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Tufts and the Evolution of Debt-Discharge Theory*

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I. INTRODUCTION

Consider poor Debtor, who purchased a personal residence for \$130,000 several years ago with a hefty mortgage and today, like many others caught between the Scylla of the economic recession and the Charybdis of collapsing real estate values,[1] finds himself losing his home. Perhaps he loses his home because he can no longer continue to meet the mortgage payments. Perhaps he simply stops making mortgage payments because he appreciates the economic reality that it would not be wise to continue to make payments on the \$122,000 remaining mortgage when the fair market value of the home has plunged to \$100,000. This approach would be particularly appealing if Debtor knew that the creditor would not, or could not, enforce any deficiency against Debtor's other assets.

What are the tax consequences upon transfer of the home to the mortgagee in *full* satisfaction of the debt? Upon researching the law, Debtor's tax advisor learns that, because the debt discharged (\$122,000) exceeds the fair market value of the property transferred in satisfaction of the debt (\$100,000), the tax consequences will vary dramatically depending on whether the debt is styled "recourse" or "nonrecourse."

These are the facts of a 1991 Technical Advice Memorandum,[2] which Memorandum demonstrates most clearly both the irrationality and the growing acceptance as settled doctrine of the irreconcilable conceptual approaches taken by the government (including both the Internal Revenue Service in rulings and cases and the Treasury Department in regulations) regarding the discharge or cancellation[3] of recourse and nonrecourse debt in the course of a transfer of property.

If the debt is "recourse,"[4] the government bifurcates the transaction (the "bifurcated approach"): The property disposition is analyzed under section 1001 of the Code, and the discharge of indebtedness is analyzed under sections 61(a)(12) and 108. Under this approach, the asset is considered sold for its fair market value (resulting in the realization of gain or loss on

1. I did not originally think the reference to Scylla and Charybdis called for a footnote, but upon recently reading another reference to these unfortunate creatures accompanied by an explanatory footnote, I decided to cite that helpful footnote for any reader in need of clarification. See Kenneth Lasson, Feminism Awry: Excesses in the Pursuit of Rights and Trifles, 42 J. Legal Educ. 1, 23 n.94 (1992).

2. I.R.S. T.A.M. 9130005 (March 29, 1991); see infra notes 174-98 and accompanying text.

3. A debt is cancelled or discharged, rather than satisfied, when it is not repaid in full, as when property transferred in payment of the debt has a value less than the outstanding indebtedness.

4. By "recourse debt" I generally mean a debt for which the debtor is personally liable for the amount of the debt.

the property disposition under section 1001), and the sale proceeds are then considered used to settle the outstanding indebtedness (resulting in the realization of income from the discharge of indebtedness under section 61(a)(12)). The authority cited for the bifurcated approach is a regulation which provides: "The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12)."[5] The accompanying example states:

> In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500-$6,000).[6]

Thus, with a recourse mortgage our Debtor would realize a $30,000 nondeductible personal loss on the property disposition[7] and $22,000 of ordinary income resulting from the discharge of indebtedness.[8]

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5. Regs. § 1.1001-2(a)(2).

6. Regs. § 1.1001-2(c), ex. 8. If property is sold in foreclosure for less than the full amount of an outstanding recourse liability and the creditor does not abandon its rights to collect the deficiency, the debtor's amount realized for purposes of calculating gain or loss under section 1001(a) equals the proceeds received in the sale. If the creditor eventually abandons its claims regarding the deficiency, the debtor will be charged with cancellation-of-indebtedness income ("COD income") at that time. If the debtor pays the deficiency in full, COD income is avoided. See Aizawa v. Commissioner, 99 T.C. No. 10 at 48,401 (CCH), 9,910 (P-H) (Aug. 6, 1992). This separation of the tax consequences of the sale from the tax consequences of the debt is consistent with the bifurcated approach.

7. The difference between the fair market value of the residence ($100,000) and the taxpayer's cost basis ($130,000) produces a $30,000 realized capital loss under sections 1001 and 1221. Because the loss arises on the disposition of a personal-use asset, the loss is nondeductible. IRC § 165(a) and (c).

8. The difference between the fair market value of the asset transferred in payment of the debt ($100,000) and the amount of the debt discharged on the transfer ($122,000) produces $22,000 of ordinary income under section 61(a)(12) which must be recognized immediately unless, in general, the debtor has filed bankruptcy under Title 11 of the United States Code or is insolvent. See IRC § 108(a)(1). In the event of either bankruptcy or insolvency, the debtor pays the tax due on the COD income more slowly over time (presumably when the taxpayer is in a better financial condition) through reduction of favorable tax attributes or of basis of depreciable property owned by the debtor. See IRC §§ 108(b), 1017. Of course, deferral by itself results in partial forgiveness because of the time value of money. See Charlotte Crane, More Theory About Debt Discharge Income, 8 Am. J. Tax Pol'y 107, 109-11 (1989) (describing the value of tax deferral on the reduction of property basis in lieu of immediate recognition of COD income). The only instance in which the exclusion provided in section 108(a) was intended by Congress to result in complete

forgiveness is that rare one in which the taxpayer has none of the tax attributes listed and owns no property the basis of which could be reduced. The general intent of the statute is not to forgive the tax but rather merely to defer it. See S. Rep. No. 1035, 96th Cong., 2d Sess. 10 (1980) (law was intended "to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge").

The insolvency exclusion provided in section 108(a) differs dramatically from the common-law insolvency exclusion that it replaced which was developed by the courts prior to adoption of current section 108 as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (1980). The common-law insolvency exclusion was a complete forgiveness provision which rested on the cryptic rationale given by Justice Holmes in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), the case that established the general rule that the discharge of indebtedness produces gross income. Justice Holmes reasoned that when the taxpayer bought its bonds on the market for nearly $138,000 less than their face amount, "it made available $137,521.30 assets previously offset by the obligation of bonds now extinct." Id. at 3. Later courts reasoned that if no assets were freed from liabilities as a result of the discharge, as in the case of an insolvent taxpayer who is not made solvent by the discharge, then no income is even realized.

By 1980, the freeing-up-of-assets rationale had gone by the wayside; most commentators argued that the rationale underlying the general rule that income is realized on the forgiveness of debt is simple symmetry. See infra notes 81-117 and accompanying text (discussing current rationale in more detail). Because the loan amount is excluded on receipt on the theory that there is no "accession[] to wealth" over which the taxpayer has "complete dominion," Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), in light of the obligation to repay with after-tax dollars, an extinguishment of that obligation to repay takes away the authority for the initial exclusion. Under that theory, solvency becomes irrelevant; COD income is realized even by insolvent debtors. (And rightly so. After all, wages earned by a taxpayer with a negative net worth are not exempt from tax merely because the debtor is insolvent and is not made solvent by the increase in assets.) See Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 6.4.1, at 6-31 to 6-32 (2d ed. 1989). Recognizing the financial straits of bankrupt and insolvent debtors who realize COD income, however, Congress permitted those debtors to defer recognition of that realized income to some point in the future through the mechanism contained in section 108(b). See generally Estate of Newman v. Commissioner, 934 F.2d 426, 430-32 (2d Cir. 1991) (containing an excellent, succinct history of the developing theory of the insolvency exclusion).

The only instance in which no COD income is considered as even being realized (and thus by definition will never be recognized in the future through the mechanism in section 108(b)) arises when a solvent debtor outside bankruptcy negotiates a debt reduction with the seller of property who also financed the purchase of the property with the cancelled debt. Because the seller wears two hats—seller of property and lender of dollars to finance the purchase—until 1980 numerous factual controversies arose in the case of a reduction of a purchase-money mortgage. The surrounding facts had to be examined carefully to determine whether the seller-creditor had his seller's hat on (in which case the reduced debt reflected a renegotiated purchase price) or his creditor's hat on (in which case the reduced debt reflected cancelled debt). The former resulted in no income but a lowered cost basis, while the latter resulted in no alteration in the purchased property's basis but also resulted in the realization of COD income. After 1980, even when the surrounding facts clearly indicate an intention by the seller-creditor to cancel debt rather than renegotiate the purchase price, the debt reduction is "treated as a purchase price adjustment" by fiat under section 108(e)(5). In essence, the now-repealed option to reduce basis instead of recognizing COD income (see infra notes 38-40

If the debt is "nonrecourse,"[9] the government collapses the two component parts into the property disposition under section 1001 by including the entire debt in the amount realized (the "collapsed approach"). No cancellation-of-indebtedness income ("COD income") is deemed realized. This approach was approved by the Supreme Court in *Commissioner v. Tufts*,[10] discussed more fully below, and can now be found in the following subsections of the same treasury regulation containing the rule for recourse debt discussed above.

> *Except as provided in paragraph (a)(2)* [pertaining to recourse debt]..., the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.[11]
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> ....
>
> The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from

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and accompanying text) remains in this very narrowly defined context but is mandatory. The provision applies whether the debt involved is recourse or nonrecourse and whether the property is used in a trade or business, is investment property, or is personal-use property. Because section 108(e)(5) by definition applies only to amounts that would otherwise be COD income, facts that indicate a post-purchase renegotiation of purchase price of debt-financed items, instead of debt reduction, ought still to be treated as resulting in a nontaxable price reduction and not COD income even if the item purchased with the debt constitutes services instead of "property" within the meaning of section 108(e)(5). Cf. infra note 217 (discussing the *Zarin* case).

For an exhaustive article examining all the tax permutations of discharge-of-indebtedness doctrine, see Fred T. Witt, Jr. & William H. Lyons, An Examination of the Tax Consequences of Discharge of Indebtedness, 10 Va. Tax Rev. 1 (1990).

9. "Although the term 'nonrecourse' is used in a number of provisions, it is nowhere defined in the Code. Similarly, the regulations do not provide a general definition of what constitutes nonrecourse indebtedness." Frederick H. Robinson, Nonrecourse Indebtedness, 11 Va. Tax Rev. 1, 3 (1991). By "nonrecourse debt," I generally mean a debt for which the debtor is not personally liable. The lender is barred from action against the borrower's other assets if the security value is insufficient to satisfy the loan. For a helpful description of the origins and use of nonrecourse debt for both nontax and tax reasons, see Daniel N. Shaviro, Risk and Accrual: The Tax Treatment of Nonrecourse Debt, 44 Tax L. Rev. 401, 421-27 (1989).

10. 461 U.S. 300 (1983).

11. Regs. § 1.1001-2(a)(1) (emphasis added).

> being treated as money received from the sale or other disposition of the property. *However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.*[12]

Thus, our Debtor would be considered to be disposing of his property for $122,000 under this approach, producing an $8,000 nondeductible personal loss.[13] No COD income would be considered realized.[14]

Does the dichotomy in treatment of recourse and nonrecourse debt make conceptual sense? If not, how did it come about and why does it remain? What are the practical consequences of the dichotomy? These are the questions with which this article deals. And while the questions seem to be fairly narrow in scope, their resolutions require a broad consideration of fundamental principles of income taxation, including the treatment of gains and losses attributable to personal-use property.

Part II of this article delves into the historical development of the dichotomy, exploring the decision and briefs in *Tufts* and the promulgation of the regulations formalizing the *Tufts* approach for nonrecourse debt and containing the bifurcated rule for recourse debt. A thoughtful parsing of both the *Tufts* decision and the supporting briefs reveals that the Court was not likely aware that the bifurcated approach controlled in the case of recourse debt and was not likely aware that it was cementing *different* approaches in the *Tufts* situation depending on whether the debt involved in the transaction is recourse or nonrecourse.

Part III examines whether the dichotomy makes sense in light of both the historical development and the more recent development of doctrine in this area and its effects in the tax world. Even if the collapsed approach for nonrecourse debt were defensible at the time *Tufts* was considered, its continued defensibility at this point in the evolution of debt-discharge theory is questionable. Nonrecourse indebtedness, once considered an inseparable part of the ownership interest in the securing property, has been increasingly recognized as a separate tax attribute requiring independent tax analysis in

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12. Regs. § 1.1001-2(b) (emphasis added).

13. The difference between the Debtor's $130,000 cost basis and the $122,000 amount realized produces the $8,000 realized capital loss under sections 1001(a) and 1221, which loss is a nondeductible personal loss under section 165(a) and (c).

14. In the more distant past, neither the government nor the courts consistently applied the bifurcated approach in the case of recourse debt, oftentimes applying the collapsed approach instead. See Alice Cunningham, Payment of Debt with Property—the Two-Step Analysis After Commissioner v. Tufts, 38 Tax Law. 575, 599-605 (1985) [hereinafter Cunningham I]. However, the bifurcated approach has clearly controlled in recent years in the case of recourse debt. See infra note 72 and accompanying text (discussing a recent case and ruling consciously affirming the bifurcated approach for recourse debt).

contexts prior to a transfer of the securing property. The theory underlying the collapsed approach, that nonrecourse indebtedness is considered too intimately tied to the property ownership to be analyzed as a separate tax attribute on disposition of the property itself, is fast becoming a conceptual relic in this evolution.

Moreover, the perceptiveness of tax professionals who appreciate the radical difference in tax consequences on disposition of the securing property depending on whether the debt is recourse or nonrecourse, as well as the radical difference in tax consequences on the discharge of nonrecourse debt itself depending on whether the securing property is retained or transferred, has resulted in the structuring of transactions that exploit these discontinuities. Of course, that in itself is not troublesome if the differing treatments are warranted for sound conceptual reasons, but an examination of the reasons fashioned for the collapsed approach finds them wanting.

Because all good things come to those who wait, the heart of the critique of the collapsed approach is reserved for Part IV. Part IV considers the indefensible effects of the collapsed approach on the disposition of personal-use property and the lessons learned in that context. The collapsed approach allows, in effect, a backdoor deduction of what is considered taxable personal consumption in that context. Examining the consequences of the collapsed approach in those circumstances (circumstances which may be rare in the real world) demonstrates the fatal flaw of the collapsed approach in *all* contexts: It links the accession to wealth that arises on failure to repay loan proceeds to the ownership interest in the securing property when the accession to wealth should be attributed solely to the liability relief.

The article ultimately suggests the adoption of the bifurcated approach for both nonrecourse and recourse debt when debt is discharged upon the transfer of property worth less than the outstanding debt.

II. THE HISTORICAL DEVELOPMENT OF THE DICHOTOMY

A. *The* Tufts *Decision*

1. *The* Tufts *facts and the two* Tufts *issues.*—In the simplified facts of *Commissioner v. Tufts,*[15] Tufts transferred property with a fair market value of $1,400,000 to a buyer who agreed to reimburse sale expenses and to take the property subject to the nonrecourse mortgage. Tufts had financed

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15. 461 U.S. 300 (1983). The taxpayer incurring the nonrecourse debt was actually a partnership in which Tufts was a partner. The property disposed of was actually each partner's interest in the partnership. These subtleties, however, did not affect the outcome of the case, and the holding applies to all dispositions of property subject to nonrecourse debt, whether or not within the context of a partnership.

the property's construction entirely with a $1,850,000 nonrecourse mortgage, and thus the property's initial basis was $1,850,000 under the rule in *Crane v. Commissioner.*[16] Because of $400,000 of depreciation deductions taken while Tufts owned the property, its adjusted basis was $1,450,000 at the time of the sale.[17] Tufts had not made any principal payments on the $1,850,000 loan before selling the property. Tufts claimed a $50,000 loss on the disposition under section 1001, implicitly accepting that the transaction was governed entirely by section 1001 but arguing that the amount realized under that section was equal to the amount of debt of which he was relieved but limited to the fair market value of the property transferred. Tufts lost in the Tax Court[18] but won a reversal in the Fifth Circuit Court of Appeals.[19] The Supreme Court granted the government's petition for certiorari.

Justice Blackmun's opinion for the Court began:

> Over 35 years ago, in *Crane v. Commissioner*, 331 U.S. 1 (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case

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16. 331 U.S. 1 (1947). Under *Crane*, the amount of purchase debt is included in cost basis, whether the debt is recourse or nonrecourse. On the death of her husband, Mrs. Crane received an apartment building subject to nonrecourse debt of $225,000 plus $7,000 in overdue interest. For estate tax purposes, the land and building were valued at $262,000—precisely the amount of the principal and overdue interest—so her equity in the land and building was zero. She took depreciation deductions totalling $25,500 over her seven years of ownership. She collected rent and paid expenses and taxes, but the remaining net cash flow was not sufficient to service the debt. At the end of seven years, the $225,000 principal remained and the interest arrearage actually increased.

The mortgagee threatened foreclosure, so Mrs. Crane sold the property for $3,000 in cash (less $500 in selling expenses). The mortgagee also took the property subject to the nonrecourse mortgage. She reported $2,500 gain, arguing that the amount realized was $2,500 and her adjusted basis was zero because "property" within the meaning of the predecessor of section 1014 (pertaining to the basis of property acquired from a decedent) referred to "equity" in the land and the building, not the land and building themselves. The Supreme Court held that "property" referred to the land and building themselves, not merely her equity, and thus her original unadjusted basis on receipt of the land and building was not zero but rather $262,000. Id. at 11. Once the Court determined that her basis included the nonrecourse debt, it concluded that the amount realized on sale similarly included the debt. Id at 13. While *Crane* itself dealt only with the basis of property acquired from a decedent, its holding that acquisition debt is included in basis was immediately extended to cost basis as well.

17. Basis is reduced by allowable depreciation deductions under section 1016(a)(2).

18. Tufts v. Commissioner, 70 T.C. 756 (1978).

19. Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981).

> now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.[20]

Thus, from its first sentence, the Court did not identify and treat as separate issues what were really two independent questions that needed to be resolved in order to determine the tax consequences to Tufts on the disposition.[21] The first issue was whether relief from nonrecourse debt in excess of the fair market value of the property transferred could properly be considered an accession to wealth. That was the question with which the government was most concerned and the question on which it spent all of its efforts. If the answer to the first question were in the affirmative, as the government argued and as the Court held, then the second question concerned an issue not presented by the facts of *Crane*—the proper conceptual approach to that debt relief. With respect to this issue, the government argued, more implicitly than explicitly, that the transaction should *not* be bifurcated into its component parts—discharge of debt and property disposition—but rather that the collapsed approach, under which debt relief is collapsed into the analysis of the property disposition under section 1001, was proper. The debt cancellation simply becomes part of the amount realized in that computation.

This second issue never arose in *Crane* because no debt was cancelled as part of the transaction; Mrs. Crane satisfied the debt in full. The inclusion of the nonrecourse debt in amount realized was the *only* means available to take account of the accession to wealth simply because the value of the property was deemed to equal or exceed the amount of the debt encumbering the property. Thus, there was no possible competition between section 61(a)(12) and section 1001. With the guidance given it, the Court failed to appreciate this distinction between *Crane* and *Tufts* and thus failed to give adequate attention to the second issue presented by *Tufts* which was *not* an issue in *Crane*. The Court indicated that *Tufts* was really no different in character from *Crane*: "In *Crane v. Commissioner*, ... this Court took the first and controlling step toward the resolution of this issue."[22]

2. *The Court's resolution of the first issue.*—The Court dedicated almost the entirety of its majority opinion to the first issue, concluding correctly that the relief from the entire indebtedness, including that portion of nonrecourse indebtedness exceeding the fair market value of the property

20. *Tufts*, 461 U.S. at 301-02.

21. For the tax consequences to the buyer, see Erik M. Jensen, The Unanswered Question in Tufts: What Was the Purchaser's Basis?, 10 Va. Tax Rev. 455 (1991) [hereinafter Jensen I.].

22. *Tufts*, 461 U.S. at 304.

transferred, produced an accession to wealth. To do so, the Court had to abandon the intimation made earlier in *Crane* that the rationale for this conclusion was due to the "economic benefit" realized by the taxpayer on being relieved of the debt. Under the economic-benefit rationale, the *Crane* Court argued that a mortgagor receives an economic benefit when he transfers property subject to a mortgage, even if the mortgage is nonrecourse to the taxpayer, because he will treat the loan as if he were personally liable in order to protect the equity he has in the property.[23] *Tufts* picked up on the *Crane* Court's intimation in footnote 37 of the case that if the securing property is worth *less* than the mortgage debt, the taxpayer who is not personally liable on the debt has no economic reason to satisfy the debt in full and thus receives no economic benefit when another assumes that obligation.[24]

In ruling against Tufts, Justice Blackmun stated:

> *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a *true loan*. This approval underlies *Crane*'s holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.[25]

Justice Blackmun's "true loan" rationale reflects the fact that the taxpayer did not include in income any of the nonrecourse loan proceeds on receipt on the

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23. See Crane v. Commissioner, 331 U.S. 1, 13-14 (1947).

24. Footnote 37 in *Crane* stated:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

Id. at 14 n.37.

25. *Tufts*, 461 U.S. at 307 (emphasis added). The language here regarding the appropriateness of including the entire debt relief in amount realized illustrates the failure of the Court to tease out what are really two separate issues. The fact that the full amount of the loan can properly be taken into consideration in determining the tax consequences does not determine whether those consequences should arise solely under section 1001 or whether the consequences of the debt relief should be analyzed under the provisions governing COD income.

theory that there was no "accession to wealth"[26] because of the obligation to repay with after-tax dollars. Indeed, the taxpayer's inclusion of the full amount of debt in basis (upon which depreciation is calculated) evidenced the taxpayer's acknowledgment that these loan proceeds were received and excluded on that theory. When the obligation to repay disappeared so did the justification for the original exclusion from income. This rationale is the same used by modern commentators to justify the inclusion in gross income of COD income.[27]

3. *The Court's deference to the collapsed approach with respect to the second issue.*—The conclusion that relief from nonrecourse indebtedness in excess of the fair market value of the property transferred in the transaction constitutes an accession to wealth for which the tax law can account fails to answer the question regarding *how* the tax law should account for such relief. As noted above, the majority opinion gave short shrift to this issue, simply stating that the collapsed approach adopted by the Commissioner was not unreasonable.[28] The Court indicated in a footnote that the bifurcated approach described in an amicus brief[29] "indeed could be a justifiable mode of analysis"[30] but that the proper role of the Court was not to decide which method was best. Rather, its job was to decide only whether the method chosen by the Commissioner was a reasonable one. Because the government, as developed more fully below, neither fully alerted the Court that the bifurcated method was used for recourse debt nor, consequently, defended using *different* approaches for different types of debt, the Court's conclusion that the collapsed approach was "reasonable" was itself unsurprising. Thus, the Court affirmed that Tufts's disposition generated $400,000 of gain under section 1001: the difference between Tufts's $1,450,000 basis and the $1,850,000 debt of which he was relieved.

Justice O'Connor, in her concurring opinion, agreed with the majority regarding the proper role of the Court but went on record as strongly endorsing the bifurcated approach, advocated in an amicus brief submitted by

26. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (defining income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

27. See supra note 8 and infra notes 81-117 and accompanying text (describing current debt-discharge theory).

28. See *Tufts*, 461 U.S. at 310. Indeed, had it not been for Professor Barnett's amicus brief (see infra notes 31-35 and accompanying text), the Court would probably not have been aware of the possibility of using the bifurcated approach.

29. See infra notes 31-35 and accompanying text (discussing the amicus brief).

30. *Tufts*, 461 U.S. at 310 n.11 (indicating that the Court might also affirm that approach if the Commissioner changed his position).

Professor Wayne G. Barnett of her alma mater,[31] as the more conceptually correct approach.[32] The bifurcated approach described is in its essentials the bifurcated approach actually adopted in the regulations for recourse debt when property worth less than the debt is transferred in complete discharge of the debt.[33] Under that approach,[34] Tufts's asset would be considered sold

31. Brief for Amicus Curiae, Commissioner v. Tufts, 461 U.S. 300 (1983) (No. 81-1536). Professor Barnett was Professor of Law at Stanford Law School from 1966-1986. He has been Professor Emeritus at Stanford since 1986. See Ass'n of Am. Law Schools, The AALS Directory of Law Teachers 1991-1992, at 163 [hereinafter the Directory]. Stanford was Justice O'Connor's alma mater. Because Justice O'Connor graduated from Stanford in 1952, however, she could not have been Professor Barnett's student.

32. *Tufts*, 461 U.S. at 317 (O'Connor, J., concurring).

33. Professor Barnett's approach is actually a bit broader than the bifurcated approach taken in the regulations for recourse debt. Barnett's bifurcated approach, under which the tax consequences of the liability are analyzed separately from the tax consequences of the property transfer, would apply in all cases, even in cases unlike *Tufts* in which the fair market value of the property transferred exceeds the extinguished liability. The bifurcated approach for recourse debt described in the regulations, in contrast, applies only in those cases in which the fair market value of the property transferred is less than the extinguished debt, for only in those cases is there a tension between COD income under section 61(a)(12) and gain under section 1001.

Professor Cunningham describes the broader approach with the following example.

> Assume, for example, that the unpaid balance of the debt is $100 and that the property transferred in payment of the debt has a fair market value and an adjusted basis of $110. Under the *Tufts* analysis, the transaction would produce asset loss of $10 (the $110 adjusted basis of the transferred property less the $100 amount realized from the discharged debt). That loss would be taxable under the gain-from-sale rules and thus might be subject to the capital loss limitations. Similarly, the two-step analysis also would produce a net loss of $10: (1) a liability loss of $10 (the $100 debt discharged less the $110 paid therefor) and (2) an asset gain of 0 (the $110 value of the transferred property less the $110 adjusted basis of such property). However, the $10 liability loss would be taxable under the debt-relief rules and hence would be deductible in full against ordinary income as a premium paid in discharge of the debt.

Cunningham I, supra note 14, at 585-86 (footnote omitted). She notes that this scenario might occur when foreign-currency-denominated debt is repaid with foreign currency that has appreciated against the dollar. At the time she wrote the article, the Code was silent regarding the proper taxation of such transactions. The Tax Reform Act of 1986 enacted section 988 of the Code, entitled "Treatment of certain foreign currency transactions," which essentially accomplishes the result she describes in her example.

Outside of foreign-currency transactions (now addressed by statute), the facts of Professor Cunningham's example (a transfer of property with a fair market value exceeding the debt settled on the transfer) would not seem to be very common. Most taxpayers would, it seems, sell the property first, settle the debt in cash, and keep the excess cash. The tension that exists between the creation of COD income under section 61(a)(12) and the creation of gain under section 1001 because the discharged debt exceeds the fair market value of the property transferred is the more significant one in the real world. While adoption of the for its $1,400,000 fair market value. That sale would produce a loss of $50,000 under section 1001 for Tufts. The sale proceeds would then be considered used to extinguish Tufts's liability with respect to the indebtedness. Because a $1,850,000 debt would be considered extinguished for $1,400,000, Tufts would realize $450,000 of COD income.

While the net *amount* of income happens to be the same on these particular facts under the bifurcated approach as under the collapsed approach—$400,000 net positive amount—the *character* of the income may well be different, and that was the point stressed by Professor Barnett.[35] COD income is ordinary and potentially deferrable under section 108 while gain from the sale of an asset is most likely capital, at least in part,[36] and not deferrable.

In view of the limitation on the deductibility of capital losses[37] and the historical preference given net capital gain at that time, why did the Service argue for $400,000 gain instead of $450,000 ordinary income coupled with a $50,000 capital loss? Would not the latter bring in more dollars to the

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bifurcated approach in all transfer cases (i.e., even to recourse debt cases to which it does not apply now, cases in which the fair market value of the property transferred is greater than the discharged debt), would be the more conceptually pure approach, the extension of the bifurcated approach to nonrecourse debt in the single context in which it now applies to recourse debt (i.e., when the fair market value of the property transferred is less than the discharged debt) would alleviate the vast majority of incongruous results arising under current law. Thus, this article makes that more modest proposal. If the proposal advocated in this article is adopted, a transfer of property with an adjusted basis and value of $110 in satisfaction of a $100 debt would continue to produce a $10 loss under section 1001, whether the debt is recourse or nonrecourse.

34. See supra notes 4-8 and accompanying text (describing the bifurcated approach).

35. In his brief Professor Barnett stated:

> [C]ontrary to the parties' assumptions, the resolution of the "amount realized" question the government presents will in fact have no effect whatever on the total amount of the gain that ... [Tufts] must be held to have realized. All that it will determine, to the contrary, is the character of the gain: how much is to be treated as an asset gain (and hence as a capital gain) and how much as a liability gain (and hence as ordinary income potentially deferrable under § 108).

Brief for Amicus Curiae, supra note 31, at 14; see Cunningham I, supra note 14, at 585 ("In actuality, the difference between the one-step and the two-step analyses lies not in the amount of income or loss, but in its character."). See infra notes 191-98 and accompanying text (arguing that the more significant difference between the two methods is the intolerable inconsistency in the amount of income taken into account when personal-use property is transferred in satisfaction of the debt).

36. This conclusion assumes that the asset is either a capital asset or a section 1231 asset. Some or all of Tufts's gain under the majority's analysis would have constituted ordinary income in any event under the depreciation recapture provisions. See IRC §§ 1245, 1250.

37. See IRC §§ 1211, 1212.

Treasury? At the time the case was decided, the answer was "not necessarily." Prior to the Tax Reform Act of 1986,[38] section 108 allowed deferral of COD income arising on the discharge of "qualified business indebtedness" even by solvent taxpayers[39] by a timely election to reduce the basis of depreciable property.[40] With that incentive to use the collapsed approach now history, why doesn't the Treasury issue a revised regulation conforming its approach for nonrecourse debt relief to that of recourse debt relief?[41] As this article argues that it must do just that—that using *different* approaches depending on the status of the debt is not reasonable and, further, that the collapsed approach itself is flawed—the medicine should not be too difficult to swallow.[42]

B. *The* Tufts *Briefs*

The Court's easy affirmation of the collapsed approach is understandable in view of the posture of the case, the information provided it, and the

38. Pub. L. No. 99-514, § 822(a), 100 Stat. 2373 (1986).

39. See supra note 8 (discussing the section 108(a) exclusion for insolvent and bankrupt taxpayers).

40. See William D. Popkin, Introduction to Federal Income Taxation 529 (1987) ("The Commissioner probably preferred sales proceeds treatment because discharge of indebtedness income usually resulted in tax deferral, by allowing the taxpayer to reduce basis.").

41. "To my mind, the Court left little doubt about how the government could, if it wished, adopt the Barnett view. Had that analysis been codified in regulations, the Court strongly hinted that it would have deferred to the revised Treasury position." Erik M. Jensen, Nonrecourse Liabilities and Real Costs: A Reply to Professor Johnson, 11 Va. Tax Rev. 643, 650 (1992) [hereinafter Jensen II]. See also Kimberly S. Blanchard, Discharge of Nonrecourse Debt: A Reexamination of the Distinction Between Recourse and Nonrecourse Debt and Related Issues, Special Report, 50 Tax Notes 773, 779 (Feb. 18, 1991) (arguing that the Treasury Department has the power to unilaterally change the collapsed approach affirmed in *Tufts* because the only reason that the *Tufts* Court affirmed the collapsed approach rather than the bifurcated approach was deference to the Commissioner). The current Supreme Court has recognized that deference under Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), to an administrative agency's permissible construction of a statute is warranted, even if it blatantly reverses a longstanding construction, so that the agency may take account of changes in policy, theory, the state of technology, or other changes over time. See, e.g., Rust v. Sullivan, 111 S. Ct. 1759, 1769 (1991); see also Antonin Scalia, Judicial Deference to Administrative Interpretations of Law, 1989 Duke L.J. 511, 518 ("[T]he capacity of the *Chevron* approach to accept changes in agency interpretation ungrudgingly seems to me one of the strongest indications that the *Chevron* approach is correct.").

42. On the other hand, the insolvency and bankruptcy exclusions under section 108(a), which are not available to shelter gain realized under section 1001, may be used by many more taxpayers today than one might at first imagine. With net capital gain taxed at or near the rates applied to ordinary income (see IRC § 1(h)), the government's best revenue interests might yet be in preserving the collapsed approach.

government's own apparent misunderstanding of how a *Tufts* transfer would be taxed in the case of recourse debt under its regulations.[43] First, Tufts's attorneys had no incentive to argue that use of the bifurcated approach was necessary because that approach would likely have produced a larger tax bill for Tufts.[44] Tufts did not make a timely election at the time of the sale to reduce the basis in other property held in lieu of recognizing the COD income under the "qualified business indebtedness" provision. Thus, the $450,000 in COD income would have been immediately taxable under section 61(a)(12) (unless Tufts was insolvent or in bankruptcy court),[45] and the $50,000 capital loss would have been subject to the capital-loss-limitation rules contained in sections 1211 and 1212. It follows that Tufts was better off, if he lost the issue concerning whether *any* accession to wealth occurs in view of the debt exceeding the fair market value of the property transferred, accepting the collapsed approach in analyzing that accession to wealth. As noted, he recognized $400,000 of gain under section 1001, some of which would be ordinary, under that approach.

Second, the government's briefs, which are quoted extensively below to give an accurate picture of the cumulative effect of the government's statements, also failed to help the Court appreciate the second issue in *Tufts*. In fact, the briefs illustrate that the government did not appreciate how its own regulations operated in the case of a *Tufts* transfer involving recourse debt. From the petition for writ of certiorari onward, the government characterized the case as presenting only a single issue, thus allowing the Court to conclude easily that if relief from nonrecourse debt in excess of the fair market value of the property transferred was properly considered an

43. "[T]he quality of a court's thinking is often limited by the quality of arguments presented to it." Jensen II, supra note 41, at 648.

44. The thrust of Tufts's Supreme Court brief was that the statutory definition of amount realized cannot be judicially expanded to include the recapture of earlier tax benefits. Brief for the Respondents, Commissioner v. Tufts, 461 U.S. 300 (1983) (No. 81-1536). Perhaps recognizing that if the Court agreed with that proposition it might conclude that Tufts nevertheless realized COD income, the brief also argued that, "This Case Involves only 'Amount Realized' upon the 'Sale or Disposition' of ... [Property] and not Cancellation of Indebtedness Income." Id. at 10. In support of this proposition, the brief conceded that although COD income would be realized if the debt had been recourse (id. at 13-14), no COD income can be realized with respect to nonrecourse debt because "non-recourse debt is not truly debt.... Economically, non-recourse obligations are not true debt at all. No one owes the debt or has promised to repay it." Id. at 16-17. The brief recognized that a loophole existed if the debt relief neither created amount realized nor created COD income but that it was Congress's job to close it. "Petitioner contends that this Court should close the non-recourse loophole by expanding Section 1001(b) because Congress has not seen fit to do so. Respondents contend to the contrary, for exactly the same reason." Id. at 17.

45. See supra note 8 (discussing the section 108 exclusion for insolvent and bankrupt taxpayers).

accession to wealth, the *sole* method to ensure its taxation was to include it in the amount realized on the property disposition. The single question presented by the government in its petition was:

> Whether a person who owns property subject to mortgage indebtedness for which he assumes no personal liability (nonrecourse debt), where such indebtedness is properly includable in his tax basis of the property for depreciation and other purposes, must likewise include the full measure of the indebtedness as an "amount realized" when he disposes of the property subject to the mortgage, whatever the fair market value of the property at the time of the disposition.[46]

The government's principal brief rephrased the question a little which, if anything, served to stress the computation of gain or loss under section 1001.

> Whether, for purposes of computing gain or loss for tax purposes, a person who owns property subject to mortgage indebtedness for which he assumes no personal liability (nonrecourse debt) and who properly includes the funds borrowed under the mortgage in his cost basis of the property for depreciation and other purposes, must likewise include the full measure of the unrepaid indebtedness as an "amount realized" when he disposes of the property subject to the mortgage, whatever the fair market value of the property at the time of the disposition.[47]

The brief toys a little with the notion of COD income but does so only to support the argument that relief from the nonrecourse indebtedness in excess of the property's fair market value constitutes an accession to wealth.[48] The brief then immediately goes on to characterize that accession to wealth not as COD income (because related to the failure to repay the full principal amount of the debt) but as amount realized.[49]

> If the theoretical basis for excluding the proceeds of a loan from the gross income of the borrower is the existence

46. Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at (I), Commissioner v. Tufts, 461 U.S. 300 (1983) (No. 81-1536).
47. Brief for the Petitioner at (I), *Tufts*, (No. 81-1536).
48. See id. at 11-13.
49. See id. at 15-16.

> of an offsetting liability to repay the loan, then the termination of that liability with the repayment in cash of less than the amount received should normally give rise to taxable income. The classic illustration of that principle is this Court's decision in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). There, the Court held that where a corporation purchased and retired some of its own bonds for less than their par value (which it had received for them when issued), the difference was taxable income. The taxable receipt arose upon the cancellation or discharge of the indebtedness when the corporation purchased its bonds for less than the liability they represented.
>
> The proposition that relief from a liability can be treated as consideration received on the disposition of property—*i.e.*, part of the "amount realized"—is squarely supported by *Crane v. Commissioner*, 331 U.S. 1 (1947), the decision that is the focus of this case. There, the Court concluded that relief from the obligation of a nonrecourse mortgage was part of the amount realized by the mortgagor upon the sale of the encumbered property for cash plus the buyer's taking subject to the mortgage. Upon such a transfer, "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." *Id.* at 14.[50]

Most troubling were the errors in omission as well as commission in dealing with the disparate treatment of recourse and nonrecourse debt in the *Tufts* situation. The briefs not only failed to alert the Court to the disparate treatment provided in the regulations (and thus failed to argue further that such disparate treatment was justifiable), they actively misled the Court to the belief that the government treats nonrecourse debt and recourse debt *alike* on the disposition of property in full satisfaction of a debt exceeding the fair market value of the property. Thus, the Court was led to believe that a holding for the government would *conform* the tax consequences of Tufts's transaction to an identical transaction involving recourse debt. The Court's belief that its holding was *doing away with* the distinction between recourse and nonrecourse debt in a *Tufts* situation is plainly evident.

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50. Id. (footnote omitted). Not only does this excerpt use COD-income theory in justifying the argument that an accession to wealth occurred, while reverting to the collapsed approach in taxing that accession, it also fails to acknowledge that *Crane* could not have involved COD income. The debt relief in *Crane* could only have been included in amount realized as no debt was cancelled; the property's value covered the debt.

> Although a different approach might have been taken with respect to a nonrecourse mortgage loan, *the Commissioner has chosen to accord it the same treatment he gives to a recourse mortgage loan.*
>
> ... *Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.
>
> ....
>
> Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. *The only difference between that mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property.*[51]

Commentators characterizing the effect of *Tufts* have similarly assumed that the Court believed that what it was doing was conforming the treatment of nonrecourse and recourse debt in a *Tufts* transaction. In his student treatise, Professor Marvin A. Chirelstein comments that the *Tufts* Court held that "[i]n effect, borrowing with personal liability and borrowing without personal liability are to be treated alike for ... [purposes of section 1001]."[52]

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51. *Tufts*, 461 U.S. at 308-12 (emphasis added) (footnotes omitted).

52. Marvin A. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts 270 (6th ed. 1991); see also William J. Rohrbach, Jr., The

The government's briefs repeatedly reinforce this incorrect notion. In its principal brief, the government repeats a statement it made in its petition for writ of certiorari (and repetition brings with it emphasis):

> Moreover, a taxpayer's basis does not turn on whether he is personally liable on the indebtedness encumbering the property, or whether the debt is nonrecourse in nature. *In either event,* the debt is includable in his cost basis and *any amount remaining unpaid is includable in the amount realized upon disposition to a person taking the property subject to the mortgage.*[53]

The italicized statement is simply not true if the property is worth less than the debt, the precise facts before the Court in *Tufts*. The recourse debt relief in excess of the property's value creates COD income, not amount realized.[54]

Compounding the incorrect insinuation is the hypothetical immediately preceding the text quoted above in both the principal brief and the petition for writ of certiorari. The hypothetical describes a transfer in which no debt is cancelled because the debt is *less* than the value of the property transferred.

> [I]f A purchases property for $25,000 in cash and obtains a $75,000 mortgage loan, his basis in the property is $100,000. If he later sells it for $35,000 plus the [buyer's] agreement to assume the unamortized mortgage balance of $75,000, the amount realized is $110,000 ($35,000 plus $75,000), resulting in a $10,000 gain.[55]

While that is a true statement of the law, it has nothing to do with whether the accession to wealth in the very different *Tufts* situation should be analyzed as COD income or amount realized. There is no potential COD income in the hypothetical. Indeed, because the debt discharged was worth

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Disposition of Properties Secured by Recourse and Nonrecourse Debt, 41 Baylor L. Rev. 231, 237-38 (1989) ("By edict from the high nine on the Potomac, nonrecourse and recourse indebtedness will be treated similarly upon the sale or disposition, and gain or loss will be then easily determined under section 1001 of the Code.").

53. Brief for the Petitioner at 11, *Tufts* (No. 81-1536) (emphasis added); see also Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 8, *Tufts* (No. 81-1536).

54. See supra notes 4-8 and accompanying text (describing bifurcated approach).

55. Brief for the Petitioner at 10-11, *Tufts* (No. 81-1536); see also Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 8, *Tufts* (No. 81-1536).

less than the property transferred in the hypothetical, the buyer had to kick in some cash to boot. The hypothetical is simply another version of the *Crane* situation, in which the issue of potential COD income does not exist. Thus, while true, the statement misleads one to believe that, in the *Tufts* situation *as well*, the sole candidate for the honor of controlling the accession to wealth is the "amount realized" portion of section 1001.[56]

Again and again, the brief implies, if only by omission of any mention of the potential application of section 61(a)(12), that if the Court should rule that the accession to wealth cannot be included in amount realized under the section 1001 analysis, it will escape taxation altogether.[57] Again

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56. The same hypothetical is repeated yet a third time later in the brief, by which time the Justices could probably recite it in their sleep:

> If A purchases property for \$100,000 by putting up \$25,000 and obtaining a \$75,000 fully recourse mortgage loan for which he is personally liable, his basis in the property is \$100,000. The \$100,000 is his cost, on the assumption that he will pay off the \$75,000 loan in accordance with his undertaking. If he later sells the property for \$35,000 cash plus the buyer's agreement to assume the unamortized mortgage balance of \$75,000, the amount realized is \$110,000 (\$35,000 plus \$75,000). In these circumstances, \$100,000 turns out not to have been A's actual cost because, instead of repaying the loan, he has sold the property subject to the mortgage. We do not, however, reach back and adjust his basis downward in such a case, but rather account for his nonpayment of the loan by charging him with \$75,000 of consideration received from the purchaser. Moreover, as the lower courts and the Treasury have interpreted it, *Crane* established that the same results generally obtain even if the debt is nonrecourse in nature so that the property owner has no obligation to satisfy the debt other than out of the property. In such a case, the borrowed funds are includable both in the borrower's cost basis and in the amount realized upon disposition.

Brief for the Petitioner at 19-20, *Tufts* (No. 81-1536). In one fell swoop, the brief manages to imply once again that (1) a holding for the government would treat nonrecourse and recourse debt alike in the *Tufts* situation; (2) the rationality of the hypothetical, which does not involve debt cancellation because the property is not worth less than the debt, supports the government's position in the *Tufts* situation; and (3) the accession to wealth identified inevitably has to be analyzed as additional amount realized rather than COD income.

57. Beginning at page 19, for example, the brief states:

> Just as the exclusion of borrowing from the debtor's gross income is premised upon the existence of a corresponding obligation to repay the debt, the inclusion of borrowed funds in the cost basis of debt-financed property likewise proceeds upon the identical assumption that the owner of the property will pay off the debt encumbering the property. If that assumption proves false because the owner of the property disposes of it subject to the mortgage, the elimination of indebtedness rule likewise fixes the day of reckoning upon which the taxpayer is required to close out the transaction and account for any potential income represented by his release from the unrepaid mortgage indebtedness. If this day of reckoning does not occur, *the property owner will escape taxation forever on the amount of*

and again, the brief implies, if only by omission, that the collapsed approach applies in the case of recourse debt as well as nonrecourse debt when the property transferred is worth less than the debt.[58]

Professor Barnett did mention, perhaps too briefly, in his amicus brief that the government required the bifurcated approach for recourse debt in the *Tufts* situation.

> *The impermissibility of the distinction drawn between recourse and nonrecourse liabilities.*—Although the government's brief is less than clear on the point, the regulations are explicit that their rules for asset-for-relief exchanges involving nonrecourse liabilities are quite different from the

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> *the unrepaid loan proceeds. The taxpayer will have received funds whose tax-free receipt was predicated only on the assumption that the loan would be fully repaid. Nothing in the Code calls for such a bizarre result.* Indeed, the fundamental teaching of this Court in *Crane* rejects it.
>
> ....
>
> As we have shown, the inclusion of borrowed funds in basis—where the receipt of such borrowing was not taxable—requires the *quid pro quo* of including the full amount of the unpaid debt in amount realized to insure that all potential for income is ultimately accounted for upon the sale or disposition of the property. *If such were not the case, the taxpayer would have the best of both worlds—basis inflated by nonrecourse indebtedness, on the assumption that the debt will be paid by him, and the exclusion of the amount of the unpaid debt upon disposition,* even though we then know with certainty that the taxpayer will not pay the debt because it has been transferred with the property. *A rational tax system cannot simultaneously comprehend the adoption of such contradictory assumptions.* Logic, and the statute's directive to tax all income "from whatever source derived," demand that if nonrecourse borrowed funds received tax free can purchase basis and the resultant tax deductions, then the unrepaid amount of such indebtedness must be included in amount realized upon the disposition of the property subject to the mortgage.

Id. at 19-20 (emphasis added).

58. At page 18, for example, the brief states:

> Where property is used to discharge a debt, the amount of the debt discharged may be greater than the value of the property transferred. Where the proceeds of the loan represented by the debt are received tax free, and the creditor accepts the property in full satisfaction of the remaining debt, the debtor's taxable gain or loss on the property transferred is measured by including the full amount of the debt discharged as the consideration received. This situation occurs where, as here, property subject to a nonrecourse mortgage is transferred subject to the mortgage and the amount of the outstanding mortgage exceeds the value of the property.

Id. at 18. There is no disclaimer to the effect that "this situation" specifically does not include a *Tufts* situation where the debt is recourse.

> rules that are to be applied when the taxpayer is personally liable on the note. If the taxpayer is personally liable, the regulations prescribe, there is to be a separate reckoning for the gain or loss derived from the liability transaction as such, and for that purpose—*i.e.*, to separate the asset gain and the liability gain—the amount deemed received by the taxpayer for the asset and expended by him for the liability relief is to be fixed by the *value* of the exchanged items. It is only when the liability is without recourse that there is to be no separate accounting for the liability gain; only then that the amount deemed received for the asset is to be fixed by the *basis* of the liability; and only then that the entire gain is to be treated as an asset gain.[59]

In responding to the amicus brief, the government's reply brief never acknowledges its own regulations regarding recourse debt save in a *footnote*, and it misstates the law as to that! It is the most telling evidence that the government itself was not aware of the dichotomy it was cementing with its arguments.

> Finally, we reject the amicus Barnett's thesis ... that the gain in this case is ordinary income from the cancellation of indebtedness under Section 61(a)(12)....
>
> If one were writing on a clean slate in this area and considering the question as an original matter, one might construct a theory that would assign "basis" to liabilities, attribute significance to the value of nonrecourse liability securing property at the time of its cancellation, and break down a disposition of property subject to a nonrecourse mortgage into its component parts. In these circumstances, one could well conclude that ordinary income treatment for respondents' relief from indebtedness would be appropriate. Indeed, if respondents are correct in urging that their amount realized is limited to the $1.4 million value of the property, then the gain that respondents unquestionably realized must be accounted for as ordinary income from the cancellation of indebtedness.
>
> But the tax law has not traveled down that path and no one in this litigation or in any of the previous cases has urged that the gain realized in such circumstances is taxable as ordinary income. Indeed, apart from the anomaly of the

59. Brief for Amicus Curiae at 23-24, *Tufts* (No. 81-1536) (footnote omitted).

> decision below, the entire history of the tax treatment of mortgage indebtedness at least since *Crane* evidences a consistent judicial treatment requiring the inclusion of the full amount of the nonrecourse mortgage debt in the amount realized for the property, regardless of the value of the property upon disposition.[5] ... Given this well-established line of authority, it is simply too late in the day to expand the scope of the question presented in this case so as to recast these transactions involving mortgage debt and recharacterize the nature of the gain. The Commissioner's longstanding position to permit such gain to be attributed to the transfer of the property subject to the mortgage debt is a reasonable and permissible interpretation of the statutory definition of "amount realized" in Section 1001(b).
>
> Requiring an unraveling of the various components of assets and obligations conveyed in the sale of property subject to a mortgage, and an individualized computation and characterization of the income or loss realized upon each of these components, would introduce complexities of enormous dimensions into the taxation of any sale of property subject to a purchase money obligation.
>
> [5] Of course, if property is transferred in exchange for the discharge of an unrelated recourse debt, the transaction may produce ordinary income from the discharge of indebtedness under Section 61(a)(12) of the Code. See Treasury Regulations on Income Tax (1954 Code), Sections 1.1001-2(a)(3) and 1.1001-2(c), Example (8). See also *United States v. Davis*, 370 U.S. 65, 72 (1962).[60]

The brief fails to indicate that the bifurcated approach applies to *all Tufts* dispositions involving recourse debt. The footnote's statement that the bifurcated approach applies only in cases of the discharge of "unrelated recourse debt" is simply wrong. The regulation's words are not so limited,[61] and the government has not restricted its application to cases of "unrelated recourse debt." Indeed, both the technical advice memorandum alluded to in Part I and discussed more fully in Part IV and recent cases consciously apply the bifurcated approach to recourse debt that relates solely to the property transferred.[62] Moreover, the bifurcated approach, which the brief implies to

60. Reply Brief for the Petitioner at 7-9, *Tufts* (No. 81-1536) (citations omitted).

61. See supra notes 5-6 and accompanying text (quoting the regulation).

62. See supra note 2 and accompanying text; infra notes 72 and 174-90 and

be too cumbersome to apply to the transfer context and thus should not be forced unwillingly on the government, is the precise approach willingly adopted by the government if the debt is recourse. The brief fails to explain why such an approach is too cumbersome to apply in the nonrecourse context while at the same time is not too cumbersome to apply in the recourse context, and more important, the brief fails to offer any conceptual justification for using *different* approaches, which leads to the anomalies described below in Part III. C.

Finally, in its principal brief, the government selectively quoted from Regulations section 1.1001-2, acknowledging only the *Tufts* rule memorialized there and quoting a consistent example involving nonrecourse debt. The government failed to quote or mention the portion of the regulation mandating the bifurcated approach for recourse debt; in fact, the government affirmatively misstated yet again that "amount realized" always includes relief from debt, whether recourse or nonrecourse and whether or not the debt exceeds the value of the property transferred.

> Section 1.1001-2 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), promulgated on December 12, 1980 ... explicitly provides that the fair market value of property transferred subject to nonrecourse indebtedness "is not relevant" in determining the amount realized on the transfer.... Example (7) of that Regulation is particularly relevant, for it describes a factual situation presenting the same issues as the case at bar....
>
> Although Section 1.1001-2 of the Treasury Regulations was promulgated while this case was pending in the court of appeals, that regulation did not announce a new policy with respect to the tax treatment of nonrecourse indebtedness. To the contrary, Treasury Regulations in force since 1926 have consistently taken the position that the amount realized on the sale of mortgaged property includes the amount of the mortgage, whether the debt is recourse or nonrecourse in nature.[63]

Again, we know that that last statement is simply untrue in the *Tufts* situation involving recourse debt.

These extensive quotations serve to illustrate why the Court so easily affirmed the government's position.

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accompanying text.

63. Brief for the Petitioner at 43-45, *Tufts* (No. 81-1536) (emphasis added) (footnote omitted) (citations omitted).

C. *The Regulations*

Regulations section 1.1001-2, containing the bifurcated approach for recourse debt and the collapsed approach for nonrecourse debt, was promulgated while the *Tufts* case was before the Fifth Circuit. The terse preamble neither detailed the differing approaches nor discussed the underlying rationale for using different approaches for recourse and nonrecourse debt.[64] The bifurcated rule for recourse debt was not contained in the original set of proposed regulations.[65] With respect to its addition to the final regulations, the preamble to the final regulations simply stated:

> A number of comments suggested that amounts treated as income from discharge of indebtedness under existing regulations might be treated as amounts realized on the sale or other disposition of property under the proposed regulations. Therefore, the Treasury decision makes it clear that the amount realized on the sale or other disposition of property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness.[66]

The Supreme Court noted the timing of release of Regulations section 1.1001-2 in the middle of the *Tufts* litigation but also noted that the regulation "merely formalized the Commissioner's prior interpretation...."[67]

As discussed, the Court gave no evidence that it was aware that the regulations contained disparate analysis in the *Tufts* situation depending upon whether the debt discharged on the transfer is recourse or nonrecourse. Although Regulations section 1.1001-2 was appended in its entirety to the Brief for Petitioners,[68] it is unlikely that the Court appreciated on its own the disparate treatments provided in the regulations for recourse and nonrecourse debt, particularly in light of the misleading comments made in the government's reply brief regarding the recourse-debt provision.[69]

Regulations section 1.1001-2 is not well drafted (to put it kindly). Nowhere does it clearly state that the bifurcated approach controls in the case of recourse debt while the collapsed approach applies in the case of nonrecourse debt. One must link up the different subsections and two examples in

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64. See T.D. 7741, 1981-1 C.B. 430.
65. See Prop. Regs. § 1.1001-2, 44 Fed. Reg. 76,815 (1979).
66. T.D. 7741, 1981-1 C.B. 430.
67. *Tufts*, 461 U.S. at 310 n.9.
68. See Brief for the Petitioner app. at 1a-6a, *Tufts* (No. 81-1536).
69. See supra notes 60-62 and accompanying text.

order to arrive at the conclusion that its effect, *when taken in total,* is to use the bifurcated approach with recourse debt and the collapsed approach with nonrecourse debt.[70] The regulation certainly does not announce those results clearly,[71] and nowhere has the government justified using *different* approaches for the two types of debt. In any event, other courts since made fully aware of the dichotomy have demonstrated unquestioning acceptance of it.[72]

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70. See supra notes 4-14 and accompanying text (quoting and discussing the various provisions of Regulations section 1.1001-2 which, taken together, require the collapsed approach for nonrecourse debt and the bifurcated approach for recourse debt). Adding to the confusion of the already-quoted provisions of Regulations section 1.1001-2 are subsections (a)(4)(i) and (ii):

> (i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;
> (ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability)....

Taken together, these two statements seem to imply once again that recourse debt and nonrecourse debt are treated alike in all situations, even the *Tufts* scenario where the debt exceeds the fair market value of the property transferred.

71. The cryptic drafting may have been responsible for the fact that the government's own attorneys in the *Tufts* case misapprehended the regulation's operation. See supra notes 60-62 and accompanying text.

72. See, e.g., Bressi v. Commissioner, 62 T.C.M. (CCH) 1668, T.C.M. (P-H) ¶ 91,651 (1991). The taxpayer in *Bressi* transferred property with a fair market value of $3,010,000 and an adjusted basis of $1,807,352 in lieu of foreclosure to a creditor in satisfaction of a $3,510,251.62 debt secured by the property. The Tax Court accepted without comment the regulation's rules requiring application of the bifurcated approach if the debt is recourse and the collapsed approach if the debt is nonrecourse. Contrary to the intimation in the government's brief in *Tufts* (see supra notes 60-62 and accompanying text), the Tax Court did not limit application of the bifurcated approach to disposition of property in satisfaction of unrelated recourse debt. The property transferred was constructed with the proceeds of the recourse loans cancelled on the transfer.

The government argued, and the Tax Court found, that the debt was recourse, so the bifurcated approach controlled, resulting in $500,251.62 of COD income and $1,202,648 of gain under section 1001. The Tax Court rejected the taxpayer's argument that the debt was nonrecourse, which would have resulted in no COD income and increased gain under section 1001, taxed as capital gain to the taxpayer. The Tax Court defined "nonrecourse" as meaning "that the lienor may look only to the property that is subject to his lien to satisfy his debt and cannot look to the debtor personally for payment." *Bressi*, 62 T.C.M. (CCH) 1668, 1672, T.C.M. (P-H) ¶ 91,651 at 3227 (1991). Rejecting the taxpayer's argument that a performance bond essentially transformed the debt into nonrecourse debt, the court observed that nothing in the loan documents themselves limited the personal liability of the taxpayer.

The Internal Revenue Service, too, has reaffirmed its position that the bifurcated approach controls in the case of recourse debt. In Revenue Ruling 90-16, 1990-1 C.B. 12, the debtor transferred property with an adjusted basis of $8,000 and fair market value of $10,000 to a creditor in complete satisfaction of a $12,000 recourse debt. The ruling focused on Regulations section 1.1001-2(c), Example 8 (see supra text accompanying notes 4-5), and

Of course, pointing out that the Supreme Court was likely unaware of the dichotomous treatment it was cementing with its opinion in *Tufts* does not necessarily mean that such dichotomous treatment is in fact nonsensical or, if it is nonsensical, does not tell us *which* approach should be adopted for *both* situations. It simply means that these issues cannot be considered as having been finally decided by the Supreme Court in *Tufts*.[73] The issues must be examined on their own merits, which brings us to Parts III and IV of this article.

III. DOES THE DICHOTOMY MAKE SENSE?

Because the Court was never truly given the opportunity to decide the case as suggested in this article, its reasoning should not be seen as precluding adoption of the bifurcated approach for both nonrecourse and recourse debt. But because the government still tends to rely on some of the *Tufts* arguments, Parts A and B below examine more closely those portions of the Court's opinion often cited as justifying, as a theoretical matter, rejection of the bifurcated approach for nonrecourse debt. That discussion leads to Parts C and D, which examine the practical consequences of the dichotomy and the asserted justifications for the dichotomy other than those based on *Tufts*.

A. *The "Functional-Relation" Argument in* Tufts

The *Tufts* Court seemed to extend easily the argument first made in *Crane* that amount realized bears a "functional relation"[74] to basis that

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concluded that the taxpayer realized $2,000 of COD income under section 61(a)(12) as well as $2,000 of gain under section 1001. Because the taxpayer was insolvent, the COD income could be deferred under the mechanism provided in section 108(b), but the realized gain could not be similarly deferred. Neither the ruling nor its underlying General Counsel Memorandum (see G.C.M. 39814 (Mar. 30, 1990)) discusses the defensibility of the bifurcated approach for recourse debt in light of *Tufts* or the defensibility of using a different approach than the collapsed approach used for nonrecourse debt.

73. Thus, I fundamentally disagree with Mr. Robinson, who has written that "[i]n light of the *Tufts* case and its emphasis on the discretion of the Commissioner in this area, the validity of these regulations is beyond question." Robinson, supra note 9, at 22. That statement assumes knowledge on the part of the Supreme Court of the dichotomy it was cementing as well as conscious affirmation of it as a reasonable dichotomy. As demonstrated in the text above, the Court's rhetoric in both *Crane* and *Tufts* indicated that it thought it was conforming the treatment of nonrecourse debt to recourse debt when the securing property is transferred, including cases in which the fair market value of the property transferred is less than the extinguished debt.

74. In *Crane*, "the Court recognized the 'functional relation' in the statute between basis and amount realized." Brief for the Petitioner at 11, *Tufts* (No. 81-1536).

requires any debt included in basis to be included in amount realized on disposition of the property. The Court extended the reasoning by holding that the same is true when nonrecourse debt exceeds the fair market value of the property transferred. The government has continued to use this functional-relation argument in other contexts.[75]

The functional-relation argument proves too much if it is interpreted as requiring section 1001 amount realized to take precedence over section 61(a)(12) COD income. Indeed, recourse debt is not fully included in amount realized in the *Tufts* situation even though it is included in the basis of the property transferred; rather, the unsatisfied recourse debt creates COD income. The usefulness of the functional-relation argument is limited to the inquiry whether any accession to wealth *at all* should be considered as occurring on the disposition of property, the basis of which includes untaxed loan proceeds. As implicitly used by the government in *Tufts*, the argument implies, for example, the opposite notion that after-acquired mortgages which do *not* affect basis *cannot* be included in amount realized on disposition of property subject to the debt. That notion is untrue.[76]

Assume, for example, that taxpayer acquires Blackacre solely with $100,000 in cash. Blackacre's adjusted basis would be its $100,000 cost under section 1012. Assume further that when the fair market value of the property appreciates to $500,000, taxpayer borrows $400,000 on a nonrecourse basis using Blackacre as security. The basis of Blackacre does not include the debt, as it would under *Crane* if the debt had been purchase debt, because the $400,000 cash has its own basis (or the property purchased with the $400,000 cash has its own cost basis). Now assume taxpayer disposes of Blackacre for $100,000 in cash plus assumption of the $400,000 liability when the property is still worth $500,000 (i.e., there is no debt cancellation). The $400,000 is included in amount realized under section 1001 even though the $400,000 liability was not included in basis. Taxpayer thus has realized $400,000 of gain under section 1001.[77]

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75. See discussion infra note 100 (discussing this argument as it was made in the *Allan* case).

76. The regulations do, however, specifically provide that purchase debt that is not included in basis cannot be included in amount realized. See Regs. § 1.1001-2(a)(3) ("In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property."). This scenario arises, for example, in the case of acquisition nonrecourse debt that is so inflated that it is not considered a true liability, in whole or in part, and is thus ignored and not included in basis. See generally Jensen I, supra note 21 (discussing the purchaser's cost basis in *Tufts*).

77. See Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (holding that after-acquired debt is not included in basis but is included in amount realized upon disposition of the property securing the debt).

Just as failure to include debt in basis does not necessarily mean that relief from indebtedness need not be included in amount realized (as demonstrated in the hypothetical), inclusion of the debt in basis of the property does not by that very fact require that relief from the debt in excess of the property's value be included in amount realized as opposed to being analyzed as COD income. Inclusion of the debt in basis (coupled with excluding the loan proceeds from gross income in the year the loan was incurred) is *excellent evidence* that what the taxpayer received in the year the loan proceeds were received was not an undeniable accession to wealth over which the taxpayer had complete dominion but rather a "true loan" that would be repaid in full and thus should not be taxed on receipt.[78] When that obligation to repay in full disappears, there is a taxable accession to wealth.[79] Whether that taxable accession to wealth should be analyzed as amount realized or COD income is not answered by discussing any "functional relation" between basis and amount realized in cases in which debt is discharged on a transfer of property worth less than the debt.

B. *Footnote 11 of* Tufts

The *Tufts* Court, in footnote 11, expressed other misgivings about characterizing the debt relief in excess of the property's value as COD income.

> We are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here—an obligation to re-

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78. If property is personal-use property on which no depreciation deductions are allowable under section 167(a), inclusion of the debt in basis will not provide immediate tax benefits to the taxpayer. But the taking of depreciation deductions is not a prerequisite to the symmetry argument for rationalizing the taxation of COD income. The exclusion of the proceeds of the acquisition indebtedness from gross income is alone evidence enough of the receipt of the tax-free loan proceeds. Absent the debt, the personal-use asset would have been purchased with after-tax dollars. Cancellation of the debt without taxation, even absent tax benefits such as depreciation deductions based on basis, is nevertheless inconsistent with the prior exclusion from gross income. The loan was never repaid with after-tax dollars; thus, the tax-free consumption of the personal-use asset purchased with the debt is inconsistent with the prior exclusion. It results in personal consumption with before-tax dollars. See Chirelstein, supra note 52, at 55-56. The mechanism for taxing that consumption should be section 61(a)(12). See infra notes 191-98 and accompanying text (discussing in more detail the intersection of personal-use property with the dichotomy that is the subject of this article).

79. See discussion supra note 8 and infra notes 80-117 and accompanying text (discussing in more detail the rationale underlying the taxation of COD income).

> pay—but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation. According to that view, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. See *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 520 (1934).... [I]f the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled because the tax law has not recognized negative basis.
>
> Although the economic benefit prong of *Crane* also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach. In the context of a sale or disposition of property under § 1001, the extinguishment of the obligation to repay is not ordinary income; instead, the amount of the canceled debt is included in the amount realized, and enters into the computation of gain or loss on the disposition of the property. According to *Crane*, this treatment is no different when the obligation is nonrecourse: the basis is not reduced as in the cancellation-of-indebtedness context, and the full value of the outstanding liability is included in the amount realized. Thus, the problem of negative basis is avoided.[80]

These misgivings are premised both on outmoded theory and an outmoded case and thus should not be viewed as theoretical constraints against discarding the collapsed approach.

1. *The outmoded theory.*—The outmoded theory is the freeing-up-of-assets rationale enunciated by Justice Holmes in *United States v. Kirby Lumber*[81] as the rationale justifying the realization of COD income. As discussed previously,[82] that rationale no longer holds sway. If it did, insolvent debtors not made solvent by the debt discharge would realize no income as none of their assets would be freed from offsetting liabilities.

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80. *Tufts*, 461 U.S. at 310-12 n.11 (citations omitted). The two penultimate sentences quoted demonstrate yet again the Court's belief that relief from recourse debt is simply included in amount realized and does not create COD income. See supra notes 50-63 and accompanying text (describing other evidence showing the Court believed that it was conforming the treatment of recourse and nonrecourse debt in the situation before it when in fact the Court cemented dichotomous approaches with its decision).

81. 284 U.S. 1, 3 (1931).

82. See discussion supra note 8.

Current law abandons the freeing-up-of-assets approach by holding that insolvent debtors do indeed realize COD income, though Congress decided that for policy reasons insolvent debtors may defer *recognition* of COD income until some point in the future when, presumably, they are in a better financial condition to pay the tax due.[83]

Rather, today's commentators argue that the symmetry rationale adopted by Justice Blackmun in recognizing the accession to wealth in *Tufts* itself justifies the inclusion in income of cancelled debt. Under the symmetry rationale, solvency is irrelevant and taxing insolvent debtors (even though the tax is deferred to some future time) is conceptually defensible. Exclusion from gross income on receipt of the loan proceeds (evidenced by inclusion in the basis of property if purchase debt or simply failure to declare it as income in the case of other debt) is premised on the obligation to repay with after-tax dollars. When that obligation disappears, so does the justification for the initial exclusion.[84]

In this sense, the theory underlying COD income smacks of the broad articulation of the tax-benefit theory[85] enunciated by the Supreme Court in *Hillsboro National Bank v. Commissioner*,[86] in which the Court required inclusion in gross income of gain realized on an otherwise tax-free liquidation

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83. See discussion supra note 8; Lee A. Sheppard, Debt Assumptions Without Buildings, News Analysis, 55 Tax Notes 155, 156 (April 13, 1992):

> The pernicious notion that a borrower should recognize no COD income unless assets were somehow "freed" by the discharge has been used to justify everything from the insolvency exception to ill-advised real estate lending. Despite occasional endorsement in respectable circles, the freeing-of-assets notion is outdated, impractical, and, as the decisions relying on this notion show, wildly unpredictable in its application. The transactional approach has prevailed, as it should.

84. See discussion supra note 8; Crane, supra note 8, at 117 ("The loan proceeds theory is the most useful way to think about debt discharge income. Under this theory, income results on debt discharge because the loan represented the receipt of funds without the payment of tax, and on discharge this tax must be paid.").

85. The narrowly articulated tax-benefit rule requires that recovery of an item previously deducted must be included in gross income to the extent the prior deduction reduced positive taxable income (i.e., to the extent the deduction produced a tax benefit in the prior year). For general discussions of the tax-benefit rule, see Borris I. Bittker & Stephen B. Kanner, The Tax Benefit Rule, 26 UCLA L. Rev. 265 (1978); Louis A. Del Cotto & Kenneth F. Joyce, Double Benefits and Transactional Consistency Under the Tax Benefit Rule, 39 Tax L. Rev. 473 (1984); Alice W. Cunningham, Characterization of Income Recovered Under the Tax Benefit Doctrine, 7 Va. Tax Rev. 121 (1987) [hereinafter Cunningham II]; and Steven J. Willis, The Tax Benefit Rule: A Different View and a Unified Theory of Error Correction, 42 Fla. L. Rev. 575 (1990) [hereinafter Willis I].

86. 460 U.S. 370 (1983). The facts recounted in the text are those of United States v. Bliss Dairy Inc., No. 81-930 (7th Cir. 1983), the companion case to *Hillsboro National Bank*.

on the transfer of expensed cattle feed that was not in fact used in the course of a dairy business. The later liquidation was "fundamentally inconsistent"[87] with the premise on which the earlier deduction (proper when taken) was based, namely, that the cattle feed would be consumed in the course of the taxpayer's business. Not including in gross income loan proceeds no longer subject to a repayment obligation with after-tax dollars would be fundamentally inconsistent with the tax benefit (proper when taken) obtained in the earlier year (i.e., the exclusion from gross income premised on the obligation to repay with after-tax dollars).[88]

In short, the taxation of loan proceeds is, at its simplest, a matter of timing. Loan proceeds must be taxed at some point in time. Current law chooses to place the tax event at the point of repayment of the principal by excluding the loan proceeds from gross income on receipt but taxing the income used to repay the principal amount.[89] "In other words, the difference between the borrower and the taxpayer who saves or consumes out of his own funds is that the borrower can defer tax until repayment."[90] If loan proceeds were taxed as ordinary income on receipt, then the amounts used to pay off the principal amount would not be taxed (i.e., would be deductible).[91] Coupling an up-front exclusion of the loan proceeds with a back-end,

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87. Id. at 383.

88. See Joseph M. Dodge, The Logic of Tax 180 (1989); Louis A. Del Cotto, Debt Discharge Income: Kirby Lumber revisited under the "Transactional Equity" Rule of Hillsboro, Special Report, 50 Tax Notes 761, 764 (Feb. 18, 1991) (both noting that COD income analysis can be explained under the broad articulation of the tax-benefit theory).

89. The fact that tax-exempt proceeds may be used to repay the principal of a loan, such as gift proceeds under section 102 or interest received on certain state or local bonds under section 103, does not undercut the generalization. Congress decided that these and certain other accessions to wealth should be free of tax, and the exemption should not be lost through the back door by taxing them when used to repay the principal of a loan. The point is that the wealth used to repay the loan entered into the tax calculus, resulting in tax in most cases and exemption in a few. When no wealth is used to repay a loan, the prior exclusion of loan proceeds is no longer defensible.

90. Popkin, supra note 40, at 118; see William D. Popkin, The Taxation of Borrowing, 56 Ind. L.J. 43 (1980).

91. See Boris I. Bittker & Barton H. Thompson, Jr., Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co., 66 Cal. L. Rev. 1159, 1165-66 (1978):

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

tax-free repayment of the principal amount would allow an accession to wealth to escape taxation. Failure to repay the loan with after-tax dollars at the back end (which occurs on debt discharge) requires, in essence, retroactive taxation at the front end. The tax bill, however, will arise in the year of cancellation; the prior year's return will not be reopened.

This analysis is analogous to the treatment of depreciation recapture under sections 1245 and 1250 and the repayment of previously taxed income under section 1341, each of which, like section 61(a)(12) itself, are statutory provisions that smack of the error-correction approach apparent in the broad articulation of the tax-benefit concept. In each instance, the tax treatment in prior years is "correct" when made in the sense that it is based on certain assumptions about what will happen in future years. The exclusion of loan proceeds is correct based on the assumption that the loan will be repaid with after-tax dollars in the future; the ordinary depreciation deductions are correct based on the assumption that the deductions reflect the cost of producing ordinary business income and the asset will be consumed in the business; and gross income received in the expectation that the recipient has the right to retain the income is correctly taxed on receipt under the rates in effect for that year.

But in each case the earlier tax treatment turns out to be "incorrect" in the sense that the assumptions on which it was based do not hold true in later years. The money is *not* paid back; the property is *not* used up in producing ordinary income but rather is sold, producing gain; and the income taxed in the year of receipt must be *repaid* in a year in which an offsetting deduction under lower rates will not make the taxpayer whole. The corrective mechanism does not open up the prior year's return and change the tax treatment in the earlier year but rather accounts for the change in the prior assumptions all in the year in which the changed facts occur. As Justice O'Connor phrased it, "The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, and to protect the government and the taxpayer from the adverse effects of reporting a transaction *on the basis of assumptions that an event in a subsequent year proves to have been erroneous*."[92]

Courts that have understood this relationship between the initial exclusion of debt proceeds and the potential realization of COD income on discharge have found that no COD income arises when a debt is cancelled if no tax-free loan proceeds were received in the first instance.[93] The first

when received and requiring the taxpayer to account for any subsequent gain from settling the debt for less than the amount originally received.

92. *Hillsboro Nat'l Bank*, 460 U.S. at 383 (emphasis added) (citation omitted).

93. Professor Bittker unearthed an interesting footnote to the *Kirby Lumber* case which may have made it an inopportune vehicle in which to enunciate the principle that the

step—the receipt of tax-free dollars that represent real value in the marketplace—is critical, for without it the discharge of the obligation to pay dollars does not result in an accession to wealth. Without it there would be no prior exclusion in need of correction on the discharge. For example, the Second Circuit held in *Commissioner v. Rail Joint Co.*[94] that no COD income arose on repurchase of corporate bonds at a discount when the bonds were previously issued as a nondeductible dividend.[95] "The Second Circuit's decision was correct because the corporation had not received any property or cash upon the issuance of the bonds. Therefore, the Rail Joint Company realized no accession to wealth when it repurchased its obligations at a discount."[96] Similarly, a taxpayer whose pledge of money to a charity is forgiven realizes no COD income. Notwithstanding that upon discharge assets previously subject to the liability of the pledge are freed from that liability in the sense of *Kirby Lumber*, "the taxpayer did not receive any potentially taxable gain when he incurred the debt (where is the gain when a taxpayer pledges money

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discharge of debt produces gross income. It appears that the bonds that were repurchased at a discount in *Kirby Lumber* were originally issued in exchange for the taxpayer's preferred stock and in cancellation of dividend arrearages on that stock. The amount originally received by the corporation for the stock is unclear. See Boris I. Bittker, Income from the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Case, 4 J. Corp. Tax'n 124 (1977).

94. 61 F.2d 751 (2d Cir. 1932).

95. The Second Circuit was prescient in its view of COD income. The case predated by many years the current thinking recounted in the text. But see Del Cotto, supra note 88, at 768 n.54 (criticizing *Rail Joint* by arguing that the corporation did receive value in the form of "corporate satisfaction and gratification" upon the distribution of the dividend notes).

Rail Joint has been relied upon as recently as 1988. In United States Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988), U.S. Steel repurchased its debt instruments for cash. The debt had originally been issued in exchange for preferred stock which in turn had originally been issued for cash. In determining whether any COD income arose on the debt repurchase, the federal circuit, relying in part on *Rail Joint*, required a comparison between the repurchase price and the amount of cash originally received by U.S. Steel on issuance of the preferred stock, not the value of that stock at the time of the stock-for-debt exchange. The court held that U.S Steel realized no COD income as the cash originally received was less than the amount paid to repurchase the bonds.

For an interesting colloquy between Professors Gunn and Shakow surrounding this case, see Alan Gunn, Reconciling United States Steel and Kirby Lumber, Special Report, 42 Tax Notes 851 (Feb. 13, 1989); David J. Shakow, United States Steel and Kirby Lumber: Another View, Special Report, 42 Tax Notes 1371 (March 13, 1989); Alan Gunn, United States Steel and the Functional Approach to Legal Problems, Special Report, 43 Tax Notes 213 (April 10, 1989); David J. Shakow, A Short Retort on United States Steel, Letter to the Editor, 43 Tax Notes 1173 (May 29, 1989); Alan Gunn, Gunn's Reply, Letter to the Editor, 43 Tax Notes 1174 (May 29, 1989). See also Elliot Pisem, More on United States Steel Corporation, Letter to the Editor, 43 Tax Notes 1414 (June 12, 1989).

96. Witt & Lyons, supra note 8, at 8 (footnotes omitted).

to a charity?)."[97]

The government and the courts have begun to focus more openly on the tax-benefit underpinnings of debt-discharge theory, but they have not always gotten the focus right. In *Allan v. Commissioner*,[98] the government and the Tax Court considered the tax-benefit theory in a *Tufts* situation but did not make the connections illustrated in this article. The debtor partnership in that case was unable to pay either real estate taxes due on the collateral securing nonrecourse debt or interest on the debt itself. The creditor paid the real estate taxes and added the amount paid on the debtor's behalf to the outstanding principal balance of the mortgage. The creditor similarly added interest arrearages to the outstanding principal amount. The debtor deducted

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97. Popkin, supra note 40, at 130. Because the payment would have been deductible, the hypothetical is problematic. See IRC § 108(e)(2) ("No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction."); Del Cotto, supra note 88, at 768 (criticizing a similar hypothetical used by the *Rail Joint* court). The problem can be cured by simply changing the hypothetical to delete the charitable status of the promisee.

As recently as 1991, however, at least one commentator continued to argue under the freeing-up-of-assets rationale that a discharged debt could produce gross income even if no cash or other value was originally received in exchange for the promise to pay. The balance sheet improvement in the year of the discharge, rather than the prior exclusion (which would be absent if no loan proceeds were originally received on the promise to pay), could justify the income inclusion. Professor Del Cotto stated:

> Certainly a forcible argument can be made that a balance sheet increase in net worth, by itself and without regard to other factors or transactions, as Justice Holmes expressed it in *Kirby Lumber*, is "... an accession to income, if we take words in their plain popular meaning, as they should be taken here, *Burnett v. Sanford & Brooks Co.*, ..."
>
> Is such a rule fair to the taxpayer? Arguably, yes, because the rule makes economic and tax sense. Relief from debt without asset depletion makes available to the taxpayer assets previously burdened by—i.e., dedicated to paying—the debt. If this increase in net worth is not, to paraphrase Mr. Justice Holmes, in plain words an accession to wealth, what is it? *The fact that ... no cash or other asset was received for the debt ... is simply irrelevant* to the economic and tax fact that the debt discharge increases wealth at no cost to the taxpayer.

Del Cotto, supra note 88, at 763-64 (emphasis added) (footnote omitted). Under this approach, any promisor who promises to make a future payment for no consideration and is discharged from that obligation would realize gross income.

The tax-benefit approach to debt-discharge theory more appropriately focuses on clear accessions to wealth in the form of cash or equivalent value which is received at the time the promise to pay is made and which is excluded from gross income solely because of that promise. The balance sheet improvement in the year of the discharge because of liability relief is descriptive but a mere happenstance; the taxing event is the failure to repay with after-tax dollars the identifiable value previously received free of tax on the assumption that it would in fact be repaid. Cf. Sheppard, supra note 83.

98. 86 T.C. 655 (1986), aff'd, 856 F.2d 1169 (8th Cir. 1988).

the interest and taxes under the usual rule that deductions are not delayed until repayments are made on debt incurred to finance deductible outlays.[99]

The collateral was eventually transferred to the creditor in lieu of foreclosure at a time when the outstanding principal amount of the debt exceeded the fair market value of the property, i.e., a *Tufts* transfer occurred except that the transfer was made to the creditor instead of to a third party. The Tax Court held (and the Eighth Circuit affirmed) that the excess debt was simply included in amount realized under section 1001, creating capital gain. Relying on *Tufts*, the Tax Court rejected the government's chief contention that the tax-benefit rule required that the excess debt should be recovered by the debtor as ordinary income instead of capital gain, albeit only to the extent of the prior deductions for taxes and interest.[100]

The government's invocation of the tax-benefit rule to require recognition of ordinary income on the transfer to the extent of the prior ordinary income deductions taken with use of the loan proceeds was on the right track but headed in the wrong direction. In invoking tax-benefit theory, the government looked *forward* from the time the loan was incurred to the use to which the loan proceeds were put—spent on items producing ordinary deductions—rather than *back* to the exclusion from gross income when the loan proceeds were first deemed received.[101] The use to which the loan proceeds were put should not have been the critical element in determining whether the accession to wealth arising on failure to fully repay the loan resulted in additional amount realized under section 1001. What "scandalized" the government, as Professor Willis put it, "was the apparent inconsistency of a taxpayer using borrowed funds to generate an ordinary deduction ... but

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99. For example, assume Arterio ("Art"), who has no medical insurance, incurs huge medical bills for open heart surgery. He must borrow money from a bank in order to pay his medical bills. Art may deduct the allowable amount under section 213 in the year the medical bills are paid. The deduction is not delayed until the bank loan is repaid.

100. The government also argued in part that it would be inappropriate to include the portion of the mortgage reflecting the real estate taxes and interest arrearages in amount realized because those amounts were not included in basis and depreciated; they were currently expensed. See *Allan*, 86 T.C. at 660-61. This linkage of basis to amount realized as justifying the application of the collapsed approach (or, as the government argued here, preventing its application because of the absence of the link) has already been debunked. See supra notes 74-79 and accompanying text.

101. While I agree with Professor Willis when he criticizes the artificial distinction between recourse and nonrecourse debt (see infra notes 172 and 188-90 and accompanying text), I disagree with him that in this situation the use to which loan proceeds are put is the critical inquiry in determining the existence of gross income, as opposed to amount realized, on discharge. See Steven J. Willis, The Option Aspect of Nonrecourse Loans, 54 Tax Notes 441, 449 (Jan. 27, 1992) [hereinafter Willis II] ("ultimately this is an issue of the tax benefit rule and not discharge of indebtedness income").

then recognizing capital gain on the discharge of the loan."[102] As Willis also noted, however, there is no general bar to using tax-favored income to pay ordinary expenses.[103] What *should* have scandalized the government, in this as well as *all* nonrecourse *Tufts* transactions, is that the exclusion of ordinary income on receipt of the original loan proceeds is in effect reversed in a transaction which might, depending on the character of the property transferred, produce capital gain.[104]

What the government needed to do was to recognize once and for all the tax-benefit underpinnings of COD-income theory itself and reject the collapsed approach affirmed in *Tufts*. Had the loan proceeds been taxable on receipt, they would have been taxed as ordinary income, as all gross income is ordinary unless it consists of gain realized on the disposition by sale or exchange of a capital asset under sections 1001, 1221, and 1222 of the Code. The debtor receives cash, either actually or constructively, when he borrows; he does not sell a capital asset at that time.[105] "Had the initial assumption erroneously giving rise to the ... [exclusion] in year 1 not been made, the income realized in year 1 would have retained not only its status as an element of taxable income but its character as capital gain or ordinary income."[106] The correction that arises in the later year produces ordinary income under COD-income theory, which is itself premised on the broad articulation of tax-benefit theory, because the exclusion provided in the year the loan proceeds were received was an ordinary-income exclusion.[107]

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102. Willis II, supra note 101, at 450.

103. Id. There are some statutory bars, however. See, e.g., section 265 (disallowing certain deductions paid with tax-favored funds).

104. Even more damning than the character problems is the potential backdoor deduction of nondeductible personal consumption. See infra notes 191-98 and accompanying text (describing the effects of the collapsed approach in connection with personal-use property).

105. Professor Cunningham, however, seems to disagree by arguing that the acquisition of the put option she describes as implicit in all nonrecourse debt would transform at least an unspecified portion of such taxable loan proceeds into capital gain if taxed on original receipt. She has stated:

> The question is what benefit the taxpayer received in the tax system when the debt was incurred. When the benefit originally received was gain from the sale of property, *as where the borrower acquires a right to "put" the property to a lender in exchange for the amount of the nonrecourse debt,* then the correct treatment on discharge of the obligation to repay is to recapture the income as gain from sale.

Cunningham II, supra note 85, at 147-48 (emphasis added) (footnoted omitted). For reasons described below (see infra notes 157-73 and accompanying text), this article rejects the deemed-put-option analysis in governing the tax consequences of nonrecourse debt on a *Tufts* transfer.

106. Cunningham II, supra note 85, at 128 (footnote omitted).

107. Bittker and Thompson have argued that "*Kirby Lumber* is broader than the tax

The government's argument in *Allan*, taken to its logical extreme, demonstrates that *Tufts* was wrongly decided because the loan proceeds in *Tufts* created ordinary depreciation deductions. The narrow exception to *Tufts* that the government requested in *Allan* was fundamentally inconsistent with *Tufts* itself. Thus, the Tax Court's opinion, premised on *Tufts*, was not surprising.

The government's insistence on using the narrowly articulated tax-benefit rule to require the ordinary income inclusion in *Allan* is simply inconsistent with the tax-benefit underpinnings of debt-discharge theory, and it could come back to haunt the government. If the government had won *Allan*, or if another court in another case is persuaded by the same argument made by the government in *Allan*, the amount taxed as ordinary income rather than capital gain under the collapsed approach would be constrained by the inquiry into how the loan proceeds were spent. Only to the extent the loan proceeds were expended in a fashion producing ordinary tax deductions would the gain be characterized as ordinary; the excess would retain its character as capital under the collapsed approach. Such an approach not only requires complex inquiries and calculations, it is unnecessarily constrained.[108] The *entire amount* of the discharged debt (i.e., the amount by which

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benefit rule, for it applies even if the taxpayer does not receive a tax benefit from the borrowing transaction (*e.g.*, if the borrowed funds are expended for items of a personal nature)." Bittker & Thompson, supra note 91, at 1180 n.74. This formulation ignores the clear tax benefit received in the year the proceeds were received—exclusion of the dollars received in hand from gross income—*regardless* of how the proceeds were spent. If spent on consumption, the consumption was purchased with before-tax dollars, contrary to the Haig-Simons premise that the tax base consists of consumption plus savings. The taxation of the consumption is deferred until the debt is repaid.

108. In approximate numbers, the fair market value of the property in *Allan* was \$540,000, its basis was \$650,000, the total debt was \$1,500,000, and the portion of the debt attributable to the advances for interest and taxes was \$560,000 (meaning that \$940,000 represented the original debt). The Tax Court confirmed that Allan realized \$850,000 of gain under section 1001 (the difference between the basis of \$650,000 and the debt of \$1,500,000), \$100,000 of which was conceded to be ordinary income under the depreciation recapture provisions. The remaining \$750,000 was characterized as capital gain. See *Allan*, 86 T.C. 655, 659, 668; Cunningham II, supra note 85, at 122 & n.13; Alice W. Cunningham, Reprise: Characterization of Income Recovered under the Tax Benefit Doctrine, 43 Tax Law. 121, 122 (1989) [hereinafter Cunningham III].

If the government had won, Allan would have realized \$560,000 of ordinary income in addition to the \$100,000 conceded to be ordinary income as depreciation recapture under the government's tax-benefit rule (which presumably would not have been COD income eligible for deferral under section 108 if Allan had been insolvent or in bankruptcy court) and only \$190,000 of capital gain. Professor Cunningham advocates this result as the correct one. See Cunningham II, supra note 85, at 133-35. She notes that the analysis would have been more difficult if the property's fair market value (\$540,000) had exceeded the portion of the outstanding mortgage balance not attributable to the advances for deductible interest and taxes the debt exceeded the fair market value of the property transferred to satisfy it) should result in ordinary COD income—just as would be the case if the debt had been recourse debt—*not* merely the amount of such debt representing the nonrecourse loan proceeds used to pay deductible expenses.

A recent Tax Court case illustrates more bluntly the close relationship between the broad articulation of tax-benefit theory and COD-income theory in general. At the same time, however, the case demonstrates the ill-advised continued insistence by both the government and the courts that the two theories be recognized as independent grounds for generating ordinary income in the debt-discharge situation. (Though the case did not involve a *Tufts* transfer and thus in that sense is a bit of a diversion from the main point of this article, it is worth talking about in connection with this section, which discusses the outmoded debt-discharge theory discussed in footnote 11 of *Tufts* and the current tax-benefit theory.)

In *Schlifke v. Commissioner,*[109] the taxpayers borrowed $225,000 secured by a second mortgage on their home. The terms of the loan required sixty monthly payments of interest and a balloon payment of the principal at the end of the five-year period. For nearly three years, the taxpayers paid

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($940,000). She provides:

> For example, assume a mortgage liability of $100 (including $20 of unpaid interest) discharged by the transfer of property worth $95. As only $5 of the mortgage liability would remain unpaid, the discharge could not undermine the full $20 deduction. Whether the portion of the liability unpaid should be attributed in toto to the prior interest deduction (yielding a tax benefit recovery of $5) or whether the transferred property should be regarded as having contributed proportionally to both the deductible and to the nondeductible portions of the debt (yielding a tax benefit recovery of 5% of $20) remains unclear.

Cunningham II, supra note 85, at 128-29 n.50; see also Cunningham III, supra, at 142.

Under the bifurcated approach advocated in this article, Allan would have realized a capital loss of $110,000 (the difference between the property's fair market value and basis) and COD income of $960,000 (the difference between the debt and the fair market value of the property transferred in complete settlement of it). Because the ordinary income arises under debt-discharge theory by linking the failure to satisfy with after-tax dollars the entire debt originally excluded, the extent to which the proceeds were used for deductible purposes becomes irrelevant, and the difficulty noted above disappears. In the example posited by Professor Cunningham, the transfer would produce $5 of COD income, just as in the case of recourse debt. This would be true regardless of how much, if any, of the principal amount of the loan was used to pay deductible expenses such as taxes and interest. The *use* to which the loan proceeds were put is simply irrelevant in analyzing the taxability of COD income when debt is cancelled. (Moreover, tracing the use of fungible loan proceeds is a dubious enterprise at best. See infra note 203 (discussing the futility of tracing the use of loan proceeds in order to determine whether discharge of a debt produces COD income under the *Kerbaugh-Empire* rule that no COD income arises if the loan proceeds were expended in an unprofitable transaction).)

109. 61 T.C.M. (CCH) 1697, T.C.M. (P-H) ¶ 91,019 (1991).

deductible interest and finance charges of approximately $140,000, which did reduce the positive taxable income of the taxpayers in the years deducted. Pursuant to the loan agreement, no principal payments were made. The taxpayers were then informed that the lender failed to comply with the requirements of the Truth in Lending Act, giving the taxpayers the right to rescind the loan if they wished by repaying the principal amount of the loan "less any payments made by them."[110] The taxpayers effected the rescission by paying the creditor $85,000. The taxpayers, in effect, were permitted to charge the prior interest payments they had made against the $225,000 principal in determining the outstanding principal that needed to be repaid to accomplish the rescission. In effect, the loan was converted into an interest-free loan for the nearly three-year period it was outstanding.[111]

The Commissioner argued that the taxpayers realized $140,000 gross income in the year of the rescission under alternative theories: (1) The discharge of the $225,000 loan on the payment of $85,000 produced $140,000 of COD income; and (2) the crediting of the interest payments deducted in prior years against the principal of the loan was an event "fundamentally inconsistent"[112] with the premise of the prior deductions (that the payments were interest, not principal), producing $140,000 of gross income under the narrow articulation of the tax-benefit rule.[113] The Tax Court chose to hold for the Commissioner on the second ground, citing its aversion to grappling with the nuances of debt-discharge theory.

> The issue of income from discharge of an indebtedness for less than its face amount is, to say the least, controversial. See *Zarin v. Commissioner.* Since we conclude that respondent's determination should be sustained under the tax benefit rule, we find it unnecessary to cut our way through the thicket of sub-issues which inhere in that controversy, such as the presence of a liquidated, as distinguished from an unliquidated, indebtedness, and the enforceability of the underlying obligation, *i.e.*, whether it is void or voidable and the impact of the element of rescission thereon.[114]

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110. T.C.M. (CCH) 1697, T.C.M. (P-H) ¶ 91,019 at 78.

111. Code section 7872, which imputes interest to certain below-market loans, was not yet enacted at the time of this transaction. Thus, characterizing the loan for tax purposes as an interest-free loan generated no further tax consequences.

112. See supra notes 86-87 and accompanying text (discussing Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), which uses such language in describing when the inclusionary aspect of the tax-benefit rule operates).

113. See supra note 85 (describing the narrowly articulated version of the tax-benefit rule).

114. 61 T.C.M. (CCH) 1697, 1698, T.C.M. (P-H) ¶ 91,019 at 79 (citation omitted).

The court's troublesome language implies that absent the availability of the alternative tax-benefit argument in the case because of the happenstance that the interest was deducted and then was allowed to be credited against principal, debt-discharge theory alone might not have prevailed to require taxation. The inclusion in gross income under debt-discharge theory should not be constrained by any consideration of the "liquidity" of the loan or the "enforceability of the underlying obligation" for nontax purposes—the perceived difficulties quoted above which the Tax Court felt attached to any analysis of COD income—once the tax-benefit underpinnings of debt-discharge theory are recognized.

The debt is not "discharged," the argument goes, if it could not be enforced. But the lack of enforceability simply is the impetus for the failure of the debtor to repay fully the originally excluded loan proceeds which creates the accession to wealth in the first place. Not only should the tax law avoid placing a favorable premium on entering into loan agreements that are unenforceable (as compared to enforceable loan agreements that are not enforced in fact), it is a Catch-22 to argue that the very unenforceability which created the debt cancellation (because it prevented the creditor from collecting the debt in full) saves it from taxation. The debt in *Tufts* was, in fact, unenforceable to the extent that it exceeded the fair market value of the collateral, and yet the Court confirmed that an accession to wealth occurred on the failure to repay that debt, even though it analyzed that accession to wealth as gain under section 1001. That accession to wealth should not escape taxation *outside* the transfer context, as it would if the unenforceability of debt prevented taxation of COD income when the debt is not repaid in full; the same accession to wealth occurs in both the transfer context and the nontransfer context. Such nonissues as unenforceability cloud the fundamental *tax* point confirmed in *Tufts* that the prior loan proceeds were received *free of tax* on assumptions that prove to be unwarranted when the loan proceeds are not in fact fully repaid with after-tax dollars—for *whatever* reason. The prior receipt coupled with the failure to repay in full should be the beginning and end of the inquiry under debt-discharge theory.[115]

See infra notes 206-17 and accompanying text (discussing the cited *Zarin* case).

115. Reliance on the dictionary definition of "discharge" presents a nonissue that beclouds thinking in this area because it loses sight of the underlying structural rationale for taxing COD income in the first place. The disagreement is really one about statutory interpretation: To what extent should the dictionary definition of words control, severed from context? See Lawrence Zelenak, Thinking About Nonliteral Interpretations of the Internal Revenue Code, 64 N.C. L. Rev. 623 (1986). This debate has gained a remarkable renascence since the elevation of Antonin Scalia to the Supreme Court in view of his strict adherence to textualism. See William N. Eskridge, Jr., The New Textualism, 37 UCLA L. Rev. 621 (1990). Of course, textualism purports to take account of the larger statutory structure in interpreting words, but in practice it all too often ignores the larger structure and falls back on the

As in *Allan*, the deductibility of the interest payments made on the loan should not have controlled the inquiry, though once again the broad tax-benefit idea encapsulated in COD income justifies taxation here. If the interest paid on the loan had been nondeductible personal interest rather than deductible "qualified residence interest"[116] so that the narrowly articulated version of the tax-benefit rule could *not* have applied, the Commissioner should nevertheless have won on its first argument. If the prior payments are respected as interest because paid "as the amount one has contracted to pay for the use of borrowed money, and as compensation paid for the use or forbearance of money"[117] (even though nondeductible), the $225,000 loan was in fact discharged for a principal payment of $85,000, producing $140,000 of COD income. The deductibility or nondeductibility of the interest has no relevancy to the accession to wealth obtained because of the prior *exclusion* from gross income on the receipt of $225,000 viewed together with the failure to repay $140,000 of that principal amount with after-tax dollars.

2. *The outmoded case.*—Like the outmoded COD-income theory described by the *Tufts* Court in footnote 11, the *Fulton Gold* case,[118] also cited in *Tufts*,[119] has been relegated to a footnote in history. In that case, the taxpayer purchased property in 1920 subject to a nonrecourse mortgage which the taxpayer did not assume.[120] The taxpayer subsequently satisfied the nonrecourse debt in 1922 for less than its face amount. On disposition of the property in 1929—the transaction before the Board of Tax Appeals—the Board held that the property's basis equalled the cash initially paid for it plus the amount subsequently paid in satisfaction of the nonrecourse debt.[121] Basis did not include, as the taxpayer contended it should, the portion of the debt that was cancelled. The opinion does not make it clear whether the taxpayer included in gross income the COD income realized in 1922, though

dictionary definition of words as they are "commonly understood." For example, Justice Scalia, writing for the majority this past term, disparagingly stated, "the dissent believes petitioner's position on this point to be supported by the history *and structure* of the ADA ... sources it deems 'more illuminating' than a 'narrow focus' on the ADA's language ...." Morales v. Trans World Airlines, Inc., 60 U.S.L.W. 4444, 4446 n.2 (U.S. June 1, 1992) (emphasis added).

116. The interest on loan proceeds traced to personal uses is nondeductible unless the interest is "qualified residence interest" within the meaning of section 163(h)(3). See IRC § 163(h)(1). See generally Temp. Regs. §§ 1.163-8T through 10T.

117. Rev. Rul. 69-188, 1969-1 C.B. 54 (defining the term "interest" for tax purposes by citing Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932) and Deputy v. Dupont, 308 U.S. 488 (1940)).

118. Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519 (1934).

119. See supra text accompanying note 80.

120. See *Fulton Gold Corp.*, 31 B.T.A. at 520.

121. See id. at 521.

the taxpayer cited *Kirby Lumber* in arguing that it should get basis credit for the COD income.[122]

The Board reasoned, in essence, that *Kirby Lumber* applied only to recourse debt, that nonrecourse debt was not really "debt" but only an "encumbrance on property."

> Here the petitioner, instead of assuming the mortgage, bought the property subject to it, and by making the purchase on such terms incurred no personal liability for the debt. Accordingly, payment of the mortgage did not result in the liquidation of a personal debt. By it the petitioner merely satisfied an encumbrance on property in which it had an equity and there was no release of assets "previously offset by the obligation" of the notes or bonds evidencing the debt secured by the mortgage.[123]

Rightly or wrongly, *Fulton Gold* came to stand for the more general proposition that a cancellation of nonrecourse debt not related to a disposition of the property under section 1001 results not in COD income but rather results only in a decrease in basis. This interpretation of *Fulton Gold* has been roundly criticized[124] and, based as it was on the freeing-up-of-assets rationale which, as noted above, has been itself abandoned as the rationale underlying COD income, was finally interred by both the Tax Court and the Internal Revenue Service.

In *Gershkowitz v. Commissioner*,[125] the very much simplified facts boil down to the discharge of two nonrecourse loans: one a simple cancellation without surrender of the securing property and the other a cancellation upon surrendering the securing property, which, as in *Tufts*, had a fair market value that was less than the extinguished debt. In a reviewed decision with no dissents or separate concurrences,[126] the Tax Court held that the cancellation of a $250,000 nonrecourse debt without surrender of the securing property worth $2,500 and with a basis of $50,000 produced COD income under section 61(a)(12) to the extent of the cancelled debt.[127] In so holding,

122. See id. at 520. Professor Cunningham assumes that the taxpayer did not include any COD income in gross income in the earlier year. "When the taxpayer subsequently discharged the mortgage for less than the unpaid balance, the debtor was not charged with cancellation-of-indebtedness income." Cunningham I, supra note 14, at 607.

123. 31 B.T.A. at 521 (citation omitted).

124. See, e.g, Blanchard, supra note 41 (criticizing both *Tufts* and *Fulton Gold*).

125. 88 T.C. 984 (1987).

126. See id. at 1019.

127. See id. at 1004-14. Because the COD income was realized by a partnership, most of the analysis dealt with whether the insolvency exception to the recognition of realized

the court quoted the portion of footnote 11 of *Tufts* quoted above,[128] containing the reference to *Fulton Gold*, and rejected an argument that the *amount* of COD income must be limited to the $2,500 value of the collateral under a freeing-up-of-assets rationale. While not very clearly written, the opinion also seemed to reject any extrapolation from *Fulton Gold* that COD income could be recognized only to the extent of the basis in the securing property because of the anathema of a negative basis. The opinion has to be read more broadly as rejecting the dubious rule attributed to *Fulton Gold* in the first instance that cancellation of nonrecourse debt without a transfer of the securing property automatically results in a decrease in basis (to the extent thereof) and no COD income. The actual result in the case is simply incompatible with the approach attributed to *Fulton Gold*[129] when nonrecourse debt is cancelled without the surrender of the securing property.[130]

COD income should be applied at the partnership or partner level. The Tax Court concluded that the insolvency exception applied at the partner level, a result now codified in section 108(d)(6).

Although the court refers at some points to the amount taken into account as "gain" (see id. at 1014) and refers to the amount of debt discharged as "amount realized" (see id. at 1012), COD income is not "gain" under section 1001 but rather is ordinary income, and there is no "amount realized" on debt cancellation. "Gain" and "amount realized" are words of art under section 1001, dealing with property dispositions. In the end, however, the opinion has to be read as holding that COD income was realized on the transaction and that no transaction under section 1001 occurred as the court stated: "Having concluded that each partner must recognize ordinary income from the discharge of indebtedness as a result of the Prentice-Hall transaction, we must now consider the amount of that income." Id. at 1010.

128. See id. at 1011-12.

129. "Although the Tax Court has not actually overruled *Fulton Gold*, the court has severely limited its application." Witt & Lyons, supra note 8, at 64 n.280.

130. The Tax Court quite rightly saw the potential for abuse if it were to limit the amount of COD income to either the $2,500 value of the retained collateral based on the freeing-up-of-assets rationale or the $50,000 basis of the collateral based on an extrapolation from *Fulton Gold*. See 88 T.C. at 1014. If the taxpayer had transferred the collateral in foreclosure without the payment of a cent, it would have realized gain under *Tufts* and section 1001 to the extent of the excess of the $250,000 nonrecourse debt over the taxpayer's $50,000 basis in the collateral. In an attempt to avoid this result, the taxpayer actually paid 80% of the collateral's basis—$40,000 in cash—to the creditor in exchange for extinguishment of the debt, apparently banking on being able to use the insolvency exception to immediate recognition of the COD income created. See id. at 1013. The government was the party that actually argued that the COD income was limited to the $2,500 value of the collateral, and it did so because of the increase in the outside basis of the partners in their partnership interests under section 705(a)(1)(A) that accompanied the realization of the larger amount of COD income by the partnership. See id. at 1009. The inflated outside basis permitted flow through of large losses to each partner under section 704(a) and (d).

If the Tax Court had accepted the government's position that COD income was limited to either the value or basis of the collateral when nonrecourse debt is forgiven without surrender of the collateral, it no doubt would have come back to haunt the government. The advantages of structuring such transactions outside the partnership context by avoiding the

With respect to the nonrecourse loan extinguished on transfer of the securing property to the creditor, the *Gershkowitz* court applied *Tufts* and ruled that the entire indebtedness, including that portion in excess of the fair market value of the collateral transferred, was included in amount realized in the calculation of gain under section 1001. No COD income was deemed realized, so the insolvency exception was irrelevant.[131]

The Internal Revenue Service certainly has read *Gershkowitz* as an abandonment of *Fulton Gold*. In Revenue Ruling 91-31,[132] the Internal Revenue Service cited *Gershkowitz* in ruling that "[t]he reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income...."[133] The facts of the ruling concerned a debtor who borrowed $1,000,000 from a creditor on a nonrecourse basis in 1988 in order to purchase an office building from a seller for $1,000,000. The debt was secured by the office building, and the creditor was not the seller of the building.[134] When the value of the

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disposition of the collateral are obvious: Both gain under section 1001 and substantial COD income could be avoided on the debt discharge.

The Tax Court, however, was not very clear regarding precisely how it reached its result analytically. The Tax Court should have simply rejected outright the rule attributed to *Fulton Gold* as inconsistent with the development of theory since *Tufts* (even if *Fulton Gold* could be considered correct when decided), then rejected the freeing-up-of-assets rationale as an historical footnote in view of the symmetry rationale now accepted as the premise underlying the realization of COD income, and finally held that under that symmetry rationale the taxpayer realized COD income to the extent of the cancelled debt.

131. See *Gershkowitz*, 88 T.C. at 1016; see infra notes 141-52 (discussing inability to defer under section 108(a) gain realized under section 1001 in the *Tufts* situation, even though the accession to wealth arises because of the failure to repay debt).

132. 1991-1 C.B. 19.

133. Id. at 20.

134. Id. at 19. If the debt had been a purchase-money mortgage, forgiveness of the debt would have been treated for tax purposes as a renegotiation of the purchase price under section 108(e)(5), even if the surrounding facts clearly indicated an intention to forgive debt rather than lower the purchase price. The statutory rule was enacted in order to eliminate such factual inquiries when the creditor and seller are the same person. See discussion supra note 8. No COD income would have been created, but the cost basis of the property under section 1012 would have been reduced, accordingly.

While the approach taken by the statutory purchase-money-mortgage rule is similar to that of *Fulton Gold*, its application is both narrower and broader. It is narrower in the sense that it applies to reduce basis rather than create COD income only in the case of a purchase-money mortgage. See IRC § 108(e)(5). The forgiveness of indebtedness by a third-party creditor who is not the seller of the property purchased with the debt results in the realization of COD income, the recognition of which can be deferred only by bankrupt or insolvent debtors and certain farmers under section 108(a). The deferral mechanism in those instances might in fact be the lowering of basis of property owned by the taxpayer, including property purchased with the debt proceeds. See id. §§ 108(a), (b)(2)(D), (b)(5), 1017; Regs. § 1.1017-

building fell to $800,000 in 1989, the creditor agreed to a modification of the debt to reduce the outstanding principal amount from $1,000,000 to $800,000.[135] The ruling determined that the debtor realized $200,000 of COD income.

After describing *Tufts*, *Gershkowitz*, and *Fulton Gold*, the ruling concludes:

> The *Tufts* and *Gershkowitz* decisions implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. *Fulton Gold*, interpreted in this manner, is inconsistent with *Tufts* and *Gershkowitz*. Therefore, that interpretation is rejected and will not be followed.[136]

The Internal Revenue Service and the courts have thus laid to rest any putative dichotomy between the treatment of discharged recourse and nonrecourse debt that may have once reigned, at least in theory, when the debt discharge does not arise by reason of transfer of the securing property. Whether recourse or nonrecourse, the discharged debt creates COD income.

The conceptual approach evident in the rejection of *Fulton Gold* is the view that the tax consequences of the debt, whether recourse or nonrecourse, should be considered separately from the tax consequences of the ownership of the securing property. The rule attributed to *Fulton Gold*, under which discharge of nonrecourse debt resulted in a reduction of the securing property's basis, did *not* view nonrecourse debt as a tax incident separate from the taxpayer's ownership interest in the securing property. The nonrecourse debt was considered so intimately bound with the ownership interest in the securing property that a cancellation of all or part of the debt simply reduced the property's basis. (It is ironic that both the Service and the Tax Court cited *Tufts*, the case which cemented the dichotomous approaches to recourse and nonrecourse debt contained in the regulations on the *transfer* of property resulting in the cancellation of debt, as requiring an *abandonment*

1(a)(1). It is broader in the sense that it applies to both recourse and nonrecourse debt whereas *Fulton Gold* applied only in the case of nonrecourse debt. Cf. Rev. Rul. 92-99, 1992-46 I.R.B. 5 (reduction of nonrecourse purchase debt held by third-party lender results in COD income, not a basis reduction under section 108(e)(5), because the debt was not of the purchaser "to the seller").

135. Rev. Rul. 91-31, 1991-1 C.B. at 19.

136. Id. at 20.

of such dichotomous approaches when the securing property is *not* transferred. *Tufts*, after all, is the quintessential case treating nonrecourse debt as part and parcel of ownership of the property rather than as an independent tax attribute.) In short, discharged nonrecourse debt is now analyzed *separately* from the ownership of the underlying property securing the debt when the securing property is retained.[137]

This evolution in thinking is critical to considering the continued defensibility of using different approaches to recourse debt and nonrecourse debt when the debt discharge occurs upon transfer of the securing property because the debt is satisfied with property worth less than the debt and the lender either chooses not to collect or is precluded from collecting the deficiency. In view of the conforming conceptual approach regarding recourse and nonrecourse debt in the context in which the collateral is retained, the question regarding the disparate treatment when the collateral is transferred becomes all the more pointed.

The bifurcated approach in the transfer context analyzes the debt discharge separately from ownership of the underlying property, but that approach currently applies only in the case of recourse debt. In the case of nonrecourse debt, the approach inherent in Revenue Ruling 91-31—i.e., similarly treating the nonrecourse debt discharge separately from ownership of the securing property—is rejected when the debt discharge arises by reason of transfer of the property. Thus, in the transfer context alone does the view that nonrecourse debt and ownership of the securing property are a single, inseparable construct (which requires the collapsed approach under section 1001) continue to hold sway.

The only distinguishing feature between the situation in which relief from nonrecourse debt arises without a transfer of the securing property and the situation in which relief from nonrecourse debt arises by reason of a transfer of the securing property is, of course, the transfer itself. Yet, in the first situation the nonrecourse debt is, *as a conceptual matter*, considered separately from the property ownership (resulting in COD income rather than a reduced basis in the securing property under the cost basis rule of section 1012) while in the second situation the nonrecourse debt is, *as a conceptual matter*, viewed as inseparable from the property ownership (entering into the calculation of "gain from dealings in property" under sections 1001 and

137. The only exception arises in the case of purchase-money debt, where the statute itself treats the transaction as a renegotiation of the purchase price by the seller rather than as debt discharge. See supra notes 8, 134 (discussing section 108(e)(5)). Because of the competing *factual* characterization vying for attention in the context of a purchase-money mortgage (see discussion supra note 8), that statutory rule does not shed light on the proper conceptual approach to take in the absence of a competing factual interpretation of the transaction.

61(a)(3) rather than resulting in COD income). Thus, the act of transfer itself must somehow hold the key to the justification for viewing the nonrecourse debt in fundamentally different ways as a conceptual matter at different times in the ownership period.

Does it? Subsection D considers two possible arguments. Identifying the conceptual argument, if any, that justifies these disparate approaches becomes critical when one considers the consequences, even manipulation (described next in Subsection C), that can occur because of the disparate approaches. What appear to be improper consequences, after all, are not improper if there truly is a conceptual, substantive basis justifying these incongruous results.

C. *Real-World Consequences of the Dichotomy*

Most of the real-world consequences described below no doubt ran through the reader's mind upon considering the composite result of the section 108 rules, the dichotomous approaches used on the transfer of property depending on whether debt is recourse or nonrecourse, the *Gershkowitz* case, and Revenue Ruling 91-31. The results described below are the product of the intersection of three sets of rules: (1) Section 108 allows deferral of COD income realized under section 61(a)(12) by financially strapped debtors but not deferral of gain realized from property under sections 1001 and 61(a)(3) that results because of debt discharge;[138] (2) The cancellation of recourse debt is treated differently from nonrecourse debt when the securing property is transferred in satisfaction of a debt exceeding the property's value;[139] and (3) The cancellation of nonrecourse debt itself is treated differently depending upon whether the securing property is transferred or retained upon discharge of the debt.[140] As described below, these results could all be conformed if the bifurcated approach were adopted for nonrecourse debt in the transfer context.

Congress has decided as a policy matter (whether wise or unwise) that financially strapped debtors ought to be able to defer the recognition of realized income arising from the discharge of indebtedness and pay tax on it

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138. See discussion supra note 8 (describing deferral under section 108(a)). Cf. Timothy M. Larason, Is Gain on Transfer of Property to Creditor by Insolvent Taxpayer Subject to Income Tax?, Special Report, 49 Tax Notes 1135 (Dec. 3, 1990) (arguing that Congress may have intended gain realized under section 1001 on the transfer of property in discharge of a nonrecourse debt to be excludable under section 108(a) by insolvent debtors).

139. See supra notes 4-14 and accompanying text (describing the bifurcated and collapsed approaches).

140. See supra notes 9-14 and accompanying text (describing the collapsed approach in the transfer context) and notes 132-37 and accompanying text (describing Revenue Ruling 91-31, 1991-1 C.B. 19, in the retained-collateral context).

slowly over time (presumably when they are in a healthier financial condition) by reducing favorable tax attributes, including the depreciable basis of property.[141] Such debtors cannot defer *Tufts* gain arising under section 1001 because of the discharge of previously untaxed loan proceeds, notwithstanding that the justification for taxing *both* COD income and the gain arising under the collapsed approach is the same: the release from the obligation to repay previously received untaxed loan proceeds with after-tax dollars.[142] Thus, an insolvent or bankrupt debtor who transfers property in foreclosure to a creditor in satisfaction of a nonrecourse debt exceeding the value of the property transferred cannot defer the portion of the gain realized under the collapsed approach that would have been COD income under the bifurcated approach.

In *Estate of Delman v. Commissioner*,[143] for example, an insolvent taxpayer transferred property with a fair market value of $400,000 and adjusted basis of $500,000 to a creditor in foreclosure of a $1,200,000 nonrecourse debt.[144] Under the collapsed approach used for nonrecourse debt, the Tax Court confirmed that the transfer produced a gain of $700,000 under section 1001. Such gain could not be deferred under section 108(a) by reducing the basis of property held by the taxpayer under section 108(b) (as the taxpayer argued) because the "gain" arising under section 1001 is by definition not COD income.

Had the debt been recourse, the bifurcated approach would have controlled, producing $800,000 of deferrable COD income and a $100,000 deductible loss.[145] Just as in *Tufts*, the net *amount* taken into account for tax purposes would have been the same whether the collapsed approach or bifurcated approach controlled.[146] However, because only the bifurcated approach creates COD income, the nature of the debt as recourse or nonrecourse determined whether the taxpayer was entitled to deferral of the tax bill on that amount.

Although the Tax Court correctly applied *Tufts* in the *Delman* case,

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141. See supra note 8 (describing deferral under section 108(a)).

142. See supra notes 81-117 and accompanying text (discussing the overlap of Justice Blackmun's rationale in *Tufts* with COD-income theory).

143. 73 T.C. 15 (1979).

144. The numbers are rounded for ease of discussion.

145. The $1,200,000 debt would be considered satisfied with the property valued at $400,000, producing $800,000 of COD income. The difference between the value of the property and its adjusted basis would produce a deductible loss under sections 1001 and 165, as the property was held for investment.

146. See supra notes 35-36 and accompanying text. Just as in *Tufts*, however, the *character* of the gain might have been different. See supra notes 35-36 and accompanying text. Even the *amount* would have been different if the taxpayer had insufficient tax attributes and depreciable property to cover the amount of realized COD income. See supra note 8.

the case illustrates one of the incongruities produced by *Tufts*. In the *Delman* situation, the taxpayer is insolvent whether the debt is recourse or nonrecourse; the accession to wealth arises by reason of debt cancellation whether the debt is recourse or nonrecourse; but if the debt is recourse, the tax bill is deferred, while if the debt is nonrecourse, the bill is not deferred. It seems that horizontal equity[147] is violated for no justifiable reason unless there is a satisfactory conceptual justification for viewing nonrecourse debt at the point of transfer as part of the ownership interest in the underlying property, while *at the same time* viewing recourse debt at the point of transfer as separate from the underlying property, as well as viewing nonrecourse debt at all times prior to the point of transfer as separate from the underlying property.[148]

The difference in treatment encourages the structuring of transactions that differ in form but not substance[149]—a boon perhaps to tax lawyers advising their clients but at the least unsettling to those who believe that disparate treatment should be soundly based in theory. Witt and Lyons advise that

> [i]f the nonrecourse debt is to be discharged in full as a result of the transfer of the collateral back to the lender, then an insolvent taxpayer might consider (1) converting a nonrecourse debt into a recourse debt prior to the disposition of the collateral; (2) selling the collateral with the lender's consent and cooperation and using the proceeds to satisfy the nonrecourse debt; or (3) discharging a portion of the debt by making a cash payment on the debt and then transferring the property to the original lender. The third alternative should prevent classification of the transaction as a sale of the collateral because the taxpayer has not satisfied the nonrecourse debt according to its terms. Thus, the justification ... for treating the transfer of collateral to the lender in satisfaction of nonrecourse debt as a sale of the collateral does not

147. "Horizontal equity" refers to the maxim that similarly situated taxpayers ought to be taxed similarly.

148. See supra notes 137-38 and accompanying text (discussing the differing conceptual approaches apparent in the collapsed approach on the one hand and both the bifurcated approach and the approach of Revenue Ruling 91-31, 1991-1 C.B. 19, on the other).

149. Witt and Lyons have (euphemistically?) referred to the ability to structure a transaction to suit these disparate tax results as a "planning opportunity." See Witt & Lyons, supra note 8, at 61. Professor Shaviro labels as "tax overhead costs" or "deadweight costs" the increased resources devoted to tax planning, compliance, and administration stemming from tax rules that may not be soundly based. See Shaviro, supra note 9, at 437.

exist.[150]

The first of these "planning opportunities"[151] described by Witt and Lyons arises because of the dichotomous approaches to nonrecourse debt and recourse debt in the transfer context. Whether the debt is considered recourse or nonrecourse in this context proves to be crucial, as in the *Delman* case.[152] If the bifurcated approach were applied to nonrecourse debt as well

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150. Witt & Lyons, supra note 8, at 61. Witt and Lyons exemplify the benefits of these alternatives with the following example.

> Donald Debtor purchases a building, giving the seller a nonrecourse note for $20,000. In 1990, the note remains unpaid and the building has a fair market value of $15,000 and an adjusted basis to Debtor of $16,000. If Debtor transfers the building back to the original seller, the Service would treat the transfer as a sale of the building and Debtor would realize and recognize $4,000 of gain ..., none of which would be eligible for exclusion under section 108. To avoid this result, Debtor should consider the following alternatives:
>
> (1) Convert the nonrecourse debt to recourse debt, then transfer the building to the original seller in satisfaction of the debt. Under the regulations, Debtor would have to bifurcate the transaction, recognizing a $1,000 loss on the transfer ... and $5,000 of discharge of indebtedness income.... If Debtor is insolvent or the subject of a Title 11 proceeding...., he could take advantage of the benefits of section 108.
>
> (2) With the consent and cooperation of the nonrecourse lender, sell the building to a third party for $15,000 and use the proceeds to satisfy the nonrecourse debt. Debtor would have the same tax results as in alternative (1).
>
> (3) Make a partial payment of, for example, $1,000 on the $20,000 nonrecourse debt, then transfer the building to the original seller in satisfaction of the remaining debt. Although the Service would treat a discharge accomplished solely by the transfer of the building back to the original seller as a sale of the building, the cash payment should change that result. Debtor would have $4,000 of discharge income ... and would realize a loss of $1,000....

Witt & Lyons, supra note 8, at 62-63 (footnote omitted).

151. See supra note 149.

152. In Bressi v. Commissioner, 62 T.C.M. (CCH) 1668, T.C.M. (P-H) ¶ 91,651 (1991), discussed supra note 72, the taxpayer argued that the debt discharged on a transfer of property in lieu of foreclosure was nonrecourse, requiring the collapsed approach to control. (Apparently the solvent taxpayer preferred gain under section 1001 to COD income under section 61(a)(12) because at least part of the gain would have been taxed as capital gain.) The Tax Court concluded that the debt was recourse, applied the bifurcated approach, and held that the taxpayer realized COD income instead of gain. The bottom line was that the taxpayer paid a premium for failing to consult a sage tax advisor prior to transferring the property back to the creditor in lieu of foreclosure. As the creditor received nothing but the property anyway, the creditor might have been willing to convert the nominally recourse loan into a nonrecourse loan prior to the transfer. See also Lee A. Sheppard, Forgiveness of Nonrecourse Debt and Other Problems, News Analysis, 54 Tax Notes 784 (Feb. 17, 1992) (considering, among other

as recourse debt in the transfer context, this difference would disappear. There would be no need to convert the debt to the desired status in order to choose a desired treatment or avoid an undesired treatment. COD income would be created on the relief from debt—whether recourse or nonrecourse—not additional gain under section 1001, and the chips would fall where they would. Insolvent and bankrupt debtors would be able to defer the income, which seems to be consistent with Congress's desire with respect to debt relief, and solvent debtors would pay tax immediately on the accession to wealth at ordinary income tax rates.

The second and third "planning opportunities" described by Witt and Lyons arise because of the disparate treatments accorded a discharge of nonrecourse debt itself depending upon whether the discharge occurs because of a transfer of the collateral or a transfer of cash. The facts of *Gershkowitz*, described earlier,[153] exemplify this disparate treatment most dramatically. The structure used in *Gershkowitz* was prompted by the fact that the cancellation of nonrecourse debt *without* a transfer of the securing property produces COD income while the cancellation of nonrecourse debt *by reason of* a transfer of the securing property produces property gain.

Recall that in *Gershkowitz* the collateral securing a $250,000 nonrecourse debt had an adjusted basis of $50,000 and a fair market value of only $2,500 at the time of the transaction at issue.[154] Under the collapsed approach, the taxpayer, a partnership, would have realized and recognized $200,000 of gain under sections 1001 and 61(a)(3) if it simply transferred the property back to the creditor. The partnership was insolvent at the time and so negotiated with the creditor a discharge of the nonrecourse debt for a payment of $40,000—an amount far in excess of the value of the collateral the creditor would have received on foreclosure—in the hope of creating deferrable COD income instead of gain. Because the collateral was retained, there was no realization event under section 1001, and so the court held that the taxpayer realized $210,000 of COD income.[155]

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things, whether parties can ensure COD income rather than gain under section 1001 by converting nonrecourse debt into recourse debt shortly before a forced sale).

153. See supra notes 125-31 and accompanying text (discussing *Gershkowitz*).

154. See supra notes 125-31 and accompanying text (discussing *Gershkowitz*).

155. Gershkowitz v. Commissioner, 88 T.C. 984, 1009 (1987). On the particular facts of the case, the partners' hopes of deferral were dashed in any event. The partners themselves were all solvent, and the court held that the insolvency exception of section 108(a) should be applied at the partner, not the partnership, level. This result is now codified at section 108(d)(6). Other taxpayers outside the partnership context, however, learned of a wonderful "planning opportunity" (see discussion supra note 149) upon reading the case. As Witt and Lyons put it:

> *Gershkowitz* is significant for a number of reasons. Principally, it illustrates the differing tax consequences that will result depending upon

In so doing, the court, at least implicitly, rejected the *Fulton Gold* approach to the discharge of nonrecourse debt in the retained-collateral context. That case, as discussed above,[156] came to stand for the proposition that a discharge of nonrecourse debt without a transfer of the securing property does not result in COD income but rather results in a decrease in basis to the extent thereof. The implicit conceptual underpinning of the *Fulton Gold* approach is that the debt should not be considered a tax attribute separate from the underlying property securing the debt. That is the approach inherent in the collapsed approach to nonrecourse debt in the transfer context and the approach rejected in the bifurcated approach to recourse debt in the transfer context. The *Fulton Gold* approach would have produced either a negative basis or income that escapes taxation and so its rejection in *Gershkowitz* might be easily defended. But its rejection is an implicit rejection of its conceptual basis as well, which collapsed the nonrecourse debt into the property ownership, the conceptual basis which continues to control the very same debt in the transfer context.

If the bifurcated approach were extended to nonrecourse debt in the transfer context, this "planning opportunity," too, would disappear. Whether the discharge of the nonrecourse debt in *Gershkowitz* resulted because of a transfer of collateral worth $2,500 or a transfer of $2,500 in cash, the discharge would produce COD income, and the chips would fall where they would. Insolvent or bankrupt taxpayers could defer the income; others could not. Once again, there would be no need to make sure the correct item is transferred in connection with the debt cancellation in order to produce the desired tax results or avoid undesired tax results.

For these "planning opportunities" to be justified, the dichotomous approaches to recourse and nonrecourse debt in the transfer context must be justifiable as a conceptual matter.

D. *Asserted Justifications for the Dichotomy*

The collapsed approach is certainly not without its supporters. Since *Tufts*, many commentators, including eminent professors such as Douglas A.

> the form in which taxpayers structure a debt cancellation transaction. In the context of a nonrecourse debt, the case confirms that a taxpayer can realize discharge of indebtedness income by paying cash in satisfaction of the debt. On the other hand, if capital gain or loss is desirable, then the taxpayer can produce a section 1001 sale or exchange by transferring the property securing the debt or property with no relation to the initial borrowing transaction to the lender in satisfaction of the debt.

Witt & Lyons, supra note 8, at 80. The Service confirmed these results regarding COD income in Revenue Ruling 91-31, 1991-1 C.B. 19. See supra notes 132-36 and accompanying text.

156. See supra notes 118-24 and accompanying text (discussing *Fulton Gold*).

Kahn,[157] have defended the use of the collapsed approach for nonrecourse debt while maintaining the use of the bifurcated approach for recourse debt for reasons independent of the stated reasoning of the *Tufts* Court majority. They defend the collapsed approach, under which the debt relief is deemed tied too intimately to the property disposition to be treated independently, by arguing that there is, in fact, no debt discharge.

Some simply argue that the debt is satisfied in full according to the terms of the debt obligation by the transfer of the property and thus there is no income from the "discharge" of indebtedness within the meaning of section 61(a)(12) by definition.[158] Some take the analysis a step further by viewing nonrecourse debt as encompassing an option component to put[159] the property back to the creditor if the fair market value of the property falls

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157. Professor Kahn is the Paul G. Kauper Professor of Law at the University of Michigan. See The Directory, supra note 31, at 501. See also infra notes 162-73 and accompanying text (discussing Professor Kahn's position).

158. See, for example, the following quotation from Fred T. Witt and William H. Lyons:

> [T]he distinction drawn by the regulations between recourse and nonrecourse debt is necessary because Treasury and the Service have adopted the position, accepted by the Supreme Court in *Commissioner v. Tufts*, that nonrecourse debt is true debt. Under this position, a transfer of collateral to the lender in satisfaction of a nonrecourse debt will not give rise to discharge of indebtedness income *because the debt has been satisfied according to its terms*. That is, the lender's only recourse in the event of a default on the debt instrument is repossession of the collateral.

Witt & Lyons, supra note 8, at 59 (emphasis added) (footnotes omitted).

159. A "put" is an option entitling the holder to sell property for a specified price to the other party to the option. A more far-reaching analysis of nonrecourse debt is to view the lender as the true owner of the property with the debtor as the holder of a "call" option, an option entitling the holder to purchase property for a specified price from the other party to the option, which the debtor would exercise by paying off the purported "principal amount" if the fair market value of the property continues to exceed the amount of the purported debt. See Robinson, supra note 9, at 42-43 (discussing this approach in extreme cases). This analysis was suggested by the Tax Court in Estate of Franklin v. Commissioner, 64 T.C. 752 (1975), aff'd, 544 F.2d 1045 (9th Cir. 1976), in which the amount of nonrecourse debt exceeded the fair market value of the property ostensibly purchased with the debt by such an exorbitant amount that the Tax Court concluded that all the buyers had done in effect was to purchase a call option for the property with the purported "down payment." 64 T.C. at 762 & n.7; 544 F.2d at 1047 n.3. In such cases, foreclosure would not result in a property disposition under section 1001 for the debtor, as the debtor is never considered as owning the property for tax purposes. The debt is not respected as bona fide debt.

In less extreme cases, in those run-of-the-mill situations in which the nonrecourse purchase debt is not so inflated that no purchase is deemed to occur in the first instance, the debtor is considered as the owner of the property for tax purposes, which raises the question of the debtor's proper treatment on disposition. It is to that more common situation that the put-option analysis is argued to apply.

below the principal amount of the indebtedness.[160] The agreed strike price of the put is whatever the amount of the outstanding indebtedness happens to be at the time of transfer. The accession to wealth is so intimately tied to the property disposition, arising as it does because of an imputed contract right to sell the property to the creditor (in effect), that the accession to wealth is properly analyzed under section 1001 rather than section 61(a)(12).

The more simplistic version of the argument—that the debt is satisfied in full according to its terms and thus cannot by definition give rise to COD income—is beguiling but is a red herring. It attaches too much significance to the raw terminology in section 61(a)(12), on the literal meaning of the word "satisfied" as well as the literal meaning of the word "discharged," while losing sight of the structural reason why the accession to wealth which that section labels "income from the discharge of indebtedness" is included in gross income in the first place.[161] Such a reliance on the dictionary definition of words focuses on nonissues that arise because of an excessive solicitude to the perceived exactitude of the meaning of words severed from their structural context as part of the Internal Revenue Code. The point is not that Congress should have chosen better words than "discharge of indebtedness" to describe the accession to wealth—the words are as clear as they probably can be—but rather that those words must be given meaning by taking account of the larger structural context in which they are used.

The salient inquiry is not whether the debt is "satisfied" according to its terms for commercial law purposes, as surely it is in such situations, but rather how the accession to wealth that arises on the transfer, because of the prior tax exclusion of the full amount of the loan proceeds that are in fact not fully repaid, should be taken into account for *tax* purposes. Making the semantic argument that the debt is "satisfied" (or "unenforceable") for commercial law purposes does not help answer that *tax* question. The fact remains that there is an accession to wealth that must be accounted for, it arises solely because of the prior exclusion of loan proceeds, and thus it is intimately tied to the failure to repay that full amount of previously excluded dollars with after-tax dollars.

That relationship between the prior exclusion and failure to repay with after-tax dollars is the conceptual underpinning for taxing COD income,

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160. See, e.g., Yishai Beer, Nonrecourse Loans: Do Not Forget to Tax the Option, Special Report, 53 Tax Notes 837 (Nov. 18, 1991); Cunningham I, supra note 14, at 593; Alvin D. Lurie, New Ghosts for Old—Crane Footnote 37 Is Dead (Or Is It?), 2 Am. J. Tax Pol'y 89, 96 n.15 (1983); Willis II, supra note 101; Willis I, supra note 85, at 634-35.

161. Similarly, unenforceability of a debt is thought by some to be a significant factor to consider in the debt-discharge area because of the terminology used. A debt is not "discharged," the argument goes, if it could not be enforced. See discussion supra notes 114-15 and accompanying text; discussion infra notes 167, 217.

not property gain. After all, the amount of gain inherent in property is related to the yet-untaxed appreciation in value since purchase owing to the rule of administrative convenience embodied in the realization requirement (that such gain will be deferred during ownership in order to avoid annual valuations). Property gain (or loss) is thus intimately tied to value, not to the excess debt encumbering it. The collapsed approach distorts the gain component of the transaction, transforming a mere deferral rule (the realization requirement) into a rule that alters the *amount* of gain. Analyzing whether a debt is literally "discharged" for commercial law purposes and, since it is not, then relying on the fallback provisions of the gain-realization provisions (in order to ensure that the accession to wealth that indisputably occurs on the transaction does not escape taxation altogether) loses sight of the underlying conceptual rationale for taxing the accession to wealth that arises in these situations in the first place. The failure to repay *debt* is the only fact that is relevant.

The more sophisticated version of the argument (which seems to be at the root of even the more simplistic version)—that nonrecourse debt should be considered as encompassing a put option that is exercised on transfer which requires the accession to wealth to be controlled by the provisions pertaining to property dispositions—is more beguiling still because of its technicality. Without using the term "option," Professor Kahn, in his student treatise, states the argument in the following way in defending the disparate treatment between recourse and nonrecourse debt in the *Tufts* situation.

> If a loan is made to a taxpayer on a nonrecourse basis, the lender implicitly agrees to accept the encumbered property as full payment for the outstanding balance of the debt if the debtor does not satisfy the debt in cash or other property. In effect, the parties agree at arms' length that the property will be treated by them as never having a value that is less than the amount of the outstanding debt. So, if the property is acquired by the creditor as the final payment on the debt, there is reason to treat the property as having been valued by the creditor and the debtor at a figure that is equal to the outstanding debt. The treatment of the entire debt as consideration for the transferred property in such cases is warranted by the usual rule that a value set at an arms' length bargain will not be disturbed by the tax authorities.
>
> On the other hand, when the debt is a recourse debt, the creditor has not consented at the time of the loan to treat the underlying property as never having a value that is less than the outstanding debt. To the contrary, the creditor has retained the right to collect from the debtor any deficiency in the payment received that results from an inadequacy in the

value of the encumbered property. So, if the creditor agrees to forego his right to collect the deficiency from the debtor, that constitutes a forgiveness by the creditor of that portion of the debt. The regulation reflects the reality that the creditor does forgive a portion of the debt when he chooses not to enforce his right to require the debtor to make-up [sic] the unpaid portion of the debt.[162]

The quoted analysis turns on one misplaced assumption and two items that should have no relevance in determining the proper tax consequences of the accession to wealth that arises in these transfer situations. The assertion that the arm's-length agreement between creditor and debtor (that the value of the property should always be deemed to equal the outstanding principal at any point in time) should be respected for tax purposes is not convincing. Even arm's-length agreements are suspect if the parties' tax positions are not adverse or if they do not report the arm's-length allocation consistently, and the fact is that, notwithstanding the implicit agreement described above, the lender will *not* treat the value of the property on foreclosure as equal to the outstanding loan amount for tax purposes. Rather, the lender will value it at fair market value and take a deduction for the resulting "bad debt" under section 166.[163] Moreover, requiring the lender to honor the implicit agreement by disallowing a bad debt deduction, if that is the alternative suggestion to the one advanced in this article, fails to account for the other weaknesses of this analysis.

Two items accorded persuasive force in the recourse context by Professor Kahn but that should be irrelevant in determining the proper tax consequences of the accession to wealth in the transfer situation are (1) the *timing* of the agreement that a deficiency in repayment will not be pursued and (2) the *unilateral* versus *bilateral* nature of the agreement not to pursue a deficiency. Professor Kahn notes that the feature distinguishing a recourse debt from a nonrecourse debt is that in the former "the creditor has not consented *at the time of the loan* to treat the underlying property as never having a value that is less than the outstanding debt"[164] and "that the creditor does *forgive* a portion of the debt when *he chooses* not to enforce his right"[165] to collect any deficiency remaining upon transfer of the property. After stating these assertions, he fails to explain why they are relevant.

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162. Douglas A. Kahn, Federal Income Tax: A Student's Guide to the Internal Revenue Code 492-93 (2d ed. 1992).

163. See Cunningham I, supra note 14, at 595 (discussing authority confirming this result).

164. Kahn, supra note 162, at 493 (emphasis added).

165. Id. (emphasis added).

Why should the *timing* of the agreement not to pursue a deficiency matter in determining the proper *tax* consequences of the debtor's accession to wealth that occurs only at the time the deficiency is not, in fact, pursued? In the nonrecourse situation, much seems to be made of the fact that the creditor foregoes collection of the deficiency before any deficiency arises whereas in the recourse situation the creditor does not forego collection of the deficiency until such time as the deficiency arises. Why should that timing difference affect the tax analysis of the *conceded* accession to wealth that arises in *both* situations solely because the creditor will not, in fact, collect the entire loan amount previously advanced to the debtor and previously excluded from gross income for tax purposes?

Moreover, why should the *voluntariness* or *involuntariness* of the creditor's actions in foregoing collection of the deficiency affect the tax analysis of the conceded accession to wealth that arises in *both* situations solely because the creditor will not, in fact, collect the entire loan amount previously excluded from gross income for tax purposes? Professor Kahn implies that if the creditor voluntarily chooses to "forgive" a loan, the debtor realizes COD income but that if the creditor does not voluntarily choose to "forgive" a loan but rather fails to collect because of a *bilateral* agreement with the debtor, the debtor does not realize COD income, so the accession to wealth is properly analyzed as amount realized.[166] This reasoning ignores the conceptual underpinnings for taxing debtors when they fail to repay the full amount of previously excluded loan proceeds.

While some do loosely refer to income arising under section 61(a)(12) as "debt-*forgiveness* income," the conceptual underpinnings justifying the inclusion in gross income under section 61(a)(12) of *recourse* debt that is not fully repaid has nothing to do with the subjective state of mind of the creditor in failing to collect the entire amount of previously advanced (and untaxed as ordinary income) loan proceeds. The reason the debtor is taxed under section 61(a)(12) is simply because of the failure to repay with after-tax dollars the amount previously received from the lender and excluded from gross income solely on the assumption that the full principal amount would, in fact, be repaid with after-tax dollars. The proper perspective for the analysis is from the taxpayer-debtor's point of view. Thus, the *absence* of that subjective state of mind on the part of the creditor to "forgive" voluntarily the debt in the *nonrecourse* context does not justify the conclusion that the accession to wealth that arises in the nonrecourse context should not be analyzed as COD income under section 61(a)(12). Indeed, a bilateral agree-

166. The very evidence Professor Kahn seems to require to create COD income could result in its nontaxability. If the "forgiveness" arises out of "detached and disinterested generosity," Commissioner v. Duberstein, 363 U.S. 278 (1960), the realized COD income could be excluded from gross income as a gift under section 102.

ment entered into between the debtor and lender to reduce nonrecourse debt *after* the initial loan is incurred will result in COD income if the collateral is retained.[167]

Nonrecourse debt simply limits the creditor's ability to pursue full collection under commercial law of the amount previously received untaxed by the debtor—no more. As Justice Blackmun emphasized in *Tufts* itself:

> The only difference between [a nonrecourse] mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.
>
> This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free and included them in his basis on the understanding that he had an obligation to repay the full amount. When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent....[168]

There is no getting around the fact that the accession to wealth for tax purposes arises solely because of that previous exclusion of *loan proceeds*—the very heart of COD-income theory—whether or not the loan proceeds were advanced on terms giving the lender recourse beyond the value of the collateral and whether or not the occasion for failure to pay the entire nonrecourse indebtedness is a transfer of the collateral (which produces gain under current law) or a bilateral modification of the loan agreement (which

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167. See supra notes 132-36 and accompanying text discussing Revenue Ruling 91-31, 1991-1 C.B. 19. Professor Kahn's implicit argument—that in order for a debtor to realize COD income the creditor must "forgive" the debt by "choos[ing] not to enforce his right" to collect the debt in full—suffers from the same weakness of looking to the enforceability of the debt that is found in the *Zarin* and *Schlifke* cases. See supra notes 114-15 and accompanying text; supra note 162 and accompanying text; discussion infra note 217. The implicit message is that only debt that is enforceable but that is not in fact enforced by the creditor can result in COD income when not collected in full. That reasoning simply loses sight of the conceptual basis for taxing COD income in the first place.

168. Tufts v. Commissioner, 461 U.S. 300, 311-12 (1983) (citations omitted).

produces COD income under current law). The *reason* the lender fails to collect does not affect the debtor's accession to wealth for tax purposes, and the transfer of the collateral is simply the event that identifies that the remaining indebtedness will never be repaid, thus triggering the realization of ordinary income previously deferred on the assumption the loan proceeds previously received would be repaid in full.

The most fundamental problem with the put-option justification for the collapsed approach, however, is that it is inconsistent with treating nonrecourse debt as "true debt" in full as does current law except in the most abusive of situations.[169] The put option that is deemed embedded in all nonrecourse debt under this approach is never taxed as an option during the ownership of the property. For example, the premium deemed paid for the put is never treated as a premium paid for a put; it is treated as additional interest.[170] It is inconsistent to argue on the one hand that a put should be deemed to be a part of all nonrecourse debt at the time the property is transferred in satisfaction of a debt exceeding the property's value (justifying the collapsed approach) but to ignore the put on the other hand at all other times during the property ownership.[171] That conclusion, however, does not mean

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169. See supra text accompanying note 25 (quoting Justice Blackmun as characterizing the nonrecourse debt in *Tufts* as a "true loan" for tax purposes). While not addressing in particular the dichotomy between the bifurcated and collapsed approaches in the *Tufts* situation, Professor Shaviro argues that "the existing nonrecourse debt rules involve an absurd and unnecessary level of contradiction and complexity. The rules should be consolidated and changed to treat nonrecourse debt somewhat more like personal liability debt." Shaviro, supra note 9, at 405. "[O]nly the overstatement of purchase price argument provides a convincing ground for treating nonrecourse debt differently than personal liability debt." Id. at 432. Professor Shaviro is referring to the issue left unanswered in the *Tufts* case itself: What was the purchaser's basis? See Jensen I, supra note 21. Because acquisition nonrecourse liability is included in basis, the potential for abuse in overstating the amount of acquisition nonrecourse indebtedness can be a problem. This potential is greatest in the case of seller-provided nonrecourse financing (as opposed to the acquisition of property subject to preexisting nonrecourse indebtedness). See generally Jensen II, supra note 41, at 645-46 (discussing these different abuse potentials); discussion supra note 159 (discussing the *Estate of Franklin* case); discussion supra note 76 (citing and discussing the pertinent regulation). However, once the purchaser's appropriate cost basis is determined under the analysis set forth in Professor Jensen's article (i.e., once it is determined whether to respect the debt as "true debt"), the tax consequences on disposition of the property should not differ depending on whether that debt is labelled recourse or nonrecourse.

170. See generally *Beer*, supra note 160; Willis II, supra note 101 (both describing what the authors conclude should be the appropriate tax consequences under the option rules if the put option is recognized and given effect during the ownership period).

171. The put-option argument is less extreme than some other views of nonrecourse debt because it recognizes the debt as true debt to a great extent. It simply adds the put option to the deal. Other arguments that are also far from absurd can be made that nonrecourse debt should not be treated as debt to any extent. One can argue that nonrecourse debt is nothing more than an opportunity to purchase the property securing the debt. See discussion supra note

that a put option should, in fact, be given credence during the owner-ship period as well. As Professor Willis has persuasively illustrated, the put option some deem embedded in all nonrecourse debt is really nothing more than a risk premium—a premium paid to the lender for agreeing to shoulder the downside risk that the collateral will lose value—and risk premiums are not similarly segregated from recourse debt and treated as a put option, requiring application of the collapsed approach on transfer of the collateral.[172]

While clearly not absurd if viewed in isolation of other rules considered in this article,[173] the put-option justification for the collapsed approach does not have such strong conceptual force that the discontinuities described above in Subsection C (which arise solely because of the collapsed approach) should be tolerated with an easy mind. The mind becomes more uneasy yet when the collapsed approach is considered in the context of personal-use property, discussed in Part IV.

IV. PERSONAL-USE PROPERTY: PROVIDING THE ANSWER

It is time to return to the facts of the technical advice memorandum

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159 (discussing the call-option approach in the *Estate of Franklin* case). Alternatively, one can view nonrecourse debt as co-ownership of the securing property by the debtor and creditor or as some other form of shared equity investment. See *Tufts*, 461 U.S. at 308 n.5 (considering this alternative).

As Robinson notes, however, these alternative conceptions of nonrecourse debt have as their common denominator the view that a nonrecourse loan is something other than true debt. Robinson, supra note 9, at 41. Thus, these differing conceptions carry with them "far different tax treatment[s]" (Robinson, supra note 9, at 41) than arise under current law. For example, such conceptions would alter the availability of depreciation deductions to the debtor who takes them in full under the current approach. Except in abusive cases, the Code—as well as the Supreme Court—rejects these more radical approaches to nonrecourse debt, viewing nonrecourse debt as true debt. See supra text accompanying note 168 (quoting *Tufts*); discussion supra note 44 (describing the unsuccessful argument made in Tufts's brief that nonrecourse debt is "not truly debt"). The evaluation of the collapsed approach has to be made with this fundamental structural decision to respect typical nonrecourse debt as "true debt" in mind.

172. Professor Willis illustrates this phenomenon with the hypothetical described infra text accompanying notes 188-90. See Willis II, supra note 101, at 447. Shortly before this article went to press, Beer published his views that even recourse debt should be considered to encompass a put option, and taxed accordingly, to the extent the creditor shoulders a risk of default in the particular facts and circumstances. See Yishai Beer, The Taxation of the Risk Component in a Loan: An Option Analysis, Special Report, 57 Tax Notes 525 (Oct. 26, 1992). Beer's approach argues for the adoption of the collapsed approach for *both* recourse and nonrecourse debt, a result which would, at the least, continue the disparate results that occur between the transfer and nontransfer contexts and which would continue to present problems in the context of personal-use property. See infra Part IV.

173. See supra text accompanying notes 138-40 (describing the intersection of the collapsed approach with related rules).

with which this article began.[174] In that memorandum, the creditor foreclosed on a personal residence in a nonjudicial foreclosure proceeding. The debtor had purchased the residence for $130,000; the residence had a fair market value of $100,000 at the time of foreclosure; and the outstanding indebtedness at that time was $122,000. Although the loan documents themselves apparently did not limit the creditor's recourse rights, the creditor was barred from pursuing the deficiency in debt satisfaction under a state (Alaska) antideficiency statute.[175] How was the debtor's accession to wealth upon failure to pay the remaining $22,000 of principal originally borrowed and excluded from gross income treated for tax purposes?

One could easily argue that the effect of the state statute preventing the creditor from pursuing the deficiency against the debtor's other assets was to transform the nominally recourse loan into a nonrecourse loan. Under the collapsed approach for nonrecourse debt, no COD income would be considered realized.[176] The debtor would be considered as transferring his property with a basis of $130,000 for an amount realized that included the remaining $122,000 indebtedness, producing an $8,000 nondeductible personal loss.[177]

Without even considering the effect of the state antideficiency statute on the debt's status as "recourse" or "nonrecourse," however, the ruling simply cited the bifurcated rule that applies in the case of recourse debt found in Treasury Regulation section 1.1001-2(c), Example 8, and ruled that the debtor realized $22,000 in COD income.[178] Under the bifurcated approach, the debtor also realized a $30,000 nondeductible personal loss.[179]

The issue actually considered in the ruling was whether the value of the residence should be considered in determining whether the debtor was "insolvent" within the meaning of section 108(d)(3)[180] and thus entitled to

174. I.R.S. T.A.M. 9130005 (March 29, 1991). See supra text accompanying note 2.

175. The ruling fails to cite the Alaska statute, but apparently the statute prevented creditors from pursuing deficiencies arising on foreclosure of personal residences or purchase-money mortgages pertaining to real estate. See I.R.S. T.A.M. 9130005 (March 29, 1991). Cf. infra note 186 (quoting California antideficiency statute).

176. See supra notes 9-14 and accompanying text (describing collapsed approach for nonrecourse debt).

177. See discussion supra note 13.

178. I.R.S. T.A.M. 9130005 (March 29, 1991).

179. See discussion supra note 7.

180. That subsection defines insolvency as "the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge." On the liability side, the Service recently ruled that "[t]he amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of section 108(d)(3) of the Code, but

use the deferral mechanism in sections 108(a) and (b) (which could result in complete forgiveness if the taxpayer had no tax attributes that could be reduced in lieu of immediate recognition of the COD income).[181] If the residence were considered an "asset" for this purpose, the debtor would not be considered insolvent, but if the residence were not considered an "asset" for this purpose, the debtor would be considered insolvent.

The ruling concluded that the residence should not be considered an "asset" for purposes of testing insolvency by relying on the discredited freeing-up-of-assets rationale for the taxation of COD income in the first instance. "Because the rationale for the insolvency exception is that where no assets are freed from claims of creditors no income is realized, only assets that are subject to claims of a taxpayer's creditors should be used to determine insolvency."[182] Because the asset was exempt from the claims of creditors under the antideficiency statute that created the COD income in the first instance (obviously a bit circular), the ruling reasoned it should not be considered in determining insolvency.[183] The taxpayer could thus take advantage of the insolvency exclusion.

There is much to consider here beyond the wiseness of the conclusion that assets exempt from creditors under state statutes should not be considered in determining solvency for purposes of the insolvency exclusion of federal tax law.[184] First, why did the antideficiency statute not make the debt non-

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only to the extent that the excess nonrecourse debt is discharged." Rev. Rul. 92-53, 1992-27 I.R.B. 1. The Service added that nonrecourse debt should also be treated as a liability in determining insolvency to the extent of the fair market value of the property securing the debt. Id.

181. See discussion supra note 8 (describing the deferral mechanism under section 108(a)).

182. I.R.S. T.A.M. 9130005 (March 29, 1991).

183. The ruling is consistent with other rulings and cases similarly holding that assets exempt from the claims of creditors in whatever state in which the debtor happens to be residing should not be considered an "asset" in determining insolvency under section 108(d)(3). See, e.g., Marcus Estate v. Commissioner, 34 T.C.M. (CCH) 38, 41, T.C.M. (P-H) ¶ 75,009 at 43 (1975); Davis v. Commissioner, 69 T.C. 814 (1978); Hunt v. Commissioner, 57 T.C.M. (CCH) 919, 946, T.C.M. (P-H) ¶ 89,335 at 1700 (1989); Priv. Let. Rul. 9125010 (March 19, 1991) (all discussed in Sheppard, supra note 152, at 787).

184. Relying as it does on the outdated freeing-up-of-assets rationale underlying COD-income theory, the ruling's position has been criticized and is purportedly under reconsideration. See Sheppard, supra note 152, at 787 (reporting that Mary Harmon, special assistant to the Internal Revenue Service Chief Counsel, "stated that the Chief Counsel's office is re-examining the letter rulings in light of the demise of the freeing-of-assets theory"). The rationale for the insolvency exclusion now rests on a don't-kick-them-when-they-are-down rationale. See discussion supra note 8. COD income is undoubtedly realized by insolvent debtors on the discharge of indebtedness under the symmetry or tax-benefit rationale, but deferral of the tax bill until some point in the future is thought to allow some debtors to stay afloat. The mechanism is, admittedly, imperfect. It fails to ever tax COD income of insolvent

recourse, which (under the collapsed approach) would not produce COD income? What is nonrecourse debt but debt that deprives the creditor of recourse to assets beyond the securing collateral for satisfaction of the debt? Should the loan papers alone determine whether debt is "nonrecourse" or "recourse" when so much is at stake for tax purposes depending on which label applies?

In *Freeland v. Commissioner*,[185] the debtor bought unimproved California real estate for $50,000 by paying $9,000 in cash and giving a purchase-money mortgage for the remaining $41,000. The debtor eventually transferred the property back to the vendor-creditor by quitclaim deed prior to the institution of foreclosure proceedings at a time when the property's value had fallen to $27,000 and the indebtedness remained at $41,000. A California antideficiency statute prevented the vendor-creditor from pursuing the deficiency.[186] The opinion states, "It is conceded that by application of ... [the antideficiency statute], the note in the instant case was secured only by the property and not by the personal liability of petitioner."[187] The opinion considered only whether the conveyance by the debtor to the vendor-

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debtors who happen not to have any of the tax attributes that could preserve the income recognition for some future point. Moreover, by failing to include an interest component similar to that found in section 453A pertaining to income deferred under the installment method, it fails to take account of the substantial tax savings that arise solely because of the income deferral.

Perhaps one could defend the ruling's position (halfheartedly at least) even under the don't-kick-them-when-they-are-down rationale for the insolvency exclusion. The exclusion, premised on an inability to pay, may be warranted if the assets protected by state statutes are the bare necessities needed for life, such as personal belongings and modest residences. Perhaps the tax law ought not require immediate payment of the tax bill, allow deferral until some point in the future when the debtor is presumably in better financial health, if immediate payment would require sale of such personal assets. When one considers the opulence of some personal residences, however, the argument is not terribly persuasive.

If this rationale carries the day, however, a further change in the implementation of it is nevertheless warranted. There are obvious horizontal equity problems—the possibility of treating similarly situated taxpayers differently—in relying on 50 different state exemption statutes in determining the definition of "insolvency" for federal tax purposes. Just as a uniform definition of "alimony" was created for federal tax purposes that surely differs from many state statutes (see IRC § 71), perhaps the Code or Regulations should spell out the extent to which personal assets should not be considered in determining insolvency for federal tax purposes.

185. 74 T.C. 970 (1980).

186. The case quotes the language of the statute as follows: "No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price...." Id. at 971. Thus, the California statute apparently applies to both personal-use and other real property but applies only to seller-financed mortgages.

187. Id. at 971-72.

creditor constituted a "sale" (producing capital loss under the collapsed approach for nonrecourse debt) or an "abandonment" (producing an ordinary loss for failure to satisfy the "sale or exchange" requirement of section 1222 of the Code). The court concluded that the conveyance constituted a "sale." Should whether a state antideficiency statute transforms a debt into a nonrecourse debt depend on the concessions of the taxpayer and Internal Revenue Service as in *Freeland*?

If we look beyond the loan documents themselves to state statutes in determining the status of a creditor's recourse rights, should we also look to the economic reality surrounding the creditor's nominal recourse rights? Let us return to an example posited by Professor Willis.[188] Joe Wealthy and Joe Penniless are considering identical transactions and decide to go to the same bank for financing. On a recourse basis, the bank offers a rate of 8% to Wealthy and 15% to Penniless. The bank also offers a rate of 15% to Wealthy on a nonrecourse basis. The difference in rates quoted to Wealthy with respect to the recourse and nonrecourse loans reflects the risk assumed by the bank in the case of the nonrecourse loan that is absent in the case of the recourse loan. That same risk premium is also very apparent, however, in the 15% recourse loan offered to Penniless. "Penniless ... pays a large risk premium because the encumbered property is all he has. He and the bank do not label the loan nonrecourse, but the realist banker knows it really is. And Penniless knows it, too."[189] Because Penniless's loan is essentially nonrecourse when Penniless's finances are considered, should that mean that the debt should be considered nonrecourse for tax purposes, resulting in application of the collapsed approach on disposition of the property for less than the outstanding indebtedness? Economically, Wealthy's nonrecourse loan and Penniless's recourse loan are identical. "Surely the 'labels' are insufficient grounds for disparate [tax] results."[190]

A second—and more important—point to ponder in connection with the facts of the technical advice memorandum is that it illustrates the

188. See Willis II, supra note 101, at 447.

189. Id.

190. Id. In discussing the disparate tax results arising between recourse and nonrecourse debt on foreclosure in the partnership context, Ms. Sheppard writes:

> This article necessarily assumes that nonrecourse liabilities can be distinguished from recourse liabilities for tax purposes. "I don't know what a nonrecourse liability is," one practitioner complains, noting that the term recourse can be confusing when the borrower is an entity [or a person such as Penniless?] with limited liability. Should a so-called "exculpatory" liability that is recourse to a partnership but nonrecourse to its partners be considered a recourse liability for tax purposes? ... In the case of a single-asset partnership, there may be no practical difference between a nonrecourse liability and an exculpatory liability.

Sheppard, supra note 152, at 785.

deficiency of the collapsed approach itself. If the antideficiency statute had resulted in transforming the indebtedness into nonrecourse debt (or if there had been no antideficiency statute but the loan itself had been styled "nonrecourse"), the collapsed approach would have produced an $8,000 nondeductible capital loss and no COD income instead of $22,000 of COD income coupled with a $30,000 nondeductible capital loss. That, for reasons developed below, is the wrong conceptual result.

Many have stated that the difference between the collapsed and bifurcated approaches is really one only of character[191]—itself an ambiguous concept[192]—and thus perhaps not really particularly important (the availability of the section 108(a) exclusions aside). Recall that in *Tufts* the majority held that Tufts realized $400,000 of gain under the collapsed approach while Justice O'Connor's concurring opinion preferred the bifurcated approach, under which Tufts would have realized $450,000 of COD income and $50,000 of loss. The net *amount* taken into account on the tax return would have been $400,000 under either approach. In fact, in all business and investment contexts, the net *amount* taken into account for tax purposes will *always* be the same, whether the collapsed approach is applied or whether the bifurcated approach is applied, because both sides of the equation—the loss as well as the gain or income—will be cognizable for tax purposes. Only the character—potentially deferable and ordinary COD income versus nondeferable capital gain or reduced capital loss—differs.

The memorandum, because it deals with personal-use property, demonstrates the fallacy of the assumption that the net *amount* taken into account will always be the same, that the difference here is really one only of character. Because the loss attributable to the property transaction under section 1001 will *not* be cognizable for tax purposes in view of the personal use of the property, the decision whether to apply the collapsed approach or bifurcated approach is critical in determining the actual *amount* that the taxpayer must take into account for tax purposes.

The collapsed approach allows the taxpayer who finances personal-use property with nonrecourse debt, or debt considered to be nonrecourse, to escape taxation of the accession to wealth arising from failure to repay with

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191. See supra note 35 and accompanying text.

192. See Willis II, supra note 101, at 446:

> Unfortunately, tax law ... has ... distorting principles, not known to accounting. Not the least of these is the bizarre notion of character. Whoever originated this idea surely was not thinking as an accountant. From my standpoint, income is income. No principle of natural law makes gains—from an option or otherwise—capital and thus favored. Only politicians hoping to control the economy do.

Id.

after-tax dollars loan proceeds used in personal consumption.[193] Extrapolating from the facts of the memorandum, we can compare Little Bucks, who purchases a personal residence for $130,000 entirely with nonrecourse debt, with Big Bucks, a taxpayer who purchases an identical residence with $130,000 in cash. The difference between Little Bucks and Big Bucks is that Little Bucks can defer tax until repayment of the principal amount of the loan received free of tax while Big Bucks already paid tax on the entire $130,000 used to purchase the residence.[194] Both residences decrease in value to $100,000. The residence owned by Little Bucks is transferred to the creditor at a time when the outstanding indebtedness is $122,000; the residence owned by Big Bucks is sold for its fair market value of $100,000.

Big Bucks realizes a $30,000 nondeductible personal loss, as her loss is considered one arising out of personal consumption rather than investment.[195] Little Bucks, on the other hand, is considered as realizing only an $8,000 nondeductible personal loss under the collapsed approach. He realizes no COD income. By allowing Little Bucks to attribute the accession to wealth

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193. The fact that the debtor described in the memorandum may not have recognized any income under the bifurcated approach is inapposite. (Nonrecognition could occur because of the insolvency exclusion under section 108(a) coupled with the lack of tax attributes or depreciable property listed in section 108(b)). The policy reasons ostensibly supporting the insolvency exclusion can change and are independent from the conceptual rationale producing the realized income in the first instance.

194. See supra notes 89-91 and accompanying text (discussing this principle).

195. Of course we all know that the decrease in value may have been due to market forces and not to wear and tear on the house arising out of its use for shelter. Nevertheless, the loss on a house used as a personal residence is considered at the present time, for tax purposes, to arise from personal consumption and thus is nondeductible. Regs. § 1.165-9(a). The only exception to this rule is in the case of substantial casualty losses, see section 165(c)(3) and (h), which are allowed to be deducted on ability-to-pay grounds (i.e., vertical-equity grounds). The ability of a taxpayer with substantial personal casualty losses to pay taxes is considered diminished. Thus, to the extent losses exceed a threshold below which ability to pay is not considered substantially diminished, the loss is deductible. This is the same rationale underlying the deduction for medical expenses, a deduction for personal consumption which also includes a threshold. But see Louis Kaplow, The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums, 79 Cal. L. Rev. 1485 (1991) (arguing that the casualty loss and medical expense deductions are premised on insurance principles rather than vertical-equity principles). See generally Richard A. Epstein, The Consumption and Loss of Personal Use Property Under the Internal Revenue Code, 23 Stan. L. Rev. 454 (1971) (arguing that the current system mistaxes losses arising in connection with personal-use property).

While we may challenge the wisdom of that underlying assumption—that losses on personal residences reflect personal consumption rather than investment losses—our analysis of the situation described in the technical advice memorandum has to take notice of the current decision and the disparate treatment under it between those who finance with recourse debt (see infra note 197), those who have the opportunity to finance with nonrecourse debt, and those who pay cash.

that arises upon failure to repay $22,000 of the loan proceeds previously received free of tax to a *decrease* in his nondeductible loss, we have mistaxed Little Bucks. Both Big Bucks and Little Bucks consume the same $30,000 of value in their personal residences, yet Big Bucks is disallowed a deduction for the entire $30,000 while Little Bucks is allowed, in effect, a deduction of $22,000 of that loss. If Little Bucks had paid tax on the income used to purchase the residence (either before purchase by not borrowing money for the purchase or on the transfer by charging him with $22,000 of COD income), he would have been similarly disallowed a deduction for the entire $30,000 loss as personal consumption instead of only for $8,000. Allowing Little Bucks to escape taxation on the dollars used to purchase the residence gives him a backdoor deduction for that personal consumption; it allows personal consumption on a *before-tax* basis.

The hypothetical involving nonrecourse debt secured by personal-use property—even if not very common or realistic in the real world—illustrates the inappropriateness of attributing the accession to wealth that arises on the failure to repay debt secured only by property to the taxpayer's ownership interest in the property itself. The accession to wealth is attributable to the *debt* or, more accurately, to the failure to repay loan proceeds previously received free of tax on the assumption that they would be repaid in full with after-tax dollars. Thus, the accession to wealth in the *Tufts* situation should produce COD income—not additional gain or decreased loss on the property disposition—just as it would if the property were retained rather than transferred and just as it would if the debt were recourse.[196] Big Bucks and Little Bucks *both* realize $30,000 in nondeductible personal consumption. Little Bucks *also* realizes $22,000 in COD income because of the failure to repay with after-tax dollars $22,000 of the original $130,000 before-tax dollars used to purchase the residence.[197]

This analysis does *not* mean that we should have a special rule applying the bifurcated approach to *Tufts* transfers involving nonrecourse debt in the case of personal-use property while maintaining the collapsed approach for business and investment property. Moreover, because the hypothetical demonstrates why the collapsed approach itself is flawed *conceptually*, it also

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196. See supra notes 132-36 and accompanying text (discussing Revenue Ruling 91-31, 1991-1 C.B. 19, in the retained collateral context) and notes 4-8 and accompanying text (describing the bifurcated approach in the transfer context for recourse debt).

197. The same incongruous results would occur if Big Bucks had not purchased her residence with cash but rather incurred a recourse loan for the entire $130,000 purchase price and, just as Little Bucks, then transferred the residence to the creditor at a time when the residence was worth only $100,000 but the outstanding debt (which the creditor does not pursue) is $122,000. Under the bifurcated approach applied to recourse debt, Big Bucks would still realize a $30,000 nondeductible personal loss. Under this scenario, however, Big Bucks would also realize $22,000 of COD income. So should Little Bucks.

demonstrates that our problems would not be solved by adopting the collapsed approach for *both* recourse and nonrecourse debt. While the manipulation described in Part III. C. would be reduced if the collapsed approach were applied to all debt, the conceptual flaw inherent in the collapsed approach itself would remain. (Moreover, such an approach would continue the disparate results that occur between the transfer and nontransfer contexts.) As has been noted elsewhere, one way to test the rationality of a theory is to apply it in other factual situations.[198] Considering the collapsed approach in the context of personal-use property simply reveals more starkly the conceptual flaw in the collapsed approach itself: the inappropriate linking of the accession to wealth on the debt discharge to the tax consequences of the property disposition rather than to the debt itself. The collapsed approach should be abandoned once and for all.

A niggling footnote must be considered in advocating that solution, however: the Supreme Court's decision in *Bowers v. Kerbaugh-Empire Co.*[199] The taxpayer in that case borrowed German marks before World War I, converted the borrowed funds into dollars, lost them in a business transaction, and finally repaid the post-war devalued marks with dollars that cost about $685,000 less than the borrowed marks were worth when received and originally converted into dollars. In effect, the taxpayer borrowed more than it repaid even though the transaction as a whole, considering the use to which the loan proceeds were put, resulted in a loss for the taxpayer. The Court held that the difference between the value of the marks when received and when repaid was not income[200] because the "the whole transaction was a loss"[201] and "the mere diminution of loss is not gain, profit or income."[202] In effect, the Court applied the collapsed approach in considering the net effect of the borrowing transaction coupled with the transaction in which the proceeds were spent.

Though very poorly reasoned,[203] *Kerbaugh-Empire* was not over-

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198. Deborah A. Geier, The Tax Court, Article III, and the Proposal Advanced by the Federal Courts Study Committee: A Study in Applied Constitutional Theory, 76 Cornell L. Rev. 985, 988-89 (1991) (citing Erik M. Jensen, Monroe G. McKay and American Indian Law: In Honor of Judge McKay's Tenth Anniversary on the Federal Bench, 1987 B.Y.U. L. Rev. 1103, 1130). Sorry, I was unable to work in this citation within the first five footnotes. See David A. Golden, Note, Humor, the Law, and Judge Kozinski's Greatest Hits, 1992 B.Y.U. L. Rev. 507, 507 n.* ("While this citation [of my own work] appears self-serving, good form seems to require an author to cite his or her most recent publication within the first five footnotes of a new article.").

199. 271 U.S. 170 (1926).

200. Such difference would clearly constitute income today. See IRC § 988.

201. 271 U.S. at 175.

202. Id.

203. Taken literally, the *Kerbaugh-Empire* rule would require tracing of all loan proceeds to evaluate whether a debt discharge produces COD income. No COD income would

ruled in *Kirby Lumber*;[204] it was distinguished,[205] thus giving some more contemporary judges reason to believe it might continue to have vitality in considering debt-discharge income. If it does, one could reasonably argue that Little Bucks ought not to be charged with income on the discharge of his $122,000 indebtedness for $100,000 when his house lost value—whether the debt is recourse or nonrecourse for that matter—because the "whole transaction was a loss," in the words of *Kerbaugh-Empire.*

For example, one dissenting opinion in the Tax Court in *Zarin v. Commissioner*[206] discussed *Kerbaugh-Empire* as follows in arguing that a compulsive gambler who borrowed $3,400,000 from a casino, lost it all, and settled resulting debt-collection litigation for a payment of $500,000 does not realize $2,900,000 in COD income.

> I find it unnecessary to rely in *Kerbaugh-Empire* and therefore need not embrace or reject the approach of that case. I am constrained to note, however, that it does not follow from the "freeing of asset" approach adopted by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), that *Kerbaugh-Empire* is moribund for all

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be deemed realized under this approach if the proceeds were used in an unprofitable transaction. "It is usually impossible to make this latter determination, however, since the borrowed funds are ordinarily absorbed into the business so completely that tracing the travels of interchangeable dollars lacks even the surface plausibility that it could claim in *Kerbaugh-Empire.*" Bittker & Thompson, supra note 91, at 1162.

In addition to that practical criticism, there is a more fundamental conceptual criticism to the Court's approach. The business transaction in which the proceeds are lost would itself produce a deduction in most instances, thus producing the effect of a double deduction if the related COD income is not taken into account. See id. at 1163-64.

204. United States v. Kirby Lumber Co., 284 U.S. 1 (1931). See supra note 8 (discussing *Kirby Lumber*).

205. *Kirby Lumber* dismissed *Kerbaugh-Empire* as follows:

> In *Bowers v. Kerbaugh-Empire Co.* ..., [the taxpayer] owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.... The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.

284 U.S. at 3.

206. 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

> purposes. Nor does such moribundity flow from *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), or *Commissioner v. Tufts*, 461 U.S. 300 (1983). See *Colonial Savings Association v. Commissioner*, 85 T.C. 855, 862 n.11 (1985), affd. 854 F.2d 1001 (7th Cir. 1988).
>
> ... The concept that petitioner received his money's worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth.[207]

The majority opinion in the Tax Court, which held that Zarin realized $2,900,000 in COD income, rejected *Kerbaugh-Empire* as implicitly overruled by later Supreme Court opinions, quoting at length a Ninth Circuit opinion concluding the same.[208] One such later Supreme Court opinion predictably discussed is *Tufts*, in which the taxpayer used the loan proceeds in an unprofitable transaction (depreciation deductions aside) and yet was held to have realized an accession to wealth on the failure to repay nonrecourse debt in excess of the value of property transferred in satisfaction of it. One opinion not mentioned,[209] however, seems to have dealt with the language of the *Kerbaugh-Empire* argument obliquely and to have rejected it. One of the arguments made by Mrs. Crane[210] in support of her position that the relief from nonrecourse indebtedness not in excess of the fair market value of the property transferred in satisfaction of it is not income within the meaning of the Sixteenth Amendment was that "the entire transaction was thought to have been 'by all dictates of common sense ... a ruinous disaster,' as it was termed in her brief...."[211] The Court did not accept this argument.

> She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed

207. Id. at 1101 (Tannenwald, J., dissenting).

208. Id. at 1093-94 (quoting the opinion in Vukasovich, Inc. v. Commissioner, 790 F.2d 1409, 1414-15 (9th Cir. 1986)). The Service itself recently recognized that *Kerbaugh-Empire* is no longer good law. "[S]ubsequent Supreme Court decisions and other court cases, when viewed together, have discredited *Kerbaugh-Empire*." Rev. Rul. 92-99, 1992-46 I.R.B. 5.

209. Crane v. Commissioner, 331 U.S. 1 (1947).

210. See supra note 16 (describing *Crane*).

211. 331 U.S. at 15.

> that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the act itself.[212]

Even without deductions produced by the use of loan proceeds (e.g., in the case of a purchase of a personal residence), the exclusion of the proceeds on receipt produces an unwarranted tax benefit if not fully repaid with after-tax dollars. If the loan proceeds are dissipated in a business or investment, the loan proceeds will be deductible (e.g., Crane's and Tufts's depreciation deductions, and Allan's interest and real estate tax deductions, as well as recognizable losses on disposition). If the loan proceeds are dissipated in personal consumption, there is no deduction but there is not intended to be any deduction (e.g., Zarin's net gambling loss[213] and Little Bucks's loss). If the failure to repay the loan proceeds with after-tax dollars is itself not taxed, there will result, in effect, a double deduction in the case of loan proceeds dissipated in business or investment (as occurred in *Kerbaugh-Empire*[214]) or an inappropriate deduction for personal consumption in the case of loan proceeds used for personal consumption (as occurred in the hypothetical of Little Bucks and at least arguably in the *Zarin* case[215]).

The Third Circuit reversed the majority holding in *Zarin*, agreeing with the dissents'[216] conclusion that Zarin realized no income, but expressly stated, "We do not pass on the question whether or not *Bowers [v. Kerbaugh-Empire]* is good law."[217] *Kerbaugh-Empire*, notwithstanding Judge Tannen-

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212. Id. at 15-16 (footnote omitted).

213. See infra note 217 (discussing the nondeductibility of net gambling losses).

214. See supra note 203 (discussing the double-deduction effect).

215. See infra note 217 (discussing whether *Zarin* should properly be viewed as a nonstatutory purchase-price-adjustment case, resulting in no taxation, or as a COD-income case, resulting in taxation in order to avoid the backdoor deduction of personal consumption).

216. Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990). There were three Tax Court dissenting opinions in *Zarin*. In addition to the opinion penned by Judge Tannenwald, joined by Judge Wells (see supra note 207 and accompanying text), Judge Jacobs wrote a dissent, as did Judge Ruwe, joined by Judges Chabot, Swift, Williams, and Whalen. 92 T.C. at 1105-1107, 1107-16.

217. 916 F.2d at 116 n.11. The Third Circuit majority reasoned that because the debt was unenforceable under state law, the amount of indebtedness was in dispute. Thus, the court applied the usual rule that no COD income arises on settlement of a debt, the amount of which is in dispute. The Third Circuit's reasoning is described in more detail—and lambasted—in Daniel Shaviro, The Man Who Lost too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption, 45 Tax L. Rev. 215, 252-58 (1990). Professor Shaviro disagrees not with the result that no income is realized but with the poor reasoning of the Third Circuit in reaching that result. Perhaps because the facts are interesting and unusual (a definite plus when pondering tax cases), the case has generated an unusual amount of interest. See commentary collected in Babette B. Barton, Legal and Tax Incidents of Compulsive Behavior: Lessons

from *Zarin*, 45 Tax Law. 749 (1992).

The argument that the unenforceability of the debt rendered the amount of the debt uncertain is off the mark. The reason that no COD income is realized on the settlement of a debt, the amount of which is in dispute, is because the realization of COD income depends entirely on the prior value received untaxed at the time the loan was incurred. See supra notes 93-97 and accompanying text (discussing *Rail Joint* and related material). If that amount is uncertain, so is the conclusion that COD income arises on the settlement. There was no uncertainty regarding the dollar amount of the debt in *Zarin*; only its enforceability was at issue. The unenforceability of the debt was indeed a "red herring," as termed by Ms. Sheppard. See Lee A. Sheppard, A Gambling Exception to Cancellation of Indebtedness Income?, News Analysis, 49 Tax Notes 1516 (Dec. 31, 1990). The nonrecourse debt in *Tufts* was unenforceable to the extent it exceeded the value of the property transferred in satisfaction of it, yet the total amount of the debt, including the unenforceable amount, produced an accession to wealth for tax purposes. The rule should be no different in the nontransfer context. Debt discharge analysis should not turn on such nonissues as liquidity or enforceability. The unenforceability of a debt, i.e., the inability of the creditor to force repayment in full, simply creates the COD income in the first place. See supra notes 114-15 and accompanying text (describing Tax Court's hesitancy to decide the *Schlifke* case under COD-income theory because of such nonissues); supra note 161 and accompanying text (discussing how terminology used in section 61(a)(12) leads to consideration of such nonissues); and supra note 167 (discussing the irrelevancy of the voluntariness or involuntariness with which the creditor foregoes collection of the debt in analyzing whether debtor realizes COD income on failure to repay debt in full). Debt discharge analysis should focus on the amount previously received free of tax by the taxpayer on the assumption that the amount would be repaid with after-tax dollars. Whether someone has the right to enforce repayment does not change the character of the accession to wealth that occurs on failure to repay. Enforceability simply is not relevant when the matter is viewed from the taxpayer-debtor's perspective, as it must be.

The fact that the loan proceeds were lost gambling is also a nonissue, notwithstanding Judge Tannenwald's concern that the more one gambled and lost on credit, the more income with which one would be charged if the loan is eventually discharged rather than paid. If loan proceeds are lost in a business or investment activity, the losses are deductible. If loan proceeds are lost in personal consumption, they are not, and are not intended to be. The more money spent on personal consumption and saving, the higher the tax bill. Failure to charge a taxpayer with income on the discharge of debt used in personal consumption allows a backdoor deduction for personal consumption. See supra notes 193-97 and accompanying text (discussing the personal consumption losses of Big Bucks and Little Bucks). While gambling can constitute a "trade or business" on the right facts (see Groetzinger v. Commissioner, 771 F.2d 269 (7th Cir. 1985), aff'd, 480 U.S. 23 (1987)), resulting in above-the-line deduction of professional gambling expenses under section 62(a)(1), net gambling losses (the excess of gross losses over gambling receipts) are rendered nondeductible personal consumption by statutory fiat. See IRC § 165(d).

If *Zarin* had borrowed the $3,400,000 in cash from a third-party creditor (instead of from the casino itself) and then lost it gambling, there should be no doubt that *Zarin* would have realized $2,900,000 in COD income upon settlement of the debt with the third-party creditor for $500,000. The previous $3,400,000 in cash was received free of tax on the assumption that it would be repaid with after-tax dollars. When that assumption proves unwarranted by $2,900,000, the debtor's accession to wealth is apparent. While it is true that consumption and savings define the tax base and that "[c]ash is a plausible initial proxy for income solely because of its uses, consumption and saving, and not because it has any innate, wald's *Zarin* opinion and the noncommittal stance taken by the Third Circuit, should be considered dead. It was bad law when decided, and its conceptual

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uniquely income-like quality" (Shaviro, supra, at 223), cash received in kind from a third party and used directly in consumption should be includable in full. It is difficult to value the consumption as anything less than the face amount of the cash actually used for consumption in that case.

The crux of the *Zarin* case, then, fell on the happenstance that the creditor wore two hats: lender as well as vendor of the services purchased with the credit. *Zarin's* debt was, in a broad sense, a purchase-money mortgage but, instead of purchasing property as in the more typical conception of that term, he purchased services. (One of the other nonissues in the case was whether Zarin had in fact purchased "property" on purchasing the gambling chips so that the rule in section 108(e)(5) could apply. Suffice it to say that *Zarin* did not spend $3,400,000 on little pieces of plastic; he spent the money on the activity of gambling which he purchased from the lender's establishment. It is not inherently bizarre to characterize gambling as services or other entertainment. See Erik M. Jensen, Economic Performance and Progressive Jackpots: A Better Analysis, Letter to the Editor, 45 Tax Notes 635 (Oct. 30, 1989).)

The fact that the loan was financed by the vendor might have rendered the amount loaned, though a precise number was attached, more nebulous in fact for the same reason that the amount of "true debt" may be artificially inflated in the case of more typical, seller-provided nonrecourse financing. See supra note 169. In such a case, some of that precisely delineated $3,900,000 amount might be "funny money" and should not enter into the first step in calculating the amount of COD income realized: the amount of prior value received and excluded from income. If the entire $3,900,000 is respected as "true debt," there is yet another possible avenue providing for nontaxation.

In cases involving the more typical purchase-money mortgage of property, factual disputes arose on the reduction of debt revolving around whether the debt was actually discharged or whether the purchase price of the property was actually renegotiated downward. In order to avoid these factual disputes, Congress enacted section 108(e)(5) (see supra notes 8 and 134), which makes an actual factual inquiry in such cases unnecessary. Even when the facts clearly show an intent to reduce debt rather than reduce the purchase price, the statute by fiat provides that the reduction will be "treated as a purchase price adjustment." Thus, no COD income is deemed realized; the purchaser is considered to have received a post-purchase, nontaxable discount in price.

Thus, one question presented by *Zarin* is whether there ought to be a similar rule regarding purchase-money mortgages of services, i.e., mortgages in which the lender is also the vendor of the purchased services, in order to obviate just the kind of dispute involved in *Zarin*. That is, should such transactions result in no taxation on the theory that the purchaser of services on credit should be deemed to have received a purchase-price adjustment—a post-purchase, nontaxable discount in price—rather than to have realized COD income in order to avoid a factual inquiry into the nature of the settlement with the vendor-creditor for less than the full amount originally borrowed? If such a rule is wise as a policy matter, then the other question is whether judges should be the ones to craft it. Does the presence of section 108(e)(5), pertaining to purchase-money mortgages of property only, carry the negative implication that all other purchase-money mortgages (as broadly defined here) fall outside the rule? Or should the presence of section 108(e)(5) invite judges to extend by analogy its rule to situations not contemplated by the Congress who enacted it? Because section 108(e)(5) requires the presence of COD income in the first place, true purchase-price adjustments ought still to result in no taxation under section 61 itself. Such is the stuff of statutory interpretation. See Popkin, supra note 40, at 157.

and practical weaknesses are even more glaring today.

V. CONCLUSION

The taxpayer in *Tufts* was held to have realized $400,000 of gain under section 1001 under the collapsed approach to analyzing the relief from nonrecourse debt upon the transfer of property worth less than the debt. If the debt in *Tufts* had been recourse, the bifurcated approach provided in the government's own regulations would have created a $50,000 loss and $450,000 of COD income. The Supreme Court rejected use of the bifurcated approach in *Tufts* apparently without fully appreciating that it would have controlled the transaction if recourse debt had been used. The Supreme Court, thinking (with the guidance that it was given) that it was *conforming* the tax consequences of nonrecourse debt and recourse debt by recognizing the former as "true debt," in fact unwittingly memorialized their *difference* when property worth less than the debt is transferred in satisfaction of the debt. It is not at all certain that the Supreme Court would knowingly condone the disparate treatments of what it considers "true debt" for tax purposes in the absence of sound reasons justifying the different approaches.

The disparate treatment of relief from recourse and nonrecourse debt when property worth less than the debt is transferred in satisfaction of the debt has no persuasive conceptual rationale. Neither the regulations themselves nor the preamble to them give any reason for the disparate treatment, and none can be fashioned. It leads to manipulation and, even worse, to treating similarly situated taxpayers in quite different manners without sound justification.

And more than merely the character of income or gain is at stake. The most telling situation revealing the weakness of the collapsed approach is that involving personal-use property. Its application in that context is untenable as it results in sheltering from the tax base taxable personal consumption. Its application in that context reveals the real weakness of the approach for *all* contexts, including business and investment contexts: It links the accession to wealth to the property ownership when the accession to wealth relates solely to the liability discharge.

The holding in *Tufts* that the taxpayer realizes an accession to wealth when nonrecourse debt remains unsatisfied upon a transfer of the securing property was necessary, and the Court is to be lauded for it, but the method of accounting for that accession to wealth should not be tied to the ownership interest in the underlying property. Nor should it be tied to the uses to which the loan proceeds are put—whether deductible or nondeductible. The accession to wealth arises solely because of the failure to repay loan proceeds previously received free of tax on the assumption that they would be repaid with after-tax dollars. When that fails to transpire, the debtor realizes ordinary

COD income, notwithstanding the fact that the event undermining the prior assumption that the loan proceeds would be repaid in full with after-tax dollars happens to be a transfer of the securing property.

The evolution of debt-discharge theory has increasingly recognized its tax-benefit underpinnings and has increasingly recognized that the liability should be analyzed for tax purposes separately from the ownership interest in the securing property. Thus, a reduction of nonrecourse indebtedness without transfer of the collateral is now considered to result in COD income, not in a basis reduction as under earlier views of nonrecourse debt. It is time to take the last step. It is time, in the continuing evolution of debt-discharge theory, to recognize that the collapsed approach is not defensible. It is time to discard *Tufts*.[218]

218. Will it happen? I would not bet the ranch. As Professor Shaviro commented with respect to other outdated ideas pertaining to nonrecourse debt: "Man may be mortal, but legal doctrine endures." Shaviro, supra note 9, at 457.