IN THE SUPREME COURT OF THE UNITED STATES

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DAVID A. and LOUISE A. GITLITZ, et al.,

Petitioners

v. : No. 99-1295

COMMISSIONER OF INTERNAL REVENUE

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Washington, D.C.

Monday, October 2, 2000

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:00 a.m.

APPEARANCES:

DARRELL D. HALLETT, ESQ., Seattle, Washington; on behalf of the Petitioners.

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

C O N T E N T S

P R O C E E D I N G S

(10:00 a.m.)

CHIEF JUSTICE REHNQUIST: We will hear argument first this morning on number 99-1295 David A. Gitlitz versus the Commissioner of Internal Revenue.

Mr. Hallett.

ORAL ARGUMENT OF DARRELL D. HALLETT

ON BEHALF OF THE PETITIONERS

MR. HALLETT: Mr. Chief Justice, may it please the Court: As a result of the position taken by the Commissioner of Internal Revenue on the brief before this Court, the issue the Court needs to decide is a limited one. And that issue is whether the amount of debt discharge or cancellation of debt of an insolvent debtor which is excluded from income under Section 108 is income, such that it amounts to an item of income which increases the shareholder's stock basis under Sections 1366 and 1367 of the Internal Revenue Code.

The Commissioner rests his entire case in his brief on the argument that under Section 108 no income is realized by the insolvent debtor. Your Honors, that position is clearly contrary to the statute. And if I may rather than paraphrasing initially, read the statute, I think it's really critical to this issue and resolves this issue. And that statute is section 108(a)(1) in the

appendix to the petition, at Page 34.

And it states as follows: Gross income does not include any amount which, but for this subsection, would be includable in gross income by reason of the discharge of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent.

To paraphrase that, Your Honors, what that subsection (a) says in hopefully plain English is that an item is only excluded under Section 108 if it otherwise would have been included in gross income under Section 61.

QUESTION: Well, I think your argument under the statute is a strong one. But is there any reason in tax theory or practical equity why Congress would want to allow this result in this particular case? I mean, I understand that the statute may compel this, but is there some underlying rationale to support your position?

MR. HALLETT: It may well be consistent with the restructuring of the Internal Revenue Code in 1954, in which Congress said very broadly in Section 61 that gross income includes all income from whatever source derived, and listed specific items, some 15 of those, and one of them is income from subsection 12.

And then consistent with that over in Sections 101 through 138, those items that are included in income are specifically excluded from gross income. So --

QUESTION: What I am asking is why would Congress allow you to use income that you don't pay tax on, to increase the basis and then which would allow you to deduct additional unrelated losses?

MR. HALLETT: Well, first of all, because this statute clearly says that --

QUESTION: I know that's position number one. I'm asking, is there a reason for this?

MR. HALLETT: There's a reason for it is that in the final analysis, the basis reflects the shareholder's equity in the corporation, roughly speaking, and the shareholder gets equity in the corporation by contributing capital. He also gets equity in the corporation when income is realized, taxable or nontaxable. And the Congress recognized that if losses have accumulated such that they are not deductible because they exceed the basis, well when income is realized, nontaxable income such as municipal bond interest, that income goes down to increase the basis to reflect the fact that there now is an increased equity investment.

QUESTION: Mr. Hallett, it seems that the Subchapter S shareholder is the only solvent entity who could take advantage of this. The peculiar thing about this provision is that every other taxpayer, say a Subchapter C corporation, a partner in a partnership, the

insolvent would have to be that entity, that tax paying entity. But here you have the peculiarity that the Subchapter S corporation, which is not itself a taxpayer, is the insolvent, while the shareholders are highly solvent. And is there any reason why Congress would want to give those solvent taxpayers this advantageous treatment?

MR. HALLETT: I think what -- they clearly did that in 1984 when the Congress said that in the case of an S corporation, the amount is excluded if there's insolvency at the corporation level. They certainly recognized that by doing that, the benefit of the exclusion would come down to the shareholder who could well be solvent.

And I think to the extent the legislative history reflects why they did that, it made it simpler to look to the insolvency of the corporation rather than up to 75 shareholders. They may well have recognized that in any situation, certainly not all, if the S corporation is in trouble, the shareholder is in trouble as well.

QUESTION: But it wasn't that way up until -- and yet, in 1982 -- well, let me put it this way: Do you recognize that if the 1982 law was still in place, the government should win?

MR. HALLETT: Well, it would depend on whether

or not my clients the shareholders were insolvent. If they were insolvent then they would be entitled to the result that we are seeking.

QUESTION: Yes, but in this case where we have very solvent shareholders and an insolvent Subchapter S corporation.

MR. HALLETT: This particular case, if the law would have remained as it was in 1982, then if the shareholder were solvent he would not be able to exclude the amount from gross income.

QUESTION: So it was the change in '84?

MR. HALLETT: It was a change in 1984.

QUESTION: And so we would look to a reason for that change if we are trying to understand, as Justice Kennedy asked, whether there might be something other than the words of the statute going for the position you are taking?

MR. HALLETT: That is true. We would look to the change. But I think you would also look to the critical statutes that existed prior to the change in 1984 and the statutes which provide for the basis increase, and those are Sections 1366 and 1367.

Now when Congress made the change in 1984, they did not change those provisions.

QUESTION: Mr. Hallett, is it invariably the

case that this comes as a windfall to the solvent shareholder? Would the government never recapture the benefit that the shareholder gets?

MR. HALLETT: Well, it's not the case that it's a windfall. It's certainly not the case that it's a windfall.

QUESTION: Accept my characterization of it as a windfall. Would any events in the future enable that benefit to the shareholder to be recaptured by the government?

MR. HALLETT: Well, certainly if you view a benefit excluding the debt discharge amount from gross income, then if the attribute deduction provisions come into play, you could view that as a recapture of the benefit in the future.

QUESTION: Well, suppose the corporation suddenly becomes solvent, its business picks up or in some new sort of business. I assume that at that point the distortion would even out for years, say one, two, three, four and five, because the net operating losses which might otherwise have been deducted against the new income are now diminished by reason of the discharge of indebtedness income.

MR. HALLETT: That's correct.

QUESTION: So there, to answer Justice Scalia's

question, there might be, I think there might be some instances in which this distortion, if we can call it that, or windfall, does even itself out?

MR. HALLETT: That's correct. And much as Your Honor stated, the increase in basis by the amount of discharged debt occurs at the time of the insolvency and permits the taking of the losses. And by taking of the losses, the losses of course go away.

QUESTION: So it isn't always a windfall or distortion, accepting those characterizations?

MR. HALLETT: It's not always a windfall.

QUESTION: And I guess this was in Justice Kennedy's question. The events that deny the windfall character will be in subsequent tax years; is that correct?

MR. HALLETT: That's correct. That's correct.

QUESTION: Going back to your very initial point about Section 108, if Section 108 had read, items of income shall not include , instead of gross income does not include , then the government would be right; is that correct?

MR. HALLETT: Well, I don't think so because it -- it would still presuppose that the item is income. In other words --

QUESTION: No. I'm saying if it specifically

said income from discharge of a debt shall not be treated as an item of income.

MR. HALLETT: Yes.

QUESTION: Then your whole case would collapse.

MR. HALLETT: Yes. If Congress would have said specifically that COD is not income.

QUESTION: So it s the difference between excluding from gross income and specifically stating that it's not an item of income, as the case turns out.

MR. HALLETT: Exactly. And that's a very important distinction that was drawn when Section 108 was enacted in 1980.

I'd also point out, Your Honor, that if the Commissioner were correct, that COD is not income, then Section 108 would never apply to an insolvent debtor. And if we look at Section 108(b), it only comes into play if an amount is excluded under Section 108(a). Now if it's not income and it's therefore, doesn't come within 108(a) because it otherwise wouldn't be income, then the attribute reduction process which the Commissioner places so much weight upon would never occur.

QUESTION: So what's supposed to happen? Some disaster must occur in the tax code since the government did at one point push this argument, but it stopped, I want to know what disaster occurs if you just take

108(d)(7)(a), in which it says these things will apply at the corporate level. It says it applies at the corporate level, those three sub -- four subsections, (a), (b), (c) and (g); (c) and (g) are just special cases, but (a) and (b) is the main case. It says they apply at the corporate level. What does that mean? It means it doesn't flow through. It's very simple; nothing flows through. The attributes don't flow through. Nothing flows through.

All right. Now once you say that, that cures what seems an anomaly from a point of view of policy. Why don't we interpret it that way?

MR. HALLETT: Because the statute doesn't say that.

QUESTION: Well, let's see what it says. It says, in the case of an S corporation, subsections (a), (b), (c) and (g) shall be applied at the corporate level. Now why can I not take those words to mean they shall be applied at the corporate level and only the corporate level, i.e., they do not flow through?

MR. HALLETT: Because we have to look at what is applied at the corporate level. For example, subsection (a), the exclusion from gross income is applied at the corporate level. And that's logically because the corporation realizes the income and it excludes it.

QUESTION: Right.

MR. HALLETT: Subsection (b), and this is the critical part of the statute, an essential part of the statute as amended in 1984, is that the insolvency is determined at the corporate level. But those two provisions do not say anything about the basis pass through.

QUESTION: I know they say nothing. They say nothing. So what I'm doing is suggesting that because they say nothing one way or the other, one can interpret those words shall be applied at the corporate level to mean everything to do with 108 applies at the corporate level in the case of the Subchapter S corporation, and does not flow through. So what I'm asking you is why can I not do that?

MR. HALLETT: Because the statute doesn't say everything occurs at the corporate level. It says the gross income is excluded --

QUESTION: I've got that point. Your point is the language.

MR. HALLETT: Yes.

QUESTION: Is there anything other than the language?

MR. HALLETT: The plain language of the statute.

QUESTION: Nothing else.

MR. HALLETT: And the failure to say anything in either 108 or Sections 1366 and 67 about the general rule of basis -- pass through to basis not occurring.

QUESTION: So you're --

MR. HALLETT: There's nothing to suggest that. Not a hint.

QUESTION: Is it an answer to Justice Breyer, and I may be wrong about this, that if that interpretation prevailed, there would be some instances in which the shareholder was really entitled to a double tax. In other words, if there were basis left and the basis were not decreased as a result of this interpretation, then the shareholder in effect would be paying a double tax in some instances, or am I wrong about that?

MR. HALLETT: Well, I'm not sure it would result in a double tax. I think it clearly would read into the Code language that's simply not there.

QUESTION: Well, that the shareholder would be taxed in effect for discharge of indebtedness income even though the corporation was insolvent.

MR. HALLETT: That's true.

QUESTION: Because the basis would not be reduced.

MR. HALLETT: That's true. That's true.

QUESTION: Mr. Hallett, may I go back to an

earlier colloquy, and that is, as I understand it in this case, the tax attributes, at least under your theory, they wouldn't -- that would be an academic question because the losses here were entirely wiped out against the increased basis. Isn't that right? There were no losses left.

MR. HALLETT: True. Once we go through the process of determining how much the losses exceeded basis for the taxable year, as the statute tells us to do, if the losses are completely absorbed by the COD, if they are completely absorbed because of the increase in basis, then assuming there's no other attribute, assuming there's no basis in assets that can be reduced, that would be true.

QUESTION: I take that to be the case here, that the losses were totally absorbed.

MR. HALLETT: No. Actually, and I have to point out, this is not in the record, Your Honor, the losses were totally absorbed but there was some $800 thousand basis in assets and properly applied, even though the losses were absorbed, the COD income is still there and the COD income would be applied in the next taxable year to reduce the basis in the assets.

QUESTION: But that's not -- we don't have the next tax return before us, so we don't --

MR. HALLETT: No, no, that's true. That's correct. And I would just point out, it's a very

important concept of Section 108 that, I think it's -- you read the legislative history and it does admittedly talk about a purpose is to pick up the income in the future through the attribute reduction, but Congress allowed a very very important exception to that. And that's the full ability to use net operating loss carryovers or basis in the case of property sold in the year of discharge. Very very important, such that certainly many taxpayers are going to have excluded COD income but they are not going to have any attributes to be reduced.

I don't believe the situation we have here is in any way an anomaly. We have absolute proof of that in one of the cases. The Pugh case, there were no attributes at all. There were no suspended losses, there was no basis in assets to reduce. And the Court of Appeals of course held that the COD passed through.

So we know that situation. We know that situation exists.

QUESTION: Why do you say it's no anomaly? I would think with an ordinary corporation the chance of an insolvent corporation ending up with a lot of positive income in the year of insolvency is pretty low. With an individual, the chance of an individual ending up with a lot of positive income in the year of insolvency is pretty low.

In the case of an S corporation, the chance that a shareholder of the insolvent S corporation could have a lot of positive income in that year is pretty high. And therefore, if we accept your intention for an S corporation, your interpretation, we reach as a practical matter quite a different result in terms of tax windfalls than you do in the other two instances.

MR. HALLETT: Well, I think though in the other two instances, take a corporation that's in trouble and has net operating losses, it could well be the situation that it doesn't have any basis in its assets in excess of the liabilities. It excludes the amount from income and it doesn't have any attributes to reduce. That's what I'm saying; it's not an anomaly to have a situation such as we have in this case that whether it's a corporation, a regular corporation or a partnership, that we don't end up with any attributes to reduce, particularly because they can be used in the taxable year of the discharge.

QUESTION: May I ask you a question about -- nobody seems to discuss in the briefs about, 108(2)(e), which says, it seems to say in so many words, (e)(1), it says basis reduction , that -- why isn't that relevant, that there's a direct reduction to basis under (e)? You know what I'm talking about? It's on page 36 of the appendix.

Reduction -- subsection (b) says reduction of tax attribute and it lists the things that are reduced.

MR. HALLETT: Yes.

QUESTION: And the last thing listed is the basis of the property of the taxpayer.

MR. HALLETT: Yes.

QUESTION: Why doesn't that --

MR. HALLETT: Well, that could come into play if for example, if the taxpayer here had $800 thousand of basis in property, not the taxpayer, but if the S corporation had the $800 thousand basis in property, then that would be reduced. That would be reduced. It would be reduced though specifically, Section 1017 says it would be reduced after the taxable year of the discharge, as of the beginning of that year.

I would just call the Court's attention as well to one other section that I think solidifies that income is realized as a result of debt discharge and that's Section 108(e)(1) on page 43. And it specifically says there is no other insolvency exception to the general rule that COD is income to be included in gross income. And that general rule is provided in Section 61(a)(12).

And finally on this matter, the Commissioner goes back to 1923 and cites court cases particularly in the depression era, and a Treasury regulation that was

promulgated before the substantial 1980 revisions of Section 108. And I would point out that those court cases are flawed reasoning. The notion is that --

QUESTION: They are what, Mr. Hallett?

MR. HALLETT: They represent flawed reasoning. The rationale in those cases that if a debtor realizes debt discharge, that there is no income if he's insolvent. Of course the Court held in 1931 in Kirby Lumber that as a general proposition there is income. And these cases in the depression era picked up on some language in Kirby Lumber about the forgiveness of the debt frees up assets . And they said well, if you're insolvent, it doesn't add to assets. And so there is no realization of income.

That was the rationale of those cases. And I submit that just defies economic reality where a debtor has $2 million in debt, or $1 million in debt, or $100,000 in debt, and that is discharged. And if he's a few hundred dollars or a few hundred thousand dollars still insolvent after the discharge, that's a real economic benefit. He can take the amount that otherwise would be paid for principal and interest on that debt and apply it to expenses to keep going. When you recognize that the insolvency is determined based on the fair market value of the assets, it could well have a situation where the real

estate operating assets, the value doesn't exceed the debts.

But when a million dollars of debt is discharged, that money is indeed freed up. It does indeed free up the liquid assets to either pay down other debts or refinance or pay expenses.

If that rationale applied, if that rationale applied, that would mean where a debtor is insolvent and sells an asset for a million dollar gain, that -- but is still insolvent, and say he takes the million dollars and uses it to pay off debt, if that rationale applied, there would be no income in that situation. Because after the transaction, even though he's had gain, he's still insolvent. That's not the tax law.

And I submit that that transaction cannot be meaningfully distinguished from the situation where the debt is directly discharged.

Let me turn briefly to the specific language of Sections 1366 and 1367. And I think there's a question of where do you start here. Do you start with Section 108 or do you start with Sections 1366 and 67? I don't think it makes a difference. Because if you start with Section 108, you go to 108(d)(7)(b). And that sends you over to Sections 1366 and Sections 1367. Sends you over to determine the amount of the losses that are disallowed for

the taxable year of the discharge before you can determine that there is an attribute.

And those, I would just point out that 1366 and 67 are very, very broad. This isn't a narrowly drawn statute. It says in 1366 that all items of income, including tax exempt income, are taken into account in determining shareholder basis.

Congress described the reason for the basis increase in some of the legislative history as insuring that if an item is nontaxable, then if there's later a distribution, the shareholder doesn't have to recognize income as a result of the -- it preserves its nontaxability. The Commissioner seizes upon this stated purpose of a shareholder basis increase and argues that, well, that means that you only could increase basis for a nontaxable item if you get cash, money in the till that you can distribute in kind.

Well, the statutes don't require that there be a distribution in kind. The statutes don't say that you have to lock the cash up in a safe deposit box and use it in the future for a distribution. The fact is if you have municipal bond interest that's collected and used to pay debt you are in the same situation on the bottom line balance sheet situation of the shareholder and the corporation.

But the critical event here, and this is -- I'm glad the Commissioner brought up this notion of realization of income, because commentators and some of the courts have said that, well, you shouldn't give the shareholder the losses because he hasn't had an economic loss.

Well, the point is, he's had an economic gain. It's the economic gain, the income, that Congress has chosen not to tax, that permits the taking of the losses.

I would finally point out under Section 108 that -- excuse me; before I get to that I would point out that what we are asking for is consistent treatment here. An S corporation that gets excludable municipal bond interest is entitled to up the basis and take losses. And we ask for the same thing.

The -- all other debtors who exclude COD income get to use their attributes in the year of discharge and we ask for the same thing. And this 108(d)(7)(b) has really been a matter of confusion. It hasn't been read closely. It requires that before you eliminate any losses you have to go over to Sections 1366 and 67 and determine if there is an excess of losses remaining after the COD income is taken into account.

I will reserve the remainder of my time for rebuttal.

QUESTION: Thank you, Mr. Hallett.

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.

Congress did not provide to Subchapter S shareholders the unique double tax benefit that petitioners seek.

The simple question presented here is whether the discharge of debt of an insolvent is an item of income or tax exempt income that flows through to shareholders and increases their basis under 1366.

The plain text of the directly applicable statutes seems to provide a pretty clear answer to that.

QUESTION: Mr. Jones, would you clarify whether you are indeed walking away from the rationale of the Tenth Circuit which was not about the characterization of this as income, but was a timing question, as I understand it.

MR. JONES: The timing question, we don't think the timing question ever arises in this case, nor has it ever properly arisen in any of the other cases.

QUESTION: But you did argue the theory that the Tenth Circuit accepted; you argued it in the Court of

Appeals.

MR. JONES: Actually, I believe the Tenth Circuit developed that theory on its own. I believe that in the Tenth Circuit as in the other cases our argument has been twofold: that this item has never been regarded in the 80-year history of the Internal Revenue Code as income for an insolvent taxpayer. Secondly, that 108(d)(7) recognizes and is an emanation of that fact.

The Tax Court rationale was that 108(d)(7) says all of this happens at the corporate level. And it isn't income because it's excluded and it's not tax exempt income so nothing passes through.

QUESTION: To put Justice Ginsburg's question another way, if you do not prevail on your argument that it's not income, I take it you don't ask us to accept a backup position that reflects the view of the Circuit on timing.

MR. JONES: If the Court were to disagree with our basic contentions, then you would be faced with a problem -- then as a Court the problem would be that you have the clear history of the statute that says this is not to be treated as income. It's to be applied against tax attributes and then to be disregarded. So you would have that clear history. You would also have the presumptive rule that tax statutes should not be

interpreted to provide a double benefit.

QUESTION: No, we don't think it's a problem. Let's assume that we simply reject that argument. I want to know if the backup argument, if you think that as a matter of sound, statutory construction, I think this is what Justice Ginsburg was asking, for us to accept the timing rule adopted by the Circuit.

MR. JONES: It is an appropriate resolution of the problem if you reach it, and the reason that is so, is that 1336(d)(2)requires the losses, the suspended losses from the prior year, to be brought into the corporation in the year of the discharge. And then --

QUESTION: 1336 or 66?

MR. JONES: 1366(d)(2).

QUESTION: Now Mr. Jones, we've got some 20 pages in the appendix of statutory sections. When you cite a statutory section, could you refer us to the page of the appendix on which it is?

MR. JONES: On Page 53 of the petition appendix. It says, any loss or deduction which is disallowed for a taxable year by reason of the prior paragraph of that same page, shall be treated as incurred by the corporation in the succeeding taxable year.

Now this is the point that the Tenth Circuit made, that this provision brings back into the year of the

discharge the losses from the prior year, the suspended losses from the prior year. And then --

QUESTION: But Mr. Jones, isn't that antithetical to the -- is it in 1017 the general timing rule that you take this in the next year, not in the year of the --

MR. JONES: It is a different treatment of suspended losses. It is expressly a different treatment of suspended losses and how they are handled on the Subchapter S return. These are rules peculiar to Subchapter S's. Yes. The answer to your question is yes. It is a different treatment for suspended losses. It brings them into the year of the discharge. And then under 108 we know that the tax attribute reduction is to apply at the corporate level.

QUESTION: If you think that the timing rule is changed here, it's surprising that you didn't make any suggestion of that in your brief.

MR. JONES: Well, I think that it's -- I wouldn't call it a fall-back argument but I would call it not a correct way to analyze the basic problem that we have in this case, which is that the courts have glossed over the question of whether this has ever been regarded as an item of income, and in particular whether Congress intended it to be treated as such, when the history of the statute says as clearly as it could that Congress accepted the 80

year old position of the Treasury and the judicial insolvency exception, did not regard this as an item of income, said that it was to be applied to reduce tax attributes and then in the words of both the House and Senate reports, has no further tax consequences.

QUESTION: Let me see if I can get you to focus precisely on the point I'm trying to understand. You have just told us that in the Tenth Circuit brief we will not have found this unusual approach to the timing question. We would not have found that in the government's argument. We certainly don't find it in our brief in this Court. I'm just trying to determine whether the government at least considered it an alternate argument in the lower courts and for some reason abandoned it here.

MR. JONES: I think it -- I wouldn't quite put it that way. I think that the right way to put it is the way I have put it, which is that with proper -- we are presenting this case to you with complete integrity. We think this issue need not be reached in this case.

QUESTION: Did you present it the same way in the Tenth Circuit?

MR. JONES: Actually, I believe in the Tenth Circuit we didn't address the issue. I believe the Tenth Circuit developed its analysis on its own.

QUESTION: So if I look at the government's

brief, I'll find that corroborated?

MR. JONES: I think that's correct.

QUESTION: Did you address the issue you are now addressing in the Tenth Circuit?

Mr. JONES: I'm sorry, Justice?

QUESTION: Did you address the issue you're presenting to us in the Tenth Circuit other than --

MR. JONES: Yes.

QUESTION: -- in footnote 14 of your brief.

MR. JONES: Although in the Tenth Circuit, we were defending the tax court's ruling.

QUESTION: Yes, but for whatever reason, this argument that you now say is so obvious on the face of the Code, was this referred to in your argument to the Tenth Circuit other than in a footnote, footnote 14 of your brief?

MR. JONES: Well, you are expressing a close familiarity with that and I don't remember footnote 14.

QUESTION: I didn't dig this out myself. It was stated in your opponent's presentation. Is it inaccurate?

MR. JONES: It is -- I have recently looked at our brief in the Tenth Circuit and my recollection of our brief in the Tenth Circuit was that we made the same point and we made the same argument in the context that the tax court resolved the issue, which is that first they talked

about how it's all done at the corporate level. And then having reached that conclusion, emphasized that there is no item of income and no tax exempt income in connection with this item.

QUESTION: This does not constitute income. You made that explicit argument?

MR. JONES: Yes. In fact, we noted that the Treasury regulations have provided this for 70 years, long before 61 was enacted, long before 108, and that the courts had adopted the judicial insolvency exception, had agreed with the Commissioner that no income arises from the discharge of the debt of the insolvent.

QUESTION: Are there past cases in which the IRS has argued that something is not income, or is this a first?

MR. JONES: Well, it's an uncomfortable position for us. I mean, I would love to be able to resolve this case properly without addressing that subject. But we can't because Congress made that the fulcrum of its legislative determination.

QUESTION: You know, it seems a little contradictory to say that under Section 108, the taxpayers here have to pay some sort of tax whether you call it a deferred tax or just a price on something that you say isn't income of any type. It just seems contradictory.

And I'm concerned, if we say it's not income, that there may be other items that are currently considered to fall within section 61 as income that all of a sudden we find aren't. And I don't know how far that would take us if we --

MR. JONES: I don't know of any other. And of course I don't know if that provides you with any comfort, but let me answer the first part of the question you raised which is, are there other situations where something that does not constitute income has an effect on basis, or doesn't. The closest example, and I don't believe it's quoted in the appendix, is 1368(b). And 1368(b) is a provision that says that if a Subchapter S corporation has no earnings and profits and makes a distribution to its shareholder, that won't be treated as income and under 1367 it will reduce their basis.

Well, this is a similar determination. If something has happened here that puts the shareholders in a position whether they might --

QUESTION: Excuse me. That means it won't be treated as income to the shareholder.

MR. JONES: Yes.

QUESTION: You are not talking about whether in the abstract it's an item of income. They have to say that it's not treated as an item of income because

otherwise it normally would be.

MR. JONES: Well, actually, if you look at the close words of the statute, it doesn't say that. Section 61 begins with the phrase "except as otherwise provided, discharge of a debt is not an item of income". And that recognizes the historical distinction that Justice -- that this Court had talked about in Commissioner versus Tufts, in Justice Blackmun's opinion that the whole theory of the discharge of indebtedness doctrine is that the discharge frees up the assets of the debtors and he could use them to --

QUESTION: May we go back to the formulation that gross income does not include? Well, that same formulation is also used for tax exempt bond interest.

MR. JONES: Yes.

QUESTION: For life insurance proceeds, and even though it says the same exact words, does not -- gross income does not include, we know that those do up the basis.

MR. JONES: Not as an item of income though. They come in as tax exempt income. 1366 raises the basis for items of income including tax exempt income. Tax exempt income is something that really is income, and it's an accretion to wealth. The only example that --

QUESTION: But the words of the statute are the

same. Gross income does not include.

MR. JONES: Right. But tax exempt income is real income. It's something that you receive. It's an asset. It is an accretion to wealth within the concept of --

QUESTION: And forgiveness of indebtedness --

MR. JONES: Is not. Forgiveness of indebtedness for an insolvent, as Justice Blackmun pointed out in footnote 11 of Commissioner versus Tufts, doesn't free up any assets.

QUESTION: But that was addressed by your adversary. He said well, suppose you have a corporation which is insolvent by a million dollars, and part of that is a $950,000 indebtedness. There's a world of difference. It amazes me that the government says this isn't income.

QUESTION: Or to put it more simply, if my bank told me, you know, forget about your mortgage. Boy, I'd feel a lot richer. You are telling me that that is not an accretion of wealth? That's unbelievable.

MR. JONES: My responsibility to this Court is to tell you how Congress, what we understand Congress used these terms to mean. Congress could not have been more clear. They adopted a judicial insolvency exception that adopted a longstanding regulatory interpretation. It doesn't matter, this Court doesn't have to resolve the

broader question of whether under Commissioner versus Glenshaw Glass this might be thought to be an accretion of wealth. You don't have to resolve this question because what is before the court is how did Congress view that difference.

QUESTION: Given that is before the Court, what was your answer to Justice Ginsburg. I was having exactly the same problem. I accept its a loophole, for argument's sake. If it was a terrible loophole, this would not be the first loophole that Congress wrote and it won't be the last. And maybe it would be the last, marvelous. There are 31 separate -- 29 separate subsections of this statute that use the words "gross income does not include". And I take it in respect to every one of those but one, you will say they are items of income. And obviously one thing I would be reluctant to do is to take those same words "gross income does not include", and say that those are items of income in every instance but this one.

Or in every instance but three. Or create a new spider web of rules as to when the words "gross income does not include" does mean it is none the less items of income but doesn't in other. That's the problem I'm facing. And to say "it's Congress's clear intent" doesn't help me solve that problem.

MR. JONES: But it should help you resolve that

problem because what's at issue was what was Congress's intent when it used the phrase "items of income."

QUESTION: And are you saying it's always the same, those words "gross income does not include" in those 29 subsections whatever they are referring to is never an item of income or do you mean sometimes is and sometimes isn't?

MR. JONES: I think I'm focused on your problem. I think the answer to your question is probably that in all of those instances it wouldn't be an item of income.

QUESTION: Never? What for example about a lessor's income? There's a reference here to a payment by a lessor of a certain kind of rent which I thought surely would increase basis.

MR. JONES: It wouldn't be income received in the year. And what happens is you are supposed to reduce the basis and recognize as this Court said in Centennial Bank, recognize that deferred income in future years. And as that's recognized then it becomes an item of income in that sense. But in the first year it's not treated as an item of income for this purpose.

QUESTION: Then it's income when it hurts the taxpayer in later years?

MR. JONES: It's income -- if it's income then it increases the basis. And if its not income, it

doesn't. And if its not income and doesn't increase the basis then it's -- then any income effect would be recognized in subsequent periods.

QUESTION: Could you answer one other question which is, -- but it's going to sound as if it's on your side so be tempted to agree but don't agree because you haven't pushed this argument and I want to know why.

It seemed to me that the strongest point was the words keeping it at the corporate level. Because if you kept it at the corporate level no problem I can think of would be caused and it eliminate the loophole and seems consistent with the language, but you have not pushed that argument. And therefore there must be some disaster in tax law lurking.

MR. JONES: We do. We put it as our second point. We don't abandon that argument. It's definitely addressed in our brief. Its sort of an intellectual fussiness that causes us to address the income issue first and then the shareholder issue, I mean the corporate level issue. And that is because (d)(7) wasn't enacted, as Justice Ginsburg pointed out until 1984. But in 1980 Congress already went ahead and said this is not to be treated as an item of income; it's to be used to reduce attributes and it is to have no further tax consequences. So we shouldn't have to look to 1984 legislation in (d)(7) to answer this

question. Now (d)(7) is consistent with our answer and therefore and it is a sufficient answer. But it seems to me to be perfectly faithful to what Congress said they did and to what the text of the these statutes permit us to understand. We don't have to go to 84. We can go right to where Congress said. And I want to point out in this respect that it is solely on the 1980 legislation that professors Victor and Lokin reviewed the history, reviewed the provisions and agreed with us that the discharge of indebtedness of an insolvent party does not represent an item of income and is to be ignored after it's applied against the tax attributes. Now what Petitioners' is: let's not ignore it, let's get a tax benefit from it. We'll pass it through as if it were income. We will get a basis adjustment that allows us to deduct the standard losses. And what they have done is used 108 to enhance their tax attributes when section 108(b) makes it clear that the whole point of 108(b) is to reduce tax attributes.

QUESTION: What do you think Congress did then in '84? I take it that taxpayer is conceding that if the 82 law remained in place a Subchapter S shareholder would be just like a partner in partnership and could not get this benefit?

MR. JONES: Well that --

QUESTION: But there was a change in 108, and it seemed to me that what you were essentially arguing is that we should undo the change that Congress made in 108. And you are telling me, no, the change in 108 didn't do anything? Or what?

MR. JONES: It didn't change the basic principles of 108 that the amendment in 1984 simply said that the tax attribute reduction would be applied at the corporate level for Subchapter S corporations. This is in 108(d)(7)(a).

QUESTION: If they applied at the shareholder level then you have a solvent shareholder.

MR. JONES: If they applied it at the shareholder level for solvent shareholders they would recognize the income and pay it on their own returns. It wouldn't have any consequence.

QUESTION: Right. But what was the effect of saying take it at the corporate level so that the insolvent is the corporation?

MR. JONES: Congress said that they were doing that because they wanted all shareholders to be treated the same. That was the explanation that Congress gave.

QUESTION: Well, didn't somebody point out to Congress or didn't Congress know that a Subchapter S corporation is quite different from a Subchapter C

corporation?

MR. JONES: Well, this is a special rule actually that applies only for Subchapter S's.

QUESTION: But you just me the rationale was that all corporations should be treated alike.

MR. JONES: All shareholders of this Subchapter S corporation should be treated the same. In other words they didn't want to -- Congress said they didn't want to have shareholder one to be treated differently from shareholder two although as you are aware for partnerships that kind of different treatment can result. But Congress didn't think this had anything to do with - that the change in 108(d)(7) had anything to do with the issue here because they had already resolved the issue in 1980 when they explained how these statutes were to work.

And I want to point out that in 1993 when Congress amended Section 108 to extend its application to qualified real property indebtedness, Congress went through the operation of these same provisions and said the same thing.

QUESTION: But Congress was explicit there in a way it isn't here.

MR. JONES: I don't know how Congress could have been more explicit in--

QUESTION: Didn't Congress say that there won't

be any increase in basis?

MR. JONES: That's true.

QUESTION: and here we don't have anything that says it won't be an increase in basis.

MR. JONES: We have awfully good indication of that. We have Congress saying it's not income. It's only to be used to reduce tax attributes. It has no other tax consequences.

QUESTION: But you will concede that to say basis will not be increased is something a lot clearer than what you are presenting to us?

MR. JONES: Yes, it's perfectly clear. But to me it's -

QUESTION: So why didn't they make that same statement with respect to this, knowing that the courts were all over the lot?

MR. JONES: In 1980 the courts were not all over the lot. In 1980 no court had ever suggested that the discharge of the debt of an insolvent was income.

QUESTION: What was the year of the real estate provision?

MR. JONES: 93.

QUESTION: 93.

MR. JONES: Yes.

QUESTION: So I am asking about when they made

that change in 93 and they said basis will not be increased. Why didn't they just say, well, let's do the same thing for subchapter S corporations?

MR. JONES: I am sorry. They were talking about Subchapter S corporations in 1993. They were talking about exactly the issue we have in this case.

QUESTION: But I'm just simply asking you why didn't they make that same change to say explicitly basis will not be increased, since that would have cured --

MR. JONES: The statute wasn't amended in any of its substantive characters in 93. They just added another provision to the same statute

QUESTION: Yes, but couldn't they have said "now we are adding this provision. And we are making this thing explicit. To make the statute compatible we ought to make that same provision elsewhere."

MR. JONES: They were talking about, -- When they said basis is not adjusted, they were talking about the Subchapter S corporation provisions involved in this case. So they were talking about previously enacted provisions of Section 108 in describing how they applied.

QUESTION: There are certain words that are used.

MR. JONES: Basis is not increased by --

QUESTION: Yes. And why wasn't it made clear then? Basis is not increased, with respect to this

subchapter S?

MR. JONES: That is exactly what they said at that the time in '93. I'm sorry. We are not communicating.

QUESTION: No, we are not. We have a provision that says those words expressly. You are asking them -

MR. JONES: It's not a provision. It's just legislative history.

QUESTION: I thought it was in the statute itself.

MR. JONES: No, I am sorry. Now I understand. It was in the history of --

QUESTION: Its not in the statute itself in any case?

MR. JONES: It was in the history of the 93 amendment that Congress in going through how the statute operates, explained that for subchapter S corporations this is not an item of income; it doesn't adjust basis. That is all I am saying. I am not saying that this is binding history.

QUESTION: Is there a provision of the Internal Revenue Code that says basis will not be increased that was a change that was made in the statute, not legislative history?

MR. JONES: I am not familiar with that, but it

is just the contrary. The statute says only that basis will be adjusted if there's an item of income. An Congress said this isn't and item of income. I know that that's -

QUESTION: Perhaps I will look for it. It's that real estate -- I am sure that you must be familiar with it and I thought that in that statute itself those words appeared.

MR. JONES: I am not familiar with that.

The contention that if it is not an item of income then its tax exempt income is also fundamentally flawed for the same reason. Its not tax exempt income because its not an accretion to wealth. Its not income in the first place.

QUESTION: Except that Section 61 of Title 26 says that income includes income from discharge of indebtedness. I mean that's a germinal provision.

MR. JONES: It says "Except as otherwise provided --"

QUESTION: Yes.

MR. JONES: Income includes income from discharge --

QUESTION: So that is the normal rule.

MR. JONES: Well, that's the contingent rule. It says except as otherwise provided, income includes income

from discharge. 108 says it does not include income from discharge of an insolvent. And that is the 80 year history of the Internal Revenue Code.

QUESTION: And it also says it does not include income from a lot of other things. I mean, as Justice Breyer was pointing out earlier, there are a lot of other things as to which it says the same thing. And all it means is that although gross income would normally mean this, for purposes of subchapter S, it will not mean that. But that does not mean -- it is in the abstract, not income.

I thought the argument you are making here

MR. JONES: I don't have any objection to what you just said. I think it is perfection correct. I think it's a proper concern. But our point is that what you are supposed to, what we have to resolve here is what did Congress mean when it said items of income in 1366 because that's what flows through. Congress said this is not an item of income. And I say this, I mean the discharge of the debt of an insolvent. My only point about the congruence of 61 and 108 is that they cannot win on those provision because all those provision say is what we say: It's not income.

And what the legislative history of the provisions say is exactly - is why we are here today

,which is that Congress has always said this isn't income. Has never permitted it to have any tax consequences other than attribute reduction. And I go back again to Victor and Loken. I mean, they are a pretty objective neutral source on this, and they agree with us, that this is not the way Congress used the term and that after it is used to reduce attributes, it's to be ignored. The reason.

QUESTION: Was this some article in a law review you are talking about.

MR. JONES: It's actually in their treatise.

QUESTION: In a treatise?

MR. JONES: Federal Income Taxation. It is a pretty reliable guide.

QUESTION: How has the Court of Appeals come out on this issue?

MR. JONES: The Court of Appeals have been sort of all over the map. If you are talking about the Court in this case,--

JUSTICE: No, I meant just the Court of Appeals. The Court or Appeals ruled for the government on this issue.

MR. JONES: Yes.

JUSTICE: Have other Court of Appeals ruled against the government on this point?

MR. JONES: Yes, The Third Circuit in the Farley

case ruled against the United States, saying that the plain language of 108 makes this an item of income. And I don't understand their reasoning because the plain language of 108 says it is not an item of income. And the clear history of the statute says it should never be treated as one. And instead it is to be ignored after you reduce basis. I mean after you reduce the tax attributes.

QUESTION: In fact, no Court of Appeals has agreed with the government on this point, has it? Is there any Court of Appeals that has agreed with this argument?

MR. JONES: I don't think there is a Court of Appeals that has gone through these arguments that we have made the primary focus of our position in this court.

QUESTION: The answer is no.

MR. JONES: They haven't addressed them, Justice Scalia.

QUESTION: Why didn't the government argue this in the other courts?

MR. JONES: Again, I believe what we were doing is that we were defending the rationale of the Tax Court.

QUESTION: Which you now disagree with?

MR. JONES: As I explained to Justice Breyer, we think that the proper way to reach this, to analyze this is the way Congress did, to start with 108 in 1980. And then to point out that the amendment to (d)(7) in 1984 was

consistent with that result and promoted that conclusion. Now, what the Tax Court did was different. They said, as Justice Breyer points out that all of this should be done at the corporate level and nothing escapes to the shareholders because it's all handled at the corporate level. I think that's a correct conclusion.

But I think one of the reasons it's a correct conclusion is because there is no item of income that can escape to the shareholders and add to their basis and give them this double tax benefit wind fall. And I do want to point out that in each of these cases when a basis adjustment is allowed there is indeed a windfall there.

QUESTION: But that can't be controlling. There's no reason to simply distort the tax code to avoid a wind fall in this particular case.

MR. JONES: I don't its controlling but it is a presumption that Congress doesn't intend to do that. And so when you look at these statutes and you have the clear history, and if you have any uncertainty about the application of the plain text of those provisions, that uncertainty should be resolved to avoid creating -- either denying the intention of Congress or creating the windfall benefits.

QUESTION: I'm sorry. What's the presumption you refer to.

MR. JONES: The presumption is what this Court said in Skelly Oil, that tax statutes should not be interpreted to be provide the practical equivalent of a double deduction, which is exactly what they have sought.

QUESTION: Could it not end up being a double tax in the other direction? Let's assume an insolvent chapter S corporation that later recovers. All right. The taxpayer would never have gotten the increase of his basis that arises from this reduction of indebtedness and therefore could not offset against any future gain that he gets from the corporation. Is that fair?

MR. JONES: I think that what you are pointing out is exactly the opposite of how Congress looked this situation. What Congress said was they are getting this immediate benefit not having this treated as income in the year that the debt is discharged. And recognize that they might benefit from that in future periods if they have income from other sources, Congress said I want to reduce the tax attributes, the favorable tax attributes, like suspended losses --

QUESTION: Than you, Mr. Jones. Mr. Hallett, you have two plus minutes.

REBUTTAL ARGUMENT OF DARRELL D. HALLETT

ON BEHALF OF THE PETITIONERS

MR. HALLETT: With respect to Victor and Eustice

Treatise, what it actually says is that COD income of an insolvent debtor is not gross income. And it's cited in the brief. Not one of the authorities cited by the government say that it is not realized. They say it's excluded from gross income. With respect to -- if the Commissioner were right that because an item is excluded from gross income, then none of the items excluded from gross income, life insurance proceeds, interest on municipal bonds, none of those would increase basis because they are not income and could not be an item of income.

This double tax benefit. There is no tax benefit at all without a basis increase. The item just as well have been taxable. If it was taxable, the income would flow down to the shareholder. His basis would go up and he'd be able to his loss against the income. He'd end up with zero basis and zero income just the same position where the Commissioner urges he should end up here.

Finally the Tenth Circuit did not develop the timing rule on its own. That rule is word for word what was urged upon it by the Justice Department in that case. This case has been a constant moving target. The only time the Commissioner argued the no realization was the first time this case was decided before then Chief Judge Cohen in Tax Court. She rejected it. It was never raised

again until it was raised in the petition for certiorari in this brief.

I submit, Your Honor, a plea on behalf of tax practitioners in this country. They should be able to read the Code as written. They shouldn't have to speculate as to whether or not a result that is called for on the plain language of the statute is too good to be true or is a wind fall. The tax laws are too complicated to have to get into that kind of speculation.

Thank you.

QUESTION: Thank you, Mr. Hallett. The case is submitted.

(Whereupon, at 10:59 a.m., the case in the above-entitled matter was submitted.)