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Discharge of Indebtedness Income and the Bankruptcy Tax Act of 1980: An Economic Benefit Approach

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DISCHARGE OF INDEBTEDNESS INCOME AND THE BANKRUPTCY TAX ACT OF 1980:* AN ECONOMIC BENEFIT APPROACH

INTRODUCTION

In 1931, in *United States v. Kirby Lumber Co.*,[1] the Supreme Court adopted the general rule that discharge of indebtedness[2] for less

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* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), (b), 94 Stat. 3389, 3389-96 (1980) (codified at 26 U.S.C.S. §§ 108, 1017 (Law. Co-op. Supp. 1981)). Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 through the date of amendment by the Bankruptcy Tax Act of 1980.

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

2. Transactions constituting a discharge include the purchase of bonds by a debtor, United States v. Kirby Lumber Co., 284 U.S. 1, 2-3 (1931); Commissioner v. Pittsburgh & W.V. Ry., 172 F.2d 1010, 1012 (3d Cir.), *cert. denied,* 337 U.S. 939 (1949); Blake v. Commissioner, 8 T.C. 546, 556 (1947), *acq.* 1947-2 C.B. 1; Montana, W. & S.R.R. v. Commissioner, 31 B.T.A. 62, 63 (1934), *aff'd per curiam,* 77 F.2d 1007 (3d Cir.), *cert. denied,* 296 U.S. 604 (1935); Woodward Iron Co. v. Commissioner, 24 B.T.A. 1050, 1052 (1931); *see* Commissioner v. Jacobson, 336 U.S. 28, 38 (1949); Treas. Reg. § 1.61-12(a) (1957); *id.* § 1.61-12(c)(3), T.D. 6984, 1969-1 C.B. 38, the running of the statute of limitations, Schweppe v. Commissioner, 168 F.2d 284, 284 (9th Cir. 1948) (per curiam); Securities Co. v. United States, 85 F. Supp. 532, 532-33 (S.D.N.Y. 1948); Miller Trust v. Commissioner, 76 T.C. 191, 195-99 (1981); Estate of Bankhead v. Commissioner, 60 T.C. 535, 540 (1973); *but see* Callan Court Co. v. Commissioner, 24 T.C.M. (CCH) 1419, 1430-31 (1965) (statute of limitations not controlling; gain realized the year the debt was written off), or an agreement to discharge the debt. Capitol Coal v. Commissioner, 250 F.2d 361, 362-63 (2d Cir. 1957), *cert. denied,* 356 U.S. 936 (1958); *see* United States v. Ingalls, 399 F.2d 143, 146-47 (5th Cir 1968), *cert. denied,* 393 U.S. 1094 (1969); Wener v. Commissioner, 242 F.2d 938, 943 (9th Cir. 1957). *But see* Walker v. Commissioner, 88 F.2d 170, 171 (5th Cir.) (agreement of future discharge does not trigger realization of income), *cert. denied,* 302 U.S. 692 (1937). The discharge must be clearly shown. *See* Hyde v. Commissioner, 64 T.C. 300, 307 (1975), *acq. in part* 1980-1 C.B. 1; Meyers v. Commissioner, 27 T.C.M. (CCH) 1535, 1536 (1968), *aff'd per curiam,* 435 F.2d 171 (3d Cir. 1970), *cert. denied,* 401 U.S. 957 (1971). Substitution of one creditor for another, however, does not constitute a discharge. Bittker & Thompson, *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 Calif. L. Rev. 1159, 1171 (1978). Until recently, acquisition of the debt by a related third party was not a discharge. *See* Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670, 673-74 (9th Cir. 1969); Cooper v. Commissioner, 37 T.C.M. (CCH) 760, 770 (1978); Forrester v. Commissioner, 4 T.C. 907, 920-21 (1945), *acq.* 1945-1 C.B. 3. *But see* American Packing & Provision Co. v. Commissioner, 36 B.T.A. 340, 344-46 (1937) (income realized when bonds were purchased by subsidiary); Rev. Rul. 61-96, 1961-1 C.B. 68, 69-70 (same). This allowed a friendly third party to acquire the debtor's obligations, without the debtor realizing income, and to transfer back the debt when the tax consequences were less burdensome for the debtor. Bittker & Thompson, *supra*, at 1173-74. Acquisition by related third parties is now a discharge. I.R.C. § 108(e)(4)(A). Related parties include members of the debtor's family, one of a group of controlled corporations, a trade or business under common control, or a controlling partnership. *See id.*

than the full amount of the debt may cause a taxpayer to realize income.[3] Section 61(a)(12) of the Internal Revenue Code (Code) only provides that income realized from discharge of a debt is recognized immediately,[4] and sections 108 and 1017,[5] before amendment by the Bankruptcy Tax Act of 1980 (Act),[6] only provided for an exception to immediate recognition.[7] Until passage of the Act, therefore, the Code did not provide any guidance for determining when income is realized from a discharge of indebtedness.[8] Most decisions follow *Kirby*.[9] Because of the lack of detailed guidelines for determining

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3. 284 U.S. at 3. Initially, courts were reluctant to recognize the principle of discharge of indebtedness income. *See* Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, 175 (1926); Burnet v. John F. Campbell Co., 50 F.2d 487, 488 (D.C. Cir. 1931); Commissioner v. Simmons Gin Co., 43 F.2d 327, 328-29 (10th Cir. 1930); American Tobacco Co. v. Commissioner, 20 B.T.A. 586, 588 (1930), *nonacq.* X-1 C.B. 73 (1931); Meyer Jewelry Co. v. Commissioner, 3 B.T.A. 1319, 1322-23 (1926). The courts' early reluctance to accept realization of discharge of indebtedness income stems from the Supreme Court's definition of income as "the gain derived from capital, from labor, or from both combined." Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Stratton's Independence, Ltd. v. Collector of Internal Revenue, 231 U.S. 399, 415 (1913)). *See* Kerbaugh-Empire Co. v. Bowers, 300 F. 938, 942, (S.D.N.Y. 1924), *aff'd*, 271 U.S. 170 (1926).

4. Under the Code, gains are normally included in the taxpayer's gross income in the year that the gain is realized. The Code provides for nonrecognition of gains under certain circumstances, however, so that the tax consequences are deferred. *See, e.g.*, I.R.C. §§ 351(a), 354(a), 1031(a), 1032 (a), 1035(a), 1036(a). Additionally, it is possible that a gain that has been realized will be excluded from all tax consequences under the Code. *See, e.g.*, *id.* §§ 102(a), 118(a).

5. I.R.C. §§ 108, 1017 (1976) (amended 1980).

6. Pub. L. No. 96-589, § 2(a), (b), 94 Stat. 3389, 3389-96 (codified at I.R.C. §§ 108, 1017).

7. I.R.C. §§ 108, 1017 (1976) (amended 1980).

8. Stone, *Cancellation of Indebtedness*, 1 N.Y.U. 34th Inst. on Fed. Tax'n 555, 555-56 (1976). Section 61 only provides that gross income includes "[i]ncome from discharge of indebtedness." I.R.C. § 61(a)(12). The treasury regulations under § 61, although more comprehensive, have proved incomplete. *See* Treas. Reg. § 1.61-12 (1968); Stone, *supra*, at 555 & n.1, 556. Sections 108 and 1017, prior to amendment in 1980, permitted deferment of ordinary income treatment of discharge of indebtedness income if certain requirements were satisfied. Neither section specified rules for realization of discharge income from different types of debt discharge, *id.*, even though detailed rules on discharge of indebtedness had been proposed in 1954 by the House of Representatives. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 12-13, A28-29, A35, A267, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4025, 4036-38, 4164-65, 4171-72, 4409. The Senate rejected the proposed rules, leaving the law "to be settled according to rules developed by the courts." S. Rep. No. 1622, 83d Cong., 2d Sess. 14, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4629, 4643.

9. *E.g.*, Helvering v. American Chicle Co., 291 U.S. 426, 430 (1934); Denman Tire & Rubber Co. v. Commissioner, 192 F.2d 261, 263 (6th Cir. 1951); Commissioner v. Stanley Co. of Am., 185 F.2d 979, 980-82 (2d Cir. 1951); Montana, W. & S.R.R. v. Commissioner, 77 F.2d 1007, 1007-08 (3d Cir.) (per curiam), *cert. denied*, 296 U.S. 604 (1935); Commissioner v. Coastwise Transp. Corp., 62 F.2d 332, 334 (1st Cir. 1932); Twin Ports Bridge Co. v. Commissioner, 27 B.T.A. 346, 355, 357 (1932).

when income is realized from discharging indebtedness, however, judicial exceptions to the *Kirby* rule based on policy grounds have been created.[10] The Act is intended to eliminate some of these exceptions, and to effectuate congressional intent merely to defer taxation of income realized from debt discharge.[11]

The Act substantially expands Code section 108[12] to establish certain rules for determining whether a specific discharge produces in-

10. *E.g.*, Helvering v. American Dental Co., 318 U.S. 322, 330-31 (1943) (gifts); United States v. Hall, 307 F.2d 238, 241-42 (10th Cir. 1962) (compromise of disputed liability); Commissioner v. Capento Sec. Corp., 140 F.2d 382, 386 (1st Cir. 1944) (stock for debt transfer); Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141, 143-44 (2d Cir. 1942) (contingent obligations); Helvering v. A.L. Killian Co., 128 F.2d 433, 434 (8th Cir. 1942) (purchase money obligations); Commissioner v. Mesta, 123 F.2d 986, 988 (3d Cir.) (property for debt transfer), *cert. denied*, 316 U.S. 695 (1941); Helvering v. Jane Holding Corp., 109 F.2d 933, 938-39 (8th Cir.) (contributions to capital), *cert. denied*, 310 U.S. 653 (1940); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934) (insolvent debtor); Collins v. Commissioner, 22 T.C.M. (CCH) 1467, 1471 (1963) (nonrecourse obligations); Barnhart-Morrow Consol. v. Commissioner, 47 B.T.A. 590, 600-01 (1942) (insolvent debtor), *acq.* 1944-1 C.B. 3, *aff'd*, 150 F.2d 285 (9th Cir. 1945); *see* Bittker & Thompson, *supra* note 2, at 1166; Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 225 (1959); Stone, *supra* note 8, at 556; Wright, *Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness* (pts. I-II), 49 Mich. L. Rev. 459, 460, 667, 698 (1951); Note, *A Review of Judicial Exceptions to the* Kirby Lumber *Rule*, 30 U. Fla. L. Rev. 94, 94-95 (1977). These exceptions also may have been caused by judicial reluctance to tax debtors in financial trouble. *See* Bittker & Thompson, *supra* note 2, at 1160. The insolvency exception is the most evident example of this reluctance. *See* Eustice, *supra*, at 246-47. The insolvency exception excluded discharge of indebtedness income income if the debtor was insolvent before and after the discharge. Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); Astoria Marine Constr. Co. v. Commissioner, 12 T.C. 798, 800-01 (1949); Main Properties v. Commissioner, 4 T.C. 364, 383-85 (1944), *acq.* 1945-1 C.B. 5; Kramon Dev. Co. v. Commissioner, 3 T.C. 342, 349 (1944), *acq.* 1944-1 C.B. 17; Treas. Reg. § 1.61-12(b)(1) (1957); Rev. Rul. 58-600, 1958-2 C.B. 29, 30. Discharge of indebtedness resulted only to the extent the debtor was made solvent. Haden Co. v. Commissioner, 118 F.2d 285, 286 (5th Cir.), *cert. denied*, 314 U.S. 622 (1941); Texas Gas Distrib. Co. v. Commissioner, 3 T.C. 57, 61-62 (1944), *acq.* 1944-1 C.B. 27; Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 291-92 (1937). *But see* Fifth Avenue-Fourteenth St. Corp. v. Commissioner, 147 F.2d 453, 457 (2d Cir. 1945) (insolvent debtor realized taxable income only to the extent the creditor would have recovered income after liquidation of the debtor). Paradoxically, although a discharge of indebtedness of an insolvent taxpayer outside of bankruptcy did not require the debtor to reduce the basis of retained property, a discharge of indebtedness in bankruptcy did. Treas. Reg. §§ 1.1016-7 to -8 (1957). The Bankruptcy Tax Act of 1980 has abolished the insolvency exclusion. Pub. L. No. 96-589, § 2(a), 94 Stat. 3392 (codified at I.R.C. § 108(e)(1)).

11. S. Rep. No. 1035, 96th Cong., 2d Sess. 10-11 (1980), *reprinted in* 1981 U.S. Code Cong. & Ad. News 11,329, 11,337-38 [hereinafter cited as Senate Report]; *see* I.R.C. § 108(e).

12. I.R.C. § 108, *amended by* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389 (1980). The Act also rewrote § 1017. I.R.C. § 1017, *amended by*

come,[13] and to permit special tax treatment other than nonrecognition.[14] Prior to the Act, income realized from a discharge was either recognized or nonrecognized.[15] The Act adds a third possible tax consequence involving the reduction of what are labelled "tax attributes" by the income realized from a debt discharge.[16] The tax attributes, in their order of reduction, are: (1) net operating losses; (2) certain tax credit carryovers; (3) capital loss carryovers; (4) bases of property; and (5) foreign tax credit carryovers.[17]

The tax consequences accorded discharge of indebtedness income under section 108[18] depend upon the financial status of the taxpayer.[19] A solvent taxpayer recognizes ordinary income,[20] or, in a business context, can elect nonrecognition of income[21] by reducing the

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Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(b), 94 Stat. 3394 (1980). Section 1017 is the discharge of indebtedness income nonrecognition section of the Code. To the extent allowed by the rules of § 108, income may be applied to reduce bases of property held by the taxpayer pursuant to the rules of § 1017, in lieu of immediate recognition of ordinary income.

13. *See* I.R.C. § 108(e).

14. *See id.* § 108(b).

15. *See id.* § 61(a)(12); I.R.C. §§ 108, 1017 (1976) (amended 1980); *supra* note 8.

16. I.R.C. § 108(b).

17. *Id.*

18. Section 108 provides the tax treatment of discharge of indebtedness income if the income is realized either in bankruptcy or when the taxpayer is insolvent. *Id.* § 108(a)(1), (b); *see infra* notes 25-29 and accompanying text. A solvent taxpayer can elect § 108 tax treatment. Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43; *see* I.R.C § 108(a)(1)(C), (c), (d)(4); *infra* notes 20-24 and accompanying text. Discharges of a bankrupt debtor will not be distinguished in this Note from discharges of an insolvent debtor.

19. *See* I.R.C. § 108(a), (b)(1). For a general discussion of § 108, see Ruge, *Tax Treatment of Discharge of Indebtedness—Bankrupt, Insolvent and Solvent Debtors* (pt.1), 2 N.Y.U. 39th Inst. on Fed. Tax'n 40-1, 40-19 to 40-24 (1981); Sheinfield & Caldwell, *Taxes: An Analysis of the Tax Provisions of the Bankruptcy Tax Act of 1980*, 55 Bankr. L.J. 97, 111-14 (1981).

20. Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43.

21. I.R.C. § 108(c), (d)(4). The discharged indebtedness to which such an election applies is called qualified business indebtedness, and this election is available to corporations or individuals involved in a trade or business. *Id.* § 108(d)(4); Temporary Treas. Reg. § 7a.1(c)(2) (1981). Whether an individual is involved in a trade or business is a question of fact. Treas. Reg. § 1.108(a)-1(a)(2) (1956). The debt can be qualified business indebtedness if used to purchase, improve, or repair property used in the taxpayer's trade or business, but not merely when the collateral for the indebtedness was used in the trade or business. *Id.*; *see* Rev. Rul. 76-86, 1976-1 C.B. 37, 38 (inventory is property used in a trade or business). Electing to treat the discharged debt as qualified business indebtedness allows the taxpayer to reduce bases in depreciable property rather than recognize ordinary income. I.R.C. § 108(c)(1)(A); *see* Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43.

bases of depreciable property.[22] If the taxpayer does not have enough basis to absorb all of the income, the excess is recognized immediately;[23] the solvent taxpayer does not have the option of reducing tax attributes.[24] An insolvent taxpayer, however, never recognizes ordinary income.[25] Such a taxpayer is required to reduce tax attributes by the discharge of indebtedness income,[26] unless he elects to reduce bases in depreciable property[27] in lieu of reducing tax attributes.[28]

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22. I.R.C. § 108(c); *see supra* note 21. Property is depreciable if covered by § 167, and the reduced basis decreases the permissible depreciation deduction. I.R.C. §§ 167, 1017(b)(3)(B); *see id.* § 108(d)(5). *See generally* Kem v. Commissioner, 51 T.C. 455, 460-62 (1968) (owner not allowed depreciation deductions on herd of cattle during period of lease), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

23. Senate Report, *supra* note 11, at 16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343; *see* I.R.C. § 108(c)(2).

24. *See* I.R.C. § 108(b)(1); Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43.

25. *See* I.R.C. § 108(a)(1)(B). This rule applies only to the extent the taxpayer is insolvent immediately prior to the discharge. *Id.* § 108(d)(3); Senate Report, *supra* note 11, at 15, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342. Congress defined insolvency as an "excess of liabilities over the fair market value of assets." I.R.C. § 108(d)(3). Although property exempt from claims of creditors is not included in the fair market value of the taxpayer's assets, Cole v. Commissioner, 42 B.T.A. 1110, 1113 (1940), *nonacq.* 1941-1 C.B. 13, intangible assets, such as goodwill, can be. *See, e.g.*, J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273, 1291-92 (1958), *acq.* 1959-1 C.B. 4; Conestoga Transp. Co. v. Commissioner, 17 T.C. 506, 514-15 (1951), *acq.* 1952-1 C.B. 2. *But see* Davis v. Commissioner, 69 T.C. 814, 834 (1978) (business expertise and established business relationships not included). For example, if a corporate taxpayer repurchased bonds issued at $100,000 for $25,000 cash, discharge of indebtedness income would be $75,000. If, before the discharge, the taxpayer had assets of $125,000 and liabilities of $200,000, the amount by which the taxpayer is insolvent is $75,000 and the $75,000 income will not be recognized. If, however, the amount by which the taxpayer is insolvent is only $50,000, $50,000 will not be recognized because of insolvency, and $25,000 will be ordinary income, or nonrecognized because of the qualified business indebtedness election. *See* Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43; *supra* notes 20-24 and accompanying text. In this situation, the creditor would ordinarily have long term capital gain or loss, *see* I.R.C. § 1232(a), although the debtor's income is ordinary if recognized. *See* I.R.C. § 61(a)(12); Eustice, *supra* note 10, at 232.

26. I.R.C. § 108(b). Discharge of indebtedness income must reduce, in order, the tax attributes of: (1) net operating loss and its carryovers; (2) certain credit carryovers; (3) net capital loss and its carryovers; (4) the bases for depreciable and nondepreciable property; and (5) foreign tax credit carryovers. *Id.* The reductions in (1), (3), and (4) are dollar for dollar; the reductions in (2) and (5) are one for two. *Id.* § 108(b)(3). The reduction in (4) cannot exceed the aggregate bases of the property, less the aggregate liabilities. *Id.* § 1017(b)(2). This limitation does not apply when the taxpayer elects to reduce bases of depreciable property before reducing tax attributes. *Id.*

27. This election applies only to the extent of the taxpayer's bases in depreciable property. I.R.C § 108(b)(5)(B). The income that exceeds these bases must be applied to reduce tax attributes. Temporary Treas. Reg. § 7a.1(c)(1)(i) (1981); Senate Re-

Any discharge of indebtedness income that remains after all tax attributes have been reduced is disregarded.[29]

Section 108 does not respond to all issues which arise when a determination must be made whether discharge of indebtedness income is realized.[30] It neither adequately defines indebtedness[31] nor reflects an adequate theoretical basis for realization of income.[32] Lacking guidance, courts have variously focused on the nature of the debt, the solvency of the debtor, the existence of a prior tax benefit to the debtor, the nature of the property transferred to effect the dis-

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port, *supra* note 11, at 13, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,340. For the purposes of this election or the election by a solvent debtor for nonrecognition treatment, *see supra* notes 20-24 and accompanying text, the debtor may increase available depreciable property in three ways. First, real property held as inventory for sale may be treated as depreciable property. I.R.C. § 1017(b)(3)(E). Second, stock in a subsidiary may be treated as depreciable property if the subsidiary reduces basis in its property and the parent and subsidiary file a consolidated return. *Id.* § 1017(b)(3)(D). This rule can apply through a chain of subsidiaries. Senate Report, *supra* note 11, at 15-16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,342-43. Third, the taxpayer may acquire additional depreciable assets. *See* I.R.C. §§ 108(b)(3)(B), (c)(2), 1017(a)(2) (period between cancellation and point of reducing bases during which taxpayer could acquire assets).

28. I.R.C. § 108(b)(5). The tax consequences of reducing tax attributes or depreciable property differ. Carryover expiration dates, whether carryovers should be preserved, and whether and how much income remains after reducing tax attributes should all be weighed by taxpayers. A taxpayer with few tax attributes would be foolish to elect to reduce bases of depreciable property. When the taxpayer elects to reduce bases the recognition of income is only postponed. Bittker & Thompson, *supra* note 2, at 1185. When the basis of property is reduced, depreciation deductions decrease and the gain from a sale increases. *Id.* Moreover, the amount that reduces the basis of property might have to be recaptured as ordinary income. I.R.C. § 1017(d). The Treasury Department is expected to issue regulations to set the order in which the taxpayer must reduce bases of assets under § 1017(b)(1), similar to Treas. Reg. §§ 1.1017-1,-2 (1956). Senate Report, *supra* note 11, at 15, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343. Because reduction of basis is not a disposition, I.R.C. § 1017(c)(2), the taxpayer need not recapture investment credits. Panhandle E. Pipe Line Co. v. United States, 654 F.2d 35, 44 (Ct. Cl. 1981) (taxpayer was entitled to its full investment credit despite the election to defer recognition of discharge of indebtedness income); Senate Report, *supra* note 11, at 20, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,347. *Contra* Treas. Reg. § 1.47-2(c) (1967) (basis reduction causes recapture); Rev. Rul. 74-184, 1974-1 C.B. 8 (recapture required under §§ 108 and 1017 (1976) (amended 1980)).

29. Senate Report, *supra* note 11, at 13, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,340; *see* I.R.C. § 108(a)(1), (b)(1).

30. *See* I.R.C. § 108(a)(1).

31. *See id.* § 108(d)(1)(A), (B) (any indebtedness liability or an encumbrance on the taxpayer's property). The regulations under the pre-amendment section 108, however, define indebtedness as "an obligation, absolute . . . to pay on demand or within a given time, in cash or another medium, a fixed amount." Treas. Reg. § 1.108(b)-1(c) (1956).

32. *See* I.R.C. § 108(a)(1)(A), (B), (C).

charge and the intentions of the creditor in accepting less than full payment as essential elements in determining whether income has been realized. This Note examines these varying approaches and criticizes their results as inconsistent and illogical.[33] It argues that a more appropriate basis for determining discharge of indebtedness income is the untaxed economic benefit received by the debtor. Once it is determined that income has been realized, whether it is recognized, nonrecognized, applied to reduce tax attributes, or excluded from all tax consequences will depend solely on Code provisions that already reflect policy considerations. With this two-step approach, consequences of discharges will be more certain and consistent.

I. Theories Underlying Discharge of Indebtedness Income

A. *Economic Benefit Theory*

Gross income includes the gain or benefit derived from all sources.[34] The central inquiry with respect to whether a taxpayer should realize income from the discharge of indebtedness, therefore, is whether the taxpayer received an untaxed economic benefit.[35] The initial economic benefit from borrowing is disregarded because this benefit is offset by the obligation to repay.[36] Taxing the initial benefit would seriously reduce the benefits of borrowing and impair debt financing. When the assumption of repayment is no longer justified, however, the initial economic benefit is not offset.[37] Absent countervailing congressional intent, therefore, the past economic benefit from borrowing, like other economic benefits, should be taxed.[38] In simple terms, "income results from the discharge of indebtedness because the taxpayer has received more than is paid back. . . ."[39] Admittedly,

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33. *See* Bittker & Thompson, *supra* note 2, at 1166-84; Eustice, *supra* note 10, at 231-53; Stone, *supra* note 8, at 559-73; Wright, *supra* note 10, at 465-84, 671-94.

34. I.R.C. § 61(a); *see id.* § 64; Treas. Reg. § 1.61-6(a) (1957).

35. Bittker & Thompson, *supra* note 2, at 1165-66; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 Yale L.J. 1153, 1176 (1940); *see* United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968); W. Andrews, Basic Federal Income Taxation 269 (2d ed. 1979); Eustice, *supra* note 10, at 225.

36. W. Andrews, *supra* note 35, at 269; Bittker & Thompson, *supra* note 2, at 1159, 1166. For a recent discussion concerning the appropriateness of initially excluding borrowed funds from income, see Popkin, *The Taxation of Borrowing*, 56 Ind. L.J. 43 (1980).

37. Bittker & Thompson, *supra* note 2, at 1165-66; Eustice, *supra* note 10, at 288.

38. Bittker & Thompson, *supra* note 2, at 1165-66; Eustice, *supra* note 10, at 288; Surrey, *supra* note 35, at 1176. The rationale for this rule can also be explained in tax benefit rule terminology. For a discussion of the tax benefit rule, see *infra* note 74. When the assumption of full repayment proves invalid, the taxpayer should realize income to rectify the erroneously granted tax benefit.

39. 1 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 6.4.1, at 6-31 (1981).

courts have not accepted the economic benefit theory.[40] Scrutiny of various fact patterns, however, demonstrates that it is more useful[41] and logical than the approach currently employed, the freeing of assets theory.

B. *Freeing of Assets Theory*

Courts relying on a freeing of assets theory reason that the discharge from debt for less than the amount owed releases, for the debtor's general use, assets which were "previously offset by the obligation" to repay and should, therefore, be taxed under *United States v. Kirby Lumber Co.*[42] This theory is not correctly focused and therefore is not consistently applied. On the one hand, various courts have refused to apply the theory to require realization of income when a promise to make a gift is revoked, or when a debt arising out of a tort is released,

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40. *See infra* notes 42-45 and accompanying text.

41. Valuation of the initial benefit and the consideration transferred to effect the discharge is beyond the scope of this Note. Cost, however, is a good starting point for valuation. *See* Guggenheim v. Rasquin, 312 U.S. 254, 258 (1941) ("[c]ost is cogent evidence of value"); St. Louis-S.F. Ry. v. United States, 444 F.2d 1102, 1107 (Ct. Cl. 1971) (consideration paid is better measure of value than face value), *cert. denied*, 404 U.S. 1017 (1972); Fashion Park, Inc. v. Commissioner, 21 T.C. 600, 604-06 (1954) (same), *nonacq.* 1955-1 C.B. 7; Gould v. Commissioner, 14 T.C. 414, 416 (1950) ("a sale [price] is regarded as the best evidence of the value of the article involved"). For a good discussion of the problems inherent in valuing property, see Cupler v. Commissioner, 64 T.C. 946, 954-59 (1975), *acq.* 1976-1 C.B. 1. Although applying the economic benefit theory may give rise to valuation problems, such problems should not be so burdensome as to outweigh the benefits obtained by correctly applying the theory. Such valuations are encountered in every facet of tax administration. *See, e.g.*, I.R.C § 84(a) (appreciated property transferred to a political organization); *id.* § 108(a)(3), (d)(3) (debtor's insolvency); *id.* § 334(a) (property received in a partial or complete liquidation); *id.* § 1001(b) (amount realized from disposition of property); *id.* §1015(a) (property acquired by gift); *id.* §§ 2031(a), (b), 2032(a) (gross estate of a decedent); *id.* § 2512 (valuation of gifts); Treas. Reg. § 1.170A-1(c)(1), (2), (3) (1972) (charitable contributions).

42. 284 U.S. 1, 3 (1931); *See* Commissioner v. Stanley Co. of Am., 185 F.2d 979, 981 (2d Cir. 1951); Commissioner v. Pittsburgh & W.V. Ry., 172 F.2d 1010, 1012-14 (3d Cir.), *cert. denied*, 337 U.S. 939 (1949); Central Paper Co. v. Commissioner, 158 F.2d 131, 133 (6th Cir. 1946); Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141, 143 (2d Cir. 1942); Haden Co. v. Commissioner, 118 F.2d 285, 286 (5th Cir.), *cert. denied*, 314 U.S. 622 (1941); Commissioner v. Coastwise Transp. Corp., 71 F.2d 104, 106 (1st Cir. 1934); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); Miller Trust v. Commissioner, 76 T.C. 191, 195, 201 (1981); Collins v. Commissioner, 22 T.C.M. (CCH) 1467, 1470-71 (1963); Bialock v. Commissioner, 35 T.C. 649, 660-62 (1961), *acq.* 1961-2 C.B. 4; Astoria Marine Constr. Co. v. Commissioner, 12 T.C. 798, 801 (1949); Kramon Dev. Co. v. Commissioner, 3 T.C. 342, 349 (1944), *acq.* 1944-1 C.B. 17; Texas Gas Distrib. Co. v. Commissioner, 3 T.C. 57, 61-62 (1944), *acq.* 1944-1 C.B. 27; Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 292 (1937); Bittker & Thompson, *supra* note 2, at 1165; Eustice, *supra* note 10, at 228.

despite the freeing of assets. The rationale is that a taxpayer does not realize income when assets are freed if no economic benefit was received by the debtor on creation of the liability.[43] On the other hand, courts have used the theory to exclude certain discharges, such as disputed or nonrecourse debt, despite the clear benefit received when the debt was incurred. It is reasoned that unless assets are freed, the discharge of such liabilities does not result in the realization of income.[44] For example, one individual borrowed $15,000 secured by $100 worth of stock under a nonrecourse note. The Tax Court held that his discharge of indebtedness income was limited to $100, the assets freed by the discharge.[45] Accordingly, $14,900 of benefit escaped taxation.

Kirby involved the repurchase by a corporation of its debt obligations for less than par.[46] The Supreme Court reasoned that the difference between the excess of the amount of the obligation over the amount paid to retire the obligation "made available" additional "assets" to the corporation and, therefore, caused it to "realize" an "accession to income."[47] The thrust of *Kirby* was to tax economic benefit. The Court's reference to freeing of assets was for the limited purpose of distinguishing its prior holding[48] in *Bowers v. Kerbaugh-Empire Co.*[49] in which the Court, in its first encounter with discharge

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43. *See* Bradford v. Commissioner, 233 F.2d 935, 937-38 (6th Cir. 1956) (discharge of liability that was assumed without consideration); Ruben v. Commissioner, 97 F.2d 926, 928-29 (8th Cir. 1938) (release from tort claim); Commissioner v. Rail Joint Co., 61 F.2d 751, 751-52 (2d Cir. 1932) (repurchase at discount of bonds previously distributed as dividends); C. Ludwig Baumann & Co. v. Commissioner, 2 T.C.M. (CCH) 188, 190 (1943) (discharge of debt that was assumed for cancellation of a lease); Warren & Sugarman, *Cancellation of Indebtedness and its Tax Consequences* (pt. 1), 40 Colum. L. Rev. 1326, 1332-33 (1940).

44. Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141, 143 (2d Cir. 1942) (contingent obligations); Collins v. Commissioner, 22 T.C.M. (CCH) 1467, 1471 (1963) (nonrecourse obligations); Astoria Marine Constr. Co. v. Commissioner, 12 T.C. 798, 801 (1949) (insolvency); Kramon Dev. Co. v. Commissioner, 3 T.C. 342, 349 (1944) (same), *acq.* 1944-1 C.B. 17; Texas Gas Distrib. Co. v. Commissioner, 3 T.C. 57, 61 (1944) (same), *acq.* 1944-1 C.B. 27; Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 292 (1937) (same); *see* Haden Co. v. Commissioner, 118 F.2d 285, 286 (5th Cir.) (same), *cert. denied*, 314 U.S. 622 (1941); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934) (same); N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263, 1265 (1939) (disputed debt), *nonacq.* 1940-1 C.B. 8; Bittker & Thompson, *supra* note 2, at 1165 & n.18.

45. Collins v. Commissioner, 22 T.C.M. (CCH) 1467, 1471 (1963).

46. 284 U.S. at 2.

47. *Id.* at 3.

48. *See id.*

49. 271 U.S. 170 (1926). *Kerbaugh* was decided five years before the Court adopted the general rule of discharge of indebtedness income in *Kirby*.

of indebtedness, rejected an argument for realization of discharge of indebtedness income.

The Court in *Kerbaugh-Empire* examined the net effect of a loan transaction and held that there was no income because the losses incurred from unsuccessful business activities, financed with the borrowed funds, exceeded the gain from discharge.[50] The *Kerbaugh* doctrine is broader than the economic benefit theory in that it adjusts for any subsequent loss, or a decline in value of the benefit received.[51] This adjustment is ill-founded because subsequent losses should be irrelevant to realization of discharge of indebtedness income.[52] Consider, for example, a taxpayer who borrows $1,000 to invest in a stock which subsequently becomes worthless. Under *Kerbaugh*, the loss of the $1,000 would offset the $1,000 received on borrowing and thus, no income would be realized on discharge. This is an incorrect result because the taxpayer received $1,000 which he was allowed to exclude from income under the assumption of full repayment and which he has now realized. Furthermore, the limitations on losses found in sections 165 and 1211 of the Code[53] may be frustrated by permitting a taxpayer to offset losses against discharge of indebtedness income.

Although *Kerbaugh* has been strongly criticized[54] and is given limited application,[55] it has never been overruled.[56] *Kerbaugh* is not only inconsistent with the more logical economic benefit theory,[57] it is

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50. 271 U.S. at 175.

51. *See id.* at 172-75; *see supra* notes 35-39 and accompanying text.

52. Bittker & Thompson, *supra* note 2, at 1162-66; Note, *Discharge of Indebtedness and the Federal Income Tax*, 53 Harv. L. Rev. 977, 985 (1940) [hereinafter cited as *Discharge of Indebtedness*].

53. *See* I.R.C. §§ 165, 1211.

54. *See* Bittker & Thompson, *supra* note 2, at 1162-66; Wright, *supra* note 10, at 461-65.

55. The taxpayer must clearly trace the subsequent loss to the borrowed money to escape realization of income under the *Kerbaugh* theory. *See* Commissioner v. Jacobson, 336 U.S. 28, 35 n.1, 39 n.4 (1949); Church's English Shoes, Ltd. v. Commissioner, 229 F.2d 957, 958 (2d Cir. 1956) (per curiam); Willard Helburn, Inc. v. Commissioner, 214 F.2d 815, 819 (1st Cir. 1954); Capitol Coal Corp. v. Commissioner, 26 T.C. 1183, 1194-95 (1956), *aff'd*, 250 F.2d 361 (2d Cir. 1957), *cert. denied*, 356 U.S. 936 (1958). This requirement is quite burdensome. *See id.* (commingled funds make tracing impracticable).

56. *See* Bradford v. Commissioner, 233 F.2d 935, 938-39 (6th Cir. 1956). *Kerbaugh* was arguably affirmed *sub silentio* in Commissioner v. Jacobson, 336 U.S. 28, 30 (1949) (leaving open the possibility of tracing losses to offset discharge of indebtedness gain).

57. The *Kerbaugh* theory is an economic benefit theory, but differs from the economic benefit theory as proposed in this Note. Under *Kerbaugh*, the economic benefit received as a result of borrowing is valued as of the time of the discharge. The economic benefit should be the value as of the time of borrowing. It is this value which is excluded from income because of the assumption of full payment. *See supra* notes 35-39 and accompanying text.

also inconsistent with the Supreme Court's position that the government can compute income on an annual basis.[58] If *Kerbaugh* is utilized in a particular fact pattern, an adjustment should be made for tax benefits derived from the subsequent loss, such as deductions for business losses.[59]

II. Type of Debt Discharged

The economic benefit theory compares the value of the benefit received by the debtor as a result of borrowing with the value of the consideration transferred to discharge the obligation.[60] The nature of the debt discharged is irrelevant to determinations made under this theory. Many courts, however, have looked to the nature of the discharged debt. Focusing on this inquiry permits economic benefits to remain untaxed and may frustrate congressional intent.

A. *Less Than Absolute Liability*

Because courts focus on the freeing of assets, an initial question has been whether assets were encumbered by the obligation to repay. Whether this obligation is absolute has therefore affected the determination of discharge of indebtedness income. Some courts hold that disputed indebtedness does not encumber assets and, therefore, discharge of indebtedness income is not realized from the compromise discharge of such indebtedness.[61] In effect, the initial economic bene-

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58. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364 (1931). "A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first [year's income]. . . ." *Id.* at 364-65. Under the proposed economic benefit theory, the taxpayer in the example in the text would realize income from the discharge of indebtedness in the year of discharge, and capital loss for the worthless security in the year of worthlessness. *See* I.R.C. § 165(g).

59. Bittker & Thompson, *supra* note 2, at 1163; *Discharge of Indebtedness*, *supra* note 52, at 985; *see* I.R.C. § 165(a), (c). Otherwise the taxpayer may receive a double tax benefit: first, a deduction under the applicable code section; and, second, an offset against discharge of indebtedness income.

60. *See supra* notes 35-39 and accompanying text.

61. *See, e.g.*, United States v. Hall, 307 F.2d 238, 240-41 (10th Cir. 1962); Fidelity & Columbia Trust Co. v. Lucas, 11 F. Supp. 537, 539 (W.D. Ky. 1935), *aff'd on other grounds*, 89 F.2d 945 (6th Cir. 1937); N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263, 1265 (1939), *nonacq.* 1940-1 C.B. 8. *But cf.* Standard Brass & Mfg. Co. v. Commissioner, 20 T.C. 371, 375-76 (1953) (compromise discharge of indebtedness for accrued and previously deducted royalties resulted in income), *aff'd per curiam*, 218 F.2d 352 (5th Cir. 1955); Commercial Elec. Supply Co. v. Commissioner, 8 B.T.A. 986, 991-92 (1927) (settlement of legal dispute gave rise to income). Some commentators support this result because of the difficulty of measuring the debt discharged. *See* Blattner, *Debt Cancellation*, 1 N.Y.U. 30th Inst. on Fed. Tax'n 237, 253 (1972); Eustice, *supra* note 10, at 237; Wright, *supra* note 10, at 680.

fit is excluded because of the assumption of repayment, and when that assumption proves erroneous, the discharge of indebtedness income is excluded because the indebtedness is disputed. If the debtor has in fact received an untaxed economic benefit,[62] however, this benefit should be taxed. Furthermore, this exception is susceptible to abuse. It permits the use of a self-serving dispute to avoid taxation despite receipt by the debtor of a clear initial economic benefit.[63]

Under the freeing of assets theory, discharge of contingent obligations also may not result in income.[64] For example, the Tax Court has held that a debtor did not realize income from a discharge because, under terms of the loan agreement, the debtor and the creditor could rescind the indebtedness at any time, and consequently, the debtor had no assets tied up by the debt.[65] This result, however, ignores an economic benefit that was initially excluded from gross income because of the assumption that the loan would be repaid in full. Applying the economic benefit theory would prevent this result.[66]

Similarly, release from a nonrecourse debt[67] may not result in discharge of indebtedness income. The Tax Court has held that the income realized on the discharge of such debt is limited to the value of the collateral pledged,[68] rather than the value of the initial benefit received as a result of borrowing.[69] A contrary result occurs, however, when the value of the loan comprises part of the adjusted basis of the collateral transferred to discharge the obligation.[70] In this situation, the Tax Court treats the discharge as a sale or exchange subject to capital gains treatment, and measures the gain as the difference between the amount due on the debt, presumably the measure of the economic benefit received but not yet repaid, and the adjusted

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62. For a discussion of the measurement problems that this might entail, see *supra* note 41.

63. *See* N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263, 1265 (1939), *nonacq.* 1940-1 C.B. 8.

64. Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141, 143 (2d Cir. 1942); Main Properties, Inc. v. Commissioner, 4 T.C. 364, 379 (1944), *acq.* 1945-1 C.B. 5; Terminal Inv. Co. v. Commissioner, 2 T.C. 1004, 1013-15 (1943), *acq.* 1944-1 C.B. 27.

65. Main Properties, Inc. v. Commissioner, 4 T.C. 364, 379-80 (1944) (stock that had become worthless exchanged for note), *acq.* 1945-1 C.B. 5.

66. *See supra* notes 35-39 and accompanying text.

67. A debtor is not personally liable for a nonrecourse debt. Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 Or. L. Rev. 3, 3 (1980). A creditor can only forelose on the security for the loan. *See* Millar v. Commissioner, 577 F.2d 212, 213-15 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).

68. Collins v. Commissioner, 22 T.C.M. (CCH) 1467, 1471 (1963) ($100 income on the forgiveness of a $15,000 nonrecourse loan secured by stock worth only $100).

69. *See supra* notes 35-39 and accompanying text.

70. Crane v. Commissioner, 331 U.S. 1 (1947), requires that a purchase money obligation be reflected in the purchaser's adjusted basis of the property. *Id.* at 6-11.

basis of the collateral transferred.[71] No rationale is offered for the two different results. The correct measure of the debtor's income should not depend on whether the basis of the collateral includes the nonrecourse loan amount. Because Congress specifically included nonrecourse debt within the definition of indebtedness in section 108,[72] nonrecourse debt should be included under general discharge of indebtedness rules, which should focus on whether the debtor has fully repaid any initial untaxed benefit received on borrowing.[73]

B. *Non-principal Debt*

The Commissioner of Internal Revenue (Commissioner) and the courts also exclude from discharge of indebtedness income non-principal debt that failed to produce a prior tax benefit.[74] In other words,

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71. Estate of Delman v. Commissioner, 73 T.C. 15, 28 (1979); Millar v. Commissioner, 67 T.C. 656, 660 (1977), *aff'd*, 577 F.2d 212, 214-16 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978). *Contra* Tufts v. Commissioner, 651 F.2d 1058, 1063 (5th Cir. 1981), *rev'g* 70 T.C. 756, 763-66 (1978). *See generally infra* notes 117-124 and accompanying text (transfer of property to discharge a debt). For a good discussion of *Crane, Millar* and *Tufts*, see Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 Or. L. Rev. 3 (1980).

72. I.R.C. § 108(d)(1)(B).

73. *See supra* notes 35-39 and accompanying text.

74. *E.g.*, Barnhart-Morrow Consol. v. Commissioner, 47 B.T.A. 590, 600-01 (1942), *acq.* 1944-1 C.B. 3, *aff'd*, 150 F.2d 285 (9th Cir. 1945); Rev. Rul. 67-200, 1967-1 C.B. 15, *clarified*, Rev. Rul. 70-406, 1970-2 C.B. 16; Private Letter Ruling 7845004 (July 27, 1978); *see* Rev. Rul. 76-316, 1976-2 C.B. 22 (superceding Rev. Rul. 73-432, 1973-2 C.B. 17) (extends to relations between a corporation and its subsidiary). This is the same result that is obtained under the tax benefit rule. Under the tax benefit rule if a taxpayer has derived a tax benefit from a deduction in a previous year, the subsequent recovery of that item results in the realization of income. 34 Am. Jur. 2d Fed. Tax § 5250 (1981). Thus, if the prior deduction did not produce a tax benefit, the subsequent cancellation of the liability would not result in income under the tax benefit rule. *See* Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265, 265-66, 273 (1978); O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 Tax L. Rev. 215, 215, 240-44 (1972); Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev. 129, 130, 140-44 (1943). Congress has expressly recognized the tax benefit rule as applied to bad debts, prior taxes, and delinquency amounts. I.R.C. § 111; *see* Merchants Nat'l Bank v. Commissioner, 199 F.2d 657, 659 (5th Cir. 1952) (bad debts); Union Trust Co. v. Commissioner, 111 F.2d 60, 61 (7th Cir.) (taxes), *cert. denied*, 311 U.S. 658 (1940). The Regulations extend the rule to "all other losses, expenditures, and accruals." Treas. Reg. § 1.111-1(a) (1956); *see* Hillsboro Nat'l Bank v. Commissioner, 641 F.2d 529, 530-31 (7th Cir. 1981) (refunds); Mayfair Minerals, Inc. v. Commissioner, 456 F.2d 622, 623 (5th Cir. 1972) (per curiam) (refunds);' Bear Mfg. Co. v. United States, 430 F.2d 152, 154 (7th Cir. 1970) (contract liability), *cert. denied*, 400 U.S. 1021 (1971); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 403 (Ct. Cl. 1967) (charitable contribution); Mont-

the taxpayer is shielded from realizing discharge of indebtedness income to the extent that the deductions of non-principal indebtedness, such as rent, royalties, salaries, or interest, which can be accrued and deducted by the debtor as ordinary and necessary business expenses, did not reduce taxes.[75] This exception produces the same tax treatment regardless of whether the non-principal debt is paid in full or in part, despite the receipt of differing untaxed economic benefits.[76] Despite the absence of a tax benefit from deducting the debt expense, when the non-principal debt is not paid in full, the taxpayer receives an economic benefit from the borrowing and should realize discharge of indebtedness income.[77]

C. *Purchase Money Obligation*

Courts have found that the compromise reduction of a purchase money obligation is a purchase price adjustment, and have required the debtor to reduce the basis of the purchased property rather than recognize discharge of indebtedness income.[78] Although Congress has

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gomery v. Commissioner, 65 T.C. 511, 520 (1975) (casualty loss). Courts recently have held that the tax benefit rule overrides the exclusionary rules of I.R.C. § 337. Connery v. United States, 460 F.2d 1130, 1132-33 (3d Cir. 1972); Spitalny v. United States, 430 F.2d 195, 197-98 (9th Cir. 1970); Commissioner v. Anders, 414 F.2d 1283, 1287-88 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969); Anders v. United States, 462 F.2d 1147, 1148-49 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972); Estate of Munter v. Commissioner, 63 T.C. 663, 674-77 (1975). *But see* Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 838-40 (9th Cir. 1963) (inapplicable in § 336 liquidations). The Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(c), 94 Stat. 3396 (1980) (codified at I.R.C. § 111(d)), provides that deductions that increase an unexpired carryover are considered to have produced a tax benefit. I.R.C. § 111(d). Because most non-principal debts will increase some carryover which has not yet expired, the rule of excluding discharge of indebtedness income merely because the debt had not reduced taxes will arise only infrequently.

75. *See* I.R.C. § 162(a); *see, e.g.*, Retail Properties, Inc. v. Commissioner, 23 T.C.M. (CCH) 1463, 1474-75 (1964); Warner Co. v. Commissioner, 11 T.C. 419, 430 (1948), *aff'd per curiam*, 181 F.2d 599 (3d Cir. 1950); Rev. Rul. 67-200, 1967-1 C.B. 15, *clarified*, Rev. Rul. 70-406, 1970-2 C.B. 16. Although principal indebtedness may indirectly generate depreciation deductions or other types of deductions, no inquiry is made to determine whether these deductions have or have not generated tax benefits. *See* Bittker & Thompson, *supra* note 2, at 1181.

76. *See* Wright, *supra* note 10, at 673. The economic benefit would be in the form of services or the use of property or money rather than the receipt of borrowed funds. Eustice, *supra* note 10, at 253.

77. *See supra* notes 35-39 and accompanying text.

78. Commissioner v. Sherman, 135 F.2d 68, 70 (6th Cir. 1943); Helvering v. A.L. Killian Co., 128 F.2d 433, 434-35 (8th Cir. 1942); Hirsh v. Commissioner, 115 F.2d 656, 658 (7th Cir. 1940); Gehring Publishing Co. v. Commissioner, 1 T.C. 345, 353-54 (1942), *acq.* 1943-1 C.B. 9; Pinkney Packing Co. v. Commissioner, 42 B.T.A. 823, 829-30 (1940), *acq.* 1941-1 C.B. 8; *see* Hextell v. Huston, 28 F. Supp. 521, 523 (S.D. Iowa 1939).

adopted this special treatment for purchase money obligations as a part of an objective test to resolve whether a particular debt reduction should result in discharge of indebtedness income or a price adjustment,[79] it has confined the treatment of reductions to discharges of the debt of the solvent buyer by the original seller.[80] Nevertheless, even this limited application of the rule produces inconsistent results.

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79. Senate Report, *supra* note 11, at 16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343-44. Additionally, courts have refused to adjust basis if, after the debt reduction, the fair market value of the property exceeds the debt. Montgomery v. Commissioner, 65 T.C. 511, 521 (1975); Blattner, *supra* note 61, at 252; Wilson, *Taxation of Debt Collection and Cancellation*, 48 Calif. L. Rev. 623, 642 (1960); Wright, *supra* note 10, at 677; *see* Commissioner v. Coastwise Transp. Corp., 71 F.2d 104, 106 (1st Cir.), *cert. denied*, 293 U.S. 595 (1934); L.D. Coddon & Bros. v. Commissioner, 37 B.T.A. 393, 398-99 (1938). This distinction is fallacious and should be rejected. *See* Surrey, *supra* note 35, at 1169; Wright, *supra* note 10, at 678-79. Whether the value declines one dollar below the debt is of little consequence. The distinction results in realization of discharge of indebtedness income if the property value falls to one dollar above the debt and adjustment of purchase price if it falls to the debt or below. Congressional intent to establish an objective test supports rejection of this distinction. *See* Senate Report, *supra* note 11, at 16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343-44. Additionally, the Tax Court has suggested that price adjustment does not apply when the debt reduction amount exceeds the adjusted basis of the property due to depreciation deductions. Montgomery v. Commissioner, 65 T.C. 511, 522 (1975). In this fact pattern, if the purchase price adjustment is used, the excess of the debt reduction over the basis of the property should give rise to either ordinary income under a tax benefit analysis, *see* Parker v. Delaney, 186 F.2d 455, 457-59 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); *supra* note 74; *cf.* Senate Report, *supra* note 11, at 20 & n.24, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,347 & n.24 (purchase price adjustment requires recapture of investment credit), or discharge of indebtedness income under the economic benefit theory. *See supra* notes 35-39 and accompanying text. Both analyses seem equally appropriate although the tax consequences differ if the excess reduction is characterized as discharge of indebtedness income and the debtor elects to reduce bases of other depreciable property. *See supra* notes 20-29 and accompanying text.

80. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3393 (1980) (codified at I.R.C. § 108(e)(5)); Senate Report, *supra* note 11, at 16, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343-44. For example, the rule does not apply to a mortgage debt placed on the property after purchase. *Id.; see* Edwards v. Commissioner, 19 T.C. 275, 281 (1952), *acq.* 1953-1 C.B. 4. *Contra* Hirsch v. Commissioner, 115 F.2d 656, 658 (7th Cir. 1940). The reduction must result from direct negotiation between buyer and seller, not from an unrelated cause such as the running of the statute of limitations. Senate Report, *supra* note 11, at 16-17, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,343-44; *see, e.g.*, Fifth Avenue-Fourteenth St. Corp. v. Commissioner, 147 F.2d 453, 456-57 (2d Cir. 1945); Commissioner v. Coastwise Transp. Corp., 71 F.2d 104, 105-06 (1st Cir.), *cert. denied*, 293 U.S. 595 (1934). A purchase price adjustment is a disposition under the investment credit rules of the Code. Senate Report, *supra* note 11, at 20 n.24, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,347 n.24. In contrast, a basis reduction is not a disposition. *See supra* note 28.

Superficially, the purchase price adjustment has the same effect as discharge of qualified business indebtedness;[81] more gain, or less loss, will be realized when the property is sold or exchanged, and if the purchased property is depreciable, deductions for depreciation will decrease.[82] Purchase price adjustment may, however, have more beneficial tax consequences. A purchase price adjustment need not involve depreciable property, as is required for discharges of qualified business indebtedness.[83] Also, individual taxpayers can utilize the purchase price adjustment for property not used in their trade or business.[84] Lastly, the reduction in basis because of a discharge of qualified business indebtedness must be recaptured as ordinary income if there is a gain on disposition; whereas a purchase price adjustment results in capital gain.[85]

Because the compromise reduction is often essentially a discharge, the question arises whether the exception is justified. If the value of the property was overstated at the time that the purchase money obligation arose, no discharge of indebtedness income should be realized under the economic benefit theory because the debtor has not received an unpaid for economic benefit.[86] The purchase price adjustment would be appropriate in such a case because the reduction of the purchase price would merely correct the originally overstated value. The adjustment, however, has also been applied when the debtor received an initial economic benefit that was never paid for, as when the creditor reduced the purchase money obligation because the market value of the property declined after purchase.[87] The rationale is that because the debtor suffers an overall loss due to a subsequent decline in the value of the property, no discharge of indebtedness income is realized.[88] As has been discussed, this overall loss theory is of dubious validity.[89] Under the economic benefit theory, only the value of the property received for the debt—the untaxed economic

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81. *See supra* note 21.
82. *See supra* note 28.
83. *See* I.R.C. § 108(c)(1)(A), (e)(5); *supra* note 21.
84. *See* I.R.C. § 108(d)(4), (e)(5).
85. *See id.* §§ 1017(d), 1221, 1222, 1231.
86. *See supra* notes 35-39 and accompanying text. The economic benefit theory compares the value of the original untaxed economic benefit with the amount eventually paid for the benefit. *See id.* Subsequent revaluation of the purchased property merely values the initial untaxed benefit correctly.
87. *See* cases cited *supra* note 78.
88. *See* Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, 172-75 (1926); Commissioner v. Sherman, 135 F.2d 68, 70 (6th Cir. 1943); Helvering v. A.L. Killian Co., 128 F.2d 433, 435 (8th Cir. 1942); Hextell v. Huston, 28 F. Supp. 521, 522-23 (S.D. Iowa 1939); Bittker & Thompson, *supra* note 2, at 1170 & n.35; Stone, *supra* note 8, at 556.
89. *See supra* notes 49-58 and accompanying text.

benefit as of the time of borrowing—and the amount paid for the discharge are relevant. Subsequent declines in the value of the economic benefit are not considered.[90] Although Congress has allowed the use of the purchase price adjustment, albeit in limited circumstances,[91] to foster certainty in tax administration,[92] such adjustment may permit the unwarranted avoidance of tax.[93] Elimination of the use of the adjustment would provide the same certainty and result in more consistent tax treatment.

III. Type of Consideration Transferred

The nature of the consideration transferred to discharge debt has affected whether discharge of indebtedness income is realized. A debtor may transfer property or perform services rather than transfer money to discharge part or all of the debt. Under the economic benefit theory, however, the consideration transferred by the debtor to discharge the debt is not a factor with respect to whether income is realized.[94]

A. *Stock for Debt*

1. Principal Debt

Traditionally, a corporate debtor does not realize taxable income when it issues stock in exchange for debt, even though the stock may be worth less than the debt.[95] This rule, created by courts and accepted by the Commissioner, was codified in new section 108.[96] In

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90. *See supra* notes 35-39 and accompanying text. Furthermore, such use of the purchase price adjustment has necessitated the administrative inconvenience of considering what happens to property after purchase. *See Discharge of Indebtedness*, *supra* note 52, at 987-88.

91. *See supra* note 80 and accompanying text.

92. *See supra* note 79 and accompanying text.

93. Under the rule as codified by Congress, *see supra* note 80, a debtor and creditor are able to have transactions that are essentially equivalent to discharges of indebtedness treated as price adjustments.

94. *See supra* notes 35-39 and accompanying text. The Code should determine how this income will be taxed or whether it will be excluded from all tax consequences.

95. Commissioner v. Capento Sec. Corp., 140 F.2d 382, 385-86 (1st Cir. 1944); Rev. Rul. 59-222, 1959-1 C.B. 80, 82; *see* Tower Bldg. Corp. v. Commissioner, 6 T.C. 125, 134-35 (1946), *acq.* 1947-1 C.B. 4 (nonacq. withdrawn); I.R.C. § 108(e)(8). The Commissioner reasons that a stock for debt transaction is a mere change from a fixed indebtedness to a capital stock liability. Rev. Rul. 59-222, 1959-1 C.B. 80, 82; *see* Eustice, *supra* note 10, at 238. Stock is not debt, however, Eyster v. Centennial Bd. of Fin., 94 U.S. 500, 502 (1876); Claridge Apartments Co. v. Commissioner, 138 F.2d 962, 965 (7th Cir. 1943), *rev'd on other grounds*, 323 U.S. 141 (1944), and this rationale is suspect. *Cf.* Twin Ports Bridge Co. v. Commissioner, 27 B.T.A. 346, 355, 357 (1932) (taxpayer realized discharge of indebtedness income from the transfer of stock of another corporation for its debt).

96. *See* I.R.C. § 108(e)(8); Senate Report, *supra* note 11, at 11, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,338.

amending this section, Congress sought to encourage reorganization, rather than liquidation, of financially distressed companies.[97] Although this policy is commendable,[98] section 108 does not adequately implement it. For example, stock for debt transfers that do not involve financially distressed companies seemingly are eligible to receive this preferential treatment.[99] In addition, reorganizations such as debt for debt transfers, which may involve financially distressed companies, are not expressly covered by section 108, and thus, may cause discharge of indebtedness income to be realized.[100] To implement the legislative intent, courts should construe the statute so as to apply the rule only to financially distressed companies and to any form of reorganization.[101] Financially sound companies should realize discharge of indebtedness income,[102] which should be taxed under the general rules of sections 61 and 108.[103]

97. Senate Report, *supra* note 11, at 11, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,338. The House, however, would have eliminated the stock for debt rule. *Id.* This rule does not apply if only nominal or token shares of stock are issued to discharge the debt. I.R.C. § 108(e)(8)(A). This determination is factual and turns on whether the creditor receives an equity interest in the corporation after the discharge. Senate Report, *supra* note 11, at 17, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,344. When discharged for stock and other property, the debt is considered satisfied first by the other property and then by the stock. *Id.* Finally, deductions taken because of the debt, such as a bad debt deduction, are subject to recapture under § 1245. I.R.C. § 108(e)(7)(A); Senate Report, *supra* note 11, at 18, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,345.

98. As was said earlier, policy considerations should influence how realized income is taxed—not whether, in fact, income is realized. The result is identical, however, whether income is held not to be realized or, for policy reasons, is excluded from all tax consequences. Because income should be realized under the economic benefit theory if the stock transferred is worth less than the liability, the stock for debt rule is more correctly understood to exclude from tax consequences income that is realized.

99. The exclusion provisions of § 108 are not expressly limited to financially distressed debtors. *See* I.R.C. § 108(e)(8).

100. *See* Commissioner v. Stanley Co. of Am., 185 F.2d 979, 981 (2d Cir. 1951); Commissioner v. Coastwise Transp. Corp., 71 F.2d 104, 105-06 (1st Cir.), *cert. denied*, 293 U.S. 595 (1934); Rev. Rul. 77-437, 1977-2 C.B. 28; Eustice, *supra* note 10, at 241. Ancillary changes in the terms of indebtedness, such as extension of maturity or reduction of interest rate, do not constitute a discharge, and thus, no income is realized. *See* Rev. Rul. 58-546, 1958-2 C.B. 143. Where the difference between the value of the exchanged debts is small, however, courts have characterized the difference as a premium on issuance of the new debt. Great W. Power Co. v. Commissioner, 297 U.S. 543, 546-47 (1936); Virginia Elec. & Power Co. v. Early, 52 F. Supp. 835, 837 (E.D. Va. 1943); Eustice, *supra* note 10, at 241; Stone, *supra* note 8, at 562. This distinction is significant because premium on debt is prorated or amortized over the life of the debt, Treas. Reg. § 1.61-12 (c)(2), T.D. 6984, 1969-1 C.B. 38, while discharge of indebtedness income is immediately subject to § 108 treatment. *See* I.R.C. § 108 (a)(1).

101. *See* Senate Report, *supra* note 11, at 11, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,338.

102. *See supra* notes 35-39 and accompanying text.

103. *See supra* notes 18-29 and accompanying text.

2. Interest

When debt is discharged in return for stock, interest accrued on the debt should be considered separately from the debt. Prior to the Act, the discharged interest in a reorganization was treated as part of the discharged debt and was not taxed to either the debtor or creditor.[104] Under the Act,[105] however, a cash basis creditor who exchanges securities in a Code reorganization, including stock for debt recapitalizations,[106] realizes interest income to the extent of the stock received for the accrued unpaid interest.[107] The Act does not address the tax consequences to the debtor. The question is, therefore, whether the bifurcation of principal and accrued interest for assessing the tax consequences to the creditor should be similarly applied to the debtor for discharge of indebtedness income purposes.

Although the income realized on the discharge of the principal is excluded from tax consequences because of the stock for debt rule,[108] the income realized from the discharge of interest is not similarly excluded. Thus, the debtor may realize discharge of indebtedness income on the discharge of accrued interest. Allocation of stock to accrued interest in a stock for debt discharge can be designated in the plan of reorganization.[109] If no designation is made, the stock may be allocated between the principal and interest on a pro rata basis, or stock may be deemed transferred first to discharge the interest, as it is for the creditor.[110]

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104. *See* Commissioner v. Carman, 189 F.2d 363, 364-65 (2d Cir. 1951); Rev. Rul. 59-98, 1959-1 C.B. 76, 76-77.

105. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 4(e)(1), 94 Stat. 3403 (1980) (codified at I.R.C. § 354(a)(2)(B), (a)(3)(B)).

106. *See* I.R.C. § 368(a)(1)(E); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.17, at 14-76 to -77 (abr. 4th ed. 1979). A discharge of a corporation's bonds for preferred stock is a recapitilzation. Treas. Reg. § 1.368-2(e)(1) (1955). The reorganization also must have a business purpose. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

107. Senate Report, *supra* note 11, at 34, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,361; *see* I.R.C. § 354(a)(2)(B), (a)(3)(B). Prior to the Act, courts uniformly held that stock transferred was not received in exchange for accrued interest. *E.g.*, Tandy Corp. v. United States, 626 F.2d 1186, 1193-95 (5th Cir. 1980); Columbia Gas Sys. v. United States, 473 F.2d 1244, 1247-50 (2d Cir. 1973); Bethlehem Steel Corp. v. United States, 434 F.2d 1357, 1361 (Ct. Cl. 1970); Scott Paper Co. v. Commissioner, 74 T.C. 137, 163-64 (1980).

108. I.R.C. § 108(e)(8); *see supra* notes 95-96 and accompanying text.

109. *See* Senate Report, *supra* note 11, at 38, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,364 (indicating that the Act is intended to abrogate the rule in Commissioner v. Carman, 189 F.2d 363 (2d Cir. 1951)). In *Carman*, the Second Circuit deemed irrelevant a designation by the debtor that stock was transferred to discharge accrued interest. 189 F.2d at 364.

110. *See* Senate Report, *supra* note 11, at 34, 38, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,360, 11,364.

Regardless of the method of allocation, if the fair market value of the stock[111] allocated to discharge the accrued interest is less than the amount of the interest, the debtor should realize discharge of indebtedness income under the economic benefit theory.[112] The Second Circuit[113] has held that where no allocation was made, none of the stock transferred was attributable to the discharge of interest, and therefore, the debtor realized discharge of indebtedness income in the amount of the discharged interest.[114] The argument might be raised that forcing the debtor to realize discharge of indebtedness income is inconsistent with the congressional policy of encouraging reorganizations.[115] Congress has specifically decided, however, that the creditor must realize income to the extent stock is transferred to pay the interest.[116] Because it is the creditor who must approve the discharge, it is not a deterrence to a reorganization that, in lieu of the creditor realizing interest income, the debtor realize some discharge of indebtedness income.

B. *Property for Debt*

The transfer of property to discharge debt is another instance in which the nature of the consideration for the discharge of indebtedness affects the tax consequences. Courts generally treat such a transfer as a sale or exchange of property, and measure the gain as the excess of the value of the debt over the adjusted basis of the property.[117] No distinction is made between gain attributable to appreci-

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111. Admittedly, determining the fair market value of stock that is being issued may pose a measurement problem. *See supra* note 41. Nevertheless, such a measurement is congressionally mandated when an unsecured creditor receives stock in a "workout." Senate Report, *supra* note 11, at 17, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,344; *see* I.R.C. § 108(e)(8)(B).

112. *See supra* notes 35-39 and accompanying text. The reorganization provisions of the Code do not exclude discharge of indebtedness income to the corporation. *See* I.R.C. §354(a); Eustice, *supra* note 10, at 238.

113. Columbia Gas Sys. v. United States, 473 F.2d 1244 (2d Cir. 1973).

114. *Id.* at 1247-50. The stock for debt and accrued interest transfer was not a Code reorganization, *id.* at 1246, but this would not appear to be significant.

115. *See supra* note 97 and accompanying text.

116. *See supra* notes 105-07 and accompanying text.

117. *See* Commissioner v. Mesta, 123 F.2d 986, 988 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942); Kenan v. Commissioner, 114 F.2d 217, 219-20 (2d Cir. 1940); Peninsula Properties Co. v. Commissioner, 47 B.T.A. 84, 91-92 (1942), *acq.* 1942-2 C.B. 14. *But see* Turney's Estate v. Commissioner, 126 F.2d 712, 713 (5th Cir. 1942) (treated as a discharge of indebtedness). Similarly, if a secured nonrecourse debt that is also a purchase money obligation is foreclosed or transferred to the creditor, courts hold that the debtor realizes a gain or loss from a sale or exchange rather than discharge of indebtedness. *See* Electro-Chemical Engraving Co. v. Commissioner, 311 U.S. 513, 514 (1941); Helvering v. Hammel, 311 U.S. 504, 510 (1941); Commissioner v. Fortee Properties, 211 F.2d 915, 916 (2d Cir.), *cert. denied*, 348 U.S. 826 (1954); R. O'Dell & Sons v. Commissioner, 169 F.2d 247, 248 (3d Cir. 1948); Estate

ated property and gain from the discharge of indebtedness.[118] If the fair market value of the property transferred differs from the value of the debt, however, gain from the sale or exchange of the property should only equal the excess of its fair market value over adjusted basis, and under the economic benefit theory, discharge of indebtedness income should equal the excess of the amount due on the debt over fair market value of the property, the actual amount paid to discharge the debt.[119]

Although the taxable income is, in some circumstances, characterized incorrectly without bifurcation of the gain, the Commissioner seems content with the courts' formulation.[120] Proper characterization of this gain, however, is important. Only gains realized from a sale or exchange should be outside the reach of section 108 or ordinary income treatment.[121] Without bifurcation,[122] the intent of Congress to provide special tax treatment for discharge of indebtedness in-

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of Delman v. Commissioner, 73 T.C. 15, 39 (1979); Mendham Corp. v. Commissioner, 9 T.C. 320, 323-25 (1947); Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 688-89 (1943), *nonacq.* 1943-1 C.B. 35.

118. *See* Bittker & Thompson, *supra* note 2, at 1172-73; Stone, *supra* note 8, at 571; *Discharge of Indebtedness, supra* note 52, at 992.

119. Bittker & Thompson, *supra* note 2, at 1172-73; Stone, *supra* note 8, at 571; *Discharge of Indebtedness, supra* note 52, at 992-93; *see* Treas. Reg. § 1.1017-1(a)(5) (1956) (difference between obligation discharged and property transferred can reduce basis); Eustice, *supra* note 10, at 234; *supra* notes 35-39 and accompanying text. When the debtor was insolvent, courts ignored sale or exchange treatment and applied the insolvency exception. *See, e.g.*, Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); Main Properties, Inc. v. Commissioner, 4 T.C. 364, 383-85 (1944), *acq.* 1945-1 C.B. 5. For a discussion of the insolvency exception, see *supra* note 10. The Tax Court has refused to bifurcate gain from a property for debt discharge, Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 689 (1943), *nonacq.* 1943-1 C.B. 35; Peninsula Properties Co. v. Commissioner, 47 B.T.A. 84, 91-92 (1942), *acq.* 1942-2 C.B. 14; *but cf.* United States v. Davis, 370 U.S. 65, 71-74 (1962) (gain or loss when property is transferred to satisfy marital rights is the difference between fair market value and the adjusted basis of the property), but may be ready to change its position. *See* Danenberg v. Commissioner, 73 T.C. 370, 381-82, 386-88 (1979). The Tax Court held that the debtor realized a gain from a sale or exchange and that, but for the insolvency exclusion, the debtor would have realized discharge of indebtedness income. *Id.* at 386-89. *Danenberg* is not directly on point because the property was deemed to have been sold for cash just prior to the debt discharge and the cash was deemed to have discharged the debt. *Id.* at 382. Nevertheless, the Tax Court pointed out that a property for debt discharge involves a separate tax issue when the fair market value of the property transferred is less than the amount of the debt discharged. *Id.* at 381.

120. *See* Rev. Rul. 76-111, 1976-1 C.B. 214, 215 (discharged indebtedness treated as gain from the sale or exchange; fair market value disregarded).

121. *See* Spartan Petroleum Co. v. United States, 437 F. Supp. 733, 737 (D.S.C. 1977); Estate of Delman v. Commissioner, 73 T.C. 15, 39 (1979).

122. This Note does not weigh the administrative inconvenience of establishing the fair market value of property, and recognizes that bifurcation may pose such practical problems. *See supra* note 41.

come[123] is frustrated by allowing sale or exchange tax treatment for discharge of indebtedness income.[124]

C. *Services for Debt*

If a debtor renders services to discharge a debt, the debtor realizes compensation income in the amount of the debt discharged.[125] Here, as with property, the fair market value of the services is ignored. Ordinary income should be limited to the fair market value of the services[126] and be immediately recognized.[127] The excess of the debt amount over the fair market value of the services should be discharge of indebtedness income subject to the favorable section 108 tax treatment.[128]

IV. Gifts and Contributions to Capital

The intention of the creditor in discharging a debt can affect tax consequences. If the discharge of indebtedness can be characterized as a gift,[129] income realized under the economic benefit theory, which would be subject to section 108 tax treatment, will be excluded from gross income under section 102.[130]

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123. Senate Report, *supra* note 11, at 10-11, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,337-38.

124. The tax consequences of discharge of indebtedness income, *see supra* notes 18-29 and accompanying text, differ from the tax consequences of a sale or exchange. Spartan Petroleum Co. v. United States, 437 F. Supp. 733, 737 (D.S.C. 1977); Estate of Delman v. Commissioner, 73 T.C. 15, 39 (1979); *see* Bialock v. Commissioner, 35 T.C. 649, 660-62 (1961), *acq.* 1961-2 C.B. 4.

125. Treas. Reg. § 1.61-12a (1957); *see* Rev. Rul. 68-507, 1968-2 C.B. 485, 486.

126. Here again there may be some administrative inconvenience in determining the fair market value of the services. *See supra* note 41.

127. *See* I.R.C. § 61 (a)(1).

128. *See supra* notes 18-29, 35-39 and accompanying text.

129. I.R.C. § 102(a). The intent of the donor is determinative, in that the gift must proceed from "'detached and disinterested generosity,' . . . 'out of affection, respect, admiration, charity or like impulses.'" Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956), and Robertson v. United States, 343 U.S. 711, 714 (1952)); *accord* Bogardus v. Commissioner, 302 U.S. 34, 43 (1937). Whether donative intent is present is a factual question. Commissioner v. Jacobson, 336 U.S. 28, 51 (1949). Prior to *Jacobson*, a transaction was a gift if gratuitous, that is, "something . . . for nothing." Helvering v. American Dental Co., 318 U.S. 322, 331 (1943). Even purely business or selfish motives were deemed irrelevant. *Id.*; *see, e.g.*, Shellabarger Grain Prods. Co. v. Commissioner, 146 F.2d 177, 185 (7th Cir. 1944); George Hall Corp. v. Commissioner, 2 T.C. 146, 146-47 (1943), *nonacq.* 1972-1 C.B. 3 (acq. withdrawn). Although never expressly overruled, this analysis is largely moribund. Bittker & Thompson, *supra* note 2, at 1178; Wilson, *supra* note 79, at 637-38.

130. *See* Helvering v. American Dental Co., 318 U.S. 322, 330-31 (1943); cases cited *supra* note 129.

Under the Act, a discharge of indebtedness is never a gift when in a commercial context.[131] It may, nevertheless, be a contribution to capital. A contribution to capital is excluded from gross income under section 118.[132] Prior to the Act, however, courts split on whether cancellation by a minority, cash basis stockholder[133] of non-principal debt that had given rise to a tax benefit to the debtor[134] was a tax-free contribution to capital.[135] Non-principal debt, such as wages, would

131. Senate Report, *supra* note 11, at 19 n.22, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,346 n.22. Before this clear indication of congressional intent, courts generally rejected gift analysis in a commercial setting. *See* Commissioner v. Jacobson, 336 U.S. 28, 38-40 (1949) (repurchase of bonds); Capitol Coal Corp. v. Commissioner, 250 F.2d 361, 363 (2d Cir. 1957) (corporate settlement), *cert. denied*, 356 U.S. 936 (1958); Denman Tire & Rubber Co. v. Commissioner, 192 F.2d 261, 263 (6th Cir. 1951) (compromise of tax claims); Spear Box Co. v. Commissioner, 182 F.2d 844, 846 (2d Cir. 1950) (repurchase of bonds); Pacific Magnesium, Inc. v. Westover, 86 F. Supp. 644, 648-49 (S.D. Cal. 1949) (cancellation of corporate debt), *aff'd per curiam*, 183 F.2d 584 (9th Cir. 1950); Securities Co. v. United States, 85 F. Supp. 532, 532-33 (S.D.N.Y. 1948) (allowing statute of limitations to run); Marshall Drug Co. v. United States, 95 F. Supp. 820, 821-22 (Ct. Cl.) (cancellation by trade creditors), *cert. denied*, 341 U.S. 948 (1951); Arlington Metal Indus. v. Commissioner, 57 T.C. 302, 305-07 (1971) (cancellation of corporate debts); Dosek v. Commissioner, 30 T.C.M. (CCH) 688, 689-90 (1971) (debt for property transfer); Standard Brass & Mfg. Co. v. Commissioner, 20 T.C. 371, 375-76 (1953) (contract settlement), *aff'd per curiam*, 218 F.2d 352 (5th Cir. 1955); 1180 East 63rd St. Bldg. Corp. v. Commissioner, 12 T.C. 437, 445-46 (1949) (compromise of tax claims). *But see* Reynolds v. Boos, 188 F.2d 322, 326 (8th Cir. 1951) (cancellation of back rent); Clem v. Campbell, 62-2 U.S. Tax Cas. ¶ 9786, at 86,158 (N.D. Tex. 1962) (cancellation of employee's debt); Bosse v. Commissioner, 29 T.C.M. (CCH) 1772, 1776-77 (1970) (same); Capitol Coal Corp. v. Commissioner, 26 T.C. 1183, 1193 (1956) (debt cancelled by relative of insider), *aff'd*, 250 F.2d 361 (2d Cir. 1957), *cert. denied*, 356 U.S. 936 (1958).

132. I.R.C.§ 118(a), (b)(1); Treas. Reg. § 1.61-12(a) (1957); *e.g.*, United States v. Oregon-Washington R.R. & Nav. Co., 251 F. 211, 213 (2d Cir. 1918); Lawrence v. Commissioner, 13 B.T.A. 463, 466-67, (1928), *acq.* 8-1 C.B. 26 (1929); Treas. Reg. § 1.61-12(a) (1957); *see* Helvering v. Jane Holding Corp., 109 F.2d 933, 938-39 (8th Cir.), *cert. denied*, 310 U.S. 653 (1940). *But see* Briarcliff Inv. Co. v. Commissioner, 90 F.2d 330, 331 (5th Cir.) (shareholder's purchases in open market attributed to corporation), *cert. denied*, 302 U.S. 731 (1937).

133. A corporation cannot deduct expenses to a cash basis, greater than 50% shareholder if, within two and one-half months after the corporation's taxable year, the expenses have not been paid. I.R.C. § 267(a)(2), (b).

134. Because principal indebtedness cannot be deducted as an ordinary and necessary business expense under § 162(a), only non-principal indebtedness such as interest, wages, rents or royalties which can be deducted as an ordinary and necessary business expense under § 162(a) produce a tax benefit problem. *See* cases cited *infra* note 135; I.R.C. § 111; *supra* note 75.

135. Three positions have been taken. The Eighth Circuit and the Commissioner maintained that this fact pattern gave rise to income to the corporation under the tax benefit rule. Helvering v. Jane Holding Corp., 109 F.2d 933, 941-42 (8th Cir.), *cert. denied*, 310 U.S. 653 (1940); Rev. Rul. 76-316, 1976-2 C.B. 22, *superceding* Rev. Rul. 73-432, 1973-2 C.B. 17; Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 Notre Dame

be ordinary income to the cash basis shareholder when received.[136] In this limited factual circumstance, the shareholder, by forgiving the debt, could avoid reporting the debt as income while the corporation could deduct the wages and thereby reduce taxable income.[137] To eliminate this result, Congress requires the corporation to realize discharge of indebtedness income when the discharged debt exceeds the shareholder's basis in the debt.[138]

Law., 215, 245 (1980); Surrey, *supra* note 35, at 1176-77; Warren & Sugarman, *supra* note 43, at 1348-49, 1358-69; *see* Putoma Corp. v. Commissioner, 601 F.2d 734, 751-54 (5th Cir. 1979) (Rubin, J., dissenting in part). A second view is that the forgiveness is tax-free. Carroll-McCreary Co. v. Commissioner, 124 F.2d 303, 305 (2d Cir. 1941) (forgiveness of salaries); Commissioner v. Auto Strop Safety Razor Co., 74 F.2d 226, 226-27 (2d Cir. 1934) (forgiveness of royalties and interest); Putoma Corp. v. Commissioner, 66 T.C. 652, 666-67 (1976) (same), *aff'd*, 601 F.2d 734 (5th Cir. 1979); Hartland Assocs. v. Commissioner, 54 T.C. 1580, 1585-86 (1970) (same), *nonacq.* 1976-2 C.B. 3; Midland Tailors v. Commissioner, 2 T.C.M. (CCH) 281, 284 (1943) (forgiveness of salary); Tanner Mfg. v. Commissioner, 2 T.C.M. (CCH) 305, 307 (1943) (same). The third view is to assign the income to the shareholder. Dwyer v. United States, 622 F.2d 460, 462 (9th Cir. 1980); Commissioner v. Fender Sales, Inc., 338 F.2d 924, 928-29 (9th Cir. 1964), *cert. denied*, 382 U.S. 813 (1965), *acq.* Rev. Rul. 67-402, 1967-2 C.B. 135; Bittker & Thompson, *supra* note 2, at 1181. In *Fender Sales*, the Ninth Circuit held that two 50% shareholders realized income under the assignment of income doctrine when the corporation issued stock in exchange for unpaid salaries. 338 F.2d at 928-29. The Tax Court in *Putoma*, a case factually similar to *Fender* with the exception that no stock was issued to the two 50% shareholders in return for the cancellation of salary and interest indebtedness, held that the assignment of income doctrine should not apply because there were such doubts concerning the collectibility of the indebtedness in view of the financial condition of the corporation that the creditors could not be said to have had "dominion and control" over it. 66 T.C. 652, 670 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979). The assignment of income doctrine is based on the principle that when the taxpayer "has fully enjoyed the benefit of the economic gain represented by his right to receive income, [he] can [not] escape taxation because he has not himself received payment of it from his obligor." Helvering v. Horst, 311 U.S. 112, 116 (1940). Furthermore, the Court in *Horst* said: "[I]ncome is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." 311 U.S. at 116-17. Therefore, it can be argued that the shareholder can be regarded as having assigned his income to the corporation as the means of procuring the satisfaction of his wants, and should realize taxable income in the amount assigned.

136. *See* I.R.C. § 451(a).

137. Commissioner v. Fender Sales, Inc., 338 F.2d 924, 930 (9th Cir. 1964) (Barnes, J., dissenting), *cert. denied*, 382 U.S. 813 (1965), *acq.* Rev. Rul. 67-402, 1967-2 C.B. 135; Putoma Corp. v. Commissioner, 66 T.C. 652, 675 (1976) (Simpson, J., dissenting in part), *aff'd*, 601 F.2d 734 (5th Cir. 1979); Eustice, *supra* note 10, at 250-51; Warren & Sugarman, *supra* note 43, at 1348. A cash basis shareholder does not realize income when a non-principal debt is forgiven. *See* I.R.C. § 451(a). An accrual basis shareholder would realize income if the debt is forgiven after the shareholder has accrued the income. *See* Treas. Reg. § 1.451-1(a) (1957).

138. Senate Report, *supra* note 11, at 18 n.21, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,345 n.21; *see* I.R.C. § 108(e)(6). This rule applies only when the

There are two possible policies underlying this rule, one focusing on the tax benefit to the corporation,[139] and the second focusing on the avoidance of income by the shareholder.[140] Neither one is adequately implemented by section 108. If Congress intended the corporation to realize income because it previously had benefited from the expense that gave rise to the debt,[141] then the section fails because the provision includes all non-principal debt, even when the corporation had no taxable income and had therefore received no prior tax benefit.[142] Similarly, the corporation realizes discharge of indebtedness income even if the expense was a nondeductible capital expenditure.[143]

If Congress intended the corporation to realize income because the shareholder has not previously reported the contributed debt as income,[144] the section also fails. If both the debtor and creditor are cash basis taxpayers, and if the forgiven debt would have been deductible when paid, there is a provision in section 108 that excuses the corporation from having to realize income.[145] This is the correct result only if the tax benefit doctrine underlies congressional intent. It does not, however, address the shareholder's avoidance of income. Nevertheless, there is still the possibility of causing the shareholder, in this limited situation, to realize income on the cancellation under an unrelated theory, the assignment of income doctrine.[146]

CONCLUSION

Tax law demands consistency. Varying judicial rules that cause inconsistent tax consequences for similar circumstances frustrate certainty and engender confusion. Adoption of the economic benefit

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shareholder is acting as a shareholder, rather than as a creditor. Senate Report, *supra* note 11, at 19 n.22, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,346 n.22. Moreover, the transaction cannot be characterized as a gift. *Id.; see supra* note 131 and accompanying text.

139. *See supra* notes 134-35 and accompanying text.

140. *See supra* note 135.

141. *See* Senate Report, *supra* note 11, at 19 & n.22, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 11,346 & n.22; *supra* notes 134-35 and accompanying text.

142. If a taxpayer does not have income, or his losses and deductions exceed gross income, a deduction may not reduce taxes.

143. *See* I.R.C. § 263.

144. Bittker & Thompson, *supra* note 2, at 1180-81; *see* Putoma Corp v. Commissioner, 601 F.2d 734, 754 n.4 (5th Cir. 1979) (Rubin, J., dissenting); O'Hare, *supra* note 74, at 241, 243; *supra* note 135.

145. I.R.C. § 108(e)(2).

146. *See* Dwyer v. United States, 622 F.2d 460, 462-63 (9th Cir. 1980). The shareholder in *Dwyer* realized income on the cancellation under the assignment of income doctrine, even though the corporation had never deducted the non-principal debt. *Id.* at 462; *see supra* note 135.

theory for discharge of indebtedness income would resolve the inconsistencies inherent in the current melange of judicial rules and promote uniformity in the administration of tax laws. Relief from unduly burdensome tax consequences will then be provided, as intended, solely by the Bankruptcy Tax Act of 1980.

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