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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED DOMINION INDUSTRIES, INC., :
Petitioner :
v. : No. 00-157
UNITED STATES. :
- - - - -X
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

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

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

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

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

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

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

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

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

25 MR. FOX: Well --

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

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

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

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

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

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

3 QUESTION: Well, then --

4 MR. FOX: -- incontrovertible.

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

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

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

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

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

9 QUESTION: Mr. Fox --

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

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

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

10 In this case --

11 QUESTION: Can be or must be?

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

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

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

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

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

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

1 other loss.

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

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

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

11 MR. FOX: Yes.

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

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

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

10 QUESTION: Okay.

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

16 MR. FOX: Well --

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

20 MR. FOX: That may not --

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

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

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

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

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

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

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

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

1 result that the Chief seeks to reach here --

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1 going to get the product liability deduction.

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

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

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

25 This provision was explained this way. Under

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

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

22 QUESTION: Very well, Mr. Fox.

23 MR. FOX: Thank you.

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

25 ORAL ARGUMENT OF KENT L. JONES

1 ON BEHALF OF THE RESPONDENT

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

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

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

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

24 QUESTION: And each of the corporations --

25 MR. JONES: The only --

1 QUESTION: -- is a taxpayer in your view?

2 MR. JONES: Each of these corporations is a

3 taxpayer.

4 QUESTION: Did they each file a return?

5 MR. JONES: The only way that they avoid filing

6 a separate return is by electing under 1.1502 to file a

7 consolidated return. And so the question is, how do you

8 go from the provisions of the Code that dictate how we

9 treat --

10 QUESTION: How many checks does the --

11 MR. JONES: -- separate taxpayers.

12 QUESTION: -- when they file that return, how

13 many people -- how many different corporations give the

14 Government money?

15 MR. JONES: Well, each of them is severally

16 liable, and so the answer --

17 QUESTION: The question is how many give them

18 money, not whether they --

19 MR. JONES: Well, I don't know. The answer can

20 vary. Sometimes a check can be drawn from each of the

21 corporations or by any one of them. They are severally

22 liable for this tax. That is to say each of them is

23 liable for the consolidated tax. To understand how --

24 QUESTION: For the whole tax?

25 MR. JONES: Yes, sir.

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

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

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

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

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

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

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

9 MR. JONES: Yes.

10 QUESTION: -- I mean, capital --

11 MR. JONES: There are some exceptions of items
12 --

13 QUESTION: Charitable deductions? Capital
14 losses?

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

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

20 MR. JONES: You don't --

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

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

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

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

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

22 QUESTION: You just used the term consolidated
23 taxpayer --

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8 MR. JONES: They were --

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

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

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

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

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

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

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

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

12 MR. JONES: Yes, sir. It's resolved by Section
13 12 of the regulations which require the separate taxable
14 income to be calculated by reducing from each taxpayer's
15 income the product liability expenses it incurred.

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

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

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

5 QUESTION: But your colleague disputes, and the
6 court of appeals happen to agree, that your reliance on
7 1502-12 simply solves this.

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

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

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

14 QUESTION: Well --

15 MR. JONES: And Reg 12 --

16 QUESTION: Which is -- which is --

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

18 QUESTION: Which defines separate taxable
19 income.

20 MR. JONES: Yes, sir.

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

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

1 QUESTION: But how about the courts of appeals?

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

7 QUESTION: But the Fourth Circuit did --

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

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

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

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

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

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

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

6 Suppose we agree with the Fourth Circuit and the
7 Sixth Circuit that the position you are taking about 1502-
8 12 is incorrect. Do you embrace the position that the
9 Fourth Circuit takes as a proper way to resolve this case
10 and all other --

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

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

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

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

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

20 MR. JONES: Yes, there is.

21 QUESTION: Which one?

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

1 separate affiliate level --

2 QUESTION: Yes.

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

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

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

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

20 MR. JONES: Okay.

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

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

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

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

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

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

17 QUESTION: Well, except I think it does. If,
18 for instance, for legal expense, the corporation has had
19 to have hired a lawyer and deduct a legal expense for
20 something that was a medical expense. I don't understand
21 --

22 MR. JONES: The only --

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

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

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

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

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

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

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

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

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

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

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

6 MR. JONES: The purpose --

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

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

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

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

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

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

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

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

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

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

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

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

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

1 invoke 269?

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

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

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

11 QUESTION: But you're not powerless.

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

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

16 MR. JONES: Well, the other --

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

19 MR. JONES: I don't mean to say it's a horrible
20 --

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

25 MR. JONES: I think that the other --

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

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

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

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

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

1 QUESTION: There's nothing --
2 MR. JONES: -- that is this situation.
3 QUESTION: Mr. Jones. Mr. Jones, there is
4 nothing wrong with a strategy to avoid the payment of
5 taxes. The Internal Revenue Code doesn't prevent that.
6 MR. JONES: But the question is whether the
7 consolidated provisions permit it, and in Woolford Realty
8 the Court said that the mind rebels against the notion
9 that in allowing for consolidated returns Congress meant
10 to provide for such a facile and obvious means of juggling
11 tax attributes to avoid the payment of taxes. That's what
12 we have -- we have a facile and obvious method of juggling
13 tax attributes.
14 QUESTION: But Mr. Jones, you don't disagree
15 with your opponent's hypothetical involving a company with
16 two divisions -- a computer division and a hot dog
17 division, or something like that.
18 MR. JONES: It's a single corporation. Right.
19 QUESTION: But it's that -- also is sort of
20 contrary to the basic purpose of deduction, it seems to
21 me.
22 MR. JONES: No, because the -- what Congress was
23 concerned about was the company who was liable for the --
24 whether the company that was liable for the product
25 liability expenses had been fairly treated, and if that

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

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

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

25 QUESTION: Was it a hundred and eighty degrees

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

4 MR. JONES: Yes, that was also well off the
5 point. The locus of the income at the individual
6 corporate level is often important -- it's often critical
7 -- in determining the proper tax treatment of that item.
8 This case is just one more example of that. For example
9 --

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

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

18 QUESTION: So that can --

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

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

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

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

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

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

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

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

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

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

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

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

1 I think I've covered what I intended to.

2 QUESTION: Thank you, Mr. Jones.

3 Mr. Fox, you have two minutes remaining.

4 REBUTTAL ARGUMENT OF ERIC R. FOX

5 ON BEHALF OF THE PETITIONER

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

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

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

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

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

20 Thank you.

21 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Fox.

22 The case is submitted.

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

25