OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

# THE SUPREME COURT

# OF THE

# UNITED STATES

CAPTION: COTTAGE SAVINGS ASSOCIATION, Petitioner

V. COMMISSIONER OF INTERNAL REVENUE

CASE NO: 89-1965

PLACE: Washington, D.C.

DATE: January 15, 1991

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IN THE SUPREME COURT OF THE UNITED STATES

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COTTAGE SAVINGS ASSOCIATION, :

Petitioner :

v. : No. 89-1965

COMMISSIONER OF INTERNAL :

REVENUE :

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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 10:05 a.m.

APPEARANCES:

DENNIS L. MANES, ESQ., Cincinnati, Ohio; on behalf of the Petitioner.

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



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C O N T E N T S

P R O C E E D I N G S

(10:05 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument first this morning in No. 89-1965, Cottage Savings Association v. Commissioner of Internal Revenue.

Mr. Manes.

ORAL ARGUMENT OF DENNIS L. MANES

ON BEHALF OF THE PETITIONER

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

The Cottage Savings Association case involves a 1980 transaction between Cottage Savings Association and other savings and loan institutions regulated by the Federal Home Loan Bank Board. This case is representative of numerous other transactions that were done during the same time period throughout the country.

This transaction occurred during a very difficult time period for the savings and loan industry. There was a point in time when savings and loans were caught in a cash squeeze. Interest rates were spiralling upward, and the institutions were watching their funds that they currently held or that normally would flow into the savings institution be depleted and put into higher money market yielding type funds.

In order to maintain the funds that it had or attract new funds, the savings and loan institutions had to attract these funds by giving higher interest rates. The Federal Home Loan Bank Board was not a source of funds because they also were charging high interest rates to the member institutions. On the other side of the coin, Cottage and other savings and loan institutions were straddled with low-rate, long-term fixed mortgages.

As a result, their earnings were declining, since interest paid on deposits that they were able to maintain or attract far exceeded the income flow from the fixed-term mortgages that they held. In effect the savings institutions were lending long and borrowing short. The future did not look good for Cottage or other savings and loan institutions.

Then something happened. An agency of the Government, the Federal Home Loan Bank Board, stepped up to the plate for its industry and adopted R-49. The stated objective of R-49, which was a promulgation of the Federal Home Loan Bank Board, was to create a transaction that would cause a loss for tax purposes, and not require the savings institution to book the loss from a regulatory standpoint. The effect to the savings institution on their net worth requirement was negative if they entered into one of these transactions, and the sponsoring organization was recognizing that the policy of these transactions was to create a loss for tax purposes.

Cottage and other savings institutions were in a terrible financial situation, and they really had two choices. One, they could sit back and watch their net worth further erode, and possibly taking it below the net worth requirements that were in existence, or two, follow the Federal Home Loan Bank Board's transaction, the transaction that the Federal Home Loan Bank Board promulgated and endorsed, and enter into a transaction that would create a loss for tax purposes.

QUESTION: Of course, the Home Loan Bank Board doesn't give tax advice, does it? Did the Home Loan Bank Board assure your clients that they'd get a tax deduction?

MR. MANES: That's correct. We did not --

QUESTION: Yes, right.

MR. MANES: -- get a guarantee from the Federal Home Loan Bank Board.

QUESTION: And you could have -- you could have gone to the Internal Revenue Service or to the Treasury and asked for advice on the matter, I suppose, couldn't you? Was that done?

MR. MANES: That was not done in the Cottage situation, no. There was --

QUESTION: You can't really say the Government misled you here. The Home Loan Bank Board gave you a regulatory boon enabling you to apply for a tax loss without losing any solvency as far as the regulator was concerned, but they didn't give -- guarantee anything beyond that.

MR. MANES: That's correct. But it was an agency of the Government that was --

QUESTION: Sure, it was. But it was not an agency of the Government who said you can have a tax benefit. So the fact that it was an agency of the Government makes no difference. It said you can do this without running afoul of regulatory restrictions, right?

MR. MANES: That's correct, but --

QUESTION: And they made good on that promise. They didn't pursue you for doing this. I mean, you were not required to decrease your net worth for regulatory purposes, right?

MR. MANES: That's correct.

QUESTION: So they gave you everything they promised.

MR. MANES: But they also had a stated objective, and the stated objective of R-49, as the Government recognizes, was to prepare the transaction that would produce the loss. And I think that that's a -- you know, an important pronouncement by a governmental agency, for the Government.

QUESTION: They have no authority to pronounce on tax consequences. You could have gotten a letter from Treasury if you wanted to be sure about that. You were rolling the dice, right?

MR. MANES: We were rolling the dice, so to speak, but we did have a pronouncement from an agency that had a lot of authority.

QUESTION: That you were free to roll the dice. That's all they told you.

MR. MANES: I'll accept that statement.

QUESTION: Let me follow through on that. Two or three times you've referred to for the purpose of taking tax losses. Wasn't the purpose for -- purely for regulatory purposes, for accounting purposes as far as the Home Loan Bank Board was concerned?

MR. MANES: That was the effect of R-49. The effect of R-49 was -- as pointed out, was from a regulatory standpoint, and whether or not the loss would be required to be booked. And R-49 wasn't a mandatory provision. The taxpayer had an election to book the loss or record the loss from a regulatory standpoint. But --

QUESTION: What accounting effect was intended by R-49?

MR. MANES: The accounting effect is that R-49 was giving the taxpayer an option that if R-49 was followed they could book the loss or not book the loss. Cottage, as well as the industry at the time, was under the impression that --

QUESTION: What do you mean put the loss?

MR. MANES: Book the loss.

QUESTION: Book the loss. All right. Book the loss. It need not book the loss --

MR. MANES: That's correct.

QUESTION: -- under 49.

MR. MANES: And therefore it wouldn't have any effect --

QUESTION: But they could claim a tax -- even though you didn't book the loss, you would claim a tax loss?

MR. MANES: That's correct, from a tax standpoint.

QUESTION: So the accounting effect was really nil if you elected not to book the loss?

MR. MANES: That's correct.

QUESTION: Well, Mr. --

MR. MANES: From accounting regulatory standpoint.

QUESTION: Mr. Manes, don't we really have to look at the Code provisions to see if there's a tax loss or not? Do you plan to talk about that?

MR. MANES: Yes, I do. The -- that's a point in response to, you know, the questions that I had already. Cottage, as well as the industry, thought the tax law was pretty clear, regardless of the pronouncement that I mentioned of the --

QUESTION: Well --

QUESTION: Why don't you tell us about it.

QUESTION: The Treasury has a regulation that says there has to be a material difference if there is an exchange. Now, is this an exchange or a sale, do you suppose?

MR. MANES: We do not argue that issue. The courts that have decided that point --

QUESTION: So we take the case assuming it's an exchange?

MR. MANES: That's correct.

QUESTION: Okay.

MR. MANES: That's correct. That's not an issue.

QUESTION: All right. And there may have to be a material difference, however, if we apply the Treasury regulation?

MR. MANES: Yes. And that's one of the questions here, is to the effect of the Treasury regulation and what is a material difference.

The transaction was challenged by the Internal Revenue Service, and the basis of the challenge from the Internal Revenue Service was the regulation that you're referring to. The basis of the challenge is that the property that Cottage exchanged was not materially different than the property that it had received.

Our position is that we're really talking about some basic tax concepts here, and these concepts are elementary in the tax law. And the concepts are of realization and recognition. And the test for realization is a all-encompassing type of test. The Code itself, in section 1001 states that you compute gain or loss by taking the amount realized and subtracting from that the adjusted basis. And that's a -- that's a computational section recognizing that there's realization.

QUESTION: That's (a), correct?

MR. MANES: That's correct. Code section 1001(a).

The Code then goes further and states that these realized gains or losses are to be recognized unless there's an exception in subtitle (a) of the Internal Revenue Code. And Congress has been pretty clear here in section 1001(a), and Congress has been clear here in the exceptions to the recognition rules, which is the second test here to determine if a loss is to be realized, recognized, and deducted. And they've acted in various areas in the question of recognition, and areas where material difference is really the test. And material difference is, from what we feel, is really a test in recognition. And recognition is the result unless you're in a specific exception of subtitle (a).

And the Government and -- recognizes that there is no applicable section here. What the Government is asking is for the Court to write a statutory -- or, I'm sorry, excuse me -- a nonstatutory wash sale rule when Congress has been --

QUESTION: Well, but we normally defer to IRS regulations that interpret the statute, and they say there has to be a material difference. They talk about, for example, the situation of exchanging bushels of wheat if the price of wheat drops, and they argue that that would be a perversion of the statute to say that we will recognize a loss in that situation.

MR. MANES: The reference to the regulation and the effect on the statute is normally when the statute is not clear. And here the statute is clear. Congress has acted in the area. Congress has the test for nonrecognition, and therefore there must be realization. Because in order to get the nonrecognition you must have realization.

QUESTION: You say the regulation then is unauthorized by the statutes?

MR. MANES: No, I'm not, Mr. Chief Justice. I think the regulation, for what it says, which is a statement that if you meet the material difference requirement, then there is realization. And it really doesn't say the converse, that if you don't meet it there is not realization. And I think that's a --

QUESTION: If one were to imply the converse from the regulation, would you say the converse implication was not authorized by the statute?

MR. MANES: It's not authorized by the statute --

QUESTION: If you don't say that it seems to me you lose your case.

MR. MANES: It's not authorized by the statute, and it doesn't follow the Supreme Court cases that that regulation was really founded upon. And those Supreme Court cases were very hair-trigger type tests as to what is material difference.

QUESTION: Well, but then you're saying the regulation could be valid, but that the IRS is interpreting it incorrectly.

MR. MANES: I am not --

QUESTION: That the regulation should be read to refer to these Supreme Court cases that established a constitutional distinction.

MR. MANES: I agree that the regulation -- I'm not challenging the validity, per se, of the regulation. The regulation is there. But the regulation is based upon the early cases that the Government argued a hair-trigger type test for realization, and the early cases really muddied the issue because they kind of combined realization and recognition. And the later portion of it, especially the Code itself, separates these.

QUESTION: But there's language in some of this Court's opinions that there has to be -- to the effect that there has to be a material difference, and perhaps the IRS was trying to codify that language, in effect, with its regulation.

MR. MANES: That regulation was based upon the case law at the time, which talked about having something materially different. And it was based upon cases where the Government was arguing for a hair-trigger, broad-line approach.

QUESTION: I don't know what you mean by that. But do you -- do you take the position that today in the exchange of bushels of wheat example that we should recognize a tax gain or loss?

MR. MANES: I think that it would be tested first under realization, or realization would be --

QUESTION: Yes or no? Under today's law do you take the view that an exchange of bushels of wheat should result in a taxable gain or loss?

MR. MANES: I would answer that as yes. And the answer is based upon a finding of realization, and also you then would have to look to see if there is an exception to the recognition portion. And that's where Congress legislated. And that's where Congress has taken into account material differences. Material differences are really a test of recognition.

QUESTION: Is that consistent with Eisner v. Macomber?

MR. MANES: Yes. Because Eisner dealt with whether or not just depreciation itself, or just depreciation in the asset, whether or not that --

QUESTION: Well, I thought that there was an event. There was an event of a stock dividend, was there not? If I recall.

MR. MANES: Well, it's questionable whether that itself was an event, whether a stock dividend would be a triggering event.

QUESTION: Well, it would be if the stock dividend were disproportional.

MR. MANES: That would be correct. And that's been handled --

QUESTION: And the only reason that it, it was held to be nontaxable was the economic position of the taxpayer hadn't changed.

MR. MANES: And that really is a question of recognition. And we do have sections in the Code dealing with recognition, as to whether or not that is a taxable event. You have plenty of sections in the reorganization rules that deal with this.

Another area, I think, that supports this --

QUESTION: Suppose we disagree with you and think that the deference we owe to the regulation means that we will apply it? Do you have a fallback position?

MR. MANES: We feel we fall within the definition or the regulation as to what is materially different. We feel we fall into it whether it's a hair-trigger or an easy test to meet, which the Government normally argues. The Government is usually arguing the gain side, not the loss side, and there they ask for a hair-trigger test. They asked for a hair-trigger test in Weiss v. Stearn, where the stock in the reorganization was in the same State.

And we also feel that here the asset itself, where you have a different obligor, where you have a different collateral securing that obligation, different real estate, and where you have a different stream of income which has resulted from those differences, then it is materially different.

QUESTION: I take it the court of appeals agreed with you on 1001?

MR. MANES: That would be a fair interpretation of the Sixth Circuit.

QUESTION: And they turned you down on 165?

MR. MANES: Yeah, which the Government is now saying is a portion of the material different argument. It's a -- they're not really arguing it, like the Sixth Circuit did, that it's a separate test.

QUESTION: So for you to win you have to say the court of appeals was wrong on 165?

MR. MANES: Or we could say that the Government, and their position is that it's a material difference test, and it's still satisfied in material difference.

QUESTION: Well, I would suppose we wouldn't decide that. We would say that the court of appeals was wrong on (a)165 and wrong on 1001 and remand to see if in this particular transaction there was a material difference. Because I don't know that you get the same answer on every single trade of mortgages, would you?

MR. MANES: We feel that on trades of mortgages you would get the same answer.

QUESTION: So you would -- if -- if the -- if we would say the regulation is valid, you would then go to the court of appeals for the Fifth Circuit rationale?

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

QUESTION: Is it because all mortgages are unique?

MR. MANES: We feel that mortgages are unique, especially with the different obligor and different --

QUESTION: But that simply is inconsistent with the whole design of these transactions. They matched up the mortgages on the computer banks and they came out within a few cents of each other, and they switched. And there was absolutely no showing that -- unless I'm wrong, correct me -- that they investigated to see if they were going to get high rent, or high income homes or low-income homes. Nobody seemed to care. They were just switching these mortgages around. Correct me if I'm mistaken.

MR. MANES: From a pure subjective point of view, I think you're correct. From a objective criteria --

QUESTION: From a computer point of view.

MR. MANES: Right. But there's still an objective standard here where you do have different obligors and different collateral, and the history has shown that these did act differently. There was a major difference between those received and those that were sold.

QUESTION: Did the computer matching and analysis seek to make an analysis of relative risk, so that the computer was attempting in effect to substitute one pool with a given level of risk with another at exactly the same level of risk?

MR. MANES: Only within the context of R-49.

QUESTION: I'm not sure that I know what you mean by that.

MR. MANES: Well, R-49 was --

QUESTION: Let's forget R-49. If I'm just going out on the market to buy a participation in a pool of mortgages, and I am looking at the two pools in question here, does the computer purport to tell me that I am buying a participation with the same level of investment risk, no matter which of the two I buy into?

MR. MANES: You're buying a potential stream of income that will perform differently --

QUESTION: Sure, but I want to know what the risk is that I'm not going to get the income. I want to know what the risk is that there's going to be a default. Am I buying -- do I have a choice based, assuming the computer is properly programmed, do I have a choice of buying into two, two pools of equal risk, or am I simply buying into two pools of mortgages with roughly equal collaterals and net values of collateral, market values of collateral?

MR. MANES: Justice Souter, that would depend upon what factors the computer was looking at.

QUESTION: And that's what I want you to tell me.

MR. MANES: Okay, well --

QUESTION: I mean, what I'm getting at is whether there is a material difference depends in part of what kinds of differences would be relevant to a mortgage lender. And one of the things that a mortgage lender would be concerned with is the degree of risk. And if what we have got are two pools which on the matter of risk are virtually homogeneous, that may suggest one answer in this case. But if we have got two pools in which the risks, relative risks, have not been assessed, then we might come up with another answer.

MR. MANES: I'd like to direct you to Fannie Mae, and their amicus brief, because that issue was addressed there. And the issue was that -- and I hate to refer back to R-49 because of the question, but that R-49 wasn't a complete situation of trying to bring these risks so close together that they would perform exactly the same. In history --

QUESTION: Well, is -- your answer to my question then is no, the computer did not purport to give you two pools of identical risk?

MR. MANES: That's correct.

QUESTION: Okay.

MR. MANES: That's correct, because there is a lot of other factors that would have had to be taken into account.

The Government has raised the difference of economic position between the taxpayer before and after the transaction as a determining issue here, and they raise it in a very subjective analysis. And the Internal Revenue Code hasn't really be built upon a subjective analysis. The Internal Revenue Code has been built upon objective facts that Congress has adopted and that we can look at for a result.

And they also state that the economic position of the taxpayer had not changed because this potential flow of income, this stream of income could turn out to the be the same. But it could also turn out to be different, which is what happened, which shows that they are materially different.

And from an economic position standpoint, a very important criteria of what is the same economic position was brought out throughout this case. And that was that Cottage, at least in this particular case, started out with 100 percent mortgage before the transaction. And after the transaction it had a 90 percent participation in other mortgages. And that was determined to be a transaction that put Cottage in a much less liquid position regarding its mortgages after the transaction.

QUESTION: Of course the only purpose of that was to enable the relationship between borrower and lender to continue, was it not?

MR. MANES: That -- that's correct, because that's the normal way that mortgages are bought and sold.

Mr. Chief Justice, and may it please the Court, I'd like to reserve the rest of my time for rebuttal.

QUESTION: Very well, Mr. Manes.

Mr. Roberts, we'll hear now from you.

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:

The court below correctly concluded that the taxpayer, Cottage Savings, was not entitled to a deduction for losses claimed to arise from its swap with pools of substantially identical mortgage loans.

QUESTION: They don't claim the losses arose from the swap. They were realized at the time of the swap. They arose before the swap. They were in fact real losses, weren't they?

MR. ROBERTS: There was a real decline in the book value of the mortgage loans --

QUESTION: So the loss had arisen prior to the transaction.

MR. ROBERTS: The loss was arising as time went by. The question is whether or not their swap of pools of substantially identical mortgage loans resulted in a realization of that loss.

QUESTION: Mr. Roberts, if the facts had been just the reverse and the values of the properties had gone up and there was an exchange, what position would IRS take?

MR. ROBERTS: Well, the position would be no gain would have been realized. I'd point out, of course, that that situation wouldn't arise, because there would be no need to engage in a swap. Gain would not be realized simply by holding on to the valuable, appreciating mortgages.

QUESTION: But you may have other situations where there are exchanges in the future for -- where there might be a gain, and the IRS is prepared to apply exactly the same test to that one?

MR. ROBERTS: Exactly the same test, Your Honor. And the fact that it cuts both ways for our position we think indicates that it is a neutral position in the tax code, and not simply something we're trying to --

QUESTION: And what do you look at? Just the fact that the economic value at the time of the exchange is the same?

MR. ROBERTS: No, Your Honor.

QUESTION: No.

MR. ROBERTS: The economic value --

QUESTION: What's your test, then, for material difference?

MR. ROBERTS: We think you should look at all the available evidence presented, and see if the difference had a capacity to affect the decision. Now here all the available evidence indicates that the differences that Cottage now relies on, differences in borrowers, differences in collateral, were of no significance to any parties to the transaction --

QUESTION: This is a subjective test or is it an objective test?

MR. ROBERTS: It has been labelled --

QUESTION: You first said that the -- whether the differences were of a nature as to affect the decision, and now you're saying here they in fact didn't affect the decision. Which is going to be crucial for your --

MR. ROBERTS: The former. It is an objective test. We've -- my brother has labelled it subjective, but it is not. We've looked to the conduct and the intent of the parties as probative evidence for the objective nature of the transaction.

QUESTION: Suppose -- suppose two taxpayers who have stock in different mutual funds have a study done by an expert, and he says these two funds, their performance in the past has been just about the same, in the future they are likely to be the same, as far as I can tell it's tweedle-dum and tweedle-dee. And they swap their stock in these two different mutual funds. Is that a -- is that an event that would trigger a gain or a loss, or not?

MR. ROBERTS: Yes, it is. The mutual funds --

QUESTION: It is? Why?

MR. ROBERTS: The mutual funds are not matched up the way that these pools of mortgages were. In the first place, the mutual funds are run by separate management companies who may have different perspectives on how to --

QUESTION: Well, these houses are owned by different people, whose economic success and ability to pay their mortgages are quite different.

MR. ROBERTS: And if you're considering to -- whether to invest in a mutual fund, you want to know who the management of the fund is, you want to know what their investment philosophy is. Here --

QUESTION: If you take a mortgage on a house you want to know who the mortgagor is, too.

MR. ROBERTS: Not in the secondary mortgage market. It is not a factor. In fact at the time of the transaction Cottage conducted no credit checks of the borrowers, no appraisal of the properties.

QUESTION: But that's being subjective. You're just saying not that nobody could see a difference, but that this particular trader didn't care.

MR. ROBERTS: And that's strong evidence of what the nature of the transaction is.

QUESTION: No. Because if I was doing the swap I would have cared. You see, I wouldn't have -- I wouldn't have accepted that. I want to know who these mortgagors are. So you're really not applying an objective test. You're just saying that these particular traders didn't care who the mortgagors were.

MR. ROBERTS: No, I am saying that these particular traders didn't care who the mortgagors were, but not that that is the critical factor, but it's evidence of the objective nature of the transaction. If you were engaged in the secondary mortgage market, you wouldn't care who the mortgagors were. You don't go into that market and say --

QUESTION: Oh, I see. It's not any trader. It's a trader who's in the secondary mortgage market.

MR. ROBERTS: Well, yes.

QUESTION: Does it have to be a trader in the secondary mortgage market living in New York?

MR. ROBERTS: No. A secondary --

QUESTION: You know, how specific -- when you get specific enough then it's the same thing as a subjective test.

MR. ROBERTS: No, it's not. I'm not suggesting that the result is going to be different depending upon the subjective reactions of the different traders and the different R-49 transactions. We think they all point the same way. None of these traders cared who the borrowers were or what the collateral was. In the secondary mortgage market you don't go in and say I have Tim Smith's mortgage on 148 Oak Street, what am I bid. You say I've got a $150,000 30-year note secured by a single family residence in Virginia, fair market value of $75,000, loan-to-value ratio of 80 percent. In other words, the precise factors set forth in Memorandum R-49.

QUESTION: But that just shows that these traders didn't care.

MR. ROBERTS: That's the market I'm describing, not just these traders. These transactions in the market aren't based on who the borrower -- if someone --

QUESTION: Yes, but the mutual -- you could make the same argument about two mutual funds that pay the same interest rate and they are equally liquid, they are both short term funds, and one is the First National Bank and the other is the Chase Manhattan Bank, or something. And the average person in the market would think that's tweedle-dum and tweedle-dee, wouldn't he?

MR. ROBERTS: I think not, Your Honor. I think the average person in the market wants to know before he puts his money in a mutual fund what the management is, what their philosophy is, what the holdings. That's the prospectus to tell you what the different holdings are. That's not how this market works.

QUESTION: Of course with a mutual fund you wouldn't care because it's not recognized under -- what is it, 1031 -- anyway. Exchange of like kind, but it's not --

MR. ROBERTS: I don't think that's true, Your Honor. I don't think under the --

QUESTION: Oh, it is recognized?

MR. ROBERTS: I don't think the IRS regards



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different mutual funds as being of like kind. They certainly don't regard different issuers of stock as being of like kind, and I don't think there would be any difference in the mutual fund context.

QUESTION: Was there any finding in the tax court or by the court of appeals that the secondary mortgage market had this characteristic which you describe?

MR. ROBERTS: Not so much in the tax court in this case. There was a finding in the Centennial case along those lines, and Cottage has indicated that the facts of its case are similar to the facts of those -- that -- those cases in the Fifth Circuit.

QUESTION: That was a finding by the court of appeals or by the tax court?

MR. ROBERTS: In Centennial, by the Federal district court.

QUESTION: By the -- that came up through the Federal district court?

MR. ROBERTS: Yes, Your Honor.

QUESTION: So, if I understand what you're saying, what you recite in your brief as being a simple example, you very facilely say swapping one bushel of wheat for another bushel of wheat doesn't make any difference, that that's not an event that triggers recognition, that's really not true. You really have to know who the traders are, don't you?

MR. ROBERTS: You don't have to know who the traders are, but you have to know the market.

QUESTION: That's right.

MR. ROBERTS: It could be in a particular case, if there is, if it turns out that South Dakota wheat is -- sells at a premium to Kansas wheat, then you do have to know.

QUESTION: Well, there's two farmers and I say, you know, I have grown this new type of wheat, do you want to swap it for some of your old wheat and you try some of mine and I'll try some of yours. You don't consider that subjective? You say that's just identifying the market? That's -- that's not being subjective?

MR. ROBERTS: It is identifying the market, yes.

QUESTION: I call it being subjective.

MR. ROBERTS: Well, an example we put forth in our brief is serial numbers on stock certificates. Do those make a material difference? It depends what market you're in. If you're in the market where the shares represent shares in a company, you don't care what serial number your share of IBM has when you swap it for another. But there is also a market out there for antique shares, and you want to make certain when you're trading that you're getting IBM share 0001. It does make a difference. You can't simply say as an abstract matter serial numbers on stock certificates make no difference. It does depend on the market, and it does depend on how parties in that market treat the characteristic.

QUESTION: There are going to be a lot more factual inquiries in cases involving the recognition of gain if the Court accepts your theory, I think.

MR. ROBERTS: Well -- it is unavoidable, I think, in the realization inquiry to ask, as the regulation sets forth, whether the properties are materially different. That is in fact a fact-specific inquiry set forth in the regulations. But I don't want the irony of --

QUESTION: Do you think the regulation when it was adopted was intended to do any more than effectively codify this Court's decisions?

MR. ROBERTS: Well, I think it was intended to define and clarify the concept that the Court began to articulate in the decisions in the 1920's. Those decisions, of course, did not address the entire range of issues in which the realization question could arise, so I would assume --

QUESTION: I'm just -- I'm not sure that I understand what you say the limiting principle is here for the Government's test. It just isn't clear to me yet.

MR. ROBERTS: The differences that are relied upon in the exchange of property have to be material differences, differences that make a difference.

QUESTION: The differences actually relied upon.

MR. ROBERTS: Well, that are put forth by the taxpayer in response to the challenge that that was just an exchange of property that was not materially different.

QUESTION: Well, they have put forth those differences here. There are different risks of repayment. They've put forth those as differences.

MR. ROBERTS: There are not different risks of repayment. The --

QUESTION: Well, but they are, because each borrower has a different ability to repay the loan, and perhaps the security, the collateral, is different.

MR. ROBERTS: The value of the mortgage loans that are traded, that value, it's an asset that measures risk. That's what people want to know. And the question is what characteristics do you look at to effect risk. Here the market does not look at who the particular borrower is or what the collateral is. The parties certainly had no interest in that. They were willing to swap these without any regard to who the borrowers were or what the collateral was, and the bank board, the Federal agency charged with regulating this industry specifically said that if you meet these criteria, and you -- those things are then substantially identical. And if you swap them your economic position is not going to change.

And therefore -- I don't want the irony of their position to be lost. At the time they went through a carefully crafted transaction to ensure that what they were giving up would be substantially identical to what they were getting back.

QUESTION: But they --

QUESTION: But your economic position doesn't change lots of times and when you nonetheless have to recognize the loss or gain. If you sell property for a certain amount of money, your economic position doesn't change, but you nonetheless may have to recognize the loss.

MR. ROBERTS: Well, your net worth doesn't change. If you, before you had property worth $10,000 and now you have $10,000 in cash, but your economic position changes dramatically, because you are holding very different assets. Here, before and after the transaction --

QUESTION: But, you say your economic position changes dramatically when you sell stock -- 50 shares of stock for $10,000. The actual physical property which you possess, the share of stock as opposed to the dollars, changes, but I don't see how your economic position changes.

MR. ROBERTS: You're worth the same before the transaction and after.

QUESTION: Yeah.

MR. ROBERTS: I agree. But you're holding a very different economic asset. Before the transaction --

QUESTION: You're holding a different asset, yup.

MR. ROBERTS: Before the transaction you had shares in stock, and they could go up and could go down. After the transaction you simply had cash.

QUESTION: But for some centuries since the invention of money, I thought people would have said you economic position was the same.

MR. ROBERTS: Well, to the extent you mean your worth, what you're worth, that hasn't changed. But you have engaged in a transaction that would realize either loss or gain because you've disposed of a piece of property that you owned. Here that really didn't happen. In the swap Cottage got back exactly what it gave up --

QUESTION: No it didn't, no it didn't, no it didn't. All you have established is that they didn't care very much about what differences there were in the mortgage.

MR. ROBERTS: Not just that they didn't care --

QUESTION: But they were really different loans, those -- and it turned out that the loans they got paid off a good deal less than the ones they swapped. Didn't they end up the losers on the thing, 100 and -- I forget what the number was -- $160,000 or so?

MR. ROBERTS: Well, that fact, future performance, was unknown and unknowable at the time of the transaction.

QUESTION: But that shows that in fact what they got was quite different from what they gave up. They didn't have the same assets afterwards.

MR. ROBERTS: With respect, Your Honor, the subsequent performance does not show that, because what the asset measures at the time is risk. And the risk at the time, according to the R-49 criteria, according to the perspective of the market, according to the perspective of the bank board, was exactly the same.

QUESTION: Why isn't that true in the stock example?

MR. ROBERTS: In the stock --

QUESTION: The market values the stock by taking the risk into consideration, and the market says in effect holding this stock gives you in effect the same economic risk as holding the $10,000.

MR. ROBERTS: No, because there are material differences in the -- in an exchange of stock the material difference is in the issuers. The fact that they coincide --

QUESTION: No, but that's true, but I think to the -- maybe I misunderstood you. I thought to the extent that you were replying to Justice Scalia that you had sort of two identical risk situations, that that was decisive on material difference. And if that's going to be, then I think you've got to carry the argument beyond the exchange of mortgages into the stock example.

MR. ROBERTS: Well, it's like a sinking fund bond. A company issues these bonds and they are going to retire, say, 10 percent of them every year, and they pick which ones to retire in a lottery. At the time that those bonds are sold there is a risk, 10 percent risk that it would be retired after the first year, and that would change the subsequent performance. But those two bonds have exactly the same risk, they're worth exactly the same on the day they are issued. One of them is going to perform very different than the other nine, but you don't know which one, and the risk at that time is precisely the same. And that's what these assets measure.

QUESTION: Of course then the rights and

obligations are exactly the same, too, but that's not like saying that 100 homes in North Carolina are identical to 100 homes in South Carolina, one in the cities and another in the country. There's surely a lot of difference between the underlying assets.

MR. ROBERTS: There is a difference in the underlying assets. And that we're not saying there's no difference in who the borrowers are, what the --

QUESTION: You're just saying there's no difference in the risk. But I don't know why that's any different than exchanging General Motors bonds for Chrysler bonds having precisely the same par value and interest as -- and the reason you do it is because the tax benefit you get far exceeds whatever trivial difference there is in risk. That's the only motivation --

MR. ROBERTS: Here it's not simply the fact that --

QUESTION: -- and it's a perfectly legitimate motivation.

MR. ROBERTS: Here it's not simply the fact that the value coincides, that the risk is the same. The reason the value coincides, the risk is the same, is because Cottage and its trading partners went through an elaborate transaction --

QUESTION: Yeah, but you say that doesn't matter. If they just picked it out of the air and it just happened to come out this way it would be the same thing.

MR. ROBERTS: It could happen to have the same risk, but we wouldn't say they are not therefore materially different.

QUESTION: I think you're really making a subjective test argument.

MR. ROBERTS: It depends on the nature of the transaction.

QUESTION: Of the market, you say, which --

MR. ROBERTS: And of the market.

QUESTION: Let's go to your sinking -- your sinking fund bonds again where, where they are selected randomly which ones will be paid off over the 10-year period. And let's assume I call up a friend of mine, I say you know, I'm feeling lucky this week. I have these sinking fund bonds, what do you say I swap mine for yours, because I'm really feeling lucky. Now, is that -- does that trigger recognition of loss or gain?

MR. ROBERTS: No. No, the tax --

QUESTION: Why not?

MR. ROBERTS: -- law doesn't look at idiosyncracies in particular taxpayers. If one of these parties said --

QUESTION: Oh, it has to rise to the level of being a market? Suppose I called it a market, a market in sinking fund bonds, you know. I'll trade you the numbers I have for the numbers you have.

MR. ROBERTS: It would be no different than if one of these trading partners decided it was only going to swap loans that happen to have red folders and not green ones. They said just give me the red ones and not the green ones. That type of idiosyncracy would not be taken into account in the tax law. But we do need to look at the nature of the market to decide what are material differences. There is no way to say as an abstract matter, as the court of appeals in the Centennial case did, that we know that the borrowers and collateral make a difference.

QUESTION: But this is a material difference for that market. Suppose there are 10 people that do this? I open a trading post, you know, for people who want to gamble with these bonds. You trade the numbers I have for the numbers you have, we'll see whose gets called sooner or later. That's the only, the only thing that we're trading them for. And you say that does not create a market?

MR. ROBERTS: No, it wouldn't.

QUESTION: I don't understand why.

MR. ROBERTS: Not a rational, economic --

QUESTION: Well, let me give you another. Supposing in this very case you had the same economic analysis, but in addition to the tax motivation one of the traders said we'd like to concentrate more of our loans in urban areas, and the other one said we want to move into rural areas, just as a matter of policy. So they selected rural versus urban, but came up with the same economic analysis you have in this case. Is that -- would you realize a loss or not then?

MR. ROBERTS: Well, that of course is the argument that Fannie Mae raises in the Centennial case where it's filed in an amicus brief. It would be the same analysis in that case, because the differences in the location alone did not have any effect on the market or on the value.

QUESTION: And that would not be material difference?

MR. ROBERTS: The position that they're advancing is, is somewhat inherently inconsistent. They're saying, for example, that the urban loans are going to prepay faster, or --

QUESTION: No, they just want to advertise to the public we're an urban loan mortgage company or something. It has nothing to do with their judgment of which will get paid out faster, they just liked to -- or they wanted to have them all in the Northeast instead of the Southeast, or something like that.

MR. ROBERTS: A factor that's extrinsic to the market like that, and that has no effect on value, I don't think is --

QUESTION: But why then is that different from General Motors versus AT&T? I don't understand.

MR. ROBERTS: Well, because General Motors and AT&T are shares of stock in two very different corporations.

QUESTION: Well, but these are different areas of the country, different types of property, and you've got 90 percent of twice as many loans instead of 100 percent of half as many loans -- I mean, 90 percent and 10 percent. You've got an interest in a portfolio twice as large as the one you started with, too.

MR. ROBERTS: We're not -- we're not saying there are not differences. There are differences.

QUESTION: You just say they're not material.

MR. ROBERTS: They're not material differences, because they make no difference to the market or to the bank board. The bank board --

QUESTION: Well, now wait, to the market or the bank board. Suppose the market says urban, rural, it makes no difference, we're going to value them the same.

But I, as a banker, I think that urban real estate is really going to flop. I'm the only one, but, you know, that's how people get rich. I happen to think that. And therefore my motivation is to get rid of my urban holdings and acquire rural holdings. But the market is not taking account of urban versus rural. Those dumb people out there, they think they're all the same. But I, I have a special motive. What happens? Is that an event that would produce recognition or not?

MR. ROBERTS: Then you couldn't have done an R-49 transaction, because one of the things you had to make certain of in your R-49 transaction was that the fair market value of the loans you're swapping were the same. And if you didn't think they were, then you couldn't go to the bank board and say I have no loss, these are the same.

QUESTION: No, I haven't said -- I have said the fair market value is the same, because the dumb people like -- out there, who create the market, they think it's all the same. That's how people get rich, you know. They out guess the market. The market value is the same, but I personally want to get more rural real estate. And you're saying that cannot be a recognizable event because the market doesn't recognize that difference?

MR. ROBERTS: Well, I still think you can't engage in an R-49 transaction because you would have to report -- you would have to tell the bank board --

QUESTION: You either have to come out with a -- what seems to me a silly position on that hypothetical, or you have to acknowledge that you're applying a subjective test and not an objective test.

MR. ROBERTS: Well -- I'm not sure how much difference it makes whether you attach the label subjective or objective. Our position is that you look to the conduct and the intent of the parties as probative evidence of the nature of the transaction in which they engaged. Now, if people were making those judgments, that these loans were in fact different, I think they're going to do better.

QUESTION: Just me. Nobody else.

MR. ROBERTS: Well, just you. Then we'd have to look at the other evidence and see if that meant that that characteristic was or should be considered a material difference in these transactions. Here all of the parties, not just in this case and the other cases, did not regard the differences that are now cited after the fact as material -- as material at the time. The bank board didn't. The bank board's job in the, issuing these accounting standards was to keep track of how the position of the S&L's changed. And they said if you match these up according to the R-49 criteria and you swap those loans, your position is not changed; you're substantially identical. And now they want to come back and say that the substantially identical loans are actually materially different.

QUESTION: Mr. Roberts, what should -- don't you have to do something about the court of appeals' holding?

MR. ROBERTS: Our position, Your Honor, is that the court of appeals, first of all, was wrong to conclude that there was no materially different requirement. We think there it. It's set forth in a regulation that has been in effect since 1935. Second --

QUESTION: Say that again?

MR. ROBERTS: The court of appeals in this case rejected our argument that there is a materially different requirement in the tax law --

QUESTION: Oh, yes.

MR. ROBERTS: And we think that was wrong. The requirement is set forth in the regulation which has been in effect since 1935, and this Court has frequently noted the deference that is due Treasury regulations. Now, if the Court rejects that position, if this Court rejects that position and agrees with the Sixth Circuit that there is no materially different requirement, then we think that the same reasons that we advanced in the materially different context should be applied under section 165. So we're not --

QUESTION: Which you think is what the court of appeals did in this case?

MR. ROBERTS: In this case the court of appeals said there is no materially different requirement --

QUESTION: Yeah.

MR. ROBERTS: -- but then the same arguments it applied in the 165 pigeon hole.

QUESTION: So you do defend the court of appeals' treatment of 165 if we reach that question?

MR. ROBERTS: Yes, if it's necessary to reach that question, we agree with it. The --

QUESTION: But you think the arguments are essentially the same? Loss sustained and gain realized is the same concept?

MR. ROBERTS: We think so. We think it's properly addressed under the realization rubric, because that's where the Treasury regulation is, and that regulation is entitled to deference and can be applied. But if the Court disagrees with that, then we don't think a loss has been sustained, because, by the nature of the transaction, Cottage got back something that was substantially identical to what it -- to what it gave up.

Now, my brother hasn't mentioned exactly what the R-49 criteria are, and I think it's important to keep that in mind. They were very -- 10 very precise criteria that had to be matched, and they were matched by computer before the swap could take place. Loans had to be secured by a single family residence in the same State, they had to have the same terms for 30-year loan, had to be the same type, conventional for conventional, same interest rate, similar seasoning, principal amount, swapped without recourse, similar fair market value, similar loan-to-value ratio. Those were all matched up, and when those were all matched up the parties were willing to swap those straight up.

Differences in borrowers and collateral or some of the differences that Justice Scalia were talking about, if those made a difference they would have entered into the calculation of the value. They would have said here are loans matched up according to R-49. Do you want to trade? And you say no, I think urban loans are going to be more valuable, mine is worth more. Or I think this borrower is less of a credit risk, yours is worth more. But that didn't happen. Same discount factor. They matched the two loans up; they were each sold for 62 percent of book value.

QUESTION: But on that reasoning, if the computer had matched up two baskets of common stock, you would then reach the same result in this case, wouldn't you?

MR. ROBERTS: No, the value would be the same in that case, but that's not all we're saying. It's not simply the fact that the value is the same. The value is the same because they are matched up according to the factors that the market considers in arriving at an assessment of risk. That's not the case in just matching up baskets of stock so that the --

QUESTION: What about baskets of stock in the same industry? All common stock, all in oils or all in chemicals, and so on?

MR. ROBERTS: There is a material difference between Texaco stock and Exxon stock.

QUESTION: Because the companies are different.

MR. ROBERTS: Because the companies are different and the shares represent a share in those companies. Here the sole purpose of the mortgage loan in the secondary mortgage market is to measure risk. And here the bank board told you what you had to match up to make sure the risks were the same, and then said if you did that you could swap them.

QUESTION: What about bonds? Do they, do they go with stock or do they go with mortgage loans?

MR. ROBERTS: I think if someone were investing in a bond, they'd want to know whose bond it is. In the secondary mortgage market someone who is investing in these pools of substantially identical mortgage loans doesn't say who is the borrower on that originally, or what condition is the --

QUESTION: So if I have computers do this thing with bonds, it's no good, but if they do it with mortgages, it's okay?

MR. ROBERTS: Well, it's not just the fact that the computers are doing it. It's that the market treats it differently. Most parties are going to treat it differently. And they are different. A Texaco bond, no matter how closely matched, is different than an Exxon bond.

QUESTION: What about two different issues of Texaco bonds? You know, they do them periodically. Both due in 1991, both the same interest rate.

MR. ROBERTS: Well, if it's --

QUESTION: And then the next question if you say well, that's the same, then what if they're slightly different in interest or maturity, but market value is precisely the same because one is discounted to 99 and the other is 101?

MR. ROBERTS: Well, there is line drawing --

QUESTION: Is there material difference or not between two bond issues of the same corporation?

MR. ROBERTS: If they're identical, there is --

QUESTION: They're not identical, but they're identical in market value.

MR. ROBERTS: Well, then we need to know what the differences are.

QUESTION: Well, one's a slightly higher interest rate and slightly different maturity, but the, but it all washes out when you trade it at the time because you buy it at a discounted rate.

MR. ROBERTS: I believe that those would be found to be materially different --

QUESTION: It would be materially different.

MR. ROBERTS: -- because of the difference in the terms. All of the -- all of the terms that the market --

QUESTION: It seems to me they're a lot more alike than what you've got here.

MR. ROBERTS: No, if you're trading bonds on the market, the first thing you're going to ask, of course, is whose bond is it and what's the interest rate. So a change in interest rate is going to be different. Here the only things that --

QUESTION: Yes, you changed the interest rate on the coupon, but the effective interest rate, because you buy it at a discount, is precisely the same. When you buy bonds on the market, you don't buy them at par.

MR. ROBERTS: Well, but it's going to make a difference. It's going to make a difference to the rational economic trader which bond he has.

QUESTION: What about exchanges of shares identically valued in two separate bond funds? The person who buys doesn't know what bonds his fund is holding.

MR. ROBERTS: Well, but there again it's sort of like the mutual fund example. The differences in the management, how they're going to trade the bonds is something that would be a material difference.

QUESTION: Well, I think though, we're -- again we're right back to the fact that there are differences in the homeowners who are going to pay or not pay the loans, there are differences in the banks who are not -- are or are not going to collect promptly. I don't see where the distinction lies.

MR. ROBERTS: Well, the distinction is partly in the market. I mean, we're familiar with how important who the borrower is and what the collateral is when you take out a mortgage on your home. But the market in pools of these mortgage loans doesn't work that way. They don't care who the borrower is. They want to know what's the fair market value, what's the loan-to-value ratio, what's the interest rate, what's the seasoning, in other words the factors that are set forth in Memorandum R-49. These other differences did not make a difference to the market, did not make a difference to the parties acting in that market, and did not make a difference to the bank board.

The swap pools of mortgages loans were therefore not materially different under the Treasury regulation as interpreted by the Commissioner, and therefore did not result in a realized loss.

QUESTION: Yeah, but in my example the differences in the bonds in the two funds didn't make any difference to the fair market value of the share of stock either. And yet no one would argue that the bonds were all identical and that they all carried -- that they all were in fact going to perform necessarily in the same way over time.

MR. ROBERTS: It's not just the value, it's the factors that went into determining value. And the whole purpose of Memorandum R-49 was to make sure that the factors that went into determining value were matched up precisely.

Thank you, Your Honor.

QUESTION: Thank you, Mr. Roberts.

Mr. Manes, do you have rebuttal? You have 4 minutes remaining.

REBUTTAL ARGUMENT OF DENNIS L. MANES

ON BEHALF OF THE PETITIONER

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

I'd like to address various issues that were raised by the Government, and one came up in the context of what if the reverse was the situation and we were arguing gain. And the answer to that was that gain would be realized. And that argument is contrary to the argument that the Government raised in every reported type case that involves -- that this body has decided, starting with Weiss and going through Rockefeller, Fellis, and so forth. There the Government has always argued for a hair-trigger test as to what is realization, that it doesn't take very much of a difference, and that the difference is based upon objective items. For example, in Weiss, whether or not the -- there were different terms on the refunding, or on the bonds or the stock that was involved. Whether or not they were located in different States. And these were objective criteria. The --

Another interesting point that was alluded to is whether or not this transaction, if it occurred today, at least from a regulatory standpoint, would be given the same effect. And it's clear under the statement of position of the AICPA, which the regulatory bodies would now follow because the regulatory bodies for RAP or regulatory purposes follow general accounting principles, would require these types of transactions to be realized and recognized from a financial accounting standpoint. And, you know, that is, you know, consistent to the tax laws.

Realization should only require two things. One, has there been an increase or decrease in value of the asset involved from the basis which you hold it, and two, whether or not there has been a sale or disposition.

QUESTION: Excuse me --

MR. MANES: And from there --

QUESTION: Could I -- for regular accounting purposes, you would have to revalue these mortgages even if you didn't engage in a swap, isn't that right? I mean, if you're following normal, what's the organization that you mentioned? Wouldn't their normal procedures require you to revalue your stock of mortgages --

MR. MANES: That would be correct.

QUESTION: -- as there's a decline in the real estate market, whether or not you trade them for other mortgages?

MR. MANES: That would be correct.

QUESTION: Does the accounting reference you made appear in any of your briefs?

MR. MANES: Yes, Your Honor. It appears in our brief on page 17.

QUESTION: Thank you.

MR. MANES: And then after a realization is determined, you look to the statutory authority that Congress has laid out to see whether or not the realization is to be recognized. And these statutory exceptions to recognition are very clear, and the Government is asking the Court to develop a nonstatutory recognition rule, and they do it in the guise of realization.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Manes.

The case is submitted.

(Whereupon, at 11:05 a.m., the case in the above-entitled matter was submitted.)

## *CERTIFICATION*

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#89-1965 - COTTAGE SAVINGS ASSOCIATION, Petitioner V.
COMMISSIONER OF INTERNAL REVENUE

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*BY* Rooj Estnur Hunter

*(REPORTER)*