IN THE SUPREME COURT OF THE UNITED STATES

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UNITED DOMINION INDUSTRIES, INC., :

Petitioner :

v. : No. 00-157

UNITED STATES. :

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Washington, D.C.

Monday, March 26, 2001

The above-entitled matter came on for oral argument before the Supreme Court of the United States as 10:03 a.m.

APPEARANCES:

ERIC R. FOX, ESQ., Washington, D.C.; on behalf of the Petitioner.

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Respondent.

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P R O C E E D I N G S

(10:03 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument now in Nunber 00-157, United Dominion Industries, Inc. v. United States.

Mr. Fox.

ORAL ARGUMENT OF ERIC R. FOX

ON BEHALF OF THE PETITIONER

MS. FOX: Mr. Chief Justice, and may it please the Court:

There is a single element in this case that properly determines its outcome, and that is that the product liability loss, as the district court said, and you can find this on page 36A of Appendix B. The product liability loss is a subset of the net operating loss. Section 172(a) and 172(b)(1)(A) of the Internal Revenue Code provides that a net operating loss can be carried back three years.

Section 172(b)(1)(I), and you can find the exact language on page two of petitioner's brief, provides that in the case of a taxpayer which has a product liability loss, the product liability loss shall be a net operating loss carry-back to each of the ten taxable years preceding the loss year. In Section 172(j)(1) then defines the term product liability loss, and that is, it is the lesser of

the net operating loss for the year, and that is the net operating loss that can otherwise be carried back three years, or the sum of the amounts allowable as product liability deductions.

So it is clear that the product liability loss is nothing other than a piece of the net operating loss. And if you apply that rule to a single stand-alone corporation, the first thing you do is determine whether the corporation has a net operating loss. If it has a net operating loss, the next thing you do is determine the extent to which that net operating loss is attributable to product liability deductions. And the product liability deductions in an amount not exceeding the net operating loss then becomes the product liability loss. That can be carried back ten years, but it's all part of the net operating loss.

So if you have a product liability loss that's less than the entire net operating loss, then after you carry back the product liability loss ten years, what is left of the net operating loss can be carried back three years. The important part --

QUESTION: Is the theory of the statute that development of these products usually takes longer than a three-year period, and that what we're just trying to do is allow the company to have its loss carry back apply to

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those years in which it was engaging in research? Is that the theory of the statute, or is there some other theory?

MR. FOX: I think the legislative history suggests that there was some concern that product liability suits and the like took time to arise, and that a product might be sold in a particular year, generate income, and then it wouldn't be for many years before the product liability suit arose. And in order to provide a longer period of income against which potentially large losses might be deducted, the Congress thought it was appropriate to extend the statute and allow going back as far as ten years.

I think the theory was that it would be logical that the income might arise years earlier than the three-year period, and Congress was simply extending the carry-back period to allow for that problem.

QUESTION: I suppose it doesn't help us much because if I told you, well, that makes it sound very corporation-specific, you would say, well, so are all other net operating losses when they're calculated. In the first instance, they're specific to that corporation, and yet they are carried over to affiliated groups, so product liability losses should be given the same treatment. I take it that's your argument.

MR. FOX: Well --

QUESTION: You want to make it a better argument, huh?

MR. FOX: Well, I'll try, Justice Kennedy, if I can.

I believe that the plain language of the statute when applied to an affiliated group of corporations requires the outcome that we seek.

QUESTION: Would you respond, Mr. Fox, to the claim that what you're arguing for is a double deduction, and would you tell me in the first instance something that maybe I should have gotten from the briefs, but I just couldn't find it. Did the -- did the successful companies in this affiliated group which, in fact, as I understand it, had the expenses involved here -- did they deduct the product liability expenses in the course of calculating what in effect turned out to be positive income which was then attributed to the group? Had they already -- leaving aside the treatment -- the possible treatment of the loss, has there already been a deduction taken by the constituent companies here?

MR. FOX: No. Justice Souter, I want to make perfectly clear there is absolutely no double deduction in this case, and there was no deduction in computing separate taxable income in the sense that a tax benefit was produced at that point. There was clearly a

subtraction of the product liability deduction in arriving at separate taxable income. That is --

QUESTION: Well, then --

MR. FOX: -- incontrovertible.

QUESTION: -- why aren't you asking for that same subtraction, as it were, to have the further benefit for the affiliated group?

MR. FOX: The reason is that when you -- when a single corporation or an affiliated group has a net operating loss, the total amount of that loss has not produced any tax benefit because you have had deductions that exceed income, and, yes, you've deducted them in the sense that you subtracted them, but now you come up with a negative number, and that negative number, which is all we're talking about here -- the net operating loss -- that in and of itself does not produce a tax benefit. It's just -- it's hanging out there until you can carry that negative number to some other year and take a deduction against income in that other year. Then the deduction produces a tax benefit, so we have --

QUESTION: What we're arguing about here is whether you go back three years or ten years.

MR. FOX: Exactly, Justice Scalia. That's the only thing we're talking about. The fact is that the very same product liability deductions that have been, quote,

deducted, in arriving at separate taxable income are in the net operating loss that Respondent will agree we can carry back three years. And if we can carry it back three years and take a deduction, there's no double deduction. They would not claim that. They now want to say that because we're going back ten years, there's a double deduction, but that's simply not the case because we're reducing what we can otherwise take back three years.

QUESTION: Mr. Fox --

MR. FOX: All we're doing is --

QUESTION: I understand that there's no dispute at all about the amount involved. As you said, it's just a question of whether it's a three-year carry-back or a ten-year carry-back. But there's one feature of your case that's different from the Intermet case -- the other side of this split -- and that in Intermet, the corporation had sustained the loss that Lynchburg was also a member of the consolidated group in the carry-back year. But as I understand the facts of your case, you -- the deductions of the losses sustained in '83 to '86, and you want to carry it back to '73? Years when the corporations had sustained the loss were not part of the affiliated group. Why should it be carried back -- why should the affiliated group get this benefit when the companies who sustained the loss were not part of it in those carry-back years?

MR. FOX: The regulations have a mechanism for dealing with corporations that join a group and provide that in the case of a net operating loss, if a member of the group contributes to the net operating loss by itself having a loss, and in the carry-back year, be it three years or ten years earlier, it was not a member of the group, a portion of the overall net operating loss can be allocated to that company and carried to a separate return year outside of the consolidated return.

In this case --

QUESTION: Can be or must be?

MR. FOX: Must be. In this case there -- the corporations that generated -- the members of the group that generated the product liability deductions would not have an allocated net operating loss under that provision of the regulations which is -79. And so there is no mechanism for carrying back to any separate return year. The only carry-back can be within the group.

Now, if you have a corporation that joins a group and has deductions, even though it just joined the group, any deductions it has are going to find its way into the net operating loss that can be carried back. So the question again is the fact that the corporation would have deductions, even though it had separate taxable income. The fact that it is contributing to the net

operating loss, even though it wasn't a member, say, the last year, does not prevent its deductions from being carried back three years as part of the net operating loss. And so in this case, it's merely a fact that they're going to be carried back ten years instead of three years.

QUESTION: You say the same problem exists under the three-year carry-back?

MR. FOX: Exactly, because any deductions that this corporation has for product liability are going to find their way into the net operating loss that can be carried back three years, and that would be before it was a member of the group.

QUESTION: Is this right -- and tell me, if it's wrong, I'm not going to pursue it -- but it seems to me the theory of this thing is that we have a company called Company A, and Company A has, let's say, a loss of two dollars over the year. And what this statute normally says is wait -- Company A, if you have some product liability loss, there are a lot of things that can cause losses, and you have all of them. It was a terrible company. But we're going to pretend that the two dollars there is product liability loss. That's called, let's pretend that's what the statute says -- as long as there was two dollars of it. We're not going to call it some

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other loss.

Now, what you want to do is if Company A is part of, let's say, fifteen other companies, you want to pretend that the big losses run by these other companies which had nothing to do with product liability are product liability losses, too.

MR. FOX: Well, I would agree with you, but I think --

QUESTION: Is that what you -- that's what you're reading in the statute --

MR. FOX: Yes.

QUESTION: All right. Now, if that's so, then there's a great thing we could do. We have some big losses in our company, so we look around for some other firms that happen to have some product liability losses, but they're just marginally profitable. Now we buy them up, and now our let's pretend game allows us to count as our losses which came from totally other things -- having a very bad product, for example -- now are product liability losses, so we get to go back ten years. Now, that would be a consequence of accepting your position, is that right?

MR. FOX: Theoretically, yes, Justice Breyer, but I think that is a -- that the example which comes from the Respondent's brief is a very far-fetched example.

Number one, it is highly unlikely to arise. You have to go out and find a coincidence of facts that fit just perfectly, number one. Number two is that the result that you have just posited is not something that flows from the consolidated return regulations, but it is a result that can exist if a single stand-alone corporation were to find itself in the same position, it could go out, buy another corporation if the facts fit perfectly, liquidate it, and do exactly the same thing.

QUESTION: Okay.

QUESTION: But for that matter, it would apply within the three-year period if it's just seeking a three-year carry-back, no? Although I guess it wouldn't matter if it's product liability carry-back or not. But that can happen under the three-year carry-back, can't it?

MR. FOX: Well --

QUESTION: Can't you purchase somebody with losses that will enable you to carry back what you otherwise wouldn't be able to carry back three years?

MR. FOX: That may not --

QUESTION: No, but then you're purchasing somebody with profits in Justice Breyer's example.

MR. FOX: Might not work that way because if, first of all, if they were separately profitable, then they wouldn't be contributing any losses. Of course, if

they had losses, then they'd have to carry them back to a separate return year of their own. That's why I find that this hypothetical requires coincidences that are very unlikely to exist.

QUESTION: Does Treasury Regulation -79(a) bear on the extent to which Justice Breyer's example could be calculated?

MR. FOX: Not really, not really. Not the example that is in Respondent's brief. It wouldn't affect it.

QUESTION: To what extent do we owe deference to the Government's position in this case?

MR. FOX: I would say you owe no deference whatsoever. First of all, I noticed as I was walking into the building today there was a quotation from Marbury v. Madison etched into the wall that said that it is this Court's obligation to decide what the law is. But moreover, there really is not a Treasury position here. There's no -- they have never promulgated a regulation, they've never gone through the hearing process. This is merely some lawyer at the Internal Revenue Service taking a position to deal with a situation that they really haven't dealt with by regulations.

QUESTION: But would the Government have the authority to promulgate a regulation which reaches the

result that the Chief seeks to reach here --

MR. FOX: I believe it would. I believe they would.

QUESTION: So, so then it follows from that, that the Government's position is consistent with the statute, if that's true.

MR. FOX: No, I think it is not consistent with the statute, Justice Kennedy. I'll tell you why.

QUESTION: They can promulgate a regulation that's inconsistent with the statute?

MR. FOX: They could promulgate a regulation that would be consistent with this statute but their position, given the regulations as they exist today, is inconsistent with the statute, and I will tell you why. The reason for that is, as I said earlier, the net -- the product liability loss is just a piece of the net operating loss, and an affiliated group filing a consolidated return has only one net operating loss -- the consolidated operating loss. That's the only thing that exists to be carried back three years.

Now, just as you would in the case of the separate corporation, you say, to what extent is that consolidated net operating loss the only thing that they had prescribed that can be carried back three years? To what extent is it attributable to product liability

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deductions? And you can determine that by looking at all of the product liability deductions of the group. It's right in there and every one of those deductions, regardless of whether the contributing member has negative taxable income or positive taxable income, goes right to that bottom line, and you can prove, dollar for dollar, that the net operating loss is attributable to every one of those deductions.

And that, because of the way they have designed the regulations, they have provided only for the single consolidated net operating loss. That is what could be carried back three years, that's what a piece of can be carried back ten years. And there's no getting around that fact. And you don't need a regulation to say, let's do it on a consolidated basis. You really don't have to worry about whether we should view, in this particular case, the consolidated group as a single entity or as a group of separate companies.

QUESTION: Mr. Fox, did the Government take the same position in the court of appeals that it takes here? I thought it argued for something a bit different from what the court of appeals came up with.

MR. FOX: I'm a little confused as to what position the Government is taking in this case, but in the court of appeals they basically argued that the net

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operating loss you should look at was the negative or positive separate taxable income of a company. That if you had positive taxable income, then the member didn't have a net operating loss and that was the end of the matter.

The Fourth Circuit rejected that argument. The Fourth Circuit said, as the Petitioner argued, that the definition of separate taxable income is not the same as the definition of a net operating loss because separate taxable income excludes things like charitable contributions, capital gains and the like. And so negative taxable income can never equate theoretically, and definitionally, with a net operating loss.

And so the Fourth Circuit went and found a net operating loss some place else.

QUESTION: Where did they find it, Mr. Fox?

MR. FOX: Justice Ginsburg, they found it in the regulation -79.

QUESTION: I know, but had it been argued? It was -- it was the -- where did it come from? Did the Government put it in its brief, or did they just pick it out of the air?

MR. FOX: I don't recall it being in the Government's brief but the Government from time to time has put out technical advice memoranda and the like, and

that argument had been raised by the Government, but I do not recall them arguing it specifically in the Fourth Circuit.

QUESTION: If you lose, do we create any anomaly, or is there some -- what I'm thinking of is that you have -- the Government has, it seems to me, going for it the fact the language is pretty ambiguous. The language does list some things that should be consolidated, makes no mention of this. And there's at least one anomaly that's created if they lose. All right, you have going for you that the statute could be read your way, you could want to play the let's pretend game with the whole set, but is there anything else you have going for you in terms of policy that you want to bring up, or in terms of anomalies that would be created if you lost?

MR. FOX: Well, I think from a policy standpoint if you go back and look at the 1918 legislative history, that certainly when Congress brought the consolidated return into being, they thought of the affiliated group as one single business. The Respondent wants to treat every corporation as a separate business. Well, that's clearly contrary to what Congress thought. And it may be that you have situations where you can have an affiliated group with corporations in what we would call different lines of business, but that's not what Congress was talking about.

They thought that all of the activity -- business activity under common ownership, was a single business.

But even then you could have an affiliated group of five thousand coffee shops, or five thousand vitamin stores, all managed by a separate headquarters business -- all financed out of one separate headquarters business. I think it's pretty hard there to view each separately incorporated coffee shop as a business that's separate and apart from every other business. And in that case, it would make perfectly sense -- perfect sense if one member of the group had a product liability loss, even though it might otherwise be profitable, that this entire group which is all in the identical line of business should be able to avail itself of that.

QUESTION: May I ask you a question, Mr. Fox? Going back to your response to Justice Kennedy about the purpose of the provision -- what about the fact that if you do have separate corporations in different lines of business and one of them is profitable notwithstanding its history of product liability losses ten years ago, hasn't that served the purpose of allowing that business entity to recover the loss that has to be otherwise carried back ten years?

MR. FOX: If that corporation were a stand-alone corporation, I would say yes it is. But I think

when you're dealing with an affiliated group, that puts too much emphasis on where you place the particular business. I mean, a good tax planner, if they thought this was a problem, could get around that by simply moving loss companies around. And if you take a loss company and put it where you're going to have the product liability deductions, you probably could straighten that problem out.

QUESTION: Except -- except in the case where you have a company that's acquired between three and ten years. In that case, you always will end up with a profitable company acquired between the three and the ten years. You will always have the anomaly. That company will have taken, as a deduction from its income, its product liability loss, and its taxes will have been reduced accordingly, right? And then -- and then the consolidated company will be able to go back ten years and use some of its deductions once again, in that one situation where you have the acquisition of a profitable country -- company between three and ten years.

MR. FOX: It is theoretically possible, but I would say that if that highly unlikely scenario -- I mean, you might have to face up to the possibility of going out and buying a tobacco company and you think, well, it'll throw off some product liability deductions, but you have

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no idea the extent of that. You're kind of risking your entire company on some tax dodge.

QUESTION: But Mr. Fox, isn't that the point of the Government's -- the note it makes on page 41? The footnote in which it says there's no logical reason why Petitioner should be able to use these deductions to create product liability losses for itself simply because the affiliated corporations that actually incurred the product liability expenses realized profits instead of losses. The anomaly that -- as you said, the regulation doesn't cover the profit for a corporation, but it would cover one where there had been losses.

MR. FOX: Well, I think, Justice Ginsburg, that that is not really a function of consolidated returns. Take a single stand-alone corporation that has an oil business and a computer business. Now, they might have a product liability in the oil business, but when they report their income, they are reporting the entire company's income and losses. And if there is a profit in the oil business with a product liability deduction and a huge loss in the computer business, they put that all together and, even though the oil business was profitable and the product liability was more than offset by the oil company's income, because they are in a separate corporation, they can put everything together and they're

going to get the product liability deduction.

So the fact that you have disparate lines of business is not the thing that causes the problem, because you can get exactly the same result when you're dealing with a stand-alone corporation. And if that's not a problem there, I don't really see why it should be a problem in the affiliated group context.

QUESTION: Is your underlying rationale -- and Justice Breyer asked you about policy questions --that there's really no reason to treat this affiliated group any differently than you would treat one corporation that had separate divisions?

MR. FOX: Yes, I think that is exactly the case. That's the way Congress viewed an affiliated group if you look at that 1918 legislative history. They say exactly that at some length. And I think, furthermore, that my ultimate point here is that the plain language of this statute requires that you look at the consolidated net operating loss -- that's the only thing we have that's a net operating loss, and you ask, to what extent is that net operating loss attributable to product liability deductions. We have in the general explanation of the Revenue Bill of 1978 which is cited on page 4 and 21 of our brief.

This provision was explained this way. Under

the Act, the amount of a net operating loss that is attributable to a product liability loss can be carried back an additional seven years is only one net operating loss this affiliated this group has, the consolidated net operating loss. And it seems to me that the plain language of the statute requires you to ask only one question: to what extent is that net operating loss attributable to product liability deductions? And that's the end of the matter. You don't need any special regulation.

To the extent you're a little worried about this hypothetical, number one, the Government can correct that by regulations. They already have a provision in the Code, Section 269, that allows them to set aside deductions in the case of acquisitions made for tax avoidance. So I don't believe that we should let that little tail, if you will, wag this dog. That's a very small point, purely hypothetical, it can be dealt with by regulations. It can be dealt with by Section 269. If there are no other questions, I would appreciate reserving my time for rebuttal.

QUESTION: Very well, Mr. Fox.

MR. FOX: Thank you.

QUESTION: Mr. Jones, we'll hear from you.

ORAL ARGUMENT OF KENT L. JONES

ON BEHALF OF THE RESPONDENT

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

I think it's common ground that none of the corporations involved in this case would be able to claim a product liability loss on a separate return. That's because the product liability loss provisions provide no extended carry-back benefits either for profitable corporations regardless of the amount of their product liability expenses, or for unprofitable corporations that have no such expenses. So the narrow question presented in this case is whether the fact that this profitable entity that had some expenses of this type is combined with an unprofitable entity that had no such expenses changes the result on a consolidated return.

QUESTION: Mr. Jones, can I just ask one preliminary question? The statute refers to in the case of a taxpayer which has a product liability loss -- now, who is the taxpayer?

MR. JONES: Well, the taxpayer in the 172 context is plainly the individual corporation. That's the way that all of the provisions of the Code are written. They are written to apply to the individual taxpayer.

QUESTION: And each of the corporations --

MR. JONES: The only --

QUESTION: -- is a taxpayer in your view?

MR. JONES: Each of these corporations is a taxpayer.

QUESTION: Did they each file a return?

MR. JONES: The only way that they avoid filing a separate return is by electing under 1.1502 to file a consolidated return. And so the question is, how do you go from the provisions of the Code that dictate how we treat --

QUESTION: How many checks does the --

MR. JONES: -- separate taxpayers.

QUESTION: -- when they file that return, how many people -- how many different corporations give the Government money?

MR. JONES: Well, each of them is severally liable, and so the answer --

QUESTION: The question is how many give them money, not whether they --

MR. JONES: Well, I don't know. The answer can vary. Sometimes a check can be drawn from each of the corporations or by any one of them. They are severally liable for this tax. That is to say each of them is liable for the consolidated tax. To understand how --

QUESTION: For the whole tax?

MR. JONES: Yes, sir.

QUESTION: I mean, you can get the whole thing out of any one of them, not just the aliquot portion attributable to that one.

MR. JONES: That's correct. That's Section 6 --

QUESTION: And indeed you wouldn't know what the aliquot portion would be. What about the problem that there is simply no net operating loss for each of the individual companies?

MR. JONES: Well, that's -- that's really -- the entire thrust of their argument is that if you start in a consolidated -- from a -- let me answer the question with a little bit of background. I don't want to avoid your question, but I think a little bit of background would be helpful.

To answer that question, you have to understand what is the background principle that applies in consolidated returns. Since the Woolford Realty case, the background principle has clearly been that notwithstanding the consolidation, you treat each of the corporations as a separate tax-paying entity except as the regulations provide for consolidated treatment. So then you have to go to the regulations to see how the regulations provide for the consolidated treatment. Section 12 of the reg says that in determining consolidated income, the first step is to determine the separate income of each

corporation based upon the rules that apply to the determination of taxes for separate tax-paying entities. Under that regulation, it's undisputed that the product liability expenses of each of these corporations are deducted from the income of each of these corporations, and --

QUESTION: Before you go further, aren't there some exceptions from normal --

MR. JONES: Yes.

QUESTION: -- I mean, capital --

MR. JONES: There are some exceptions of items --

QUESTION: Charitable deductions? Capital losses?

MR. JONES: That's right, that under the regulations are treated as consolidated items and aren't part of the calculation of separate taxable income.

QUESTION: So you can never really come up with a really genuine picture of what the individual --

MR. JONES: You don't --

QUESTION: -- net operating loss, if there were such a thing, was.

MR. JONES: The term separate taxable income is not a perfect equivalent. They say, well, we want a perfect equivalent to net operating loss that we'd

calculate for an individual taxpayer, and there are three reasons why that objection has no force.

The first is a simple practical one. They don't contend that under any definition of separate net operating loss they would have had a loss. Each of these companies was profitable. They're claiming the rights of a hypothetical taxpayer that, in fact, in the twenty-three year history of this provision has never existed. There has never been a taxpayer with product liability expenses who had a positive separate taxable income but a negative separate net operating loss. That has just never happened. And that's why, in the twenty-three years, there's never been any reason for the Secretary to adopt a discrete regulation designed to address these minor differences because they have never been a practical issue.

And that brings me to my third point which is there is no requirement that there be a perfectly equivalent treatment between individual taxpayers and the consolidated taxpayer. If that was a requirement, we wouldn't have consolidated returns.

QUESTION: You just used the term consolidated taxpayer --

MR. JONES: A consolidated return. If they had to be perfectly equal, we wouldn't have consolidated

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returns, we'd just have separate taxpayers calculating their taxes and we'd add them up.

QUESTION: Mr. Jones, your position that you're now announcing has been rejected, the position that you're taking on brief here is rejected by the Fourth Circuit, and they made it very clear that they weren't buying that, and they had an alternate position.

I have two questions for you. One is, going into this whole picture with this company, there was an agent -- and I assume that this large amount of money had to go up higher in the Service who said, yeah, they're right, under the consolidated regs that now exist, they get this refund. And it was a Congressional Joint Committee that said no. So the Service initially agreed. Therefore, it leads me to think that there has been no consistent clear position that the Service has taken. Is that right?

MR. JONES: I think that the Service has taken a consistent position in litigation, and as far as what happened in the negotiations between the parties, I mean, it's often the case that people try to work things out. But we're in litigation here. We're trying to decide how the law applies.

QUESTION: Well then in litigation, since the Fourth Circuit clearly rejected the position that you are

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pressing on brief, what is the consistent position that you're taking on litigation? Has the Government ever taken the position that the Fourth Circuit takes?

MR. JONES: The consistent position that we're taking is that separate taxable income is a workable rule that applies in this context, and that's the point I was about to make which is that Section 1502 of the regs -- I'm sorry, of the statute -- doesn't tell the Secretary adopt rules that are perfectly equal. It says adopt rules for consolidation that achieve a clear --

QUESTION: Mr. Jones, I'm sorry to interrupt on this point again, but as I understand it that isn't the rationale that the Fourth Circuit went on.

MR. JONES: That's not the Fourth -- the Fourth Circuit had a different perspective. I'm trying to describe to you what the Government's position is.

QUESTION: What I'm asking you first is, has the Government ever taken the position that the Fourth Circuit adopted?

MR. JONES: It's a complicated -- the answer to that is very complicated. The answer to that is, that that reg that the Fourth Circuit relied on does sometimes apply in these cases. It applied in the Amtel case which was the first case the petitioners brought to challenge this tax issue. It applied there because there was a

separate return year for some of these subsidiaries. And when the separate return years were involved, then you use the separate net operating loss definition that's contained in the 79 reg.

QUESTION: But the Fourth Circuit, as I understand it, was not relying on the regulation that relates to separate return years. That was --

MR. JONES: They were --

QUESTION: Yeah, they were. That's right. They were.

MR. JONES: That's correct. They were.

QUESTION: But they weren't doing it in the limited sense of a separate return year. They were generalizing that. They were taking that the regs --

MR. JONES: They were saying this is a rule --

QUESTION: -- label separate return year, and they were saying, well, we could use this methodology across the board. Is that right?

MR. JONES: They were saying this is an -- I think what they were saying is this is an appropriate rule to apply by analogy. And we don't disagree with that. What we're trying to explain is how the rules we have in place work. We don't disagree with the Fourth Circuit that we could apply their rule by analogy. We don't disagree that in a -- if a situation -- let me put it this

way. If there ever were the hypothetical situation in which some taxpayer came in and said, well, I have had positive separate taxable income, but I actually had a negative -- a separate net operating loss as defined in reg 79, we think that might well be a reasonable resolution. But it is not the resolution that's currently in the reg. The resolution that's currently in the reg is valid, though, because it is a legislative rule adopted by the Secretary under Section 1502.

QUESTION: What resolution is that, and what reg is that? You say this is resolved by a regulation?

MR. JONES: Yes, sir. It's resolved by Section 12 of the regulations which require the separate taxable income to be calculated by reducing from each taxpayer's income the product liability expenses it incurred.

QUESTION: But this is not the same thing as was pointed out in questions before as the thing you're analogizing it to. I mean, it's just an analogy, isn't it?

MR. JONES: The decision of the court of appeals said that the rationale of the reg 79 rule is a workable rule that would make sense if such a situation ever arose, and we don't disagree with that. What we're saying is that the legislative rules that the Secretary, in fact, has adopted under his broad authority to adopt rules that

reasonably reflect the income and avoid the evasion of taxes -- the rules that we have are workable rules, and the proof is in the pudding that in twenty-three years they have never not aptly applied.

QUESTION: But your colleague disputes, and the court of appeals happen to agree, that your reliance on 1502-12 simply solves this.

MR. JONES: I'm not -- I'm not sure what you mean.

QUESTION: Well, you said this is control -- as I understand your answer, this is controlled by 1502-12.

MR. JONES: No, Section 1502 gives us the authority to adopt reg 12. That's what I'm saying.

QUESTION: Well --

MR. JONES: And Reg 12 --

QUESTION: Which is -- which is --

MR. JONES: -- provides a workable rule --

QUESTION: Which defines separate taxable income.

MR. JONES: Yes, sir.

QUESTION: But your opponent says that is not controlling, and the courts of appeals have not agreed with you on that.

MR. JONES: Well, if the -- if the opponent agreed with us, we wouldn't of course be here.

QUESTION: But how about the courts of appeals?

MR. JONES: We've won this in some courts, we've lost it in other courts. There's a conflict, which is why we're here. And what I'm trying to make clear is we don't -- we're not saying we disagree with the analysis of the Fourth Circuit --

QUESTION: But the Fourth Circuit did --

MR. JONES: We're saying that the analysis of the Fourth --

QUESTION: Mr. Jones, the Fourth Circuit did explicitly disagree with your 1.1502-12 position that you --

MR. JONES: Yes, the Fourth Circuit thought that the rules were perfectly equivalent.

QUESTION: And it said -- it said right in the -- it's in 18A of the appendix to the cert petition that that was an incorrect position. And if you missed that statement, they repeated it later by saying that they often strain to disagree with that position. So it's clear that the Fourth Circuit rejected the position you're now presenting.

MR. JONES: I have not argued -- I have not suggested to the contrary, and what I've said is that what we -- we agree with the Fourth Circuit that if a situation ever arose where this hypothetical distinction between

separate taxable income and separate net operating loss ever came up, which it never has, the rule adopted by the Fourth Circuit might well be sensible.

QUESTION: Well, may I put this question to you, Mr. Jones?

Suppose we agree with the Fourth Circuit and the Sixth Circuit that the position you are taking about 1502-12 is incorrect. Do you embrace the position that the Fourth Circuit takes as a proper way to resolve this case and all other --

MR. JONES: It is a proper resolution of this case. It -- it answers questions that the Court doesn't need to answer. It answers the question of what would happen if these -- if this factual situation arose that never had. And what we're saying is that in that hypothetical situation, that's a good answer, but what we're also saying is that the Secretary is the one who is supposed to adopt these legislative rules, and we don't think that the Court needs to, and therefore shouldn't reach out --

QUESTION: But if you don't -- if we agree with the Fourth Circuit that the position you're taking is incorrect, so that's out of the picture -- we're not going to just assume that we agree with the Fourth Circuit and the Sixth Circuit -- there's no split on that, and then so

we have to look for an alternative if we're going to use -- and rule in your favor, and I'm asking you is the one that the Fourth Circuit took, the one that the Government would urge.

MR. JONES: It is -- it is the resolution of this case that we think is appropriate on the facts -- on the hypothetical facts that the court used in fashioning that rule, but I would simply repeat myself in saying that it's up to the Secretary to fashion these legislative rules.

QUESTION: All right, that's -- accepting that, and you just point this out to me where I didn't know that the regs actually determined this. I thought the regs were regs for calculating separable income, et cetera. And then you throw it all together and you calculate and see a loss overall. And then the question is, should we count that loss overall as if it were product liability loss? And what I didn't know is there is something that says, no?

MR. JONES: Yes, there is.

QUESTION: Which one?

MR. JONES: Well, what it is is, it's the process of the calculations required by the regulations, and that is that you've deducted -- you've taken the deduction of the product liability expenses at the

separate affiliate level --

QUESTION: Yes.

MR. JONES: They have not had losses, they have had profits. Those deductions have been used at that level and cannot go to the consolidated level. There are no deductions to take to the consolidated level to change the character of the losses of the unprofitable affiliates from the ordinary losses for which they get three years into these extended benefit losses for ten years.

QUESTION: And now the wording gets you there in the calculation. If I go through reading the wording, I won't be able to get to their result.

MR. JONES: The wording that controls this is the wording of Section 12 of the reg that says in determining the -- separate income of each affiliate, the first thing you do is you apply the rules that govern the determination of income --

QUESTION: Okay. No, I'll do it. I'll go through it.

MR. JONES: Okay.

QUESTION: If I should, when I go through it, figure out that their reading is possible, then is there some good reading -- reason why they aren't right? I mean, their -- their point would be, look, this is supposed to treat the thing like a big business, and if it

were a big single business, we could do it, so why can't we do it?

MR. JONES: Well, it's because Congress adopted in 172 a product liability loss -- that provision which is not a subset of losses, it's a subset of the losses incurred by the company that incur the product liability expenses. What they are doing is --

QUESTION: But why couldn't you say that with reference to any operating loss? I thought most of the Code was addressed to a single taxpayer.

MR. JONES: Most of the Code doesn't turn the character of the allowance on the character of the expense. Congress in 172(j) focused this special allowance on the taxpayer, in the words of the history, that suffered the loss.

QUESTION: But -- I'm sorry -- I didn't --

QUESTION: Well, except I think it does. If, for instance, for legal expense, the corporation has had to have hired a lawyer and deduct a legal expense for something that was a medical expense. I don't understand --

MR. JONES: The only --

QUESTION: -- your response. Do you see my problem?

MR. JONES: Well, I probably don't understand

your question, because what I thought you were saying is what's special about product liability expenses that they should be locused -- focused --

QUESTION: And your answer was that the expense has to be related to the reason for which it was incurred, and I say, well, that's true of any expense.

MR. JONES: It has to be related to the taxpayer that incurred it. It has to be related to the entity that incurred it -- not to some other entity.

QUESTION: Well, I suppose that's also true with all deductions. I can't take a legal expense for something that is on my son's separate return.

MR. JONES: That's right, but if, in a consolidated context, if you consolidate somebody's profit and somebody else's loss, you get a consolidated loss, hypothetically, which ordinarily you get a three-year carry-back for. The question is whether this specific situation justifies characterizing that consolidated loss as a product liability loss or for some --

QUESTION: I agree, but the fact that an entity that incurred the expense is different from the entity taking it -- presents the same problem as with any other deduction.

MR. JONES: It doesn't present a problem unless they're trying to get this special carry-back, and they

only get the special carry-back when this special type of deduction causes a loss for the company that incurred this deduction.

QUESTION: Mr. Jones, what is the principal purpose of Part 12 of the regs? I mean --

MR. JONES: The purpose --

QUESTION: It isn't designed specifically for this situation. For what other purpose do you need a definition of separate taxable income?

MR. JONES: It is a very important provision, because so many of the provisions of the Code, or -- not maybe so many -- but many of the provisions of the Code, the ability of a company to use them turns on the specific facts of that company. There are two other cases that we've cited to you in our brief, the H Enterprises case and the First Chicago case, both of which involve situations where a deduction was available only because of the characteristics of that individual company. And this relates to the background rule that I described to you from the Woolford Realty case.

You have to -- it's necessary to understand that the consolidated regulations are an overlay. You start with the separate taxable -- as separate applications and returns to each individual entity, and then you only consolidate to the extent the regs provide.

QUESTION: And do you think that -- what I find persuasive in the taxpayer's case here is the fact that net operating loss is only -- it's not defined in the regs, it's only defined in the statute, and it is defined to -- in a way that would only apply to the consolidated return and not in a way that could apply to the separate returns.

MR. JONES: Well, consolidated net operating loss is only defined in that way, but the operating losses of the individual entities are defined both in the separate taxable income context which can be negative, the regulations --

QUESTION: Yes, but isn't that the point? That they don't define it as net operating loss? I mean, there is -- at least at the verbal level, there is no such concept.

MR. JONES: There is no question that the Secretary can adopt -- could adopt a rule that did that, but let me point out what would happen then. The Secretary would then no longer be able to provide for consolidated treatment of the numerous items that they've done -- like charitable deductions and so forth. If we're going to have a separate net operating loss definition for individual corporations, it would have to be only for this issue, and then it would have to take account of, well,

we're no longer treating these as consolidated on the other -- on the consolidated return. We would have to make some adjustments there, too.

What the Secretary instead has done is he has a workable rule. It has the background rule that determines taxes at each individual affiliate. Because none of these affiliates have losses -- none of them have product liability losses to pass on to the consolidated level. Petitioner's theory would just recharacterize what is a normal loss for its other companies into some kind of special product liability loss. Now, I would like to emphasize because it is very important to us that Petitioner's theory in this case would lead to serious opportunities for manipulation and abuse.

For example, the hypothetical that's already been described to the Court -- you have a long history of profits and a current history of losses, but you don't have product liability expenses.

QUESTION: Do you have authority under 269 to disallow losses if the company is acquired for purposes of tax avoidance, or would --

MR. JONES: I think the statute says for the principal purpose of avoiding taxes.

QUESTION: So if I went out to acquire a corporation just to take advantage of this loss, you could

invoke 269?

MR. JONES: I would -- we would have to litigate whether we -- we would have to establish that was your principal purpose, and I suspect you'd say, well, you had a legitimate business purpose.

QUESTION: Well, I -- that was the assumption of Justice Breyer's question. Of course, you'd have to litigate it.

MR. JONES: We would have to litigate it, and we would be --

QUESTION: But you're not powerless.

MR. JONES: -- doing it in the face of taxpayers who were obviously planning --

QUESTION: But that's the only horrible you've presented -- that -- I mean --

MR. JONES: Well, the other --

QUESTION: -- the case where that is the principal purpose.

MR. JONES: I don't mean to say it's a horrible --

QUESTION: And then you complain when we say there's a solution for that horrible by saying, well, but then we'd have to prove that it was the principal purpose. Of course you would.

MR. JONES: I think that the other --

QUESTION: It's not a horrible unless that's the principal purpose.

MR. JONES: The other horrible is that Congress didn't intend this to happen. Congress provided no product liability loss benefits for profitable companies, regardless of the amount of expenses they've incurred.

QUESTION: To go back to the first horrible -- could somebody just do it now, even if you win, by simply folding the acquired company into its company so there's just one entity rather than the consolidated one?

MR. JONES: No, that doesn't accomplish their objective, because then the acquiring company would be liable for all these product liability expenses. They'd be a single company, and we wouldn't object then. We wouldn't have an objection to that because then they would be incurring the product liability expenses as they incurred.

Now, historically for the expenses incurred prior to the date of the merger, they wouldn't be able to use that. They'd have to have some other theory. But after the merger, that's not a problem. The problem is that this is like Woolford. This is a case where they are coming up with a strategy to avoid the payment of taxes, and even though counselor says this is an unlikely situation --

QUESTION: There's nothing --

MR. JONES: -- that is this situation.

QUESTION: Mr. Jones. Mr. Jones, there is nothing wrong with a strategy to avoid the payment of taxes. The Internal Revenue Code doesn't prevent that.

MR. JONES: But the question is whether the consolidated provisions permit it, and in Woolford Realty the Court said that the mind rebels against the notion that in allowing for consolidated returns Congress meant to provide for such a facile and obvious means of juggling tax attributes to avoid the payment of taxes. That's what we have -- we have a facile and obvious method of juggling tax attributes.

QUESTION: But Mr. Jones, you don't disagree with your opponent's hypothetical involving a company with two divisions -- a computer division and a hot dog division, or something like that.

MR. JONES: It's a single corporation. Right.

QUESTION: But it's that -- also is sort of contrary to the basic purpose of deduction, it seems to me.

MR. JONES: No, because the -- what Congress was concerned about was the company who was liable for the -- whether the company that was liable for the product liability expenses had been fairly treated, and if that

company is a single entity, then it has received the income in the past, it has paid taxes on that income, and then when the deductions come up ten years later because the expenses come up later, it's fair to let that company go back and get the monies that they've paid in taxes back ten years ago.

It is not fair, and it's not what Congress provided, to let some other company that had no product liability expenses go back and get their taxes back from ten years. That's not what 172 is about. That's not what the consolidated tax return provisions are about. That's not what this Court or Congress intended to sanction. This Court said in Woolford Realty that this sort of juggling is not to happen, and in Section 1502, Congress said that the privilege of filing a consolidated return is not to be used as a license for evading taxes. That's what we have at issue here.

I would like to point out that in Intermet, the Sixth Circuit got this issue wrong principally by relying on Section 80 of the regulations which the Court said creates a default rule under which you are supposed to apply tax provisions first at the consolidated level, unless a regulation otherwise provides. That's a hundred and eighty degrees off.

QUESTION: Was it a hundred and eighty degrees

off in Intermet to say a separate taxable income's character as positive or negative has no independent significance?

MR. JONES: Yes, that was also well off the point. The locus of the income at the individual corporate level is often important -- it's often critical -- in determining the proper tax treatment of that item. This case is just one more example of that. For example --

QUESTION: So it was also wrong when they said a member's product liability expenses affect the group's consolidated net operating loss, dollar for dollar, whether the member has a positive or negative separate taxable income.

MR. JONES: Well, actually what affects the income of the consolidated group is the positive taxable income that comes from that affiliate.

QUESTION: So that can --

MR. JONES: The positive taxable income goes over and reduces the losses of the other companies. The Sixth Circuit just got this wrong, and they thought that the --

QUESTION: What are the other examples you were about to give? Other instances in which it's important to figure out the separate taxable income of --

MR. JONES: H Enterprises is a good example. We cited this in our brief. H Enterprises involved a company -- two affiliates, one of which bought some stock and the other, which borrowed some money and transferred it to its affiliate. And the affiliate used that money to buy the stock. Now, there's a limitation on the amount of interest that can be deducted for this kind of equity acquisition, and the question was, well, do you combine these two, or do you look at their separate character? And the answer of the tax court in H Enterprises was, no, you have to look at them as separate individuals and apply that provision separately first. Now, another -- and so the result was that, well, you didn't hold the interest -- the company that borrowed the money subject to this limitation of using that, that when the other company used the money to buy stock.

The other example is -- is the First Chicago bank case which we've cited where the question is, well, can a company claim a dividends-received deduction? It can only do that if it holds a certain percentage of the stock of the company. One affiliate owned less than that amount, and another affiliate owned less than that amount, but when you combine them, they both own more than that amount. But because you local -- you focus your inquiry first on each separate company, neither of those companies

qualified for the dividends-received deduction because neither of them individually met the requirement.

When Congress has wanted to provide for consolidated treatment of loss items, they've done so expressly. In 172(h), Congress provides a loss limitation on certain kinds of interest incurred in connection with equity acquisitions and expressly stated that when this provision applies to a corporation that is a member of an affiliated group, it is to be applied to the affiliated group directly.

Congress made no such consolidation -- required no such consolidated treatment for product liability losses that are described only a few paragraphs away. The implication of this seems to be pretty clear -- that Congress recognizes the background rule that this Court described in Woolford Realty, which is, you look at each of these companies as individual entities first, unless a regulation provides separately. That's why I was focusing on how the regulations tell us what to do.

The regulations tell us take these deductions at the individual affiliate level first. Having taken them at the individual affiliate level -- these were profitable affiliates, they had no losses to pass on to the consolidated return. The losses at the consolidated level are ordinary losses with a three-year carry-back, not this

special ten-year carry-back that you can only get through juggling of tax attributes as this Court described in Woolford Realty.

I want to just briefly touch on one thing that was raised in the reply brief, which is a new argument and which is wrong. In the reply brief they say that the Gottesman case stands for the concept that you construe all ambiguities in consolidated return regulations against the Secretary. Looking at that case, it's clearly not what it holds. What it says is that penalty provisions are narrowly interpreted. Penalty provisions are to be construed against the Secretary.

The ordinary rule that this Court established in White v. United States in 305 U.S., which we always cite when taxpayers make this argument, is that there is no policy of lenity. That the tax provisions are not interpreted in favor of the taxpayer. Indeed, in a case like this involving deductions which are a matter of legislative grace, any ambiguity is to be resolved against the taxpayer. This taxpayer has not satisfied the requirement of showing that its profitable affiliates had losses from product liability.

Congress did not intend to provide benefits for any other type of corporation, and the consolidated return regulations don't get them there, either.

I think I've covered what I intended to.

QUESTION: Thank you, Mr. Jones.

Mr. Fox, you have two minutes remaining.

REBUTTAL ARGUMENT OF ERIC R. FOX

ON BEHALF OF THE PETITIONER

MR. FOX: The Respondent takes the position that if the regulations do not address a particular provision, that any provision in the Code has to be applied on a separate company basis and not on a consolidated basis. That is totally inconsistent with the position that the Internal Revenue Service took in both Gottesman and H Enterprises.

In the Gottesman case, the IRS argued that the accumulated earnings tax had to be applied on a single-entity basis. They happened to lose that case, but that was their position.

In H Enterprises, they took the position that the disallowance of interest rule had to be applied on a consolidated basis, and they won the case. What happened in that case was the taxpayer argued that they had borrowing in one company, and the tax exempt bonds in another company, and that you shouldn't look at the two together. But H Enterprises is -- clearly provides that you look at the whole thing as one, and there was no regulation that said that.

The other point I want to make is that the Government seems to think that you can kind of have a -- it's not very important as to how close the definition of separate taxable income may come to net operating loss. I think that is, in a sense, totally irrelevant because the statute says, you look at the net operating loss. The regulations have provided for a net operating loss. It's the consolidated net operating loss. I see no reason why it would even look at separate taxable income.

The question is, we have the regulations provision for the separate net operating loss, and the issue is, to what degree does that net operating loss that everyone agrees can be carried back three years -- to what extent is it attributable to product liability deductions? When we come up with the number, that's the product liability loss. And that's the end of the matter, and you don't need a regulation to tell you to get there, because the statute is clear on its face, and the Service has put in the regulation the definition of net operating loss.

Thank you.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Fox. The case is submitted.

(Whereupon at 11:03 a.m., the case in the above-entitled matter was submitted.)

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