OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: UNITED STATES, Petitioner V. CENTENNIAL SAVINGS BANK FSB (RESOLUTION TRUST CORPORATION, RECEIVER)

CASE NO: 89-1926

PLACE: Washington, D.C.

DATE: January 15, 1991

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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES, :

Petitioner :

v. : No. 89-1926

CENTENNIAL SAVINGS BANK FSB :

(RESOLUTION TRUST CORPORATION, :

RECEIVER) :

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Washington, D.C.

Tuesday, January 15, 1991

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:07 a.m.

APPEARANCES:

JOHN G. ROBERTS, JR., ESQ., Acting Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Petitioner.

MICHAEL F. DUHL, ESQ., Chicago, Illinois; on behalf of the Respondent.

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P R O C E E D I N G S

(11:07 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument next in No. 89-1926, United States v. Centennial Savings Bank.

Mr. Roberts.

ORAL ARGUMENT OF JOHN G. ROBERTS, JR.

ON BEHALF OF THE PETITIONER

MR. ROBERTS: Thank you, Mr. Chief Justice, and may it please the Court:

This case is here on certiorari to the United States court of appeals for the Fifth Circuit. That court issued two rulings adverse to the Commissioner of Internal Revenue. First, on the mortgage swap issue as just discussed in the Cottage Savings case, the Fifth Circuit agreed with the United States that there was a materially different requirement in the tax law. It then disagreed with the United States on application of that requirement, concluding that these mortgage -- these pools of substantially identical mortgage loans were in fact an exchange of property that is materially different.

The second, unrelated issue, the Fifth Circuit held that when Centennial's depositors incurred a penalty under Federal law for early withdrawal of their savings from certificates of deposit and Centennial deducted that

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penalty from the savings before turning them over, that the depositors were actually discharging their savings and loan of part of its obligation to them. That meant that the income to Centennial was entitled to special deferred treatment under section 108 of the Code.

The Fifth Circuit was wrong with its -- in its conclusion with respect to the mortgage swap issue, and it was wrong in its conclusion with respect to the section 108 issue, and the judgment below should be reversed.

The facts with respect to the mortgage swap issue are not, to coin a phrase, materially different from the facts in the Cottage Savings case. In April of 1981 Centennial and a trading partner decided to enter into one of these swaps. They plugged their mortgage loan portfolios into the computer, came up with $8.5 million in book value of loans that matched. Centennial then sold its loans to its partner for $5,662,045, and its partner sold its loan to Centennial for $5,662,043. Conducted no independent valuation of the loans, applied a common discount factor. If the loans matched up, they were worth the same.

QUESTION: How do you feel about this one, Mr. Roberts?

MR. ROBERTS: This one comes out the same way as the Cottage Savings case, Your Honor.

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(Laughter.)

MR. ROBERTS: Centennial, because --

QUESTION: You're sure there's not a material difference between the two?

MR. ROBERTS: There's not a material difference in the two cases on this issue. Centennial reported no loss to the bank board, deducted a $2.8 million loss on its tax return, which the Commissioner disallowed for failure to satisfy the materially different requirement. For reasons I have already stated, the Commissioner's decision is correct. The R-49 match-up ensured that the loans that were given up were substantially identical to those that Centennial got back. The differences in borrowers and collateral were not a material difference because the parties to this transaction in this market didn't consider those significant. In fact, Centennial conducted no credit checks, performed no appraisals of property. It didn't even know who the borrowers were at the time of the transaction. It didn't get the files on the loans until 6 years later.

The market also regarded these now-claimed differences as not material. In this case, as I mentioned earlier, the district court found as fact that the secondary mortgage market was unable to and did not differentiate between these pools of loans on the basis of

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the borrowers and the collateral.

A contrary conclusion would require overturning that factual finding. The Fifth Circuit, which concluded that the loans were materially different, did so because of its view of the nature of this transaction and this type of property. It disregarded the factual findings of the district court as to what the market was like and what the property was like.

The second issue presented in this case concerns the treatment of income that Centennial received when its depositors paid penalties required by Federal law for the early withdrawal of their savings. In 1981 Centennial had income of over $250,000 from such penalties. Centennial claims that this is income by the reason of the discharge of indebtedness, and therefore entitled to special deferred treatment under section 108 of the Code. It is not. It is income by reason of the receipt of a penalty, a penalty mandated by Federal law.

The fact that Centennial used an offset as a method of paying the penalty doesn't mean that the loan was at any extent forgiven. It simply means that that was the method of payment that they used.

Now, in a typical income from the discharge of indebtedness case, if I loan you $1,000, payable in 2 months, and then after 6 weeks, for reasons of my own, I

need the money early, I have doubt about your ability to pay at the end of the term, we get together and agree to call it quits if you pay me $800. In that situation, you have $200 of income by reason of my forgiving you that much of your debt.

QUESTION: Um-hum. Suppose I say, when you come to me with that proposition, can I pay it off -- well, let's see. You want to pay it off -- no, I want you to pay it off early. And you say to me okay, I'll pay it off early, but you'll have to pay a penalty of $200. Suppose it's put that way. Would that make the difference whether you call it a penalty or put it in another way?

MR. ROBERTS: The label you put on it would not make a difference. In your hypothetical, however, that would not be income from the discharge of indebtedness. It would be income from the receipt of the liquidated damages that we'd agreed to prior to the transaction. The key question is whether there is one obligation or two obligations. In the case that I put, where all we know is that you owe me $1,000, payable in 2 weeks, and we agree to lower the debt, I forgive some of the debt, there is only one obligation. The only obligation is yours to pay me $1,000 in 2 weeks.

QUESTION: Um-hum.

MR. ROBERTS: In the case that you pose, and in

this case, there are two obligations: your obligation to pay back the $1,000, and my obligation which we agreed to prior to the transaction to pay $200 if I want the money back early. The language of the statute, by reason of the discharge of indebtedness, looks to the source of the income that's received. In your case you have $200 income because you received the damages we agreed to, or in the facts of this case the penalty. I was obligated to you to pay that. The fact that there was a condition precedent to triggering the obligation of my wanting my money back doesn't alter the fact that there are two separate obligations.

And that's the case here. When the depositors put their money in the S&L, under Federal law they had an obligation if they withdrew it early to pay a penalty. Two separate obligations. Obligation of the S&L to pay them their money back with the agreed interest --

QUESTION: Mr. Roberts, can I just ask you a question there? As I read the instruments in the appendix, the depositor never gets less than the principal back. What is described as a penalty actually is a failure to receive some of the interest that would otherwise have been earned. Am I correct on that?

MR. ROBERTS: I think not, Your Honor. It -- if you attempted to withdraw your money very early in a

longer-term CD you would forfeit some of the principal.

QUESTION: That's not what -- do any of the instruments in the record say that? They all say you would not get the interest that would otherwise have been earned during the period. This is in a less than 90-day period. That's the phrasing of each of these instruments.

MR. ROBERTS: My understanding -- the current, the 1981 Federal regulation provided that if you had a certificate of deposit for more -- the term of which was more than 3 months, and you withdrew the amount prior to the expiration of 3 months, you would forfeit not just the interest that had been earned, but all the interest that could have been earned.

QUESTION: Well, that's right, but you still get your principal back. You still get your principal -- I don't think there are any of these certificates --

MR. ROBERTS: Well, you wouldn't --

QUESTION: -- you get less than the principal.

MR. ROBERTS: I -- well, the fact of the matter is you would forfeit all the interest that would be earned for 3 months.

QUESTION: Correct.

MR. ROBERTS: If you withdrew that after 2 days you wouldn't have any of that interest yet.

QUESTION: You'd get -- but you'd forfeit then

the interest that would have been earned during the period that you held the certificate.

MR. ROBERTS: Yes. That's what it's measured by. But it would in effect have to come out of some of your principal.

QUESTION: Well --

MR. ROBERTS: Well, here, if you deposited $1,000 for 3 months, and over that time it's going to earn $30 in interest. And you withdraw it back at the end of 2 days, you've got to pay a penalty of $30 in interest. So all you're going to get back is $970.

QUESTION: I don't read it that way. But you're telling me that's the way these instruments should be read?

MR. ROBERTS: Well, that's what's provided in the 1981 regulation, which sets that as the minimum penalty.

QUESTION: Where is that regulation in the record?

MR. ROBERTS: It's in the record. It's not reproduced anywhere in the briefs. It is cited in our brief.

Centennial -- Centennial argues that there is income by reason of indebtedness in this case because the penalty would not have arisen but for the depositor

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seeking to withdraw his funds earlier. And that's true. The obligation is conditioned upon that event. But the statute doesn't say "but for." It says "by reason of," and that language looks to the source of the income.

Here the source of the income is the penalty obligation, not any discharge of indebtedness. When the depositor withdraws his funds early, he is not saying to the S&L I forgive you whatever the amount of the penalty is that you owe me. He's saying give me my money back. And the S&L says before I can do that you have an obligation under these circumstances to pay a penalty.

That's the way that the IRS treated this transaction in the 1973 Revenue Ruling that we cite in our brief. It said there is two separate transactions, the crediting of interest and the payment of the penalty.

QUESTION: This is -- you concede this is a qualified business indebtedness --

MR. ROBERTS: Yes.

QUESTION: -- within the 108?

MR. ROBERTS: Within the 108 as it stood at the time. It's been changed since then.

QUESTION: But to be a qualified business indebtedness, the taxpayer has to make an election --

MR. ROBERTS: Yes.

QUESTION: -- under this paragraph with respect

to the indebtedness?

MR. ROBERTS: Yes.

QUESTION: Now, we're talking about the debtor here, the bank.

MR. ROBERTS: Yes.

QUESTION: What election did it make?

MR. ROBERTS: It made an election when it --

QUESTION: It didn't have any election to make. They made a deal -- they were -- it was on the hook. It didn't have any election to make.

MR. ROBERTS: It had no choice in the transaction.

QUESTION: Exactly. So it didn't make an election.

MR. ROBERTS: The election refers to when you are filling out your tax returns at the end of next year. You have a choice. You can take this as gross income or, in filling out your returns you can elect --

QUESTION: I see.

MR. ROBERTS: -- elect to reduce the basis of depreciated property that you have. And that also -- that points out --

QUESTION: I thought that was an easy way out, but it isn't.

(Laughter.)

MR. ROBERTS: It points out a further incongruity in the decision of the court below. When Centennial and other S&L's are paying interest on the CD's that are held, they get a current deduction from income for the interest that is credited. Now, when they get that interest back because of an early withdrawal penalty, they want to spread the income out over time. It seems more natural to treat the two sides of the transaction the same way. They're getting a current deduction for the interest payment, they ought to take the current income they get from the penalties in at that time rather than spread it out over time.

Now, the situation in reality is no different than, and the regulations don't prohibit this, that if the depositor wanted to say here's my check for the penalty, give me all my money back, that would have to be permitted under the Federal regulations. When you just say give me back all my money less the amount of the penalty, it's clear that all you're doing there is using the offset as a method of payment. The depositor is not forgiving any obligation that the S&L has.

As I started to point out earlier, the Commissioner --

QUESTION: Would you describe for me -- you say "but for" is not enough causation to say that it's a --

it's by reason of the discharge of the indebtedness. What must it be beyond "but for"? The motivation for the payment must be to --

MR. ROBERTS: It has to be the reason, as the statute says, and the reason means the source. Why do you have that income? Is it from discharge of indebtedness? Is it because I, the depositor, say for reasons of my own I'd like my money back now? No. That's not how it works. The reason is because of the penalty mandated by Federal law. Why am I -- why am I letting you take -- to deduct that from my savings, or why am I giving you a check for that amount? Because I have an obligation to do that in the event of an early withdrawal, not because -- and that obligation applies whether you and I like it or not. It's not like the earlier situation we discussed, where we sit down and say, you know, let's call it quits for $800. It's a very different sort of transaction.

QUESTION: What if it isn't a Federal regulation? What if we just agree at the time we make the loan, you and I, that if you discharge it early you'll have to pay a premium? Then that would not be --

MR. ROBERTS: That would not be income by reason of the discharge of indebtedness. It would be establishing a separate obligation between ourselves prior to the transaction. And at the time, if I said I'd like

my money back early, I would have triggered my obligation to pay you the penalty, the liquidated damages in that case, that we agreed upon. We would not be entering into a negotiation to forgive some of the debt. There would be two obligations between us. Yours to give me the money back, mine to pay you what we agreed upon in the event of an early withdrawal.

QUESTION: Why does that make any sense? It's the same deal, whether we negotiate it before -- before I come asking for prepayment or afterwards. It's exactly the same deal. What sense does it make to say if you negotiate it beforehand it can't qualify for this treatment, but if you negotiate it at the time it can?

MR. ROBERTS: It's not the same deal. The question is whether or not there are separate obligations that are being discharged. Now, if we don't have any agreement ahead of time and I just come to you and say I'd like the money early, can we talk about it, there's still only one obligation.

QUESTION: Well, there's one obligation until we make an agreement. At some point before the money is paid over you're going to say okay, yes, you can prepay, but, and at that point there'll be an agreement. Instead of having been made 2 years ago, it'll be made a minute before the money changes hands. But there will be an

agreement.

MR. ROBERTS: Well -- but the agreement will be your forgiving me part of the debt that I owe you. In the other example it's just setting an obligation, a separate obligation. When we come down the line and that condition is triggered, we're not forgiving the debt. We're paying, as the Seventh Circuit put it in the Colonial Savings case, liquidated damages.

QUESTION: Would it make any difference in your analysis if the penalty had not been required by Federal regulation?

MR. ROBERTS: No, Your Honor, it would not. If it had been set in advance it would still set up a system of two different obligations. And the question under the statute, what's the reason for the income that you -- that you receive, and you would say the reason is that we had this deal and you are obligated to pay me that on early withdrawal. You wouldn't say the reason is that you have decided to forgive me some of what I owe you.

Now, the Commissioner of Internal Revenue set forth his understanding of these transactions in a revenue ruling. He said there are two separate transactions: the payment of the interest and the payment of the penalty. The fact that the S&L's typically just netted out when -- in the event of early withdrawal, doesn't obscure that

fact.

Congress knew about that revenue ruling. It modified the Internal Revenue Code to take account of it, adding a provision that let depositors who didn't itemize their deductions take a deduction in the case of the penalty that they incurred. But it didn't alter the Commissioner's understanding of how the transaction took place.

Two separate transactions. Separate transactions because they involve separate obligations. Since they are separate obligations, the income is not income from the forgiveness of debt. It is income used to pay the other obligation.

QUESTION: May I ask you a hypothetical question? Supposing, just to -- testing the importance of whether there are two separate obligations or only one, supposing you had one separate document that in substance says I hereby loan you $10,000 as a certificate of deposit on the understanding that you will repay at the end of 90 days $10,250, whatever the interest rate might be. Or if you repay, and then it has a schedule of 89 different entries on it, and a slightly different dollar value at each one of those dates, depending on how much interest, you know, you balance the thing out. So there is one document describing one obligation that can be discharged

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in 90 different ways. Would then the -- and you don't describe anything as a penalty. Would that be a different case than this?

MR. ROBERTS: Well, I'm not even sure that in that -- yes, I think so. And in that case I'm not sure that you could say that there was any debt at all. If I came back at the end of 20 days, I say our deal was set for 20 days --

QUESTION: Well, there's a debt. You deposit the $10,000 just like a bank deposit. You just fill out the payment obligation for each possible day on which payment might be made. It's clearly --

MR. ROBERTS: But there's no forgiveness of the debt if I come in 3 days later and I say our deal for 3 days was that you would give me this much back, and that's what I would like.

QUESTION: Yes. It tells you just how much you get back on each day that it might be paid off. Economically it would be precisely the same as what you have got here, but you don't use the term penalty. You just have a schedule so people can figure it out in advance, what, how much it would cost to with -- for an early withdrawal.

MR. ROBERTS: Well, but I don't think --

QUESTION: And I say it's all in one document,

so you don't worry about whether it's two separate obligations or not. I'm not sure that's not a stronger case for you, frankly, but I just -- I'm just wondering whether you really need to rely on this two separate obligation notion.

MR. ROBERTS: Well, I think the two separate obligation notion is of course stronger in this case because it's set forth in the Federal regulations and in the -- in the opinions.

QUESTION: It describes it as a penalty, but it describes economically the same thing I have described to you in one document.

MR. ROBERTS: But in your -- in your case I don't understand that there's -- it's as if there are, for 30 days, 30 different deals.

QUESTION: Well, they might be, some of these you forfeit the interest accrued up to the date. You could do these in a way that would have a smaller penalty if you withdrew on the 89th day than if you withdrew on the second day.

MR. ROBERTS: I'm just saying that in your case I don't see that there is an ongoing, an entire ongoing obligation. You wouldn't be --

QUESTION: Sure there is.

MR. ROBERTS: For example, if you decide to

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withdraw it after 3 days you couldn't be said to be forgiving the obligation for the next 27 days.

QUESTION: No, because it's all one obligation. But it seems to me it's the functional equivalent of what -- what the regulations describe.

MR. ROBERTS: Well, I think it's different in that there are, as I would say, 30 different deals in your case.

QUESTION: Well, there are under the regulations, too. The penalty differs depending on -- as I understand it, the penalty differs depending on which day you withdraw it. The longer you keep the money in, the less -- the more interest you receive.

MR. ROBERTS: Yeah. But the obligation going the other way is not one to pay back at set days. It is simply to pay back at the end of the -- at the end of the term.

QUESTION: Well, subject to the right to withdraw upon payment of a penalty, which is the equivalent of an obligation to pay back a little less if they withdraw earlier. Well, you don't think it's the same?

MR. ROBERTS: I think that the case where the penalty is set in advance, it's easier in that situation to see why -- why are you getting the money. You're

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getting the money because of the obligation I have to pay the penalty set by the Federal law and our agreement. And that separate obligation means that the income you receive is not income by reason of the discharge of indebtedness. It's income because of the obligation that I have.

QUESTION: So are you saying the discharge of indebtedness must always be something that is renegotiated?

MR. ROBERTS: It's difficult for me to envision a situation where, if it's all set in advance, that that's not also a separate obligation. If it's something --

QUESTION: And the distinction is between the original -- an original contract and the novation?

MR. ROBERTS: Well, the novation would be the negotiation to forgive some of the debt, only one obligation, the debtor's, forgive some of that. And that would result in income by reason of the discharge of indebtedness. In the other situation there is a separate obligation, and that's the source of the income.

On this issue the Seventh Circuit in Colonial Savings we think got it right in recognizing that the situation is no different from the depositor writing a check for the penalty and getting the full amount back. The fact that they chose the offset as the method of payment shouldn't lead to a different tax result.

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I'd like to reserve the remainder of my time for rebuttal.

QUESTION: Very well, Mr. Roberts.

Mr. Duhl, we'll hear from you.

ORAL ARGUMENT OF MICHAEL F. DUHL

ON BEHALF OF THE RESPONDENT

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

I know you've heard a lot about the mortgage exchange issue, but I would like to make four short points, if I could, because we take a somewhat different position from Cottage, and it will be addressed to some of the questions that were raised in that earlier argument.

First, we believe the "materially different" phrase in the regulation should be interpreted in the context in which it arose. Those very same words were used by this Court in a series of cases in the early 1920's to try and distinguish a very narrow class of situations in which the properties exchanged were so identical that income could not be said to have been realized in the constitutional sense. That's really what that phrase is aimed at.

Secondly, the Weiss v. Stearn case and Marr v. the United States shows how narrow that class of exchanges is.

QUESTION: Well, I take it, or correct me if I'm wrong, that income as defined in section 61 reaches to the full extent of income under the Sixteenth Amendment?

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

QUESTION: So then what those cases say is relevant here?

MR. DUHL: Yes, Your Honor, that's exactly what we -- exactly how we interpret this regulation. That the Court has said in other cases that 61 stretches to the entire power of Congress' power to tax, and in those earlier cases all the Court was doing was defining out that very narrow category that doesn't cross over that threshold. And if you look at the Weiss case and the Marr case --

QUESTION: And so you're saying that the Government couldn't tax, under its theory couldn't tax this even if it chose to by a specific statutory provision?

MR. DUHL: I'm not -- I think if you were to apply those cases, yes. In the last 50 years the constitutional thinking about taxation has changed dramatically. In the Horse case the Court said that realization is really a principle of convenience. And in fact there is now a section of the Internal Revenue Code that purports to tax unrealized appreciation in certain

foreign currency exchange transactions and certain regulated investment contracts. It isn't whether or not it could be taxed or not. All we are saying is that these words were used at an earlier time to define a very narrow class. The regulation comes in at that time, uses the same words, and defines a very narrow category.

In Weiss and in Marr the very same thing happened. One corporation transferred all of its assets to a newly formed corporation. The shareholders of the old corporation received stock in the new corporation in exchange for their stock in the old corporation. In both cases. In the Weiss case the stockholder also got some cash, but there was no dispute about the taxability of that. In both cases the Government argued that the exchange of shares in the new corporation for shares in the old corporation causes gain to be realized in that case. And in Weiss the Court said well, because the new corporation was -- was incorporated in the very same State, and therefore presumably had the same rights and powers as the old corporation, the shares really represented the same property interests that the old corporation shares did. There wasn't in effect any potential for different consequences to flow strictly from the fact that you had two different shells.

In Marr, on the other hand, the new corporation

was organized in a different State, and Justice Brandeis noted that the different noted that the different State, it therefore had different rights and powers under the new State's law, and therefore it was materially different. He didn't ask whether the shareholders knew what those rights and powers were, whether the market knew. The fact is the shares of stock were still valued at the same price on the market, so that although there may be different risks involved, the market can't perceive what the difference is at that time, but it's the potential for significant different consequences that makes the difference.

QUESTION: When was the regulation promulgated, Mr. Duhl?

MR. DUHL: The regulation was promulgated in 1935, but there was an earlier regulation that was in existence prior to 1924 that used the same phrase, it used "essentially different" instead of "materially different."

QUESTION: And what are the dates of the Weiss and Marr decisions?

MR. DUHL: Weiss and Marr were -- Weiss came down in 1924. Marr was decided in 1925, but both under the old statute. The statute was changed significantly in 1924.

QUESTION: And is it your view that the

predecessor of the present regulation was based on Weiss and Marr?

MR. DUHL: Yes, it is, Your Honor.

QUESTION: And it was then -- the regulation -- the predecessor was promulgated after those two decisions?

MR. DUHL: I don't know when the predecessor regulation was promulgated. To be based on, it must have been -- it must have been, yes.

QUESTION: Well, to be based on Weiss and Marr -- correct, it would have to be.

MR. DUHL: Yes.

QUESTION: Mr. Duhl, you would -- this is the moment of truth. You would say that exchanging one bushel of wheat for another bushel of wheat would quality?

MR. DUHL: Would not be materially different.

QUESTION: No, it would be materially --

MR. DUHL: No --

QUESTION: Would or would not? That would not be materially different?

MR. DUHL: My -- I don't think you know enough when you ask is one bushel of wheat the same as another bushel of wheat. You have to --

QUESTION: It's different wheat, in two different bushels.

MR. DUHL: But to the extent that there are no different consequences that can flow from one bushel or the other, I would suggest that's what the not materially different phrase is for.

QUESTION: All you know is it's two different bushels of wheat. One bushel may have worms in it, the other one may not. I don't know what consequences there are.

MR. DUHL: Well, and I think what --

QUESTION: But chances are there is no difference, but I can't say for sure, just as with these mortgages.

MR. DUHL: Well, I believe you have to look at what you have.

QUESTION: What I know for sure is it's not the same bushel of wheat, which you couldn't say in these cases. It's the same assets, the same rights, it's -- it has a different name. This is not a bushel that has just a different name, the way that two different corporations in the same State with the same assets, just a different name. These are different bushels of wheat.

MR. DUHL: Then they would be materially different, Your Honor. But I point out to you there is also a section of the Internal Revenue Code, section 1031, which says you don't recognize gain or loss on the

exchange of like kind properties. And surely the two bushels of wheat are like kind properties. And so Congress has answered that question. I mean, it becomes a theoretical question that is unnecessary to answer.

QUESTION: Well, you don't content that fungible goods are materially different, do you?

MR. DUHL: I believe that's what the materially different phrase was designed to do. It's designed to say fungible goods may be different, but if they're fungible then they're not -- it's not material.

QUESTION: Almost by definition, if they're fungible.

MR. DUHL: That's correct. In our case -- the legislative history --

QUESTION: Excuse me, what does fungible mean except that the market treats them as the same? They are really different wheat, but the market doesn't care. I thought that's the very definition of fungible?

MR. DUHL: Well --

QUESTION: And if you buy that, you've bought, you've bought the Government's theory.

MR. DUHL: No, Your Honor. I don't believe fungibility in that sense, because the market makes everything fungible in terms of dollars and value. That is presumably in the marketplace anything that sells for

$25 is fungible with anything else that sells for $25. Fungibility to me, as I understand the term "fungibility," has always been two of the exact same kind of article. But all I am suggesting, Your Honor, is that the term "materially different" is really aimed at, just as at the shares of stock in the Weiss case. They're different shares, because they're two different corporations, different serial numbers. They are different. But they're not materially different because nothing potentially can flow from them. They represent the same property interest.

The legislative history of the 1924 statute, the very structure of the Code itself and the sections of the Code we point out, all demonstrate that Congress intended that all exchanges, almost all exchanges, be taxable. That's why in this case, in all these mortgage exchange cases, all the 9 court of appeals judges and all of the 16 tax court judges that considered the issue held that loss was realized. The question -- they then went on to ask whether there was a non-recognition provision.

The Government's argument here is really created in this case. It is inconsistent with the position it has taken over the last 50 years. It was created to try to deal with this situation, because of R-49. We think R-49 has nothing to do with the tax consequences of the

transaction and that it should not be adopted. It is simply inconsistent with all of this history.

Finally, finally I do think the prior discussion about mutual funds, about stocks, about bonds, demonstrates that it's difficult to reconcile the Government's position about this, and I think the easiest example to see that in is in the case of Triple-A bonds. If I happen to hold an investment in Triple-A bonds of one company, and those bonds have gone up substantially in value, and I want to diversify my investment, under the Government's argument I think I can call my broker and say I want you to exchange my bonds for other Triple-A bonds, having the same interest rates, the same maturities, the same payment schedules. I don't care who the issuers are, so long as they are Triple-A. And I can say to myself I haven't realized any income because I don't care who the other issuers are.

It has all the same characteristics, the same market value, and I therefore don't report anything. And the Government, the IRS never knows whether I have engaged in that transaction or not, because I don't tell them. I don't have to tell them. More aggressive taxpayers, I think, can use that kind of analysis to deal with stocks. It seems to me the Government never really comes to grips with the concept of material difference and how its effect

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on value in the marketplace. That is the marketplace only looks at things in terms of valuation. And its risk analysis is only in terms of what is the potential consequence that can happen. But all of that is a foresight look.

And in our case, in our case -- in every exchange case you know the obligors are different. You know the collateral is different. And therefore you know that different consequences can result. You don't know what they may -- what they will be. You don't know whether they will occur. But if I hold a mortgage of John Doe and I hold a mortgage of Tom Roe, they may -- because John Doe defaults doesn't mean that Tom Roe is going to default.

QUESTION: Yet the purpose of R-59 -- 49, Mr. Duhl, was to enable the savings and loans to generate income by taking a tax loss without really altering their fundamental economic position, wasn't it?

MR. DUHL: Well, I think it depends on what you mean by fundamental economic position, Mr. Chief Justice. That is, they clearly have modified their economic position in the sense that their financial fortune was tied in with the loans they had originally, and their financial fortune is now keyed into the new ones.

QUESTION: But wasn't the idea behind R-49 that

this change really was not going to change anybody's net worth?

MR. DUHL: That's correct, because nothing changes net worth so long as you get equivalent value. And the concept was, well, they wouldn't be changing their risk because it's -- the possibility that Tom Roe will default may be equal to the possibility that John Doe will default. But if I hold Tom Roe's and he defaults, and I used to hold John Doe's, that's materially different to me. I have now lost. And if I had kept what I had I wouldn't have lost, whereas at the time the market says they're both worth the same amount. The market can't tell that Tom is going to default and John is not. That's the key to the entire concept of substance in the tax law. My fortune is tied into this piece of property or it's tied into this piece of property.

And here everybody knew, in fact the tax court in the Fannie Mae case said it was common sense that the difference in mortgages, the difference in obligors, the difference in collateral, would cause a difference in economic consequence to occur. That's all that --

QUESTION: I -- suppose you trade -- you trade wheat in one warehouse for wheat in another warehouse, and one, and the warehouse you've traded burns down. It would've made a big difference.

MR. DUHL: It makes a big difference.

QUESTION: So, I guess what you say is it depends on whether you're trading wheat in baskets or in warehouses? Is that the difference?

MR. DUHL: Well, that's -- one of the questions I would have asked is what's the location of the wheat? Are they sitting right next to each other or are they -- is one in California and one in New York? If they are, I think that -- that's materially different.

That is, the "materially different" phrase really was coined in the context of the constitutional issue. That issue was simply -- has subsided over the years, but the phrase has stayed. And it is -- it is necessary, I think, to have a concept like that where there are very minor changes, for example in a bond term, or some other very minor modification that gives the flexibility to say, well, it really isn't an exchange, it's the same property.

But in our case it just isn't the same property. In none of these cases is it the same property. And it's no different than what goes on at the end of the year, every tax year, when taxpayers who have losses in certain investments sell them and reinvest in other investments that are in the same industry and therefore subject to the same kinds of risks, but they're different companies.

Different companies have different fortunes, different obligors on notes have different fortunes.

QUESTION: And I take it if the Government doesn't like that they can have a wash sale statute?

MR. DUHL: That is exactly right, Your Honor. That the Congress over the years has created a very complex set of rules to deal with nonrecognition in those situations where either gain isn't appropriately recognized, or, in the context on the loss side where they don't think it's appropriate that taxpayers be able to recognize that. There are such rules in the Code now. They don't apply here. And to create a nonstatutory judicial rule creates and raises all the problems that were discussed in the Cottage argument about what are the facts, did it matter, did he care. All of things are things that Congress can set forth in statutory rules specific things to deal with.

And we just don't have that here. We don't have it here for a reason. In fact, the whole concept of exchanges of notes came up in the section 1031 context and Congress decided they want gain to be -- or loss to be recognized there, because they think those things are like money. So they specifically made a judgment. And now here we're pulling back, and it's just --

QUESTION: On that point, was there ever an

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argument that these mortgages were securities within that provision?

MR. DUHL: In one of the cases earlier on the Government argued not that they were securities within the meaning of 1031, but that they were securities within the meaning of the wash sale rule, 1091. And the courts held that they clearly were not, and the Government dropped the argument, I think.

QUESTION: But not within the context of 1031?

MR. DUHL: But not within the context of 1031.

Let me now turn to the discharge of indebtedness issue, and here we're again talking about realization, but here we all agree income was realized. The question was, was it realized within the meaning of the statutory phrase by reason of the discharge of indebtedness? And we have suggested in our brief that the only reason the taxpayer here realized income was because the depositor came in and said he wanted to cancel the debt, he wanted the debt discharged, he wanted his money back. And but for the depositor coming in and seeking the discharge, we would not have had income.

I think the easiest way to think about the difference between the two sides, and I think why our position is correct, is to go back to some of the hypotheticals that were discussed, including the

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hypotheticals in the petitioner's reply brief that he brought forth this morning. That is, earlier on it was agreed that if the depositor -- if there is no regulation, if there is no provision in the CD agreement, and the depositor simply walks into the bank and says I would like to deposit my $100,000 for 2 years in a certificate of deposit. The bank takes the money, opens the account, the depositor walks away.

And then a year later the depositor comes back and says I know my CD is for 2 years, but I would like to have my money back, and the bank says, well, I don't have to give it back to you, but I will if you agree to accept $95,000. And the depositor agrees and the bank gives him the $95,000. There is discharge of indebtedness income, income realized by reason of the discharge.

It should not matter whether the bank says to the depositor at that time, well, I don't have to give it back to you. I will give -- I will give it back to you, but you have to pay me a penalty of $5,000 --

QUESTION: Mr. Duhl, if there are, you know, plausible, reasonable arguments on both sides of this question, don't we customarily defer to a revenue ruling by the Commissioner, which I understand there is in this situation?

MR. DUHL: Well I -- there are two answers to

that, Your Honor. First of all, I think normally deference isn't given to revenue rulings the way it is to regulations. That is, revenue rulings are simply litigating positions --

QUESTION: No deference whatever, or simply less deference than to regulations?

MR. DUHL: Well, there is definitely -- the Court has said, last term in the Davis case, said the Court gives deference to a revenue ruling when it is longstanding and when it is contemporaneously adopted. That's not the case here, first of all. Second of all, the --

QUESTION: When was this revenue ruling adopted?

MR. DUHL: 1973. And we're talking about a change in the statute that goes back to 1942 with respect to solvent taxpayers.

And secondly, the revenue ruling doesn't deal with our situation. The revenue ruling simply says that a depositor who incurs such a forfeiture or a penalty must separately deduct that charge, as opposed to not reporting interest income. And the reason it says that is because interest income is accrued as it is credited to a depositor's account. So that if the bank credits interest quarterly, under these CD arrangements the depositor is entitled to withdraw the interest.

So all the ruling is saying is once it's in his account and he can withdraw it, it's no different than his principal. It's as if he took the money out and redeposited it. And so therefore, they say, once it's income to you, you can't retroactively go back and say it's not income because you forfeited. They say you treat it as a separate -- as a separate deduction.

That doesn't answer the question, however, of whether that separate deduction is income by reason of the discharge of indebtedness to the bank. It's simply dealing with the depositor's side.

QUESTION: Mr. Duhl, I'm concerned about the hypothetical that Justice Stevens gave to Mr. Roberts about a debt agreement in which you pay less and less depending upon how soon you pay it off. It -- is every time you pay it off voluntarily earlier, is the difference between that price and what you would have had to pay if you waited longer, is that always income by reason of discharge of indebtedness?

MR. DUHL: I believe, Your Honor, that if in fact the agreement is that there is a schedule that says if it is paid back in 1 year you would pay X, if 2 years you pay Y, and Y is greater, that that is the essence of discharge of indebtedness, yes.

QUESTION: Could -- isn't it possible that

discharge of indebtedness means only permitting you to pay it off before it -- before you're entitled to -- before you're entitled to? I mean, normally when a debt matures and you pay it, you don't say you're discharging the debt. Discharging the debt means interrupting the whole process of the loan, doing it prematurely.

MR. DUHL: I can agree with that, Your Honor. But it seems to me --

QUESTION: In which case Justice Stevens' hypothetical wouldn't qualify as a discharge of an indebtedness.

MR. DUHL: Well, I would look at Justice Stevens' hypothetical as the last date being the maturity date, and any period point in between is an early discharge. It seems to me it's a question of how one looks at it.

QUESTION: Well, but it's not an earlier discharge if you have an absolute right at any point to pay it off. I mean, couldn't it have been directed to the classic situation where you say I know that -- I know that technically this money is out for longer. You don't have to pay it back to me yet, but gee, I would really like to have it back. And I'll tell -- you have no obligation to.

MR. DUHL: Let me --

QUESTION: Whereas the bank here had an

obligation to turn the money over.

MR. DUHL: Perhaps --

QUESTION: If the depositor came in and said I want it now, the bank had to give it over.

MR. DUHL: That is correct, Your Honor. But that -- that's true only in the sense that the bank agrees that it will give it back if it doesn't have to give everything back. And the parties here did agree on a specific maturity date. And all they did was anticipate in advance that it may very well be that the depositor will want his money back early. So that there's no disagreement here that this was an early discharge on these facts. Everyone agrees to that. And surely --

QUESTION: Well, but you can also view it as an agreement pursuant to which there are -- during a 90-day CD for example -- there are 90 alternative ways of discharging that indebtedness. And you just elected alternative February 16 rather than the other. And then there has been no premature discharge of that particular method of satisfying the debt.

MR. DUHL: Well, except that in our case -- in our case the election is made by the creditor, not the debtor.

QUESTION: Yes, but in the agreement made at the outset it was clear that the -- that he could do that and

the bank would have to comply with his request. There was no post-contract formation, renegotiation of a debt.

MR. DUHL: That's correct, Your Honor, but the bank says I will --

QUESTION: Are there any cases other than in this particular area where this provision has been applied to a situation in which the parties in advance had agreed on the different ways in which the debt could be discharged?

MR. DUHL: Yes, Your Honor. The Columbia Gas case that we cite in our brief, we believe is exactly this case, in the sense that in that case a corporation issued certain bonds that were convertible into stock before maturity. And the bond document specifically said that if a bondholder chooses to convert into stock prior to maturity, that any interest that has accrued in the meantime, from the last interest payment date until the date of conversion, will not be taken into account in the conversion. That is, stock will not be given for that interest. So that the bondholder forfeited that interest, paid a penalty equal to that amount of interest. And the issue in that case was whether or not the corporation has discharged of it and had realized income by reason of the discharge of indebtedness because of that interest that it was -- that it was released from, and the court held it

was. And the court of claims in Bethlehem Steel case also held it was.

In our view the Government doesn't say that case is wrongly decided, it simply says, well, there was no obligation to make a payment in that case. And we say that there was just as much an obligation to make a payment in that case as there is in our case. Neither one of them -- do the documents talk about making a payment, having an obligation, but in both cases there is an amount that gets, in advance, agreed to be forfeited.

The more basic point really is that the medium of payment characterization of discharge of indebtedness income to which the Government is trying to push our case really doesn't have anything to do with situations in which the discharge, the penalty, the forfeiture, is all integrally related to the initial creation of the debt. It's very easy to distinguish those cases because they deal with totally separate, independent obligations. It's the independence that draws that doctrine into play. It's not that there is a separate obligation.

So that in the painting, house painting case, for example, that's on page 16 of the reply brief of the petitioner, where he suggests, in the context of our facts, that we can continue to think about this example, if the depositor says to the bank here is my $100,000, but

if you paint my house you only have to return $95,000. The Government uses that example to suggest our "but for" test is incorrect because it says there too the bank would not have realized income but for the fact that it -- that the debt was discharged, because it -- he says -- the bank didn't -- the depositor didn't contract to pay the bank to paint his house. But surely he did contract to pay the bank to paint his house. That was the deal. If you paint my house you only have to give me back $95,000. The value of the painting is $5,000.

QUESTION: Mr. Duhl, suppose I enter into an agreement with somebody, they give me money now, and in exchange -- I have to pay back $10,000 after 10 years. But it's agreed that if I pay back within 9 years it's only $9,000, 8 years $8,000, 7 years $7,000, and so forth. Now suppose 7 years go by and I pay the $7,000. Have I acquired $3,000 income by reason of discharge of an indebtedness?

MR. DUHL: And interest is being paid currently, so that extra $3,000 doesn't represent interest for keeping the debt out longer?

QUESTION: Well, I don't know what it -- that's just the deal between us. They gave me $3,000 to begin with, and I said I would pay back $10,000 after 10 years. But 9 after 9 years, and so forth.

MR. DUHL: I don't think that's discharge of indebtedness income, Your Honor, because the Internal Revenue Code has other rules that deal with such zero coupon, no-interest-bearing notes, so to speak. That is in that case it's clear that the time value of money is such that if you give somebody $3,000 today, he's getting the use of those funds, you're being deprived of the use of those funds, and you're entitled to interest in compensation for that. And so the growing -- the growing amount of principal that has to be repaid, depending on when it is repaid, is really a substitute for interest. And I think under the Internal Revenue Code, the Internal Revenue Service would clearly treat it that way. There are sections that require it to be treated that way. And it's not discharged at all.

Here we ought to ask what is the -- what is the depositor paying for? The depositor here is paying to discharge the debt. He wants to terminate the debt. In the house painting case he wants his house painted, so he is paying for it. If you look at the creditor's balance sheet you will always be able to distinguish pure discharge from -- from medium of payment, because in the pure discharge case he starts with $100,000 receivable, he winds up with $95,000 cash after he withdraws, and he has a loss of $5,000, because there's nothing else there.

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In the medium of payment case, in the house painting case, he similarly starts with an asset of $100,000. That turns into $95,000 of cash, but there is another asset on his balance sheet now that's worth $5,000. That is his house has gone up by 5. His net worth in a medium of payment case is exactly the same. It's simply that the payment is incidental to the debtor-creditor relationship. Because it exists, because two relationships exist, they simply offset one against each other. That's the independent nature of a medium of payment obligation.

In this case all the obligations, as the Fifth Circuit held, are integrally related to each other. They all relate to the pure debtor-creditor relationship, and because of that the penalty is being paid to discharge the debt. And as a result, it is -- it would not have been realized but for the discharge, and therefore it is realized by reason of the discharge.

QUESTION: If you're through, can I ask you a question about Columbia Gas?

MR. DUHL: Yes.

QUESTION: I noticed from your footnote in your brief that the Second Circuit adopted the IRS position in that case. So was the taxpayer arguing that it was not -- not income at all? Is that what they were doing?

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MR. DUHL: No, the taxpayer was arguing that yes, they did not have to report that income --

QUESTION: I see.

MR. DUHL: -- but they could simply offset it. Because in that case, Your Honor, the taxpayer did not make the election that he needed to make, and so it didn't help him that it was discharged.

QUESTION: I see.

MR. DUHL: Thank you.

QUESTION: Thank you, Mr. Duhl.

Mr. Roberts, do you have rebuttal?

REBUTTAL ARGUMENT OF JOHN G. ROBERTS, JR.

ON BEHALF OF THE PETITIONER

MR. ROBERTS: Very brief, Your Honor.

On the mortgage swap issue, it's important to keep in mind what the taxpayer is trying to accomplish here. He is trying to have his cake and eat it too. He structured a transaction to ensure that the pools of mortgages that were swapped would be substantially identical. Because they were, because they did not change his economic position, the taxpayer showed no loss to the bank board. They said our position hasn't changed, everything is the same, and then turned around and, industrywide, claimed hundreds of millions of dollars of tax losses.

As one of the district judges noted, it is almost ludicrous to maintain, as the taxpayer does and must, that something can at the same time be substantially identical and materially different. Their position rests on that inherent contradiction, and I would respectfully urge the Court not to embrace that position.

QUESTION: Of course, isn't it also somewhat ludicrous to assume the savings and loan industry didn't suffer all these losses?

MR. ROBERTS: It certainly suffered the losses. They did not realize the losses as a result of these swap of substantially identical pools.

On the section 108 issue I will take one more run at Justice Stevens' hypothetical. There is no income from discharge of indebtedness, forgiveness of indebtedness in that case, because there is no forgiveness of any obligation at all, either to forgive the indebtedness or as a method of offset. The debt obligation is simply being satisfied according to its 90 or 30 different terms.

The Columbia Gas case, as Justice Stevens points out, the issue in that case was whether there was income at all. It wasn't litigated as an issue of whether it should be income from discharge of indebtedness or regular income.

Thank you, Mr. Chief Justice.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Roberts.

The case is submitted.

(Whereupon, at 12:02 p.m., the case in the above-entitled matter was submitted.)

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