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TAXATION-DEBT REDUCTION

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TAXATION—DEBT REDUCTION—Inherent in an economy financed by a large volume of credit, extending over varying intervals of time, is the problem of debt reduction and revalorization.[1] The ramifications of this problem in the income tax field have long intrigued legal scholars and confounded the courts.[2] A recent case illustrates anew the danger,

[1] FISHER, BOOMS AND DEPRESSIONS (1932); CLARK, THE INTERNAL DEBTS OF THE UNITED STATES (1933); WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935).

[2] Rottschaefer, "The Concept of Income In Federal Taxation," 13 MINN L. REV. 637 (1929); MAGILL, TAXABLE INCOME, c. 7 (1936); 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 11.20 (1942). One senses an almost Lincolnesque attitude with which the courts approach the two leading cases in this area: "So much has been said and written concerning these two decisions of the Supreme Court, we

to client and counsel, lurking in the assumption that the tax significances of debt reduction have finally been reduced to mathematical certainty. The taxpayer borrowed $90,000 from a bank in 1925, using the funds to pay off encumbrances upon, and make improvements on, a piece of property. As a part of the transaction he executed bonds, secured by a mortgage on the property, which the bank sold to the public. The taxpayer retired the bonds as they matured until the advent of the depression when he found it necessary to secure extensions of interest and principal payments. Finally, in 1938, 1939, and 1940, he repurchased certain of the bonds at less than par, making some purchases through the secretary of a bondholders' committee, and through a security house; and others directly from the bondholders. The commissioner adjusted the taxpayer's tax returns for those years by adding to income the difference between the issue price and retirement price of each bond. Before the Tax Court[3] a majority felt that the gain resultant from the committee and security house purchases was income, as these lacked the personal element necessary to find gifts from the bondholders. But they thought the gains from the direct purchases were gifts within the doctrine of *Helvering v. American Dental Co.*[4] Six judges dissented on the grounds that the Supreme Court never intended to make the tax consequences of bond repurchases dependent on the degree of acquaintance between debtor and bondholder. Hence, they argued, the gains from all purchases were income under *United States v. Kirby Lumber Co.*[5] On cross appeal to the seventh circuit it was held that, since none of the purchases was made in an open market, the gains from all the purchases were gifts to the taxpayer from the bondholders.[6] Thus is provided fresh impetus for the spirited controversy as to when, if ever, a taxpayer realizes taxable gain through the reduction of his indebtedness.

A. *The Discharge of Indebtedness May Result in Income*

Nowhere does the Revenue Code specifically tax gain arising on the discharge of indebtedness. However, a Treasury Regulation to that effect[7] received a judicial nod of approval in *United States v. Kirby Lumber Co.*[8] There a corporate taxpayer issued its bonds for money and repurchased some of the bonds for less money in the same tax-

realize our inability to elucidate further." Commissioner v. Jacobsen, (C.C.A. 7th, 1947) 164 F. (2d) 594 at 597.

[3] Lewis F. Jacobsen, 6 T.C. 1048 (1946).

[4] 318 U.S. 322, 63 S.Ct. 577 (1943).

[5] 284 U.S. 1, 52 S.Ct. 4 (1931).

[6] Commissioner v. Jacobsen, (C.C.A. 7th, 1947) 164 F. (2d) 594, cert. granted, (U.S. 1948) 68 S.Ct. 792.

[7] TREAS. REG. 62, Art. 545 (1) (c) (Revenue Act of 1921).

[8] 284 U.S. 1, 52 S.Ct. 4 (1931).

able period. The court found that the debtor had plainly realized a gain taxable under that section of the statute which laid its hand on "income derived from any source whatever."[9] This holding was regarded as establishing the proposition that taxable income, within the constitutional and statutory sense, may be realized by a debtor on the discharge of his debt below par.[10] Subsequent decisions extended the principle to include transactions where the debtor received property instead of money when the liability was incurred,[11] and where the debt was discharged as a result of direct negotiations between debtor and creditor.[12]

In its first decade of operation the *Kirby* rule suffered a number of judicial[13] and legislative[14] restrictions. When the Supreme Court, however, had occasion to examine the limitations which had been engrafted on its original decision it laid them all aside in determining that the cancellation of indebtedness might result in a gift.[15]

B. *The Discharge of Indebtedness May Result in a Gift*

After the *Kirby* case the provision that a gratuitous cancellation of indebtedness might be a gift disappeared from the Treasury Regula-

[9] § 213 (a), Revenue Act of 1921, now I.R.C., § 22 (a).

[10] The Court, in the face of Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920), could hardly approve the Regulation, note 7, supra, without assuming that a discharge of indebtedness below par there may be a "realization" of income within the constitutional sense. Moreover, it has been frequently stated, following Eisner v. Macomber, supra, that income under present Revenue Acts has much the same meaning as that accorded income under the 1909 Corporation Excise Act. Under that Act it was held that a debtor realizes income when his debt is extinguished by the statute of limitations without payment, Great Northern Ry. Co. v. Lynch, (D.C. Minn. 1921) 292 F. 903. Accord, Annis Van Nuys Schweppe, 8 T.C. 1224 (1947).

[11] Helvering v. American Chicle Co., 291 U.S. 426 at 430, 54 S.Ct. 460 (1934).

[12] Commissioner v. Coastwise Transp. Corp., (C.C.A. 1st, 1934) 71 F. (2d) 104 at 106, cert. den., 293 U.S. 595, 55 S.Ct. 110 (1934).

[13] The following limitations appeared: (a) An insolvent debtor realized no gain by a debt reduction. See E. B. Higley & Co., 25 B.T.A. 127 (1932). (b) Cancellations by a stockholder were contributions to the capital of the debtor corporation. See Commissioner v. Auto Strop Razor Co., (C.C.A. 2d, 1934) 74 F. (2d) 226. (c) Some cancellations were a reduction of the original price of property purchased by the debtor. See Hirsch v. Commissioner, (C.C.A. 7th, 1940) 115 F. (2d) 656.

[14] Under the Bankruptcy Act of 1938 no taxable income is realized by debt reductions through a corporate reorganization, an arrangement or composition, a real property arrangement, a wage earner's plan, or a railroad adjustment. See TREAS. REG. 111, § 29.22 (a)-13 (b); Bankruptcy Act of 1938, c. 15, § 735, 52 Stat. L. 840. Except in the case of wage earner's plans and railroad adjustments, tax exemption carried with it a reduction of basis of the debtor's property by an amount equal to the amount of the debt cancelled, Bankruptcy Act of 1938, §§ 270, 396, 522, 52 Stat. L. 840 at 904, 915, 929. The debtor relief provisions of the 1939 Revenue Act, as amended, exempt any income realized through debt reductions by certain corporate debtors. See 1 C.C.H. STAND. FED. TAX REP., ¶ 83.159 (1948).

[15] Helvering v. American Dental Co., 318 U.S. 322, 63 S.Ct. 577 (1943).

tions,[16] but there remained in the Revenue Code itself the general exclusion of gifts. The *American Dental Co.* decision, in which the gift theory reappeared, dealt with the adjustment of pre-depression liabilities. A corporate debtor owed rent of $15,200 for the year 1933, and interest on notes given on the purchase of merchandise prior to 1932. Through direct negotiations with his creditors the debtor discharged the past due rent by payment of $7,500, and secured the cancellation of all interest due on the notes from 1932 through 1936. Both the rent and interest had served to offset taxable income for the periods in which the debtor had accrued them as liabilities. Moreover, the amounts cancelled were charged off in 1937 while the debtor was hard pressed financially, but still solvent.

The Supreme Court, when the case reached that body, considered the various legislative and judicial rules for absolving debtors from tax liability for debt reductions. None, however, quite fitted the case at hand. Groping about for some method of relieving the taxpayer it examined the gift exclusion. Finding the line between gifts and gain to be extremely "narrow"[17] it abandoned the necessity for donative intent and announced that since the creditor received nothing of monetary value in exchange for the amounts cancelled, such amounts were gifts to the debtor.

The lower courts immediately regarded this holding as a kind of "deus ex machina" which had come to relieve them of the necessity of wrestling with the vexatious distinctions which had developed in this field.[18] Accordingly, they applied it to all manner of cases where theretofore they had found income.[19] Indeed, so eager were they to call every debt reduction a gift that one commentator felt that the principle of the *Kirby* case survived as a rule only in the field of "repurchase by a solvent taxpayer of its bonds at less than the issue price."[20] Subsequent opinions, however, seemed to indicate a more discriminating attitude and a more reluctant application of the concept.[21] The

[16] TREAS. REG. 86, Art. 22(a)-14 (Revenue Act of 1934).

[17] Helvering v. American Dental Co., 318 U.S. 322 at 327, 63 S.Ct. 577 (1943).

[18] Support was drawn from a statement of the Court that "in this view, there is no substance in the Commissioner's differentiation between a solvent or insolvent corporation or the taxation of income to the extent of assets freed from the claims of creditors . . .," Helvering v. American Dental Co., 318 U.S. 322 at 330, 63 S.Ct. 577 (1943); and from the fact that the opinion ignored the tax benefits derived through the previous deduction of the cancelled debts.

[19] Friedman, "Cancellation of Obligations," 24 TAXES 875 at 878 (1946).

[20] Id. at 876 (1946).

[21] Where the debt had not been incurred prior to the depression and/or was not discharged during the depression there has been greater reluctance to absolve the debtor. John Huberman, T.C. Dkt. 109627, 1943 P-H MEMO. DEC., ¶ 43,323; F. W. Leadbetter, T.C. Dkt. 110258-110259, 1943 P-H MEMO. DEC., ¶ 43,387;

limitations now appearing on the gift doctrine,[22] and the *non sequiter* which it shares with much of the legal theory in this area,[23] warn us to be chary in assessing its final effect. In terms of ultimate theory the *American Dental Co.* decision has at least indicated that, absent controlling statutory provisions, future contests will begin with the query whether the *Kirby* or *American Dental Co.* rule governs the transaction.

C. *The Narrow Line That Divideth*

The Tax Court has found that the determination of when a debt reduction crosses the narrow line from taxable gain to tax free gift is dependent on the degree of acquaintance between debtor and creditor. The Seventh Circuit Court thought the governing factor to be the presence or absence of an open market for the sale of the debtor's obligations. One may well wonder, with the dissenting judges in the *Jacobsen* case, whether the Supreme Court intended such tenuous distinctions to determine the receipt of income. Neither the "degree of acquaintance" nor "open market" test seems a sufficiently firm foundation on which to rest the legal significances of debt reduction.[24] While

Elizabeth Operating Corp., T.C. Dkt. 112709, 1943 P-H MEMO. DEC., ¶ 43,434; Texas Gas Distributing Co., 3 T.C. 57 (1944); Reliable Incubator & Brooder Co., 6 T.C. 919 (1946); Marion A. Blake, 8 T.C. 546 (1947); Annis Van Nuys Schweppe, 8 T.C. 1224 (1947); Central Paper Co., Inc. v. Commissioner, (C.C.A. 6th, 1946) 158 F. (2d) 131.

[22] The doctrine is inoperative (a) where the debt is discharged by (1) the unilateral action of the debtor, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 63 S.Ct. 902 (1943); (2) the statute of limitations, Annis Van Nuys Schweppe, 8 T.C. 1224 (1947); (3) the voluntary transfer of property securing the debt, Lutz & Schramm Co., 1 T.C. 682 (1943); (4) the involuntary transfer of property securing the debt, R. O'Dell & Sons Co., 8 T.C. 1165 (1947); (b) where the creditor is the alter ego of the debtor, F. W. Leadbetter, T.C. Dkt. 110258-110259, 1943 P-H MEMO. DEC., ¶ 43,387; (c) where any transaction seems to the court to fall within the Kirby principle, Central Paper Co. v. Commissioner, (C.C.A. 6th, 1946) 158 F. (2d) 131.

[23] An argument is suspect that cannot be used on both sides of the equation. It is incongruous, at least, where an act of a creditor is seen at one and the same time to be a gratuitous gesture, resulting in a gift to the debtor, Cocheco Woolen Mfg. Co., T.C. Dkt. 4175, 1945 P-H MEMO. DEC., ¶ 45,234; and a hard-headed piece of business calculation, resulting in loss to the creditor, George A. Adams, T.C. Dkt. 106694, 1944 P-H MEMO. DEC., ¶ 44,222.

[24] Each proceeds on the premise that the intent of the parties somehow governs the character of the transaction. This premise, however, must first be demolished to reach the result that a cancellation without donative intent *may* be a gift. That it may then be resurrected to determine what cancellations *are* gifts, strains logic in a field where it already carries a heavy burden. The inherent absurdities are suggested by Edmont Hotel Co., 10 T.C. 260 (1948). A corporation borrowed money in 1934 becoming obligated by contract to repurchase certain amounts of the bond issue. The debtor, wholly owned by *X*, purchased bonds at less than par from the creditor corporation,

the courts have now been able to conclude that "the line between income producing reductions and others is not precise or definite,"[25] they have not so far developed adequate legal standards for fixing the line.[26]

Basic to the legal principles so far announced in the field of debt reduction is the assumption, that absent some extenuating factor in the individual case, all discharges of indebtedness at less than the nominal dollar value fixed in the contract result in gain to the debtor. Economists, accountants, and congressmen have long been aware of the fallacy of this basic assumption.[27] Debts, it is true, are generally measured in terms of dollars, but dollars do not always give the same measurement.[28] As usually expressed by economists, the value of money is the reciprocal of prices, meaning simply that the value of a dollar varies inversely with a rise or fall in the price level. A debt discharged at par in a period of lower prices than that prevailing when the liability was incurred may result in real income to the creditor. Conversely, if discharged at par in a subsequent period of higher prices it may result in real income to the debtor.[29] A corollary from these propositions is the fact that a discharge below par might be income to

also owned by *X*, and from *Y*, a stranger, neither purchase being made on the open market. Struggling in rather cramped quarters to reach at least some of the obvious gain realized on the transaction, the court taxed the repurchase from *Y* since there was "no evidence indicating a personal or business relation" between *Y* and the debtor.

[25] Claridge Apts. Co. v. Commissioner, 323 U.S. 141 at 146, 65 S.Ct. 172 (1944).

[26] Accountants and attorneys were agreed on the precarious nature of the test; Reno, "Present Status of American Dental and Kirby Decisions and Their Effect on the Cancellation of Debts," N.Y. UNIV. SIXTH ANNUAL INST. ON FED. TAX. 727 at 732-733 (1948); Friedman, "Status of the Cases Dealing with Cancellation of Obligations," N.Y. UNIV. FOURTH ANNUAL INST. ON FED. TAX. 703 at 712 (1946).

[27] 1 TAUSSIG, PRINCIPLES OF ECONOMICS, 3d ed., c. 22, § 3 (1935). Authorities are collected in Hanna, "Currency Control and Private Property," 33 COL. L. REV. 617 (1933). See also, PATON, ESSENTIALS OF ACCOUNTING 810 et seq. (1938); 76 CONG. REC. 2918 (1933).

[28] "The dollar is, at best, merely a unit for the measurement of values. It is a fluctuating and variable criterion, and therefore an imperfect one." Hurst v. Chicago B. & Q. R.R., 280 Mo. 566 at 572, 219 S.W. 566 (1920).

[29] "Emitting a large issue of bonds is equivalent to engaging in a serious speculation in money. . . . Suppose, for example, that a corporation puts out an issue of ten-year bonds amounting to $100,000,000 at a time when the price index stands at 100, and that at maturity when the debt is paid the index has advanced to 200. The result of this transaction is an indubitable gain of $50,000,000 measured in terms of dollars as of date of issue and $100,000,000 expressed in money value as of date of maturity. And similarly if the bonds were issued when the index stood at 200 and were paid in dollars represented by an index of 100 a genuine loss of purchasing power amounting to $100,000,000 in prices of date of issue or $50,000,000 in prices of date of payment would have been suffered." PATON, ESSENTIALS OF ACCOUNTING 815 (1938).

neither party, but just the "equivalence" of the originally bargained-for consideration.[30] Although the law in general has not yet recognized the economic significance of a variable monetary unit in devising legal theories of income, a review of developments in the area of debt reduction suggests that there may have been an inarticulate shaping of legal doctrine in the direction of economic reality. Inasmuch as the economic factors, and attendant legal consequences, vary somewhat with the type of liability reduced, clarity is furthered by some consideration of the nature of the liability.

D. *The Nature of the Reduced Liability*

1. *Liability offset by receipt of a tangible asset.* A liability may be incurred on the receipt of money or property. Where this liability is discharged at less than the nominal par within the same period in which it was incurred then plainly the debtor ". . . has realized within the year an accession to income."[31]

By far the overwhelming majority of cases reaching the courts for decision, however, involve a liability incurred in one taxable period and discharged in another. Where the reduction, if made within one taxable period, would result in gain, it is indeed difficult, under conventional legal theory, to suggest "a reason why the delay in adjustment should result in exemption."[32] Significantly, though, the cases establishing first principles in this field involved transactions carried out between periods of relatively stable prices and economic conditions,[33] but subsequent cases involved adjustment of pre-depression liabilities. The following presented a typical situation: a receipt of property or money in the pre-1929 period of high prices with a liability to repay therefor $15,000, and a discharge of this obligation in

[30] A sufficiently sustained rise in prices will cause abandonment of the normal judicial concept that obligations expressed in terms of money may be discharged by payment of the exact amount fixed in the contract, and that an "equivalence theory," that is, a return of money or property of the same relative purchasing power as that received, will be adopted to relieve creditors. Dawson, "Effects of Inflation on Private Contracts: Germany 1914-1924," 33 MICH. L. REV. 171 (1934). A sufficiently sustained fall in prices will beget the same theory in aid of debtors; Perry v. United States, 294 U.S. 330 at 357, 55 S.Ct. 432 (1935); Dawson, "The Gold Clause Decisions," 33 MICH. L. REV. 647 (1935).

[31] United States v. Kirby Lumber Co., 284 U.S. 1 at 3, 52 S.Ct. 4 (1931), under both legal and economic theory, HAIG, THE FEDERAL INCOME TAX 7 (1921).

[32] 44 COL. L. REV. 102 at 105 (1944).

[33] United States v. Kirby Lumber Co., 284 U.S. 1, 52 S.Ct. 4 (1931), bonds issued and repurchased in 1923; Helvering v. American Chicle Co., 291 U.S. 426, 54 S.Ct. 460 (1934), debts incurred in 1914 extinguished in 1922-1923-1924. Commissioner v. Coastwise Transp. Corp., (C.C.A. 1st, 1934) 71 F. (2d) 104, debt incurred in 1922 reduced in 1924-1925.

the depression period of low prices, at $8,000.[34] Between the period when the liability was incurred and the period of discharge, prices had so fallen that each dollar repaid had the value of two borrowed.[35] Traditional legal theory, unencumbered by legislation, disregards the variation in value of the monetary unit on which the contract is based, and dictates that it be carried out at its nominal face value. From this the argument flows smoothly to the conclusion that on a discharge below the nominal face the debtor must have realized a gain. This conclusion, however, flys in the face of what "everyone knows" to have been economic realty.[36] To have found income to the debtor from such an adjustment would have been incongruous for a period when the Supreme Court itself was saying that in view of the increased value of dollars, a creditor, whose claim was nominally worth $16,931, when paid off at $10,000, "has not shown . . . that in relation to buying power he has suffered any loss whatever." "On the contrary," continued the Court, payment of the nominal par "would appear to constitute not a recoupment of loss in any proper sense but an unjustified enrichment" at the debtor's expense.[37]

The legal device most equitable,[38] and most in accord with Con-

[34] *T* purchased a piece of realty for $29,000 in 1928, paying $10,000 cash and assuming a mortgage of $19,000. Partial payments were made, reducing the debt to $15,000, until 1936, when *T* offered to convey the property, then worth $8,000 to *E* who refused but offered to accept $8,000 cash in settlement. *T* paid the money securing a cancellation of the $7,000 balance. *Held*, *T* received "nothing of exchangeable value." Hirsch v. Commissioner, (C.C.A. 7th, 1940) 115 F. (2d) 656 at 658. In addition, see Transylvania Ry. Co. v. Commissioner, (C.C.A. 4th, 1938) 99 F. (2d) 69; Carroll-McCreary Co., Inc. v. Commissioner, (C.C.A. 2d, 1941) 124 F. (2d) 303; Allen v. Courts, (C.C.A. 5th, 1942) 127 F. (2d) 127; Commissioner v. Sisto Financial Corp., (C.C.A. 2d, 1943) 139 F. (2d) 253; Chenango Textile Corp. v. Commissioner, (C.C.A. 2d, 1945) 148 F. (2d) 296.

[35] Norman v. B. & O. R.R. Co., 294 U.S. 240 at 273, 55 S.Ct. 407 (1935).

[36] In view of the increased purchasing power of the dollar in the depression, "everyone knows," said a member of Congress in the debate on adoption of the 1933 debtor relief sections of the Bankruptcy Act, that "many of the debts under which our farmers and individual citizens are staggering have, therefore, doubled and trebled in amount. . . ." 76 CONG. REC. 2918 (1933).

[37] Perry v. United States, 294 U.S. 330 at 357, 55 S.Ct. 432 (1935). A creditor paid off in appreciated currency was taxed in Landes Bros. v. Simpson, 19 Tax Cases 62 (K.B. 1934).

[38] Since the gift doctrine ignores any reduction of basis it may result in tax inequity. Suppose *A* purchases a building in 1929 at $40,000 but later discharges this liability in 1934 by payment of $20,000. If this reduction is called a gift *A* is relieved of tax liability, but retains an inflated $40,000 basis for depreciation and gain or loss calculations. Where property of a depreciable nature is returned to the creditor when the balance is cancelled the Tax Court takes the position that this is a sale and the debtor must report as income any difference by which the amount of the debt extinguished exceeds the adjusted basis of the property. See R. O'Dell & Sons Co., 8 T.C. 1165 (1947).

gressional action,[39] is the theory which treats the debt adjustment as a reduction of the original purchase price of the property acquired. To the extent, however, that *Burnet v. Sanford & Brooks Co.*,[40] is thought to interfere with this adjustment of the original contract, the gift concept may provide the only device, absent a curative statute, available to afford relief to some debtors in scaling down their debts to a depressed price level.

Less spectacular in its effect on the discharge of indebtedness is a pronounced rise in prices with consequent depreciation of money. While theoretically the payment of a debt at par with depreciated dollars results in real income to the debtor, there has been little effort to tax this gain. If, however, the 1940-1948 inflation in the United States were multiplied tenfold and the debtor were furnished with a relatively stable currency, with which to purchase the depreciated money used in discharging the obligation, the tax collector would be moved to action. This was the situation in *Bowers v. Kerbaugh-Empire Co.*[41] where the debtor repaid the debt at par, but with depreciated German marks purchased with American dollars. Through the operation of the foreign exchange rate the real economic gain to the debtor was thrown in sharp relief.[42] Had the debtor repaid the debt in Germany using an equivalent number of depreciated marks received through furnishing goods or services in that country, the resultant gain would have been subject to a special tax,[43] and a finding of income is not impossible under an Anglo-Saxon tax system. But this case was decided in the formative period of income taxation when the Supreme Court was attempting an all inclusive definition of income. The Court was unable to fit the facts before it into its previous definition of income,[44] for "the transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital," and hence could not have resulted in

[39] Statutory provisions for the scaling down of indebtedness adopted after 1933 were bottomed on the theory "that debts have increased tremendously on account of the increased purchasing power of the dollar," 76 CONG. REC. 2918 (1933). Yet under the Bankruptcy plans and Revenue Act exemptions, supra, note 14, only wage earner's and certain railroad adjustments were absolved from reduction of basis.

[40] 282 U.S. 359, 51 S.Ct. 150 (1931).

[41] 271 U.S. 170, 46 S.Ct. 499 (1926).

[42] The claim of the German creditor had passed to the United States Alien Property Custodian who accepted as the then value of 3,216,445 marks, a payment of $80,411.12, such payment being $684,456.18 less than the value of the marks at the time they were borrowed. Bowers v. Kerbaugh-Empire Co., id. at 173.

[43] In an article dealing with the legal aspects of the German inflation the author points out that there was enacted in Germany "a tax on inflation gains acquired through payment of debts in depreciated currency," Dawson, "Effects of Inflation on Private Contracts: Germany 1914-1924," 33 MICH. L. REV. 171 at 214 (1934).

[44] Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920).

income to the debtor.[45] By way of apology for its inability to include the obvious gain within the concept of taxable income, the Court added that anyway the debtor had sustained a loss in the use of the borrowed funds. This statement focused attention on the wrong end of the transaction and resulted in judicial inconsistencies in later attempts to distinguish the decision.[46] Careful economic analysis could have limited the case to the proposition that a debtor does not realize income by discharging a debt at par with depreciated currency.[47] There has been no inclination to depart from the holding, as thus understood,[48] and there probably will not be in the future, absent a much more serious inflation than has as yet occurred.[49]

2. *Liability incurred without receipt of an offsetting asset.* Where a liability which was incurred by the debtor without; at the time, receiving anything of value is subsequently reduced or cancelled, it is now generally agreed that the amount of the reduction is not income. Hence a debtor who discharges a $10,000 judgment, rendered against him in a tort action, by a payment of $8,000 realizes no taxable gain.[50]

This general rule must be considered in connection with the possible effects of modern accounting practices. Thus if the indebtedness cancelled or reduced is a deductible expense item which has been accrued against taxable income, then the subsequent reduction or cancellation might well result in income to the extent of tax benefit derived by the debtor through the previous accrual.[51] It is difficult logically to apply either the *Kirby* limitations or gift concept to absolve the debtor

[45] Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 at 175, 46 S.Ct. 499 (1926).

[46] MAGILL, TAXABLE INCOME 245 (1936).

[47] Rottschaefer, "The Concept of Income In Federal Taxation," 13 MINN. L. REV. 635 at 660-663 (1929); as one commentator cautiously suggested, the Kerbaugh-Empire case "may not be a debt cancellation case at all but one in which the taxpayer performed its obligation in full." Friedman, "Status of the Cases Dealing with Cancellation of Obligations," N.Y. UNIV. FOURTH ANNUAL INST. ON FED. TAX. 701 at 703, note 2.

[48] B. F. Goodrich Co., 1 T.C. 1098 (1943); Wm. H. Coverdale, T.C. Dkt. 3981, 1945 P-H MEMO. DEC., ¶ 45,240. Conversely, a creditor paid with depreciated currency cannot claim a loss, although the court indicated he might be able to prove that he had overstated his income, S. E. Boyer, 9 T.C. 1168 (1947).

[49] The debtor in Germany enjoyed freedom from tax on gains through discharge of debts with depreciated currency until after the mark had fallen to less than 1/1500 of its pre-war purchasing power. Dawson, "Effects of Inflation on Private Contracts: Germany 1914-1924," 33 MICH. L. REV. 171 at 203 (1934).

[50] Commissioner v. Rail Joint Co., (C.C.A. 2d, 1932) 61 F. (2d) 751; Ruben v. Commissioner, (C.C.A. 8th, 1938) 97 F. (2d) 926; C. Ludwig Bauman & Co., T.C. Dkt. 110283, 1943 P-H MEMO. DEC., ¶ 43,253. Although if the mere freeing of assets were sufficient, as has sometimes been supposed, the $2,000 should be income to a solvent debtor, Warren and Sugarman, "Cancellation of Indebtedness and Its Tax Consequences," 40 COL. L. REV. 1326 at 1330 (1940).

[51] S. Rossin & Sons, Inc. v. Commissioner, (C.C.A. 2d, 1940) 113 F. (2d) 652; Hurd Millwork Corp., 44 B.T.A. 786 (1941).

in this type of debt reduction, for the situation is simply this: the debtor has effectuated a tax saving by an erroneous deduction at the expense of other taxpayers, and tax equity suggests that this type of transaction be left to be governed by the ordinary tax benefit rules.[52]

3. *Liability incurred offset by receipt of an intangible asset.* Liabilities to pay for the use of property, or services, expressed in terms of rent, interest, or wages, present a peculiar problem. There are two possible avenues leading to a determination that income might result from the reduction or cancellation of such a liability. Under the asset theory, in using the property or services, the debtor is seen to receive, in the period of use, a substantial economic benefit the equivalent of cash. Any excess of the agreed value of the use over the consideration paid to satisfy the debt arising therefrom, is income to the debtor. So if *A* rents a store in 1939 promising to pay a rental of $1,000 a year, but defaults in payment, and subsequently discharges the debt by payment of $800 in 1941, he has realized income of $200. The deduction approach grows out of the fact that this type of liability (rent, interest, wages) is generally a deductible expense. Thus when a taxpayer has accrued the unpaid liability at its face value against taxable income for a prior period and subsequently pays less than the amount accrued, then the "Release of indebtedness which has led in prior years to a tax benefit may well cause a subsequent readjustment to create taxable income on the familiar theory that recovery of items once deducted is the equivalent of the receipt of income."[53]

The economic considerations are different when a deduction issue is present in the case, for then the inquiry is not whether an additional tax, which may be economically unjustified, should be imposed; but whether equity does not demand that the debtor return the tax saving he has already made. Unfortunately, for a clear disposition of the problem, the case[54] finally reaching the Supreme Court presented both aspects of income. The debtor had incurred the cancelled liabilities through the use of property and money in a prior period (the receipt of assets). But in addition these liabilities had been accrued, for the periods when incurred, against taxable income (the receipt of tax benefits). The general tenor of the opinion suggested that the Court was not looking to the tax saving to find income, but was considering merely the difference between the economic benefits received, and the consideration paid (the excess of receipts over disbursements).[55] But inas-

[52] Plumb, "The Tax Benefit Rule Today," 57 HARV. L. REV. 129 (1943); Plumb, "The Tax Benefit Rule Tomorrow," 57 HARV. L. REV. 675 (1944).

[53] Chenango Textile Corp., 1 T.C. 147 at 162 (1942).

[54] Helvering v. American Dental Co., 318 U.S. 322, 63 S.Ct. 577 (1943).

[55] The Court analyzed the transaction as "akin to a reduction of sale price," Helvering v. American Dental Co., 318 U.S. 322 at 330, 63 S.Ct. 577 (1943), rather than the reduction of a deduction, and indicated that another problem might

much as the Court ignored the effect of the deductions in rendering its decision, the lower courts have assumed that the gift concept is to be applied regardless of previous erroneous deductions on the part of the debtor.[56]

A possible rationalization of the decision may be that the Court did not consider that the tax benefit aspects were even an issue in the case. It recognized that "The taxpayer had accrued the rent and interest in former years," but eliminated this factor from the case with the observation that "no claim for additional taxes" was made by the commissioner.[57] Thus the presumption that the Court considered the tax benefits fully, and determined they were of no effect, ascribes to the Justices an occult power to anticipate their own decisions by nearly a year.[58] The reasonable inference, supported by some authority,[59] is that the Court considered it was merely laying down a rule for application to simple asset type debt reductions.[60] While this argument, in its entirety, has been so far rejected, it is significant that the *American Dental Co.* decision cannot be pressed to the point of allowing deductions of an accrued liability, subsequently cancelled by the creditor, for a year in which it is open to the commissioner to disallow the deduction.[61]

If the tax benefit aspects are disregarded there can be little criticism

have been presented had the commissioner based the case on a claim for additional taxes for the prior years. Id. at 324.

[56] Friedman, "Cancellation of Obligations," 24 TAXES 875 at 878 (1946).

[57] Helvering v. American Dental Co., 318 U.S. 322 at 324, 63 S.Ct. 577 (1943).

[58] Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, with its tacit approval of the tax benefit theory, was not decided until Dec. 20, 1943, some ten months after the American Dental Co. decision.

[59] A corporation which received overpayments on contracts to provide services, with agreement to make refunds under certain conditions, placed the same in a liability account. When the liabilities were cancelled without expenditure the commissioner reduced the basis of the corporation's property by the amounts of the liabilities extinguished, thus disallowing a portion of depreciation deductions. To avoid losing the deductions which had resulted in tax benefits, the corporation claimed the cancellations were gifts, but the Court rejected this argument, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 63 S.Ct. 902 (1943). A strong opinion by Vinson, C.J., in Crane v. Commissioner, 331 U.S. 1, 67 S.Ct. 1047 (1946) is also contrary to the tax benefit theory thought to flow from the American Dental Co. case.

[60] As the deduction approach stood when the Court considered the American Dental Co. case, deductions recovered had to be taken in at their full amount whether they had resulted in tax saving or not. Plumb, "The Tax Benefit Rule Today," 57 HARV. L. REV. 129 (1943). It was not possible, therefore, to indicate that a cancellation might be taken in only to the extent of its tax benefit, for this rule was not to receive judicial approval until some time later.

[61] McConway & Torley Corp., 2 T.C. 593 (1943). Nor can a debtor, who purchases property on credit, deduct a loss on the sale of the property where his creditor has cancelled the unpaid portion of the purchase price. Charles L. Nutter, 7 T.C. 480 (1946).

of the decision. That the carrying of contracts to pay a fixed number of dollars for the future use of property or money into a period of drastically reduced prices, results in economic inequity to the debtor was amply demonstrated by the late depression.[62] Where such contracts are scaled down to the actual dollar value of the use, it is difficult to see, under any test, that income has been realized. In the *American Dental Co.* case, for example, the facts show that what the debtor paid to discharge the debt, though below the contract price, was the equivalent of the actual use value of the property for the period in question.[63] Absent the frank recognition of a variable monetary unit the gift concept permits perhaps as near a correlation of legal result and economic reality in this area as the tax system allows.

E. *Conclusion*

The problem confronting the courts when the depression, with its unprecedented price decline, generated an unprecedented reduction of indebtedness, was the fact that the law "entirely fails to acknowledge the phenomenon of a variable unit of monetary measure."[64] That inequities would result from too wide a divergence between legal and economic doctrine in the income tax field had been prophesied.[65] But for this divergence the courts could have distinguished the *Kirby* case on sound grounds with a simple holding that no income was realized where debts were adjusted to prevailing economic levels. Faced, however, with the conventional legal approach which does not accept the economist's recognition of the dollar as a variable unit of value, they were forced in the depression to depart on a series of legalistic distinctions to avoid injustice to debtors. Such distinctions, however worthy of criticism from the standpoint of legal theory, generally achieved an economically sound result. Understood as the final result of this process, the gift concept falls into its proper place and no more establishes that all cancellations are gratuities than the *Kirby* principle established that all cancellations result in income.[66] We may thus

[62] See Dallas Transfer & Terminal Warehouse Corp. v. Commissioner, (C.C.A. 5th, 1934) 70 F. (2d) 95, where the rental value of the premises for the period when the rent was cancelled was apparently zero.

[63] The annual rental on the pre-1929 lease had been fixed at $15,200. In December, 1933, a new lease was made reducing the rental to $8,400 yearly. The taxpayer paid $7,500, which was thus quite close to the actual value of the premises. The four year cancellation of interest did not amount to more than a 50 per cent reduction in interest rates, if that much.

[64] PATON, ESSENTIALS OF ACCOUNTING 813 (1938).

[65] HAIG, THE FEDERAL INCOME TAX (1921); Rottschaefer, "The Concept of Income in Federal Income Taxation," 13 MINN. L. REV. 637 (1929).

[66] The Supreme Court itself indicated later that the American Dental Co. case should be "read in the context of its facts." Detroit Edison Co. v. Commissioner, 319 U.S. 98 at 103, 63 S.Ct. 902 (1943).

expect in periods of economic well-being a more discriminating application of the doctrine than the blind adherence common to depression cases, and that mere citation of *Helvering v. American Dental Co.* in the debtor's brief will be insufficient to characterize the reduction as a gift.[67] More probably the debtor will need to go forward with specific economic data which demonstrates to the court the inequity of taxing the apparent gain.[68]

The complete cancellation of the principal of an obligation will be exceptional outside of Bankruptcy or Reorganization, where tax effects are now largely governed by statute. For the reduction cases, the gift concept remains as an adjunct to the original *Kirby* limitations to permit the necessary "gross accommodation"[69] between legal result and economic reality. It might well be reserved for those cases where the problem actually is whether the debtor has received more than he returns, and economic factors persuade the court that the argument finding gain from the reduction "is a highly technical one that should have no weight against the equities of the situation."[70] As to those reductions which would in no wise be income, absent a previous accrual resulting in tax benefit to the debtor, it might be provided by statute, in those cases where some adjustment is deemed advisable, that the debtor pay over to the Treasury, in the year of cancellation, the actual tax saving effected by the erroneous deduction.[71]

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[67] Elizabeth Operating Corp., T.C. Dkt. 112709, 1943 P-H MEMO. DEC., ¶ 43,434.

[68] In finding income in one debt reduction case the Tax Court said, "We are unable to view the situation of April 1, 1940, through the petitioner's statistical dark glasses." Bush Terminal Bldg. Co., 7 T.C. 793 at 809 (1946).

[69] Frasek v. Commissioner, (C.C.A. 2d, 1928) 25 F. (2d) 653 at 655.

[70] Transylvania Ry. Co. v. Commissioner, (C.C.A. 4th, 1938) 99 F. (2d) 69 at 71.

[71] While overall tax relief is current policy, (see Revenue Act of 1948), there is no Congressional policy to permit tax advantage through the use of erroneous deductions; I.R.C., § 24 (b) 1, § 129, §131 (c); Detroit Edison Co. v. Commissioner, 319 U.S. 98, 63 S.Ct. 902 (1943); Crane v. Commissioner, 331 U.S. 1, 67 S.Ct. 1047 (1947). Consistency suggests that the equivalent value of the tax savings be returned, but this is perhaps too much to hope for the present. As with any innovation in law, recognition of a variable dollar bides the test of time. Concern over the effects of an unstable price level has moved from the dry pages of texts on Money & Banking to the front pages of responsible publications: "Shrinking Value of the Dollar," U.S. NEWS (April 8, 1948) p. 23; 37 FORTUNE, No. 4 (April, 1948). This may well portent the course of the future.