argument?

A No. Well, we say that the Code doesn't specifically answer the question as presented here: how to avoid the double deduction. Now we think the better way to answer the question is to answer it by applying the tax benefit principle.

But if the Court says that that isn't the better way to do it, then we think the basis adjustment should be made. The Code just doesn't speak specifically to the point. Now we have to comply ---

Q Well, the basis adjustment can be made, but what does that do to the partnership?

A If the Court should hold that the tax benefit rule doesn't apply here, then the basis of the receivables should be reduced to net in the hands of the corporation, so as to avoid a double deduction.

Q If you were on the buying side, or on the receiving side -- on the corporate side -- of taking in receivables that had been valued at less than face, you probably wouldn't pay any more than their true value, would you?

A No, you wouldn't pay more than their true value

for them. You would pay the net amount. And then your basis would be what you paid.

Q What you are saying is that what we should do is to say the corporation really paid face value for the receivables and, hence, the transferring stockholders actually received income?

A I don't think we have to say that the corporation paid the face amount. It seems to me that Section 362 provides that the basis of property, in the hands of the transferee corporation corporation, shall be the same as in the hands of the transferor. That basis -- at least so far as good interpretation of the Internal Revenue Code is concerned -- would be the face amount of the receivables.

Q This partnership could have sold and assigned the accounts receivables independent of this tax-free transfer, couldn't they?

A Yes; and our position, if it had done that, would be precisely what it is here; that the reserve for bad debts has to be restored to income ---

Q If they sold it for the net amount?

A If they sold it for the net amount; and that they are entitled to a loss measured by the difference between the face amount and the net amount, because that is a sale of property. And on a sale of property, accounts receivable, with a basis let's say of $100 for a net value of $90, they are

entitled to a loss of $10.

Q Would that be a washed transaction?

A It would be in most cases, Mr. Chief Justice, because accounts receivable, under Section 1221(4) of the Code, would be an ordinary income asset. But if the accounts receivable happened to be a capital asset in the hands of the selling entity -- in the hypothetical that you posited -- then the gain or the loss would be a capital loss and the restoration to income would be restored to ordinary income.

Q But here if the partners have to take this into income, but they don't get any income out of it, they won't be entitled to the loss. The loss would be the corporation's?

A That is right. Because the corporation will suffer the loss.

I think I should point out that the purpose of the reserve method of accounting for bad debts is to better match cost against revenue, as has been pointed out in the briefs. But that purpose was never intended to provide a loss to an entity that didn't suffer it; and that once we know that the partnership entity has terminated, the partnership should not end up with any more bad debt deductions than it would have wound up with had it been on the specific charge-off method of accounting for bad debts.

And had it been on the specific charge-off method, it would not have gotten this deduction for future losses which it

took and which, we submit, has to be restored to income when the partnership terminates.

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

You have some time left, Mr. Apolinsky.

REBUTTAL ARGUMENT OF HAROLD I. APOLINSKY

ON BEHALF OF PETITIONERS

MR. APOLINSKY: Mr. Chief Justice, if it please the Court:

I think that the statements of Mr. Zinn points up the problem they have in applying the tax benefit rule realistically. They set forth the rule, but they don't apply it. Certainly, in the taxable exchange area when there is a cash sale of accounts receivables, the rule, as set forth in their brief, says that you restore to income a deduction when you recover it.

Well, if you have a sale for the receivables at gross, that is a recovery, and it would come into income. If you have a sale at net, the most logical conclusion, it seems to me, is that you have no recovery under the tax benefit rule. And, therefore, there is no income to the taxpayer selling in a taxable transaction.

The Government, in order to bend the rule to fit our tax-free situation, sets up a hypothesis that they have a loss realized on the receivables which counteracts the return to income of the reserve, and the wash result is a net of zero.

We say that is an incorrect approach to the problem. The loss occurred when the taxpayer got the deduction for the reserve -- when he set it up, that is when the deduction occurred. The fact that later on he sold at net was merely a realization that his estimate, his loss, was correct, not a subsequent loss down the road to offset some artificial inclusion in income.

We further say that we do not agree in our brief -- and our brief, I think, shows that -- that there is a different rule to apply in Section 337, liquidation. I did not cover that, because it is covered in my brief. But Mr. Zinn said that we did agree, and we do not.

In fact, the revenue ruling in 1957, where the Government covered the liquidation under a one-year liquidation rule, specifically set up the hypothesis that the corporation sold its receivables at face. They said, therefore, the reserve comes back into income. Well, that seems to be the tax benefit rule in its proper application. I have set out that entire revenue ruling in the last page of my appendix.

I also take issue with Mr. Zinn when he disputes whether, upon the liquidation of a partnership, the reserve comes into income of the partners. In my judgment, in a pro rata liquidation of a partnership under Section 736, there is no recognition of income to the partners.

I would just focus our attention, if I will -- The

Government has assumed, as we said, that there is a problem of a double deduction. We maintain that there is no problem of a double deduction, because there has been no -- in our case no one has tried to take a second deduction, and in no case discussed today or in any of the briefs has any taxpayer attempted to take a second deduction at any stage. So that the basic hypothesis for the need for the revenue ruling is, it seems to me, unfounded; that there is no second deduction to guard against, and, therefore, without that problem there is no need to even travel under 7805.

But under that section -- The solution, if we were to assume for argument there is a problem, under that section the solution has to be consistent with the statute. Section 351, which says, "No gain or loss if property is transferred,"-- if, it doesn't say, "from property". It is not tied to the property. It says, "if property is transferred;" that the legislative history of that Section points out that that is not a taxable event. It is just a change of form.

In 1924 Congress, in reviewing it, said, "No gain or loss," and then in the next sentence they said, "This is not a time for the realization of income."

So, we say there is no magic in saying that what we have over here is income, and the statute should have said, "No gain, loss or income." Because in 1924 they used the two terms interchangeably.

Certainly, the cure to the illness should not be worse than the illness itself. And that is what is going to happen if we restore to the partnership this income. It creates artificial tax planning.

Partners, proprietors transferring to corporations cannot put receivables into their corporations, because, if that matured a reserve for bad debts, they would not then have any cash to pay the income tax with.

So what has happened since 1962 is that people with reserve for bad debts have been, artificially, holding out their receivables or else, possibly, making cash sales at net to third parties to create what the Government says is a wash situation. This is a recurring problem. The Government, in their petition for certiorari, agrees that we have incorporations of businesses every day.

It just seems to me that we should not visit the need for some artificial planning. Congress in 1921 said to encourage business readjusments -- and even spoke of arti icial transactions -- that they were going to place this tax-free environment.

The simplest thing, I think, is not to look to a specific solution to a double deduction. We say there isn't. Or simply for the Court to remind the tax bar -- as we don't need reminding -- of your decision of Skelly Oil; there is just not going to be any second deduction allowed, irrespective

of which particular route is followed.

We urge that the Fifth Circuit be reversed and that the District Court's decision be affirmed, so that the partnership in this situation would not take into its income the reserve for bad debts.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Apolinsky. Thank you, Mr. Zinn. The case is submitted.

(Whereupon, at 1:19 p.m. the argument in the above-entitled matter was concluded.)