CANCELLATION-OF-INDEBTEDNESS INCOME AND TRANSACTIONAL ACCOUNTING

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ABSTRACT

*More than three-quarters of a century after the Supreme Court's decision in *United States v. Kirby Lumber* established that the cancellation of a debt produces taxable income, there is still uncertainty both in the courts and among commentators concerning the rationale for the taxation of cancellation-of-debt (COD) income. Is the taxation of COD income based on the simple fact that the cancellation of a debt improves the taxpayer's balance sheet, thus increasing the taxpayer's net worth in the year of cancellation? Or is it based on a multi-year perspective, in which inclusion of the cancelled debt in income is necessary because the overall transaction—consisting of the creation of the debt in one year and the cancellation of it in another—produces an economic gain for the taxpayer? The choice between the rationales is crucial in a significant number of cases involving no-benefit debts. In a no-benefit debt cancellation situation, the taxpayer received nothing of value when the debt was created. This article examines the theoretical underpinnings of the taxation of COD income, and concludes that the whole-transaction analysis should be recognized as the only rationale for the taxation of COD income, with the result that COD income should not follow from the cancellation of a no-benefit debt. The article also analyzes nine fact patterns in which a taxpayer at least arguably received nothing of value when the debt was incurred, so that the cancellation of the debt should not produce COD income. The consideration of one of these categories—cancellations of obligations to pay accrued nondeductible interest—is particularly timely because of the prospect that hundreds of thousands, or even millions, of taxpayers may soon be relieved of obligations to pay accrued credit card interest. Another of these categories—the cancellation of gambling debts—involves one of the most controversial, and most commented-on, tax cases of recent decades.*

I. INTRODUCTION

More than three-quarters of a century after the Supreme Court's decision in *United States v. Kirby Lumber*¹ established that the cancellation of a debt produces taxable income,² there is still dispute—both as a normative matter and as a description of the current state of the law—concerning the rationale for the taxation of cancellation-of-debt (COD) income. Is the taxation of COD income based on the simple

¹ *United States v. Kirby Lumber*, 284 U.S. 1 (1931).

² The result in *Kirby Lumber* is codified today at section 61, which states that gross income includes “[i]ncome from discharge of indebtedness.” I.R.C. § 61(a)(12).

fact that the cancellation of a debt improves the taxpayer's balance sheet, thus increasing the taxpayer's net worth in the year of cancellation? Or is it based on a multi-year perspective, in which inclusion of the cancelled debt in income is necessary because the overall transaction—consisting of the creation of the debt in one year and the cancellation of it in another—produces an economic gain for the taxpayer?

Although most debt cancellations result in COD income under either rationale, the choice between the rationales is crucial in a significant number of cases involving no-benefit debts. In a no-benefit debt cancellation situation, the taxpayer received nothing of value when the debt was created. For example, a negligent driver receives nothing of value when his obligation to pay tort damages to his victim arises. Cancellation of a no-benefit debt would result in COD income under the balance-sheet-improvement analysis, but would not produce COD income under the whole-transaction approach.

This article examines the theoretical underpinnings of the taxation of COD income. Part I describes the unresolved decades-old tension in the case law between the two theories of COD income. Part II argues that the whole-transaction analysis should be recognized as the only rationale for the taxation of COD income, with the result that COD income should not follow from the cancellation of a no-benefit debt. Part III considers nine fact patterns in which a taxpayer at least arguably received nothing of value when the debt was incurred, so that the cancellation of the debt should not produce COD income: debt issued as a corporate dividend, debtor substitution transactions and accommodation guarantors, nondeductible interest, pledges to make contributions to organizations not eligible to receive deductible charitable donations, debt arising from a taxpayer's commission of a tort, federal income tax debt, debt discharged in bankruptcy but revived by a promise, child support obligations, and gambling debts. The consideration of one of these categories—cancellations of obligations to pay accrued nondeductible interest—is particularly timely, because of the prospect that hundreds of thousands, or even millions, of taxpayers may soon be relieved of obligations to pay accrued credit card interest.³ Another of these categories—the cancellation of gambling debts—involves one of the most controversial, and most commented-on, tax cases of recent decades.⁴ Contrary to the claim of prominent scholars that the tax treatment of debt cancellations

³ See, e.g., David Streitfeld, *Credit Bailout: Issuers Slashing Card Balances*, N.Y. TIMES, June 16, 2009, at A1.

⁴ *Zarin v. Comm'r*, 916 F.2d 110 (3d Cir. 1990).

“would have been much simpler” if from the beginning the courts had relied on the whole transaction analysis rather than the balance-sheet-improvement rationale,⁵ the whole-transaction analysis of many of these fact patterns is quite difficult—certainly more difficult than the balance-sheet improvement analysis, which readily finds COD income in all nine situations. Nevertheless, consistency with the overall structure of the income tax requires the whole-transaction approach to COD income. Part IV briefly concludes.

II. THE TWO THEORIES OF COD INCOME IN THE COURTS

The taxpayer in *Kirby Lumber* was able to buy back its own bonds, with a par value of \$1,078,300, at a cost of only \$940,779. The taxpayer had issued the bonds earlier in the same year in which it repurchased them, receiving property worth \$1,078,300 in exchange for the bonds.⁶ The government claimed that the taxpayer was required to include in its gross income the \$137,521 difference between the value of the property received upon issuance of the bonds and the \$940,779 paid at their retirement. The Supreme Court unanimously agreed, in a very brief opinion authored by Justice Holmes. According to Justice Holmes, as “a result of its dealings [the taxpayer] made available \$137,521.30 worth of assets previously offset by the obligation of the bonds now extinct. . . . The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.”⁷

The Court’s language has been understood as endorsing the taxation of COD income under what has been labeled the freeing-of-

⁵ Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL L. REV. 1159, 1165 (1978).

⁶ The Supreme Court’s opinion does not indicate the nature of the consideration the taxpayer received in exchange for the bonds; the opinion merely states that the taxpayer received par value for the bonds. *Kirby Lumber*, 284 U.S. at 2. For several decades courts and commentators assumed that the bonds had been issued in exchange for cash. See, e.g., *Comm’r v. Rail Joint Co.*, 61 F.2d 751, 751 (2d Cir. 1932) (stating, in a recounting of the facts of *Kirby Lumber*, that “[t]he taxpayer’s assets were increased by the cash received for the bonds”). In a 1977 article, Boris Bittker explained, based on his examination of the motions and briefs in *Kirby Lumber*, that the bonds had actually been issued in exchange for shares of the taxpayer’s preferred stock and for dividend arrearages on those shares. Boris I. Bittker, *Income from the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Co. Case*, 4 J. CORP. TAX’N 124, 124-25 (1977).

⁷ *Kirby Lumber*, 284 U.S. at 3.

assets (FOA) or net worth (NW) theory. In the typical COD situation, the debt that is cancelled in the current year was incurred by the taxpayer in some prior year. (The facts of *Kirby Lumber* are atypical in this respect.) Under the FOA/NW approach, the manner in which the debt was incurred in the prior year, and in particular the consideration (if any) that the taxpayer received in exchange for incurring the debt, is irrelevant to the determination of the tax consequences of the cancellation of the debt in the current year. Suppose the taxpayer begins the current year with \$2,000,000 of assets and a debt of \$1,078,300, giving the taxpayer a net worth of \$921,700. If the taxpayer is able to obtain a release of the entire debt by making a payment of only \$940,779, then the taxpayer will have remaining assets of \$1,059,221 and no remaining liabilities—and hence a net worth of \$1,059,221, which is \$137,521 more than its net worth before the cancellation. It is this net worth increase, or freeing of assets, which the Supreme Court identifies as the taxable accession to income.⁸ This analysis looks only to the events of the year of the cancellation of the debt; the manner in which the debt was created in some earlier year does not matter.

In *Commissioner v. Rail Joint Co.*,⁹ a case decided the year after *Kirby Lumber*, the Second Circuit adopted a different rationale for the taxation of COD income. The corporate taxpayer in *Rail Joint* issued its own bonds as a dividend to its shareholders in 1914. In 1926 and 1927 it bought back some of those bonds for less than their face amounts. The government argued that the difference between the face amounts and the price paid for the bonds by the taxpayer was COD income, fully taxable under *Kirby Lumber*. The Second Circuit panel—consisting of Judges Thomas Walter Swan, Learned Hand, and Augustus Hand—ruled unanimously for the taxpayer, in an opin-

⁸ Of course, if the taxpayer's liability had been marked to market at the beginning of the current year, rather than carried at book, and if the fair market value of the bonds was below their face amount at the beginning of the year (because they bore a rate of interest below the current market rate, or because of doubts concerning the taxpayer's ability to pay), then much or all of the income attributed to the current year under the Supreme Court's realization-based analysis would have economically accrued in some earlier year. Deborah Schenk has criticized the FOA/NW approach on this basis. Deborah H. Schenk, *The Story of Kirby Lumber: The Many Faces of Discharge of Indebtedness Income*, in *TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES* 97, 104 (Paul L. Caron ed., 2003). Treating the COD income as attributable in its entirety to the current year is consistent, however, with the realization-based taxation of asset appreciation under the federal income tax.

⁹ 61 F.2d 751 (2d Cir. 1932). For a discussion of *Rail Joint* in detail, see *infra* text accompanying notes 59-78.

ion written by Judge Swan. The court conceded that the taxpayer would have COD income under the FOA/NW rationale of *Kirby Lumber*: "It is true that the purchase and retirement of the bonds in the two years in question [1926 and 1927] resulted in decreasing the corporation's liabilities without a corresponding decrease in its assets . . ."¹⁰ But the court refused to take the Supreme Court at its word, contending that "it is not universally true that by discharging a liability for less than its face amount the debtor necessarily receives taxable gain."¹¹ The court concluded that the taxpayer had no taxable gain from its dealings in its bonds, taking into account both their issuance and their retirement. Because the taxpayer received nothing of value when it issued the bonds as dividends, reasoned the court, the overall transaction did not result in any economic gain or any taxable gain: "In paying dividends to shareholders, the corporation does not buy property from them. Here the [taxpayer] never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired."¹²

This alternate rationale for COD income might be labeled the loan proceeds (LP) or mistake-correction (MC) theory. Under this approach, debt cancellation does not produce gross income merely because it increases the taxpayer's net worth in the year of cancellation. Rather, it results in gross income only if the overall transaction—the creation of the debt in one year and the retirement of the debt in another—produces an economic gain for the taxpayer.¹³ There is eco-

¹⁰ *Rail Joint*, 61 F.2d at 752.

¹¹ *Id.*

¹² *Id.*

¹³ The LP/MC theory is appropriately described as a transactional approach, but it must be distinguished from the discredited "whole transaction" approach adopted by the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926). In *Kerbaugh-Empire*, the taxpayer borrowed German marks, converted them to dollars, lost the dollars in an unsuccessful venture, and eventually repaid the loan with marks worth about \$685,000 less than the borrowed marks had been worth at the time of borrowing. The Supreme Court ruled that the taxpayer had no COD income because "the whole transaction [i.e., taking into account not only the borrowing and repayment, but also the loss of the borrowed funds in the unsuccessful venture] was a loss." *Id.* at 175. It did not matter to the Court that the taxpayer's overall loss was less than it would have been if the mark had not declined in value relative to the dollar, because "the mere diminution of loss is not gain, profit, or income." *Id.* In *Kirby Lumber* the Supreme Court gave no indication it was rejecting the legal analysis of *Kerbaugh-Empire*; instead it distinguished the earlier case on the grounds that in *Kirby Lumber* "there was no shrinkage of assets and the taxpayer made a clear gain." *Kirby Lumber*, 284 U.S. at 2.

Although both the LP/MC approach and the *Kerbaugh-Empire* approach are

conomic gain in the usual case in which the taxpayer borrows cash (initially excluded from gross income based on the assumption that the taxpayer will repay the loan), and later is relieved of the obligation to repay some or all of the loan. In the less common situation, however, in which the taxpayer receives nothing of value when the debt is created (that is, a no-benefit situation), a later cancellation of the debt

transactional, the former is much narrower in scope than the latter. The former looks only to the overall *debt* transaction, without regard to what the taxpayer does with the borrowed funds, whereas the latter also takes into account the fate of the borrowed funds. The LP/MC approach is very much alive in the courts, but the *Kerbaugh-Empire* approach is not (despite the fact that the Supreme Court has never explicitly overruled the case). See Deborah A. Geier, Tufts *and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115, 187-88 (1992) (“*Kerbaugh-Empire* . . . should be considered dead.”). In a 1986 opinion, for example, the Ninth Circuit concluded that “*Kerbaugh-Empire* is inconsistent with the Supreme Court’s latest decisions,” and that the whole transaction approach of the case is no longer good law. *Vukasovich, Inc. v. Comm’r*, 790 F.2d 1409, 1416 (9th Cir. 1986). Similarly, in a 1991 ruling the IRS remarked that “subsequent Supreme Court decisions and other court cases, when viewed together, have discredited *Kerbaugh-Empire*.” Rev. Rul. 92-99, 1992-2 C.B. 35, 36.

Kerbaugh-Empire died for two reasons. First, as a practical matter, the *Kerbaugh-Empire* doctrine required tracing of the borrowed funds to determine their fate, and that task would be difficult or impossible in many cases. See Schenk, *supra* note 8, at 106 (making this point, but also noting that Treas. Reg. 1.163-8T does require tracing of loan proceeds for the purpose of determining the tax treatment of interest payments). Second, as a theoretical matter, the *Kerbaugh-Empire* approach would often allow the taxpayer a tax loss in the absence of an economic loss. Suppose, for example, a taxpayer borrows \$100 for use in a business venture, loses \$30 in the venture, and repays \$70 (with the other \$30 of debt being cancelled). The tax consequences of the \$30 loss in the venture are determined without regard to the fact that the money lost was borrowed; the taxpayer will be entitled to claim a \$30 deduction for a business loss under section 165. I.R.C. § 165(a), (c)(1). If the taxpayer could then use the “whole transaction” analysis of *Kerbaugh-Empire* to avoid COD income, the taxpayer’s net tax result would be a \$30 loss. But that result is clearly wrong, because the taxpayer—having borrowed \$100, lost \$30, and repaid \$70—has broken even overall. See Bittker & Thompson, *supra* note 5, at 1163 (explaining how the combination of *Kerbaugh-Empire* and an allowance of a loss under section 165 results in “the business loss . . . doing double duty”). The LP/MC approach, by contrast, is subject to neither of the infirmities of *Kerbaugh-Empire*. Because the LP/MC approach pays no attention to the use of the loan proceeds, it avoids the practical difficulties of tracing. And because it does not enable taxpayers to avoid COD income based on losses accounted for elsewhere in the taxpayer’s tax calculations, it does not produce economically inaccurate results. In the above hypothetical, the tax system will reach an economically accurate result by rejecting *Kerbaugh-Empire* and imposing a tax on \$30 of COD income; the \$30 of COD income and the \$30 loss on the business venture, taken together, will accurately reflect the taxpayer’s economic wash.

results in gross income under the FOA/NW theory of *Kirby Lumber*, but not under the LP/MC theory of *Rail Joint*.

Given the intuitive appeal of the Second Circuit's approach, the great prestige of the three *Rail Joint* judges, and the fact that the *Rail Joint* and *Kirby Lumber* approaches produce different bottom lines in a significant class of cases, one might have expected lower court opinions in the years following *Rail Joint* to be replete with discussions of the relative merits of the two approaches. One might also have expected, sooner or later, a Supreme Court opinion either reaffirming the *Kirby Lumber* analysis or abandoning it in favor of *Rail Joint*. In addition to clarifying the law of COD income, such a Supreme Court opinion might have shed light on the vexed question—clearly implicated in the choice between the FOA/NW theory and the LP/MC theory—of the extent to which the income tax is based on strict annual accounting (FOA/NW theory) versus the extent to which transactional income tax accounting (LP/MC theory) is appropriate.¹⁴

As it happened, however, *Rail Joint* had little influence in the several decades following its issuance, as courts deciding COD cases overwhelmingly invoked the FOA/NW theory of *Kirby Lumber*.¹⁵ When Boris Bittker and Barton Thompson published an article in 1978 claiming that the LP/MC theory provided a sounder basis for the taxation of COD income than the FOA/NW theory (without citing *Rail Joint* as a source of the LP/MC theory),¹⁶ *Rail Joint* had become sufficiently obscure that their article was widely viewed as groundbreaking.¹⁷ Bittker and Thompson proved to be more influential than *Rail Joint*, and in the years since their article appeared the LP/MC

¹⁴ It is an oddity of *Kirby Lumber* that the leading Supreme Court case on COD income, the analysis of which raises fundamental questions about the relationship between principles of annual and transactional accounting, involved a debt created and retired within a single year.

¹⁵ But see *Bradford v. Comm'r*, 233 F.2d 935, 939 (6th Cir. 1956) (citing and following *Rail Joint* in a case involving the cancellation of a debt that the taxpayer incurred without—according to the court—receiving any consideration in return). For a discussion of *Bradford*, see *infra* text accompanying notes 79-91.

¹⁶ Bittker & Thompson, *supra* note 5, at 1165 (“The tax treatment of debt discharges would have been much simpler if it had been based at the outset on the rationale that borrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full and that a tax adjustment is required when this assumption proves erroneous.”).

¹⁷ See, e.g., Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199, 203 (1996) (describing Bittker and Thompson as having “asserted a new rationale for the taxation of COD income”).

theory has garnered substantial support both in the courts and among commentators.¹⁸

The Supreme Court, however, has never been presented with a case in which it has been forced to choose between the theories, and in its general pronouncements on COD income the Court invokes both theories without choosing between them, and without clearly acknowledging that they are different theories that sometimes produce different results. In *United States v. Centennial Savings Bank*, for example, the Court remarked,

Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.¹⁹

Moreover, some lower courts (including the Tax Court) continue to describe COD income as based on the FOA/NW rationale, and to decide cases in the government's favor despite taxpayers' plausible arguments that they received no benefits when the cancelled debts arose.²⁰

¹⁸ See, e.g., *Estate of Newman v. Commissioner*, 934 F.2d 426, 432 (2d Cir. 1991) (endorsing the LP/MC account of COD income, and describing the FOA/NW theory as a "discredited rationale"); Schenk, *supra* note 8, at 104, 107 (describing the FOA/NW theory as having been "subjected to withering criticism" and describing the LP/MC theory as "a better approach"); Geier, *supra* note 13, at 144-46 (describing the FOA/NW analysis as an "outmoded theory" that "no longer holds sway," and as having been replaced by "the symmetry rationale"); Seto, *supra* note 17, at 204 (noting that "[t]he Bittker-Thompson analysis has gained considerable support").

¹⁹ *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 582 (1991).

²⁰ See, e.g., *Payne v. Commissioner*, 95 T.C.M. (CCH) 1253, 2008 WL 724027 (Mar. 18, 2008); *Hahn v. Commissioner*, 93 T.C.M. (CCH) 1055, 2007 WL 968634 (Apr. 2, 2007). In both cases, the Tax Court held that taxpayers realized COD income when they were relieved of obligations to pay accrued nondeductible personal interest. For a discussion of these cases, see *infra* text accompanying notes 92-105.

III. THE CASE AGAINST THE FREEING-OF-ASSETS / NET WORTH THEORY

A. *The Net Worth Theory and Negative Numbers*

As formulated by the Supreme Court in *Kirby Lumber*, the FOA/NW theory is that COD income results when assets of the taxpayer are freed from an offsetting debt obligation. Conceptualized in this manner, the theory suggests an insolvency exception—that is, that cancellation of a debt should produce no COD income to the extent the cancellation reduces the taxpayer's negative net worth rather than increasing the taxpayer's positive net worth. In the years following *Kirby Lumber*, insolvency was treated as negating the existence of what would otherwise be COD income.²¹

If the insolvency exception is understood as being a necessary aspect of the FOA/NW theory, it tends to discredit the entire theory. As Deborah Schenk has remarked, “[o]nly someone who has no understanding of negative numbers could fail to see” that a taxpayer's net worth increases when cancellation of a debt moves the taxpayer's negative net worth closer to zero.²² Similarly, Theodore Seto has suggested that courts were “unwilling to characterize a decrease in negative net worth as an increase in net worth” because they were “[p]erhaps more comfortable with words than with numbers.”²³

In 1980, Congress amended the Code to provide that, although the cancellation of the debt of an insolvent taxpayer does not create an immediate gross income inclusion for the taxpayer, the taxpayer must reduce specified tax attributes on account of the debt cancellation.²⁴ The ordinary effect of the tax attributes reduction is that the taxpayer is taxed on COD income despite the taxpayer's insolvency, albeit on a deferred basis. As described by the report of the Senate Finance Committee, the 1980 amendment was designed “to carry out

²¹ The recognition of the insolvency exception by the Bureau of Internal Revenue, for taxpayers whose debts were discharged in bankruptcy, actually predated *Kirby Lumber*. I.T. 1564, C.B. II-1, 59 (1923), declared obsolete in Rev. Rul. 69-43, 1969-1 C.B. 310. After *Kirby Lumber*, the courts extended the exception to discharges of the debts of insolvent taxpayers outside of bankruptcy proceedings. See, e.g., *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F.2d 95 (5th Cir. 1934); *Conestoga Transp. Co. v. Comm'r*, 17 T.C. 506 (1951). As Bittker and Thompson noted, “[T]his approach seems to conform to the ‘freed assets’ rationale of *Kirby Lumber*.” Bittker & Thompson, *supra* note 5, at 1183-84.

²² Schenk, *supra* note 8, at 105.

²³ Seto, *supra* note 17, at 202.

²⁴ Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389, 3390 (1984).

the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.”²⁵ Some commentators understand the 1980 legislation, with its deferred taxation of debt cancellations of insolvent taxpayers, as a Congressional repudiation of the entire FOA/NW theory. Deborah Schenk, for example, states, “when Congress revamped the insolvency rules as part of the Bankruptcy Act of 1980, it abandoned the freeing-of-assets theory in favor of the loan proceeds approach.”²⁶

An alternate reading of the 1980 legislation is that it perfected, rather than rejected, the FOA/NW theory. Under this reading, freeing-of-assets was always an unfortunate way of expressing the idea that COD income is based on an increase in the taxpayer’s net worth. It was unfortunate precisely because it implied that if the taxpayer had no debt-free assets after the debt cancellation—that is, if the taxpayer still had a negative or zero net worth—then there had been no freeing of assets and thus no COD income. If Justice Holmes had used other terminology to express the same basic theory of COD income—terminology focused on an increase in the taxpayer’s net worth, or on an improvement in the taxpayer’s balance sheet—then there would have been no such implication. If the rationale for taxation of COD income is that it increases the taxpayer’s net worth or improves the taxpayer’s balance sheet, nothing in that rationale requires or even suggests that there should be no COD income simply because the taxpayer does not have a positive net worth after the debt cancellation. In short, the insolvency exception was based on an imperfect understanding of the net worth (NW) theory—an imperfect understanding encouraged by Justice Holmes’ freeing-of-assets language—and the 1980 legislation perfected that understanding by removing the insolvency exception.²⁷

With the insolvency exception eliminated, the NW theory is no longer subject to the charge of internal inconsistency. Moreover, the theory has the virtue, or at least apparent virtue, of being very much in the spirit of the Supreme Court’s landmark decision in *Burnet v.*

²⁵ S. Rep. No. 1035, at 10 (1980).

²⁶ Schenk, *supra* note 8, at 111. Geier remarks that “the freeing-up-of-assets rationale enunciated by Justice Holmes . . . no longer holds sway” because “[c]urrent law . . . hold[s] that insolvent debtors do indeed realize COD income,” albeit with recognition of that income deferred by tax attribute reduction. Geier, *supra* note 13, at 144-45.

²⁷ Because the freeing-of-assets formulation of the theory wrongly implies an insolvency exception, and because Congress rejected that implication in enacting the Bankruptcy Tax Act of 1980, the remainder of this article will refer to the NW theory, rather than to the FOA/NW theory.

*Sanford & Brooks Co.*²⁸ (a case decided by the Court a few months before *Kirby Lumber*). The taxpayer in *Sanford & Brooks* lost about \$176,000 from 1913 to 1916 in carrying out a dredging contract with the United States government. The taxpayer had no income in those years against which to deduct its loss, and the loss did not create a net operating loss carryover. The taxpayer sued the government for breach of warranty concerning the nature of the material to be dredged, and in 1920 it was awarded about \$176,000 as compensation for its loss. The taxpayer took the position that the receipt in 1920 should be treated as a tax-free recovery of its previous losses, because from a multi-year perspective the taxpayer had no economic income. Viewing the taxpayer's argument as an illegitimate attempt to replace annual accounting with transactional accounting, the Supreme Court ruled against the taxpayer. The Court proclaimed,

A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.²⁹

Under the strict annual accounting endorsed by the Court in *Sanford & Brooks*, it is the NW theory, *not* the LP/MC theory, that produces the correct result when debt created in a no-benefit situation is cancelled. Suppose, for example, a \$100,000 final judgment is entered against a taxpayer in a tort suit arising out of the taxpayer's negligent driving on a personal errand, and that in a later year \$20,000 of the debt is cancelled (perhaps in connection with the taxpayer's payment of the other \$80,000). The LP/MC theory would result in no COD income because, looking at the multi-year transaction as a whole, the taxpayer has not realized an economic benefit. The NW theory, by contrast, would include \$20,000 in the taxpayer's gross income in the later year because the taxpayer has a net worth increase of \$20,000 in the later year (determined without reference to any events in other years). *Sanford & Brooks* calls for rejection of the LP/MC theory result and acceptance of the NW theory result.

²⁸ 282 U.S. 359 (1931).

²⁹ *Id.* at 364-65.

This point was recognized by the Sixth Circuit in *Bradford v. Commissioner*,³⁰ in which the court was presented with the cancellation of a debt that it viewed as having been created in a no-benefit transaction. The court wrote,

A mechanical application of these principles [of Kirby Lumber and Sanford & Brooks] would of course support the Tax Court's decision [that the taxpayer had realized COD income]. Looking alone to the year 1946 under the rule of the Sanford & Brooks Co. case, it is obvious that when \$100,000 of the petitioner's indebtedness was discharged for \$50,000 in that year, she realized a balance sheet improvement of \$50,000 which would be taxable as ordinary income under the rule of the Kirby Lumber Co. case.³¹

In the end, the *Bradford* court refused to apply the principles of *Sanford & Brooks* and *Kirby Lumber* so mechanically; instead, it used LP/MC analysis to conclude that the taxpayer had no COD income.³² Nevertheless, the opinion constitutes an acknowledgment that the choice of the NW theory over the LP/MC theory follows logically from the Supreme Court's reasoning in *Sanford & Brooks*.

B. Transactional versus Annual Accounting, Recovery of Capital, the Exclusionary Tax Benefit Rule, and the Continuing Vitality (or not) of Sanford & Brooks

If the *Sanford & Brooks* mandate for strict annual accounting rather than transactional accounting remains good law, then the NW theory of COD income must prevail over the LP/MC theory, with the result that a taxpayer has COD income whenever a debt is discharged, even if the taxpayer received no benefit when the debt arose. But this conclusion is only as good as its assumption that *Sanford & Brooks* remains good law. As the following discussion explains, there is little or nothing left of *Sanford & Brooks*.

³⁰ 233 F.2d 935 (6th Cir. 1956).

³¹ *Id.* at 938. See also Seto, *supra* note 17, at 211 (noting that *Kirby Lumber* was decided a few months after *Sanford & Brooks*, and commenting that "[t]he net worth approach established in *Kirby Lumber* meets the requirements of the strictest form of annual accounting" by calling for "an inquiry requiring no reference to any prior year").

³² *Bradford*, 233 F.2d at 938. For a discussion of *Bradford* in more detail, see *infra* text accompanying notes 79-91.

The taxpayer in *Sanford & Brooks* argued (unsuccessfully) that the money it received in 1920 should be treated as a tax-free recovery of capital, with the money it had lost on the dredging contract in earlier years conceptualized as the capital. Recovery-of-capital issues are closely analogous to COD income issues in no-benefit situations.³³ Suppose, as an example of a recovery of capital situation, that a taxpayer transfers cash to a social welfare organization (SWO)³⁴ in year one, with the understanding that the SWO will use the cash in a particular project it has planned. The taxpayer is not entitled to any income tax benefit with respect to the transfer. In year two, the SWO decides to scale back or abandon the project, and accordingly returns some or all of the taxpayer's contribution. As another example, suppose a taxpayer pays a particular amount of federal income tax in year one,³⁵ and in year two receives a refund of a portion of the year-one tax; the refund is based on a taxpayer-favorable change in the tax law, enacted in year two but made retroactive to year one. As in no-benefit debt cancellation situations, the tax consequences in these return-of-capital situations depend on the choice between transactional and annual accounting. Under transactional accounting, a taxpayer has no economic income, and thus no taxable income, merely by reason of making a smaller-than-originally-supposed contribution to the SWO, or merely by reason of having a smaller-than-originally-supposed federal income tax liability for year one. Under strict annual accounting, by contrast, the taxpayers in the two hypotheticals receive cash in year two which increases their net worth, and which is therefore taxable in year two.

The two return-of-capital hypotheticals are easily converted to no-benefit debt cancellation hypotheticals, demonstrating the closeness of the analogy between the two types of cases. Instead of making a cash contribution to the SWO in year one, suppose the taxpayer had made a legally enforceable pledge to the SWO in year one, and that in year two the SWO and the taxpayer agreed to reduce the amount of the pledge (or to eliminate the pledge altogether) because the SWO had decided to scale back or abandon its project. Similarly, suppose

³³ See Seto, *supra* note 17, at 259 (noting the similarity between no-benefit debt cancellation cases and recovery of capital cases, and suggesting the two types of cases should be taxed consistently).

³⁴ Social welfare organizations are described in section 501. I.R.C. § 501(c)(4). They are tax-exempt with respect to their own income, but they are not eligible to receive tax deductible contributions. I.R.C. § 170(c).

³⁵ The federal income tax payment does not, of course, give rise to a federal income tax deduction for the taxpayer. I.R.C. § 275(a)(1).

the taxpayer in the second return-of-capital hypothetical had ended year one with his tax unpaid and had had his year-one tax debt reduced in year two by the retroactive taxpayer-favorable legislation.

The NW theory of COD income stands or falls with the current status of *Sanford & Brooks*. If that case continues to require the application of strict annual accounting in recovery-of-capital situations, then strict annual accounting—in the form of the NW theory—should also govern COD income analysis. Conversely, if strict annual accounting has given way to transactional accounting in the recovery-of-capital context, it should also give way in the COD context—in which case all debt cancellations should be analyzed solely under the LP/MC theory.

Sanford & Brooks involved a recovery of an item deducted in a previous year, but without tax benefit.³⁶ In 1942 Congress enacted the predecessor of today's section 111,³⁷ thereby rejecting the application of the *Sanford & Brooks* analysis to recoveries of bad debts, taxes, and tax delinquency amounts that had been deducted without tax benefit. This legislation did not overrule *Sanford & Brooks* on its facts, because the deductions in *Sanford & Brooks* were not for bad debts, taxes, or delinquency amounts. Nevertheless, the transactional accounting mandated by the legislation was in tension with the strict annual accounting of *Sanford & Brooks*.

The Supreme Court's 1943 opinion in *Dobson v. Commissioner*³⁸ pounded a second nail in the coffin of strict annual accounting. Mr. Dobson had been induced to buy stock by fraudulent representations. He eventually sold some of the stock at a loss, generating capital losses which he claimed on his returns, but from which he derived no tax benefit. Alleging securities fraud, the taxpayer sued the seller of the stock. The case was settled, with Mr. Dobson's recovery in the settlement being less than the amount of his capital losses on the stock sales. Like *Sanford & Brooks*, *Dobson* involved the recovery of an item previously deducted without tax benefit, and outside the scope of the new statute (applicable only to recoveries of bad debts, taxes, and delinquency amounts). Adopting a position of extreme deference to the Tax Court,³⁹ the Supreme Court applied transactional accounting

³⁶ A recovery of an item deducted in a previous year *with* tax benefit is, of course, taxable under the inclusionary tax benefit rule. See *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983).

³⁷ Revenue Act of 1942, Pub. L. No. 77-753, § 116, 56 Stat. 798, 812-13 (1942).

³⁸ 320 U.S. 489 (1943).

³⁹ The special deference to the Tax Court called for in *Dobson* was short-lived. In 1948 Congress enacted the predecessor of section 7842, providing that Tax Court

rather than annual accounting— because the Tax Court had done so below, and because “[t]here [was] no statute law to the contrary.”⁴⁰ The *Dobson* Court distinguished *Sanford & Brooks* on the grounds that the Board of Tax Appeals had ruled *against* the taxpayer in that case.⁴¹

Thirteen years later, in 1956, the Treasury promulgated regulations indicating its complete acceptance of the application of transactional accounting to recoveries of items deducted without tax benefit. The regulations provided that the approach of section 111, which by its terms applied only to recoveries of bad debts, taxes, and delinquency amounts, “applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years.”⁴² Finally, in 1984, Congress amended section 111 to conform the statute to the 1956 regulations; as amended, the statute applies to “the recovery during the taxable year of any amount deducted in any prior taxable year” without tax benefit.⁴³

After the 1984 legislation, nothing remains of the strict annual accounting of *Sanford & Brooks*, with respect to recoveries of items deducted without tax benefit. Nor has *Sanford & Brooks* fared any better in the closely-related context of recoveries of nondeductible items (such as the return of a contribution to an SWO or a federal income tax refund). In fact, the strict annual accounting of *Sanford & Brooks* has *never* had substantial influence in that context. Writing in the *Harvard Law Review* in 1943, twelve years after *Sanford & Brooks*, William T. Plumb, Jr., described the rule of non-taxability as well-established in cases involving the return of non-deductible expenditures: “Where the expense item was not legally deductible, it is held that no taxable income results from its cancelation or rebate . . .”⁴⁴ He

decisions were entitled to no special deference on appellate review. Rules of Decision Act, Pub. L. No. 80-773, § 36, 62 Stat. 869, 991 (1948).

⁴⁰ *Dobson*, 320 U.S. at 503.

⁴¹ *Id.* at 504.

⁴² T.D. 6220, 1957-1 C.B. 34, 44.

⁴³ Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 117(a), 98 Stat. 494, 698 (1984).

⁴⁴ William T. Plumb, Jr., *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 142-43 (1943). Cases cited by Plumb in support of this proposition include *G.M. Standifer Constr. Corp. v. Comm’r*, 30 B.T.A. 184 (1934), *aff’d on other grounds*, 78 F.2d 285 (9th Cir. 1935); and *Peabody Coal Co. v. Comm’r*, 18 B.T.A. 1081, 1091 (1930), *aff’d on other grounds*, 55 F.2d 7 (7th Cir. 1931), *cert. denied*, 287 U.S. 605 (1932). Plumb, *supra*, at 143 n.55. Interestingly, although Plumb does not discuss COD income in the text of his article, he implicitly recognizes the close connection between

went on to note that the case law supported this result “even though [the expense item] was actually deducted [contrary to law] and the adjustment of the deduction is barred by limitations.”⁴⁵ Today’s leading federal tax treatise describes the current state of the law in similar terms: “[T]ax-free recovery of capital is so basic to the federal income tax law that it has been permitted by administrative practice or judicial decision in a variety of situations in the absence of explicit statutory authorization.”⁴⁶ Today’s leading federal tax treatise describes the current state of the law in similar terms: “[T]ax-free recovery of capital is so basic to the federal income tax law that it has been permitted by administrative practice or judicial decision in a variety of situations in the absence of explicit statutory authorization.”⁴⁷

In short, the strict annual accounting of *Sanford & Brooks* has yielded to transactional accounting, with respect to both recoveries of items deducted without tax benefit (the exclusionary tax benefit rule) and recoveries of nondeductible items (the recovery-of-capital doctrine).⁴⁸ Given the extremely close analogy between recovery-of-

return of capital analysis and COD income analysis, by citing two no-benefit COD cases in the same footnote. *Id.* (citing *N. Sobel, Inc. v. Comm’r*, 40 B.T.A. 1263 (1939); and *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932)).

⁴⁵ Plumb, *supra* note 44, at 143. In support of this proposition Plumb cited *Nw. States Portland Cement Co. v. Huston*, 126 F.2d 196 (8th Cir. 1942); *Pancoast Hotel Co. v. Comm’r*, 2 T.C. 362 (1943); and *El Dorado Oil Works v. Comm’r*, 46 B.T.A. 994 (1942).” Plumb, *supra* note 44, at 143 n.56.

⁴⁶1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 5.4 (3d ed. 1999). Bittker and Lokken cite, among other authorities, *Cox v. Kraemer*, 88 F.Supp. 835 (D. Conn. 1948) (reimbursement of legal expenses incurred in successful defense against charges of official misconduct); and *Clark v. Comm’r*, 40 B.T.A. 333 (1939), *acq.*, 1957-2 C.B. 3 (reimbursement for mistake made by the taxpayer’s federal tax advisor). BITTKER & LOKKEN, *supra*, ¶ 5.4 n.10, 11.

⁴⁷1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 5.4 (3d ed. 1999). Bittker and Lokken cite, among other authorities, *Cox v. Kraemer*, 88 F.Supp. 835 (D. Conn. 1948) (reimbursement of legal expenses incurred in successful defense against charges of official misconduct); and *Clark v. Comm’r*, 40 B.T.A. 333 (1939), *acq.*, 1957-2 C.B. 3 (reimbursement for mistake made by the taxpayer’s federal tax advisor). BITTKER & LOKKEN, *supra*, ¶ 5.4 n.10, 11.

⁴⁸ Courts continue to cite *Sanford & Brooks* in a very general way, for the unexceptionable proposition that taxpayers must calculate their taxable income and their tax liabilities every year. *See, e.g., Hillsboro Nat’l Bank v. Comm’r*, 460 U.S. 370, 377 (1983); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 (Ct. Cl. 1967). And the well-known *Sanford & Brooks* dictum that taxpayers are not permitted to “postpon[e] the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period,

capital situations and debt cancellation situations, consistency with the well-established transactional analysis of recovery-of-capital situations requires that transactional analysis also govern all debt cancellation cases. The LP/MC theory should be the *only* theory of debt cancellation income.

C. The Nexus Requirement for Transactional Accounting

Application of transactional accounting to debt cancellations (under the LP/MC theory) requires a determination that a debt cancellation should be treated as part of the same overall transaction as the creation of the debt. A rejection of transactional accounting in a particular case, resulting in the imposition of tax upon the cancellation of a no-benefit debt, is appropriate in the absence of a sufficiently close nexus between the incurring of the debt and its cancellation. Consider, for example, a taxpayer who makes an enforceable pledge to an SWO for a particular project planned by the SWO. If the taxpayer and the SWO later agree to a reduction in the pledged amount because the SWO has scaled back its ambitions, there is a clear nexus between the creation of the debt and its partial cancellation. Transactional accounting should apply and the taxpayer should have no COD income. But suppose instead that the taxpayer performs services for the SWO under an agreement that the SWO will reduce the amount of the pledge by the value of the taxpayer's services. In that case, an adequate nexus is lacking. The taxpayer should be taxed on the amount of the reduction just as if she had received cash compensation for her services and had used the cash to make a (nondeductible) payment on her pledge.

or of a given transaction, will be a gain or a loss" of course remains correct. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365. But this dictum, under which taxpayers may not hold tax consequences open pending developments in future years, does not address the question at issue in the recovery of capital context (and in the COD income context) of whether the tax consequences of events in the current year may be determined by taking into account related events in past years. Holding tax consequences open pending future developments would undermine the government's need for "revenue ascertainable, and payable to the government, at regular intervals." *Id.* at 365. But looking to the past to characterize events in the current year does not undermine that need (as demonstrated, for example, by the fact that allowing basis recovery upon the sale of assets has not destroyed the tax system). This point is developed more fully in Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 TAX L. REV. 381, 389-92 (1991).

Although this latter example and similar cases of inadequate nexus might be thought of as cases of taxable COD income under the NW theory, the standard analysis of such cases is that they do not involve COD income at all. Rather, they are recast as combinations of some non-COD type of income (compensation for services, in the example) and payment (rather than cancellation) of the debt. They are referred to as cases of “spurious cancellations of indebtedness,”⁴⁹ and they are treated as having nothing to do with *Kirby Lumber*. Accordingly, there is no need to retain the NW theory of COD income in order to reach appropriate results in cases of this sort. In addition to disguised compensation for services, other situations “where careful analysis discloses that the debt was not discharged for less than its face amount but was in fact fully paid”⁵⁰ include debt cancellation serving as a gift from creditor to debtor, cancellation serving as a capital contribution from shareholder to corporation, and cancellation serving as a dividend from corporation to shareholder.⁵¹

Given the doctrine of spurious cancellations, there remains in the COD category only cases in which there is a strong connection between the creation and the extinguishment of the debt. In those remaining cases transactional accounting is appropriate. This leaves no room for the application of the NW theory of COD income. If the debt arose in a no-benefit context, and if the nexus requirement is satisfied, the LP/MC theory should apply and the taxpayer should not have COD income.

Theodore P. Seto has suggested, however, that the NW theory still has a role to play in some cases involving non-spurious cancellations of no-benefit debts.⁵² Seto’s suggestion is that cancellation of a

⁴⁹ The terminology was introduced by Bittker and Thompson. Bittker & Thompson, *supra* note 5, at 1174.

⁵⁰ *Id.*

⁵¹ *Id.* at 1175-79. Although the spurious COD analysis can apply to situations involving no-benefit debts, the analysis applies more commonly in situations in which the taxpayer did receive a tax-free benefit (most often, a loan of cash) when the debt arose. In some of those cases, the conclusion that the cancellation is spurious makes no difference in the income tax consequences—for example, compensation for services and COD income are both fully taxed as ordinary income. In other benefit cases, however, the tax difference may be substantial—for example, a genuine cancellation of a debt owed by a shareholder to a corporation would be taxed as ordinary income, but a dividend disguised as a debt cancellation will be taxed only at capital gains rates. I.R.C. § 1(h)(11). As another example, a genuine cancellation of a loan from a relative would be taxed as ordinary income, but a gift in the guise of a debt cancellation would be excluded from income under section 102. I.R.C. § 102(a).

⁵² Seto, *supra* note 17, at 258-60. Although Seto’s article offers a lengthy theo-

no-benefit debt should not be taxable if it “reflects a rescission or revision of the original transaction,” but that if the cancellation of such a debt is non-rescissory—for example, if it is on account of “a shift in interest rates or expiration of a statute of limitations”—it should be taxable as COD income.⁵³ Seto recognizes that a debt cancellation attributable to a change in market interest rates or the expiration of a statute of limitations is closely enough related to the debt to be treated as a genuine rather than spurious cancellation.⁵⁴ Nevertheless, he suggests that it should not be considered closely enough connected to the debt to qualify for a no-income result under LP/MC transactional analysis.

Seto first proposes a distinction between rescissory (nontaxable) and non-rescissory (taxable) debt discharges not in the context of no-benefit cases, but in the context of purchase price adjustments.⁵⁵ As developed by the courts, the purchase price adjustment doctrine applied when a purchase-money debt owed by the taxpayer to a person who sold property to the taxpayer was reduced pursuant to negotiations between the taxpayer and the seller.⁵⁶ Instead of triggering COD income, the reduction merely served to reduce the taxpayer's basis in the property. A version of the doctrine is now codified at section §108(e)(5). In the purchase price adjustment context, the rescissory/non-rescissory distinction makes sense as a way of determining whether, looking at the overall transaction (the seller-financed asset purchase and the later reduction of the purchase-money obligation), the taxpayer will have received an untaxed economic benefit unless the taxpayer has COD income. Thus, a debt reduction because the seller misrepresented the property (a rescissory reduction) merely brings the amount of the debt in line with the actual value of the property at the time of sale. Because there is no untaxed value in that situation, there should be no COD income. By

retical analysis of COD income generally, its discussion of no-benefit situations is brief and tentative. *See id.* at 284 (noting that the article “has not attempted . . . to . . . thoroughly analyze” no-benefit cases).

⁵³ *Id.* at 260.

⁵⁴ In fact, cancellations on account of interest rate changes and statutes of limitations are core examples of genuine debt cancellation. *See, e.g.,* Bittker & Thompson, *supra* note 5, at 1160 n.5 (mentioning changes in market interest rates and expirations of statutes of limitations as two of three common causes of COD income).

⁵⁵ Seto, *supra* note 17, at 249-54.

⁵⁶ *See, e.g.,* Commissioner v. Sherman, 135 F.2d 68 (6th Cir. 1943); Hirsch v. Comm'r, 115 F.2d 656 (7th Cir. 1940); N. Sobel, Inc. v. Comm'r, 40 B.T.A. 1263 (1939).

contrast, a reduction in the amount of the purchase money obligation based on (for example) doubts about the taxpayer's ability to pay the original amount means the taxpayer *did* receive untaxed value not offset by any debt obligation, with the result that the taxpayer should have COD income in the amount of the reduction.⁵⁷

This reason for distinguishing between rescissionary and non-rescissionary cancellations in the context of purchase price adjustments does not apply in the no-benefit context. In the purchase price adjustment context, the distinction between the two types of cancellations serves to identify situations in which the taxpayer has not received a net economic benefit from the overall transaction (rescissionary cancellations) and situations in which the taxpayer has received a net economic benefit (non-rescissionary cancellations). The need to distinguish between the two situations arises because the taxpayer initially received something of value (the purchased property) that would have been included in gross income at the time of acquisition had not the taxpayer simultaneously incurred the debt. In no-benefit situations, by contrast, the taxpayer initially received nothing that would have been included in his gross income, even in the absence of the debt. As a result, the taxpayer has enjoyed no economic benefit from the overall transaction — the creation and cancellation of the debt — whether the cancellation is rescissionary or non-rescissionary. The rescissionary/non-rescissionary distinction is attractive in the purchase price adjustment context in which Seto first proposes it, but the rationale for the distinction does not extend to the no-benefit context.

IV. WHAT IS A NO-BENEFIT DEBT?

Accepting the premise that a discharge of a no-benefit debt should be non-taxable under the LP/MC analysis, the problem arises of how to identify a no-benefit debt. It is easy enough to provide a general verbal formulation of the test for a no-benefit debt, but applying the test to particular fact patterns has produced considerable disagreement among commentators and the courts. Richard Beck has nicely stated the general principle: “[T]o the extent the debtor did not originally receive cash or other loan proceeds in exchange for incurring the debt, its cancellation should not be taxable.”⁵⁸ Beck adds an

⁵⁷ This is not the result under current section 108, however. That section makes no distinction between rescissionary and nonrescissionary reductions of purchase-money debts. I.R.C. § 108(e)(5).

⁵⁸ Richard C. E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Prob-*

important caveat: “[E]ven if the debtor does receive value [at the time the debt originated], no COD income should arise unless that value would have been taxable absent the debt.”⁵⁹ The question of how to apply these seemingly straightforward principles in particular situations has proven surprisingly contentious. The analyses of several fact patterns by courts and commentators are described and evaluated below.

A. Bond Dividends

It is appropriate to start with the problem of dividends paid in the form of debt obligations of the dividend-paying corporation, because the LP/MC theory made its first appearance in this context—in the Second Circuit’s 1932 opinion in *Commissioner v. Rail Joint Co.*,⁶⁰ issued in the year following *Kirby Lumber* and forty-six years before the revival of the LP/MC theory by Bittker and Thompson.⁶¹ The taxpayer corporation distributed its own bonds as a dividend to its shareholders. In a later year, the corporation repurchased some of the bonds for less than their face amount. The Second Circuit assumed—incorrectly, but understandably—that the bonds the cancellation of which had been at issue in *Kirby Lumber* had been issued for cash.⁶² Based on this understanding of the facts of *Kirby Lumber*, the Second Circuit believed there was a crucial factual distinction between its case and the Supreme Court’s:

Hence it is apparent that the corporation [Rail Joint] received no asset which it did not possess prior to the opening and closing of the bond transaction, and it is impossible to see

lem of Circularity in the Logic of Taxation, 14 VA. TAX REV. 153, 165-66 (1994). Similar formulations appear in Schenk, *supra* note 8, at 108-09; Geier, *supra* note 13, at 147-48; and James L. Musselman, *Is Income from Discharge of Indebtedness Really Income at All? A Proposal for a More Reasoned Analysis*, 34 U. MEM. L. REV. 607, 633 (2004).

⁵⁹ Beck, *supra* note 57, at 167. See also Seto, *supra* note 17, at 219 (making the same point).

⁶⁰ 61 F.2d 751 (2d Cir. 1932).

⁶¹ Bittker & Thompson, *supra* note 5.

⁶² *Rail Joint*, 61 F.2d at 751 (stating that in *Kirby Lumber* “[t]he taxpayer’s assets were increased by the cash received for the bonds”). Actually, the *Kirby Lumber* opinion is silent on the question of the consideration received by the taxpayer for its bonds, and Boris Bittker’s research, several decades later, determined that the bonds had been issued for shares of the taxpayer’s preferred stock and dividend arrearages on those shares. Bittker, *supra* note 6, at 124-25.

wherein it has realized any taxable income. In such circumstances the *Kirby* Case cannot be regarded as controlling.⁶³

The Second Circuit recognized that its taxpayer would have income under the NW theory of COD income,⁶⁴ but the court rejected that application of the NW theory.⁶⁵

There is a split among the commentators who have considered whether the *Rail Joint* court properly applied LP/MC analysis. The split is based on disagreement as to whether the taxpayer received anything of value when it distributed a dividend in the form of its own debt. Six commentators (including two co-authors) agree with the Second Circuit's assumption that the taxpayer received nothing of value when it issued the bonds, and so agree with the court's conclusion that the taxpayer had no COD income when it repurchased the bonds at a discount.⁶⁶ Four other commentators (including two co-authors), however, claim that the Second Circuit was wrong, either because the bond dividend should be analogized to a sale of bonds to third parties for cash followed by the distribution of the cash proceeds to shareholders,⁶⁷ or because a corporation should be understood as receiving a benefit analogous to a human being's personal consumption when it distributes value—including value in the form of its own bonds—to its shareholders.⁶⁸

The argument based on the analogy to the issuance of bonds for cash followed by a cash dividend was first made by Bittker and Thompson. "Viewed in this way," they wrote, "the distribution of the

⁶³ *Rail Joint*, 61 F.2d at 752.

⁶⁴ *Id.* ("It is true that the purchase and retirement of the [dividend] bonds . . . resulted in decreasing the corporation's liabilities without a corresponding decrease in its assets . . .").

⁶⁵ In the course of rejecting that application of the NW theory, the Second Circuit introduced a hypothetical involving the cancellation of a debt arising from a taxpayer's pledge to make a contribution to a charitable organization. *Id.* For a variation on that hypothetical, involving a pledge to a social welfare organization not eligible to receive tax-deductible contributions, see *infra* text accompanying notes 106-13.

⁶⁶ Beck, *supra* note 57, at 169-70; Geier, *supra* note 13, at 148 (noting that the corporation received no cash or property in connection with its distribution of the bonds); Alan Gunn, *Reconciling United States Steel and Kirby Lumber*, 42 TAX NOTES 851, 852 n.10 (Feb. 13, 1989); Seto, *supra* note 17, at 220; Fred T. Witt, Jr., & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1, 8 (1990).

⁶⁷ Bittker & Thompson, *supra* note 5, at 1167; Musselman, *supra* note 57, at 639.

⁶⁸ Louis A. Del Cotto, *Debt Discharge Income: Kirby Lumber Revisited Under the Transactional Equity Rule of Hillsboro*, 50 TAX NOTES 761, 769 (Feb. 18, 1991).

bonds served the same corporate purposes as a distribution of cash, and a later discharge of the bonds for less than their cash equivalent at the time of distribution should have qualified for taxable status.”⁶⁹ The problem with their analysis is that it proves too much. If their approach were applied across the board in the analysis of alleged no-benefit cases, there would be no no-benefit cases. A negligent tortfeasor who obtained cancellation of a portion of the judgment against him by payment of the remainder of the judgment⁷⁰ would be treated as if he had borrowed cash to pay the judgment in full and had later been discharged from the obligation to repay some of the borrowed cash. Similarly, a taxpayer whose pledge to a social welfare organization (SWO) was cancelled⁷¹ would be treated as if she had borrowed money to make a cash contribution to the SWO, and as if her obligation to repay the loan were later cancelled. And so on. In short, the approach of imagining an alternative arrangement involving a third party loan of cash to the taxpayer is not so much a way of applying the LP/MC approach as it is a way of rejecting it altogether.

That does not necessarily make the imagined-loan approach wrong, but it does mean that the imaginedloan approach should be understood as an argument for adopting the NW theory of COD income in preference to the LP/MC theory. So understood, is it persuasive? An objection to the imagined-loan approach is that it denies that a transaction giving rise to a debt can ever be, in substance, anything other than a borrowing of cash. One would need some explanation of why that denial is appropriate, but the proponents of the approach have offered no such explanation.

A second objection is that the imagined-loan approach violates the completeness criterion applicable to recharacterizations of transactions for purposes of the federal income tax. Under that criterion, a recharacterization must fully account for all the results of the actual transactions, so that the non-tax end results under the recharacterization are identical to the non-tax end results of the actual transaction.⁷² The recharacterization of the *Rail Joint* facts proposed by Bittker and Thompson does not satisfy the completeness requirement. At the end of the recharacterized transactions in the dividend year, the share-

⁶⁹ Bittker & Thompson, *supra* note 5, at 1167.

⁷⁰ For a discussion of this fact pattern, see *infra* text accompanying notes 114-19.

⁷¹ For a discussion of this fact pattern, see *infra* text accompanying notes 106-13.

⁷² See Lawrence Zelenak, *The Story of Seagram: The Step Transaction Doctrine on the Rocks*, in BUSINESS TAX STORIES 263, 281 (Steven A. Bank & Kirk J. Stark eds., 2005); Saul Levmore, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 U. PA. L. REV. 1019 (1988).

holders have cash and third parties hold the corporation's bonds. Under the actual facts of the case, however, the shareholders have no cash, and there are no third parties in the picture. The proposed recasting of the bond dividend in *Rail Joint* as a third party loan to the corporation followed by a cash dividend should be rejected as inconsistent with the step-transaction doctrine. Similar recastings in analogous situations—involving, for example, negligent tortfeasors and pledges to SWOs—should also be rejected.

Louis Del Cotto has suggested, however, a different reason for finding COD income in the *Rail Joint* situation under the LP/MC approach. According to Del Cotto, “[t]he bond dividend payment is an act of corporate consumption” analogous to personal consumption by a human being, and “[t]he benefit of this consumption . . . gives rise to an exclusion which is conditioned on repayment of the borrowing.”⁷³ Suppose an individual taxpayer borrows to finance personal consumption, such as a vacation. The taxpayer would have been taxed on the value of the vacation in the year of borrowing, but for the existence of the offsetting debt obligation. If the debt is later cancelled, under the LP/MC analysis the taxpayer has COD income in the year of the cancellation. Del Cotto's claim is that the bond dividend in *Rail Joint* is the corporate analogue of the debt-financed vacation.

The analogy of nondeductible corporate dividends to nondeductible personal consumption is plausible.⁷⁴ It is a useful way of understanding the policy behind the repeal of the *General Utilities* doctrine,⁷⁵ under which repeal a corporation realizes and recognizes gain upon the distribution of appreciated property to its shareholders.⁷⁶ A corporation which distributes to a shareholder an asset with a value of \$100 and a basis of zero transfers \$100 of wealth to the shareholder—creating \$100 of corporate consumption—and so must recognize \$100 of income. There is a problem, however, with applying this analysis in the context of bond dividends: Section 311(b)(1)(A) specifically provides that a corporation does not recognize gain on a dividend distribution of its own debt obligations.

⁷³ Del Cotto, *supra* note 67, at 769.

⁷⁴ See, e.g., Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope & Joshua D. Rosenberg, *FUNDAMENTALS OF CORPORATE TAXATION* 144 (5th ed. 2002) (“It was once said that a corporation derives no greater pleasure than through making distributions to its shareholders.”).

⁷⁵ *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

⁷⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269–72 (codified at I.R.C. §§ 311(b) (non-liquidating distributions) and I.R.C. § 336(a) (liquidating distributions)).

Why, as a matter of policy, does section 311(b)(1)(A) not require corporate recognition of gain on the distribution of a bond dividend? The underlying premise is that the corporation will eventually make principal payments on the bonds, using cash already subject to corporate tax (or using appreciated property, in which case the use of the property to make payments on the debt will trigger recognition of the appreciation). Thus, the appropriate corporate-level tax on the value distributed via the bond dividend will be imposed eventually, and no later than the year in which a principal payment is made. It is acceptable for a corporation to distribute (for example) \$100 of value to its shareholders as a bond dividend without triggering corporate-level taxation because payment of the bond principal is assumed, and the corporation will have recognized \$100 of income no later than the time of payment. Non-taxation of the corporation at the time of the bond dividend is based on the assumption that the corporation will eventually pay off the bond. It would seem to follow that COD income should result if any portion of the debt is later cancelled.

On the other hand, this is an odd situation, because the alleged untaxed benefit to the corporation of the debt — receipt of value by the corporation's shareholders — is the debt itself. According to Theodore P. Seto, "If it had been known at the time the bonds were issued that they would be discharged without payment, the consequences to the corporation would not have been the recognition of taxable income; instead, the corporation would be treated simply as not having paid a dividend."⁷⁷ It would be plausible to conclude, based on Seto's analysis, that there should be no COD income in the *Rail Joint* situation.

There is, however, another way of looking at the question. On the shareholder's side of the bond dividend, the dividend is treated as a closed transaction in the dividend year. If the shareholder later suffers a loss on the disposition of the bond—whether to the corporation or to some third party—that loss will be a capital loss in the year of disposition, not an adjustment (in either the dividend year or the disposition year) of the amount of the dividend. Thus, on the shareholder side of the transaction, no later event — not even the purchase of the bond by the issuing corporation at a discount — can alter the amount of the dividend the shareholder received in the dividend year. If the tax treatment of the corporation is to be consistent with the treatment of the shareholder, then the bond dividend must also be treated on the corporate side as a closed transaction in the dividend year. Under

⁷⁷ Seto, *supra* note 17, at 220.

this reasoning, a corporation that distributes a \$100 bond to a shareholder unalterably makes a \$100 distribution in the dividend year, thus foreclosing Seto's argument that the cancellation of \$20 of the bond in a later year produces no COD income because (with the benefit of hindsight) the corporation really never distributed more than \$80 of value to its shareholder. Viewing the dividend transaction as closed in the dividend year, the corporation *did* get the benefit of a distribution of \$100 of value to its shareholder in that year (not merely the benefit of a distribution of the lesser amount the corporation eventually paid on the bond), and the only reason for excluding that \$100 benefit from corporate income was the incorrect assumption that the corporation would sooner or later make principal payments totaling \$100.⁷⁸

On balance, the argument in favor of COD income in the *Rail Joint* situation, based on the concept of dividends as the corporate analogue to personal consumption, should probably prevail. It is a close call, however. The argument is subtle — perhaps too subtle — and reasonable minds can differ as to its persuasiveness. The difficulty of analyzing bond dividends under the LP/MC framework illustrates a major theme of this article, which is that—contrary to the claim of Bittker and Thompson that “[t]he tax treatment of debt discharges would have been much simpler if it had been based at the outset on the [LP/MC] rationale”⁷⁹—application of the LP/MC framework to some fact patterns can be difficult indeed. Courts should acknowledge the LP/MC rationale as the basis of COD income not because it is necessarily easier to apply than the competing NW rationale, but because it fits better than the NW rationale with the overarching structure of the federal income tax.

B. Gratuitous Debtor Substitutions and Accommodation Guarantors

*Bradford v. Commissioner*⁸⁰ vies with *Rail Joint* for the title of the leading COD case decided in the taxpayer's favor on no-benefit

⁷⁸ This account of a bond dividend as definitively closed in the dividend year is consistent with the uncontroversial treatment of a dividend in the form of appreciated property. If the shareholder receiving the property later sells it for less than its fair market value at the time of the distribution, the taxpayer has a capital loss (rather than an adjustment to the amount of the dividend), and the corporation has no tax consequences (rather than an adjustment to the amount of the gain it recognized under section 311(b) on the distribution).

⁷⁹ Bittker & Thompson, *supra* note 5, at 1165.

⁸⁰ 233 F.2d 935 (6th Cir. 1956).

grounds. In 1938 Mrs. Bradford gave a bank her note for \$205,000, and in 1946 the bank cancelled \$50,000 of the debt. The Service, of course, took the position that Mrs. Bradford had \$50,000 COD income in 1946. The Sixth Circuit disagreed, in an opinion written by Judge (later Justice) Stewart. Judge Stewart conceded that Mrs. Bradford would have COD income under the NW theory: "Looking alone to the year 1946 under the rule of the *Sanford & Brooks Co.* case, it is obvious that . . . she realized a balance sheet improvement of \$50,000 which would be taxable as ordinary income under the rule of the *Kirby Lumber Co.* case."⁸¹ Nevertheless, the court declined to apply annual accounting "so mechanically."⁸² Instead, it "look[ed] behind the cancellation of indebtedness in a given calendar year, and . . . evaluate[d] in its entirety the transaction out of which the cancellation arose."⁸³ In the proceedings below, the Tax Court had found as a fact that Mrs. Bradford had received no consideration in 1938 when she had given her note to the bank, and the Sixth Circuit accepted that finding as not clearly erroneous—notwithstanding the fact that the bank had reduced her husband's existing debt to the bank by \$205,000 upon receipt of her note. Applying the LP/MC theory to the Tax Court's no-benefit finding, the Sixth Circuit concluded that "by any realistic standard the petitioner never realized any income at all from the transaction"⁸⁴ and ruled in Mrs. Bradford's favor.

The majority view among commentators is that *Bradford* was wrongly decided; the court should have rejected as clearly erroneous the Tax Court's finding that Mrs. Bradford received nothing from the bank in exchange for her note. Instead, it should have concluded that the debtor substitution in 1938 was the equivalent of Mrs. Bradford's borrowing \$205,000 cash from the bank and giving the cash to Mr. Bradford, followed by Mr. Bradford's using the gifted cash to repay his debt to the bank.⁸⁵

⁸¹ *Id.* at 938.

⁸² *Id.*

⁸³ *Id.* at 939.

⁸⁴ *Id.* at 938.

⁸⁵ BITTKER & LOKKEN, *supra* note 46, at ¶ 7.2.2 n.12; Del Cotto, *supra* note 67, at 765-67; Musselman, *supra* note 57, at 640; Seto, *supra* note 17, at 260 n.212. Unlike the imagined cash transactions in the bond dividend situation, which fail the completeness criterion for tax recharacterizations (see *supra* text accompanying note 71), this recharacterization satisfies the completeness criterion. No hypothetical third party is introduced and all three parties—Mrs. Bradford, Mr. Bradford, and the bank—end up in the same circumstances in the recharacterized 1938 transaction as in the actual transaction.

Although there is limited support for *Bradford* among the commentators,⁸⁶ it is impossible to defend the Sixth Circuit's analysis on any grounds other than a very narrow view of the circumstances under which an appellate court should reject a lower court's findings of fact.

The case for nontaxation is much stronger, however, in the closely-related situation of the cancellation of the debt of an accommodation guarantor (as contrasted with a substitute debtor such as Mrs. Bradford). The leading case is *Aftergood v. Commissioner*,⁸⁷ in which Mr. Aftergood guaranteed an existing debt of his employer. In a later year, after the employer had defaulted and Mr. Aftergood had become liable on the debt pursuant to his guarantee, he was able to settle the debt for less than the full amount owed. Finding that Mr. Aftergood had "received nothing of value when he executed the note,"⁸⁸ and applying the LP/MC analysis, the Tax Court concluded that he had no COD income.

Richard Beck has written approvingly of *Aftergood*. He concedes that Mr. Aftergood may have received an intangible benefit by guaranteeing his employer's debt (perhaps currying favor with his employer or increasing the odds of his continued employment by increasing the odds of his employer's survival), but he argues that an intangible benefit of this sort "is not taxable under any circumstances . . . and is excludible for reasons having nothing to do with the incurrence of debt."⁸⁹ This is a reasonable view of *Aftergood*. But suppose the employer's creditor was about to insist on immediate repayment of the entire loan by the no-longer-creditworthy employer (which repayment the employer could have made, but only at considerable risk to its long-term survival), and the creditor agreed to desist only when Mr. Aftergood guaranteed the loan. In that case, the substance of the arrangement would be closer to that of a *Bradford*-type debtor substitution than a mere guarantee. It would follow that the case should be analyzed in the same way the majority of commentators have analyzed *Bradford*: as a loan from the creditor to Mr. Aftergood, followed by a transfer of the loan proceeds from Mr. Aftergood to his employer (possibly as a gift, but more likely as either a loan or a contribution to capital), followed in turn by repayment of the creditor by the employer.

⁸⁶ See Beck, *supra* note 57, at 170 n.76 (approving the *Bradford* analysis, but conceding the contrary view of the case is plausible); Witt & Lyons, *supra* note 65, at 21-22 (approving the *Bradford* analysis).

⁸⁷ 21 T.C. 60 (1953), *acq. in result*, 1954-1 C.B. 3 (1954).

⁸⁸ *Id.* at 62.

⁸⁹ Beck, *supra* note 57, at 169 n.74.

The same basic issue could arise in the case of a loan guarantee given at the time of the original lending. If the reasonable expectation of the parties was that the nominal borrower, rather than the taxpayer-guarantor, would repay the loan, the Tax Court's *Aftergood* analysis would support the conclusion that the taxpayer had no COD income. As Beck observes, any intangible benefit the taxpayer might have received from guaranteeing the loan, such as a warm glow from helping a family member or friend, should be disregarded because "the satisfaction of providing such assistance is not taxable under any circumstances."⁹⁰ On the other hand, if the lender was willing to lend only because of the taxpayer-guarantor's creditworthiness, and not because of that of the nominal borrower, then substance-over-form principles suggest the transaction should be recast as a loan from the lender to the taxpayer, followed by a transfer of the loan proceeds from the taxpayer to the nominal borrower (as a second loan, a gift, or a contribution to capital, as the facts may indicate). If the taxpayer later became liable to the lender upon the nominal borrower's default, and if the taxpayer's debt was settled for less than its full amount, the taxpayer would have COD income.⁹¹

There is a body of corporate income tax case law concerning when shareholder guarantees of loans nominally made to their closely-held corporations should be recharacterized as loans to the shareholders followed by capital contributions by the shareholders to

⁹⁰ *Id.*

⁹¹ The Tax Court could have employed an analysis along the lines suggested in the text in its decision in *Anderson v. Comm'r*, T.C. Summ. Op. 2003-169, 2003 WL 22966856 (Dec. 18, 2003). Mr. Anderson allowed a friend to use his credit card with the understanding that she would reimburse Mr. Anderson for any charges she made on his card. She did not keep her promise, and Citibank eventually agreed to cancel \$1,372 of Mr. Anderson's resulting debt. A strong argument could have been made on Mr. Anderson's behalf that he was in the same basic position as an accommodation guarantor—that is, that he had received nothing (other than the warm glow of helping a friend) when the debt was created, and that he therefore had no COD income when the debt was cancelled. The contrary argument, of course, would be to think of Mr. Anderson as having borrowed money from Citibank and relending to his friend; in that case he would have COD income upon the cancellation of the debt. He would also have a nonbusiness bad debt deduction, treated as a short term capital loss under section 166, based on his friend's unpaid debt to him. I.R.C. § 166(d). Not surprisingly, given the summary posture of the case and the taxpayer's *pro se* representation, the Tax Court's opinion does not proceed along these lines. The court's brief opinion mentions approvingly the LP/MC theory of COD income, but never discusses the possibility that Mr. Anderson might be viewed as never having received any loan proceeds. *Anderson*, T.C. Summ. Op. 2003-169, 2003 WL 22966856, at *2.

the corporations.⁹² The proper application of the LP/MC theory to the cancellation of the debt of a guarantor requires the same sort of analysis used in those corporate tax cases. In any case in which the substance of the guarantee involves a loan to the taxpayer-guarantor, the taxpayer has received the equivalent of tax-free cash at the outset, and so should have COD income when his debt is cancelled. Whether a particular case falls into this category can be determined only after a difficult and fact-intensive inquiry; this is another area in which, contrary to the claim of Bittker and Thompson, application of the LP/MC theory is not likely to simplify the law of COD income.

C. Personal Interest

In three recent cases, the Tax Court has considered whether a taxpayer has COD income upon the cancellation of an obligation to pay nondeductible personal interest.⁹³ In only one of the recent cases, *Hahn v. Commissioner*, was the taxpayer represented by counsel, and in only that case does the Tax Court's opinion indicate that the taxpayer argued that he had no COD income because he had received nothing of value when the interest obligation arose: "Petitioner's first contention is that because he did not receive cash or other property when he allegedly became obligated for the [interest], he was not enriched by the forgiveness of the obligation."⁹⁴ The taxpayer cited *Rail Joint* and *Bradford* in support of his position, but the court distinguished those cases on the grounds that Mr. Hahn had received something of value, tax-free, when his obligation arose: "We . . . disagree with petitioner's contention that he 'received no payment of cash, property, or anything else of value when he allegedly became liable for the [interest].' The right to use money represents a valuable property interest."⁹⁵

⁹² The leading case is *Plantation Patterns, Inc. v. Comm'r*, 462 F.2d 712 (5th Cir. 1972). See generally, BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.23[3] (7th ed. 2000).

⁹³ *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253, 2008 WL 724027 (Mar. 18, 2008); *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055, 2007 WL 968634 (Apr. 2, 2007); *Scott v. Comm'r*, T.C. Summ. Op. 2006-16, 2006 WL 228919 (Jan. 30, 2006).

If the taxpayer would have been entitled to a deduction upon payment of the interest (as in the case of "qualified residence interest" described in section 163(h)(3)), the tax treatment of the cancellation of the obligation to pay interest is clear. Under section 108, COD income does not arise from the cancellation of a debt "to the extent that payment of the liability would have given rise to a deduction." I.R.C. § 108(e)(2).

⁹⁴ *Hahn*, 93 T.C.M. (CCH) 1253, 2007 WL 968634, at *2.

⁹⁵ *Id.* at *3.

Did the Tax Court correctly conclude that Mr. Hahn had received something of value when his obligation to pay interest arose? By now, it will come as no surprise that there is more than one way of viewing the situation. Suppose, for the sake of concreteness, that the original interest rate on the debt was eight percent, but that after the cancellation of a portion of the interest debt the effective interest rate (taking into account only the interest Mr. Hahn actually paid) was reduced to five percent. Under one view, there should be no COD income. There is no unique market interest rate at any given time; if Mr. Hahn had happened upon the right lender, he might have been able to borrow from the beginning at five percent rather than eight percent. Therefore (so goes this argument), Mr. Hahn should be taxed as if the interest rate had been five percent all along—and obviously a taxpayer does not have a gross income inclusion merely because he pays non-deductible personal interest at five percent rather than at eight percent.

But there is another plausible interpretation. When Mr. Hahn did not pay his eight percent interest as it became due, he could be viewed as having borrowed additional cash from the lender in the amount of the accrued interest, and as then using the borrowed cash to pay the interest.⁹⁶ Under this view, Mr. Hahn would have received something of value — the hypothetical additional borrowed cash — tax-free at the time the debt obligation arose, and thus would have COD income upon the cancellation of the obligation.⁹⁷

How should a court choose between the two plausible interpretations? The problem is closely analogous to that addressed by the “common law” purchase price adjustment doctrine, as developed by

⁹⁶ Unlike the imagined cash transactions in the bond dividend situation, which fail the completeness criterion for tax recharacterizations (see *supra* text accompanying note 71), this recharacterization would satisfy the completeness criterion. No hypothetical third party is introduced, and both parties—Mr. Hahn and the lender—end up in the same circumstances under the recharacterization as in the actual transaction.

⁹⁷ In situations involving tax-deductible interest, the courts have rebuffed cash method taxpayers' attempts to generate deductions for unpaid interest by recharacterizing the unpaid interest as an additional loan from the creditor to the taxpayer, with the taxpayer using the loan proceeds to pay the interest. See, e.g., *Helvering v. Price*, 309 U.S. 409 (1940). The weight of authority does not permit a deduction even if the taxpayer and the creditor actually go through the circular cash flow exercise. See, e.g., *Battelstein v. IRS*, 631 F.2d 1182 (5th Cir. 1980), *cert. denied*, 451 U.S. 938 (1981). Arguably, however, the rejection of the circular cash flow analysis in that context is based on concerns peculiar to deductions by cash method taxpayers; if so, the judicial rejection of the analysis in the context of deductible interest need not extend to the situation discussed in the text.

the courts prior to the codification of the purchase-money debt reduction rule in section 108(e)(5).⁹⁸ Under the “common law” purchase price adjustment analysis, if a purchase-money debt owed by the taxpayer to a seller of property was reduced pursuant to negotiations between the taxpayer and the seller, for reasons that related back to the fairness of the original purchase price — for example, because of the taxpayer’s claim that the seller materially misrepresented the property — then the true value of the property was assumed to be the adjusted purchase price rather than the original purchase price. It followed that the taxpayer never received any value that was excluded from his gross income by reason of the cancelled portion of the debt, and that the taxpayer therefore had no COD income (although a downward basis adjustment was required).⁹⁹ On the other hand, the “common law” doctrine did not apply if the reason for the reduction in the amount of the debt did not relate back to the original purchase—for example, if the seller-creditor agreed to accept less than the full amount of the debt because of doubts about the taxpayer’s ability to pay the full amount, or because of a post-sale increase in market interest rates.¹⁰⁰

The problem faced by the courts developing the doctrine was the determination of whether the taxpayer had received, at the time of the debt-financed purchase, value that was excluded from gross income only because of the assumption that the taxpayer would pay the purchase-money obligation in full. This depended, of course, on the fair market value of the asset at the time of purchase. The courts needed an approach that would work for the many assets for which there is no clearly defined and objectively determinable fair market value. They also needed a solution that would not conflict with the well-established principle that a taxpayer does not realize gross income merely by purchasing an asset at a favorable price in an arms-length transaction. Faced with these constraints, the courts developed

⁹⁸ For a discussion of the purchase price adjustment doctrine, see *supra* text accompanying notes 54-56.

⁹⁹ See, e.g., *Comm’r v. Sherman*, 135 F.2d 68, 70 (6th Cir. 1943) (finding that no COD income resulted when the amount of a purchase-money mortgage was reduced by agreement of the taxpayer and the seller-mortgagee after the taxpayer had “contested the lawful right of the mortgagee to demand full payment of the face amount of the mortgage, by reason of misrepresentations made in connection with the purchase of the property”).

¹⁰⁰ *Fifth Avenue-Fourteenth Street Corp. v. Comm’r*, 147 F.2d 453, 457 (2d Cir. 1944) (“‘common law’ purchase price adjustment doctrine did not apply where the reduction in the amount of the debt ‘result[ed] from an ‘arm’s-length’ transaction relating solely to the debt itself’”).

the approach described in the preceding paragraph. For purposes of COD income analysis, the asset value received by the taxpayer is the price set by the parties, taking the debt reduction agreement into account, *if* the reason for the reduction relates to the true value of the property at the time of sale. If, however, the reason for the reduction is unrelated to the actual value of the property at the time of sale, then the value for purposes of COD income analysis is the original price agreed to by the parties, not taking the debt reduction agreement into account.¹⁰¹

Congress codified the purchase price adjustment doctrine in section 108(e)(5) in 1980,¹⁰² for the express purpose of “eliminat[ing] disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reduction should be treated as discharge income or a true price adjustment.”¹⁰³ Thus, under section 108(e)(5) any reduction in debt owed by a solvent taxpayer to a seller-creditor is excluded from gross income, whether or not the reason for the reduction relates back to the sale.

Section 108(e)(5) applies, however, only in situations involving a taxpayer’s purchase of “property.” Although there are apparently no cases on point, the pre-section 108(e)(5) analysis of purchase price adjustments should continue to apply in cases involving reductions of debt incurred for nondeductible personal consumption services purchased by a taxpayer.¹⁰⁴ If a debt for personal consumption services provided to the taxpayer is reduced by agreement between the taxpayer and the provider, to settle a dispute concerning whether the provider actually rendered all the contracted-for services, there should be no COD income. On the other hand, if the debt is reduced for some reason not relating to a dispute about the value of the services provided—such as doubts about the taxpayer’s ability to pay or a change in market interest rates—COD income should result.

Cases involving the discharge of nondeductible personal interest can and should be analyzed in the same manner. If the taxpayer’s interest obligation is cancelled (in whole or in part) for reasons relating back to the original loan transaction — for example, to resolve a bona

¹⁰¹ For a thoughtful discussion of these matters, see Seto, *supra* note 17, at 249-254.

¹⁰² Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389, 3389 (1980).

¹⁰³ S. Rep. No. 96-1035, at 15 (1980), *reprinted* in 1980-2 C.B. 620, 628.

¹⁰⁴ Seto, *supra* note 17, at 253 (offering an example involving a party).

fide dispute regarding whether the lender complied with usury laws or consumer credit disclosure requirements — the taxpayer should be treated as having borrowed at a lower interest rate (five percent, in the running example) from the beginning, so that the taxpayer has no COD income when the obligation to pay interest above that rate (at eight percent, in the running example) is cancelled. But in the (probably more common) situation in which the reason for the cancellation is unrelated to the circumstances of the original loan transaction, there should be COD income—by analogy to the pre-section 108(e)(5) treatment of purchase price adjustments, and to the current treatment of reductions of debts owed to providers of consumption services.¹⁰⁵

So was *Hahn* correctly decided? It is impossible to say, based on the Tax Court's opinion. The opinion recounts that the taxpayer disputed the creditor's claim with respect to both principal and interest, and that the taxpayer and the creditor reached an agreement that the taxpayer would pay a portion of the debt and the creditor would cancel the remainder.¹⁰⁶ The opinion says nothing, however, about the grounds on which the taxpayer disputed the claim. Without that information, it is not possible to apply the LP/MC analysis to the case.

D. Nondeductible Pledges

Suppose a taxpayer makes a legally enforceable promise to give \$100 to a social welfare organization (SWO) described in section 501(c)(4).¹⁰⁷ In a later year, after the SWO has decided to scale back the scope of the project to which the pledge relates, the taxpayer and

¹⁰⁵ In *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253, 2008 WL 724027, at *1 (Mar. 18, 2008), the taxpayers argued that the discharge of some of their debt for credit card interest was “a retroactive reduction of the rate of interest charged by MBNA and thus a reduction of the ‘purchase price’ of the loans under section 108(e)(5).” The Tax Court correctly rejected the taxpayers’ argument, on the grounds that “the lending of money in a generic credit card transaction” is not a sale of “property” within the meaning of section 108(e)(5). *Id.* at *2. The court did not consider the possibility (probably because the *pro se* taxpayers did not raise it) that the taxpayers should have avoided COD income under a “common law” analysis, if the facts were as the taxpayers alleged. In any event, the court stated that nothing in the record supported the taxpayers’ claim that the lender had agreed to a retroactive reduction in the rate of interest. *Id.* at *1.

¹⁰⁶ *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055, 2007 WL 968634, at *1 (Apr. 2, 2007).

¹⁰⁷ SWOs are exempt from tax. I.R.C. § 501(c)(4). They are not, however, eligible to receive tax deductible contributions. I.R.C. § 170(c).

the SWO agree that the taxpayer will pay \$60 on the pledge and the SWO will cancel the remaining \$40 of the obligation.¹⁰⁸ Under the LP/MC analysis, does the taxpayer have \$40 of COD income? Although there are no reported cases fitting this fact pattern, the question has been popular with commentators. The commentators have unanimously concluded that the taxpayer has no COD income because the taxpayer received nothing of value — or at least nothing that would have been subject to tax but for the existence of the pledge — when the debt was created.¹⁰⁹ The taxpayer may have enjoyed a warm glow in the earlier year from the making of the pledge, but warm glows of this sort are not included in the base of the income tax even in the absence of an offsetting debt obligation.¹¹⁰

Bittker and Thompson do not discuss this fact pattern, but the logic of their analysis of the bond dividend in *Rail Joint* would seem to produce COD income here, just as it did in the *Rail Joint* context.¹¹¹ Under their analysis, the taxpayer would be treated as if it had (1) borrowed \$100 from a bank, (2) immediately contributed the \$100 to the SWO, and (3) in a later year transferred \$60 to the bank in exchange for the bank's agreement to cancel the other \$40 of the debt. If those had been the actual facts, there would clearly be COD income in the later year, because the taxpayer had received tax-free loan proceeds (excluded from gross income based on the assumption of re-

¹⁰⁸ This hypothetical is a variation on a hypothetical discussed by the Second Circuit in *Comm'r v. Rail Joint Co.*, 61 F.2d 751, 752 (2d Cir. 1932). In the *Rail Joint* version of the hypothetical, the taxpayer makes a pledge to an organization eligible to receive tax-deductible charitable contributions. *Id.* Under current law, cancellation of such a pledge would clearly not produce COD income because section 108 provides that no COD income results from debt cancellation "to the extent that payment of the liability would give rise to a deduction." I.R.C. § 108(e)(2). By avoiding section 108, the version of the hypothetical presented in the text raises the question of how the cancellation should be analyzed under the LP/MC approach to COD income.

¹⁰⁹ WILLIAM D. POPKIN, INTRODUCTION TO FEDERAL INCOME TAXATION 130 (1987); Schenk, *supra* note 8, at 108-09; Beck, *supra* note 57, at 170; Geier, *supra* note 13, at 148-49; Gunn, *supra* note 65, at 213-24; cf. Seto, *supra* note 17, at 258-59 (reaching the no-income conclusion only in the case of a rescissionary cancellation of the pledge). For an explanation and critique of Seto's suggested distinction between rescissionary and nonrescissionary cancellations, see *supra* text accompanying notes 51-56.

¹¹⁰ Beck, *supra* note 57, at 169 n.74 (making a similar point with respect to the personal satisfaction an accommodation guarantor may realize by helping a friend or family member).

¹¹¹ For an explanation and critique of their analysis of *Rail Joint*, see *supra* text accompanying notes 68-71.

payment) in the earlier year.¹¹² As explained earlier, however, the approach of Bittker and Thompson to no-benefit COD income analysis — imagining a cash loan to the taxpayer from a third party, followed by a transfer of the cash by the taxpayer to the actual creditor — should be rejected.¹¹³ In addition to proving too much by denying the possibility of a no-benefit debt under any circumstances, the approach violates the completeness requirement for recharacterizing transactions for tax purposes, according to which a recharacterization must produce the same non-tax end results as the actual transaction.¹¹⁴ Applied here, the Bittker-and-Thompson recharacterization would leave the SWO with \$100, instead of only the \$60 it actually received, and would leave the bank with a \$40 loss, despite the non-existence of the bank.

In short, the LP/MC analysis of the SWO hypothetical is straightforward: The taxpayer has no COD income when some or all of the pledge is cancelled. Although it can be quite difficult in some situations to determine whether a taxpayer avoids COD income under a no-benefit rationale, the SWO example shows that not every case is difficult; there are *some* easy answers.

E. Negligent Tortfeasors

Another hypothetical popular with commentators, but without any reported cases on point, is the taxpayer who injures a person by his negligent driving while on a personal errand, who has a final judgment entered against him for (say) \$100,000 in the victim's tort-based lawsuit against him, who makes it as difficult as possible for the victim to collect on the judgment, and who eventually reaches an agreement with the victim under which he pays the victim \$90,000 and the victim cancels the remaining \$10,000 debt.¹¹⁵ The commentators

¹¹² Viewing the contribution of the borrowed cash to the SWO as part of the same transaction as the loan and its cancellation, and viewing the contribution as a nondeductible loss rather than as personal consumption by the taxpayer, it could be argued that the taxpayer should have no COD income because the overall result of the transaction was a \$60 loss. Such an argument, however, would require the resurrection of the thoroughly discredited "whole transaction" approach of *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926). For a discussion of *Kerbaugh-Empire*, see *supra* note 13.

¹¹³ *Supra* text accompanying notes 68-71.

¹¹⁴ *Supra* text accompanying note 71.

¹¹⁵ Two commentators have cited *Ruben v. Comm'r*, 97 F.2d 926 (8th Cir. 1938), as a case presenting the issue of whether the sort of situation described in the text produces COD income. James S. Eustice, *Cancellation of Indebtedness and the Fed-*

who have considered this situation are in agreement that it produces no COD income under the LP/MC analysis, because the taxpayer received nothing of value when the debt arose.¹¹⁶ This is clearly correct with respect to run-of-the-mill judgments for negligently-caused personal injuries. As Richard Beck remarks, "If it is argued that the tortfeasor may have enjoyed the pleasure of speeding, or a valuable saving of time, it may be answered that neither type of benefit is taxable under any circumstances, and so their exclusion from income was not caused by an offsetting debt."¹¹⁷ There would be an exclusion caused by an offsetting debt, and thus COD income upon the discharge of the debt, under the imagined-cash-loan approach suggested by Bittker and Thompson, but there is no need to discuss again here why that approach should be rejected in all its potential applications.¹¹⁸

Conversion—that is, theft—is a tort, and at first glance it might seem that the cancellation of a judgment for conversion should be taxable, because in that situation the taxpayer did receive something of value (the stolen property) when he committed the tort. But the question is not merely whether the taxpayer received something of value. Rather, it is whether the taxpayer received something of value which was excluded from his gross income, based on an assumption of eventual repayment. Under the Supreme Court's opinion in *James v. United States*,¹¹⁹ all unlawful gains are taxable, even if a repayment obligation exists. Thus, the transactional accounting adjustment required at the end of the conversion story is a deduction by the taxpayer-thief

eral Income Tax: A Problem of Creeping Confusion, 14 TAX L. REV. 225, 244 n.64 (1959); Musselman, *supra* note 57, at 656 n.316. This is not an accurate characterization of *Ruben*. A judgment of about \$350,000 had been entered against Mr. Ruben and several other defendants in a securities fraud lawsuit. A corporation of which Mr. Ruben was a major stockholder transferred about \$250,000 cash to the plaintiffs in partial payment of the judgment, and the plaintiffs agreed to the cancellation of the remainder of the debt. Although the facts of the case do involve a debt cancellation, the government argued the case solely on the basis that Mr. Ruben had received a disguised dividend. The court rejected the government's argument, concluding that Mr. Ruben was "not enriched by having any income accrue to him or by receiving any income." *Ruben*, 97 F.2d at 928. The opinion does not cite *Kirby Lumber* and does not mention the concept of COD income.

¹¹⁶ Schenk, *supra* note 8, at 108; Beck, *supra* note 57, at 170; Eustice, *supra* note 114, at 244; Musselman, *supra* note 57, at 657.

¹¹⁷ Beck, *supra* note 57, at 170.

¹¹⁸ For the arguments against that approach, see *supra* text accompanying notes 68-71.

¹¹⁹ 366 U.S. 213 (1961).

of the amount he does repay, rather than inclusion in his gross income of the amount he does not.¹²⁰

What should be the tax consequences under a variation on the original hypothetical, in which the taxpayer intentionally injures the plaintiff out of animus, and \$10,000 of the resulting final judgment is eventually discharged? On those facts, it is tempting to argue that the taxpayer has received a personal consumption benefit — in the form of the violent expression of his hostility — equal to the amount of the judgment, that the benefit was excluded from gross income because of the offsetting liability in tort, and that the taxpayer should therefore have \$10,000 of COD income. Although this is marginally more plausible than the analogous argument in the case of a negligent tortfeasor, it is nevertheless very weak. In reality, the taxpayer would have had no gross income inclusion in the year in which he committed the battery, even if it had been clear from the beginning that he would never have to pay anything in tort. The IRS makes no attempt to tax those who batter and do not get sued. More generally, the consumption value that antisocial persons may enjoy by causing others to suffer is not part of the base of the income tax.

F. Federal Income Tax Liabilities

Suppose a taxpayer owes a federal income tax debt relating to a past year, and some of that debt is cancelled pursuant to an offer-in-compromise based on doubts about collectability.¹²¹ Or suppose all of the taxpayer's federal income tax debt relating to a particular year is cancelled by the expiration of the statute of limitations.¹²² Does COD income arise in these situations? Under the LP/MC view of COD income, the crucial question is whether the taxpayer received anything of value when the tax liability arose, which would have been included in gross income but for the existence of the liability. The answer is that he did not.

Of course, taxpayers may receive, free of income tax, any number of in-kind benefits and transfer payments funded by federal taxes, up

¹²⁰ *Collins v. Comm'r*, 3 F.3d 625, 631 (2d Cir. 1993).

¹²¹ See I.R.C. §7122 (authorizing the IRS to “compromise any civil . . . case arising under the internal revenue laws”); Treas. Reg. §301.7122-1(b)(2) (2006) (authorizing compromises based on doubts about collectability).

¹²² See I.R.C. §6502 (providing generally that an assessed tax may be collected by levy or by court proceeding “only if the levy is made or the proceeding begun . . . within 10 years after assessment of the tax”).

to and including the benefits of civilization itself.¹²³ Based on this fact, James Musselman has concluded that the cancellation of a federal income tax debt produces COD income:

While no one would argue that the value of governmental services received directly correlates to the amount of tax liability imposed on any individual taxpayer, it makes good policy to presume that the value received is equal to the obligation imposed, and thus force gross income from discharge of indebtedness on taxpayers to the extent they are relieved of their obligations to pay their tax liabilities. That result seems conceptually appropriate and is probably not controversial.¹²⁴

The problem with this argument is that the tax-free nature of the various government benefits is independent not only of the amount of the recipient's federal income tax liability, but even of the existence of such a liability. If a person receives a nontaxable in-kind benefit or a transfer payment from the government, and the benefit is of a sort excluded from gross income,¹²⁵ the exclusion applies whether that person's overall federal income tax liability is large, small, or nonexistent.¹²⁶ Because the taxpayer whose federal income tax liability is cancelled received no benefit excluded from income by reason of the existence of the federal income tax liability, under LP/MC analysis he should have no COD income from the cancellation.

Two other arguments for treating cancellation of tax debts as COD income have been discussed earlier in this article, and so can be dealt with briefly here. First, applying the approach suggested by Bittker and Thompson in the bond dividend context, the taxpayer could be treated as if she had borrowed cash from a bank and had used the borrowed money to pay her tax liability when due, with the imagined debt to the bank being cancelled in the later year in which the tax debt is extinguished. For the reasons explained earlier, this

¹²³ See *Compania Gen. de Tabacos de Filipinas v. Collector of Int. Rev.*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) ("Taxes are what we pay for civilized society.").

¹²⁴ Musselman, *supra* note 57, at 654.

¹²⁵ See, e.g., Rev. Rul. 2005-46, 2005-2 C.B. 120, 120 ("The Internal Revenue Service has consistently concluded that payments to individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare are not included in a recipient's gross income ('general welfare exclusion').").

¹²⁶ See Beck, *supra* note 57, at 177-80 (elaborating on this point).

imagined-loan approach should be rejected in all the contexts in which it might be applied.¹²⁷ Second, Theodore P. Seto, although placing federal income tax liabilities in the no-benefit category and concluding that rescissionary cancellations of such liabilities should not generate COD income, would treat nonrescissionary cancellations as creating COD income.¹²⁸ He offers the expiration of the statute of limitations as an example of a nonrescissionary cancellation: "If the statute of limitations for the collection of an undisputed federal income tax liability expires, most would agree that the taxpayer thereby would realize economic income."¹²⁹ For the reasons discussed earlier,¹³⁰ Seto's proposed tax distinction between rescissionary and nonrescissionary cancellations of no-benefit debts should be rejected outside of the purchase price adjustment context.¹³¹

What is the actual state of the law with respect to cancellations of tax debts? There are no reported cases concerning COD income arising from the operation of statutes of limitations—a fact that strongly suggests the IRS does not assert the existence of COD income in such situations. The case of cancellations pursuant to offers in compromise is more complicated. In *Yale Avenue Corp. v. Commissioner*,¹³² the taxpayer had a portion of its liability for federal income tax and accrued interest thereon cancelled pursuant to an offer in compromise. In the ensuing Tax Court litigation, the taxpayer and the Commis-

¹²⁷ See *supra* text accompanying notes 68-71; see also Beck, *supra* note 57, at 181 (rejecting the imagined-loan approach in the context of cancellations of federal income tax liabilities).

¹²⁸ Seto, *supra* note 17, at 260. In Seto's usage, a discharge of a federal tax debt based on doubtful collectability or the expiration of the statute of limitations is nonrescissionary, but a discharge based on a "genuine dispute as to the existence or amount of the correct tax liability under the law" is a rescissionary cancellation. Treas. Reg. §301.7122-1(b)(1).

¹²⁹ Seto, *supra* note 17, at 260.

¹³⁰ See *supra* text accompanying notes 51-56.

¹³¹ In the particular context of tax debts, Richard Beck has made a powerful argument, based on the policy behind the statute of limitations, as to why a nonrescissionary cancellation pursuant to the statute should not generate COD income. If the extinction of a tax debt by the statute of limitations gives rise to COD income, then it creates a new tax debt equal to the amount of debt extinguished multiplied by the taxpayer's marginal tax rate. And if that new debt is itself eventually extinguished by the statute of limitations, then that second cancellation produces another new tax debt, and so on *ad infinitum*: "The statute would never completely eliminate a tax liability, just as the Zeno's arrow never reaches its goal. This result is obviously absurd because it would defeat Congress' intention to provide repose." Beck, *supra* note 57, at 194.

¹³² 58 T.C. 1062 (1972).

sioner stipulated that the cancellation would give rise to COD income unless the taxpayer was insolvent at the time of the cancellation, which the Tax Court determined the taxpayer was not. Although the Tax Court concluded that the offer in compromise produced COD income, the precedential value of the case is slight for two reasons. First, the court simply accepted the stipulation of the parties on the COD income issue, without considering whether the stipulation might have been based on a misunderstanding of the scope of COD income. Second, the Commissioner had allowed the taxpayer to claim a deduction for the accrued interest on the tax liability, and the amount of the debt cancelled was less than the amount of that deduction. The opinion does not discuss what ordering rule should be applied in allocating the cancelled debt between principal and interest, but under an interest-first rule—treating the cancelled debt as consisting entirely of interest—taxability would noncontroversially result under either COD income analysis or the inclusionary tax benefit rule.

In any event, the fact that there have been no additional cases on this issue in the thirty-eight years since *Yale Avenue* strongly suggests that the IRS no longer asserts the existence of COD income in such situations.¹³³ In an insightful article, Richard Beck persuasively argues that the strange behavior of the IRS in this area — asserting COD income resulting from offers in compromise, but only rarely — is best explained by the peculiar circumstances of the few cases in which the IRS has asserted COD income:

The common denominator of all the reported OIC cases appears to be that the Service miscalculated by failing to require

¹³³ Beck identifies three relevant cases predating *Yale Avenue*. Beck, *supra* note 57, at 163-64. In *Manhattan Soap Co. v. Comm'r*, 3 T.C.M. (P-H) 44,092, 1944 WL 7050 (Mar. 22, 1944), the Tax Court held that no COD income resulted from an offer in compromise cancelling a portion of the taxpayer's debt for excise taxes and interest thereon. The court relied on the "commercial gift" doctrine of *Helvering v. American Dental Co.*, 318 U.S. 322 (1943), which case was later effectively overruled by *United States v. Jacobson*, 336 U.S. 28 (1949). In *Denman Tire & Rubber Co. v. Comm'r*, 192 F.2d 261 (6th Cir. 1951), *aff'd* 44 T.C. 706 (1950), the court held that the cancellation, pursuant to an offer in compromise, of the taxpayer's liability for excise profits taxes and interest resulted in COD income. *Eagle Asbestos & Packing Co. v. Comm'r*, 348 F.2d 528 (Ct. Cl. 1965), involved the discharge by an offer in compromise of the taxpayer's debt for income taxes, excess profits taxes, and interest. The Commissioner argued that the cancelled interest, but not the cancelled principal, generated income under the inclusionary tax benefit rule (but not under the COD income doctrine). *Id.* at 531-32. The Court of Claims ruled for the taxpayer based on its contractual analysis of the intent of the parties in entering into the offer in compromise agreement. *Id.* at 532-33.

the taxpayers to reduce their existing [net operating loss carryforwards]. When the taxpayers unexpectedly became profitable, the Service apparently regretted its earlier lenience and attempted to recoup whatever it could from a bad bargain by assessing additional taxes for COD (or tax benefit rule) income. The Service seems to have assessed COD income selectively for this purpose, and for this purpose alone. In short, the Service's ad hoc assessments for COD income appear to have been a ploy for the ulterior purpose of extricating itself from an unfavorable agreement, or from a mistake of its own making. The COD assessments had precisely the same effect as reopening the agreements to demand nunc pro tunc a waiver of the [net operating loss carryforwards].¹³⁴

It appears, then, that the IRS recognizes that the cancellation of the principal amounts of federal income tax liabilities — and of liabilities for other nondeductible federal taxes — does not give rise to COD income, despite the fact that the IRS has never formally repudiated *Yale Avenue* and may even opportunistically use it again someday to achieve an effect equivalent to the reopening of an offer in compromise agreement.

G. Gambling Debts

In analyzing the tax consequences of the cancellation of gambling debts, it is helpful to consider four related hypothetical situations.

(1) Suppose two professional gamblers place a bet on the outcome of a football game, each agreeing to pay the other \$100,000 if the other's team wins, and each trusting the other sufficiently that neither puts \$100,000 in escrow (or "on the table") pending the outcome of the game. Also suppose that the loser is under a legally binding obligation to pay \$100,000 to the winner. If the winner eventually agrees to accept \$60,000 from the loser and to cancel the loser's debt for the other \$40,000 (for reasons that do not qualify the cancellation as a gift under section 102), does the loser have \$40,000 of COD income under the LP/MC analysis? The crucial question is whether the loser received anything of value, prior to the cancellation of the debt, that would have been taxable but for the existence of the debt. It is reasonably clear that he did not. The loser did have the opportunity to gamble, but if each team was equally likely to win the expected value

¹³⁴ Beck, *supra* note 57, at 200-01.

of the bet was zero.¹³⁵ The opportunity to make a bet with a zero expected value would not produce taxable income even in the absence of a debt obligation (and indeed the debt obligation did not exist until sometime after the bet had been made).

To make the same point a different way, consider the tax analysis if the game had ended in a tie.¹³⁶ The losing gambler would have been in the same position he actually found himself in after the game, except that he would not have owed the other gambler \$100,000. Obviously, neither gambler would have a bet-related gross income inclusion in the case of a tie game. Equally obviously, the absence of gross income in the case of the tie game is not attributable to the existence of a debt obligation, because no debt ever arises in that scenario. It follows from consideration of the tie-game hypothetical that the losing gambler did not receive anything of value that would have been taxed but for the existence of the gambling debt. Accordingly, under the LP/MC theory of COD income the losing gambler has no COD income upon the cancellation of some or all of his debt.

(2) Now consider a different situation. Suppose our taxpayer wants to make the bet described above, with the same counterparty, but that the counterparty is willing to make the bet only if the taxpayer places \$100,000 cash in escrow ("on the table"). Accordingly, the taxpayer borrows \$100,000 from a bank, and uses the borrowed money as escrow for the bet. The taxpayer loses the bet, the counterparty takes the escrowed \$100,000, and eventually the taxpayer settles his debt to the bank with a payment to the bank of \$60,000 and cancellation by the bank of the other \$40,000. Does this taxpayer have \$40,000 of COD income under the LP/MC analysis? Clearly he does, because he received cash that would have been taxable but for his repayment obligation.

(3) Now consider an intermediate situation. Suppose our taxpayer borrows \$100,000 cash from a person who happens to be his counterparty in the bet and uses the borrowed cash as the escrow payment in the bet, but that it is merely a coincidence that the lender and the counterparty are the same person. In other words, the lender did not lend the \$100,000 with the understanding that it would be placed "on the table" in connection with the bet; the taxpayer was not obligated

¹³⁵ $(2 \times \$100,000) + (2 \times -\$100,000) = \$0$. If each team was not considered equally likely to win, the same analysis would apply if the gamblers used a point spread to equalize the two gamblers' chances of winning.

¹³⁶ This is possible (although unlikely) under the tie-breaking rules used in the National Football League; it is not possible under the tie-breaking rules used by the National Collegiate Athletic Association.

at the time of borrowing the money to make the bet, and could have used the \$100,000 for any number of other purposes. (I beg the reader's indulgence for this unlikely scenario; it serves to set up the following—more likely and more important—scenario.) Given the stipulation of no connection between the loan and the bet, the COD income analysis of this situation should be identical to that of the previous situation; the taxpayer should have \$40,000 of COD income when \$40,000 of the debt is cancelled.

(4) Finally, consider a variation in which the counterparty to the bet nominally lends \$100,000 to the taxpayer, but does so in direct connection with the bet, with the understanding that the only thing the taxpayer may do with the money is put it in escrow for the bet. When the taxpayer loses the bet and the counterparty/lender pockets the escrowed cash, the taxpayer still owes \$100,000 on the so-called loan. If that debt is eventually settled by the taxpayer paying \$60,000 and the counterparty/lender writing off the other \$40,000, does the taxpayer have \$40,000 of COD income? In other words, is the substance of this situation (4) closer to that of situation (1) (gambling without escrow, which does not result in COD income), or closer to that of situation (3) (genuine borrowing followed by the use of the borrowed funds in an unrelated bet with the lender, which does result in COD income)? The answer is clear. The substance of situation (4) is the same as the substance of situation (1), and the tax consequences should also be the same. In both situations, the taxpayer will owe \$100,000 to the counterparty if, and only if, he loses the bet, and in neither situation does the taxpayer ever have control over any of the counterparty's cash. In situation (3), by contrast, the taxpayer owes the counterparty \$100,000 before he makes the bet, and he has many choices, besides the making of the bet, as to how to use the borrowed funds.

As the reader may recognize, situation (4) is a simplified version of the facts of *Zarin v. Commissioner*.¹³⁷ No non-Supreme Court federal income tax case in recent decades has generated more commentary from tax academics and practitioners than *Zarin*. Mr. Zarin, a compulsive gambler, received \$3,435,000 of gambling chips on credit from Resorts International Hotel — that is, Resorts gave him \$3,435,000 of chips in exchange for his \$3,435,000 debt obligation. At least according to the Third Circuit's view of the facts, "Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves

¹³⁷ 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989).

were of little use to Zarin other than as a means of facilitating gambling.”¹³⁸ Mr. Zarin eventually lost all \$3,435,000-worth of chips at the craps table, leaving him with no chips and a \$3,435,000 debt to Resorts. Resorts sued Mr. Zarin for that amount. The case was eventually settled by a payment of \$500,000 from Mr. Zarin to Resorts.

The IRS argued that the transaction in chips was the functional equivalent of a loan of cash, with the result that Mr. Zarin had \$2,935,000 of COD income. In other words, the IRS argued the case was an example of hypothetical situation (3), described above. (Yes, the very situation as to which I begged the reader’s indulgence for its factual implausibility.)

Sitting *en banc*, the Tax Court ruled in favor of the IRS. Writing for the majority, Judge Cohen stated: “We conclude here that the taxpayer did receive value at the time he incurred the debt and that only his promise to repay the value prevented taxation of the value received at the time of the credit transaction.”¹³⁹ Judge Tannenwald’s dissenting opinion is consistent with the view presented here, that the *Zarin* facts were an instance of situation (4):

[I]n all the decided cases involving the cancellation of indebtedness, the taxpayer had, in a prior year when the indebtedness was created, received a nontaxable benefit clearly measurable in monetary terms which would remain untaxed if the subsequent cancellation of the indebtedness were held to be tax free. Such is simply not the case herein.¹⁴⁰

¹³⁸ *Id.* at 114. The court noted that Mr. Zarin could have used the chips to purchase food, drink, lodging, and entertainment within the casino, but that Mr. Zarin would not have done so because, as a high-roller, Resorts provided him with all these benefits on a complimentary basis. *Id.* In any event, consumption satiation for non-gambling uses of the chips within the casino would have been reached with the use of a tiny fraction of Mr. Zarin’s \$3,435,000-worth of chips.

¹³⁹ *Zarin*, 92 T.C. at 1094. Eleven judges (including Judge Cohen) subscribed to the majority opinion. Eight judges dissented in three separate opinions.

¹⁴⁰ *Id.* at 1101 (Tannenwald, J., dissenting). Judge Jacobs’s dissent avoided COD income analysis altogether by concluding that Mr. Zarin’s supposed debt obligation was “void *ab initio*.” *Id.* at 1105 (Jacobs, J., dissenting). Under his analysis, the value of the chips was taxable to Mr. Zarin in the year in which he received them. *Id.* at 1105-06. However, he considered the chips to constitute a form of gambling income, with the result that under section 165(d) Mr. Zarin could offset the income with his gambling losses. *Id.* at 1106. In his dissent, Judge Ruwe claimed that the chips were “property” within the meaning of section 108(e)(5), and that the settlement of Resorts’ claim against Mr. Zarin constituted a purchase price adjustment excluded from gross income under that provision. *Id.* at 1107 (Ruwe, J., dissenting).

On appeal, a divided panel of the Third Circuit reversed. The majority offered two different grounds — both highly dubious — for its decision. First, it concluded that Mr. Zarin could not possibly realize COD income under section 61(a)(12) because he never was indebted to Resorts within the meaning of section 108(d)(1), which defines “indebtedness of the taxpayer” as “any indebtedness— ‘(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.’”¹⁴¹ As Judge Stapleton pointed out in his dissent, by its terms the section 108(d) definition applies only “for the purposes of § 108,” and so should have no bearing on the interpretation of section 61(a)(12).¹⁴² Even apart from that problem, the majority’s conclusion that the chips did not qualify as “property” under section 108(d) is questionable.

The majority also concluded, as an independently sufficient basis for its decision, that the case should be analyzed under the disputed liability doctrine, pursuant to which a taxpayer does not have COD income upon the settlement of a bona fide dispute with the taxpayer’s creditor concerning the amount owed.¹⁴³ That doctrine, which is closely related to — in fact, difficult to distinguish from — the common law purchase price adjustment doctrine,¹⁴⁴ is designed for situations in which (1) there is a dispute between the taxpayer and the creditor concerning the value of the property which the taxpayer received from the creditor when the debt arose, and (2) the taxpayer and the creditor settle the dispute by agreeing upon an particular value for the property and adjusting the amount of the debt in accordance with that agreement. The doctrine should have no application to a case such as *Zarin*, in which there was no dispute about the value of the chips.¹⁴⁵

The opinion of the Third Circuit majority is technically indefensible and has been widely criticized.¹⁴⁶ Perhaps the Third Circuit major-

¹⁴¹ I.R.C. § 108(d)(1), quoted by *Zarin*, 916 F.2d at 113./

¹⁴² *Id.* at 118 n.3 (Stapleton, J., dissenting).

¹⁴³ *Id.* at 115.

¹⁴⁴ For the purchase price adjustment doctrine, see *supra* text accompanying notes 54-56.

¹⁴⁵ Far from being based on an agreed-upon value for the chips, the settlement in *Zarin* was based partly on doubts about whether the debt was legally enforceable at all and partly on doubts as to Mr. Zarin’s ability to pay the entire amount.

¹⁴⁶ See, e.g., Schenk, *supra* note 8, at 168-70; Joseph M. Dodge, *Zarin v. Commissioner: Musings About Debt Cancellation and “Consumption” in an Income Tax Base*, 45 TAX L. REV. 677, 683 n.33 (1990); Daniel Shavero, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 252-58 (1990).

ity deserves some credit, however, for its intuition that Mr. Zarin should not be taxed, and for adhering to that intuition despite its inability to formulate a plausible technical argument in support of it.

As noted earlier, *Zarin* has inspired a great deal of commentary from tax academics and tax practitioners. The variety of views, with respect to both technical analysis and bottom-line outcome, has been at least as great among the commentators as among the twenty-two Tax Court and Third Circuit judges, with a nearly even division among the commentators on the ultimate question of whether Mr. Zarin had COD income.¹⁴⁷

Although many of the discussions of *Zarin*, by both judges and commentators, do not adopt (at least not explicitly) the LP/MC framework for COD income analysis, much of the disagreement and confusion over the case can be traced to the ambiguous character of the chips. The ambiguity concerning the nature of the chips obscured whether *Zarin* should be understood as merely a case of gambling without an escrow (as in situations (1) and (4)), so that no COD income arises, or whether *Zarin* should be understood as a case of gambling with borrowed cash (as in situations (2) and (3)), so that COD income does arise. The former characterization seems much more plausible to me, and so I agree with the result reached by the Third Circuit majority despite agreeing with none of the majority's technical analysis.

The more general lesson of *Zarin* is that it provides another illustration of how difficult it sometimes is to apply the LP/MC analysis of COD income, contrary to the expectation of Bittker and Thompson

¹⁴⁷ For commentary concluding that Mr. Zarin should not have been taxed, see MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 56-57 (11th ed. 2009); Dodge, *supra* note 145, at 692-93; Alan Gunn, *Another Look at the Zarin Case*, 50 TAX NOTES 893 (Feb. 25, 1991); Stephen D. D. Hamilton, *Third Circuit's Contingent Liability Theory Produces Correct Result in Gambling Discharge Case*, 50 TAX NOTES 409 (Jan. 28, 1991); Calvin H. Johnson, *Zarin and the Tax Benefit Rule: Tax Models for Gambling Losses and the Forgiveness of Gambling Debts*, 45 TAX L. REV. 697 (1990); and Shaviro, *supra* note 145, at 250-53. For commentary concluding that Mr. Zarin should have been found to have COD income, see Schenk, *supra* note 8, at 168-70; Babette B. Barton, *Legal and Tax Incidents of Compulsive Behavior: Lessons from Zarin*, 45 TAX LAW. 749 (1992); Robert G. Nassau, *Cancellation of Gambling Debts and Not-so-Phantom Income*, 50 TAX NOTES 188 (Jan. 14, 1991); Joel S. Newman, *Five Will Get You Ten: You Haven't Heard the Last About Zarin*, 50 TAX NOTES 667 (Feb. 11, 1991); and Lee A. Sheppard, *A Gambling Exception to Cancellation of Indebtedness Income?*, 49 TAX NOTES 1516 (Dec. 31, 1990).

that COD income analysis would always be simple under the LP/MC framework.¹⁴⁸

H. Child Support Obligations

William A. Klein claims that a taxpayer who defaults on his obligation to make a court-ordered child support payment to his former spouse should have COD income under section 61(a)(12).¹⁴⁹ Klein argues,

Suppose that [the defaulting taxpayer] had borrowed [money to pay the child support] from a bank and had paid [his former spouse] that amount. Now, instead of owing the money to [his former spouse], he would have owed it to the bank, and it is plain that if he had failed to pay, he would have income from discharge of indebtedness. There is no good reason why the result should be different when he owes the money to his ex-wife.¹⁵⁰

Klein's argument is structurally identical to Bittker's and Thompson's analysis of the bond dividend in *Rail Joint*, discussed earlier in this article.¹⁵¹ As that earlier discussion explains, the hypothetical-third-party-loan analysis should be rejected not only in the context of bond dividends, but also in all the other contexts in which the analysis may be proposed.

Once the hypothetical-third-party-loan analysis of the cancellation of a child support obligation is rejected, the LP/MC analysis is straightforward. When the child support obligation arose, the taxpayer received nothing that would have been taxable but for the existence of the obligation. Whatever warm glow a taxpayer may enjoy from being the parent of a wonderful child, such a glow is not within the scope of the definition of gross income in section 61, regardless of whether or not the glow comes with a debt attached. Accordingly, under the LP/MC analysis the discharge produces no COD income.¹⁵²

¹⁴⁸ Bittker & Thompson, *supra* note 5, at 1165.

¹⁴⁹ William A. Klein, *Tax Effects of Nonpayment of Child Support*, 45 TAX L. REV. 259, 266 (1990). Child support payments are not deductible (I.R.C. § 71(c)), so the defaulting parent would not qualify for the statutory exclusion under section 108 relating to cancellation of a debt, the payment of which would have given rise to a deduction. I.R.C. § 108(e)(2).

¹⁵⁰ Klein, *supra* note 148, at 266.

¹⁵¹ See *supra* text accompanying notes 68-71.

¹⁵² See Beck, *supra* note 57, at 172 n.87 (concluding that Klein's view of the child

*I. Debt Discharged in Bankruptcy but Revived
by a Subsequent Promise*

Richard Beck has offered the hypothetical of a taxpayer who has a debt arising from a cash loan discharged in bankruptcy.¹⁵³ The discharge would give rise to COD income under the LP/MC analysis, but for the fact that it qualifies for the bankruptcy exception of section 108. Although exclusion under the bankruptcy exception ordinarily is accompanied by a reduction of tax attributes under section 108, this taxpayer has no tax attributes to reduce. A debt discharged in bankruptcy can be revived by a post-bankruptcy promise to pay,¹⁵⁴ and the taxpayer makes such a promise out of a sense of moral obligation.

If the revived debt is itself later cancelled, does the taxpayer have COD income? Under the LP/MC analysis, the crucial question is whether the revived debt should be viewed as a continuation of the original debt. If so, then the taxpayer received cash free of tax when the debt arose, and should have COD income upon the debt's cancellation. If instead the revived debt is viewed as a new obligation created solely by the promise, then the taxpayer received nothing — or at least nothing that would have been taxable but for the debt — when the debt was created, and should not have COD income when the debt is extinguished.

Beck suggests that the result should depend upon whether the legal theory explaining the enforceability of the revived debt is based primarily on the original debt or primarily upon the moral weight of the promise.¹⁵⁵ Although this is certainly a plausible approach, it can be criticized for making tax results turn on the resolution of a difficult issue of state law,¹⁵⁶ and as possibly producing inconsistent treatment of taxpayers in different states.

support situation is "asserted unpersuasively").

¹⁵³ *Id.* at 171-72.

¹⁵⁴ RESTATEMENT (SECOND) OF CONTRACTS § 83 (1981). A debt discharged by the statute of limitations can also be revived by a promise. *Id.* § 82. A hypothetical raising the same basic issue as Beck's hypothetical could be based on the revival of such a debt.

¹⁵⁵ Beck, *supra* note 57, at 171-72.

¹⁵⁶ *Cf. Comm'r v. Duberstein*, 363 U.S. 278, 288 (1960) (rejecting the Commissioner's proposed approach to determining whether a transfer by a corporation constitutes a gift within the meaning of section 102, in part because "it would force the tribunals trying tax cases . . . into elaborate inquiries into the local law of corporations" and thus "might make the tax tribunals the most frequent investigators of an important and difficult issue of the laws of the several States").

An alternative approach would be to turn to the structure of the federal income tax itself for guidance. Looking at that structure, the key point is that the federal income tax generally treats the cancellation of a debt, including the discharge of a debt in bankruptcy, as a closed transaction. If a debt is extinguished in bankruptcy, section 108(a)(1)(A) excludes the cancellation from the taxpayer's gross income, but section 108(b) requires that various tax attributes of the taxpayer must be reduced on account of the cancelled debt. In the case of a taxpayer with sufficient attributes available for reduction, the effect is to defer—rather than permanently forgive—the tax on the cancelled debt. As Beck observes, in a case in which tax attributes are reduced, it is clear that there should be no COD income if the discharged debt is revived by a promise and the revived debt is later discharged.¹⁵⁷ Taxing the taxpayer upon the cancellation of the revived debt in that situation would have the effect of taxing him twice on the same gain. In the tax attribute reduction situation, then, it is clear that the first cancellation should be treated as a closed transaction, in the sense that if the revived debt is canceled, that cancellation should be treated as relating back only to the promise, rather than to the original loan. To be consistent, the tax rules should also view the first cancellation as a closed transaction if the taxpayer happens to avoid the usual deferral regime for lack of tax attributes available for reduction.

An analogy to an aspect of the exclusionary tax benefit rule of section 111 provides additional support for this analysis. Suppose a taxpayer is owed \$10,000, and accepts property worth \$7,000 from the debtor in settlement of the debt. The taxpayer properly claims a \$3,000 bad debt deduction under section 166, but the deduction produces no tax benefit. If the taxpayer sells the property for \$10,000 in a later year, the taxpayer has a \$3,000 taxable gain on the sale. The bad debt transaction is considered closed in the year in which the taxpayer receives the property, so the taxpayer cannot treat the gain on the sale as a tax-free recovery, under section 111, of the \$3,000 previously deducted without tax benefit.¹⁵⁸ In much the same way, the original debt transaction in Beck's hypothetical should be considered closed in the year in which the taxpayer realizes the tax-exempt COD income. With the original debt transaction considered closed, the taxpayer should not be treated as having received the original loan proceeds in exchange for his post-bankruptcy promise to pay, and thus should not have COD income upon the cancellation of the promise-revived debt.

¹⁵⁷ Beck, *supra* note 57, at 172 n.85.

¹⁵⁸ Rev. Rul. 66-320, 1966-2 C.B. 37.

Although this seems to me to be the most plausible analysis of the revived debt problem, my point is not that this analysis is incontrovertibly correct. In fact, my point is closer to the opposite: to demonstrate, once again, how much difficulty and uncertainty there can be in applying the LP/MC approach to COD income in some situations.

V. CONCLUSION

It is time to end the long-standing confusion as to whether the taxation of cancellation of indebtedness income is based on the strict annual accounting approach of the net worth theory, or on the transactional accounting approach of the loan proceeds (mistake correction) theory. The confusion is not merely theoretically untidy. As this article has shown, in a wide range of cases COD income would exist under the net worth theory, but would not exist under the loan proceeds theory. When a case with appropriate facts presents itself, the Supreme Court should take the opportunity to clarify — finally, after many decades — the analytical foundations of debt cancellation income. In its opinion in that case, the Court should announce that the implicit endorsement by *Sanford & Brooks* of the net worth theory's strict annual accounting has no continuing force.

Although an authoritative declaration that the LP/MC theory is the one and only foundation for the taxation of cancellation of indebtedness income would rationalize the law, it would not necessarily simplify the law. In a number of situations, there is room for reasonable disagreement on the question — the crucial question under LP/MC analysis — of whether the taxpayer received a benefit when the cancelled debt arose, which benefit would have been taxable but for the existence of the debt. I hope the discussions of various no-benefit situations (or would-be no-benefit situations) in this article will prove helpful to the courts as they proceed to delineate the contours of debt cancellation income under the LP/MC theory.