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## Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*

Boris I. Bittker†  
Barton H. Thompson, Jr.‡

*The Kirby Lumber case established the general rule that the cancellation of indebtedness by a creditor for less than the amount owed results in income to the debtor. This Article discusses the rationale for that holding and shows that many of the judicial exceptions to the Kirby Lumber rule are based on erroneous interpretations of that case.*

Borrowed funds are not included in gross income when received even though they increase the debtor's assets and can be used as he sees fit, because the obligation to repay increases his liabilities by the same amount, so that the transaction produces no gain.<sup>1</sup> In the ordinary case, the debt is repaid in full on maturity, thus validating the assumption on which the funds were excluded from income when received. Sometimes, however, the prediction of full repayment proves erroneous because the taxpayer is able to discharge the debt for less than the amount originally borrowed. Although this means that the taxpayer

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† Sterling Professor of Law, Yale University. B.A. 1938, Cornell University; LL.B. 1941, Yale University.

‡ B.A. 1972, J.D. 1976, M.B.A. 1976, Stanford University; Member, California Bar.

1. See *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1966), *cert. denied*, 390 U.S. 946 (1967). Factual questions frequently arise as to whether the debtor received the funds as a bona fide loan or as compensation with no expectation of repayment. See, e.g., *Chapman v. United States*, 314 F. Supp. 549 (C.D. Cal. 1970); *Moravec v. Commissioner*, 30 T.C.M. (CCH) 601 (1971). In the latter case, the proceeds of the purported loan are income to the recipient. See, e.g., *Charles R. Leaf*, 33 T.C. 1093 (1960), *aff'd per curiam*, 295 F.2d 503 (6th Cir. 1961).

has received, and has been allowed to exclude from income, more than he pays out, the federal income tax was almost twenty years old before the courts unequivocally accepted the government's theory that the discharge of a debt for less than its face amount could generate taxable income.

One obstacle to government success in this early period was *Eisner v. Macomber*,<sup>2</sup> which defined income as "the gain derived from capital, from labor, or from both combined."<sup>3</sup> An improvement in the debtor's financial status resulting from settling a debt for less than its full amount did not seem to be a gain derived by the taxpayer-debtor from either capital or labor.<sup>4</sup> Moreover, frequently when creditors agree to accept less than the amount due, it is because the debtor is in financial distress; taxing such debtors may have seemed anomalous, even heartless, especially since the closer the debtor approaches the abyss of bankruptcy, the greater the discount creditors are willing to grant and therefore the heavier the potential tax burden if the discount were taxed. This reluctance to kick debtors when they are down may have carried over to the very different situation of gain realized by a corporate debtor on open market purchases of its own bonds at less than their issue price, where the decline in market value is attributable not to the debtor's financial woes, but rather to an increase in the interest rate on obligations of equivalent risk.<sup>5</sup>

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2. 252 U.S. 189 (1920).

3. *Id.* at 207 (citing *Stratton's Independence v. Howbert*, 231 U.S. 399, 415 (1913)).

4. *See, e.g.*, *Meyer Jewelry Co.*, 3 B.T.A. 1319 (1926). In holding that cancellation of a corporate taxpayer's indebtedness did not constitute income, the Board of Tax Appeals also quoted with approval the statement in *Eisner v. Macomber* that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Id.* at 1322 (quoting 252 U.S. at 214-15). Notwithstanding this reliance on *Eisner v. Macomber*, the Board stated that there might be other circumstances in which the cancellation of a debt would constitute income, and it also suggested that a taxpayer could be required to reduce the basis of the property purchased with the borrowed funds by the amount cancelled. *Id.* at 1323.

5. There are several reasons why a debtor may be able to cancel an obligation for less than its face value. First, the creditor may be worried about the financial health of the debtor and the possibility of a default. Even a solvent debtor may be able to settle debts for less than their full amount by fraudulently concealing assets to give an appearance of financial distress. Second, the rate of interest for loans of similar risk, marketability, and maturity may have risen, lowering the value of the obligation since the creditor could now loan out the sum at a greater return. *See generally* J. VAN HORNE, *FUNCTION AND ANALYSIS OF CAPITAL MARKET RATES* (1975). A third possibility is that the statute of limitations may have run, making the debt unenforceable even though not technically discharged. *See, e.g.*, *Securities Co. v. United States*, 85 F. Supp. 532 (S.D.N.Y. 1948); *Estate of Bankhead v. Commissioner*, 60 T.C. 535 (1973).

The reason for the less-than-face cancellation of a debt may be relevant in determining the appropriate tax consequences for the debtor. For example, assume C extends a \$10,000 loan to a friend D for five years at a 0% rate of interest. The economic benefit of using the funds free for the five-year period is an indirect gift from C to D which D is entitled to exclude from income. Because of the time value of money, C will probably be willing to accept less than \$10,000 in repayment of the debt at any time before maturity. If the difference between the face value and the amount repaid is merely the discounted value of the 0% interest rate, cancellation of the debt

The government's early efforts to tax gain from debt cancellations encountered still another obstacle in 1926 when the Supreme Court made its first pronouncement on the subject in *Bowers v. Kerbaugh-Empire Co.*<sup>6</sup> That case involved a taxpayer that borrowed German marks before World War I, converted the borrowed funds into dollars, and advanced these funds to a subsidiary that subsequently lost them in unsuccessful business activities. At issue was whether the parent realized income when it repaid the loans after the war with devalued marks costing about \$685,000 less than the borrowed marks were worth when received. The Court observed that "the whole transaction was a loss" and deemed it irrelevant that the loss was less than it would have been if the German marks had not declined in value, concluding that "the mere diminution of loss is not gain, profit, or income."<sup>7</sup> Accordingly, the Court held that the difference between the dollar value of the marks at the time of repayment and when the loans were made was not income.

## I

## KIRBY LUMBER AND ITS AFTERMATH

Despite this inauspicious beginning, the government persisted in trying to establish that the discharge of debt for less than its face amount could generate income. Its perseverance was finally rewarded in *United States v. Kirby Lumber Co.*,<sup>8</sup> decided by the Supreme Court in 1931. The taxpayer in *Kirby Lumber* repurchased some of its own bonds on the open market for \$138,000 less than the amount it had received upon issuing the bonds earlier that same year. Arguing that *Kerbaugh-Empire* was not controlling in the absence of evidence of an overall loss, the government asserted that the spread between the amount received and the amount paid out for the bonds constituted taxable income. The Court upheld the government's contention in a surprisingly terse opinion, dismissing the constitutional doubts that had clouded the area without even citing *Eisner v. Macomber*:

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should be treated as a method of realizing the tax-free gift in one fell swoop rather than in installments over the original life of the debt. The cancellation should therefore not give rise to any tax liability. See D. Bruce Forrester, 4 T.C. 907, 921 (1945).

On the other hand, if the debtor has a talent for fraud, he may be able to conceal his assets successfully, outwit his creditors, and settle his debts for a song. Profits from such a gambit should perhaps be classified as income from unlawful activities—more like "borrowing" money with no intent to repay than realizing income from the discharge of a debt. Cf. *Rozelle McSpadden*, 50 T.C. 478 (1968) (income resulting from fraudulent mortgage scheme); *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1966), cert. denied, 390 U.S. 946 (1967) (swindling in form of loan); *Max D. Klahr*, 27 T.C.M. (CCH) 1293 (1968) (same). See generally *United States v. James*, 366 U.S. 213 (1961).

6. 271 U.S. 170 (1926).

7. *Id.* at 175.

8. 284 U.S. 1 (1931).

In *Bowers v. Kerbaugh-Empire Co.* . . . , [the taxpayer] owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available \$137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.<sup>9</sup>

*Kirby Lumber's* result was entirely justifiable, but its cryptic rationale set afloat erroneous ideas that have led to a confusing patchwork of rules and exceptions dominating the area to this day.<sup>10</sup>

### A. *The Transaction as a Whole*

First, *Kirby Lumber* carried forward from *Kerbaugh-Empire* the theory that the taxability of a debt discharge depends on the profitability of "the transaction as a whole," requiring consideration not merely of whether the taxpayer borrowed more than it repaid but also of whether the use of the borrowed funds was profitable. It is usually impossible to make this latter determination, however, since the borrowed funds are ordinarily absorbed into the business so completely that tracing the travels of interchangeable dollars lacks even the surface plausibility that it could claim in *Kerbaugh-Empire*.<sup>11</sup> Even where funds can

9. *Id.* at 3 (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364 (1931)). Although the opinion referred to "extinct" bonds, later cases have found it immaterial whether the bonds are retired or held for reissue. See, e.g., *Montana, Wyoming & S. R.R.*, 31 B.T.A. 62 (1934), *aff'd per curiam*, 77 F.2d 1007 (3d Cir.), *cert. denied*, 296 U.S. 604 (1935).

10. For a general discussion of some of these problems, see, e.g., Blattner, *Debt Cancellation*, N.Y.U. 30TH ANN. INST. ON FED. TAX. 237 (1972); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX. L. REV. 225 (1959); Stone, *Cancellation of Indebtedness*, N.Y.U. 34TH ANN. INST. ON FED. TAX. 555 (1976); Wright, *Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness* (pts. I-II), 49 MICH. L. REV. 459, 667 (1951). Older articles of continuing interest include Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977 (1940); Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153 (1940); and Warren & Sugarman, *Cancellation of Indebtedness and Its Tax Consequences* (pts. I-II), 40 COLUM. L. REV. 1326 (1940), 41 COLUM. L. REV. 61 (1941).

11. *Kirby Lumber* itself demonstrates the difficulty of tracing the fate of borrowed funds. Although the Court said that the taxpayer in *Kirby Lumber* suffered "no shrinkage of assets" but "made a clear gain," 284 U.S. at 3, there was nothing in the record to support this suggestion. Contrary to a common assumption, the taxpayer in *Kirby Lumber* did not issue the bonds for cash, but in exchange for its own preferred stock with dividend arrearages. See Bittker, *Income From the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Co. Case*, 4 J. CORP. TAX. 124 (1977). It is not clear how one should determine whether such a transaction resulted in a "clear gain."

be traced to a particular project, the attribution is artificial since in most cases borrowing frees up funds that the debtor can then use to finance other projects. It is therefore misleading to limit an examination of "the transaction as a whole" to the fate of only those projects directly financed with the borrowed funds.

Tying the tax treatment of debt discharge to the fate of the borrowed funds is also irrational for another reason. Since the amount borrowed will ultimately be capitalized, expensed, or nondeductible, depending on how the borrowed funds are used, the fate of the funds will already be reflected in the debtor's net income. If borrowed funds are invested and lost in an ill-fated business venture, the full amount borrowed will generally be deductible as a business loss.<sup>12</sup> If the taxpayer later settles the debt for less than its issue price, an exclusion of the difference because the funds were lost would be tantamount to a double deduction for a single loss. For example, a taxpayer who loses \$1,000 of borrowed funds in a business venture and then settles the debt for \$100 will be able to deduct the full \$1,000 even though the out-of-pocket loss is only \$100. If the taxpayer can then exclude the \$900 difference between the amount borrowed and the amount repaid from income under the rationale of *Kerbaugh-Empire*, the business loss will be doing double duty—first by creating \$1,000 of deductions and then by shielding the \$900 spread against the *Kirby Lumber* principle.<sup>13</sup>

In point of fact, a taxpayer's ability to repurchase its bonds for less than their issue price is almost always evidence either (a) that its creditors have come to doubt its ability to pay the interest and principal on the due dates or (b) that the market rate of interest on bonds of comparable risk has risen, making the taxpayer's bonds less attractive than

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Cases in which the taxpayer was unable to trace borrowed funds into business losses include *Capitol Coal Corp.*, 26 T.C. 1183 (1956), *aff'd*, 250 F.2d 361 (2d Cir. 1957), *cert. denied*, 356 U.S. 936 (1958), and *Church's English Shoes, Ltd. v. Commissioner*, 229 F.2d 957 (2d Cir. 1956). An analogous tracing problem arises in determining whether a taxpayer incurred an indebtedness for the purpose of carrying tax exempt securities, in which case interest on the loan is not deductible. *See, e.g.*, Rev. Proc. 72-18, 1972-1 C.B. 740, *clarified*, Rev. Proc. 74-8, 1974-1 C.B. 419.

12. *See* I.R.C. § 165(a), (c).

13. It is not clear that this result was in fact sanctioned by *Kerbaugh-Empire*, where a parent corporation borrowed funds from a bank in order to lend them to its subsidiary and then repaid less than the amount it had borrowed. Although the subsidiary suffered business losses, the opinions do not say whether the parent wrote off its loans to the subsidiary as bad debts. If these loans were still outstanding after the parent settled its bank loans and were subsequently written off as uncollectible, it is possible that the parent was allowed to deduct, not the full amount it loaned to the subsidiary, but only its "cost" or out-of-pocket loss—*i.e.*, the amount it paid to its own creditor for the funds advanced to the subsidiary. If this approach were followed, a repayment in full by the subsidiary would generate gain to the parent equal to the amount excluded by it from income in the year of its own settlement with the bank, because the exclusion would have required a reduction in its basis for the loans. The district court's opinion stated that the subsidiary deducted its losses, 300 F. 938, 939-40 (S.D.N.Y. 1924), but if it later defaulted on its debts to its parent or settled them for less than face amount, the subsidiary's prior deductions might disqualify it from relying on the *Kerbaugh-Empire* rationale, thus requiring it to report debt-discharge income.

similar new issues.<sup>14</sup> If the bonds in *Kirby Lumber* dropped in value because of creditor doubts about the taxpayer's financial stability, there presumably was a decline of at least an equal amount in the value of the taxpayer's business as a going concern. A similar loss of going concern value would result from an increase in the market rate of interest; one of the few reliable stock market phenomena is that an increase in interest rates almost invariably causes stock prices to drop, reflecting a lower present value for the stream of income expected from corporate assets. Whichever of these events accounted for the taxpayer's ability in *Kirby Lumber* to repurchase its bonds at a discount, "the transaction as a whole" was not necessarily any more profitable in *Kirby Lumber* than in *Kerbaugh-Empire*.

In short, the very fact that a taxpayer can repurchase its bonds for less than face amount—as in both *Kerbaugh-Empire* and *Kirby Lumber*—almost always denotes a decline in going concern value at least equal to the difference between the amount borrowed and the amount paid back.<sup>15</sup> *Kirby Lumber*, however, implicitly assumes the contrary. The lower courts have not directly attacked this unrealistic aspect of *Kirby Lumber*; but, because the Court invited examination of "the transaction as a whole," they have grafted exceptions on the *Kirby Lumber* principle to avoid its result when it is glaringly obvious that the taxpayer's ability to settle its debt for less than the amount owing evidences financial distress.<sup>16</sup>

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14. A disparity between the interest payable on the old debt and the rate charged currently on loans of equal risk may reflect a general increase in the "riskless" rate of return, a shift by the debtor into riskier activities, or a combination of both causes. See note 5 *supra*.

15. For this reason, the analogy in *Commissioner v. Jacobson*, 336 U.S. 28 (1949), discussed in notes 65-69 *infra* and accompanying text, between a repurchase of the taxpayer's own bonds at a discount and a profitable transaction in the bonds of another company is unpersuasive. If the taxpayer buys another company's bonds at a discount and later sells them at face value (or sells them short at face and later buys identical bonds at a discount to settle the short sale), the spread is pure profit; fluctuations in the value of the taxpayer's own bonds, by contrast, are ordinarily offset by changes in the value of its assets.

16. Other language in the *Kirby Lumber* opinion theoretically collides with the Court's concern for "the transaction as a whole" by alluding to the annual accounting concept. The Court stated that the taxpayer "realized within the year an accession to income." 284 U.S. at 3 (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the leading proponent of the annual accounting concept). In that case, the Court held that a taxpayer realized income in a particular taxable year when it recovered damages for breach of contract, even though the recovery was less than the losses sustained in earlier years in performing its part of the agreement.

The focus in *Kirby Lumber* on the current taxable year not only undermines its own concern with "the transaction as a whole" but is troublesome even when taken in isolation. All that happened in the year before the Court was a purchase of the bonds for less than their face amount. Because this reduced the company's liabilities by \$12,000,000 while reducing its assets by only \$11,962,000, its net worth increased by about \$138,000; but this arithmetic change merely reflected the fact that the bonds were listed on the liability side of the balance sheet at their face amount, while the cash was, of course, shown at full value. If the company's assets and its liabilities to creditors had been valued at their respective fair market values, the company's net worth would have been the same after the repurchase as it was before.

### B. The Freeing of Assets

A second source of confusion in *Kirby Lumber* was the Court's assertion that the transaction "made available \$137,521.30 assets previously offset by the [obligation to repay]." <sup>17</sup> If the Court meant that repurchase of the bonds for less than their face amount reduced the taxpayer's liabilities by more than its assets and hence increased its net worth, that phenomenon was equally present in *Kerbaugh-Empire* and will occur whether the taxpayer invested the borrowed funds successfully or not. If the reference to an increase in available assets meant that the taxpayer borrowed more than it paid back, that was also true in *Kerbaugh-Empire* and is similarly unaffected by interim gains or losses from investment of the borrowed funds.

A particularly troublesome legacy of the above passage has been the tendency of some courts to read *Kirby Lumber* as holding that it is the *freeing of assets* on the cancellation of indebtedness, rather than the cancellation itself, that creates a taxable gain. Such reasoning misses the point. Income results from the discharge of indebtedness because the taxpayer received (and excluded from income) funds that he is no longer required to pay back, not because assets are freed of offsetting liabilities on the balance sheet. <sup>18</sup> Debtors who ultimately pay back less than they received enjoy a financial benefit whether the funds are invested successfully, lost in a business venture, spent for food and clothing, or given to a charity.

### C. Summary

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. <sup>19</sup> Were we blessed

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For a discussion of the relationship among *Sanford & Brooks*, *Kerbaugh-Empire*, and *Kirby Lumber*, see R. MAGILL, TAXABLE INCOME 245-254 (rev. ed. 1945).

17. 284 U.S. at 3; see text accompanying note 9 *supra*.

18. Thus if a taxpayer borrows \$15,000 in cash and the debt is later cancelled, the taxpayer should be required to include \$15,000 in income whether or not he was personally liable for the debt. Concentrating on the freed assets rationale of *Kirby Lumber*, however, the Tax Court has held that a taxpayer who is not personally liable on a nonpurchase money debt receives income only to the extent of any collateral freed as a result of the cancellation. See note 29 *infra* and accompanying text. Focus on the freeing of assets, rather than on the gain to the debtor on cancellation of its indebtedness, may also have contributed to anomalous or debatable results in several other areas. See notes 42-44 *infra* and accompanying text (modification of original obligation and substitution of new obligations); notes 45-46 *infra* and accompanying text (exchange of stock for debt); notes 82-91 *infra* and accompanying text (insolvent debtor).

19. The "tax benefit rule," discussed in notes 73-81 *infra* and accompanying text, governs several analogous situations in which an offsetting adjustment is required when the assumption underlying an exclusion or deduction ultimately proves erroneous. See, e.g., *Charleston & W.*

with perfect foresight, it would be preferable to exclude borrowed funds from gross income only to the extent that they ultimately will be repaid and to tax at the outset the amount that eventually will be discharged. In the absence of such prevision, however, another solution is required. One alternative would be to tax the entire amount borrowed when received and to allow deductions only as the debt is paid back. But since most loans are in fact repaid in full and taxing the receipt would impose a heavy front-end burden on debt financing, a better alternative is the existing system of excluding the borrowed funds from gross income when received and requiring the taxpayer to account for any subsequent gain from settling the debt for less than the amount originally received.

Unfortunately, *Kerbaugh-Empire* linked the tax treatment of the debt discharge to the fate of the borrowed funds, and *Kirby Lumber* carried forward this idea by distinguishing rather than repudiating *Kerbaugh-Empire*, apparently sanctioning an open-ended inquiry into the debtor's financial history in order to determine whether the discharge of the debt generated a "clear gain." In a tortuous series of later decisions, examined below, the courts have held that the nature of the obligation, the mode of discharge, the creditor's objective in agreeing to the settlement, the absence of prior tax benefits, and the debtor's financial condition may, in particular circumstances, shield the taxpayer from the result reached in *Kirby Lumber*.<sup>20</sup>

## II

### THE RELEVANCE OF THE NATURE OF THE DEBT

As a general rule, the taxability of gain from the discharge of indebtedness should not depend on the specific type of debt incurred, but merely on the spread between the amount received by the debtor and the amount paid by him to satisfy his obligation. Encouraged by *Kirby Lumber's* failure to overrule *Kerbaugh-Empire* and its reference to "freed assets," however, the courts have engrafted a number of excep-

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Carolina Ry. v. Burnet, 50 F.2d 342 (D.C. Cir. 1931) (unclaimed wages held to be income to employer); Fidelity-Philadelphia Trust Co., 23 T.C. 527 (1954) (unclaimed bank deposits held to be income to bank when transferred from deposit liability account to surplus account).

20. Despite this tangled net of judicial rules, Congress has remained largely quiescent. In 1954, the Internal Revenue Code was amended to provide explicitly that gross income includes "[i]ncome from discharge of indebtedness," I.R.C. § 61(a)(12), but this statutory change leaves to the courts the task of promulgating standards for determining whether the discharge of a particular debt produces income. The same is true of §§ 108 and 1017, discussed in notes 92-102 *infra* and accompanying text, which give the taxpayer a last clear chance to avoid recognizing income on the discharge of a debt by electing to reduce the basis of its property. Other instances of legislative intervention involve limited issues rather than basic principles. See notes 82-91 *infra* and accompanying text (pertaining to the bankruptcy provisions); I.R.C. § 332(c) (relating to cancellation of parent-subsidiary debts), discussed in B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 11-40 (4th ed. 1979).



tions on to *Kirby Lumber* which depend on seemingly irrelevant considerations going to the nature of the debt.

### A. *The Nature and Amount of the Consideration*

Although the bonds in *Kirby Lumber* were issued in exchange for the taxpayer's preferred stock with dividends in arrears, the case has often been thought to involve bonds issued for cash, perhaps because the Court said that the taxpayer on issuing the bonds "received their par value."<sup>21</sup> Despite this misconception, the *Kirby Lumber* principle has been applied regularly to transactions in which a taxpayer assumes the outstanding bonds of a selling corporation as part of the purchase price for the business assets of that corporation and later discharges those bonds at a discount.<sup>22</sup> But obligations arising in other types of noncash transactions have sometimes been held outside the reach of *Kirby Lumber*. Thus in *Commissioner v. Rail Joint Co.*,<sup>23</sup> the Court of Appeals for the Second Circuit held that the taxpayer did not realize income on repurchasing for less than their face amount certain bonds that it had previously distributed as a dividend to its shareholders, because this event did not increase the taxpayer's assets. But the distribution of the bonds could properly have been analogized to a sale of the bonds for cash followed by a distribution of the proceeds as a dividend. Viewed in this way, the distribution of the 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.<sup>24</sup>

The taxpayer in *Kirby Lumber* had originally issued the repurchased bonds at par value. For this reason, it is customary to describe the case as holding that the taxpayer realizes income on discharging a debt for less than its "face amount."<sup>25</sup> The computation of income is more complicated, however, if the taxpayer receives some amount other than par value on incurring the obligation.<sup>26</sup> The economic effect

21. 284 U.S. at 2. See generally Bittker, *supra* note 11.

22. See, e.g., *Helvering v. American Chicle Co.*, 291 U.S. 426 (1934).

23. 61 F.2d 751 (2d Cir. 1932). See also *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956) (*Kirby Lumber* inapplicable where taxpayer issued note to bank to reduce prior debt owed by husband and subsequently repurchased the note for less than its face amount; taxpayer was described as having issued her note "without receiving any consideration in return," *id.* at 938, although the transaction could have been treated as an indirect way of getting cash to reduce the husband's debt).

24. The bonds in *Kirby Lumber* were issued in part to satisfy dividend arrearages on the taxpayer's preferred stock, see text accompanying note 21 *supra*, yet their discharge for less than face amount was held to constitute taxable income.

25. See, e.g., Treas. Reg. § 1.61-12(a) (1957).

26. For an example of the confusion caused when bonds are issued at other than par value in noncash transactions, see *Fashion Park, Inc.*, 21 T.C. 600 (1954) (*Kirby Lumber* inapplicable where bonds issued in exchange for preferred stock with dividend arrearages were reacquired for

of issuing bonds at a premium or discount is to reduce or increase the effective interest rate. Thus, if the nominal interest rate is above the market rate, the bonds will sell at a premium, and if the nominal rate is below market, the issuer will have to discount the bonds in order to sell them. Generally, the debtor must report the premium as income, and may deduct the discount, in installments over the life of the bond.<sup>27</sup> When the obligation is discharged for less than the issue price, the gain under *Kirby Lumber* (i.e., the difference between the issue price and the redemption price) must be adjusted by adding back any discount previously deducted or subtracting any premium previously included in income.<sup>28</sup>

### B. Nonrecourse Debt

If the debtor borrows on a nonrecourse basis, pledging real estate or other property as security for the debt, a later discharge for less than the amount owing should generate income in the same manner as if the debtor were personally liable. In both cases the debtor excludes the borrowed funds from income when received and ultimately repays less than the excluded amount. Influenced by the "freed assets" rationale of *Kirby Lumber*, however, the Tax Court has limited the taxable amount to the value when the debt is discharged of the collateral that is relieved of the liability. Where the taxpayer acquires property subject to an existing debt and later discharges the debt for less than its face amount, the Tax Court has held that no cancellation-of-indebtedness income is recognized at all but that the basis of the property must be reduced by the amount of the spread.<sup>29</sup>

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less than their face amount but for more than the amount for which the preferred stock had originally been issued).

27. Treas. Reg. §§ 1.61-12(c) & 1.163-3(a)(1) (1969).

Like discharges of debt for less than its face amount, bond premiums entail the receipt by the debtor of more principal than is ultimately paid back. In the latter situation, however, the amount of the spread and the period to which it is properly allocable are known in advance; this is not true of debt discharges.

28. For an illustrative computation, see Treas. Reg. § 1.61-12(c)(5) (1969). See also Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974); Wolf, *Original Issue Discount: Before and After National Alfalfa*, 28 TAX LAW. 325 (1975); notes 73-81 *infra* and accompanying text (discussing the tax benefit rule).

29. Compare Leland S. Collins, 22 T.C.M. (CCH) 1467 (1963) (income limited to the value of collateral released on complete cancellation of the debt) with *Fulton Gold Corp.*, 31 B.T.A. 519 (1934) (no cancellation of indebtedness income; basis of property reduced). The *Fulton Gold* approach is similar to the reduction-of-purchase price exception to *Kirby Lumber*, discussed in the text accompanying notes 34-41 *infra*. See also *Crane v. Commissioner*, 331 U.S. 1 (1947). Compare *Lutz & Schramm Co.*, 1 T.C. 682 (1943) (transaction analyzed as a sale of property rather than as a discharge of a debt where taxpayer mortgaged property and then discharged the mortgage by transferring the encumbered property to the mortgagee) with *Fulton Gold*.

### C. Disputed Liabilities

The Treasury regulations under section 108 once defined "indebtedness" as "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount."<sup>30</sup> Although this definition did not explicitly apply to the term "indebtedness" as used in section 61(a)(12),<sup>31</sup> the courts have in effect adopted it in applying the *Kirby Lumber* principle. As a result, settlement of a claim does not generate income under section 61(a)(12) if the debtor disputes liability for the amount claimed by the alleged creditor,<sup>32</sup> because such a debt is neither "absolute and not contingent" nor for "a fixed amount." As a practical matter, the amount payable is whatever the parties agree upon in their settlement negotiations,<sup>33</sup> and discharge of the remainder of the creditor's claim therefore does not increase the taxpayer's net worth as required by the *Kirby Lumber* principle.

This reasoning suggests that a debtor who acknowledges liability for a particular amount and contests the creditor's claim only to the extent of the excess should realize taxable income if the debt is settled for less than the amount of the acknowledged liability. Such a transaction could properly be treated as (1) a nontaxable cancellation of the disputed amount and (2) a discharge of the balance of the claim for less than the amount due, subject to the *Kirby Lumber* principle. There do not appear to be any reported cases, however, in which a transaction was bifurcated in this manner.

In a line of anomalous cases, the courts have stretched the "disputed liability" exception to encompass the discharge of purchase money mortgages following a decline in the value of the property.<sup>34</sup>

30. Treas. Reg. § 1.108(b)-1(c) (1956). (Section 108(b), relating to income from the discharge of indebtedness of certain railroad corporations, was repealed for taxable years beginning after 1976 by the deadwood provisions of the Tax Reform Act of 1976.) See also I.R.C. § 385; B. BITTKER & J. EUSTICE, *supra* note 20, at 4-15 to 4-16.

31. Section 61(a)(12) provides that gross income includes "[i]ncome from discharge of indebtedness." See note 20 *supra*.

32. The no-income result presupposes that a bona fide dispute exists but not necessarily that the debtor's position is valid. See, e.g., *N. Sobel, Inc.*, 40 B.T.A. 1263 (1939).

33. See, e.g., *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943). Thus if business equipment is bought for \$1,000 on credit and the buyer refuses to pay because of an alleged misrepresentation or breach of warranty, a settlement of the debt for \$750 is not a taxable event but rather a retroactive reduction of the purchase price to \$750. This lower amount, rather than the original price of \$1,000, will be the taxpayer's basis in the property for computing depreciation and for determining gain or loss when the property is ultimately disposed of. This adjustment to basis approach is also followed when property is purchased subject to an existing debt, with no assumption of personal liability, and the debt is later cancelled for less than its face amount. See note 29 *supra* and accompanying text.

34. See, e.g., *Helvering v. A.L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942), and other cases cited in *Helvering v. American Dental Co.*, 318 U.S. 322, 327-28 (1943). The Second Circuit, per Judge Jerome Frank, has described such cases as "irrational" in holding the *Kirby Lumber* doc-

Since there is no dispute about liability, this result cannot be justified on the theory that the transaction is a retroactive reduction of the price paid by the taxpayer for the property.<sup>35</sup> Perhaps in implicit recognition of the weakness of this exception, the courts have kept it narrowly confined, refusing to apply it where the debt is discharged in an open market transaction rather than in face-to-face dealings with the creditor,<sup>36</sup> the parties do not focus on the property in their negotiations,<sup>37</sup> the property is worth more than the unpaid balance of the debt before the adjustment,<sup>38</sup> or the creditor is not the person from whom the taxpayer purchased the property.<sup>39</sup>

The judicially-created "retroactive reduction of purchase price" exception to *Kirby Lumber* has the same effect as an election under section 108<sup>40</sup>—no income is realized when the debt is discharged, but the taxpayer's basis in the property is reduced by the amount forgiven.<sup>41</sup> Thus the taxpayer will have lower depreciation deductions if the property is depreciable and more gain (or less loss) when it is eventually disposed of. But the judicial exceptions are evidently available to individual taxpayers who cannot make an election under section 108 because the property acquired on credit is a personal residence or other nonbusiness property.

### III

#### THE EFFECT OF THE WAY THE DEBT IS DISCHARGED

In *Kirby Lumber*, the taxpayer eliminated debt obligations by repurchasing its bonds for cash. While cash transactions are the most common means of discharging debt, there are other ways to eliminate, scale down, or modify obligations, and these methods introduce tax complications.

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trine inapplicable where the reduced indebtedness is a purchase money obligation. *Fifth Ave.-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453, 456 (2d Cir. 1945).

35. Some cases have also justified this result on the *Kerbaugh-Empire* "overall loss" theory, see text accompanying notes 6-7 *supra*. See, e.g., *Helvering v. A.L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942). But *Kerbaugh-Empire* must be stretched to the breaking point to encompass unrealized depreciation in the value of an asset, especially since the value may have bounced back to its original level or above by the time the asset is sold.

36. See, e.g., *Fifth Ave.-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453 (2d Cir. 1945).

37. See, e.g., *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104 (1st Cir.), cert. denied, 293 U.S. 595 (1934).

38. See, e.g., *id.*; *L.D. Coddon & Bros., Inc.*, 37 B.T.A. 393 (1938).

39. See, e.g., *Denman Tire & Rubber Co.*, 14 T.C. 706, 714-15 (1950); *Edward W. Edwards*, 19 T.C. 275 (1952).

40. Section 108 is discussed in text accompanying notes 92-102 *infra*.

41. A similar approach is also followed where property is purchased subject to an existing debt, with no assumption of personal liability, and the debt is later settled for less than face value. See note 29 *supra* and accompanying text.

### A. Modification or Exchange of Debt Obligations

A reduction in the amount due on an obligation increases the debtor's net worth and brings the *Kirby Lumber* principle into play whether there is an exchange of obligations,<sup>42</sup> or simply an agreement by the creditor to accept a lesser amount. If, however, the taxpayer induces the creditor to modify merely ancillary terms of the obligation, such as the time for payment, the interest rate, collateral, or any restrictions imposed by the loan agreement, it has generally been assumed that the taxpayer does not realize income under the *Kirby Lumber* principle. This is so even though the fair market value of the altered obligation is less than the face amount of the old debt and the latter is discharged in the exchange.<sup>43</sup>

Since the debtor would have had to recognize income under *Kirby Lumber* if the new obligations had been sold for cash at their fair market value and the proceeds were then used to discharge the old obligations, it may seem anomalous not to require similar treatment if the debtor engages in a direct exchange having the same economic result. But an actual sale of the new obligations fixes their value in an arms-length transaction, while an exchange does not.<sup>44</sup> Moreover, if, in the interest of consistency, exchanges were treated as equivalent to selling the new bonds and paying the old ones with the proceeds, debtors would be impelled to employ more cumbersome devices for modifying the terms of their obligations to avoid an actual "exchange" in which the old debt might be deemed to be discharged.

### B. Exchange of Stock for Debt

When a corporation issues stock to its creditors in exchange for its

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42. See, e.g., *Commissioner v. Stanley Co. of America*, 185 F.2d 979 (2d Cir. 1951). For a discussion of whether the debtor should include the amount of the reduction when agreed upon or rather should treat the reduction as a premium on the new obligations to be amortized over their life, see Eustice, *supra* note 10, at 241-42.

Although there do not appear to be any cases on point, the most appropriate treatment of a reduction would be to bifurcate the transaction, treating the difference between the face amount of the old debt and the fair market value of the new debt as cancellation of indebtedness income to be taxed immediately and treating any difference between the fair market value and the face amount of the new debt as a premium or discount to be amortized over the life of the new obligation. One obvious problem with this bifurcated approach is that it would require the new debt to be valued, an exercise which the courts have been reluctant to assume. See note 44 *infra*.

43. See generally Eustice, *supra* note 10, at 239. See also Rev. Rul. 58-546, 1958-2 C.B. 143 (in a bond-for-bond exchange, where face amounts were the same but interest rates and maturities differed, obligor realized gain only to the extent of cancellation of its liability for accrued interest previously deducted with tax benefit).

44. See *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), in which the Supreme Court upheld the Tax Court's refusal to allow a corporation to amortize the discount on debentures issued in exchange for the corporation's preferred stock. The Court justified its holding in part on the difficulty of estimating the fair market value of the debentures and the preferred stock, observing that an estimate was particularly difficult since the exchange was of a private nature and was therefore "insulated from market forces." *Id.* at 150. See generally Wolf, *Original Issue Discount: Before and After National Alfalfa*, 28 TAX LAW. 325 (1975).

bonds or other outstanding debt, the transaction might seem to generate income under *Kirby Lumber* if the fair market value of the stock is less than the amount of the debt, since it is equivalent to selling the stock and using the proceeds to discharge the debt for less than its face value. But the Internal Revenue Service and the courts have rejected this "cash equivalent" approach on the theory that the substitution of common stock for debt "does not effect a cancellation, reduction or discharge of indebtedness, but rather amounts to a transformation from a fixed indebtedness to a capital stock liability."<sup>45</sup> Though not entirely persuasive, this theory avoids the problem of having to value the stock, and it is firmly entrenched in both the case law and administrative practice. In any event, the applicability of *Kirby Lumber* is of limited importance since this type of exchange would ordinarily constitute a tax-free recapitalization of the debtor.<sup>46</sup>

### C. Discharge by Transfer of Property Other than Cash

If rather than paying cash to discharge an obligation the debtor transfers other assets with a value less than the face amount of the debt, the difference should constitute income to the debtor under the *Kirby Lumber* principle. If the debtor's basis in the property differs from its fair market value at the time of transfer, the transaction simultaneously raises a separate tax issue of gain or loss on the disposition of property, for the transaction could be considered equivalent to selling the property for its fair market value and then using the proceeds to discharge the debt.

Consider, for example, the following three cases, each involving a transfer of a capital asset to discharge a \$100 debt:

	A	B	C
1. Debt discharged	\$100	\$100	\$100
2. Transferred property			
a. Fair market value	\$100	\$ 70	\$ 90
b. Adjusted basis	\$ 70	\$ 70	\$ 70
3. Debt-discharge income (line 1 minus line 2a)	—	\$ 30	\$ 10
4. Gain (loss) from the disposition of property (line 2a minus line 2b)	\$ 30	—	\$ 20

45. Rev. Rul. 59-222, 1959-1 C.B. 80, 82. See also *Commissioner v. Fender Sales, Inc.*, 338 F.2d 924 (9th Cir. 1964), *cert. denied*, 381 U.S. 935 (1965) (a transaction in which stock was issued by a corporation to shareholder-employees in settlement of liability for unpaid salaries was held to generate income to the shareholder-employees but not to the corporation); *Motor Mart Trust*, 4 T.C. 931 (1945), and cases cited therein; B. BITTKER & J. EUSTICE, *supra* note 20, at 14-77. But see *Claridge Apartments Co. v. Commissioner*, 138 F.2d 962 (7th Cir. 1943), *rev'd on other grounds*, 323 U.S. 141 (1944).

46. I.R.C. § 368(a)(1)(E). See generally B. BITTKER & J. EUSTICE, *supra* note 20, at 14-71 to 14-86.

As indicated, if the debt-discharge issue is separated from the capital gain (or loss) issue, Case A would result in no debt-discharge income, but in \$30 of capital gain; Case B, in \$30 of debt-discharge income, but no capital gain or loss; and Case C, in \$10 of debt-discharge income and \$20 of capital gain. If these transactions are treated solely as sales of the property for the face amount of the debt, however, there is \$30 of gain from the disposition of property and no debt-discharge income in all three cases.

Unfortunately, the courts have not isolated these two separate tax issues but instead have treated such transactions as sales of the property for the face amount of the cancelled debt.<sup>47</sup> As a result, a debtor may avoid realizing ordinary income from cancellation of indebtedness by discharging the debt with property other than cash and instead recognize gain (generally capital in nature) measured by the difference between the face amount of the loan and the basis of the property. Although this simplified analysis fails to distinguish between income from discharge of indebtedness and gain or loss on the sale of property, it has the advantage of avoiding the necessity of determining a market value for the transferred property.

#### *D. Transfer of Obligations to Third Parties*

If a creditor sells a claim against a debtor to a third party for less than its face amount, the debtor does not realize income under *Kirby Lumber*, since from the debtor's point of view the obligation is not discharged but merely transferred to a different creditor. This suggests the possibility that a debtor who believes a creditor will settle a claim for less than the face amount but who would rather delay recognition of the spread might induce a friendly third party to buy the obligation at a discount and keep it alive until a discharge will have less onerous tax consequences (*e.g.*, a year in which the debtor has offsetting losses that otherwise could not be utilized). If the new creditor purchases the obligation with funds advanced by the debtor and agrees to discharge the debt on request, the plan is at best a sham and may be fraudulent;

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47. See *Unique Art Mfg. Co.*, 8 T.C. 1341 (1947); *Eustice*, *supra* note 10, at 232-35. But see *Harry L. Bialock*, 35 T.C. 649, 661-62 (1961) (transfer of property to discharge debt generated debt-discharge income where the face amount of the debt exceeded the value of the property). While it is unclear whether the Internal Revenue Service has ever advocated bifurcation in an appropriate case, the regulations appear to recognize that, where a debt is cancelled in exchange for property, it is possible that only a portion of the resulting gain may be pure cancellation of indebtedness income. See *Treas. Reg. § 1.1017-1(b)(5)* (1956): "Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis [under § 1017]."

either way, the purchase should be imputed to the debtor and the obligation treated as discharged when the original creditor is paid off.

As is true of all "alter ego" allegations, however, the independence of the third party is a question of fact. Closely related persons, even husband and wife, are entitled to be treated as independent if their transactions can survive close scrutiny; the purchase by one of the other's obligations requires no exception to this principle.<sup>48</sup> The same is true of a purchase by a corporation of the obligations of a parent or subsidiary.<sup>49</sup>

#### IV

##### SPURIOUS CANCELLATIONS OF INDEBTEDNESS

The classic case for application of the *Kirby Lumber* principle is a financial adjustment in which a creditor accepts less than the face amount of a debt in full payment, either because of doubts about the debtor's ability to pay in full or because a rise in the interest rate for comparable loans has made the old debt worth less than its face amount. In these circumstances, the creditor attempts to get as much as possible for its claim, while the debtor pursues the corresponding strategy of paying as little as possible.

There are many instances, however, of "spurious"<sup>50</sup> cancellations of indebtedness where careful analysis discloses that the debt was not discharged for less than its face amount but was in fact fully paid. For example, if an employer lends \$50 to an employee with the understanding that the debt will be deducted from the employee's next paycheck, the debt is paid in full on payday even though no cash changes hands and the transaction is formally termed a "cancellation." The employee must report the \$50 as income, not because the debt has been cancelled for less than its face amount within the meaning of *Kirby Lumber*, but because he has been paid in full for his services.<sup>51</sup>

It is easy to confuse this type of situation with the kind of financial adjustment that is properly subject to the *Kirby Lumber* principle, particularly since "spurious" and "genuine" cancellations may occur in

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48. See, e.g., D. Bruce Forrester, 4 T.C. 907 (1945).

49. See *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969). But see *American Packing & Provision Co.*, 36 B.T.A. 340 (1937) (a parent realized income when its bonds were purchased by a subsidiary with which it filed consolidated tax returns).

50. The term "spurious" as used herein is not intended to imply doubt about the legal effectiveness of the discharge of the debt. What is spurious is any implication that the debt was cancelled for less than its face amount.

51. See, e.g., *Reginald Deimy*, 33 B.T.A. 738 (1935). But see *Estate of Watson*, T.C.M. (P-H) ¶ 44,338 (1944) (the cancellation of an employee's debt at a specified rate per month of service was held, on unusual facts, not to constitute compensation).



combination in the same case. For example, if an architect borrows \$25,000 from a bank that later agrees to accept services worth \$10,000 as full payment in discharge of the debt, the architect should properly report \$10,000 of earned income plus \$15,000 of income from the discharge of indebtedness.

Courts have tended to assign transactions involving both "spurious" and "genuine" cancellations of indebtedness to one broad category or the other. But proper characterization of such transactions frequently has important tax consequences to both the debtor and the creditor. For example, whereas income from the discharge of indebtedness is taxed to the debtor at ordinary rates<sup>52</sup> which reach seventy percent in the top tax bracket,<sup>53</sup> "earned income" is subject to a maximum tax rate of fifty percent.<sup>54</sup> From the creditor's point of view, a genuine cancellation of indebtedness gives rise to a deduction measured by the difference between the amount due and the amount actually received.<sup>55</sup> On the other hand, a creditor who agrees to a "spurious" cancellation (*e.g.*, an employer who "cancels" the employee's debt by docking his pay) is not entitled to a bad debt deduction, since *pro tanto* no loss has been suffered, and can deduct the amount "loaned" only if another provision of the Internal Revenue Code allows this.<sup>56</sup>

#### *A. Cancellation of Debt Between a Corporation and Its Shareholders*

When a corporation is indebted to a shareholder, cancellation of the debt for less than its face amount may be a way of strengthening the corporation's financial condition by increasing its capital. If the debt is fully collectible, the cancellation has the same effect as payment in full followed by a contribution of the proceeds to the corporation's capital. Since contributions to capital are not taxed to the corporation,<sup>57</sup> the regulations and cases hold that no income is realized when the means of effecting a contribution to capital is a cancellation of the corpora-

52. See Rev. Rul. 69-613, 1969-2 C.B. 163.

53. See I.R.C. § 1.

54. *Id.* § 1348.

55. *Id.* § 166.

56. Thus, if a debt is cancelled as compensation for services, the payment cannot be deducted if the employee is a domestic servant, *see, e.g.*, Max M. Lowenstein, 5 B.T.A. 208 (1926), and an architect's fee ordinarily has to be capitalized, *see* Treas. Reg. § 1.263(a)-2(d) (1958). *See also* Perlman v. Commissioner, 252 F.2d 890 (2d Cir. 1958) (cancellation of salary owed by a corporation to an employee-shareholder was a contribution to capital and therefore not deductible); Johnson, Drake & Piper, Inc. v. Helvering, 69 F.2d 151 (8th Cir.), *cert. denied*, 292 U.S. 650 (1934). *But see* Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) (bad debt deduction allowed where corporate debtor was insolvent both before and after the cancellation); *contra* Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir.), *cert. denied*, 351 U.S. 951 (1956).

57. I.R.C. § 118, *discussed in* B. BITTKER & J. EUSTICE, *supra* note 20, at 3-48 to 3-52.

tion's debt,<sup>58</sup> whether or not it issues additional stock to the shareholder-creditor. Although this rule is often regarded as an exception to the *Kirby Lumber* principle, it really is an acknowledgment that, for practical purposes, the debt has been paid rather than cancelled.

Sometimes, however, the transaction may properly be fragmented into a "spurious" cancellation of part of the debt, serving to effect a contribution to capital, and a "genuine" cancellation of the balance, reflecting either doubts about the corporation's ability to pay or an increase in the interest rate on comparable loans. Viewed separately, the spurious cancellation component would increase the shareholder-creditor's basis for the stock and would be tax-free to the corporate debtor, while the genuine cancellation component would create a bad debt deduction for the creditor and debt-discharge income for the debtor. Despite the possibility of separating these two elements, the cases generally apply the "contribution to capital" analysis to the entire transaction.<sup>59</sup>

The Internal Revenue Service has sought to restrict the contribution-to-capital exemption to "principal" debts, such as debts incurred in exchange for cash or other property, and to require income to be reported on the cancellation of debts that have given rise to deductions, such as claims for interest or wages accrued by the corporation. This distinction is of doubtful validity.<sup>60</sup> If the claim is worth its full face amount, the purported "cancellation" is the functional equivalent of payment in full by the corporation followed by an immediate reinvestment of the proceeds by the shareholder as a contribution to capital. On the other hand, if part or all of the claim is uncollectible, that amount should give rise to corporate income under *Kirby Lumber*. In neither case is there any justification for linking the tax treatment of debt to the corporation's prior deductions.

The mirror image of the cancellation of corporate debt by a share-

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58. See Treas. Reg. § 1.61-12(a) (1957); *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934); *Sheraton Plaza Co.*, 39 T.C. 697 (1963), *acq.*, 1963-2 C.B. 5. But see *Briarcliff Inv. Co. v. Commissioner*, 90 F.2d 330 (5th Cir.), *cert. denied*, 302 U.S. 731 (1937) (a corporation's principal shareholder purchased part of its outstanding debt for less than face and promptly transferred the debt to the corporation for the discounted amount; the cancellation by the shareholder of the discounted portion of the debt was held to result in income to the corporation, possibly because the shareholder was viewed as the corporation's agent in repurchasing its debt). See also *Arlington Metal Indus., Inc.*, 57 T.C. 302 (1971) (mutual release of claims by shareholders against corporation and vice versa was a taxable event, not a contribution to capital).

59. In *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *appeal docketed*, No. 77-1591 (5th Cir. Mar. 18, 1977), the Tax Court held that cancellation of a corporate debt by a shareholder was a nontaxable contribution to capital although there was such doubt about collectibility that "improvement of the corporation's prospects as a result of the cancellation was more symbolic than real." *Id.* at 670. If the shareholder's claim was wholly worthless, however, the cancellation was less a "contribution" by the shareholder than an acceptance of the inevitable. See Hutton, *Recent Cases and Rulings*, 3 J. CORP. TAX. 349, 352 (1976). See also cases cited at note 56 *supra*.

60. See notes 73-81 *infra* and accompanying text (discussing the tax benefit rule).

holder is the cancellation by a corporate creditor of a debt owed to it by its sole shareholder. If the claim is fully collectible, the cancellation has the same effect as the payment of a formal dividend which the shareholder then uses to pay off the debt. Viewed in this way, the transaction generates income for the shareholder, not by virtue of the *Kirby Lumber* case, but because dividends are taxable receipts under sections 61(a)(7) and 301(c)(1).<sup>61</sup>

### B. Cancellation of Debt as a Gift to the Debtor

Another common type of spurious cancellation of indebtedness occurs when a creditor forgives a debt as an indirect way of making a gift to a relative, friend, or nonprofit organization. If a proud grandparent loans money to a favorite grandchild for college tuition and then, overcome by emotion on graduation day, tears up the promissory notes and announces that the debt is forgiven, the transaction is so clearly outside the proper ambit of *Kirby Lumber* that even the most assiduous revenue agent is not likely to assert that the grandchild has realized income from the cancellation. Such a transaction bears no resemblance to the financial adjustments that give rise to income under the *Kirby Lumber* case but rather is tantamount to a gift by the grandparent to the grandchild of enough cash to enable the latter to pay off the debt in full.

Applying this analysis to debt cancellations in a business context, the Supreme Court dramatically—though only temporarily—narrowed the scope of *Kirby Lumber* in its 1943 decision in *Helvering v. American Dental Co.*<sup>62</sup> That case involved a routine financial adjustment between a debtor and his creditors in which the trial court found that the creditors “acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity.”<sup>63</sup> Despite this seemingly conclusive rebuttal of the taxpayer’s claim that the transaction was a gift to him of the difference between the amount owing and the amount paid, the Supreme Court reversed, saying, “The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make

61. Thus it follows that the shareholder-debtor is not entitled to elect to exclude the amount from income under section 108. See text accompanying notes 92-102 *infra*.

Cases holding that a corporation’s cancellation of a shareholder’s indebtedness is a constructive dividend to the shareholder include *Shephard v. Commissioner*, 340 F.2d 27 (6th Cir.), *cert. denied*, 382 U.S. 813 (1965), and *Cohen v. Commissioner*, 77 F.2d 184 (6th Cir.), *cert. denied*, 296 U.S. 610 (1935). For a discussion of the treatment of constructive dividends in excess of the corporation’s earnings and profits, see B. BITTKER & J. EUSTICE, *supra* note 20, at 7-27 to 7-41.

62. 318 U.S. 322 (1943).

63. *Id.* at 330.

the cancellation here gifts within the statute."<sup>64</sup>

That a tax-free gift could be effected by cancelling a debt was never in doubt. What was surprising about *American Dental* was rather the Court's willingness to treat a purely commercial settlement as a gift. The validity of its characterization can be tested by two questions. Should the debtor in *American Dental* have thanked his creditors after the settlement for their generosity? If he did not thank them, should they have been offended? The answers to both questions would almost certainly be no, because the creditors collected all they could and hence displayed no generosity.

Since the only obvious distinction between the facts in *Kirby Lumber* and those in *American Dental* was that the former involved repurchases of debt on the open market while in the latter the debtor dealt directly with his creditors, the Court's endorsement of a "gift" rationale in *American Dental* seemed to imply that face-to-face negotiations were the hallmark of a tax-free gift. Within six years, however, the Court rejected this notion in *Commissioner v. Jacobson*,<sup>65</sup> denying the "gift" exclusion to a debtor who had dealt directly with his creditors in repurchasing his bonded indebtedness from them, although there was nothing in the facts to distinguish the settlement from the *American Dental* situation.<sup>66</sup> The Court stated that the determinative factor is "whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.'"<sup>67</sup> The *Jacobson* Court refrained from overruling the *American Dental* case and, indeed, ostensibly preserved its theory that a cancellation of debt in a wholly commercial context could qualify as a tax-free gift to the debtor. But it observed that such an "extraordinary transaction" is "hardly likely"<sup>68</sup> and this caveat has proved, for practical purposes, to be a requiem for the *American Dental* doctrine.<sup>69</sup>

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64. *Id.* at 331.

65. 336 U.S. 28 (1949).

66. *Jacobson* squarely presented the issue, since the debtor had purchased some bonds directly from bondholders with whom he was personally acquainted and others through the secretary of a bondholders' committee and two security firms. The Tax Court held that the former category of purchases qualified as tax-free gifts under the *American Dental* case but that the latter purchases were akin to the open market transactions in *Kirby Lumber*. *Lewis F. Jacobson*, 6 T.C. 1048 (1946).

67. 336 U.S. at 51.

68. *Id.*

69. *Boos v. Reynolds*, 84 F. Supp. 185 (D. Minn. 1949), *aff'd*, 188 F.2d 322 (8th Cir. 1951) (cancellation of past due rent by a landlord held to be a gift and therefore excludable from the tenant's income), is sometimes cited as a post-*Jacobson* case that relied on *American Dental*. But the district court referred in its opinion to "a close and harmonious relationship" between the debtor and the creditor, *id.* at 187, and thus they may have had a personal as well as a commercial relationship. For a general discussion of the *American Dental* doctrine, see Chommie, *The Debt Release: Gift or Increase in Net Worth?*, 4 UTAH L. REV. 36 (1954).

When the commercial aspect of the debtor-creditor relationship is overshadowed by affection or other personal impulses, the cancellation of a debt can constitute a gift. But this possibility does not depend upon the validity of *American Dental*, since the debtor in that case had no personal links with his creditors. Of course, the fact that debtor and creditor are bound together by ties of friendship, blood, or marriage should not be determinative if they also have a business relationship. To qualify as a gift, the transaction must stem from " 'detached and disinterested generosity' . . . 'out of affection, respect, admiration, charity or like impulses.' " <sup>70</sup> The exclusion from income accorded to gifts <sup>71</sup> prevails over the *Kirby Lumber* principle only if the debt cancellation is attributable to motives of this type.

Thus, unless *American Dental* is unexpectedly resurrected, a personal relationship between the debtor and the creditor now appears to be a necessary but not a sufficient condition to gift classification. In each case the trial court must also determine whether the creditor agreed to accept less than the amount due because that was the best he could get, or because he placed personal considerations above his financial interest. <sup>72</sup> If objective evidence indicates that the creditor received the value of the claim or more, the cancellation can hardly be attributed to affection or similar impulses. Accepting the inevitable may be praiseworthy, but it exhibits realism, not generosity.

## V

### THE RELEVANCE OF THE TAX BENEFIT RULE

If a taxpayer takes deductions for accrued business expenses that it has not yet paid and later succeeds in discharging these obligations for less than the amount deducted, it could be argued that the forgiven amount must be included in income because the deduction presupposed ultimate payment of the accrued liability. <sup>73</sup> Had *Kirby Lumber*

70. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Commissioner v. LoBue*, 351 U.S. 243, 246 (1956); *Robertson v. United States*, 343 U.S. 711, 714 (1952)). For a general discussion of *Duberstein* and related gift issues, see Griswold, *Foreword: Of Time and Attitudes—Professor Hart and Judge Arnold*, 74 HARV. L. REV. 81 (1960); Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word 'Gift'*, 48 MINN. L. REV. 215 (1964); Rothschild, *Business Gifts as Income*, N.Y.U. 19TH ANN. INST. ON FED. TAX. 147 (1961).

71. I.R.C. § 102.

72. See, e.g., *Canton v. United States*, 226 F.2d 313, 316-18 (8th Cir. 1955) (issue of gift versus income from the discharge of debt by the taxpayer's brother in a criminal tax fraud case was submitted to the jury); *Reynolds v. Boos*, 188 F.2d 322 (8th Cir. 1951) (cancellation of past due rent by a landlord held to be a gift and therefore excludable from the tenant's income); *Clem v. Campbell*, 10 A.F.T.R. 2d 5931 (N.D. Tex. 1962) (an employer's forgiveness of an employee's debt constituted a gift where personal considerations were paramount); *Gustave J. Bosse*, 29 T.C.M. (CCH) 1772 (1970) (same); *Capitol Coal Corp.*, 26 T.C. 1183 (1956), *aff'd*, 250 F.2d 361 (2d Cir. 1957) (despite friendly relationships, three cancellations were not gifts, but a fourth was).

73. For a general discussion of the tax benefit principle, see Bittker & Kanner, *The Tax*

gone the other way, a "tax benefit" theory might have developed to prevent taxpayers from getting the benefit of tax deductions for phantom liabilities, but this potential line of growth was swallowed up by *Kirby Lumber's* broader principle.<sup>74</sup>

Indeed, the government has endeavored to use the tax benefit doctrine to circumvent restrictions on the *Kirby Lumber* principle such as its nonapplicability to the cancellation of a debt owed by a corporation to its shareholder.<sup>75</sup> Thus if such a debt includes an obligation to pay accrued interest previously deducted by the debtor corporation,<sup>76</sup> the Internal Revenue Service takes the position that the discharge is a tax-free contribution to the corporation's capital to the extent of the principal, but income under the tax benefit doctrine to the extent of the accrued interest.<sup>77</sup> The regulations provide some support for this theory.<sup>78</sup> The courts, however, have rejected it, and rightly so.<sup>79</sup> Since

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*Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329 (1948); Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968).

74. *Kirby Lumber* is broader than the tax benefit rule, for it applies even if the taxpayer does not receive a tax benefit from the borrowing transaction (e.g., if the borrowed funds are expended for items of a personal nature).

75. See notes 57-60 *supra* and accompanying text.

76. Section 267(a)(2) might operate to deny the corporation a deduction for unpaid accrued interest if the shareholder is a cash basis taxpayer, but this provision does not encompass every combination of an accrual basis debtor and a related cash basis creditor. See, e.g., *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *appeal docketed*, No. 77-1591 (5th Cir. Mar. 18, 1977).

77. Rev. Rul. 73-432, 1973-2 C.B. 17 (a solvent accrual basis corporation realized taxable income when its sole shareholder forgave interest claims that the corporation had previously deducted with tax benefit).

78. See Treas. Reg. § 1.61-12(a) (1957) (forgiveness of debt by a shareholder is a contribution to capital "to the extent of the principal of the debt"). The limitation contained in this regulation is broader than dictated by the tax benefit rule, since it could conceivably apply to interest owed by a cash basis taxpayer that realizes no tax benefit from such unpaid expenses. The Service does not appear to apply the regulation's limitation unless the liability has provided a tax benefit, however.

79. See, e.g., *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *appeal docketed*, No. 77-1591 (5th Cir. Mar. 18, 1977) (rejecting the Service's position, despite an expression of sympathy with the theory underlying it). Three dissenting judges in *Putoma* distinguished earlier cases holding the tax benefit rule inapplicable to gratuitous excuses of indebtedness on the ground that the present regulations were not then in effect. See also *Reynolds v. Boos*, 188 F.2d 322 (8th Cir. 1951) (rejecting use of the tax benefit doctrine to circumvent the gift exception to the *Kirby Lumber* rule). But see *Helvering v. Jane Holding Corp.*, 109 F.2d 933 (8th Cir.), *cert. denied*, 310 U.S. 653 (1940) (holding, in a decision of doubtful validity today, that a corporation realized income when its sole shareholder cancelled accrued interest in a transaction amounting to a contribution to capital).

In 1954, the House of Representatives proposed to codify the *Kirby Lumber* doctrine and its major exceptions (e.g., contributions to capital and adjustments of purchase price) and to make the exceptions inapplicable to the cancellation of previously deducted liabilities. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 12-13, A28-29, A35, A267, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4036-38, 4164-65, 4171-72, 4409. The Senate Finance Committee rejected the House proposal because "of considerable doubt as to its meaning and effects," preferring to leave the situation "to be settled according to rules developed by the courts." S. REP. NO. 1622, 83d

the corporation would realize no income if it paid the debt in full and the shareholder then contributed the same amount to its capital, there should be no tax liability to the corporation in this functionally equivalent transaction. The appropriate target is not the corporation, but rather the shareholder, if he did not report the interest as income when it was accrued because he is a cash basis taxpayer, since payment is constructively received when the shareholder authorizes the contribution to capital.<sup>80</sup>

At a more fundamental level, the government's distinction between "principal" debts and debts arising from deducted items is a false dichotomy because it is based on the mistaken notion that only the latter create tax benefits for the debtor. Although repayment of the principal amount of a loan does not itself give rise to a deduction, borrowed funds may be used to pay for items which are depreciable or deductible. Since both borrowed funds and accrued expenses can generate tax deductions, it is unrealistic to treat below face discharges of the two types of debt differently.

In keeping with its effort to use tax benefit principles as a sword, however, the government has conceded that they may be used by the taxpayer as a shield. Thus, on the cancellation of accrued interest, the debtor has been allowed to exclude its gain from gross income to the extent that the prior deductions failed to reduce its taxes, leaving only the balance of the cancelled liability subject to *Kirby Lumber*.<sup>81</sup> This intrusion of the tax benefit doctrine into the cancellation of debt area produces an irrational distinction between an accrual basis taxpayer's liability for unpaid expenses and its liability for borrowed funds, since cancellation of obligations of the latter type will generate income under *Kirby Lumber* even though the funds were used to purchase property that was deducted, depreciated, or amortized in earlier years without tax benefit.

Moreover, use of the tax benefit doctrine as a taxpayer shield in

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Cong., 2d Sess. 14, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4643. See also S. REP. NO. 1622, 83d Cong., 2d Sess. 186, 425, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4821, 5068. The Conference Committee adopted the Senate version, stating merely that the determination of when discharge of debt results in gross income "will be made, as under existing law, by applying the general rules for determining gross income." H.R. REP. NO. 2543, 83d Cong., 2d Sess. 23, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 5280, 5282.

80. After finding in *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), appeal docketed, No. 77-1591 (5th Cir. Mar. 18, 1977), that the forgiveness of accrued interest was a contribution to capital and therefore was not taxable to the corporation, the Tax Court rejected the Commissioner's argument that the shareholder should include the accrued interest in income. It reasoned that there were "doubts concerning collectibility" of the accrued interest so that the shareholder could not be said to have had "dominion and control" over it. *Id.* at 670. If the claim was worthless, however, it is difficult to perceive how the shareholder made a constructive "contribution." See note 59 *supra*.

81. See Rev. Rul. 67-200, 1967-1 C.B. 15, clarified, Rev. Rul. 70-406, 1970-2 C.B. 16.

debt cancellation cases is based on a misperception of its function. A taxpayer's recovery of his own property cannot be properly regarded as creating income, except when the property was written off against income in an earlier year, in which event the later recovery is inconsistent with the earlier implied representation that the property was permanently relinquished. Since the *only* reason for including the recovered property in income is the prior deduction, much can be said for imposing the requirement only if the deduction generated a tax benefit. But when a debt is cancelled without payment, there is an independent reason for taxing the gain, *viz.*, the taxpayer had the benefit of the property or services that gave rise to the debt, whether they gave rise to deductions or not. Since the *Kirby Lumber* principle does not presuppose that the taxpayer took any deductions, a fortiori its applicability should not be affected by the absence of a tax benefit for such deductions as may have been taken.

## VI

### THE EFFECT OF THE DEBTOR'S INSOLVENCY

A debtor who is, financially speaking, *in extremis* may find partial or complete relief from the *Kirby Lumber* principle in a complex network of administrative, judicial, and statutory rules. Although not internally consistent, these rules have a common origin in a 1923 ruling of the Internal Revenue Service<sup>82</sup>—now set out in the Treasury regulations<sup>83</sup>—that a debtor does not realize income from the discharge of debts in bankruptcy.

At first blush, exempting bankrupt debtors from the *Kirby Lumber* principle seems to follow from the Bankruptcy Act's<sup>84</sup> objective of giving bankrupts a fresh start after their assets are distributed among creditors. It may also seem to follow from the "freed assets" rationale of *Kirby Lumber* itself,<sup>85</sup> in that a discharge in bankruptcy does not have the effect of making "available" assets that were previously "offset" by the debt since the debtor's assets are divided among the creditors.

On the other hand, the exemption of bankrupt debtors from *Kirby Lumber* is hard to reconcile with other aspects of their tax treatment.

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82. I.T. 1564, II-1 C.B. 59 (1923), *declared obsolete*, Rev. Rul. 69-43, 1969-1 C.B. 310. If the discharge occurs not in "straight" bankruptcy proceedings but rather under Chapters 10 (corporate reorganizations), 11 U.S.C. §§ 501-676 (1976); 11 (arrangements), 11 U.S.C. §§ 701 to 799 (1976); 12 (non-corporate real property arrangements), 11 U.S.C. §§ 801-926 (1976); or 13 (wage-earner plans), 11 U.S.C. §§ 1001-1086 (1976), of the Bankruptcy Act, the exemption of the debtor from *Kirby Lumber* rests on a statutory footing. But, except for Chapter 13 proceedings, the debtor is required to reduce the basis of any retained assets after the plan or arrangement is confirmed. Treas. Reg. §§ 1.61-12(b) & 1.1016-7 (1957).

83. Treas. Reg. § 1.61-12(b) (1957).

84. The Bankruptcy Act is contained in Title 11 of the United States Code.

85. See text accompanying notes 17-18 *supra*.



For example, a debtor who spends \$10,000 of *borrowed* money on riotous living and then goes bankrupt realizes no income under current law. But a bankrupt who financed the same personal expenses with \$10,000 of unreported *income* or reported income on which the tax was not paid would be subject to tax, and the government's claim would have a high priority in the distribution of assets. Furthermore, any unpaid tax liability would survive the discharge of all other debts in bankruptcy and be collectible from assets acquired thereafter. The same curious dichotomy is present in the tax treatment of businesses. A taxpayer who invests \$10,000 of borrowed funds in business assets can take up to \$10,000 in deductions, reducing its taxes before bankruptcy or creating a net operating loss carryforward that can be used after bankruptcy,<sup>86</sup> and still discharge the debt in bankruptcy without realizing any income. By contrast, a taxpayer who purchased \$10,000 of business assets with unreported income or with reported income on which it neglected to pay taxes would be entitled to the same deductions and operating loss carryovers but would be subject to a tax liability that would survive bankruptcy. The bankrupt is also treated the same as any other taxpayer for purposes of determining the taxability of salaries and other earnings.<sup>87</sup>

Despite these paradoxes, the Treasury has shown no intention of amending the regulations to eliminate the bankrupt debtor's exemption from the *Kirby Lumber* principle. Moreover, the exemption has been so consistently applied to the discharge of debts in "straight" bankruptcy—despite repeated changes in both the Internal Revenue Code and the Bankruptcy Act—that it can properly be regarded as having implicit legislative endorsement.<sup>88</sup>

The bankrupt debtor's exemption is so thoroughly entrenched that the Treasury and the courts have used it as a standard in prescribing the tax treatment for insolvent debtors who settle their obligations without formal bankruptcy proceedings. Thus, the courts apply the bankruptcy analogy to debtors whose liabilities exceed the value of their assets both before and after the cancellation of a debt for less than its face amount,<sup>89</sup> perhaps because this approach seems to conform to

86. See Rev. Rul. 58-600, 1958-2 C.B. 29 (the cancellation of an insolvent debtor's indebtedness does not reduce its net operating loss carryforward).

87. See generally Note, *Debt Cancellation and Tax Basis Reduction in Chapter X Reorganization*, 56 YALE L.J. 891 (1947). The provisions of the Bankruptcy Act dealing with income from the excuse of indebtedness are §§ 268 and 270, 11 U.S.C. §§ 668, 670 (1976).

88. See, e.g., *Claridge Apartments Co. v. Commissioner*, 323 U.S. 141 (1944).

89. This result stems from *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934), where the taxpayer actually had a positive net worth after the cancellation; but later cases require a showing of a zero or negative net worth. See, e.g., *Conestoga Transp. Co.*, 17 T.C. 506 (1951) (result requires taking going concern value into account). See also *Astoria Marine Constr. Co.*, 12 T.C. 798 (1949); Treas. Reg. § 1.61-12(b)(1) (1957) (no income from com-

the "freed assets" rationale of *Kirby Lumber*. Exempting debtors in these circumstances encourages the use of voluntary settlements when the creditors wish to avoid the expense and delay of judicial bankruptcy proceedings. There is no sound reason for imposing on informal settlements a tax that could be avoided merely by going through bankruptcy. Moreover, if informal adjustments were to generate taxable income to a debtor with a zero or negative net worth immediately thereafter, the burden of any tax would obviously fall on the creditors.

The bankruptcy analogy is less appropriate, however, if the debtor emerges from the informal settlements with a positive net worth, since the debtor is then better off than he would have been after a discharge in bankruptcy. In this situation, the courts have held that the debtor realizes income under *Kirby Lumber* in the amount by which the remaining assets exceed the remaining liabilities.<sup>90</sup> In applying this "above water" principle, it seems reasonable to disregard the value of any assets retained by the debtor that would be exempt in bankruptcy; since the debtor's control over these assets is not affected by the cancellation of debt.<sup>91</sup>

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position among creditors if immediately thereafter the debtor's liabilities exceed the value of its assets).

In *Fifth Ave.-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453 (2d Cir. 1945), the court announced a rule that seems to require separate evaluations of an insolvent debtor's settlements with each creditor, with income to be reported on any settlement for less than *that* creditor would have received in a bankruptcy liquidation. This comparison would be difficult to make if the costs of a bankruptcy proceeding are to be taken into account in estimating the amount that each creditor would have received, and even if that obstacle is surmounted, the rationale for the procedure is unclear. If bankruptcy is the standard, it seems more appropriate to exempt the debtor whenever all of its assets are turned over to the creditors, whether they divide the proceeds equally or not. If the debtor's payment to a particular creditor exceeds the amount which that creditor would have gotten in bankruptcy, it may be a preference *pro tanto*; if so, the other creditors can avail themselves of their remedies under § 60 of the Bankruptcy Act, 11 U.S.C. § 96 (1976).

90. *Haden Co. v. Commissioner*, 118 F.2d 285 (5th Cir. 1941); *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937). The "above water" principle illustrated in these cases, though based on *Kirby Lumber*, does not necessarily require acceptance of the "freed assets" rationale of that case. Even accepting that the reason for including discharged debt in income is that the borrowed funds were excluded from income when received, a bankruptcy exception to this basic rule warrants disregarding voluntary discharges only to the extent that the taxpayer's financial status after the composition or other arrangement with creditors is comparable to the bankruptcy outcome.

For problems in valuing a debtor's post-discharge assets in applying the "above water" principle, see, e.g., *Herman Levy*, 19 T.C.M. (CCH) 120 (1960) (a corporate debtor's net worth after discharge depended in part on the value of its claim against an officer, which in turn required the valuing of property fraudulently conveyed by the officer, including a mink coat, despite the court's unfamiliarity "with the mysteries incident to the value of mink coats," *id.* at 130).

91. See *Rufus S. Cole*, 42 B.T.A. 1110 (1940), *nonacq.*, 1941-1 C.B. 13.

## VII

THE STATUTORY ELECTION TO REDUCE  
THE BASIS OF PROPERTY

Under certain circumstances, section 108 of the Internal Revenue Code allows a taxpayer who realizes income from the discharge of indebtedness to exclude the gain from gross income by consenting under section 1017 of the Code to reduce the basis of its property.<sup>92</sup> Any corporate taxpayer may make this election, but it is available to an individual only if the indebtedness was incurred or assumed "in connection with property used in his trade or business . . . ."<sup>93</sup>

Because the taxpayer must reduce the basis of the property by the amount excluded from gross income under section 108, the election generally serves to postpone the realization of gain rather than to exclude it permanently. This is because the reduced basis will result in lower depreciation deductions for depreciable property and a greater taxable gain (or a smaller deductible loss) on a subsequent sale of the property. The postponement is ordinarily advantageous to a taxpayer, and it may also permit some or all of the gain to be reported as long-term capital gain when the property is sold rather than as ordinary in-

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92. The regulations prescribe an elaborate hierarchy for reducing the basis of the taxpayer's property. In the case of a corporate taxpayer, the order is as follows:

- (1) property (other than inventory and receivables) purchased with the proceeds of the loan;
- (2) property (other than inventory and receivables) against which the cancelled debt was a lien;
- (3) all other property of the debtor (other than inventory and receivables); and
- (4) inventory and accounts receivable.

In the case of an individual, if the total basis adjustment exceeds the above four adjustments to property used by the individual in his trade or business, the remainder is allocated first to property held for the production of income and then to all other property. *Treas. Reg. § 1.1017-1(a)* (1956). A different formula may be used, however, if it is approved by the Internal Revenue Service. *Id.* § 1.1017-2.

93. *I.R.C. § 108*. (For taxable years beginning before 1977, this provision was contained in § 108(a)(1).) A debt qualifies if the proceeds were used to purchase, improve, or repair the individual debtor's business property, but a debt does not qualify merely because it is secured by business property. Whether an indebtedness is incurred or assumed by an individual in connection with property used in his trade or business depends upon the facts of each particular case. *Treas. Reg. § 1.108(a)-1(a)(2)* (1956).

Section 108 refers only to corporations and individuals, but the Internal Revenue Service has ruled that partnerships can also take advantage of the election. *Rev. Rul. 72-205, 1972-1 C.B. 37* (a partnership can elect to defer recognition, but the cancellation is viewed as a distribution of money to the partners, reducing the basis of their partnership interests). It is unclear whether the election is available to trusts and estates.

The statutory predecessor of § 108 originally applied only to corporations "in an unsound financial condition" and only if the debt was evidenced by a "security" issued on or before June 1, 1939. *Int. Rev. Code of 1939, ch. 1, § 22(b)(9)*, 53 Stat. 875. *See Surrey, supra* note 10, at 1154. Both these conditions were deleted when the provision was amended by the Revenue Act of 1942. *Int. Rev. Code of 1939, ch. 1, § 22(b)(9)*, 56 Stat. 811.

come from the discharge of indebtedness.<sup>94</sup>

If the income subject to section 108 exceeds the aggregate predischarge adjusted basis of the taxpayer's property, the excess cannot be used to reduce the basis below zero.<sup>95</sup> The Internal Revenue Service, not surprisingly, requires the unallocated excess to be reported as income in the year of the discharge.<sup>96</sup> The statutory authority for this position is not clear,<sup>97</sup> but this result is more reasonable than the alternative of permanently immunizing this part of the taxpayer's gain from tax.

An election under section 108 is limited to situations in which the taxpayer realized income "by reason of the discharge, in whole or in part, . . . of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property . . . ." If the debt is discharged as an indirect method of paying compensation<sup>98</sup> or distributing a dividend to the debtor,<sup>99</sup> the debtor's income does not arise "by reason of the discharge" of the debt within the meaning of section 108 and therefore does not qualify for exclusion.<sup>100</sup> On the other hand, if the debt is discharged for less than its face amount in circumstances not generating income, such as where the discharge amounts to a gift from the creditor,<sup>101</sup> the taxpayer has no reason to make the election and can choose instead to preserve intact the basis of the property.

A taxpayer who believes, but is not sure, that the discharge of debt fits within an exception to the *Kirby Lumber* principle should be permitted to preserve this primary contention and still file a consent under section 108 as a secondary defense. The regulations do not explicitly authorize a conditional consent, but there is no sound reason to treat such a reservation of rights as a waiver. Since the consent is not likely to mislead the government, the taxpayer should not be estopped from pressing its claim that no income was realized on the discharge. Thus, if the taxpayer actually effects the required reductions in basis, comput-

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94. See Rev. Rul. 69-613, 1969-2 C.B. 163 (income from the cancellation of indebtedness is ordinary income, not capital gain, since it is not gain realized from a "sale or exchange").

95. Treas. Reg. § 1.1017-1(a) (1956) (final sentence). For a general discussion of the concept of negative basis, see Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962).

96. Rev. Rul. 67-200, 1967-1 C.B. 15, *clarified*, Rev. Rul. 70-406, 1970-2 C.B. 16.

97. Indeed, taken literally, § 108 permits the taxpayer to exclude the entire amount of its income attributable to the cancellation, provided it files a consent to the adjustment of basis required by the regulations under § 1017.

98. See text following note 50 *supra*.

99. See note 61 *supra* and accompanying text.

100. The regulations provide that if a debt is satisfied by the transfer of property, the amount to be applied in reduction of the basis of the retained property is the difference between the amount of the debt discharged and the value of the transferred property. Treas. Reg. § 1.1017-1(b)(5) (1956). This implies that the difference (if any) between the adjusted basis of the transferred property and its fair market value is not subject to § 108 but is instead to be treated as gain or loss from the disposition of the property. See note 47 *supra* and accompanying text.

101. See notes 62-72 *supra* and accompanying text.

ing and paying its taxes accordingly, and then claims refunds for the postdischarge years on the ground that the discharge did not generate any income, it is hard to see how the government would be injured by a conditional consent.<sup>102</sup>

### CONCLUSION

The tax theory for including gain from the discharge of indebtedness in the debtor's gross income seems straightforward. Loan proceeds are excluded from gross income because the debtor is obliged and expected to repay the debt. This assumption proves incorrect if the loan is discharged for less than its face amount, and since the debtor has gained by the amount of the exclusion, taxable income should normally result. After initially rejecting this theory in *Kerbaugh-Empire*, the Supreme Court finally accepted it in *Kirby Lumber*.

Unfortunately, the Court failed to overrule *Kerbaugh-Empire* directly. As a result lower courts have developed a series of unwarranted exceptions to the *Kirby Lumber* principle that allow a debtor to benefit financially from the receipt of a loan that is never taxed and never repaid. At the same time, courts have sometimes mislabelled as discharge-of-indebtedness income "spurious" debt discharges that should properly be viewed as contributions to capital, dividends, or compensation for services. Such mischaracterizations are particularly common in transactions where only a portion of the amount discharged is attributable to excuse of indebtedness and the rest constitutes some other form of income.

Except for the bankruptcy area, statutory interventions have been limited to sections 108 and 1017, which allow debtors to delay recognition of discharge-of-indebtedness income in certain limited instances by electing to reduce the basis of their property. Although Congress has affirmed that the discharge of a debt can constitute taxable income under section 61, it has left the task of refining this principle to the courts.

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102. See Eustice, *supra* note 10, at 261-62 (conditional consents used under the Revenue Act of 1939).

