Some Tax Effects of Cancellation of Indebtedness

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IN 1940 three excellent Law Review articles appeared on the subject of this paper. The authors made scholarly and comprehensive surveys of the question, undertook to interpret some perplexing decisions, and critically analyzed the then recently enacted tax legislation specifically designed to facilitate corporate debt adjustments. It was the unanimous judgment of the authors that the status of the subject was quite unsatisfactory. Professor Warren and Mr. Sugarman complained that the courts and the legislature had "added confusion and chaos in a field of law which for many years has been in need of clarification." In the intervening period there have been important developments. New lines were hewn by the Supreme Court in Helvering v. American Dental Co. and deepened by a host of decisions interpreting and applying its doctrine, while in the Congressional field the Chandler Act amendment

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In this article the following abbreviated citations will be used: Decisions of the Board of Tax Appeals will be cited as B.T.A. Decisions of the Tax Court (formerly Board of Tax Appeals) will be cited as T.C. Memo. Op., Dkt. refers to docket number of a Memorandum Opinion of the Board of Tax Appeals or the Tax Court. Acquiescence of the Commissioner of Internal Revenue in a decision of the Board of Tax Appeals or the Tax Court will be cited as A. Non-acquiescence will be cited as N.A. Internal Revenue Bulletins will be cited as I.R.B. and Cumulative Bulletins of the Internal Revenue Bureau will be cited as C.B. Internal Revenue Code will be cited as I.R.C. U.S. Tax Cases will be cited as U.S.T.C.


2. The worth of these articles has been attested by frequent citation. In Helvering v. American Dental Co., 318 U. S. 322, 63 Sup. Ct. 577 (1943), for example, they were cited in the briefs of both petitioner and respondent as well as in the opinion of the Court.

3. Warren and Sugarman, supra note 1, at 1326.

of 1940, the Revenue Act of 1942 and the Revenue Act of 1943 have provided an acceptable solution in a substantial number of debt adjustment situations. Nevertheless what the Supreme Court in the Dental case, speaking of the tax effect of the remission of indebtedness, called "uncertainties" in 1940, the Tax Court in 1944 still classifies in the "vexed category of controverted gain". Accordingly, it appeared that an article which would have for its purpose, not a recanvassing of the entire subject, but, rather, a review of some of the more recent developments, might serve a useful purpose.

From United States v. Kirby Lumber Co. came the basic principle that an increase in net assets resulting from a complete or partial cancellation of indebtedness constitutes "gross income". Exceptions to the Kirby doctrine immediately developed. The Tax Court has observed that not only was Sec. 268 of the Chandler Act "an obvious legislative effort to release 77B reorganizations from the tax burden of the Kirby case", but that "some courts have devised a formula for lifting certain types of debt adjustment out of the Kirby case." The several exceptions now encompass so many debt adjustment cases as drastically to limit the application of the fundamental rule. Three exceptions are traceable directly to the judicial concept of "gross income", as defined in Code Sec. 22(a):

1. No income is realized upon cancellation of indebtedness if the borrowed funds have been lost.
2. No income is realized if the cancellation constitutes an adjustment of purchase price.
3. No income is realized if stock of the debtor is issued in exchange for debt or if there is a mere substitution of bonds for bonds.

A further exception rests upon the applicability to the gratuitous forgiveness of indebtedness of Code Sec. 22(b)(3) exempting gifts from income taxation. Additional exceptions stem from statutory provisions specifically relating to the income tax effects of debt adjustments—the Chandler Act, as amended, and Code Sections 22(b)(9) and 22(b)(10).

6. 284 U.S. 1, 52 Sup. Ct. 4 (1931).
7. The definition of "gross income" in the Revenue Act which was under consideration by the Court was substantially the same as that of I.R.C. § 22(a), 53 Stat. 875, 876, 26 U.S.C.A. § 22(a) (1939).
In each of the foregoing categories some recent refinements or variations of the original rule have been supplied by the courts or Congress.\footnote{There are other well grounded exceptions, \textit{e.g.}, that no income is realized on the repurchase of obligations issued without the receipt of money or property. Commissioner \textit{v.} Rail Joint Company, 61 F. (2d) 751 (C.C.A. 2d, 1932). But where there have been no recent noteworthy developments, no attempt has been made in this paper to retread the ground.}

\textbf{GENERAL RULE}

The first essential to the \textit{Kirby} rule, under which a purchase by a taxpayer of its own obligations at a discount creates taxable income through the resulting increase in net assets, is that the obligation be one personal to the taxpayer. A lien on a taxpayer's property for which he is not liable is not such an obligation, and, therefore, its discharge for less than face amount does not give rise to taxable gain. Accordingly, where real estate was purchased subject to delinquent tax assessments which the purchaser did not assume and was under no personal obligation to pay, and which later were discharged at a substantial discount, the transaction was held to adjust cost but not to result in taxable income.\footnote{Hotel Astoria, Inc., 42 B.T.A. 759 (1940), A. 1940-2 C.B. 4. The discharge was effected through the surrender of municipal bonds which were acceptable at par in payment of taxes. They were purchased at a large discount for this specific purpose. There was no evidence that at the time of surrender their market value exceeded cost.}

The next essential is that the taxpayer's obligation be absolute and not contingent. A parent corporation, for example, which has guaranteed the bonds of its subsidiary, realizes no income through a mere discharge of the guaranty. As was stated by the Second Circuit,\footnote{Corporacion de Ventas de Salitre y Yoda de Chile \textit{v.} Commissioner, 130 F. (2d) 141 (C.C.A. 2d, 1942). It may be noted that the corporation had no actual stockholders but the Court assumed that its "adhering producers" might be regarded as such.} "the obligation to be retired must be one which unconditionally subjects the obligor's assets to liability for the payment of a fixed amount." There it was held that the corporation's purchase at a discount of bonds issued by it resulted in no taxable income because, even though its stockholders were unconditionally bound to pay the bonds, they were contingent and not absolute obligations of the taxpayer corporation. Similarly, the Tax Court has held\footnote{Terminal Investment Co., 2 T.C. 1004 (1943), A. I.R.B. 1944-5, 1.} that where certain scrip certificates had given rise to no charge upon the taxpayer's corporate assets when issued, and no charge subsequently arose therefrom, a surrender of the certificates to
the taxpayer did not increase the latter's assets, and, therefore, produced no income.

Thirdly, the Kirby rule has no application in the case of performance of a contract of purchase and sale in accordance with its terms. Thus, where a taxpayer agrees to "purchase or cause to be purchased" certain assets at a specified price, and thereupon causes a controlled corporation to make the purchase, the Kirby rule does not require the conclusion that such satisfaction of the taxpayer's obligation constitutes either dividend or any other form of income. In such a case the taxpayer has simply done what he contracted to do, namely, to purchase or procure a purchaser. 13 Again, where a taxpayer purchased property for a consideration represented by a note, and the deed recited that it would become absolute only when the purchase price was fully paid, and the parties had an understanding reached during the negotiations that if the note were prepaid a substantial discount would be allowed, there was merely an execution of the purchase contract and no income was realized upon payment of a lesser sum and the surrender of the note. 14

Here, again, there was merely performance of an executory contract. And where a taxpayer acquired property, and pursuant to the contract of purchase, assumed certain mortgage indebtedness, and the contract provided that that indebtedness might be satisfied by transferring at face value mortgage certificates issued by the creditor, and the taxpayer acquired such mortgage certificates at a discount and transferred them to the creditor, no income was realized. 15 In this case, however, the value of the property did not exceed the cost of the mortgage certificates. Of course, the rule as to performance of an executory contract of purchase and sale has no application in the case of the payment of a debt to a third party; for instance, if a taxpayer purchases property and later, on the security of the property, borrows money from a third party under an agreement whereby the debt may be paid off at less than par, no situation is presented to which the executory contract rule can be applied. Thus, where long after acquisition of property by the taxpayer, a corporation other than the seller issued certificates in respect of a mortgage made by the taxpayer, and authorized the latter to pay down the mortgage by surrender of such certificates at face, and the taxpayer acquired such certificates dealt in on the market, at a discount and so surrendered them, there was no performance of a contract of purchase and sale and,

under the *Kirby* doctrine, taxable gain resulted.\(^{16}\)

In the *Kirby* case, the bonds, the purchase of which gave rise to income, had been issued at par for cash. What the rule is for the determination of gain or loss on the reacquisition of obligations issued for property worth less than the face amount of the bonds is somewhat uncertain.\(^{17}\) An issue of bonds for assets having a value of less than the face of the bonds has been treated by the Third Circuit\(^{18}\) as an issue at a discount, but the question in that case related, not to gain or loss on retirement of bonds, but to annual amortization of discount during the life of the bonds. The Court observed that even the discount question had "not been squarely decided previously by court decision". In a case in which $50,000,000 of debentures had been issued and the Board had treated as a consideration therefor a monopoly of "great value" granted to the taxpayer, and the bonds were later repurchased at less than par, the Second Circuit doubted whether the Board's decision that profit was thereby realized could be sustained "without a finding that the monopoly was worth as much as the face of the taxpayer's debentures".\(^{19}\) However, the Circuit Court did not find it necessary specifically to pass upon the point. The Tax Court has also stressed issue price rather than par value, and this seems to be the better view.\(^{20}\) To the contrary it may be argued that a solvent taxpayer who issues $100 of obligations in payment of property worth less than $100, and later, while still solvent, reacquires the obligations at less than $100, increases his net assets by the difference and thereby realizes taxable income.\(^{21}\) The Tax Court has recently recognized that the question "perhaps remains open".\(^{21}\)

Can the effect of the *Kirby* rule, under which a corporation which purchased its own bonds at a discount would be taxable on the amount

\(^{16}\) Fifth Avenue-14th Street Corporation, 2 T.C. 516 (1943), on appeal — F. (2d) — (C.C.A. 2d).

\(^{17}\) In Helvering v. American Chicle Co., 291 U.S. 426, 54 Sup. Ct. 460 (1934), the bonds had been assumed upon the purchase of assets the nature of which did not appear, and in Commissioner v. Coastwise Transportation Corp., 71 F. (2d) 104 (C.C.A. 1st, 1934), cert. denied 293 U.S. 595 (1934), the notes were issued in part payment of property worth in excess of the face of the notes.


\(^{19}\) Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F. (2d) 141 (C.C.A. 2d, 1942).

\(^{20}\) In any event, proper account must be taken of unamortized premium or expense.

\(^{21}\) Kramon Development Co., Inc., 3 T.C. 342 (1944).
of the discount, be avoided by having a subsidiary or affiliated corporation make the purchase? Can a corporation thus effect indirectly a tax saving which it could not accomplish directly? *Commissioner v. Capento Securities Corporation* involved a corporation organized for the specific purpose of purchasing at a discount the bonds of an affiliate which in a later year issued preferred stock in exchange. The Court said it did not have to decide whether "the principle of the *Kirby Lumber* case could be extended to nullify this tax-avoiding device", as only the later year was under review. If the corporations did not file a consolidated return, no income should be held to result from the transaction. There is nothing in the *Gregory* case or the line of decisions which followed in its wake, laying heavy emphasis upon the necessity of a business purpose, to force a conclusion that the transaction was taxable, assuming that the purchasing corporation, unlike that in the *Gregory* case, was not immediately dissolved but continued a normal existence. Certainly, if a corporation which was a going business concern made the purchase it does not seem that the *Gregory* doctrine could successfully be invoked to render the transaction taxable.

The corollary of the *Kirby* rule, first recognized in the *Dallas* case, that where an insolvent debtor conveys property to his creditors, or any of them, in full or partial satisfaction of his obligations, no taxable gain results if the debtor remains insolvent after the transfer, and the further corollary, first somewhat weakly advanced in *Lakeland Grocery Company*, that where an insolvent debtor in such a transaction becomes solvent he realizes taxable gain to the extent by which the transaction renders him solvent, may now be considered quite firmly established.

23. 140 F. (2d) 382 (C.C.A. 1st, 1944).
25. See in this connection *Paul, Studies in Federal Taxation* (3d series, 1940) 121-134.
28. 36 B.T.A. 289 (1937). Two dissenting members thought the full amount of the cancelled debt was taxable while four other dissenters thought that no part of the debt cancelled was taxable.
29. *Haden Co. v. Commissioner*, 118 F. (2d) 285 (C.C.A. 5th, 1941), *cert. denied* 314 U.S. 622 (1941), which, however, in so far as it held a gratuitous debt cancellation not to be a gift, was apparently overruled in the *Dental* case.
Borrowed Money Lost

Few tax decisions of the Supreme Court have evoked more unfavorable comment than the Kerbaugh-Empire case. Writing in 1936, Mr. Magill was quite critical. Professor Warren and Mr. Sugarman applied to it such terms as "no longer a controlling precedent in this field" and "generally discredited"; Mr. Surrey thought that the decision's reliance on the loss of the money borrowed had "generally been regarded as completely discredited by the later decisions." The criticism was principally directed to the fact that the Court dovetailed into a single business deal what normally would have been considered two separate transactions: (1) the debt transaction consisting of the borrowing of the funds and their repayment, and (2) the construction transaction financed through the proceeds of the loan. The separateness of each was accentuated by the circumstance that the construction loss occurred in years prior to the completion of the loan transaction and was sustained by another taxable entity, the taxpayer's subsidiary. The Kerbaugh-Empire decision was originally interpreted to stand for either of two propositions: (1) that a liquidation of a money obligation for less than the amount received does not result in income, or (2) that if one phase of a transaction results in a loss and in a later year another phase of the same transaction results in a counter-balancing profit, no income is realized. But in the Kirby case a liquidation of a money obligation for less than the amount received thereon was held to constitute income, a result squarely contrary to the first proposition, while in the Sanford & Brooks case in which one phase of the transaction had resulted in losses in prior years and another in a recovery in the taxable year, the recovery was held to be taxable, thus negativing the second proposition. The

30. 271 U.S. 170, 46 Sup. Ct. 449 (1926). The taxpayer had borrowed money repayable in German marks or their gold equivalent, had subsequently, through a subsidiary, lost in business the money borrowed, and had repaid the loan when marks had greatly depreciated, but not to the extent of the losses sustained. Pointing out that the excess of the subsidiary's losses over its income exceeded the amount borrowed, the Court held that the difference due to the depreciation of the mark between the amount borrowed and the amount repaid was not income.

31. MAGILL, TAXABLE INCOME (1936) 215 et seq. See also Rottschaefer, The Concept of Income in Federal Taxation (1921) 13 MINN. L. REV. 637, 661. Professor Rottschaefer considered the Court's reasoning "inadequate and inaccurate".

32. Warren & Sugarman, supra note 1, at 1329.

33. Surrey, supra note 1, at 1169.

34. 284 U.S. 1, 52 Sup. Ct. 4 (1931).

logic of this analysis when made seemed quite irresistible. At this date, a better perspective of the case can be had.  

The Kirby case did not overrule the Kerbaugh-Empire case. At most, its effect was to hold that the Kerbaugh-Empire doctrine had no application to a situation in which there was no showing as to the disposition of the borrowed funds. Nor did the Sanford & Brooks case overrule the Kerbaugh-Empire case. At most, it indicated that the latter's application was limited to debt adjustment transactions. In the Sanford & Brooks case there was no occasion for the Court to determine whether in the year involved the taxpayer had received the equivalent of cash, for the simple reason that in that year it had actually received the cash representing the proceeds of the judgment. The only question was whether the losses for prior years arising from the transaction could be offset against the recovery by the taxpayer in the taxable year. The Court held that they could not. In the Kerbaugh-Empire case no cash or property had been received, but the corporation's liabilities had been reduced and it was incumbent upon the Court to determine whether, through such reduction, the equivalent of cash had been realized. To do this the Court deemed it proper to view in its entirety the transaction out of which the supposed income arose. If the loan only were looked to, the financial position of the taxpayer was improved, but if account were also taken of the business done with the proceeds of the loan, there was no such improvement. As the Supreme Court later said in the Dental case, "the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction." Approaching the problem in this light, and limiting the application to debt adjustment cases, it does not seem that the Kerbaugh-Empire case is either overruled or discredited. On the contrary, the decision seems to have become the basis of a further development in the law of income taxation in relation to debt cancellation.

Readjustment of Purchase Price

From the Kerbaugh-Empire rule has evolved the "readjustment of purchase price" theory in debt cancellation cases. It first appeared in a

36. MERTENS, LAW OF FEDERAL INCOME TAXATION (1942) § 11.20.
37. In a dissenting opinion in Estate of Rogers v. Helvering, 320 U.S. 410, 417, 64 Sup. Ct. 172, 175 (1940), Chief Justice Stone and Justice Roberts wrote: "We have too often committed ourselves to the proposition that taxation is a practical matter concerned with substance rather than form, see Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, . . . to depart from it now." See also Commissioner v. Sherman, 135 F. (2d) 68 (C.C.A. 6th, 1943); Frank v. United States, 44 Fed. Supp. 729 (E.D. Pa., 1942).
District Court decision in which the Court held that where land was purchased for $20,000 and later depreciated in value to $6,500, the payment of $6,500 in cancellation of a $10,000 mortgage note which represented part of the purchase price resulted in no income. Of this decision Mr. Surrey thought that at best it stood

"for the proposition that gain is not to be recognized where the value of the property obtained upon incurrence of the obligation has declined below the amount of the obligation. This particular situation cannot properly be excepted from the rule that the realization of income in these cases need not await the disposal of the property, for that rule necessarily divorces the factors of basis and value from the realization of income."

Professor Warren and Mr. Sugarman were equally critical of the decision and thought that the fact "that the property declined in value should have no legal effect even though it may have a strong emotional effect."

But in Hirsch v. Commissioner, where property purchased for $29,000 had shrunk in value to $8,000 at a time when the unpaid purchase price was $15,000, and the seller agreed to a reduction of $7,000, the Seventh Circuit, in line with the Hextell decision, held that no income was realized, on the ground that the transaction "was in its essence a reduction in purchase price". Next, the Eighth Circuit, also in line with the Hextell decision, held that where property purchased for $100,000 had depreciated in value to $60,000, the extinguishment of $20,000 out of an $80,000 purchase money indebtedness did not result in income for the reason that it was equivalent to a voluntary "reduction in the purchase price". In both of these cases the taxpayer had previously offered to reconvey the property to the mortgagee in satisfaction of the debt. A similar situation was presented in Gehring Publishing Company, Inc., which was likened by the Tax Court to the Hirsch and Killian cases, and so decided. In the Dental case, the Supreme Court cited the Hirsch, Killian and Gehring cases, but made no statement of the rule of these cases, simply noting:

"Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain."

39. Surrey, supra note 1, at 1169.
40. Warren and Sugarman, supra note 1, at 1335.
41. 115 F. (2d) 656 (C.C.A. 7th, 1940).
43. 1 T.C. 345 (1942).
In Commissioner v. Sherman, et al., Exrs.,\(^4\) where the fair market value of the property was less than the amount of the mortgage debt, the Sixth Circuit concluded that no income had been realized on the debt cancellation. On the other hand, in Fifth Avenue-14th Street Corporation,\(^4\) involving another debt adjustment situation, where 'the record did not show the value of the property, the Tax Court declined to follow the Hirsch and Killian cases, stating:

"One of the factors requisite to an application of the doctrine of the Hirsch and Killian cases is the depreciation in value of the property to a point where it does not exceed the unpaid balance of the purchase price."\(^4\)

It is not clear whether by the phrase, "unpaid balance of the purchase price", the Court meant unpaid balance before, or unpaid balance after, adjustment.

In Ralph W. Gwinn the Tax Court undertook to state the rule of the Hirsch case, as follows:

"In order to apply the 'readjustment of purchase price' theory of Hirsch v. Commissioner and its companion cases, it becomes necessary to compare the value of the purchased property when the reduction in indebtedness occurred with the figure to which the debt was then reduced. If the amount remaining due after adjustment continues to be as much as the diminished value of the property, the necessary elements for application of the Hirsch principle . . . appear to be furnished."\(^4\)

It may be doubted whether the last quoted statement is not too narrow a construction of the Hirsch rule. No reference is made in the Hirsch or allied cases to the necessity of comparing diminished value of property with debt remaining due after adjustment. An application of the Gwinn interpretation of the Hirsch doctrine may be shown in the following illustration: The purchase price of property was $200,000. The property is now worth $50,000. The remaining purchase money mortgage debt is $100,000. The seller cancels $60,000 of the debt, thus reducing it to $40,000, and the purchaser agrees to pay such balance in cash. The purchaser has thus paid, or agreed to pay, $140,000 for property worth

\(^{44}\) Supra note 37.

\(^{45}\) 2 T.C. 516 (1943).

\(^{46}\) In Frank v. United States, 44 Fed. Supp. 729 (E.D. Pa., 1942), where the property owner refinanced a purchase money mortgage with new bonds issued to others than the sellers, and later reacquired the bonds at a discount, the Court held that the rationale of the Hirsch, Hextell and Killian cases had no application, and that income resulted from the transaction.

$50,000, and in the meantime has effected a cancellation of his obligation to pay a further $60,000. If the Gwinn interpretation were correct, the purchaser, although suffering a loss in value of property of $150,000, would have realized income of $60,000 from the debt cancellation, since "the amount remaining due after adjustment", $40,000, does not "continue(s) to be as much as the diminished value of the property", $50,000.

Nor does the Hirsch case stand, as may be implied from the Fifth Avenue-14th Street case, for the proposition that no income is realized from the cancellation of debt incurred on the acquisition of property if the debt remaining due before adjustment continues to be as much as the diminished value of the property. This might have the effect of excluding actually realized income. For example, if property were purchased for $100,000, of which $10,000 was paid in cash and $90,000 by mortgage, and the mortgage debt were later reduced through cancellation by $40,000 to $50,000, and the value of the property at the time of cancellation were $75,000, it would seem that the purchaser had realized income through the $40,000 debt cancellation, the property having in the meantime diminished in value by only $25,000. Viewing this transaction as a whole, the financial position of the taxpayer has been improved by $15,000.

A rule which might come closer to the Kerbaugh-Empire admonition to consult the "result of the whole transaction", which would accept the specific statement in the Killian case that the "transaction concerning the purchase of the real estate is viewed in its entirety", and which would be within the rationale of the Hirsch and companion cases, would be that a cancellation of debt incurred in the purchase of property results in income only if and to the extent that the amount of the cancellation exceeds the amount of diminution in the value of the property between the date of purchase and the date of the debt cancellation.

Stock for Debt and Bonds for Bonds

From time to time well established principles in the law of income taxation are challenged. That a corporation realizes no gain or suffers no loss upon the issuance of stock in payment of debt or in exchange for evidences of debt, is surely a well-grounded doctrine. Some doubt was cast upon it by a Board member in 1939. The case presented the question whether, upon an issuance of stock for bonds and accrued interest, the corporation was entitled to deduct such interest. Having decided

48. 2 T.C. 516 (1943).
that it was, the Board member proceeded to observe that the Commissioner had not attempted to tax the issuing corporation upon gain on the exchange. He then went on to explain that

"though petitioner's satisfaction of the bond and the then accrued interest obligations, by transfer of its preferred stock, may have resulted in a realized gain to petitioner in the sum of the difference between the then fair market value of the stock and the amount of those obligations—the realization of gain here is immaterial."

In 1942, the Commissioner adopted the suggestion thus offered, and contended before the Board and the Circuit Court that upon the original issuance by a corporation of preferred stock of a par value and actual market value of $50,000 in exchange for its bonds of a face value of $500,000, the corporation had realized a taxable gain of $450,000. In disposing of the claim, the Board said:

"The corporation had a liability of $500,000 on the bonds, having presumably borrowed that amount. . . . To substitute a capital stock liability for a bonded indebtedness . . . can not be called a present realization of gain. . . . Gain is not realized by a corporation in the receipt of the subscription price of its shares . . . and this would seem to be no less true when the subscription price, instead of being newly paid, is the amount which has already been paid in as the principal of a bond loan."

The Circuit Court affirmed on the basis of the Board's reasoning. Prior to this decision, there does not seem to be any case which squarely decided the point.52

If the stock issued for the debt is treasury stock, in which the corporation dealt as it might in shares of another corporation, the rule is otherwise, and gain or loss, measured by the difference between the cost of the treasury stock and the amount of debt discharged, is realized.53

As was originally stated in Great Western Power Company of California v. Commissioner,54 the question as to whether, upon an exchange of one obligation for another, a premium paid by the debtor corporation is deductible depends upon whether the transaction is a mere exchange

52. In the following cases, stock was issued for bonds, but the question of gain or loss on issuance did not arise: Chicago, R. I. & P. Ry., 13 B.T.A. 988 (1928); 375 Park Avenue Corp., 23 B.T.A. 969 (1931); Pierce Oil Corp., 32 B.T.A. 403 (1935); The Liquid Carbonic Corp., 34 B.T.A. 1191 (1936); Appeal of Howard W. Starr, 1 B.T.A. 681 (1925).
or is to be viewed "as if the retirement were accomplished by the payment of cash." Obviously, the same question is presented if a discount is involved. The answer to the factual inquiry as to whether the transaction is one of substitution or one of purchase determines the answer to the question of gain or loss. In the Great Western Power case, the facts showed a mere substitution of obligations. On a similar set of facts, a District Court recently ruled that a premium paid in connection with an exchange by a corporation of its old bonds for new was not deductible, but was required to be spread over the life of the new bonds.

Gratuitous Forgiveness

The essential facts of the Dental case were these: The taxpayer owed overdue note interest and back rent. From its creditors it sought and obtained an adjustment of both. The items involved had been accrued in prior years and had served fully to offset income. Without any consideration therefor, the noteholders, who were the taxpayer's customers, agreed to cancel part of the interest, and the lessor agreed upon receipt of a portion of the rent to cancel the balance. The Commissioner determined that the forgiveness of the debt was income. Taxpayer contended, among other things, that the forgiven debts were exempt as gifts. The Board found that the cancellations were not gifts, and sustained the Commissioner. The Circuit Court reversed on the ground that the cancelled debts were gifts, and the Supreme Court, with two dissenting votes, affirmed.

Before the Board, the taxpayer's principal argument related to book entries which, it urged, showed that the debts had been actually cancelled in a prior year. But the Board found that the cancellations took place in the year under review. The taxpayer also contended that the cancellations actually represented gifts. Said the Board:

"No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity."

The Circuit Court found that there was no consideration to the landlord for the cancellation of the rent, and none to the noteholders for

56. 44 B.T.A. 425 (1941)
57. 128 F. (2d) 254 (C.C.A. 7th, 1942).
58. 318 U.S. 322, 63 Sup. Ct. 577 (1943).
the cancellation of the interest. As to the latter, the Court said that they "might have expected more business in the future, but the debtor-taxpayer did not promise any. Certainly the creditors' expectation was not consideration. The transaction was a pure cancellation of indebtedness, without any consideration and for the benefit of the debtor."

Therefore, it concluded that the cancellations of the debts represented gifts. As to the Board's statement of lack of donative intent, the Court replied:

"Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. There is no evidence that the creditors did that which they did not intend to do. The creditors' motives are immaterial."

No obstacle to the Court's decision was the circumstance that it might "result in the Government getting no tax, although the taxpayer had benefited by deducting the rent and interest accrued."

By way of preparing the foundation for its conclusion, the Supreme Court pointed, first, to Circuit Court decisions in which the remission of indebtedness was not treated as resulting in gross income, and then to the specific statutory enactments in that connection. As to judicial action, the Court said:

"Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction."

As to specific legislative relief, the Court referred to the provisions of the Chandler Act and to Code Sec. 22(b)(9), as added by the Revenue Act of 1939 and amended by the Revenue Act of 1942. Then the Court came down to the point, which was simply whether or not the forgiveness was a gift under Code Sec. 22(b)(3). For the purpose of that section the Court defined the term "gift" as "the receipt of financial advantages gratuitously." With reference to the Board's statement as to donative intent first quoted above, the Court said:

"With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22(b)(3) exempts gifts. . . . The

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59. In Haden Co. v. Commissioner, 118 F. (2d) 285 (C.C.A. 5th, 1941), the Court had held a similar cancellation of debt to result in gain to the extent to which the debtor was thereby made solvent.
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 the cancellation here gifts within the statute."

A few words may be said regarding Mr. Justice Frankfurter's dissenting opinion. The Justice made three points. The first was that the particularity with which Congress described the transactions in which income attributable to the discharge of indebtedness was excluded, appeared to put the Dental situation in a nonexempt category. But the references to the Chandler Act and Code Sec. 22(b)(9) would seem to prove either too little or too much—too little, in that what Congress intended by these provisions relating to discharge of indebtedness has no bearing on the meaning of gifts within Code Sec. 22(b)(3) as applied to forgiveness of debt; too much, in that if the Chandler Act and Code Sec. 22(b)(9) are to be the exclusive yardstick for measuring exemption in debt forgiveness cases, then even the forgiveness of a debt out of "pure generosity" would constitute taxable income. Secondly, to the charge of the Court that the Board reached its conclusion upon "an application of erroneous legal standards", the Justice replied that the Board "did not invoke wrong legal standards. It knew well enough the difference between taxable income and gifts." This counter-assertion does not advance the argument. Thirdly, the Justice expressed the view that the Board's conclusion should be upheld for reasons of "wise fiscal as well as judicial administration." By the term "judicial administration", the Justice may have meant that it was the peculiar function of the Board to ascertain reasonable inferences from facts, and, therefore, in this instance, whether a gift was intended. But this could be so only if the Board applied right legal principles—which gets back to the second point. No elaboration is made of the reference to "wise fiscal . . . administration." Possibly the Court had in mind the circumstance that the items involved had been deducted by the taxpayer in the computation of prior years' income. At any rate, the desirability of the collection of additional revenue by the Treasury would seem to fall short of a cogent judicial argument.

The opinion in the Dental case discloses three elements which invite analysis: (1) the elimination of the "deduction" approach or "tax benefit" theory, (2) a clarification of the "donative intent" concept, and (3) the matter of "consideration".
Prior to the *Dental* case, there had been developed a theory that upon the cancellation of indebtedness income was realized if the debt, for example, accrued interest, had been deducted in the taxpayer-debtor's income tax return for a prior year (the "deduction" approach) or, at least, if the deduction had offset taxable income (the "tax benefit" theory). Professor Warren and Mr. Sugarman favored the latter as a "realistic approach to income taxation". To the same effect was *Helvering v. Jane Holding Corporation*, in which the Court commented:

"The controlling decisions establish that when such items of income are so entered as accrued debt by a solvent taxpayer returning on the accrual basis, the items are deemed in law to be restored to income if and when the debt is subsequently forgiven."

In that case the Circuit Court upheld the Government theory that interest accrued and deducted constituted income when the stockholder-creditors cancelled the debt. On the same theory, Professor Warren and Mr. Sugarman counted as inequitable the Second Circuit opinion in *Commissioner v. Auto Strop Safety Razor Company, Inc.*, holding that royalties cancelled by a parent corporation on a cash basis constituted a nontaxable capital contribution to a subsidiary which had previously accrued and deducted that amount. Mr. Darrell also thought that "release from a debt, however incurred, should be treated as income to the extent that the debt was utilized to offset prior years' income."

These theories, in so far as they relate to gratuitous forgiveness of debt, are now outmoded. In *Carroll-McCreary Company, Inc. v. Commissioner*, the Court held that a release by stockholders of debts for unpaid salaries owed to them was nontaxable income, even though the corporation had received the benefit of the salary deduction in a prior year's income tax return. The *Dental* case specifically dealt with forgiveness of interest and rent, which not only had been deducted in prior years' returns, but had been used to offset income in such years. In the *Dental* case the *Auto Strop* decision was approvingly cited.

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60. Warren and Sugarman, *supra* note 1, at 1349.
63. 74 F. (2d) 226 (C.C.A. 2d, 1934).
64. Darrell, *supra* note 1, at 982.
65. 124 F. (2d) 303 (C.C.A. 2d, 1941).
In *Pondfield Realty Company, Inc.*\(^66\) another case of a forgiveness of salary by a stockholder-employee where the salary had accrued and been deducted by the taxpayer-employer in a prior year, the Tax Court had held that the forgiveness resulted in taxable income, distinguishing the *Carroll-McCreary* case on the ground that the stockholder-employees in that case had reported the salary as income. The Tax Court did not believe that if the employees had omitted to return the salary as income, the Circuit Court "would nevertheless have decided that the forgiveness was a nontaxable capital contribution". But, on the authority of the Supreme Court's decision in the *Dental* case, the Circuit Court,\(^67\) on motion of the parties, reversed and remanded the case to the Tax Court.

In *George Hall Corporation,*\(^68\) where a holder of less than 2,000 out of 3,000 shares of the taxpayer-corporation forgave interest in arrears on its debentures, and the interest had in a prior year been deducted by the corporation, the forgiveness was first held to represent taxable income in the year under review on the ground that since the corporation had deducted the interest when it accrued "and charged its assets with the burden of the interest debt", it must be taxed when the "burden was removed by the cancellation". But after the *Dental* case, the Tax Court\(^69\) reconsidered and reversed.

Therefore, whatever vitality the tax benefit theory has in other fields, it appears that in the case of a gratuitously forgiven debt, whether the subject matter of the gift was deducted in a prior year's return, and, if deducted, whether it offset taxable income, is without significance. In these cases, the courts now focus their entire attention on the clear language of Code Sec. 22(b)(3) exempting gifts from income taxation.

Nor is it possible to vitiate the effect of the *Dental* decision by invoking the estoppel doctrine and contending that since the taxpayer claimed the interest deduction, he is estopped to deny that the forgiveness is income. This would be an attempt to "create income out of what never was income either in law or in fact".\(^70\) However, the rule that unpaid interest, accrued and deducted in the taxpayer's return, is not income in the year in which gratuitously forgiven does not extend to the allowance of such interest deduction when the accrual and forgiveness occur within the same taxable year.\(^71\)

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\(^66\) 1 T.C. 217 (1942).


\(^68\) 1 T.C. 471 (1943).

\(^69\) 2 T.C. 146 (1943).

\(^70\) 70. Pancoast Hotel Co., 2 T.C. 362 (1943), A. 1943 C.B. 18.

\(^71\) Shellabarger Grain Products Co., 2 T.C. 75 (1943), aff'd on other grounds, — F.
Another effect of the Dental case is to require a reappraisal of the term "donative intent", as applied to gifts within the intendment of Code Sec. 22(b)(3), and perhaps also under Code Sec. 1000.\textsuperscript{72}

The generally accepted notion of donative intent as applied to debt adjustment cases was illustrated by Randolph Paul in discussing gift taxes:\textsuperscript{73} "If a creditor cancels a portion of an indebtedness in order to salvage something, it seems clear that donative intent is not at work." Professor Warren and Mr. Sugarman\textsuperscript{74} sought to make a distinction between a gratuitous forgiveness and forgiveness with donative intent. In a gift tax case which involved a waiver of rights to undeclared dividends on preferred stock, a field closely related to forgiveness of indebtedness, the Board held that action "may be prompted entirely by anticipated business benefits which negative a donative intent".\textsuperscript{75} And in the Dental case, the Board had found that the creditors "acted for purely business reasons" and, therefore, by the Board's standard, had not acted with donative intent.

A comparison of these statements with those of the Circuit Court and the Supreme Court in the Dental case, quoted above, leaves no room for doubt that for the purpose of Code Sec. 22(b)(3) an attempt on the part of a creditor "to salvage something", or the fact that a creditor, in scaling down a debt, has an eye to future business or profits, does not militate against a donative intent. It has been said that under Code Sec. 22(b)(3), as interpreted in the Dental decision, the requirement of donative intent has been abandoned.\textsuperscript{76} The correctness of this interpretation is doubtful. Donative intent would seem to be required, but is \textit{ipso facto} present if the forgiveness is voluntary and gratuitous. "As long as there was no consideration for the cancellation, the intent to give necessarily followed." Of the above quoted statement from the

\textsuperscript{(2d) — (C.C.A. 7th, 1944); McConway & Torley Corp., 2 T.C. 593 (1943). The point involved depends on the rule as to accrual of deductions rather than the rule as to income from gratuitous forgiveness of debt. But where bonds with coupons attached were acquired by debtor corporation in exchange for a new issue of preferred stock, interest accrued during the year of exchange is deductible. Here there is no forgiveness, but an exchange of bonds and coupons for a single consideration—stock. Hummel-Ross Fibre Co., 40 B.T.A. 821 (1939).}

\textsuperscript{72} The gift tax phase of the matter is considered \textit{infra} at pp. 167-168.

\textsuperscript{73} Paul, \textit{Federal Estate and Gift Taxation} (1942) 1092.

\textsuperscript{74} Warren and Sugarman, \textit{supra} note 1, at 1366.

\textsuperscript{75} Emily Coles Collins, 1 T.C. 605 (1943), N.A. 1943 C.B. 29.

\textsuperscript{76} (1944) 44 Col. L. Rev. 102, 105.
Circuit Court opinion in the *Dental* case, Circuit Judge Goodrich, in *Sportwear Hosier Mills v. Commissioner*, 77 said:

"If this language means that in every instance where a payment is made without consideration the conclusion necessarily follows that a gift has been made, it goes considerably beyond what has previously been thought to be the law."

In view of the Supreme Court's affirmance of the Circuit Court decision in the *Dental* case, and on precisely the same ground as that on which the Circuit Court relied, it is not unfair to state that, although it does go considerably beyond what has previously been thought to be the law, in every instance where an indebtedness is voluntarily forgiven without consideration—"a release of something to the debtor for nothing"—a gift has been made within the purview of Code Sec. 22(b)(3). 78 Of course, where there are no direct negotiations between the debtor and the creditor, as in the *Fifth Avenue-14th Street* case, 79 in which the taxpayer-mortgagor dealt with the mortgage certificate holders whose rights were enforceable only through the trust company mortgagee, there was no room for the "donative intent" theory and, accordingly, income was held to be realized.

**Consideration**

It has been fairly stated that there "is always a reason for a gift", but that any "reason, not amounting to legal consideration, is not material." 80 In the *Dental* case, there was no *quid pro quo*, 81 but the Circuit

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77. 129 F. (2d) 376 (C.C.A. 3d, 1942).
78. In F. W. Leadbetter, T.C. Memo. Op., Dkts., 110,258, 110,259 (August 13, 1943), the Tax Court ruled that the excess of a debt due a corporation from its stockholder over the value of property transferred by the stockholder in settlement was taxable income to the stockholder, but here the creditor was a personal holding corporation controlled by the debtor, and the corporation's act could not fairly be construed as a voluntary forgiveness of part of the debt.
79. 2 T.C. 516 (1943). Likewise, in Bulkley Building Company, T.C. Memo. Op., Dkt. 109, 679 (October 25, 1944), the Tax Court held that upon the acquisition by a corporation of its own obligations at a discount, income realized with respect to obligations acquired directly from the holders through acceptance of invitations of tender was exempt under the *Dental* rule, but that as to bonds acquired in the market the transactions lacked the personal element necessary to constitute a gift, within the meaning of the *Dental* case, and, accordingly, that income thereby realized was taxable under the *Kirby* rule, as applied in the *Fifth Avenue-14th Street* case.
81. Debt adjustments made by a business corporation with its debtors may maintain good will. The *Dental* decision has been criticized for requiring strict legal consideration, and it has been said that "in applying a statute which is to determine the net income of
Court pointed out that with a slight variation the transaction might have been for a consideration rendering the forgiveness taxable. If, said the Court, the landlord had said: "If you will make a new lease, I will reduce your indebtedness to $7,500,' the making of the new lease might have constituted consideration for the promise to forgive."

In one recent case the Dental rule may have been stretched beyond its limits. The due date of certain notes of the taxpayer had been extended by the bank which held them, and the bank had thereafter agreed, in consideration of immediate payment, to accept some $8,000 less than the amount due. Citing the Dental decision, the Tax Court held that no income was realized. Here it would appear that the prepayment of the note did constitute a consideration, and that, therefore, there was no gratuitous forgiveness. On the other hand, in order to take a case outside the Dental rule because of the presence of consideration, it is necessary that the consideration pass from the debtor to the creditor. Thus, a forgiveness, by a parent corporation of a debt due from a subsidiary, the parent having agreed with its own creditor to forgive the subsidiary's debt in order that the latter might pay the parent a dividend out of the proceeds of which the parent would pay its own debt, is not debt cancellation for consideration, since, as between the parent and the subsidiary there was no consideration and the matters between the parent and its creditors leading to the cancellation were "motives" and, under the Dental case, not significant.

A forgiveness of corporate debt by a stockholder-creditor is without consideration if made to put the corporation on a sound financial footing, or to relieve the corporation of a strained financial condition, or to facilitate a loan to the corporation. From these and other cases already cited, it is clear that the courts have no hesitancy in treating as within the rationale of the Dental case forgiveness of indebtedness by stockholders. In these instances, such forgiveness is regarded as a voluntary transfer without consideration, a gift. In one case, the Tax Court said it felt bound as a legal proposition, on the authority of a business corporation" a less legalistic definition should have been applied. (1943) 12 Fordham L. Rev. 198, 201.

82. Shellabarger Grain Products Co., 2 T.C. 75 (1943), aff'd, — F. — (2d) (C.C.A. 7th, 1944).
83. McConway & Torley Corp., 2 T.C. 593 (1943).
85. George Hall Corporation, 2 T.C. 146 (1943).
87. George Hall Corporation, 2 T.C. 146 (1943).
of the Dental decision, to hold that a debt forgiveness by a debenture-holder, who was also a large stockholder, was a gift, and, therefore, not taxable income of the debtor corporation, adding: "The fact that the regulations may give ground for calling it a contribution of capital . . . does not affect the decision." The soundness of the view that a contribution to capital constitutes a gift may be questioned. Assume a solvent corporation with a single class of stock outstanding. By a transfer of assets, or a forgiveness of debt, a stockholder increases the net corporate assets, but receives no additional shares of stock. Has he not, by virtue of his stockholder relationship, received a consideration? After the transaction he may be neither richer nor poorer. In substance he may have given away nothing. Only to the extent that he has transferred assets or forgiven debts out of proportion to his stock interest may he be said in a real sense to have made a gratuitous transfer or to have effected a gratuitous forgiveness. This is not to say that a forgiveness of debt by a stockholder creates corporate income. To the extent to which the forgiven debt is in proportion to his stock interest the stockholder has made an investment, not a gift. And from the standpoint of the debtor corporation the forgiveness is a capital transaction whereby the corporation realizes no taxable income. To the extent to which the forgiven debt is in excess of his proportionate stock interest, the stockholder has made a gift, and, under the Dental decision, the corporation has realized no taxable income. But whether it be a contribution to capital or a gift, or both, a forgiveness of debt by a stockholder gives rise to no income and it would seem to be in order for the Treasury Department, which, following the Board's decision in the Jane Holding Corporation case, added the phrase, "to the extent of the principal of the debt", to the previous regulation, so as to make it read:

"In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt",88 to delete the addition.

Burden of Proof

Where the Commissioner determines that a taxpayer has realized income through the reduction or cancellation of indebtedness, such holding carries with it a presumption of correctness, and reliance upon the Dental decision is fruitless unless the taxpayer adduces evidence that

the reduction or cancellation was voluntary and gratuitous. A mere showing that interest was cancelled, with no evidence that the cancellation was voluntary and gratuitous, is not a sufficient basis for excluding such income.  

Forgiveness from Standpoint of Creditor

From the standpoint of the creditor, both the income tax aspect and the gift tax aspect of debt cancellation require consideration.

Does a creditor on a cash-receipts basis, to whom amounts are owed representing salary due in prior years realize income in the process of forgiving such indebtedness? By an application of the doctrine of the Dental case, combined with that of the Horst case, the Commissioner so contended in John Harvey Kellogg. The gist of his ingenious argument was that the gratuitous forgiveness of a debt is a gift (the Dental doctrine), that a gift presupposes something to give, in this instance past-due salary, that one who has a right to income may realize it through the enjoyment of transferring it (the Horst doctrine), and that, therefore, one entitled to such salary payments may realize income through the exercise of the privilege of surrendering the right thereto. To state the argument more simply, the waiver of the salary constituted a constructive receipt and a simultaneous surrender. The Tax Court was unwilling to extend the Horst doctrine to that length, and, finding a "prohibitive difficulty in keeping the conception within rational limits", reversed the Commissioner's determination. The latter's acquiescence indicates his abandonment of that approach.

Another income tax implication from the standpoint of the creditor is suggested by the Dental case. May a creditor, under Code Sec. 23(k), claim a bad debt deduction for a debt or a portion thereof which he has gratuitously forgiven? If it were worthless when he made the gift, it would seem that he would be entitled to the deduction, but it would likewise seem that if a portion of the debt were gratuitously forgiven, the deduction with respect to that portion could not be postponed until a subsequent year when the debt was liquidated. At that time as to that portion there was no debt. The creditor had already disposed of it.

Where a creditor accepts a compromise settlement of a note evidencing a business debt, it is of importance that the record show that he is
dealing with the debtor or an agent of the debtor, and not with a third party; otherwise, he may be faced with the claim that the transaction was the sale of a capital asset subject to the applicable statutory limitations.\textsuperscript{93}

More troublesome is the gift tax question. To the extent that a debt, when forgiven, is without value, the gift tax problem becomes academic, but the debtor in these situations, although normally in financial straits, is not always without assets, \textit{e.g.}, the debtor in the \textit{Dental} case. If, without consideration, a creditor forgives a debt, there is, as established in the \textit{Dental} decision, a gift to the debtor under Code Sec. 22(b)(3), which provides for the exclusion from gross income and the exemption from income taxation of the "value of property acquired by gift". At the same time, there arises the question of tax liability of the creditor under Code Sec. 1000, which imposes a gift tax upon the transfer by an individual "of property by gift". Again, if a creditor cancels a debt for an inadequate consideration, then, since Code Sec. 1002 provides that a transfer for "less than an adequate and full consideration in money or money's worth" is deemed to be a gift, there arises a question as to whether the creditor may not be subject to gift tax, even though the debtor, there being no gratuitous forgiveness, is subject to income taxation with respect to the same item.

Prior to 1934, the Income Tax Regulations provided:

"If ... a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."\textsuperscript{94}

Since, at the same time, the Gift Tax Regulations\textsuperscript{95} provided that a taxable transfer might result from "the forgiving of a debt", it was thought that there was "confusion in the Regulations"\textsuperscript{96} and that the elimination of the above quoted provision in the Income Tax Regulations ended the confusion. But the \textit{Dental} decision has gone even further than effectually restoring the Regulation. In the light of the \textit{Dental} case, the eliminated provision was the source of confusion, not because it provided that a forgiven debt might be a gift, but, rather, because it provided that it might be a gift only if the creditor "merely desires to

\begin{footnotesize}
\textsuperscript{93} George A. Adam, T.C. Memo. Op., Dkt. 1720 (June 28, 1944).
\textsuperscript{94} Reg. 77, Art. 64 (1932).
\textsuperscript{95} Reg. 79, Art. 2.
\textsuperscript{96} Warren and Sugarman, \textit{supra} note 1, at 1363.
\end{footnotesize}
benefit a debtor”. The presence or absence of that desire is, under the Dental case, of no consequence.

Prior to the decision of the Circuit Court in the Dental case, it was suggested that to constitute a taxable gift, a discharge of indebtedness must be one accompanied by “an intent to benefit the debtor, or donative intent.” In view of the new definition contained in that decision, further elaboration of the foregoing phrase is required.

The term “gift” is used both in Code Sec. 22(b)(3) and in Code Sec. 1000, but it does not follow that a transaction which is a gift under the one section is also a gift under the other. As was said by the Supreme Court in the Dental case, “‘Gifts’, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear.” A forgiveness of debt, therefore, might be a “gift” under Code Sec. 22(b)(3), for the purpose of exempting the debtor from income tax, but not a “gift” under Code Sec. 1000, for the purpose of imposing a gift tax upon the creditor. “Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts”, the courts have been quite circumspect in dealing with debt adjustment cases in relation to income taxes. Would it not seem that possibly it was also the legislative purpose not to exact gift taxes from creditors upon the gratuitous forgiveness of debts when such action is designed primarily to benefit the creditor, and that the courts would be equally astute in regard to gift taxes? In determining the “coloration” to be assigned to the term for the purpose of gift taxes, a further factor to be weighed is that the gift tax provisions supplement the estate tax provisions, and that since in the nature of things a forgiveness of debt primarily for the purpose of benefiting the creditor would not normally occur in estate taxation, it was not intended to be brought within the ambit of the gift tax provisions. In any event, it would seem that the courts would be quite averse to imposing a gift tax on a forgiveness of indebtedness if the predominant design was economically to benefit the creditor, albeit the forgiveness also benefited the debtor. But the problem remains, and as yet there is neither Treasury ruling nor court decision to guide the taxpayer.

97. PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) 1092.
98. In I.T. 3329, 1939-2 C.B. 153, the Bureau ruled that payments voluntarily made by a corporation to the widow of a deceased officer were deductible expenses to the corporation but nontaxable gifts to the widow.
CANCELLATION OF INDEBTEDNESS

Excess Profits Tax Considerations

The discharge or forgiveness of indebtedness also has its peculiar place under the excess profits tax provisions of the Code. The abnormal character of such income, if the indebtedness is represented by a bond or other evidence of debt, and if the taxpayer's obligation has been outstanding for more than six months, is recognized in the provisions whereunder such income is excluded in the calculation of excess profits net income for the taxable year, whether computed for the purpose of the income credit\(^{100}\) or the invested capital credit,\(^{101}\) and in the calculation of the excess profits net income for the base period.\(^{102}\) Also excluded in the calculation of excess profits net income for the base period are certain deductions in relation to the discharge of indebtedness, if represented by a bond or other evidence of debt, and if the obligation of the taxpayer has been outstanding for more than eighteen months.\(^{103}\) Thus, although consistency would require that if, in respect of the taxable period and the base period, profits on the discharge of obligations outstanding over six months are not included as income, losses on such discharges should likewise not be included as deductions, Congress has been somewhat indulgent in making no provision in respect of the taxable period for exclusion of any losses on the discharge of obligations, and, while not going as far in respect of the base period as to provide for exclusion of losses on discharge of obligations if outstanding for more than six months (which would be consistent with the provision for exclusion in the base period of profits on the discharge of obligations outstanding over six months), has provided, in respect of the base period, for the exclusion of losses on the discharge of obligations outstanding for more than eighteen months.

A forgiven debt may also be a factor in the calculation of invested capital. In one case which recently came before the Tax Court the creditors of a corporation, none of whom were stockholders, except one who was the record holder of a single share, voluntarily cancelled debts due them. The question was whether the amount of the forgiven debts could be treated as equity invested capital, which is defined\(^{105}\) to include: "Property . . . previously paid in . . . for stock, or as paid-in surplus,

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104. Liberty Mirror Works, 3 T.C.-No. 126 (1944).
or as a contribution to capital." The Court ruled that none of the forgiven debts could be treated as equity invested capital. The decision has been construed to mean that debts forgiven by non-stockholders cannot be considered as either paid-in surplus or contributions to capital, and has been criticized as not entirely convincing. The holding of the Court is not quite as broad as to state that under no circumstances are debts forgiven by non-stockholder creditors to be treated as invested capital. What the Court said was that it did not think that "the gratuitous forgiveness of a corporation's debts by non-stockholder creditors necessarily results in a contribution to capital..." In this case, the forgiven debts included amounts owing to merchandise creditors and amounts owing to banks on account of advances for working capital. When a merchandise creditor partially cancels his debt, whether as to principal or interest, or both, the transaction takes on more the aspect of a reduction of sales price of the merchandise than that of a contribution to capital, and hence the amount cancelled would not seem a proper element in the computation of invested capital. More doubtful is the status of forgiven bank debt which represented advances for working capital. It would seem that no hard-and-fast rule can be laid down as to whether forgiveness of indebtedness by non-stockholders does or does not represent contributions to capital, but that each case must be decided on its own facts.

**Specific Statutory Provisions**

The general rule that income is realized in the discharge of indebtedness by payment of an amount less than the amount borrowed or assumed is subject to further exceptions contained in the Chandler Act as amended in 1940 and as restricted by the Revenue Act of 1942 and the Revenue Act of 1943; by Code Sec. 22(b)(9) as added by the Revenue Act of 1939 and amended by the Revenue Act of 1942 and by Code Sec. 22(b)(10) as added by the Revenue Act of 1942. These provisions reflect repeated Congressional attempts to meet the demands of importunate corporate taxpayers for relief from

112. Ibid.
taxation in transactions resulting in debt adjustments, coupled with Congressional apprehension lest the relief granted result in an undue advantage to taxpayers. The conventional trial-and-error method has been followed. The product is a melange of legislation. While it is not possible within the limits of this article to review these provisions in detail, a few observations may be made.

Obviously, the most appropriate place for statutory provisions relating to income taxation is in the Internal Revenue Code. No reason is apparent why the applicable provisions of Sec. 268 of the Chandler Act, providing for exclusions from income of amounts attributable to the discharge of indebtedness, or the related provisions of Sec. 270 thereof, providing for reduction of tax basis by the amount by which certain indebtedness has been reduced, should not be part and parcel of the Internal Revenue Code, or at least incorporated therein by reference. The point should not be overstated, but is rather emphasized by the Code provisions113 which recite conditions under which the provisions of Sec. 270 of the Chandler Act shall not be effective.

By the provisions of Sec. 270, the basis of a debtor’s property is reduced by the amount of certain debt cancelled in a 77B reorganization. Code Sec. 113(b)(4), relating to adjusted basis of property, provides that when a debt adjustment plan is consummated in a 77B proceeding and the final decree is entered before September 22, 1938 (the effective date of the Chandler Act), and there is no transfer of assets to another corporation, Sec. 270 shall not apply. Code Sec. 113(a)(22) provides that if the 77B reorganization is one which qualifies under Code Sec. 112(b)(10), or so much of Code Sec. 112(d) or (e) as relates to Code Sec. 112(b)(10), then Sec. 270 of the Chandler Act shall not apply. Code Sec. 113(a)(22) contemplates acquisition of assets by a new corporation, and is applicable whether the final decree was entered either before or after September 22, 1938. The net result of the foregoing is that if in a 77B proceeding a new corporation is organized, and for its property issues solely stock and securities (Code Sec. 112(b)(10)), or stock and securities plus “boot” (Code Sec. 112(d) or (e)), there is no reduction of basis by reason of debt adjustment, and if a corporation reorganized in a 77B proceeding continues in existence and the final decree was entered before September 22, 1938, there is also no reduction of basis by reason of the debt adjustment, while if the old corporation is so reorganized and continues in existence but the final decree is

entered after September 27, 1938, Sec. 270 does apply and there is a reduction of basis by reason of debt adjustment. There does not seem to be any satisfactory explanation of the requirement for a reduction of basis by reason of debt adjustment where the old corporation continues in existence, and no such reduction where a new corporation is organized.

No model of draftsmanship is to be found in the tax provisions of the Chandler Act. The most glaring defect in Sec. 270 as originally enacted was remedied by the amendment of 1940, which supplied a floor by which the reduction of basis of assets was limited to their fair market value. But the scope of application of the section remained obscure. In a case involving a transferee of assets of a corporation in reorganization under Sec. 77B, the Board held that Sec. 270 was prospective only, and did not require a reduction of basis for taxable years ending prior to September 22, 1938. The Circuit Court affirmed. The Seventh Circuit, on the other hand, reversing the Tax Court, held that Sec. 270 also applied retroactively, and in a transaction involving a 77B proceeding, did require a reduction of basis for such prior years, although the 77B proceeding was confirmed prior to September 22, 1938. In view of the conflict, the Supreme Court granted certiorari. The latter has now decided that neither of the foregoing views was correct and that in a 77B proceeding, Sec. 270 applied only to a proceeding pending on September 22, 1938. Meanwhile, the legislation has been further patched by the Revenue Act of 1943. As added by that act, Code Sec. 113(b)(4) (making Sec. 270 inoperative in certain cases) is deemed to be applicable to years beginning after December 31, 1935, while Code Sec. 113(a)(22) (making Sec. 270 inoperative in other cases) is effective with respect to years beginning after December 31, 1933, but not affecting tax liability for any year beginning prior to January 1, 1943.

Sec. 270 presents further complications. If stock is issued for bonds, and the par value of the stock equals, but its market value is less than, the issue price of the bonds, two questions are presented: whether, for the purpose of determining if indebtedness has been reduced, the market value of the stock should be compared with the issue price of the bonds, 114. Paul, Debt and Basis Reduction Under the Chandler Act (1940) 15 Tulane L. Rev. 1.
119. 321 U.S. 759.
120. - U.S. - (December 4, 1944).
and, if so, whether the exchange has effected a reduction of indebtedness. As to the first point, it would seem that the correct comparatives are market value of stock and issue price of bonds. On the second point, the Tax Court held that there was no "true reduction or cancellation of the original indebtedness, but what amounts to a continuation of it in another form". The Circuit Court rejected this view and held that the stock "wiped out a direct debt liability".

It may also be noted that Code Sec. 22(b)(9) affords relief only to a corporate taxpayer, and that no provision has been made for an individual taxpayer; that Code Sec. 22(b)(9) applies only in respect of certain types of indebtedness, but neither Code Sec. 22(b)(10), relating to certain railroads, nor Sec. 268 of the Chandler Act, relating to certain insolvent corporations, is so limited; that Code Sections 22(b)(9) and 113(b)(3) require an adjustment of basis of assets, as does also Sec. 268 of the Chandler Act, while Code Sec. 22(b)(10) requires no such adjustment; that Code Sec. 113(b)(3) provides no limit on the extent of a basis-adjustment, while Sec. 270 of the Chandler Act now includes a "fair market value" limitation; that Code Sec. 22(b)(9) furnishes the taxpayer with an option, while Sec. 268 of the Chandler Act is mandatory, and that Code Sections 22(b)(9) and 22(b)(10) are in the form of temporary legislation, while the Chandler Act is permanent.

In the event that a taxpayer wishes to contend that a debt reduction did not give rise to taxable income, e.g., on the ground that taxpayer was insolvent after the transaction, and was thus within the Dallas rule, or on the ground that the transaction constituted a gift under the Dental rule, and alternatively to claim a right of election to exclude the income under Code Sec. 22(b)(9), a practical difficulty arises. The Treasury Department Regulations make no provision for a qualified consent to adjustment of basis. In the Bulkley Building Company case, the taxpayer had made such an election by filing its consent to adjustment of basis. In an effort to avoid such adjustment, but without actually withdrawing its consent, the taxpayer contended before the Tax Court that the income was nontaxable under the Dental rule. The allowance of the taxpayer's claim under Code Sec. 22(b)(9) eliminated any deficiency for the year. The Court pointed out that the taxpayer had not withdrawn its consent, and, without deciding whether the election

might have been withdrawn, declined to pass upon the question as to whether the Dental rule could be invoked. It would seem that the Treasury Department should amend its regulations to provide for a qualified consent.

**CONCLUSION**

Two closing observations may be made. Each court decision which has since become a landmark in this field met, initially at least, with considerable adverse legal criticism. This was so of the Kerbaugh-Empire case, establishing the theory that no income is realized in the settlement of indebtedness for less than the amount borrowed where the borrowed funds have been lost; it was so of the Dallas case, establishing the theory that no income is realized through debt cancellation if the debtor continues insolvent; it was so of the Hirsch case, establishing the theory that no income is realized from debt cancellation if it effects a reduction of purchase price, and, finally, it was so of the decision in the Dental case that no income is realized from the voluntary gratuitous forgiveness of debt. If limited to the foregoing propositions, none of these cases appears to be unsound. On the contrary, along with the Kirby decision, they presently furnish the only substantial basis for the development of further judicial law on this subject. Legislation is another matter. In the Chandler Act, Congress made a well-intentioned but poorly executed attempt at relief, and has not yet caught up with all the deficiencies of that statute. By their terms, the present relief provisions of the Code will shortly expire. If it be the policy of Congress to grant a measure of tax relief in debt adjustment situations, it would seem that all applicable provisions, including those of the Chandler Act, should be brought within the framework of the Internal Revenue Code, and that an effort should be made to achieve more uniformity of treatment and closer coordination of the various provisions.