

OFFICIAL TRANSCRIPT  
PROCEEDINGS BEFORE  
**THE SUPREME COURT**  
**OF THE**  
**UNITED STATES**

CAPTION: NEBRASKA DEPARTMENT OF REVENUE, Petitioner v.  
JOHN LOEWENSTEIN

CASE NO: 93-823

PLACE: Washington, D.C.

DATE: Tuesday, October 11, 1994

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IN THE SUPREME COURT OF THE UNITED STATES

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NEBRASKA DEPARTMENT OF REVENUE, :  
Petitioner :  
v. : No. 93-823  
JOHN LOEWENSTEIN :  
- - - - - X

Washington, D.C.  
Tuesday, October 11, 1994

The above-captioned matter came on for oral  
argument before the Supreme Court of the United States at  
11:06 a.m.

APPEARANCES:

L. JAY BARTEL, ESQ., Assistant Attorney General of  
Nebraska, Lincoln, Nebraska; on behalf of the  
Petitioner.

TERRY R. WITTLER, ESQ., Lincoln, Nebraska; on behalf of  
the Respondent.

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1 P R O C E E D I N G S

2 (11:06 a.m.)

3 CHIEF JUSTICE REHNQUIST: We'll hear argument  
4 next in Number 93-823, Nebraska Department of Revenue v.  
5 John Loewenstein.

6 Mr. Bartel. Is that the correct pronunciation  
7 of your name?

8 MR. BARTEL: Yes, Your -- Mr. Chief Justice.

9 CHIEF JUSTICE REHNQUIST: Mr. Bartel.

10 ORAL ARGUMENT OF L. JAY BARTEL

11 ON BEHALF OF THE PETITIONER

12 MR. BARTEL: Mr. Chief Justice, and may it  
13 please the Court:

14 Section 3124, title 31 of the United States  
15 Code, prohibits State taxation of Federal obligations and  
16 the interest thereon. This prohibition extends to every  
17 form of State taxation that considers in its computation  
18 Federal obligations or the interest on Federal  
19 obligations.

20 The question presented in this case is whether  
21 Nebraska's taxation of income received by a mutual fund  
22 shareholder derived from repurchase agreements involving  
23 Federal obligations violates section 3124, repurchase  
24 agreements which we believe, in essence, were transactions  
25 that in substance were loans between private parties

1 secured by Federal obligations.

2 The Nebraska supreme court erred in holding that  
3 Nebraska's tax violated section 3124. The computation of  
4 Nebraska's tax did not consider directly or indirectly  
5 either Federal obligations or interest on Federal  
6 obligations. The repurchase agreements entered into by  
7 the mutual funds which distributed income to Respondent  
8 Loewenstein were in essence secured loans in which Federal  
9 obligations merely served as collateral.

10 QUESTION: Could you describe in perhaps a  
11 little detail exactly what a typical agreement like this  
12 was, and why it was entered into?

13 MR. BARTEL: Repurchase agreements are called  
14 repos for short, and they're in essence contracts  
15 involving the simultaneous sale and future repurchase of  
16 an asset, usually Treasury securities. Repos generally  
17 consist of what is a two-part transaction. In step 1, the  
18 party that holds Federal securities, denominated as the  
19 seller, transfers the securities to another party, the  
20 buyer, in exchange for cash. In this case the buyer would  
21 have been the mutual funds.

22 The second step consists of a contemporaneous  
23 agreement by the seller to repurchase the securities at  
24 the original sale price, plus an agreed-upon amount of  
25 interest in a rate specified in the agreement.

1 QUESTION: Not dependent on the rate that the  
2 security pays?

3 MR. BARTEL: That is correct, Mr. Chief Justice.  
4 The interest paid by the seller is paid on prevailing  
5 market rates on loans or financing transactions of similar  
6 maturity and risk. In fact, it was stipulated below that  
7 the interest paid by the seller on repurchase is less than  
8 the interest rate accruing on the underlying obligations.  
9 That was in the second stipulation, paragraph 19.

10 QUESTION: But you could say the same thing  
11 about the normal sale of Treasury bonds, couldn't you? If  
12 you sell a bond that has a certain maturity price, and if,  
13 in fact, rates for other obligations have gone up, the  
14 money you get won't depend upon the face interest on the  
15 Government obligation. It will depend upon what the  
16 market is at the time, won't it?

17 MR. BARTEL: That is true. Yes, that's correct,  
18 Your Honor.

19 QUESTION: And yet that transaction, you  
20 acknowledge, is exempt from taxation, is it not?

21 MR. BARTEL: Yes. The distinction here, Your  
22 Honor, is that the way the repurchase agreement is  
23 structured, that the funds in essence are never, the owner  
24 is entitled to the Federal exemption. What they receive  
25 is interest at a rate agreed to between private parties

1 that really doesn't bear a relation to the interest rate,  
2 and more importantly --

3 QUESTION: Yes, but I'm -- that factor is  
4 irrelevant, once you acknowledge that in just a straight  
5 sale of a Treasury bond, it -- the amount you pay for it  
6 has nothing to do with the interest rate on the face of  
7 the bond. It has to do with what the going market is, so  
8 I don't see how that's a point for you at all, the fact  
9 that the interest rate depends on market rate.

10 MR. BARTEL: It is in purposes of the overall  
11 analyzation, I think, of the nature of the agreements,  
12 because what we are contending, again, is that the real  
13 substance, the true substance of the agreements is that  
14 the mutual funds were not the true owners or substantive  
15 owners of the underlying obligations.

16 QUESTION: Well, what kind of unforeseen  
17 consequences would result from our characterization of  
18 this as a loan? If there is a bankruptcy by the entity  
19 that is acquiring the bonds temporarily, then if it's the  
20 owner there would be one consequence, if it was a loan  
21 there would be another. What about treating the thing as  
22 a loan for purposes of SEC regulation of the sales?

23 I mean, I'm concerned that calling it something  
24 here may have some unforeseen consequences.

25 MR. BARTEL: We are not asking the Court to



1 adopt a secured loan characterization of all repos for all  
2 purposes. With respect to your concern with respect to  
3 the treatment of the purchase agreements in bankruptcy,  
4 Congress has in large part, of course, dealt with that  
5 concern by an amendment to the Bankruptcy Code. There may  
6 be purposes for securities law transactions to be viewed  
7 again as differently.

8 It's pointed out in the amicus briefs filed by  
9 the Investment Company Institute and the Federal Reserve  
10 Bank of New York that not all repos are identical to the  
11 precise transactions involved in this case.

12 QUESTION: Are there other instances where  
13 something is characterized one way for bankruptcy  
14 purposes, yet another way for security purposes, yet  
15 another way for tax purposes? Is that -- is it  
16 extraordinary to have a different characterization for tax  
17 purposes than for other purposes?

18 MR. BARTEL: I would not think so, although I  
19 don't have any ready examples.

20 I think the mere fact that when you look at  
21 repos themselves and that there has been a division of the  
22 characterization and treatment, depending upon the purpose  
23 served, even the bankruptcy decisions, the Bevill case,  
24 that discuss the characterization of repos for tax  
25 purposes recognize that there may be different reasons why

1 a rule or a principle of construction should be adopted  
2 for tax purposes that is different than the concerns in a  
3 bankruptcy context.

4 And that, in essence, is why we think that the  
5 economic substance principle, which has been recognized by  
6 Federal courts, construing the exemption of repurchase  
7 agreements involving cases construing section 103 of the  
8 Internal Revenue Code, which deals with the exemption of  
9 interest on State and local obligations, and State court  
10 cases that have also relied on the economic substance  
11 analysis to look at --

12 QUESTION: In the respondent's brief, the red  
13 brief at about page -- it's at page 26 -- he sets forth a  
14 hypothetical transaction where a \$10,000 Treasury bill is  
15 due in 360 days, and he has a series of hypotheticals, and  
16 the first one, of course, is if the taxpayer just holds it  
17 for 360 days, and he paid \$9,500 for it, he redeems it for  
18 \$10,000, there's then \$500 worth of interest, and all of  
19 that is covered by the exemption. Everybody agrees with  
20 that.

21 Do you agree with his second example -- I take  
22 it you do -- that if the bill is sold, just as an outright  
23 sale, no repo agreement, just an outright sale, 180 days  
24 down the road, that the exemption of \$500 is given \$250 to  
25 each holder?

1 MR. BARTEL: It appears in the hypothetical that  
2 what he's dealing with is a short-term Treasury bill that  
3 may be an obligation issued with discount. That, to the  
4 extent that I believe that is the nature of the  
5 hypothetical, that is correct, but we don't --

6 QUESTION: So that it's correct that if I own a  
7 bill for 180 days, a 360-day bill, and I then transfer it  
8 to a second holder, we each split the exemption?

9 MR. BARTEL: I believe under the OID rules under  
10 the Federal Income Tax Code there would be -- if you are  
11 the actual holder and there is a transfer in substantive  
12 owner, then that holder who is a substantive owner is  
13 required to report that portion as income, that's correct.

14 QUESTION: Well, and they each get the exemption  
15 under Nebraska law, don't they?

16 MR. BARTEL: Yes, that's correct.

17 QUESTION: All right. Now, when we get to the  
18 repo transaction, do you agree with the characterization  
19 he gives of how the repo transaction works?

20 MR. BARTEL: No, we do not, Your Honor, because  
21 we believe it, again as we explain in our brief, fails to  
22 take into account the fact that the funds do not receive  
23 exempt interest from the Federal Government.

24 QUESTION: Under Nebraska law under your theory,  
25 if you prevail, will the full \$500 of exemption be

1 accorded to someone in this transaction?

2 MR. BARTEL: We believe that it is accorded to  
3 someone in the transaction. It is accorded to the seller-  
4 borrower-repurchaser. They are the substantive owner of  
5 the obligations, and they're the ones who maintain the  
6 entitlement to the exemption.

7 Now, what respondent seems to be saying is that  
8 the fact that most States have a statute which disallows  
9 deduction for interest expense incurred to carrier hold  
10 the Federal obligation. Now, the seller-borrower may be  
11 required to make application of such a statute if it pays  
12 interest, to hold or acquire that Federal obligation.

13 QUESTION: -- Nebraska requires the add-back?

14 MR. BARTEL: Yes, most States do, that's  
15 correct. In fact, I think all States do according to  
16 amicus Investment Company Institute.

17 QUESTION: Well, under Nebraska law in the repo  
18 transaction, would the original holder who is the seller-  
19 borrower receive under this hypothetical a \$500 exemption?

20 MR. BARTEL: Well, the effect of the add-back  
21 provision could be to reduce the economic benefit. They  
22 would still receive a \$500 exemption, but there may be a  
23 requirement to add back, but we don't believe that that is  
24 an impairment or a violation of section 3121.

25 QUESTION: But it does bring up the question

1 that if you're wrong about 3124 and what it requires, it  
2 may not follow that Loewenstein or the mutual fund is the  
3 person Nebraska would look at to make the cure? What  
4 about just not allowing -- not requiring the add-back?

5 MR. BARTEL: That would be an application to the  
6 dealer. It would not be an application --

7 QUESTION: Yes. If the argument is that what  
8 3124 requires is that every dollar of interest be fully  
9 reflected, I suppose Nebraska could do that two ways. One  
10 way would be to say, Loewenstein gets the benefit.  
11 Another way would be to say this person, whatever we  
12 call -- the repoer, some briefs have called it, doesn't  
13 have to add back the expense of the financing.

14 MR. BARTEL: It's our position, of course, that  
15 section 3124 doesn't require that result, and we would  
16 rely on the Court's decision on First National Bank of  
17 Atlanta v. Bartow County.

18 QUESTION: But would you pick one or the --  
19 would you be -- do you know which one Nebraska would pick  
20 if it were required to make that decision?

21 MR. BARTEL: No, I do not.

22 QUESTION: That's the key question to me, I  
23 mean, these two questions that Justice Kennedy brought up  
24 and this. I don't understand this statute, Nebraska 77-  
25 2716(e), which is the add-back.

1           Now, in order to make this clear, I have to take  
2 a second, and I want to use a slightly more realistic  
3 example. I mean, you've been arguing is it really a  
4 collateralized loan, or is it really a sale? Well, it has  
5 some characteristics of each. Is a nectarine really a  
6 plum? Is it really a pear? Is it really an -- I mean,  
7 it's some of each, or whatever.

8           All right. Suppose you start there and say,  
9 that doesn't solve it. But what might solve it is that  
10 the Government, when it issues the bill at an original  
11 issue discount, it's easy to figure out what the interest  
12 of that is. The IRS does it all the time, and then you  
13 allocate it day-by-day, and just say the State can't tax  
14 that. Is that right, and if that is right, how does this  
15 statute fit into it?

16           I mean, let me give you -- suppose that the  
17 repoer has \$1 million of Treasuries, 90-day bills. Let's  
18 say they pay \$15,000 of interest at 6 percent for 90 days,  
19 and suppose what he does is he repos it out to the Ford  
20 Motor Company for 1 day, which my calculation says is  
21 worth about \$167 in interest. That T-bill interest goes  
22 right to the repoer.

23           Now, what the repoer has got is, he's got  
24 \$1 million in cash for a day, and he's had to pay, say,  
25 \$150 for it. Does this Nebraska statute mean on his tax

1 return he puts in \$167 of tax-free interest, and then  
2 reduces that by \$150? To me, that's an odd reading of the  
3 statute, because I would say the \$150 is not an expense of  
4 this repo transaction. Rather, it's an expense related to  
5 whatever transaction he will engage in with the \$1 million  
6 cash that he's got.

7 He might, for example, take in -- I guess that's  
8 called a reverse. He takes in \$1 million of Treasuries  
9 from Solomon Brothers, and what he hopes to do is charge  
10 them \$152 for that 1-day's use of the million, so he's got  
11 \$152, subtracts the \$152, and it's \$2. That's how I'd  
12 read that statute of Nebraska.

13 But they've said, your opponents, that isn't how  
14 it's read, the \$150 is allocated to the \$167, and now I  
15 want to know from you, is it, or isn't it?

16 Have you followed -- have you followed it all  
17 right? I'm sorry to be so -- but you see what I'm saying?  
18 I'm saying that the payment to Ford, the payment to Ford  
19 from the repoer, is a payment for the \$1 million in cash  
20 that the repoer got. It shouldn't be allocated to the  
21 \$167 interest on those Treasury bills that are in the  
22 hands of Ford for the day. It should be allocated to  
23 whatever income that million dollars is used in the hands  
24 of the repoer to generate.

25 Is that the right reading of the statute? If it

1 is, you are only taxing the -- you're not -- you're  
2 leaving the whole 10 percent, or whatever it is, free of  
3 tax. If it isn't, you're taxing some of it. If it's too  
4 complicated to follow, forget it. I'm sorry. I'll have  
5 to find out the answer.

6 The question is, I want to know how this  
7 particular statute works, (e).

8 MR. BARTEL: We attempted to respond in our  
9 brief with a response to their example. I hope that's --  
10 that's adequate.

11 QUESTION: Is part of your response that in  
12 respect to how you treat that deal, you treat it just the  
13 way the Feds treat municipal and State bonds with respect  
14 to the add-back of the expense?

15 MR. BARTEL: In our view, the Nebraska statute  
16 is the counterpart to Internal Revenue Code section 265,  
17 which denies interest expense deduction incurred to carry  
18 State and local obligations, that's correct.

19 QUESTION: I thought that that's what the system  
20 was. It's exactly tracking what the Feds do.

21 But how do you treat State and municipal bonds,  
22 the same way?

23 MR. BARTEL: In repo transactions?

24 QUESTION: Yes.

25 MR. BARTEL: The Nebraska statute only exempts



1 from State taxation interest earned from ownership of  
2 Nebraska-based obligations. It does not, on its face,  
3 exempt repo interest attributable to transactions  
4 involving Nebraska-based obligations, so it's our position  
5 in Nebraska, consistent with our taxation of repo income  
6 involving Federal obligations, that that, too, would be  
7 subject to Nebraska income tax. There is no  
8 discrimination, contrary to the argument that respondent  
9 has made.

10 QUESTION: So you're saying the treatment is the  
11 same.

12 MR. BARTEL: Yes.

13 QUESTION: Mr. Bartel, I have a problem with  
14 your urging us to look at the economic reality of the  
15 transaction. I mean, there are various levels of economic  
16 reality, I suppose. Certainly one reality is that as a  
17 result of this transaction the buyer owns the Treasury  
18 bills for, you know, for the period, and that is real.  
19 The buyer really owns them, right? Is not the buyer the  
20 owner during that period?

21 MR. BARTEL: We would take the position that  
22 it's ownership only in the most nominal sense, bare legal  
23 title, if you will. All the true indicia of ownership we  
24 don't believe go to the buyer.

25 If you look at the general repurchase agreement

1 in this case --

2 QUESTION: Yes, well, you're raising exactly my  
3 point. We want to talk about this case. We're going to  
4 have to examine these repo agreements one by one to  
5 determine what -- you know, what the economic reality of  
6 this particular repurchase agreement is. Why isn't it  
7 much simpler, for purposes of the administration of the  
8 Federal tax law, to say whoever owns them gets the  
9 deduction, period, work it out?

10 MR. BARTEL: The Internal Revenue Code has by  
11 ruling adopted various criteria, or it looks at  
12 characteristics that can -- are used to determine whether  
13 secured loan characterization is appropriate to repurchase  
14 agreements involving State and local obligations. Those  
15 are referred to in our brief.

16 Economic substance is important, because we are  
17 dealing with a tax matter, and that is the general  
18 principle that's been long recognized.

19 In the context here, we think analyzing economic  
20 substance as a standard is appropriate. Now, that may  
21 lead to different results if you have different  
22 characteristics in other repos, but we're dealing here  
23 with a specific type of repo engaged in by the mutual  
24 funds. We think the Court can accept the economic  
25 substance principle, lay the ground rules, and that will

1 allow parties to --

2 QUESTION: Lay the ground rules such as what,  
3 such as whether the agreement, as in this case, does not  
4 give full indicia of ownership?

5 MR. BARTEL: Yes.

6 QUESTION: Each case is a different inquiry.

7 MR. BARTEL: But if parties outside --

8 QUESTION: It's going to be a very narrow  
9 decision you're asking us to write, this just in the  
10 circumstances of this particular repo agreement.

11 MR. BARTEL: Because of the fact that repos can  
12 differ so much in nature, I think we'd be hard-pressed to  
13 ask for anything else.

14 QUESTION: To what extent does Nebraska copy, or  
15 is it guided by, how the Federal authorities treat repo  
16 arrangements? Do you look at these individual -- these  
17 different deals on your own, or is there some attempt at  
18 conformity?

19 MR. BARTEL: The revenue ruling at issue simply  
20 spoke in terms of repos being deemed secured lendings. It  
21 did not establish specific criteria for repos themselves.  
22 What rule may be adopted as a result of a decision would  
23 obviously depend on that decision.

24 QUESTION: Is there any interstate cooperation,  
25 since many States are your friends in this matter?

1           MR. BARTEL: In terms of the treatment, it seems  
2 that most States tax this income. That's the general  
3 consensus you derive from looking at the brief of the  
4 amicus State and Local Legal Center, as well as Investment  
5 Company Institute.

6           As to how they do it, whether it's by judicial  
7 decision, whether they do it by administrative ruling,  
8 there is even some inconsistency with some States saying  
9 that they can tax all dividends from mutual fund  
10 shareholders. We haven't attempted to do that. We're  
11 only looking at that portion which is derived from  
12 repurchase agreements.

13           So I don't know that other States have adopted  
14 exactly the same test, but I think they're all urging the  
15 Court, the amicus States, to look at economic substance as  
16 the test to be applied.

17           QUESTION: Very bravely I'm going to try this  
18 again, since I'm thinking that it seems quite important in  
19 my mind as to how the case comes out.

20           The repoer receives the interest on the Treasury  
21 bill while the bills are repoed, is that right?

22           MR. BARTEL: That is correct.

23           QUESTION: The repoer pays some money to the  
24 holder of those bills. That's right?

25           MR. BARTEL: That is correct.

1 QUESTION: And you're saying the money he pays  
2 is his own payment of interest. It's an expense.

3 MR. BARTEL: That is correct.

4 QUESTION: When Nebraska then gets its tax  
5 return, you say -- suppose it was \$5,000 in interest. He  
6 would say \$5,000 in interest was tax-free. That's what  
7 he'd put at the top.

8 MR. BARTEL: Yes.

9 QUESTION: Then he has to -- he then looks at  
10 the statute and says, but I paid \$4,000. I paid \$4,000 to  
11 the holder of the bills when they were repoed. Does he  
12 have to, in effect, subtract the \$4,000 from the \$5,000 so  
13 he only has \$1,000, or does he not?

14 MR. BARTEL: Again, based on my understanding of  
15 the statute, that would be the application, assuming it  
16 was a Nebraska --

17 QUESTION: So the answer to my question is yes,  
18 he does have to subtract the \$4,000 from the \$5,000, as  
19 you read the Nebraska statute.

20 MR. BARTEL: Yes.

21 QUESTION: And we should assume that's so for  
22 purposes of deciding this case?

23 MR. BARTEL: I don't know that I can say that, I  
24 guess, but I'm -- my understanding --

25 QUESTION: Well, it's important because if the

1 answer is yes, which is the answer you've given, that  
2 diminishes the exemption, doesn't it?

3 MR. BARTEL: No more so than does any State  
4 statute which has an add-back like Nebraska's if this were  
5 a direct borrowing to obtain the obligation.

6 In other words, that would require a reading of  
7 section 3124 that we think is well beyond what is -- is  
8 required by First National Bank of Atlanta. The pro rata  
9 deduction --

10 QUESTION: The question is not whether it's  
11 legal to diminish it. The question is, does it diminish  
12 it, and the answer is --

13 MR. BARTEL: Only in an economic sense, is my  
14 answer to that, and it's not constitutionally required,  
15 and the statute doesn't require that the exemption be  
16 handled any differently.

17 QUESTION: What you are saying is you are  
18 essentially treating this like a secured loan? The  
19 parties are concerned that you're treating this as though  
20 it were a borrowing to finance the purchase of these  
21 bills.

22 MR. BARTEL: Yes. That is in substance what it  
23 is. That's how it's --

24 QUESTION: It would seem to me that the economic  
25 sense of it is that if the person who has the cash derived

1 from the collateralized loan, if that's what you want to  
2 call it, uses that cash to earn money from, say, a General  
3 Motors instrument, or something like that, that that is  
4 outside nonexempt income, and that the cost of that is  
5 outside expenses that are offset against the outside  
6 income, but it doesn't seem to me that your statute does  
7 that.

8 MR. BARTEL: Well --

9 QUESTION: And if that is so, then it seems to  
10 me that the respondents may have a point.

11 MR. BARTEL: The key, though, is if you look at  
12 the exemption statute itself, what is a State precluded  
13 from doing? It may not tax -- impose a tax on a Federal  
14 obligation, or interest on a Federal obligation, that  
15 considers that in its computation. Our --

16 QUESTION: Yes, but you're asking us to  
17 recharacterize the transaction that the parties have --  
18 have engaged in here in an economic sense, so we are  
19 simply asking you in an economic sense whether or not the  
20 full exemption is being accorded to one or both of the  
21 parties under your accounting system, and it seems to me  
22 that you're saying well, maybe not.

23 MR. BARTEL: In an economic --

24 QUESTION: And that, it seems to me, bears upon  
25 the wisdom or the prudence of our allowing you to

1 recharacterize the transaction in the way that you seek to  
2 do.

3 MR. BARTEL: Even if the transaction were  
4 characterized as a sale and repurchase, if the funds were  
5 the actual owner, then that raises another question. Then  
6 is not, if they are the owner and they are reselling the  
7 obligation, wouldn't that in essence be gain on sale,  
8 which the States have, I think, the authority to tax a  
9 gain on sale of a Federal obligation.

10 So if they are -- it's clear from the agreements  
11 that what they're bargaining for is not the interest from  
12 the Federal Government, and if it is a real sale, then in  
13 actuality what they are getting is gain on sale of that  
14 Federal obligation.

15 If there are no further questions, I would like  
16 to reserve any remaining time for rebuttal.

17 QUESTION: Very well, Mr. Bartel.

18 Mr. Wittler, we'll hear from you.

19 ORAL ARGUMENT OF TERRY R. WITTLER

20 ON BEHALF OF THE RESPONDENT

21 MR. WITTLER: Mr. Chief Justice, may it please  
22 the Court:

23 Since 1862, Federal obligations have been, by  
24 statute, exempt from taxation by the States. Nebraska  
25 statutes begin by recognizing this exemption by providing



1 a deduction from a Federal adjusted gross income.

2           However, the Nebraska Department of Revenue has  
3 adopted an administrative ruling that essentially takes  
4 away that exemption in the case of repurchase agreements.  
5 That revenue ruling violates the applicable Federal  
6 statute and the Supremacy Clause, and the Nebraska supreme  
7 court reached the correct ruling when it invalidated that  
8 revenue ruling.

9           The results -- to reach that result, the Revenue  
10 Department says that you should disregard the way in which  
11 the parties structure their transaction and restructure it  
12 to fit their interpretation. The Revenue Department's  
13 ruling does not comply with this Court's decision in Frank  
14 Lyons, which sets out basically a three-part test for  
15 determining whether or not the structure the parties have  
16 chosen should be respected.

17           First of all, that case requires that it be a  
18 genuine multiparty transaction with economic substance,  
19 secondly, the form of the transaction must be based on  
20 business and economic realities, and thirdly, it must be  
21 based on tax-independent considerations. It may not have  
22 been structured that way solely to avoid tax.

23           The transactions in this situation, these  
24 repurchase agreements, meet each of those three test under  
25 Frank Lyons, and accordingly the Government should be

1 required to respect the form in which the parties have  
2 chosen to structure their transaction.

3 QUESTION: Well, do you think the Frank Lyon  
4 opinion, Mr. Wittler, was intended as the be-all and end-  
5 all for what anybody might do with respect to  
6 restructuring a tax transaction to show the economic  
7 reality of it?

8 MR. WITTLER: No, Mr. Chief Justice, I do not  
9 think that Frank Lyon was the be-all and end-all. I  
10 think, though, that any -- the form that you choose is not  
11 determinative in this case.

12 The way in which you read Frank Lyon, or the way  
13 in which you might adjust the holding of Frank Lyon is  
14 really not determinative, because the State's position is,  
15 we don't look at any of those aspects. We look solely at  
16 the so-called economic substance, and that's the only test  
17 we apply, and we apply it as we see fit, and we reach the  
18 result that we choose.

19 QUESTION: Well, do you agree that the  
20 estimation of the economic substance in this case is a  
21 correct one?

22 MR. WITTLER: Yes, Your Honor, but I think that  
23 begs the question, and let me explain why.

24 Economics strives to be value-free. It tries to  
25 be value-neutral. The law, on the other hand, is value-

1 driven, it's value-laden, and let me give you some  
2 examples of why I think that begs the question.

3 If I have a widget factory, and I hire 12-year-  
4 old children, or I hire adults, to an economist, he or she  
5 would say, the economic substance of those two  
6 transactions is the same. But the law says no, a very  
7 different result comes about.

8 If I hire a salesperson to sell my widgets, and  
9 I pay him or her commission, the law says it's deductible.  
10 If I pay a bribe to someone to purchase my widgets, the  
11 law says that's unlawful. An economist says those two  
12 payments are exactly the same for economic substance. The  
13 law says, we don't care, we treat them dramatically  
14 different.

15 If I borrow \$100,000 for a vacation home, my  
16 interest is tax-deductible. If I borrow \$100,000, buy an  
17 RV to go to exactly the same place for a vacation, it's  
18 not tax-deductible.

19 That's why -- that's the basic fallacy of the  
20 State's approach, is to look solely at economic substance.

21 QUESTION: Well, I'm not sure it is, because if  
22 one or the other theories, and I'm not sure which one it  
23 is, operates to deprive securities of their economic-  
24 exempt status, then the purpose of the statute -- then the  
25 purpose of the statute is contravened, and we interpret

1 the law according to the purpose of the statute.

2 So we do begin by asking what is the economic  
3 effect on the market for Federal securities, on the grant  
4 or the denial of the full exemption to which the  
5 securities are entitled, and we're asking that, and it  
6 seems to me the structure of the transaction has a great  
7 deal to do with that.

8 MR. WITTLER: It does, Your Honor, but that --  
9 and that structure is chosen by the parties for reasons  
10 independent of the tax considerations, and I think we  
11 mentioned in our brief that a significant part of this  
12 market, participants in this market, are municipalities,  
13 school districts, agencies that pay no tax. They enter  
14 into repurchase agreements not for tax reasons, but  
15 because of business and regulatory concerns that they have  
16 to meet.

17 And I want to go back just one moment to what I  
18 feel is the basic fallacy of the economic analysis. If I  
19 loan \$10,000 to General Motors, and I loan \$10,000 to the  
20 United States Treasury, the economic substance of those  
21 two transactions is identical.

22 But Congress has said the \$500 that I earn on  
23 one is fully taxable, and the \$500 on the other is not  
24 taxable by the State, and that's what we're here to talk  
25 about.

1           QUESTION: How do you distinguish the situation  
2 of the municipal bond and the Federal taxation? Municipal  
3 bonds are also exempt, but if we were talking about  
4 municipal bonds and the taxing authority is the Federal  
5 Government, then I believe that the position of the  
6 Government is that the interest -- that the interest to  
7 the reserver would be taxable.

8           But you say -- so explain -- the same kinds of  
9 transactions, but on the one hand T-bills and the State  
10 taxing authority, and the other hand, municipal bonds and  
11 the Federal taxing authority.

12           MR. WITTLER: Justice --

13           QUESTION: Why can't Nebraska say, we want to do  
14 the same thing that the Feds are doing?

15           MR. WITTLER: Because Nebraska doesn't have a  
16 Supremacy Clause, and the U.S. Congress does, and in the  
17 recent case involving South Carolina v. Baker, this Court  
18 held that the exemption of municipal bonds interest is  
19 statutorily based. It's granted by Congress. It has no  
20 constitutional features.

21           QUESTION: Oh, so you're resting not just --  
22 it's not just what 3124 means, but you're saying the  
23 Constitution requires that, so even if Congress was  
24 explicit in 3124, and says, and we don't mean that the  
25 interest paid to the reverser is not income, that would be

1 unconstitutional?

2 MR. WITTLER: That's not what I mean to say,  
3 Your Honor. If Congress -- if 3124 was repealed tomorrow,  
4 we'd still have a problem with the Nebraska approach,  
5 because it singles out Federal obligations and doesn't  
6 mention State obligations, so it discriminates.

7 But no, our basic position is it's based on the  
8 statute.

9 QUESTION: So you're rejecting what we were just  
10 told, that -- we were just told that Nebraska treat State,  
11 its obligations the same way, and you're saying it  
12 doesn't?

13 MR. WITTLER: I disagree with that, Your Honor.  
14 There is nothing in the record, number 1, to answer that  
15 question. I don't know for a fact how they treat them.

16 What I know is that the Department of Revenue  
17 apparently thought it necessary to adopt this regulation  
18 to reach Federal repo income, and it has not seen fit to  
19 adopt a similar regulation to allow it to meet State of  
20 Nebraska repo income, so all I know is that there's a  
21 ruling that addresses Federal, none that addresses State,  
22 and I believe under those circumstances it discriminates.

23 QUESTION: There has been, so far as I know, no  
24 voice from the U.S. side, the Treasury side, in all of  
25 this, and you are not exactly in the position of McCulloch

1 in this case.

2 With all the friends that are appearing, is  
3 there any reason why we have not had any position for the  
4 United States? If the idea is that 3124 means that you  
5 can't have this add-back for the -- why have we heard  
6 nothing but silence from the Federal Government?

7 MR. WITTLER: I can give you a theory, Your  
8 Honor. The United States may have an interest on the one  
9 hand in seeing that the exemption is preserved, because  
10 that reduces costs, borrowing costs to the Treasury, in  
11 which case they would side with us, and there may be  
12 persons within the United States who are concerned about  
13 maintaining the validity of union planners in that line of  
14 cases and going after revenue arising from municipal bonds  
15 who would be, their interest being with the Nebraska,  
16 State of Nebraska.

17 QUESTION: Could a third possibility be that  
18 under either theory the full exemption is allowed and  
19 therefore the market is unaffected?

20 MR. WITTLER: I don't believe so, Your Honor. I  
21 think that the way Nebraska has structured its approach,  
22 which is a very curious way to do it, it starts with the  
23 Federal -- your Federal adjusted gross income, which  
24 includes revenue from the United States, because it's  
25 taxable at the Federal level.

1                   And then it says, okay, now you can back out  
2 your interest on Federal obligations, unless you borrowed  
3 some money to help hold those obligations. If you  
4 borrowed some money from General Motors or from anybody  
5 else, you don't get to back it all out, you just get to  
6 back out the part that is offset by a deduction, and  
7 that's where we lose the parity with the Federal approach,  
8 because the Federal approach --

9                   QUESTION: But that seems to me quite a  
10 plausible theory if they deprive you of any of the  
11 exemption, because then it works out, and that's the  
12 problem I have with your footnote at page 29. It seems to  
13 me that you're comparing apples and oranges, or nectarines  
14 and peaches, whatever we're using here today.

15                   (Laughter.)

16                   MR. WITTLER: No, Your Honor, I don't believe I  
17 am, because the statute says, their position is, even  
18 though I've loaned -- I've sold these to somebody else, I  
19 really own them. If I really own them, I must -- but yet  
20 I'm paying interest to somebody, I must be paying that  
21 interest to carry the obligations.

22                   In other words, I own the obligations. I'm  
23 carrying them, even though I've loaned them out, and that  
24 is what 2716(1)(e) says. If you've paid that interest to  
25 carry those obligations, we're going to take away your



1 Federal exemption, we're going to narrow it down, chew it  
2 down, and that's where the loss comes in.

3 QUESTION: Well, if you disregard Nebraska's  
4 add-back to the borrower's interest expense deduction,  
5 does the borrower otherwise get the full benefit?

6 MR. WITTLER: Yes. If you disregard the statute  
7 that says you don't get the full benefit, you do get the  
8 full benefit, that's absolutely true, and the reasons go  
9 back to an earlier question --

10 QUESTION: Then why should Loewenstein or the  
11 mutual funds prevail in any event? Why isn't the flaw, if  
12 there be a flaw, that the add-back -- if -- your theory  
13 about what 3124 requires doesn't mean that Loewenstein has  
14 to be the one to get the tax benefit. It could be the  
15 repoer by not charging him with the add-back.

16 MR. WITTLER: I agree that at a Federal level,  
17 in terms of the statutory scheme, you're right, and as  
18 long as somebody gets it, the statute's complied with.

19 The problem, and the reason why you have to be  
20 careful how you draft a statute to achieve that result,  
21 goes back to this Court's holding in Denman v. Slayton  
22 back in 1930.

23 If you allow people to simply pass the  
24 obligation back and forth by borrowing to buy exempt  
25 obligations, then you face a situation where I've got

1 \$10,000 in salary income, and I decide I'm going to go out  
2 to my local bond dealer, borrow \$10,000 worth of  
3 securities, or borrow \$100,000 worth of securities, pay  
4 them \$10,000 in interest, receive \$10,000 from the  
5 Government, offset the two, bingo, I pay no tax. Not only  
6 do I not pay tax on the interest-free income, but I've got  
7 a nice deduction for interest that I can offset against my  
8 salary, and I wash my hands. I pay no interest.

9 That's why the scheme of 265 was developed, and  
10 that's why you've got to have an offset one place and add  
11 back another. It makes a difference from a tax equity  
12 point of view.

13 QUESTION: You know, Mr. Wittler, it seems to me  
14 that we dealt with an aspect of this argument in the  
15 Bartow County Board of Tax Assessors case, where the Court  
16 said that the tax exemption required by the Constitution  
17 and section 3124 is not a tax shelter, and Federal  
18 obligations may be acquired in part by liabilities, and  
19 when they are, a pro rata method of allocating a fair  
20 share to the liabilities doesn't infringe on the immunity.

21 And it seems to me your argument runs somewhat  
22 counter to what the Court said in Bartow --

23 MR. WITTLER: Justice --

24 QUESTION: -- that you don't have to have out  
25 there somewhere the full exemption, that if there -- if

1 you borrow money, and you have to offset the cost of that  
2 to engage in the purchase of the Federal obligations, you  
3 lose some of the exemption. I thought that's what this  
4 Court said.

5 MR. WITTLER: Bartow County dealt with a net  
6 worth tax, and a net worth, the net worth is an  
7 abstraction. It's not a tax of your assets. It's not a  
8 tax against your liabilities.

9 What the taxpayer wanted to do in Bartow County  
10 was say, I've got these nontaxable assets, I've got these  
11 liabilities, they cancel each other out, and what I have  
12 left is tax exempt. What the taxing authority wanted to  
13 do was just reverse it and say, no, we're going to offset  
14 your liabilities against your exempt obligations, and  
15 everything you've got that's left is fully taxable, and  
16 the compromise was, realistically, was to say no, we have  
17 to offset them. We have to have them be pro rata, and the  
18 tax exempt can bear their fair share of the burden.

19 Here, the State is saying no, not only are you  
20 not going to get a double benefit, you're not going to get  
21 any benefit. We're going to treat you just like if you'd  
22 gone out and bought a fully taxable obligation for General  
23 Motors or anybody else.

24 That's realistically the only reason that the  
25 State Department of Revenue adopts a ruling like this, is

1 to earn some money for the State, and if you run through  
2 the arithmetic, they will increase their revenues by  
3 exactly the amount of repurchase revenue they recapture,  
4 and to take my example of the total of \$500 in interest  
5 that the Federal Treasury writes a check for, it slowly  
6 disappears, the more and more people down the road who  
7 have repurchase obligations, and that's why it's basically  
8 a violation of the statutes.

9 QUESTION: That's -- I want to go back, if I  
10 can, to Justice Kennedy's -- it's the same question I  
11 think many of us have. It starts with your footnote, and  
12 it -- I'm thinking of the \$1 million in Treasury bills.  
13 Say they issue for \$985,000, as there's \$15,000 you might  
14 call an original issue discount. That's the interest.

15 And suppose you start with the proposition that  
16 that \$15,000 is the amount the State shouldn't tax --

17 MR. WITTLER: Right.

18 QUESTION: -- forgetting how you characterize  
19 it. They can have any kind of system they want, within  
20 limits, as long as they don't get at that \$15,000.

21 Now, you've continuously said, and you do that  
22 in your footnote, that it's that statute we've been  
23 talking about that requires an add-back of some kind. You  
24 know what I'm thinking.

25 MR. WITTLER: Yes, I do.

1 QUESTION: But as I read that statute, it  
2 doesn't. As I read that statute, it only requires an add  
3 back of costs incurred to carry the bonds.

4 MR. WITTLER: That's right.

5 QUESTION: Well, you're not carrying the bonds  
6 when you've repoed the bonds out to General Motors.  
7 General Motors is carrying the bonds. Rather, you've got  
8 \$1 million --

9 MR. WITTLER: I agree --

10 QUESTION: -- and you're going to use -- you've  
11 got \$1 million because they have your bonds for a day and  
12 you have their million for the day, and so the money that  
13 you're paying to General Motors for the 1-day's loan of  
14 the Treasury bills, so you get the million, is not a cost  
15 of the Treasury's bills. It's a cost of whatever income  
16 you use that million in your hands to get.

17 So that's why I read the statute, as I read it  
18 according to its language, as not infringing on the  
19 \$15,000, but I have to admit you've told me it infringes  
20 on the \$15,000, and they seem to concede the point, and  
21 there doesn't seem to be a finding by the Nebraska supreme  
22 court on the matter, and therefore I don't know what to  
23 do.

24 \ That's my question.

25 (Laughter.)

1 MR. WITTLER: Well, you can affirm the Nebraska  
2 supreme court. But --

3 QUESTION: Thank you.

4 (Laughter.)

5 MR. WITTLER: Your Honor, if you adopt their  
6 position that we --

7 QUESTION: No, I'm -- what I'm interested in is  
8 that narrow statute that talks about adding back the  
9 expenses of carrying the Treasury bills. If I take it  
10 literally -- I don't want to just repeat myself, but if I  
11 take it literally, you wouldn't add it back, because it  
12 isn't a cost of carrying the Treasury bills, which during  
13 the repo are in the hands of the person to whom you have  
14 repoed them. Rather, it is a cost of whatever income you  
15 use the money you "borrowed" to earn.

16 MR. WITTLER: But Your Honor, this language --

17 QUESTION: So you wouldn't add it back.

18 MR. WITTLER: -- tracks section 265, and there  
19 is extensive litigation history about how you decide  
20 whether you add it back in or not, and the cases  
21 consistently take the position that with repos you add it  
22 back in.

23 QUESTION: All right. Then you're right. If  
24 that's what happens, you add it back in, and if in fact  
25 you had a 90-day bill, and what you did was, you gave it

1 to 90 different people for a day, you would discover there  
2 was virtually no interest that wasn't taxed.

3 MR. WITTLER: That's right.

4 QUESTION: That's what your point is.

5 MR. WITTLER: That's our position.

6 QUESTION: Yes. All right, got it.

7 QUESTION: But then this entire case, this  
8 entire controversy comes up because -- because of the  
9 requirement of the add-back. In other words, if Nebraska  
10 didn't have that requirement, you would have no case,  
11 Loewenstein would have no case, is that right? Nevada --

12

13 MR. WITTLER: No, Your Honor. The -- it's a  
14 two-step add-back. We start at the Federal level, where  
15 the income is included, because Federal law says --

16 QUESTION: Let's just --

17 MR. WITTLER: Yes.

18 QUESTION: -- focus on this part about the add-  
19 back that the repoer has to do under Nebraska law. If  
20 Nebraska didn't require that, you'd have no case, is that  
21 correct?

22 MR. WITTLER: Well, I'd have no case, but I'd  
23 also owe no tax. I would have gotten an exemption.

24 QUESTION: How would you have gotten the  
25 exemption? Isn't it -- if Nebraska -- you, I thought, are

1 arguing for Loewenstein --

2 MR. WITTLER: Yes, ma'am.

3 QUESTION: -- not the repoer.

4 MR. WITTLER: That's right.

5 QUESTION: Okay. The repoer doesn't get all the  
6 interest, and doesn't have to add back any -- any  
7 offsetting cost of borrowing for whatever the borrowing is  
8 for --

9 MR. WITTLER: All right. I'm sorry.

10 QUESTION: -- so every dollar is accounted for,  
11 but the repoer gets it all.

12 MR. WITTLER: Right.

13 QUESTION: And the reverser gets interest  
14 income.

15 MR. WITTLER: Right.

16 QUESTION: If that's the position that Nebraska  
17 took, there would be no argument under 3124, and  
18 Loewenstein would lose, is that --

19 MR. WITTLER: That's right, but Loewenstein  
20 would know that he was going to lose, and he would say to  
21 the repoer, I'm not going to cut the deal that I cut with  
22 you last year, because now I know I'm going to have to pay  
23 tax on it, so now I want more money, because I'm going to  
24 have to pay tax.

25 QUESTION: If I'm right about Nebraska having a



1 choice, if what they're doing is not permissible, then  
2 they have a choice.

3 MR. WITTLER: Yes.

4 QUESTION: And why should a court, a Federal  
5 court, make that choice for them?

6 MR. WITTLER: Because the -- they have a choice  
7 only in the sense they have to do it the constitutional  
8 way.

9 QUESTION: Yes, but you told me the Constitution  
10 doesn't care about whether the repoer or the reverser gets  
11 the benefit.

12 MR. WITTLER: I'm saying somebody has to get it.  
13 They've said nobody gets it. If --

14 QUESTION: But if they -- even if -- even if  
15 that -- even if you would prevail on that point, somebody  
16 gets it, what authority does this Court have to say which  
17 somebody it should be?

18 MR. WITTLER: It hasn't. I think no authority.  
19 I think all it can do is interpret 3124, that says,  
20 somebody gets it, and Nebraska says nobody gets it.

21 QUESTION: But it seems to me --

22 MR. WITTLER: And that violates the Supremacy  
23 Clause.

24 QUESTION: But it seems to me quite plausible  
25 for Nebraska to say that you don't get it, because by your

1 contract, you pay all of the Federal interest back.  
2 Loewenstein pays all of the Federal interest back to the  
3 original holder.

4 MR. WITTLER: But as --

5 QUESTION: And if --

6 MR. WITTLER: -- I pointed out, money is  
7 fungible. That doesn't make any difference. We could  
8 redraft the contract tomorrow to say it's cut the other  
9 way, and the net effect is the same.

10 QUESTION: Well, that might make a difference.

11 QUESTION: Well, suppose -- think about it in  
12 terms of a zero coupon bond, and there's just one coupon  
13 that's clipped at the end of the line, and that's the  
14 person that gets the interest, and in the meantime there's  
15 a repo transaction, and -- and the dealer transfers the  
16 Federal obligation to the repoer, and the repoer has to  
17 pay -- pays the money over and receives interest for that,  
18 which is not the interest on the Federal obligation.

19 I mean, why cannot the State tax that interest  
20 quite properly, and then at the end of the line, whoever  
21 owns, presumably the dealer by that time, the bond with  
22 the coupon will clip the coupon, get the interest, and get  
23 the deduction?

24 MR. WITTLER: First of all, Your Honor, Nebraska  
25 law incorporates by reference that tax law. Even if it

1 didn't, 31 U.S.C. 3124(b) says, in determining the tax  
2 status of interest, we look at Federal law.

3 Federal law has made a policy decision that  
4 we're going to prorate that zero coupon interest over a  
5 period of time, and I don't know, but I presume the reason  
6 is because otherwise people could wait till the day before  
7 that comes due, run out, buy it, say, "Even though I've  
8 only earned this 30-year bond 1 day, all of the interest  
9 in this last payment is mine," and that leads to the sort  
10 of tax manipulation that the Court found unacceptable in  
11 the Frank Lyon case.

12 But here, the basic principle is that somebody  
13 has to get tax exempt interest income according to the  
14 statute, and under the law of the State of Nebraska, they  
15 have tried to take away at least a portion of that  
16 exemption.

17 QUESTION: Well, but -- this is just repeating  
18 Justice Ginsburg's question, but I still don't understand  
19 your answer to it.

20 Granted what you've just said, that they've  
21 taken away the interest income, somebody's entitled to get  
22 it, don't you have more of a case to make than that?  
23 Don't you have to show that your client is entitled to get  
24 it, and all we can say is, somebody's entitled to get it?  
25 Why does that mean that you win? I mean, you're

1 claiming --

2 MR. WITTLER: Because --

3 QUESTION: You're claiming that Nebraska has to  
4 give it to your client, not to the repoer. Why is that?  
5 Whereas all you come before us and say is, Nebraska has to  
6 give it to either my client or the repoer.

7 MR. WITTLER: Because Nebraska has said, in a  
8 separate statute, Mr. Repoer, you clearly don't get it.  
9 We're not going to give it to you because you've entered  
10 into a repurchase arrangement, and you've been paying out  
11 interest over time. We're not going to let you get the  
12 deduction. They've taken that position.

13 If that's their position, then I say somebody's  
14 got to get it, and my guy was the one who should have got  
15 it, and you can work through the arithmetic in the statute  
16 to show why he should have.

17 QUESTION: So we just decided, in effect, on the  
18 hypothetical, we assume that the repoer doesn't get it,  
19 and therefore you're left.

20 MR. WITTLER: Your Honor, with all due respect,  
21 I don't think it's a hypothetical. It's simply, the  
22 literal language of the statute says --

23 QUESTION: Is it clear under the statute that  
24 the repoer doesn't get it?

25 MR. WITTLER: I believe it's clear, yes, Your

1 Honor.

2 QUESTION: Is it clear under the statute that  
3 your client doesn't get it?

4 MR. WITTLER: It's clear under the revenue rule  
5 that my client doesn't get it. The statute does not  
6 address that.

7 QUESTION: Whereas the statute does address the  
8 repoer? I mean, it seems to me the uncertainty stems from  
9 revenue rulings under both, doesn't it?

10 MR. WITTLER: No, sir. There's a statute that  
11 talks about taking interest deductions, and there's a  
12 statute that talks about excluding Federal obligations.

13 QUESTION: Yes, but isn't it true that although  
14 the -- let's assume there's \$600 of Federal interest, and  
15 \$500 of interest paid to the buyer-lender. Now, the \$500  
16 doesn't reduce the amount of the Government interest  
17 that's exempt from tax, but is it not available as an  
18 ordinary deduction for interest payments in connection  
19 with what the person wanted to use the money for? He does  
20 get the benefit from it in a different form, does he not?

21 MR. WITTLER: He gets the same benefit, Your  
22 Honor, that he would have gotten if he bought a fully  
23 taxable obligation.

24 QUESTION: Right.

25 MR. WITTLER: He gets an interest deduction.

1 QUESTION: But he does therefore get the benefit  
2 of the deduction.

3 MR. WITTLER: Yes, but that has nothing to do  
4 with the fact that it was a taxable or nontaxable --

5 QUESTION: Instead of treating it as \$600 of  
6 tax-free income, he treats it as \$100 of tax-free income  
7 and a \$500 deduction from your gross income, which brings  
8 you out to the same figure.

9 MR. WITTLER: But where did the -- where did the  
10 other \$500 go? That's the question.

11 QUESTION: Well, the other \$500 is income to the  
12 person who lent the money. The \$500 is interest to the  
13 buyer-lender.

14 MR. WITTLER: But then we have two people who  
15 have gotten \$500, Your Honor.

16 QUESTION: No. One of them's a deduction, one  
17 of them's income. It's true that -- I understand what  
18 you're saying about changing the character of it. It's  
19 not Federal income exempt from taxation under the statute,  
20 but the \$500 is a business expense, I should think,  
21 because it's the cost of borrowing that money.

22 MR. WITTLER: It's a business expense, and it  
23 goes against the tax-exempt income, except --

24 QUESTION: Well, but it brings you down to the  
25 same amount of taxable income, it seems to me. Maybe I'm

1 missing something.

2 MR. WITTLER: No, Your Honor. I agree, for one  
3 party to the transaction, he gets a deduction-free  
4 interest payment, just like he'd get whether he's dealing  
5 in taxable or tax-exempt obligations, and he gets a  
6 little, tiny exemption for what's left over, the  
7 difference between the \$500 and \$600. He gets \$100.

8 But no -- the remainder paid by the Federal  
9 Government goes to somebody else who now becomes fully  
10 taxable, and that's the evil in the approach the State of  
11 Nebraska takes.

12 QUESTION: So could we do this, could we say,  
13 suppose you said, look, the States have to respect \$15,000  
14 of the original issue discount, and they have a lot of  
15 leeway as to how they do it, but they have to respect it.

16 One way they could do it here is, they could  
17 say, the repoer gets the \$15,000, gets the whole thing,  
18 and doesn't deduct this as a cost. Another way they could  
19 do it is give it to their -- your client.

20 We don't know how Nebraska does it. We send it  
21 back to the Nebraska supreme court and tell them to decide  
22 Nebraska law and how it works out consistent with the  
23 principle. Could we do that?

24 MR. WITTLER: You certainly could do that, Your  
25 Honor, but the Federal law says --

1 QUESTION: \*

2 MR. WITTLER: -- it will be governed by the  
3 Internal Revenue Code, and the Internal Revenue Code  
4 explains how we allocate these payments that occur over  
5 time, so -- and Nebraska law then incorporates by  
6 reference the Federal Internal Revenue Code, so it  
7 wouldn't advance us a great deal.

8 QUESTION: Yes, but if you're going by the Code  
9 you'd say, fine, you allocate the original issue discount  
10 day by day, but I don't know that the Federal Code would  
11 require giving days 3 to the repoer, or to the person  
12 who's holding the security, say, Ford Motor, or General  
13 Motors. I don't see anything in the Code that tells you  
14 the answer to that question.

15 The natural thing, if it's --

16 MR. WITTLER: Thank you.

17 QUESTION: Thank you, Mr. Wittler.

18 Mr. Bartel, you have 3 minutes remaining.

19 REBUTTAL ARGUMENT OF L. JAY BARTEL

20 ON BEHALF OF THE PETITIONER

21 MR. BARTEL: Again, may it please the Court:

22 It seems that the issue in respondent's argument  
23 is focused on the validity of the add-back provision which  
24 Nebraska and apparently other States have.

25 We believe the validity of the add-back



1 provision was established by the Court's decision in First  
2 National Bank of Atlanta v. Bartow County, and if that is  
3 the only argument that they have to present, we think that  
4 the Court can certainly reverse the decision of the court  
5 below.

6 QUESTION: I have just one question about why  
7 Nebraska is not taking the position that California and  
8 some other States have taken that all of this is beside  
9 the point, because what Loewenstein receives is simply a  
10 taxable dividend from the mutual fund.

11 MR. BARTEL: Of course, that's largely a policy  
12 question. Our Department of Revenue simply, in looking at  
13 the cases, I suppose, from the other States, saw that the  
14 trend was to allow the pass-through of interest income  
15 earned by direct ownership of Federal obligations.

16 We have not raised the issue, but I assume it's  
17 based on the trend in those decisions, but, of course, our  
18 position isn't binding on what other States may attempt.

19 There's been no decision, obviously, by this  
20 Court on that question.

21 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Bartel.  
22 The case is submitted.

23 (Whereupon, at 12:04 p.m., the case in the  
24 above-entitled matter was submitted.)

25

## CERTIFICATION

*Alderson Reporting Company, Inc., hereby certifies that the attached pages represents an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:*

NEBRASKA DEPARTMENT OF REVENUE, Petitioner v. JOHN LOEWENSTEIN

CASE NO.: 93-823

*and that these attached pages constitutes the original transcript of the proceedings for the records of the court.*

BY Ann Marie Federico

(REPORTER)