Supreme Court, U.S.
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In The

# Supreme Court of the United States

NESTLÉ PURINA PETCARE COMPANY,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit**

## PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

I. Whether the Eighth Circuit, in agreement with the Third Circuit but in conflict with the Ninth Circuit, erred in holding that a deduction for dividends paid to withdrawing participants of an ESOP, as specifically authorized by §404(k) of the Internal Revenue Code, is nonetheless precluded by §162(k)(1), which disallows an otherwise allowable deduction "for any amount paid or incurred in connection with the redemption of [petitioner's] stock."

II. Whether this Court should clarify the deference owed by one circuit to the federal tax decisions of other circuits.

III. Whether the Eighth Circuit erred in holding that petitioner's deductions for "applicable dividends" paid under §404(k) were barred by §162(k)(1), where §162(k)(2)(A)(iii) expressly provides that the bar set forth in §162(k)(1) shall not apply to "deductions for dividends paid (within the meaning of Section 561)."

## CORPORATE DISCLOSURE STATEMENT

Petitioner Nestlé Purina PetCare Company is a wholly-owned subsidiary of Nestlé Holdings, Inc., a Delaware corporation. Nestlé Holdings, Inc., is not a publicly traded company, and therefore no publicly held corporation owns 10% or more of petitioner's stock.

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## PETITION FOR WRIT OF CERTIORARI

Petitioner Nestlé Purina PetCare Company respectfully requests that the Court grant a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

## OPINIONS BELOW

The opinion of the United States Court of Appeals is reported at 594 F.3d 968 (8th Cir. 2010) and is reproduced in Appendix A (A-1). The opinion of the United States Tax Court is reported at 131 T.C. No. 4 (2009) and is reproduced in Appendix B (A-9).

## JURISDICTION

The Tax Court had original jurisdiction over this case pursuant to 26 U.S.C. §§6213(a) and 7442. The Tax Court's final decision was entered on December 18, 2008, and petitioner's notice of appeal was timely filed on February 5, 2009. The United States Court of Appeals for the Eighth Circuit had jurisdiction under 26 U.S.C. §7482. Its opinion and judgment were filed on February 9, 2010. This Petition was filed within 90 days of that date. This Court has jurisdiction under 28 U.S.C. §1254(1).

## STATUTES INVOLVED

The relevant portions of the statutes involved in this case are reproduced in Appendix C (A-44).

## STATEMENT OF THE CASE

### Formation and Funding of the ESOP

In 1989, petitioner created an Employee Stock Ownership Plan ("ESOP") component to its qualified retirement plan for its employees (Stip. ¶11).[1] The ESOP was created, among other reasons, to enhance the retirement income of Ralston's employees as well as providing them with an opportunity to own Ralston stock (Stip. ¶12). Employee participation in the ESOP was voluntary (Stip. ¶28). In almost every respect, Ralston's was a typical ESOP (Stip. ¶21) and did not contain any unusual provisions inserted for the purpose of generating the tax deductions at issue here.

In connection with the creation of the ESOP, Ralston authorized the issuance of new preferred stock, which was purchased and held solely by the ESOP (Stip. ¶¶42, 48(a), 50, 52, 53). To finance the purchase, the ESOP borrowed $500,000,000 from

[1] Petitioner Nestlé Purina PetCare Company was known as Ralston Purina Company during the tax years in question and will be referred to here as "Ralston" to be consistent with the record and the opinions below.

various institutional lenders (Stip. ¶54).[2] Principal and interest due on the loan were paid by the ESOP with the proceeds of Ralston's contributions to the ESOP, contributions by employee-participants, and regular ("stated") dividends on the preferred stock (Stip. ¶58).

A separate ESOP account was maintained for each employee-participant (Stip. ¶32). Shares of preferred stock owned by the ESOP were initially held in a suspense account, but then were allocated to participants' accounts as principal was paid on the ESOP loan (Stip. ¶¶55-57).

## Cashout Distributions to Terminated Participants

Upon termination of employment, the departing employee could no longer participate in the ESOP, and he or she was required to direct the ESOP to convert the shares of preferred stock allocated to his or her ESOP account into cash, shares of Ralston common stock, or a combination of both (Stip. ¶63). The ESOP had to provide this right to departing participants because the preferred stock was not readily tradable on an established securities market (Stip.

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[2] When the ESOP loan was paid in full in 1998, all shares of the preferred stock were converted into Ralston common stock. In December 2001, a Swiss corporation indirectly acquired all of Ralston's common stock resulting in the discontinuance of the ESOP component of the qualified retirement plan (Stip. ¶101).

¶¶23, 48(a), and §409(h)(1)). Additionally, the withdrawing participant needed to elect to either: (1) receive an immediate distribution in cash of the value of his or her ESOP account (a so-called "cashout distribution"); (2) receive an immediate distribution of Ralston common stock; (3) direct a rollover of his or her account balance to an individual retirement account or other qualified plan; or (4) utilize a variety of deferral options, including the receipt of an annuity (Stip. ¶¶65, 67).

**ESOP Funding of Cashout Distributions**

In accordance with the preferred stock's Certificate of Designation, the ESOP could, in its sole discretion, require Ralston to redeem shares of preferred stock when and to the extent necessary to provide, among other things, monies needed to fund cashout distributions to withdrawing participants (Stip. ¶¶48(l), 71). Such redemptions, though, were not a prerequisite to the ESOP's obligation to pay cashout distributions due to terminating participants; on the contrary, the ESOP retained the obligation to pay such cashout distributions even if Ralston did not redeem any of the ESOP's preferred stock (Stip. ¶75).

The ESOP could require Ralston to redeem preferred stock for the additional purposes of (a) satisfying a participant's investment elections (including requests for withdrawals or loans) or (b) paying principal and/or interest on the ESOP loan (Stip. ¶91). The ESOP was not required to use, and did not always use, the amount realized from preferred stock redemptive dividends to pay cashout distributions to departing employees (Stip. ¶91).

The ESOP was not required to redeem shares of preferred stock equal in value to the value of shares of preferred stock allocated to a departing participant's ESOP account upon termination of employment to fund cashout distributions (Stip. ¶92). Rather, the ESOP had the discretion (which it exercised in some instances) to fund cashout distributions from otherwise available cash, such as employee contributions not necessary to make payments on the ESOP loan (Stip. ¶¶72, 92).

### The Claimed Deductions

Sections 404(k)(1) and 404(k)(2)(A)(ii) provide that a corporation "shall be allowed as a deduction . . . the amount of any applicable dividend paid in cash . . . with respect to applicable employer securities . . . which . . . is paid to the plan and is distributed in cash to participants in the plan . . . not later than 90 days after the close of the plan year. . . . " During its tax years ending September 30, 1994, and September 30, 1995, Ralston redeemed, at the ESOP's request, approximately $9.4 million of preferred stock (Stip. ¶¶78, 82). Respondent ("Commissioner" or "government") does not contest that these redemptions (referred to as "redemptive dividends") were essentially equivalent to dividends within the meaning of §302(b)(1) and, therefore, treated as dividends for purposes of §§301 and 316 (Stip. ¶93). The ESOP distributed these proceeds to withdrawing participants as cashout distributions within the time frame required by §404(k) (Stip. ¶¶80-81, 85-86). The ESOP funded additional cashout distributions during the 1994 and 1995 tax years in the amount of approximately $1.6 million and $1.1 million, respectively, from otherwise available cash (Stip. ¶¶81, 86). *Id.*

Ralston claimed a deduction under §404(k) for the applicable dividends – *i.e.*, the amounts distributed by the ESOP as cashout distributions that were funded by the redemptive dividends. Ralston did not claim a deduction for cashout distributions that were not funded by redemptive dividends (Stip. ¶¶81, 86).

**Tax Court Proceedings**

This case was initiated when Ralston filed its petition with the Tax Court for redetermination of the notice of deficiency issued by the Commissioner concerning adjustments not relevant here. Jurisdiction was based on 26 U.S.C. §§6213(b) and 7442. While the case was still pending in the Tax Court, the Ninth Circuit in *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), affirmed an Idaho District Court determination that the same type of "applicable dividends" at issue here were deductible under §404(k). The Ninth Circuit also held that such deductions were not barred by §162(k)(1), which prevents a corporation from deducting "any amount paid or incurred by a corporation in connection with the redemption of its stock." Consequently, Ralston requested and, with the consent of the Commissioner, received permission to amend its Tax Court petition to claim deductions for applicable dividends under §404(k).

Ralston and the government settled all issues in Ralston's Tax Court petition except for the applicable dividend issue. The facts were fully stipulated, and on cross-motions for summary judgment, the Tax Court, in an opinion filed on September 10, 2008, determined as a matter of law that deductions for applicable dividends funded by the proceeds of redemptive dividends were barred by §162(k)(1) (A-9). The basis for this decision was the Tax Court's declaration, *sua sponte*, that the redemptions of preferred stock were "statutorily integrated" (A-28) – a term not found in any tax case ever reported and a legal conclusion never urged by the Commissioner – with the cashout distributions. In addition, the Tax Court rejected, without any analysis whatever, Ralston's argument that the exception to §162(k)(1) provided by §162(k)(2)(A)(iii) – *i.e.*, for amounts paid which constitute a "deduction for dividends paid" – was applicable and permitted the claimed deductions (A-20). The Tax Court entered its final Decision on December 18, 2008 (A-41), and Ralston filed its notice of appeal to the Eighth Circuit on February 5, 2009.

**The *General Mills* Case**

On January 26, 2009, a panel of the Eighth Circuit in *General Mills, Inc. & Subsidiaries v. United States*, 554 F.3d 727 (8th Cir. 2009) ("*GMI*"), reversed a decision of the United States District Court for the District of Minnesota, and concluded that deductions for applicable dividends funded by the proceeds of redemptive dividends were barred by §162(k)(1).[3] In its decision, the court openly disagreed with *Boise Cascade,* cited the very recent Ralston Tax Court decision referring to "two connected steps," and summarily held that §404(k) itself "creates a nexus between the [cashout distributions] and the stock redemption" – a paraphrase of the Tax Court's "statutory integration" theory. *Id.* at 729-30. The panel also found "irrelevant" various facts relied upon by the Minnesota district court demonstrating that the redemptive dividends and cashout distributions were factually separate and distinct. *Id.* at 730. Because the Tax Court opinion in this case was handed down after the briefing in *GMI* was completed, neither party in *GMI* had an opportunity to brief the issues raised by that opinion.

[3] Because of its relevance to the issues presented by this case, the *GMI* opinion is reproduced in Appendix D (A-50) for the Court's convenience.

### The *Conopco* Case

The Third Circuit on July 13, 2009, followed the *GMI* rationale in *Conopco, Inc. v. United States*, 572 F.3d 162 (3d Cir. 2009), in affirming a district court judgment that had disallowed a deduction under §404(k) based on reasoning that was rejected by *Boise Cascade*, *GMI*, and the Tax Court in this case.[4]

### Proceedings Below

By the time Ralston's case was submitted to the Eighth Circuit on December 15, 2009, the *GMI* decision was already on the books, and the Ralston panel held that it was bound by the law-of-the-Circuit rule to reject Ralston's position on the §162(k)(1) issue (A-4). The court refused Ralston's request to reconsider *GMI* and did not even discuss Ralston's challenge to the Tax Court's opinion or its refusal to follow *Boise Cascade*. The court also ruled that the exception to §162(k)(1) contained in §162(k)(2)(A)(iii) for "any deduction for dividends paid (within the meaning of Section 561)" did not apply.[5] Although §561 merely defines (circularly) a deduction for dividends paid to include dividends paid during the taxable year, the court relied on the fact that §162(k)(2)(A)(iii) permits a deduction for dividends

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[4] Neither General Mills nor Conopco sought review by this Court.

[5] This second issue was not presented in either *GMI* or *Conopco*.

paid "within the meaning of Section 561" and does not say "within the meaning of §404(k)" (A-6). It also noted that a Treasury Regulation, §1.561-1(a), without purporting to be exclusive, listed five sections as to which the deduction for dividends paid was applicable, but did not mention §404(k) (A-6).

Although the parties stipulated that the dividends at issue were indeed dividends under §316 (and therefore were "dividends" for purposes of §561), the court relied on the legislative history to conclude that the "true meaning" of the plain language of the statute was not intended to include this particular type of "dividend paid" (A-7).[6]

## REASONS FOR GRANTING THE PETITION

This Court should grant certiorari to resolve a stark conflict between the Ninth Circuit, on the one hand, and the Eighth and Third Circuits, on the other, involving an important provision of the Internal Revenue Code. The decision below contravenes the Congressional purpose of encouraging ESOPs by providing deductions to employers for cashout distributions funded by redemptive dividends. And the court's construction of §162(k)(2)(A)(iii) misconstrues the plain, unqualified term "dividends paid" to exclude §404(k) dividends paid, without any statutory

[6] Both the *GMI* opinion and the decision below in this case were authored by Circuit Judge Duane Benton.

support for such a limitation. This Court's intervention is therefore needed to provide uniformity in the application of these federal statutes that affect millions of ESOP participants.

## I. CERTIORARI SHOULD BE GRANTED TO RESOLVE THE CIRCUIT SPLIT REGARDING THE IMPORTANT ISSUE OF THE DEDUCTIBILITY OF "APPLICABLE DIVIDENDS" UNDER §404(k).

### A. The Statutory Scheme

As noted previously, §§404(k)(1) and 404(k)(2)(A)(ii) provide that a corporation "shall be allowed as a deduction . . . the amount of any applicable dividend paid in cash . . . with respect to applicable employer securities . . . which . . . is paid to the plan and is distributed in cash to participants in the plan . . . not later than 90 days after the close of the plan year. . . ."[7] The court in *GMI* did not dispute that the provisions of this section were met, and the Tax Court assumed they were (A-19). Ralston paid its ESOP certain sums to redeem preferred stock held by the ESOP. The government did not contest that these redemptions are dividends for tax purposes (Stip. ¶93) and thus are called "redemptive dividends." In some cases, the ESOP thereafter used some or all of the proceeds of redemptive dividends to satisfy cashout

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[7] The relevant text of the statutory provisions at issue in this case is set forth in Appendix C beginning at A-44.

distributions due to terminated participants. To the extent that such cashout distributions were paid to those departing employees not later than 90 days after the end of the ESOP's plan year, Ralston claimed a deduction for "applicable dividends" as specifically authorized by §404(k).

The Commissioner disallowed the deductions by primary reliance on §162(k)(1), which provides " . . . no deduction otherwise allowable shall be allowed under this chapter for any amount incurred by a corporation in connection with the redemption of its stock." Although admittedly broader, §162(k)(1) was added to the Internal Revenue Code mainly to preclude corporations from claiming a deduction for "greenmail" payments made to repurchase stock from corporate raiders threatening a hostile takeover. *See* H.R. Rep. No. 99-426, 99th Cong. 1st Sess. at 248 (1985). Most importantly, the legislative history clarifies that §162(k)(1) is intended to bar deductions for two types of expenses: (1) the consideration paid to repurchase stock, and (2) expenditures which are "necessary or incident" to the repurchase. *See* Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 278 (Comm. Print 1987).

### B. Section 404(k) Requires Two Transactions for There To Be a Deduction.

As is evident from the plain language of §404(k), the deduction for dividends paid does not arise solely on account of the redemptive dividend – *i.e.*, there must be both a redemptive dividend and a cashout distribution. The government has acknowledged that two transactions are necessary for an "applicable dividend" under §404(k) (Gov't 8th Cir. Br. in *GMI*, p. 42), and that the §404(k) deduction is determined by the amount, timing, and use of the cashout distribution.[8]

Indeed, the parties' stipulation shows that the payment of redemptive dividends by Ralston was not a prerequisite to the obligation of the ESOP to make cashout distributions (Stip. ¶75). The ESOP was required to make cashout distributions to terminated participants even if Ralston did not redeem any of the ESOP's stock.[9] On the other hand, the ESOP could force Ralston to redeem stock for various other reasons and was not required to use, and did not always

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[8] For example, the 1994 redemptions generated $3,128,066 in proceeds to the ESOP, but only $2,317,656 was distributed to terminated participants as cashout distributions during the 1994 tax year (Stip. ¶¶78, 80). Hence, Ralston's claimed deduction for 1994 was limited to $2,317,656 (Stip. ¶80). Because the remaining $810,410 was distributed by the ESOP during the 1995 tax year (but within the time limit set forth by §404(k)), this amount was deducted on the 1995 return (Stip. ¶81). The ESOP also funded cashout distributions in the amount of approximately $1.6 million in the 1994 tax year, but because those distributions were not funded by redemptive dividends, no deduction was claimed under §404(k) or any other Code provision (Stip. ¶81).

[9] In fact, prior to 1994, there were no redemptions of preferred stock even though the ESOP made cashout distributions to many terminated participants (Stip. ¶77).

use, the proceeds of the redemptive dividends to fund cashout distributions (Stip. ¶¶71, 91, 92).

The *GMI* court seriously erred in refusing to consider whether these factors prevented the cashout distributions from being paid "in connection with" Ralston's redemption of the ESOP's stock – the essential inquiry under §162(k)(1). The court's labeling of these factors as "irrelevant" is bewildering because they are so obviously central to the consideration of whether the redemptive dividends and the cashout distributions should be considered separate or unitary. The stipulated facts plainly established that for purposes of §162(k)(1) there was no *necessary* connection between the two transactions and that the deduction for applicable dividends should have been allowed. Instead of affording Ralston the opportunity to explain the court's mistakes in *GMI*, the Eighth Circuit compounded its error by blindly adhering to *GMI* without addressing Ralston's challenges to the rationale of that opinion.

### C. The Cashout Distributions Were Not Made "In Connection With" the Redemptive Dividends.

The Commissioner admitted below that a cashout distribution was required for the deduction of an "applicable dividend" but argued that the cashout distribution was made "in connection with" Ralston's redemption of the ESOP's stock and for that reason was barred by §162(k)(1). In *Boise Cascade*, though, the Ninth Circuit correctly observed that "we are confronted with two segregable transactions: the stock redemption by Boise Cascade and subsequent distribution to the Plan Participants by the Trustee. The two are not ineluctably linked. In fact, the transactions were entirely separate." 329 F.3d at 757.

The *Boise Cascade* court addressed the "in connection with" language of §162(k)(1) and emphasized the legislative history showing that this provision "was not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time and arising out of the same general circumstances." *Id.* The court observed that the "triggering event for the Trustee's duty to distribute payments is the election of the Participant, not the redemption of the stock." *Id.* at 758. Therefore, the distribution by the ESOP to the terminated participant is a separate transaction that is not "in connection with" a redemption of the taxpayer's stock and, as a result, the deduction is not barred by §162(k)(1). *Id.*

The Ninth Circuit bolstered its conclusion by legislative history confirming that expenditures deemed to be "in connection with" a stock redemption are those that are (1) for the consideration paid to redeem the stock, or (2) expenses "necessary or incident" to the repurchase, such as legal, accounting, and brokerage fees which facilitate the redemption. *Id.* Since Boise Cascade was not claiming a deduction for the consideration paid to redeem the stock, and because the cashout distribution was not "necessary or incident" to the redemptive dividend, it was not made "in connection with" the redemption, and deductibility was not barred by §162(k)(1).

The Ninth Circuit's analysis was correct and should have resulted in a judgment for Ralston. The Tax Court, however, concocted a new theory of tax law, *sua sponte*, by declaring that the two admittedly separate transactions are "statutorily integrated" – whatever that means. Nowhere in the countless volumes of Article I and Article III tax law decisions had such a term ever before been deployed. The court said that because two transactions are required to satisfy the elements of §404(k), they must be deemed "statutorily integrated" for purposes of §162(k)(1) and therefore are "in connection with" each other as a matter of law (A-21-22). Never in the lengthy history of these various cases had the government ever advanced such a "statutory integration" theory – not even in *GMI*, where it was nevertheless adopted by the Eighth Circuit on its own initiative. And the appellate court deemed the issue foreclosed by the time Ralston's appeal ripened.

The "statutory integration" theory, however articulated, is wrong as a matter of linguistics and of law and defies legislative history. The dictionary defines "integrate" as "to unite with something else." *Webster's Ninth New Collegiate Dictionary*, p. 628 (1988). Indeed, we commonly think of "integration" as the blending together of the races, a process whereby they are literally commingled. By no measure is the redemptive dividend "united with" or "mixed with" the cashout distribution. They are, as *Boise Cascade* held, "entirely separate" transactions. The government, too, has consistently acknowledged that the two events are required for a deduction under §404(k) and has urged that the "correct analysis" is a "bifurcated" one in which this Court should look "at one or the other of the two [transactions] separately . . . " (Gov't 8th Cir. Br. in *GMI*, p. 42). The Tax Court and the *GMI* court, however, ignored the plain meaning of "integration" and simply held that because §404(k) requires two transactions to qualify for the deduction as a matter of fact, those two separate occurrences should be deemed unified *as a matter of law* under §162(k)(1). That conclusion cannot withstand scrutiny but was imposed upon Ralston by the Court of Appeals without independent consideration.

The rationale deemed dispositive below also contravenes existing tax jurisprudence, as the "statutory integration" pronouncement is inconsistent with the concept of integration in other tax cases. This issue was never briefed in the Tax Court or in *GMI*, and the Court of Appeals in this case refused to consider ample authority holding that two formally separate transactions involving the same funds without any restriction on the receiving party as to their disposition (as in the case of the Ralston ESOP) should not be treated as integrated. *See Wilgard Realty Co. v. Commissioner*, 127 F.2d 514, 516 (2d Cir. 1942) (acquisition and disposition of property are separate transactions even if pursuant to preconceived plan of disposition not amounting to binding obligation); *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971) (trust's receipt and subsequent disposition of assets considered separate transactions); *Kass v. Commissioner*, 60 T.C. 218, 226 (1973) (recognizing "the *truism* that the step-transaction doctrine, even when worded consistently . . . and applied to identical facts, *may result in integration in one case and 'separateness' in another case simply because the legal question to be answered has changed*") (emphasis added); *see also King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct.Cl. 1969). ("It has been persuasively suggested that the aphorisms about 'closely related steps' and 'integrated transactions' may have different meanings in different contexts, and that there may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied.").

Moreover, no matter how the redemptive dividends and cashout distributions are denominated for purposes of §404(k), that does not mean that the cashout distributions are "in connection with" the redemptive dividends as required to bar a deduction under §162(k)(1). Sections 162(k)(1) and 404(k) have different language, purposes, and legislative histories. Section 404(k) authorizes a deduction if the ESOP timely distributes the proceeds of a redemptive dividend. There is no requirement that the redemptive dividend and the distribution be factually "connected" or "integrated" or that the distribution be "necessary or incident" to the dividend. They might occur in different tax years, could be separated by as much as 15 months, and, in fact, are initiated and received by different parties (redemptive dividends by the ESOP and cashout distributions by terminating participants).

The legislative history refutes the notion that payments made to departing ESOP participants should be considered to be "in connection with" the redemption of Ralston's stock:

> "Congress intended that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal and similar fees incurred in connection with the repurchase; and any other expenditure that is *necessary or incident to* the repurchase. . . . " Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 278 (Comm. Print 1987) (emphasis added).

Likewise, Congress emphasized that the phrase "in connection with" a repurchase

> "is not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time and arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under

> an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision." H.R. Conf. Rep. 99-841, 1986 U.S.C.C.A.N. 4075, 4256-57.[10]

There are numerous cases that have explored the breadth of the deductions barred by §162(k)(1). In each instance, the courts have disallowed a deduction only for expenditures "necessary or incident" to the redemption. *See, e.g., Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 361-62 (1994), *supplemented by* 107 T.C. 187 (1996) (barring a deduction for costs and fees incurred by a taxpayer to obtain debt used to redeem stock because the loans were "absolutely necessary to the redemption" and arose "solely because of the redemption"); *Custom Chrome, Inc. v. Commissioner*, T.C. Memo 1998-317 (disallowing a deduction for legal and professional fees paid to effect a leveraged buyout because such fees were "necessary or incidental to the redemption"), *rev'd in part on other grounds*, 217 F.3d 1117, 1126-27 (9th Cir. 2000). In *Chief Industries v. Commissioner*, T.C. Memo 2004-45, the court noted that the *Fort Howard* decision rejected a deduction for the financing expenses because the redemption "would not have been

[10] As with the example in the legislative history, we are faced here with the deductibility of a compensatory payment (*i.e.*, a cashout distribution) made to a departing employee. The two hypothetical transactions in the Conference Report are considerably more "connected" than those in the present case; yet Congress decreed that the deduction be allowed.

possible without the financing" and that the "financing was 'necessary' to the transaction as a whole and was '*an integral part*' of a detailed plan." In short, each of these decisions disallowed a deduction only for expenses which were necessary to facilitate the redemption. The Eighth Circuit has substantially expanded the sweep of §162(k)(1) in a manner at odds with this line of cases.

Consistent with the authorities under §162(k)(1), the language "in connection with" has likewise been interpreted in other contexts to mean "to facilitate." For example, the phrase "used or possessed any firearm or ammunition *in connection with* another felony offense" in the Sentencing Guidelines is construed to mean that the firearm "must facilitate, or have the potential of facilitating, the drug trafficking offense." *United States v. Martinez*, 258 F.3d 760, 762 (8th Cir. 2001), citing *United States v. Regans*, 125 F.3d 685, 686 (8th Cir. 1977). And this Court has recently interpreted "facilitate" as synonymous with "aid" or "abet." *Abuelhawa v. United States*, 129 S.Ct. 2102, 2106 (2009).

The government has never asserted, and the record does not show, that the cashout distributions to terminated participants by the ESOP "facilitated" the redemption of preferred stock. Manifestly, they were not "necessary or incident" to those redemptions within the intendment of Congress.

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Congress authorized ESOPs as vehicles to create widespread access to capital ownership and, in so doing, encouraged companies to make substantial payouts from earnings to "put purchasing power into consumers' hands." 129 Cong. Rec. 33815 (1983). To further this goal, Congress expressly authorized "a tax deduction to ESOP companies for the amount of cash dividends that they pay on stock in their ESOP, provided that the dividends are . . . distributed currently to employees. . . . " 129 Cong. Rec. 33826 (1983). The incentive provided by the §404(k) deduction helped to fuel dramatic growth in the creation of ESOPs by employers. Since 1974, the number of ESOPs has grown from about 200 to more than 11,000 at the end of 2005 (Stip. ¶14). These ESOPs own assets worth approximately $600 billion and have nearly 10,000,000 employee participants, representing 10% of the entire private sector workforce (Stip. ¶¶14-15). The significance of the decision below is thus apparent.

In enacting the Tax Reform Act of 1976, which provided substantial tax incentives to employers to create ESOPs, Congress specifically expressed "deep concern[ ]" that the objectives of the legislation not be made unattainable by restrictive regulations and rulings. *See* Pub. L. 94-455 §803(h), 90 Stat. 1520, 1590 (1976). The court below has done exactly that through a feat of judicial alchemy by transmuting two transactions into one, and has unnecessarily created a conflict with the better-reasoned decision of the Ninth

Circuit in *Boise Cascade*, which is also more faithful to the legislative wish.[11]

## II. THIS COURT SHOULD CLARIFY THE DEFERENCE OWED BY EACH CIRCUIT TO THE FEDERAL TAX DECISIONS BY OTHER CIRCUITS AND SHOULD HOLD THAT THE EIGHTH CIRCUIT WAS REQUIRED TO FOLLOW THE DECISION OF THE NINTH CIRCUIT ON THE SAME ISSUE TO PROMOTE CONSISTENCY AND PREDICTABILITY IN THE INTERPRETATION AND APPLICATION OF FEDERAL TAX LAW AND POLICY.

Unlike non-governmental litigants and other federal agencies, the Internal Revenue Service does not deem itself bound by an adverse decision of a federal appellate court but feels free to shop around until it finds a circuit that agrees with its position. There is no principled reason why the federal tax

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[11] The government will likely seek to minimize the precedential effect of the decision below by relying on made-for-litigation regulations, Treas. Reg. §1.162(k)-1 and 1.404(k)-3. T.D. 9282 (Aug. 29, 2006). Apart from the fact that the regulations are inconsistent with the plain meaning of the governing statutes – and thus invalid, *National Cable & Telecommunications Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005), the Commissioner cannot deprive taxpayers of their right to deduct redemptive dividends under §404(k) by bootstrapping its litigating position with self-serving regulations promulgated during the pendency of this case. *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).

collector should be exempted from the application of nonmutual offensive issue preclusion (collateral estoppel) that would be binding on any private participant in the litigation process. *See Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 329-33 (1979); *Restatement (Second) of Judgments* §27 (1980).

Here the government lost the §162(k)(1) issue in the Ninth Circuit. Ralston, General Mills, and Conopco relied on that decision, only to be told "never mind" by other circuits after the expenditure of many hundreds of thousands of dollars in legal fees. That is precisely the type of inconsistent adjudication that collateral estoppel is designed to prevent. *Montana v. United States*, 440 U.S. 147, 153-54 (1979) (federal government collaterally estopped from relitigating issue it earlier lost because such a result "protects their adversaries from the expense and vexation attending multiple lawsuits, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions"); *Alaska Dep't of Environmental Conservation v. E.P.A.*, 540 U.S. 461, 490 n.14 (2004) ("Preclusion principles . . . unquestionably do apply against the United States, its agencies and officers.").

Whether or not absolute concepts of issue preclusion are implicated in this context, the Court at least should signal in unmistakable terms that earlier tax decisions from other circuits should not be lightly disregarded. There is a difference of opinion among – and sometimes within – the various circuits as to the amount of deference to be accorded to a previous appellate determination on an issue of federal tax law. This confusion only serves to fuel the Commissioner's penchant for circuit-shopping. For instance, the Eighth Circuit itself has said that "This court has long taken the position that uniformity of decision among the circuits is vitally important on issues concerning the administration of the tax laws. . . . Although we are not bound by another circuit's decision, we adhere to the policy that a sister circuit's reasoned decision deserves great weight and precedential value." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985). Such language would provide comfort for conscientious counsel in advising his client that a unanimous reasoned tax decision of a foreign circuit is quite likely to be followed in the client's home circuit.

Likewise, in *Aeroquip-Vickers, Inc. v. Commissioner*, 347 F.3d 173, 181 (6th Cir. 2003), the Sixth Circuit put it this way: "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system. We would therefore hesitate to reject the view of another circuit." (quoting *Nickell v. Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987)). *See also Hill v. Commissioner*, 204 F.3d 1213, 1217-18 (9th Cir. 2000) (same); *Square D Co. v. Commissioner*, 438 F.3d 739, 744 (7th Cir. 2006) (respect for the decisions of other circuits is especially important in tax cases due to the importance of uniformity); *Gibraltar Fin. Corp. v. United States*, 825 F.2d 1568, 1572 (Fed.Cir. 1987) (because of need to ensure equal application of the tax system to taxpayers, court is not inclined to reach result in conflict with another circuit unless statute or precedent gives it no alternative).

Despite these oft-repeated admonitions, the Eighth Circuit summarily refused to follow *Boise Cascade* in *GMI*, saying that there were "cogent reasons" for departing from the Ninth Circuit's decision (A-56). But those "reasons" amounted to nothing more than a difference of opinion about whether the redemptive dividends and the cashout distributions should be considered two transactions or one – hardly a self-evident or earth-shaking determination, and not one required by any statutory language. That ruling in *GMI* was then invoked to prevent Ralston from even arguing why *Boise Cascade* should be followed.

This Court should reinforce the proper degree of deference to be accorded to tax rulings by sister circuits. In most cases, absent a change in the statutory law, an intervening Supreme Court decision, or a patently irrational or aberrant previous opinion, a subsequent circuit should not depart from existing precedent from another Court of Appeals based on nothing more than a philosophical difference or a terminological quibble. Furthermore, even if "cogent reasons" is a proper test, it was not met here by anything but lip service. *Boise Cascade* was right, but even if, *arguendo*, reasonable minds might differ, sound principles of judicial husbandry dictate that the settled expectations of the taxpaying public should not be unceremoniously subverted on such thin reasoning.

## III. THE COURT OF APPEALS VIOLATED THE PLAIN MEANING RULE BECAUSE RALSTON'S CLAIMED DEDUCTIONS ARE NOT BARRED BY §162(k)(1) DUE TO THE EXCEPTION PROVIDED BY §162(k)(2)(A)(iii).

Even if *Boise Cascade* is not followed, Ralston is still entitled to prevail because of the exception to the bar of §162(k)(1) contained in §162(k)(2)(A)(iii) – an issue that was not presented in either *Conopco* or *GMI*. Section 162(k)(2) provides exceptions to the application of §162(k)(1). In particular, §162(k)(2)(A)(iii) specifies that the bar of §162(k)(1) does not apply to "Any . . . deduction for dividends paid (within the meaning of section 561)."[12] Hence, the bar of §162(k)(1) would not apply to Ralston's claimed deductions if they constituted any type of deduction for dividends paid as defined in §561. That is precisely what the claimed deductions are for.

Consistent with its title, "Definition of deduction for dividends paid," §561 is a definitional section setting forth the meaning of the phrase "deduction for dividends paid." Section 561(a) defines a deduction for dividends paid to mean:

> "The deduction for dividends paid shall be the sum of –

[12] During the tax years in question, this provision was contained in §162(k)(2)(A)(ii), as indicated in the Appendix (A-44). When a new subparagraph (ii) was enacted in 1996, this provision was renumbered as (iii) and has been so cited throughout this case.

> "(1) the dividends paid during the taxable year,
>
> "(2) the consent dividends for the taxable year (determined under section 565), and
>
> "(3) in the case of a personal holding company, the dividend carryover described in section 564."

Section 561(b) states that "in determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) . . . shall be applicable." Section 562(a) provides:

> "For purposes of this part, the term 'dividend' shall, except as otherwise provided in this section, include *only dividends described in section 316* (relating to definition of dividends for purposes of corporate distributions)." (Emphasis added.)

Consequently, there is a "deduction for dividends paid (within the meaning of section 561)," as amplified by §562, when three elements are present: [1] a deduction [2] for dividends paid, [3] which dividends are described in §316.

Regarding the first element – an allowable deduction – §561 does not create or authorize a deduction. In order to be entitled to claim a deduction for a dividend paid, a taxpayer must point to another section of the Internal Revenue Code which grants such a deduction. Here, §404(k)(1) fills that role by unambiguously authorizing "a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with respect to applicable employer securities."[13] Even the title of §404(k) confirms that it provides a "*Deduction for dividends paid* on certain employer securities."

There also can be no dispute that the second and third elements specified in §§561 and 562 (*i.e.*, [2] dividends paid, [3] which are described in §316) are present here inasmuch as the government does not challenge that "the [redemptive dividends] . . . are treated as dividends for purposes of Code Sections 301 and 316" (Stip. ¶93).

The cardinal rule of statutory construction has been repeatedly articulated by this Court: "'In determining the scope of a statute, we look first to its language. If the statutory language is unambiguous, in the absence of "a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive."'" *Reves v. Ernst & Young*, 507 U.S. 170, 177 (1993), quoting *United States v. Turkette*, 452 U.S. 576, 580 (1981), in turn quoting *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980).

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[13] The government acknowledged that the cashout distributions to terminated participants were paid in cash and that the stock held by the ESOP was "applicable employer securities" (Stip. ¶¶44, 78-86).

Under the plain language of the relevant statutes, the claimed deductions thus fall squarely within the exception provided in §162(k)(2)(A)(iii), even if §162(k)(1) were otherwise applicable, because they are for a "deduction for dividends paid (within the meaning of §561)." Accordingly, Ralston is entitled to the claimed deductions.

The Eighth Circuit's contrary conclusion largely defies analysis. The court (a) noted that a Treasury Regulation interpreting §561 makes reference to five Code sections for which the deduction for dividends paid is applicable, (b) observed that each of those sections references §561, and (c) concluded that because §404(k) does not specifically mention §561, its dividend is not a dividend paid within the meaning of §561 and thus does not satisfy the exception in §162(k)(2)(A)(iii) (A-6). That syllogism prompts some serious head-scratching.

The Court of Appeals attempted to buttress its "a-dividend-is-not-a-dividend" holding by resort to legislative history in which the conferees referred to certain types of corporations and transactions to which §162(k)(2)(A)(iii) would apply (A-7). The report does not purport to treat the cited examples as exclusive and does not indicate that future Congressional grants of deductions would be nullified if the enacting statute did not make express reference to §561. Congress knows how to use the word "only," but did not do so in the passage cited by the court.

In any event, the court's invocation of marginal legislative history transgresses the rule expressed by this Court in *Cooper Industries, Inc. v. Aviall Services, Inc.*, 543 U.S. 157, 167 (2004), "[I]t is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed." (quoting *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998)).[14]

To be sure, Congress, in enacting §162(k)(1), intended *generally* to bar a corporation from being able to claim a deduction for amounts paid in connection with the repurchase of its stock. As indicated earlier, the impetus for this enactment was the controversial practice of fending off corporate raiders by paying them "greenmail" to buy back their stock and get rid of them. *See* H.R. Rep. No. 99-426, 99th Cong., 1st Sess. at 248 (1985). But in enacting exceptions to the bar in §162(k)(2), it is equally plain that Congress did not intend §162(k)(1) to prevent a corporation from deducting payments that are truly dividends rather than a mere greenmail-like return of capital. In particular, by enacting §162(k)(2)(A)(iii), Congress did not want §162(k)(1) to prevent a taxpayer from being able to claim a "deduction for dividends paid." The

[14] Moreover, there is even more compelling legislative history confirming that the Eighth Circuit's interpretation would frustrate the essential Congressional purpose of encouraging ESOPs. *See, e.g.*, 78 Cong. Rec. 2663 (1934); Tax Reform Act of 1976, §803(h), 98 Stat. 1520, 1590 (1976); 129 Cong. Rec. 33813-28 (1983); 130 Cong. Rec. 12697 (1984).

Eighth Circuit's contrary conclusion will be seized upon by the government to challenge the deductibility of other dividends expressly made deductible by a code section that does not expressly refer to §561 – such as §808 (dividends to policyholders) and §591 (dividends by commercial banks and other savings institutions).

The decision below violates this Court's jurisprudence requiring that the statute be given its plain meaning and deprives Ralston of the deduction that Congress conferred upon it.[15]

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[15] An applicable §404(k) dividend arising from the proceeds of a redemptive dividend is not a second-class dividend – just like a rose, a dividend is a dividend by any other name. Yet, under the holdings below, while a cash distribution funded by a regular quarterly or semi-annual dividend would not be barred by §162(k)(1), a cash distribution funded by a redemptive dividend would be barred. Such result makes no economic sense, does not further any Congressional purpose, and certainly could not have been intended by Congress.

## CONCLUSION

For the reasons stated, the petition for writ of certiorari should be granted.

Respectfully submitted,

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