

THE REVENUE ACT OF 1939 AND THE INCOME TAX TREATMENT OF CANCELLATION OF INDEBTEDNESS*

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IN 1931 the Supreme Court decided the case of *United States v. Kirby Lumber Co.*² The corporation involved had issued bonds at par in 1923 and in the same year had purchased some of these bonds in the open market at a figure less than par. Holding contrary to the views of the lower tribunals³ but in accord with Treasury Regulations,⁴ the Supreme Court ruled that the difference represented taxable income. Mr. Justice Holmes declared for the Court:

"Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available \$137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."⁵

It was unfortunate that Mr. Justice Holmes saw nothing to be accomplished by a further consideration of the previous cases, for the *Kirby* decision has resulted in considerable confusion as to the income tax consequences of a cancellation of indebtedness, and placed a heavy burden upon corporations seeking to adjust their capital structures. Many financially embarrassed corporations, with their bonds selling far below par, have desired to purchase and retire these securities in order to reduce current interest obligations and avert bankruptcy. But as such a step

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The views expressed herein are entirely those of the writer. Nothing herein is to be construed as the official opinion of the United States Treasury Department.

2. 284 U. S. 1 (1931).

3. Cases cited in MAGILL, *TAXABLE INCOME* (1936) 225, n. 52.

4. *Id.* at 223, n. 47.

5. 284 U. S. 1, 3 (1931).

under the *Kirby* decision would have resulted in an income tax on the difference between the face amount of the bonds and the figure at which they were purchased, few corporations were either able or willing to pay such a heavy price for the reduction of their indebtedness.

In response largely to corporate pleas, voiced principally by the railroads,⁶ the Revenue Act of 1939⁷ contains provisions designed to afford tax relief in these cases.⁸ Section 215 adds paragraph (9)⁹ to Section 22(b) of the Internal Revenue Code, relating to exclusions from gross income. The addition provides that the amount of income attributable to the discharge of the indebtedness of a corporate taxpayer in an unsound financial condition shall be excluded from gross income, if the taxpayer consents to regulations providing for a reduction in the basis of property held by it.¹⁰ The reduction is prescribed under new paragraph (3)¹¹ added

6. *Hearings on Revenue Revision Before Committee on Ways and Means*, 76th Cong., 1st Sess. (1939) 232-248; 84 CONG. REC. 10468 (1939).

7. For other discussions of aspects of the Revenue Act of 1939 see Alvord and Biegel, *Basis Provisions for Stock Dividends Under the 1939 Revenue Act* (1940) 49 YALE L. J. 841; Eichholz, *The Revenue Act of 1939 and the Basis of Stock Dividends and Rights* (1940) 40 COL. L. REV. 404; Darrell, *Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977.

8. H. R. REP. NO. 855, 76th Cong., 1st Sess. (1939) 5.

9. INT. REV. CODE § 22(b) (9) (1939).

10. Section 22(b) (9) reads as follows:

"(9) INCOME FROM DISCHARGE OF INDEBTEDNESS.—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if—

(A) it is established to the satisfaction of the Commissioner, or

(B) it is certified to the Commissioner by any Federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal agency authorized to exercise regulatory power over such corporation,

that at the time of such discharge the taxpayer was in an unsound financial condition, and if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under § 113(b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term 'security' means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge occurring before the date of the enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1942."

11. INT. REV. CODE § 113(b) (3) (1939).

to Section 113(b) of the Code, relating to the adjusted basis of property.¹² The relief is limited to discharges occurring after June 29, 1939 and in taxable years beginning after December 31, 1938 and prior to January 1, 1943.

As the amount excluded from gross income is the amount of *income* attributable to the discharge of indebtedness and as that amount is the maximum amount that may be applied in reduction of basis, the amendment still makes necessary precise answers to the questions raised by the *Kirby* case. Moreover, while the amendment as originally proposed extended only to the bonded indebtedness of a corporation, in its final form it is applicable to most corporate debts. Our examination of the extent to which income is realized on a cancellation of indebtedness must therefore cover a wide front.

A. EXTENT TO WHICH INCOME IS REALIZED ON A CANCELLATION OF INDEBTEDNESS

1. *Discharge of indebtedness in general.* Given a solvent taxpayer, and placing to one side those special cases where the discharge results in a gift¹³ or a contribution to capital, the *Kirby* principle that income in the constitutional sense may be derived from the discharge of indebtedness is generally recognized.¹⁴ The discharge¹⁵ may in itself be the source

12. Section 113(b) (3) reads as follows:

"(3) DISCHARGE OF INDEBTEDNESS.—Where in the case of a corporation any amount is excluded from gross income under § 22(b) (9) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under § 22(b) (9)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Commissioner with the approval of the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in § 22(b) (9). The reduction shall be made as of the first day of the taxable year in which the discharge occurred except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began."

13. *Gibson v. Comm'r*, 83 F. (2d) 869 (C. C. A. 3d, 1936); I. T. 1982, III-1 *CUM. BULL.* 109 (1924); *cf.* *Smith Insurance Serv., Inc.*, 9 B.T.A. 284 (1927).

14. The income realized is ordinary income and not capital gain, as it does not arise from the sale or exchange of a capital asset [§ 117(b)]. I. T. 2846, XIV-1 *CUM. BULL.* 112 (1935). The statutory classification is open to question. A bondholder who pays \$90 to a corporation for a \$100 bond which is later redeemed at \$100 realizes \$10 capital gain by virtue of § 117(f). This corporation which borrows \$100 and repays \$90 would seem to be in a similar situation.

15. While the debt must be *pro tanto* discharged, the fact of discharge may be implied from the circumstances. Thus, if a corporation transfers wage checks unclaimed after a

of income, as in the purchase of obligations at less than their face amount, or it may result in income which is regarded as derived from a more traditional source, such as salary or dividends. If *A*'s employer in payment for services rendered cancels a debt which *A* owes him, *A* will be regarded as having received additional compensation to the extent of the amount cancelled.¹⁶ If a corporation cancels a stockholder's debt, the cancellation will be treated as a dividend paid to the latter.¹⁷ While the situations are infrequent, discharges of a solvent debtor may occur for reasons that are non-donative.¹⁸ A bank in receivership anxious to terminate its affairs may prefer to accept sixty or seventy-five cents on the dollar rather than to institute litigation or foreclosure proceedings;¹⁹ a creditor may hope to induce future purchases from his debtor by cancelling an obligation of the latter; a company may hope to retain salesmen if it writes off advance commissions not earned; a lessee may decide to abandon his lease and forfeit his right to the return of an advance payment.²⁰

number of years to profit and loss, the amount of such checks constitutes income. *North American Coal Corp. v. Comm'r*, 97 F. (2d) 325 (C. C. A. 6th, 1938); *Charleston & W. C. Ry. v. Burnet*, 50 F. (2d) 342 (App. D. C. 1931); *Chicago, R. I. & P. Ry. v. Comm'r*, 47 F. (2d) 990 (C. C. A. 7th, 1931), *cert. denied*, 284 U. S. 618 (1931); *Great Northern Ry. v. Lynch*, 292 Fed. 903 (D. Minn. 1921); *G. M. Standifer Constr. Corp.*, 30 B.T.A. 184 (1934); *Atlantic Coast Line R. R.*, 23 B.T.A. 888 (1931). But there must be some reasonable ground for the debtor's action. *Cf. United States v. Little War Creek Coal Co.*, 104 F. (2d) 483 (C. C. A. 4th, 1939).

16. *Reginald Denny*, 33 B.T.A. 738 (1935); *cf. I. T. 2043*, III-2 CUM. BULL. 94 (1924).

17. *Waggaman v. Helvering*, 78 F. (2d) 721 (App. D. C. 1935), *cert. denied*, 296 U. S. 618 (1935); *Wiese v. Comm'r*, 93 F. (2d) 921 (C. C. A. 8th, 1938), *cert. denied*, 304 U. S. 562 (1938); *Fitch v. Helvering*, 70 F. (2d) 583 (C. C. A. 8th, 1934); *Cohen v. Comm'r*, 77 F. (2d) 184 (C. C. A. 6th, 1935), *cert. denied*, 296 U. S. 610 (1935); *Hudson v. Comm'r*, 99 F. (2d) 630 (C. C. A. 6th, 1938), *cert. denied*, 306 U. S. 644 (1939); *Hugh H. Miller*, 25 B.T.A. 418 (1932); *Henry D. Muller*, 16 B.T.A. 1015 (1929); *Ida L. Dowling*, 13 B.T.A. 787 (1928); *Virginia H. Holden*, 9 B.T.A. 220 (1927).

18. *Model Laundry, Inc.*, B.T.A. Memo. Op. Docket No. 93493, Jan. 15, 1940; *Spokane Office Supply Co.*, B.T.A. Memo. Op. Docket No. 86762, April 29, 1939. Both cases involved cancellation of rent owed by solvent lessee.

19. *Cf. United States v. Little War Creek Coal Co.*, 104 F. (2d) 483 (C. C. A. 4th, 1939) (involving settlement of claim).

20. *Commissioner v. Langwell Real Est. Corp.*, 47 F. (2d) 841 (C. C. A. 7th, 1931); *Warren Serv. Corp.*, 404 C. C. H. 1940 Fed. Tax Serv. ¶9333 (C. C. A. 2d, 1940); *cf. cases cited in note 15 supra*. The entire amount of the forfeited payment should be the measure of the income. The holding in the *Warren* case that the present worth of the amount which would have been payable at the end of the lease is the amount of income seems erroneous in this regard. The result was based upon the absence of interest payments on the lessor's part, the court stating that if interest were payable, inclusion of the full amount at forfeiture would be justified as the value of the interim use of the money would be balanced by the interest payable. But on this argument income would be realized at the start of the lease, which the court denied. The deduction for interest paid, and the effect of a difference in the rates of interest were also not considered by the court. See Comment in 401 C. C. H. 1940 Fed. Tax Serv. ¶10392.

With respect to bonded indebtedness, income results whether the obligations were issued and then purchased by the corporation at less than their face amount in the same year, as in the *Kirby* case, or in different years.²¹ Similarly, income results whether the bonds were purchased in the open market²² or directly from the sole holder.²³ The former requirement of the Regulations that the purchased bonds must be retired,²⁴ has been dropped,²⁵ apparently with the concurrence of the courts.²⁶ The indebtedness may be discharged with either cash or new obligations such as bonds or notes,²⁷ but the exchange of stock for bonds raises special problems to be considered later.

2. *Discharged debtor in financial straits.* Where, as typically, the debtor is financially embarrassed, the tax consequences of a cancellation by his creditors remain uncertain. Four possible theories may be spelled out from an examination of cases on the subject. The Bureau of Internal Revenue early ruled, in 1923, that a taxpayer received no income by virtue of a discharge of indebtedness resulting from an adjudication in bankruptcy or a creditors' composition agreement approved by a court.²⁸ It stated, however, that where creditors of a partnership forgave part of its indebtedness because its condition was such that receivership would have destroyed the business, the amount forgiven was income. Thus, if a creditor forgave a debt without desiring to benefit the debtor but because the latter was unable to pay, the debtor realized income.²⁹ The ground of the distinction between the two rulings was not disclosed.

21. *Commissioner v. Norfolk S. R. R.*, 63 F. (2d) 304 (C. C. A. 4th, 1933), *cert. denied*, 290 U. S. 672 (1933); *Norfolk S. R. R.*, 25 B.T.A. 925 (1932).

22. *United States v. Kirby Lumber Co.*, 284 U. S. 1 (1931).

23. *Commissioner v. Coastwise Transp. Co.*, 62 F. (2d) 332 (C. C. A. 1st, 1932), 71 F. (2d) 104 (C. C. A. 1st, 1934), *cert. denied*, 293 U. S. 595 (1934).

24. U. S. Treas. Reg. 77, Art. 68(2).

25. U. S. Treas. Reg. 86, Art. 22(a)-18 and succeeding Regulations. A requirement of formal retirement would permit the corporation to place the income consequent upon the retirement in the year most favorable to it.

26. *Montana, W. & S. R. R. v. Comm'r*, 31 B.T.A. 62 (1934), *aff'd per curiam*, 77 F. (2d) 1007 (C. C. A. 3d, 1935), *cert. denied*, 296 U. S. 604 (1935); *Virginia Iron, Coal & Coke Co.*, 29 B.T.A. 1087 (1934); *American Brake Shoe & Foundry Co. v. I. R. T. Co.*, 19 F. Supp. 234 (S. D. N. Y. 1936) (purchase of bonds required by sinking fund agreement); *accord*, *Woodward Iron Co.*, 24 B.T.A. 1050 (1931); *cf.* *Garland Coal & Mining Co. v. Helvering*, 75 F. (2d) 663 (App. D. C. 1934). *But cf.* *Transylvania R. R. v. Comm'r*, 99 F. (2d) 69 (C. C. A. 4th, 1938) (corporation expressly did not retire bonds, being entitled under a lease to receive rentals equal to the interest on outstanding bonds).

27. *Commissioner v. Coastwise Transp. Co.*, 62 F. (2d) 332 (C. C. A. 1st, 1932), 71 F. (2d) 104 (C. C. A. 1st, 1934), *cert. denied*, 293 U. S. 595 (1934); *Briarcliff, Inc. v. Comm'r*, 90 F. (2d) 330 (C. C. A. 5th, 1937), *cert. denied*, 302 U. S. 731 (1937).

28. I. T. 1564, II-1 CUM. BULL. 59 (1923); *cf.* S. M. 1495, III-1 CUM. BULL. 103 (1924).

29. I. T. 1547, II-1 CUM. BULL. 58 (1923).

Perceiving no distinction, the Board of Tax Appeals held in *Meyer Jewelry Co.*³⁰ that the creditors' partial forgiveness of the debts of a financially embarrassed debtor did not give rise to income within the constitutional meaning of the term. The Board relied upon the *Eisner v. Macomber* rule that an enrichment through increase in the value of capital investment is not income, even though it recognized that the debtor was relieved from paying the amount forgiven, achieved a more favorable balance sheet and benefited through being able to remain in business. The *Meyer* rule was followed in later Board decisions, whether the debtor was actually insolvent or merely financially embarrassed.³¹ The Board was simultaneously holding, also without regard to the financial condition of the debtors, that income likewise was not realized in the bond purchase cases.³²

Two circuit court of appeals decisions complete the picture at this stage. In *Commissioner v. Simmons Gin Co.*³³ the taxpayer was indebted to commission firms for loans on which its cotton was the collateral. The cotton market dropped so that the loans exceeded the collateral, resulting in the taxpayer's insolvency. Virtually all its creditors then agreed to cancel one-half of its indebtedness, and arrangements were made for the payment of the remaining half. The Tenth Circuit Court of Appeals held that the saving was not income in the constitutional sense, for, inasmuch as assets had remained the same despite the decrease in liabilities, nothing was received or drawn to the taxpayer's use. The court said:

"The Gin Company had no assets to offset the indebtedness that was forgiven and when such indebtedness was discharged its liabilities were decreased but its assets remained exactly the same both before and after the release of such indebtedness. There is a distinction between the release or discharge of a liability to a solvent and to an insolvent taxpayer. Suppose an insolvent had assets of the value of \$10,000 and owed \$100,000; that its creditors agreed to settle for \$20,000 payable in four annual equal payments, evidenced by notes and secured by a mortgage on such assets. Could it be said the debtor received income in the sum of \$80,000—eight times the total amount of its assets?

"Since there were no assets off-setting or representing such indebtedness released, nothing was received or drawn by the Gin Company to its separate use, benefit and disposal. There was a

30. 3 B.T.A. 1319 (1926).

31. *John F. Campbell Co.*, 15 B.T.A. 458 (1929), *aff'd*, 50 F. (2d) 487 (App. D. C. 1931); *Simmons Gin Co.*, 16 B.T.A. 793 (1929), *aff'd*, 43 F. (2d) 327 (C. C. A. 10th, 1930); *Eastside Mfg. Co.*, 18 B.T.A. 461 (1929); *Progress Paper Co.*, 20 B.T.A. 234 (1930); *Herman Senner*, 22 B.T.A. 655 (1931).

32. Cases referred to in note 3 *supra*. There was almost no linkage of the two lines of authority.

33. 43 F. (2d) 327 (C. C. A. 10th, 1930).

mere diminution of loss and a 'mere diminution of loss is not gain, profit, or income.' *Bowers v. Kerbaugh-Empire Co.*"³⁴

In the second case, *Burnet v. Campbell Co.*,³⁵ a taxpayer in "financial distress, and . . . probably insolvent," was granted a partial cancellation of some of its debts by creditors who hoped thus to secure payment of the balance. It was thereby enabled to remain in business and realize a profit in succeeding years. The Court of Appeals for the District of Columbia held that the creditors' forbearance did not result in income to the debtor, because the term did not apply to such a partial cancellation for the purpose of effecting payment of the balance.

At this point, the *Kirby* decision intervened with its holding that the discharge of a debt by payment of a lesser sum produces income, and with its statement that assets previously offset by the obligation were made available through the discharge. The decision, however, had no immediate effect on the Board's disposition of non-bond purchase cases. Three more decisions found no income where creditors had granted a partial cancellation because of the debtor's inability to pay the full amount.³⁶ In one case,³⁷ the Board argued that the indebtedness was forgiven so that the debtor might continue as a going concern, that the parties contemplated no profit from the transaction, and that the forgiveness merely relieved it of a portion of its liabilities.

Further, in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*,³⁸ the Fifth Circuit Court of Appeals held that no income was realized where an insolvent lessee obtained a cancellation of past due rent through the lessor's desire to keep the building occupied by retaining the tenant. As part of the transaction the lessee conveyed to the creditor its principal asset, an equity in other property. The court said that the lessee was insolvent before and after the transaction, so that it received nothing. There was therefore an absence of income in the constitutional sense. While the taxpayer in the *Kirby* case possessed greater assets upon cancellation, here there was merely a discharge of liabilities without an

34. *Id.* at 329. In *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170 (1926), a corporation borrowed a sum of money in German marks and later repaid the loans when marks had fallen in value. The difference between the value of the borrowed marks and the amount paid was held by the Commissioner to be income. The borrowed money had been used by a wholly-owned subsidiary in the performance of construction contracts. Losses were sustained in such work, and the excess of losses over income was more than the amount claimed to be income. The Supreme Court held that the transaction in question did not result in a gain within the *Eisner v. Macomber* test since "the result of the whole transaction was a loss." *Id.* at 175.

35. 50 F. (2d) 487 (App. D. C. 1931).

36. *E. B. Higley & Co.*, 25 B.T.A. 127 (1932); *Towers & Sullivan Mfg. Co.*, 25 B.T.A. 922 (1932); *Porte F. Quinn*, 31 B.T.A. 142 (1934). The Board relied chiefly upon the *Meyer Jewelry Co.* and *Campbell Co.* cases.

37. *E. B. Higley & Co.*, 25 B.T.A. 127 (1932).

38. 70 F. (2d) 95 (C. C. A. 5th, 1934); see note 42 *infra*.

increase of assets. Finally, the Treasury dropped from its Regulations the sentence stating: "If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."³⁹ In its stead was inserted: "Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication among his creditors if immediately thereafter the taxpayer's liabilities exceed the value of his assets."⁴⁰ The Bureau contended that this change implied that income was realized in the obverse case where assets exceeded liabilities.

In 1937 the Board of Tax Appeals suddenly announced a new approach. In *Lakeland Grocery Co.*,⁴¹ the creditors of an insolvent debtor in receivership partially cancelled its indebtedness by accepting payment of \$89,237.55 less than the full amount. The cancellation brought the debtor from an insolvent to a solvent condition, with assets exceeding liabilities by \$39,596.33. The Board said that the *Meyer, Campbell* and *Dallas Transfer* cases were not in point, since the debtors involved had been regarded as insolvent both before and after the cancellation,⁴² whereas here assets free from liabilities were present after the cancellation. Stating that this clear increase in assets was income under the *Kirby* rule, the Board found taxable income on the transaction to the extent of the excess of assets over liabilities, or \$39,596.33. The Board, in *Madison Railways*, thereafter applied its insolvency rule to the case of a purchaser of bonds which was insolvent both before and after the purchase to hold that no income resulted from the purchase.⁴³

In the remaining pertinent case of *Transylvania Railroad v. Commissioner*,⁴⁴ a corporation had leased all its property to an operating company in return for a rental largely consisting of the payment of the interest on the lessor's bonds. The lessor later purchased some of these bonds, but, not desiring to reduce the rental, did not retire them. The

39. U. S. Treas. Reg. 77, Art. 64, REVENUE ACT OF 1932 and prior Regulations.

40. U. S. Treas. Reg. 86, Art. 22(a)-14, REVENUE ACT OF 1934, and succeeding Regulations.

41. 36 B.T.A. 289 (1937); *accord*, *The Haden Co.*, B.T.A. Memo. Op., Docket No. 91776, Oct. 20, 1939.

42. However, in the *Meyer* case, the debtor was probably solvent both before and after the cancellation. In any event the question was not examined by the Board. Nor was it considered in the *Campbell* case. In the *Dallas Transfer* case the taxpayer was regarded by the Board as solvent after the cancellation. The circuit court of appeals treated the taxpayer as insolvent before and after the cancellation by including its \$200,000 capital stock as a liability. Prior to the cancellation other liabilities exceeded assets, but after the transaction assets exceeded liabilities by almost the amount cancelled if, as proper, the capital stock be disregarded.

43. 36 B.T.A. 1106 (1937).

44. 99 F. (2d) 69 (C. C. A. 4th, 1938).

Board's holding that the purchase created taxable income,⁴⁵ was reversed by the Fourth Circuit Court of Appeals, in part on the ground that there was practically a total loss in the value of the lessor's property.⁴⁶

It is apparent that the decisions establish no single authoritative rule. Four possible views may be sketched:

(a) *No income if cancellation designed to assist financially embarrassed debtor.* It may be contended that no income results if creditors cancel indebtedness in order to restore a financially embarrassed, though not necessarily insolvent, debtor to a better financial condition. This appears to have been the original Board rule, for the decisions did not concern themselves with whether the financial embarrassment of the debtor extended to actual insolvency or with the relation of assets to liabilities after the cancellation. Thus the Board said in *E. B. Higley & Co.*:

"The debt was forgiven so that the business might be rehabilitated and continued as a going concern. The parties contemplated no profit from the transactions, which merely relieved the taxpayer from a portion of its liabilities."⁴⁷

The Court of Appeals for the District of Columbia adopted a similar approach in *Burnet v. Campbell Co.*, stating:

"We do not believe that the term 'income' as commonly understood applies to the partial cancellation by a creditor of a debt due to him from a disabled creditor, in order that such debtor may therefore be enabled to pay the balance of the debt."⁴⁸

But if a solicitous attitude on the creditors' part be made the criterion, so that the motive for the cancellation must be that of assistance to the debtor, a debtor who benefited through a bank's settlement of claims for fifty cents on the dollar to avoid litigation would realize income, even though it was financially embarrassed. Moreover, this view would produce a tax when a financially embarrassed corporation bought its bonds in the open market, for it could hardly be said that the requisite attitude on the part of the creditors was present. It is difficult to perceive any reason for not taxing in the cases quoted from above and taxing in the case of a bond purchase. While differences in the creditor's motive would distinguish the cases factually, there is no justification for making motive a factor. The motive was not donative in the cases mentioned, for the action represented an attempt to salvage something from the wreckage. The saving cannot therefore be non-taxable as a gift.⁴⁹ Aside from the

45. 36 B.T.A. 333 (1937).

46. This view of the court was, however, contrary to the Board's finding that the corporation failed to show a failure of assets or loss of the money originally borrowed.

47. 25 B.T.A. 127 (1932).

48. 50 F. (2d) 487, 488 (App. D. C. 1931).

49. None of the Board decisions holding that no income was realized characterized the transaction as a gift. The early Regulations, quoted *supra* p. 1160, however, apparently treated these transactions as donative in nature.

gift question, motive would seem irrelevant. This approach may therefore be reduced to the proposition that a financially embarrassed debtor never realizes income from the cancellation of his debts, regardless of the motive of the cancelling creditors.

The new paragraph added to Section 22(b)(9) by the Revenue Act of 1939 denies this proposition. It excludes from gross income the amount of any income attributable to the discharge of the indebtedness of a taxpayer who is "in an unsound financial condition" at the time of such discharge. Under the theory broached above, this new paragraph is entirely unnecessary for no income would be attributable to such a discharge. Congress, however, evidently thought that some income arises despite the debtor's financial straits.

(b) *No income if debtor insolvent prior to cancellation.* It might be argued from the cases that income is not realized if the debtor was insolvent prior to cancellation. Thus, the *Simmons Gin* case stated that a distinction existed between solvent and insolvent debtors and held that the latter do not realize income on a cancellation of their debts.⁵⁰ This position is derived from two related sources. One is *Bowers v. Kerbaugh-Empire Co.*⁵¹ where, in holding that the saving in dollars resulting from the payment of a loan at a time when the currency in which the loan was measured had declined in value was not income, the Supreme Court argued:

"The contention that the item in question is cash gain disregards the fact that the borrowed money was lost, and that the excess of such loss over income was more than the amount borrowed. When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value, but the mere diminution of loss is not gain, profit, or income."⁵²

Most of the cancellation cases finding no income because of the debtor's insolvency rely upon this case, stating that the cancellation served merely to decrease liabilities and thereby to diminish losses. The Court's reliance on the loss of the money borrowed, however, was proven faulty in the later case of *Burnet v. Sanford & Brooks Co.*⁵³ Here, in a situation better suited to the application of such a theory, the Court relied upon

50. In *F. W. Sickles Co. v. United States*, 404 C. C. H. 1940 Fed. Tax Serv. ¶ 9286 (Ct. Cl. 1940) it was held that no income is realized if the taxpayer is insolvent after the forgiveness of the indebtedness.

51. 271 U. S. 170 (1926).

52. *Id.* at 175.

53. 282 U. S. 359 (1931).

the annual nature of the income tax to tax for one year compensation received under a contract for losses sustained in earlier years.⁵⁴

The treatment of the *Kerbaugh-Empire* case in the *Kirby* case provided the second source for the position being considered. Mr. Justice Holmes distinguished the former case in these words:

"In *Bowers v. Kerbaugh-Empire Co.* the defendant in error 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."⁵⁵

The distinction adopted is surprising when it is considered that the opinion later cites *Burnet v. Sanford & Brooks Co.* with approval. But in the cases arising after the *Kirby* case in which no income is found because of the debtor's insolvency, much is made of this matter of free assets. Thus, in the *Dallas Transfer* case the Court said:

"In effect the transaction was similar to what occurs in an insolvency or bankruptcy proceeding when, upon a debtor surrendering, for the benefit of its creditors, property insufficient in value to pay his debts, he is discharged from liability for his debts. This does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. . . . The decision (the *Kirby* case) . . . that the increase in clear assets so brought about constituted taxable income is not applicable to the facts of the instant case, as the cancellation of the respondent's past due debt to its lessor did not have the effect of making the respondent's assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before."⁵⁶

But if the condition of the assets after cancellation is the important consideration, the debtor's status prior to the cancellation is not determinative, so that insolvency before the cancellation does not alone compel the conclusion that income is not realized. For the same reason there can be no distinction between a debtor who is insolvent prior to cancellation and

54. See discussion in MAGILL, *op. cit. supra* note 3, at 215 *et seq.*

55. 284 U. S. 1, 3 (1931).

56. 70 F. (2d) 95, 96 (C. C. A. 5th, 1934).

a debtor who is financially embarrassed but not insolvent.⁵⁷ Emphasis on free assets after cancellation must lead inevitably to the solution adopted by the Board in the *Lakeland* case, now to be considered.

(c) *Board of Tax Appeals "net assets" approach.* In the *Lakeland* decision the Board unequivocally held that, in the case of a debtor insolvent prior to cancellation, income would result to the extent that assets exceeded liabilities after cancellation. No other court has adopted this rule of thumb, though two courts since the *Kirby* case have had an opportunity to apply it in situations where the debtor was insolvent before cancellation and presumably solvent thereafter.⁵⁸ The rule, involving precise asset valuation, is hard to administer. The tax on the income realized obviously narrows the difference between assets and liabilities. Despite this apparent inconsistency, such a mechanical approach—concerned not with the debtor's condition prior to cancellation but with the relation of assets to liabilities after cancellation—is logically compelled by the cases which, relying on the above-quoted remarks in the *Kirby* case concerning the relation of assets to liabilities, find no income because of the insolvent condition of the debtor. We must therefore inquire whether the Supreme Court decisions require such a freeing of assets and the consequent net assets test.

(d) *Cancellation results in income regardless of financial condition of debtor.* A taxpayer's net worth has never been made a criterion of taxable income. Suppose that taxpayer *A*, at the beginning and the end of 1939, has liabilities exceeding assets by \$50,000. In 1939 he sells for \$40,000 stock which in 1937 cost him \$10,000. The gain realized is unquestionably \$30,000. Suppose that taxpayer *B*, in a similar condition of insolvency, receives \$30,000 as compensation for services in 1939. Here, too, a gain of \$30,000 is realized even though *B* may be required to turn the \$30,000 over to his creditors to reduce his liabilities. Let us assume, in the second case, that *B*'s employer is a creditor to the extent of \$30,000 and that, instead of paying *B* his salary in money, the employer cancels the \$30,000 debt. In the language of the cases discussed above the cancellation serves merely to reduce liabilities, leaving no assets free for *B*'s use. Would any court hold that *B* does not receive \$30,000 of income derived from "salaries, wages, or compensation for personal service of whatever kind and in whatever form paid?" It would be difficult to hold that *B* realizes income when he receives \$30,000 from employer *C* which he at once uses

57. The House Ways and Means Committee Report does not draw a distinction, but indicates that the term "unsound financial condition" covers both cases. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 23-24.

58. *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F. (2d) 95 (C. C. A. 5th, 1934) (see the discussion of this case in the *Lakeland* opinions); *Transylvania R. R. v. Comm'r*, 99 F. (2d) 69 (C. C. A. 4th, 1938).

to pay the debt owing to creditor *D*, but realizes no income when employer and creditor are the same person.

Basic to our tax law is the theory that the realization of income depends on the outcome of each separate transaction whence taxable income can be derived, and not upon the net result of all such transactions (except, of course, as expenditures and losses during the taxable year may be permitted to enter into the computation of net income). Thus the balance sheet or net worth at the end of the year and its relation to the balance sheet or net worth at the beginning of the year are, for this purpose, immaterial. Given the discharge of a \$40,000 debt by payment of \$10,000, or the purchase and retirement of a \$40,000 bond for \$10,000, our inquiry is whether these transactions can result in taxable income and, if so, how that income is to be measured and when it is to be taxed. The *Kirby* and other cases indicate that such transactions may give rise to income, as do the transactions of buying and selling stock, of working for a salary, of receiving trust income. These same cases demonstrate that the income is the difference between the face amount of the obligation and the amount paid in discharge of the indebtedness.⁵⁹ Other cases, like the *Sanford & Brooks* case, indicate that under our annual system of income taxation this income should be taken into account in the year of discharge.⁶⁰ The transaction thus begins when the money is borrowed and is "closed" for tax purposes when the obligation is discharged.⁶¹ Under general income tax theory the result of other transactions, and hence the overall con-

59. Complications may arise where the amount received on incurrence of the obligation is less than its face amount. See p. 1178 *infra*.

60. *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359 (1931) prevents a relation back which would take account of the prior history of the transaction in respect of the use of the borrowed money. *Helvering v. American Chicle Co.*, 291 U. S. 426 (1934) prevents treatment of the transaction by means of an adjustment of its initial phase.

61. Two analogies support the theory that the basic factors in the computation of gain on the cancellation of indebtedness are the amount received when the loan was made and the amount paid on discharge of the indebtedness. The first is the decisions of the Supreme Court in the bond discount and premium cases: *Old Colony R. R. v. Comm'r*, 284 U. S. 552 (1932) and *Helvering v. Union Pacific R. R.*, 293 U. S. 282 (1934). The second case held that if bond discount is viewed not as excess interest but as a loss, it is realized only upon payment of the bonds at maturity and not at their issuance (as the Commissioner contended in view of issuance prior to March 1, 1913), although the certainty of the loss permits its anticipation through annual amortization by a taxpayer on the accrual basis. The issuance of the bonds is thus not a closed transaction but merely the beginning of a transaction which is closed only when the bonds are discharged according to their terms. The case of discharge of indebtedness at less than face amount should be an *a fortiori* situation. While the first case probably leans in the other direction, in that the premium on bonds issued prior to March 1, 1913 was held not subject to tax, the discount decision is the later. The second analogy is the short sale. If a short sale is made in 1939 and covered by a purchase in 1940, the resulting gain is taxable income in 1940 rather than 1939, indicating that a purchase can close a transaction. Cf. *Frances B. Farr*, 33 B.T.A. 557 (1935); I. T. 2187, IV-2 CUM. BULL. 25 (1925); U. S. Treas. Reg. 103, § 19.117-6.

dition of the balance sheet, are as immaterial to the computation of income here as in the sale and employment transactions just described. It appears, under this reasoning, that income should be realized on a discharge of indebtedness without regard to whether the taxpayer is insolvent, financially embarrassed or solvent, if the discharge is accomplished by payment of less than the face amount of the obligation.⁶²

The Regulations approved in the *Kirby* case drew no distinction between solvent and insolvent corporations, but merely stated that if "a corporation purchases and retires any of such bonds at a price less than issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."⁶³ Nor did the Supreme Court draw that distinction. The language it used to distinguish the *Kerbaugh-Empire* case is unfortunate, but even that language does not require differentiation between the two classes of corporations. The Court spoke of the "whole transaction as a loss," which differs from saying that the taxpayer was insolvent. The money borrowed may have been profitably used, so that although other ventures produced insolvency the transaction itself was not a money-loser. The assets purchased with the borrowed money may still be held at the same value. Indeed, the Court has found income where the value of those assets has actually declined.⁶⁴ The *Kirby* decision further said that "assets previously offset by the obligation of bonds now extinct" were made available. Yet the reduction of liabilities and consequent release of assets need not be limited to zero upwards. Reduction of a minus net worth of \$20,000 to a minus net worth of \$5,000 also accomplishes that result, for the taxpayer is so much nearer to solvency. Finally, while it said that "there was no shrinkage of assets," it will later appear that succeeding decisions have not been halted by a decline in the total value of the assets.

While this last approach appears to accord more closely with accepted income tax conceptions, difficult emotional obstacles are present in these cases which have served to turn many courts from the rigorous road of tax theory. Adding the burden of an income tax to the difficulties of an

62. A distinction may exist between these two cases: *A*, having liabilities of \$100,000 and a piece of property worth \$100,000 but with a \$10,000 basis, sells the property for \$100,000 and realizes a \$90,000 gain. *B*, having liabilities of \$100,000 and assets of \$10,000, turns the \$10,000 over to his creditors in return for cancellation of the remaining indebtedness. *A*'s gain is represented by actual assets in hand, even though they may have to be handed over immediately to creditors; *B*, however, never possessed \$90,000 of assets during the taxable year. It may be contended that a debtor left with no assets realizes no income; or, stated differently, that the income realized is limited to the assets on hand after the cancellation, which is not the same as the net assets theory of the *Lakeland* case. But this distinction contradicts the theory underlying the *Kirby* case.

63. *E.g.*, U. S. Treas. Reg. 74, Art. 68(1)(C).

64. *Infra* p. 1168.

insolvent or financially embarrassed debtor is an unwelcome task for the courts. The sternness of the tax collector is here highlighted by the consideration shown by the cancelling creditors, even though such consideration may be motivated by business reasons. Imposition of the tax either serves to reduce the amount they may salvage from the wreckage or makes it that much harder for the debtor to survive. But consideration of this phase of the problem may be reserved.

3. *Discharged obligations issued on the purchase of property.* The *Kirby* case involved a situation where the bonds later discharged had been issued for money. Upon their discharge the transaction was completed and gain could be cast, as money was involved at both ends. But suppose a corporation buys property worth \$50,000 with bonds or notes whose face amount is \$50,000. Three years later the corporation discharges the obligation by a payment of \$30,000. It still possesses the purchased property whose value remains \$50,000. Is the *Kirby* case applicable so that \$20,000 of income is realized, or does the discharge merely result in a reduction of the cost, and thus the basis, of the property to \$30,000? In *Helvering v. American Chicle Co.* the taxpayer corporation, in purchasing the assets of another corporation, had assumed its liabilities, including bonds. Some of the bonds were later purchased on the open market at less than their face amount and retired according to a provision that required annual amortization. Both the Board⁶⁵ and the Second Circuit Court of Appeals⁶⁶ held that no income was realized — rather that the cost of the assets was reduced by the saving.⁶⁷ The circuit court of appeals said:

“But the distinction does seem to us critical between obligations whose consideration is money, and those issued or assumed for property which the obligor still holds. . . . When a taxpayer gets money by issuing an obligation which he later discharges for less than its face, the transaction is completed, because money need not be sold or exchanged to be ‘realized’. So we read *United States v. Kirby Lumber Co.* . . . But if he buys property by an obligation in the form of a bond, note, or the like, and if it remains in kind after the debt is paid, there can be no ‘gain’. The cost has indeed been definitely settled, but that is only one term of the equation; as long as the other remains at large, there is no ‘realized’ gain.”⁶⁸

The Supreme Court reversed in a decision⁶⁹ which ignored the fact that property instead of money had been received for the obligation incurred.

65. 23 B.T.A. 221 (1931).

66. 65 F. (2d) 454 (C. C. A. 2d, 1933).

67. *Accord*, I. T. 2195, IV-2 CUM. BULL. 36 (1925); I. T. 2406, VII-1 CUM. BULL. 68 (1928); *cf.* *Progress Paper Co.*, 20 B.T.A. 234 (1930).

68. 65 F. (2d) 454, 455 (C. C. A. 2d, 1933).

69. 291 U. S. 426 (1934).

The Court stated that it found nothing to distinguish the case in principle from the *Kirby* case. While there seems to be merit in the circuit court's position, practical difficulties would arise where the property had been disposed of in whole or in part, and with respect to the depreciation deduction.⁷⁰ Consequently, the Supreme Court's view that income is realized and the basis is not affected seems preferable.⁷¹

Would the decision have been the same if the value of the property in the above example had dropped to \$30,000, instead of remaining at \$50,000? In the *American Chicle* case the Supreme Court presumed from the record's silence as to the state of the taxpayer's assets and as to gains or losses on the transaction that there could have been a substantial profit, and that an increase in assets accompanied the decrease in liabilities. In *Commissioner v. Coastwise Transportation Corp.*,⁷² a fleet of ships had been acquired in 1922 by a taxpayer which made payment partly in notes for \$608,400 secured by a mortgage on the ships. Later in 1924 the taxpayer retired \$152,000 of the notes for \$75,000; and in 1925 issued bonds in the amount of \$375,000, secured also by the ships, for the \$456,300 of notes remaining — in both cases dealing only with the seller of the property. As of 1924, the vessels had depreciated in value from \$1,267,500 to \$1,083,419.73. The taxpayer had incurred deficits in 1923 and 1924 but had a surplus in 1925. In finding all these facts immaterial, the First Circuit Court of Appeals stated that, while as a bookkeeping matter the vessels had declined in value, the ships were still being operated and the situation might well change.⁷³ Since the value of the mortgaged property was more than sufficient to pay the indebtedness, income was held to have resulted upon the decrease of the liability.

The Board, too, has stressed this last point in *L. D. Coddon & Bros., Inc.*⁷⁴ The taxpayer, on purchasing property in 1931, had become liable for a purchase money mortgage which in 1933 amounted to \$19,250. In

70. *Cf.* *B. F. Avery & Sons, Inc.*, 26 B.T.A. 1393 (1932), *app. dism'd*, 67 F. (2d) 98 (C. C. A. 6th, 1933). The rulings cited *supra* note 67 were withdrawn after the decision in the *Avery* case, I. T. 2772, XIII-1 CUM. BULL. 212 (1934); I. T. 2771, XIII-1 CUM. BULL. 200 (1934).

71. Where the purchase price is paid prior to transfer of the property and adjustments in the purchase price are made through a cancellation of obligations which likewise occurs prior to the transfer, the cancellation will presumably be treated as a reduction of cost. *Des Moines Improvement Co.*, 7 B.T.A. 279 (1927); *cf.* *Union Pacific R. R.*, 32 B.T.A. 383 (1935), *other issues aff'd*, 86 F. (2d) 637 (C. C. A. 2d, 1936); *L. D. Coddon & Bros., Inc.*, 37 B.T.A. 393 (1938).

72. 62 F. (2d) 332 (C. C. A. 1st, 1932), 71 F. (2d) 104 (C. C. A. 1st, 1932), *cert. denied*, 293 U. S. 595 (1934).

73. In a case wherein it was stipulated that the decrease in the value of the bonds was primarily the result of a decline in the value of the corporate assets, the Board has held such shrinkage in asset value to be immaterial. *Consolidated Gas Co. of Pittsburgh*, 24 B.T.A. 901 (1931).

74. 37 B.T.A. 393 (1938).

that year the mortgage was satisfied for \$12,000 because the land, once worth \$20,000, had appreciably declined in value. While the loss in value was greater than the saving obtained, the Board found income because the property was sufficient to pay the indebtedness. It left open the question whether a similar result would obtain where the value of the property was less than the amount of the obligation.⁷⁵ This was the situation in *Hextell v. Huston*,⁷⁶ where land worth \$20,000 had been purchased in 1918, partly for a \$10,000 note secured by a mortgage. In 1935, when the land was worth \$6,500, the note was paid off for \$6,500; \$500 interest was waived. The district court said that the scaling down of the indebtedness produced a realization of loss, so that the \$3,500 saving in the principal was thus balanced by the loss in value, leaving no gain to be taxed. The decision is quite erroneous as to the realization of a loss. At best, it stands only for the proposition that gain is not to be recognized where the value of the property obtained upon incurrence of the obligation has declined below the amount of the obligation.⁷⁷ This particular situation cannot properly be excepted from the rule that the realization of income in these cases need not await the disposal of the property, for that rule necessarily divorces the factors of basis and value from the realization of income.⁷⁸ The value of the property in relation either to its original cost or to the amount of the discharged obligation, and any correspondence between loss in value and amount of indebtedness cancelled are therefore immaterial. If the property purchased (or the money borrowed) by means of the obligations later discharged has been completely lost, the discharge at less than the face amount of the obligations should result in income. There is no reason why the *American Chicle* and the *Coastwise Transportation* cases should not be carried to their logical conclusion, for the reliance placed by the *Kerbaugh-Empire* decision on the loss of the money borrowed has generally been regarded as completely discredited by the later decisions.

Where the purchaser has merely bought the property subject to a mortgage so that the indebtedness discharged was not a personal obligation, the Board has said that no income is realized if the discharge was effected by payment of an amount less than the indebtedness — the payment merely satisfies an encumbrance on the property without release of assets previously offset by the obligation.⁷⁹ But as the debt to which

75. Cf. cases cited *supra* note 20, which disregard a present loss.

76. 28 F. Supp. 521 (S. D. Iowa 1939).

77. Cf. P. J. Hiatt, 35 B.T.A. 292 (1937) (appears to accept this proposition).

78. Such a rule tends to offset ordinary income on the cancellation against capital loss on the disposition of the property, so that the balance might not be close in the case of an individual taxpayer.

79. *Fulton Gold Corp.*, 31 B.T.A. 519 (1934) (permitting Commissioner to reduce the basis of purchased property by amount of the cancellation and denying taxpayer's contention that reduction was improper because cancellation resulted in realization of

the property was subject became part of the purchaser's cost basis, it is not so clear that the case can be distinguished from one involving a personal obligation.⁸⁰

4. *Corporation's indebtedness cancelled by stockholders.* The earliest case on cancellation of indebtedness, *United States v. Oregon-Washington Railroad & Navigation Co.*,⁸¹ held that cancellation of a corporation's debt to its sole stockholder did not give rise to a realization of income by the corporation, but constituted instead a contribution to its capital. The Regulations⁸² early adopted this approach and were approved in *Commissioner v. Auto Strop Safety Razor Co., Inc.*⁸³ While the *Oregon-Washington* case apparently distinguished between the cancellation of the principal (a contribution to capital) and cancellation of the interest on the debt (presumably income), the former Regulations and the later cases did not draw such a distinction. In the *Auto-Strop* case royalties, loans and interest due were, on their cancellation, treated alike as contributions to capital. In *Edward Mallinckrodt, Jr.*,⁸⁴ the Board treated the cancellation of interest due on the sole stockholder's loan to the corporation as a contribution to capital, stating it could not be treated differently from the cancelled principal. Dissenting opinions, however, argued that the cancellation of the interest should result in income. In apparent reliance on these opinions, the Regulations were changed to state that the cancellation by a stockholder amounts to a contribution to capital to the extent of the principal of the debt.⁸⁵ The Board's decision has since been reversed by the Eighth Circuit Court of Appeals in *Helvering v. Jane Holding Corp.*,⁸⁶ partly on the ground that the former Regulations

income); *American Seating Co. v. Comm'r*, 14 B.T.A. 328 (1928), *other issues in* 50 F. (2d) 681 (C. C. A. 7th, 1931); *P. J. Hiatt*, 35 B.T.A. 292 (1937).

80. The difficulties occasioned where the personal debt is cancelled after the disposition of the property and which justify the separation of purchase and cancellation that underlies the *American Chicle* rule are absent when only a charge against the property is removed. The property would still be in the taxpayer's hands and its basis may therefore be readily adjusted.

81. 251 Fed. 211 (C. C. A. 2d, 1918).

82. U. S. Treas. Reg. 45, Art. 51, and succeeding Regulations through U. S. Treas. Reg. 94, Art. 22(a)-14.

83. 74 F. (2d) 226 (C. C. A. 2d, 1934). Forfeit of amounts paid on a subscription to capital stock results in a contribution to capital even though the persons forfeiting were not stockholders. *Comm'r v. Inland Finance Co.*, 63 F. (2d) 886 (C. C. A. 9th, 1933); *Realty Bond & Mtge. Co. v. United States*, 16 F. Supp. 771 (Ct. Cl. 1936); *Illinois Rural Credit Ass'n*, 3 B.T.A. 1178 (1926); *Industrial Loan & Investment Co.*, 17 B.T.A. 1328 (1929).

84. 38 B.T.A. 960 (1938). The sole stockholder, a trust, desired to make distributions to its beneficiaries but was not empowered to do so while the corporation was indebted to it. The indebtedness was therefore cancelled.

85. U. S. Treas. Reg. 101, Art. 22(a)-14, and Reg. 103, § 19.22(a)-14; *cf.* U. S. Treas. Reg. 94, Art. 22(a)-14 and prior Regulations.

86. 109 F. (2d) 933 (C. C. A. 8th, 1940).

dealt only with the principal indebtedness and that the interest thereon was to be differently treated. In finding that income resulted from the cancellation of the interest due on the indebtedness, the court relied on the previous deductions taken by the corporation for the interest as it accrued. Thus in a case where the corporation is on the cash basis, the decision is not authority for the Regulations' present distinction between interest and principal. This distinction is difficult to justify where, as in the instance of the cash basis, the interest has not been previously used to offset taxable income.

Although the cases do not consider the point, it seems clear that the relationship of stockholder and corporation should not automatically cause the cancellation to be considered as a contribution to capital rather than as a realization of income. Suppose creditors *A*, *B*, and *C* of corporation *D* cancel its indebtedness to them because of the corporation's financial condition. Creditor *A* happens to own a few shares of stock in the corporation. Does his cancellation result in a contribution of capital, and that of creditors *B* and *C* in a realization of income? Presumably not, as creditor *A* did not hope to gain anything *qua* stockholder and hence did not intend a contribution to capital. In the few cases on the subject, the stockholder-creditor has been either the sole or a principal stockholder, so that his cancellation was directly linked to his status as stockholder. While the quantum of the creditor's interest as a stockholder is generally indicative of intent, it need not be controlling, and the intent may be supplied by other factors.⁸⁷

87. Compare the reliance of Member Sternhagen in the *Mallinckrodt* case, 38 B.T.A. 960 (1938), on the intent of the cancelling creditor. Cancellation by a stockholder in connection with withdrawal from the corporation should not be a contribution to capital.

The Regulations state that if the shareholder "gratuitously" forgives the debt, the transaction amounts to a contribution to capital. The effect of the requirement that the forgiveness be gratuitous is not clear. In *Helvering v. Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8th, 1940), the circuit court of appeals stated that the forgiveness was not gratuitous, but in return for good and valuable consideration: the corporation's surrender of its right to have the assets of the trust kept undistributed while the corporation remained indebted to the trust. But as the corporation could not have prevented the cancellation, the action of the trust can scarcely be said to have produced consideration on the corporation's part. The word "gratuitously" can scarcely be given the effect of limiting the Regulations to donative transfers, for the cases go beyond such transfers and hold that what would be income to another taxpayer because of lack of donative intent becomes a contribution to capital in the case of a corporate debtor. Forgiveness in the *Jane Holding Corp.* case was gratuitous but not donative as the motive was not to benefit the corporation but to effect a distribution by the trust. If the reliance upon the gratuitous nature of the forgiveness is intended to exclude transactions in which consideration moves from the corporation, so that there is both a payment to the extent of the consideration and a cancellation of the remaining indebtedness, the exclusion of the indebtedness thus discharged by payment would be proper. But the circuit court did not find the value of the "consideration" moving from the corporation but merely its existence, which under this interpretation of the Regulations is not a complete answer.

The House Ways and Means Committee report states:

"Wherever a discharge of indebtedness is accomplished by the transfer by the debtor of property in kind, such as by the issue of its own stock, the difference between the amount of the obligation discharged and the value of the property transferred is the amount which may be excluded from gross income and applied in reduction of basis."⁸⁸

While the general rule therein stated is valid,⁸⁹ the statement implies that if a corporation issues stock worth \$400 in exchange for a \$1,000 bond, thereby discharging its obligation on the bond, it realizes \$600 income. The transaction may, however, be thought to involve a contribution to capital: the bondholder has paid for stock with the discharged obligation. Certainly the bondholder turned stockholder now depends directly upon the corporation's future operations for the return of his remaining investment.⁹⁰ That he has in effect paid more for his stock than it was worth is immaterial, for in this respect the situation is the same as cancellation by a creditor who is already a stockholder of a debt owed him by the corporation. Unless, however, the exchange of bond for stock is part

88. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 25.

89. If a debt is paid by a transfer of property of equal value, any gain inherent in the property is realized, so that the difference between the amount of the debt discharged and the basis of the property is taxable income. E. F. Simms, 28 B.T.A. 988 (1933); Twin Ports Bridge Co., 27 B.T.A. 346 (1932); Carlisle Packing Co., 29 B.T.A. 514 (1933); Ohio Central Tel. Co., 28 B.T.A. 96 (1933); Hagan Corp., 21 B.T.A. 41 (1930); Marbara Corp., 36 B.T.A. 519 (1937); I. T. 1562, II-1 CUM. BULL. 33 (1923); *cf.* Helvering v. Midland Mut. Ins. Co., 300 U. S. 216 (1937). These cases need not be rested upon the *Kirby* case, although it is frequently cited. The income is considered as gain on a sale or exchange and hence is a capital gain. *Rogers v. Comm'r*, 103 F. (2d) 790 (C. C. A. 9th, 1939), *cert. denied*, 60 Sup. Ct. 98 (U. S. 1939); *William R. Kenan, Jr.*, 40 B.T.A. 124 (1939); *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd*, 83 F. (2d) 1019 (C. C. A. 2d, 1936), *cert. denied*, 299 U. S. 573 (1936). *But cf.* *Bingham v. Comm'r*, 105 F. (2d) 971 (C. C. A. 2d, 1939). Where the discharged debt exceeds the value of the transferred property, the difference can hardly be considered as gain on the disposition of the property. Instead, with respect to such excess, the transaction must be treated as a pro tanto cancellation of the debt, as the sentence quoted indicates. U. S. Treas. Reg. 103, § 19.113(b)(3)—1(F) so states. *William Levitt*, B.T.A. Memo. Op., Dec. 30, 1938. *But cf.* *Springfield Industrial B'ld'g Co.*, 38 B.T.A. 1445 (1938).

90. In cases involving an exchange of stock for bonds, par for par, the courts have not permitted the corporation any deduction in the year of the exchange for the unamortized discount on the bonds, but have considered the transaction as an adjustment of the corporation's capital structure. *Chicago, R. I. & P. Ry. v. Comm'r*, 47 F. (2d) 990 (C. C. A. 7th, 1931), *cert. denied*, 284 U. S. 618 (1931); *Liquid Carbonic Corp.*, 34 B.T.A. 1191 (1936); *Pierce Oil Corp.*, 32 B.T.A. 403 (1935); *375 Park Ave. Corp.*, 23 B.T.A. 969 (1931). If the bonds were discharged by means of other bonds of a lower face amount than that of the discharged obligations, the corporation would realize income. *Comm'r v. Coastwise Transp. Corp.*, 62 F. (2d) 332 (C. C. A. 1st, 1932), 71 F. (2d) 104 (C. C. A. 1st, 1934), *cert. denied*, 293 U. S. 595 (1934).

of a reorganization or recapitalization,⁹¹ the bondholder will be allowed a loss measured by the difference between the cost of the bond and the value of the stock, so that his basis for the stock is its fair market value. The stockholder cancelling a debt would presumably receive an increase in his basis measured by the amount of the debt.⁹² This difference in the basis treatment — in that the bondholder treats the cancelled amount as lost whereas the stockholder still regards it as part of his investment in the corporation — may well occasion a difference in treatment on the corporation's side, thus justifying the quoted statement.

5. *Nature of liability.* In the *Kirby* case the liability in question was incurred through the receipt of money. On its discharge by the payment of money, therefore, the gain made on the transaction was clearly defined. In the *American Chicle* case and similar cases the liability was incurred on the purchase of property and therefore could have been viewed as representing the receipt of a money equivalent at that time. Thus, in the usual cancellation of indebtedness case, the debtor received "money" when the liability arose, and later on its discharge paid back less money.⁹³ But suppose the creditor has not originally received "money," so that there is no asset to offset the liability on its occurrence. Thus, taxpayer *A* with a judgment of \$10,000 entered against him because of his negligent operation of an automobile is able to satisfy the judgment by a payment of \$8,000. Taxpayer *B*, who has become liable for double the par value of his bank stock, \$10,000 in all, settles that liability by a payment of \$8,000. Taxpayer *C*, who endorsed his friend's \$10,000 note, is able, on the friend's default, to settle his liability as endorser for \$8,000. Taxpayer *D* who, in consideration of the gifts of others, agreed to contribute \$10,000 to a certain charity, satisfies his pledge by a contribution of

91. See note 97 *infra*.

92. Edward Mallinckrodt, Jr., 38 B.T.A. 960 (1938), *other issues in*, *Helvering v. Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8th, 1940). The stockholder whose indebtedness is cancelled is therefore not entitled to a deduction for a bad debt. But the other decisions are not all in accord. *Johnson, Drake & Piper, Inc. v. Helvering*, 69 F. (2d) 151 (C. C. A. 8th, 1934), *cert. denied*, 292 U. S. 650 (1934) (no deduction); *American Cigar Co. v. Comm'r*, 66 F. (2d) 425 (C. C. A. 2d, 1933), *cert. denied*, 290 U. S. 699 (1933) (no deduction); *Deeds v. Comm'r*, 47 F. (2d) 695 (C. C. A. 6th, 1931) (deduction allowed; no discussion of contribution to capital aspect); *Carl C. Harris v. Comm'r*, 19 B.T.A. 895 (1930) (deduction allowed); *Ransom E. Olds*, 18 B.T.A. 1215 (1930) (no deduction), *rev'd on stipul.*, 59 F. (2d) 1070 (C. C. A. 6th, 1931). The Board recently stated that a cancellation by a stockholder of a worthless debt owed by the corporation is not a contribution to its capital and its amount cannot be added to the stockholder's basis. *Hughes Tool Co.*, 40 B.T.A. 962 (1939).

93. Where the cancelled obligation represents interest or rent due, the debtor can be considered as having received the money equivalent of the use of the borrowed money or the rented property. See discussion *infra* p. 1175. Where the obligation is not personal but a lien on the property, the debtor may perhaps be said to have received a money equivalent through the medium of a lower purchase price.

\$8,000. Do taxpayers *A*, *B*, *C*, and *D* each realize \$2,000 income on satisfaction of these liabilities? Two cases point to a negative answer.

In *Commissioner v. Rail Joint Co.*,⁹⁴ a corporation in 1914 approved an appraisal of its assets which added \$3,000,000 to its surplus account. It then issued a bond dividend to its stockholders. In 1926 and 1927 it purchased some of these bonds, presumably on the open market, at less than their face amounts, cancelled them, and credited the difference to surplus. The Second Circuit Court of Appeals held that the difference was not income. After pointing out that in the *Kirby* case assets had been increased by the money received, the Court said that here the incurrence of the obligation was attended merely by a writing up of book value without any increment in assets. The corporation simply retained a part of the surplus it had intended to distribute. The case of taxpayer *D* above was put and answered by saying that the payment of the \$8,000 did not result in a realization of income, but merely fixed the amount of the deduction for a charitable contribution. As the bonds were clearly an obligation of the corporation, the case squarely holds that the discharge of a liability for less than its amount does not result in income if no asset is received on its occurrence. The decision contradicts the Board's "net assets" approach, for although assets were released which had previously been subject to an obligation and the net of assets over liabilities thus increased (the Board's criterion) the court found no income.

In *Ruben v. Commissioner*,⁹⁵ the taxpayer and two others had acquired practically all of corporation *X*'s stock. This stock was held for them by corporation *Y*, all of whose stock they owned, the taxpayer's interest being one-fourth. Minority stockholders of corporation *X* sued for an accounting and damages derived from the stock purchases and the management of corporation *X*. The lower court rendered a money judgment against corporation *Y* and its stockholders as individuals. The case was settled while pending on appeal by corporation *Y*'s paying a sum of money to the plaintiffs. The Commissioner claimed that one-fourth of the sum was a taxable dividend to the taxpayer, as the latter's obligation had been satisfied by the corporation. The Eighth Circuit Court of Appeals held that no income was realized—the taxpayer had received nothing, but had been relieved by the settlement of a claimed liability. On the authority of this case our taxpayer *A* above would not realize income, but would merely have reduced his loss.

Whereas the *Ruben* case situation and that of taxpayer *A* present the weakest set of facts in which to find income, the *Rail Joint* case presents the strongest situation. In the latter case the incurrence of the obligation

94. 61 F. (2d) 751 (C. C. A. 2d, 1932) (criticized in MAGILL, *op. cit. supra* note 3, at 230-1).

95. 97 F. (2d) 926 (C. C. A. 8th, 1938).

benefited the debtor, for it effected the payment of a dividend which the corporation was expected to distribute in the normal course of business. The case could have been viewed as a payment of a cash dividend and the return of the cash to the corporation for the bonds. Taxpayers *B, C,* and *A,* and the taxpayer in the *Ruben* case, however, were involved in loss situations in which the receipt of income would seem incongruous. The approach of the courts must then be taken as opposed to any realization of income where no tangible consideration has been received in return for the incurrence of the obligation.

6. *Effect of previous deductions.* Suppose a creditor cancels both the principal and interest due him on a loan because of his debtor's financial condition. Where the debtor is solvent, the amount of both principal and interest will be included in gross income. Presumably the debtor on the cash basis will also obtain an interest deduction in the year of cancellation.⁹⁶ The debtor on an accrual basis will have already taken the deduction which should not be disturbed.⁹⁷ Suppose, however, that the debtor is insolvent, and being on the accrual basis, has annually deducted the interest payable. Under the view expressed in 2(d) above, as income would be realized here as well as for the solvent taxpayer, no different problems would arise. But if we accept the net assets theory,

96. As will be discussed later, §215 of the Revenue Act of 1939 assumes that the difference between the face amount of a bond issued at a discount and its purchase price is income, and that the unamortized discount would be deductible. As bond discount is viewed by the courts as a form of interest, the assumptions underlying §215 support the statement in the text. Cf. *Helvering v. Union Pacific R. R.*, 293 U. S. 232 (1934). The deduction for "interest paid" can be upheld only by considering the passage of the interest through the taxable gross income gate as a payment of such interest. It is questionable whether the word "paid" can be so stretched. It may also be contended that the deduction is not allowable because of absence of actual payment and that in view of the loss of the deduction the cancellation of the interest should not give rise to taxable income. Where the interest charge is part of the cost of doing business, allowing the deduction for the cancelled interest seems proper as its actual payment is no more necessary than payment of the principal. The situation is analogous to that of property purchased with notes later cancelled, where, as discussed above, the basis of the property remains unchanged and the saving becomes income. While the inclusion in gross income of the amount of interest cancelled as income arising from a discharge of indebtedness and the deduction of the same amount as interest paid will ordinarily cancel out for a solvent taxpayer, the importance of the proper treatment of interest cancelled where the taxpayer is in an unsound financial condition will be apparent when the effect of §215 is considered.

97. In *Hummel-Ross Fibre Corp.*, 40 B.T.A. No. 123 (1939), stock was issued in exchange for bonds and accrued interest, the par value of the stock being equal to the face amount of the bonds. The Board sustained the deduction for accrued interest against the contention that the interest obligation had been cancelled, stating that instead of cancellation there was an exchange of stock for bonds plus accrued interest. While gain may have resulted to the extent of the difference between the fair market value of the stock and the amount of the obligations, such gain would not be recognized as the exchange was a tax-free recapitalization.

with the result that no income arises from the cancellation of the principal or interest as such, do the previous deductions for interest nevertheless compel inclusion of the cancelled interest in gross income? As the deductions were accorded on the assumption that the interest would be paid, tax equity would seem to require that upon cancellation of the interest the deductions be "balanced" by such an inclusion, provided that the statute of limitations has run so as to prevent disturbance of the deductions. Analogous is the case of the bad debt charged off and later paid, where the creditor must include in gross income the amount paid if he has previously obtained a bad debt deduction. If the taxpayer were on the cash basis, as no deduction exists to create the necessity for equitable adjustment, the interest would not be includible in gross income.

On this analysis of tax equities, however, the principal should likewise be included in gross income regardless of the financial condition of the debtor. Adjustment is necessary in the case of the deduction for accrued interest because such deduction has caused an amount of taxable income (from other sources) included in gross income to escape tax through the reduction effected in the total gross income. But essentially the same may be said with respect to the unpaid principal: an amount received by the taxpayer and not taxed because expected to be repaid, has in fact not been repaid and hence has escaped tax. If adherents to the net assets theory refuse to tax the unpaid principal, they should likewise exclude unpaid interest from gross income, even though accrued interest deductions have previously been obtained. This is the result which the Board apparently reaches.⁹⁸

The Second Circuit Court of Appeals held in *Commissioner v. Auto Strop Safety Razor Co., Inc.* that where the principal stockholder cancelled interest due on a loan to the corporation, the fact that the corporation on

98. *Towers & Sullivan Mfg. Co.*, 25 B.T.A. 922 (1932) (cancellation of both debts incurred on purchase of goods and the interest thereon did not give rise to income where taxpayer was insolvent, even though cost of goods had been previously taken as a deduction and interest had been accrued as a deduction).

Where the accrued interest deducted is part of the cost of doing business, the situation is similar to that where a taxpayer has taken a deduction for the cost of goods purchased and has later obtained a cancellation of the notes given in payment. On grounds of tax equity the cancellation would result in income so that the true cost of the goods may be reflected in the tax amount. The Board decisions, though uncertain, tend to deny a tax on cancellation despite the previous deduction for the cost of the goods purchased. *Towers & Sullivan Mfg. Co.*, *supra*; *The Haden Co.*, B.T.A. Memo. Op., Docket No. 91776, October 20, 1939 (refusing to depart from the *Lakeland* rule because debts cancelled had previously been deducted as business expenses in the form of rent and materials purchased); *cf.* *Progress Paper Co.*, 20 B.T.A. 234 (1930). *But cf.* *Avery & Sons, Inc.*, 26 B.T.A. 1393 (1932) (finding of income on grounds that taxpayer was solvent and that debts cancelled had previously figured as deductions). See also § 270 of the Bankruptcy Act, as amended, which reduces basis by the amount of indebtedness cancelled, but "not including accrued interest unpaid and not resulting in a tax benefit on any income tax return."

the accrual basis had previously taken annual deductions for interest did not change what would otherwise be a contribution to capital into the receipt of income. But in the *Rail Joint* case, the same court had stated that if a charitable pledge of \$1,000 made in one year was satisfied by a payment of \$500 in a later year, the difference was income in the later year if the \$1,000 had been deducted in the earlier year. Cancellation and payment were regarded as finally fixing the proper amount of the deduction, and inclusion of the difference was necessary to insure proper reflection of the entire transaction. The distinction between this case and the interest cases is far from clear. The *Jane Holding Corp.* case⁹⁹ disagreed with the *Auto Strop* decision and held that where accrued interest had been deducted by a solvent corporation, later cancellation by the stockholder of the interest due resulted in income to the corporation rather than a contribution to capital, since the income items offset by the previous deductions then had to be restored to taxable income. Although this decision seems proper, it does not require that the principal indebtedness forgiven by the stockholder likewise, on tax equities, result in income to the corporation. Although the amount of the loan received by the corporation has escaped tax, nevertheless as all sums originally received from stockholders have likewise escaped tax, the principal indebtedness may be included with these sums and properly treated as a contribution to capital. But while the interest forgiven may in one sense be a contribution to capital, the fact that it has through previous deductions permitted taxable income to avoid tax prevents it from following the principal as a tax-free contribution to capital.¹⁰⁰

B. CONSIDERATION OF PROVISIONS ADDED BY REVENUE ACT OF 1939

1. Further problems regarding amount of income to be excluded.

(a) "Income attributable to the discharge . . . of any indebtedness."

New paragraph (9) of Section 22(b) excludes from gross income at the taxpayer's election "the amount of any income of the taxpayer attributable to the discharge . . . of any indebtedness of the tax-

99. 109 F. (2d) 933 (C. C. A. 8th, 1940). This decision has been discussed in note 87 *supra*. The court emphasized that the corporation was solvent. The attempted distinction of the *Auto Strop* decision on the ground that a contribution to capital was intended will hardly hold, as the court itself realized, for on the tax equity theory even a donative forgiveness would not justify exclusion of the interest.

100. Similarly, as a gift is not income, if principal and accrued interest are forgiven with donative intent, the principal may escape tax even on the tax equity theory, but the forgiven interest should result in income. Where the relationship is not that of stockholder-corporation, or the motive not donative, there is no justification for permitting the principal indebtedness to avoid tax. As the text indicates, tax equities require like treatment of accrued interest and principal in the case of an insolvent non-corporate debtor. A net assets approach should also relieve accrued interest from tax in the case of an insolvent corporate debtor.

payer."¹⁰¹ The preceding discussion has been concerned with ascertaining in what situations income may be realized on a discharge of indebtedness, and with the amount of such income. The further question exists whether the income is "attributable" to the discharge of indebtedness, for it is only to such income that Section 22(b)(9) applies. Where the taxpayer has merely borrowed money from the creditor, the saving, upon cancellation of the loan, is clearly attributable to the discharge of the debt. But suppose that in payment for services performed by the taxpayer, its creditor cancels the taxpayer's \$5,000 debt. The \$5,000 of income would here seem attributable not to the discharge of the debt but to the performance of services. The discharge was the means of payment but the income represented by such payment was derived from compensation for personal service. Suppose the debtor is a stockholder of the creditor corporation, so that the amount of the cancelled debt is a taxable dividend. While this case is closer to the line, the discharge here is also but the means of payment, and the income is attributable not to the discharge but to the relation of stockholder and corporation.¹⁰² While in the first case a consideration — the performance of services — is definitely present, some consideration in the form of a stockholder's expectation of dividends may be found in the second situation. Where consideration is lacking, however, so that the discharge is not the medium of payment but rather the source of the income, the new paragraph is applicable.

(b) *Treatment of bond premium and discount.* Where bonds issued at par are discharged through purchase by the obligor, the difference between the face amount of the bonds and the amount for which they were purchased measures the income to the corporation.¹⁰³ The new paragraph applies this test even where the bonds were issued at a premium or discount. The unamortized premium is treated separately, although likewise excluded from income, and the unamortized deduction is expressly disallowed, thus implying that it would otherwise be allowable. In computing the amount to be deducted from basis in the case of bonds issued at a premium, the maximum is the difference between the face amount and the purchase price plus the unamortized premium,

101. The word "income" would seem to mean "gross income," so that the phrase refers to the amount otherwise includible in gross income but for § 22(b)(9), rather than a net figure reached by deducting any amounts properly allowable on the transaction. The treatment of bond discount and premium supports this view. Moreover, the paragraph relates to exclusions from gross income.

102. A contrary conclusion would reduce the basis by the full amount of the dividend (under the assumption made in note 101 *supra*), whereas only 15% of such amount would have been in effect taxed, due to the credit allowed by § 26(b).

103. The market value of the bonds, either at the time of purchase or on March 1, 1913, is immaterial. Consolidated Gas Co. of Pittsburgh, 24 B.T.A. 901 (1931); Virginia Iron, Coal & Coke Co., 29 B.T.A. 1087 (1934).

as both were excluded from gross income. In the case of bonds issued at a discount, the amount of the unamortized discount, disallowed as a deduction, must be subtracted from the amount excluded from gross income — the difference between the face amount of the bonds and the purchase price. Regulations 103, Section 19.22(a)-18 dealing with the purchase of bonds in general, however, appears to adopt a different approach. It states that on the purchase of bonds formerly issued at a premium, the gain or income on the transaction is the excess of the issuing price minus any amount of premium already returned as income, or the excess of the face value plus the amount of premium not yet returned as income. In the case of bonds issued at a discount, the gain or income is the excess of the issuing price plus any amount of discount already deducted, or the excess of the face value minus the amount of discount not yet deducted, over the purchase price. The courts have applied the same rule in cases involving bonds issued at a discount.¹⁰⁴ These courts and the Regulations may be merely stating the mathematical computation in one transaction without going through the entire process of including the difference between the face amount and the purchase price in gross income and allowing the unamortized discount as a deduction. Or perhaps they are proceeding on the assumption that the amount so stated is the income (the difference between the issuing price and the purchase price is income resulting from the discharge, and the amount of the amortized discount already deducted must also be included in gross income to balance the previous deductions) and that there is no deduction for unamortized discount. Either result would be adequate for the purpose at hand. If a \$100 bond were issued at \$90 and purchased for \$80, there being \$6 unamortized discount, the amount excluded from gross income under the Act and the first construction of the Regulations would be \$20, and the amount to be deducted from basis would be \$14. Under the second construction of the Regulations, the amount excluded and the amount to be deducted would each be \$14, no deduction being disallowed as none was attributable to the unamortized discount. Where the difference in approach may have a consequence, as in the application of Section 275(c) in a situation where the saving on the discharge was taxable because of the corporation's sound financial condition, the assumptions of the Revenue Act of 1939 should be followed, because that Act rejects the second interpretation of the Regulations.

2. *Kind of indebtedness.* New paragraph (9) of Section 22(b) applies only to indebtedness evidenced by a security. The term "security" is defined to mean "any bond, debenture, note, or certificate, or other

104. *Commissioner v. Norfolk S. R. R.*, 63 F. (2d) 304 (C. C. A. 4th, 1933), *cert. denied*, 290 U. S. 672 (1933); *Norfolk S. R. R.*, 25 B.T.A. 925 (1932).

evidence of indebtedness issued by any corporation, in existence on June 1, 1939." The paragraph as originally introduced was in effect limited to bonded indebtedness, for the various evidences of indebtedness were all qualified by the phrase "with interest coupons or in registered form."¹⁰⁵ But the qualification was removed, perhaps because the paragraph as limited was thought to provide insufficient relief.¹⁰⁶ The phrase "other evidence of indebtedness" should thus be broadly construed and not limited by the words preceding it.¹⁰⁷ Hence, any corporate debt, obligation or contract liability evidenced by a written obligation in existence on June 1, 1939 and issued by a corporation is subject to the new provisions.¹⁰⁸

The indebtedness may be that of the taxpayer itself or another's indebtedness which the taxpayer has assumed. If the original indebtedness is that of a corporation and is evidenced in writing and in existence on June 1, 1939, the assumption by the taxpayer may be oral and may occur after that date. If the original indebtedness, however, does not satisfy the definition of a security, *e.g.*, a partnership debt, the assumption by the taxpayer corporation must meet that definition to fall within the paragraph.¹⁰⁹

3. *Financial condition of taxpayer.* The new provisions are not operative unless the taxpayer is in "an unsound financial condition" at the time of the discharge. Congress thought that a financially sound corporation which finds it advisable to purchase its own bonds should be required to pay tax at that time on the saving thus secured. This form of income was thus regarded as no different from any other type. Relief was to be accorded only to corporations in financial difficulties whose ability to purchase their own bonds at less than face amount was largely due to their own weakness. Congress, feeling that these corporations should be encouraged to scale down their indebtedness, removed the tax deterrent to such action by permitting a postponement of tax.

The taxpayer must establish to the Commissioner's satisfaction that its financial condition is unsound, unless such condition is certified to that

105. H. R. 6851, 76th Cong., 1st Sess. § 215, as introduced. The original wording thus adopted the definition of "securities" used in § 23(k)(3). The same terminology appears also in § 117(f).

106. 84 CONG. REC. 10482 (1939).

107. Thus Mary D. Gerard, 40 B.T.A. 64 (1939) and Frank J. Cobbs, 39 B.T.A. 642 (1939), applying the doctrine of *nocitur a sociis* to exclude certain corporate obligations from the provisions of § 117(f), are not pertinent to § 22(b)(9).

108. The term "issued" still has meaning. Thus U. S. Treas. Reg. 103, § 19.22(b)(9)-1, states that indebtedness represented only by open account book entries is not covered by the paragraph.

109. U. S. Treas. Reg. 103, § 19.22(b)(9)-1. The words "any indebtedness of the taxpayer or for which the taxpayer is liable" in § 215(a), while seemingly redundant, are intelligible if the phrase "indebtedness" is read with the modifier "evidenced by a security," and in the light of the original limitation of "security" to bonded indebtedness.

official by a Federal agency authorized either to lend to the taxpayer or to exercise regulatory power over it.¹¹⁰ The Commissioner is bound by such certification, but, in its absence, is free to prescribe his own standards if not arbitrary or unreasonable. The House Ways and Means Committee Report offers the Commissioner two guides: (1) that insolvency is not a *sine qua non*—a corporation's liabilities need not exceed its assets nor need it be unable to meet its current obligations as they fall due to be in an unsound financial condition; (2) that a corporation's obligations are selling in a free market at prices below their issue price and below the market price of similar issues of similar businesses is highly indicative of an unsound financial condition.¹¹¹

4. *Reduction of basis.* While the new paragraph added to Section 22(b) excludes from gross income the amount of income attributable to the discharge of the indebtedness, the new paragraph inserted in Section 113(b) provides that such amount, or a part thereof, shall in the Commissioner's discretion, as expressed in Regulations, be applied in reduction of the basis of any property held by the corporation. The wisdom of such a provision depends upon the answer to two questions of policy: (1) Shall the relief accorded to corporate debtors in financial difficulties be absolute, in the sense that no tax shall ever be collected with respect to the amount saved, or shall it be of a temporary nature and the tax merely postponed? (2) If the latter, what form shall the recoupment of tax take?

It has been argued with respect to the first question that there are situations where complete tax immunity would be unwise. Suppose a corporation has purchased a building in exchange for notes for \$100,000. Because of a decline in the building's value, the notes are discharged on

110. SEN. REP. No. 648, 76th Cong., 1st Sess. (1939) 5 recommended utilization of information obtained by such other Federal agencies, thereby relieving the Commissioner of the necessity of making an independent finding in such cases. Cf. 84 CONG. REC. 10964-5 (1939). Presumably these agencies will not permit taxpayers to shop around for such certificates but will only issue them when the taxpayer's financial condition is involved in a matter pending before them. The Regulations do not state which Federal agencies the section covers. The RFC and the ICC seem well within the definition adopted; inclusion of the SEC may be doubtful.

111. H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 23-24. Cf. 84 CONG. REC. 10469, 10486 (1939).

Sales below par or the market price of similar issues are not conclusive, however; such sales may be due to a low interest rate or a long maturity. U. S. Treas. Reg. 103, § 19.22(b)(9)-1. It has been urged that the uncertainties inherent in the phrase "unsound financial condition" should be eliminated by the adoption of an arbitrary dividing line, such as bonds selling at 40. But the range of the present bond market will not permit of any sensible point of division. If the figure is too low, many corporations will be unjustifiably deprived of relief; if too high, the Congressional desire to tax purchases by clearly solvent corporations will be thwarted. Moreover, a figure stated in the statute as a presumption or as a minimum might in administration become a binding maximum.

payment of \$30,000. If the \$70,000 were merely eliminated from income, the taxpayer corporation would still have a \$100,000 basis for depreciation and gain or loss on the building, though the building actually cost it only \$30,000. If the taxpayer sells the building for \$30,000 it will have a \$70,000 loss; if it sells for \$100,000 it will pay no tax. But even here the taxpayer is merely saving a tax once on \$70,000, which is the amount of relief supposed to be accorded. The situation does not in this sense differ from that of the taxpayer which discharges a \$100,000 loan by payment of \$30,000. While the basis of the building is not in line with its actual cost, such a situation would exist in the case of a solvent debtor which would have to pay tax on the \$70,000, for the basis would remain \$100,000. There may be this difference between the taxpayer which bought the building and the taxpayer which borrowed the \$100,000: when the former sells the building for \$30,000 its condition may be such that it should not be permitted to take a \$70,000 loss, or if it sells it for \$100,000, it may be in a position to pay tax on a \$70,000 gain. But the taxpayer which borrowed the money may have recovered sufficiently in the next few years to be able then to pay tax on the \$70,000. Furthermore, if a distinction is to be drawn, where would the taxpayer which borrowed \$100,000 and invested it in a building find itself? The physical tie-up between the building and the \$70,000 saving should thus not be determinative; the first example merely presents a situation in which recoupment through reduction of basis is relatively simple to administer.

It is true of both taxpayers that if large losses have brought about the unsound financial condition, the net loss carryover provision would permit applying them to the next two years. This is perhaps undesirable, if such years are profitable, for in effect those losses have been given tax consequence through the refusal to tax the \$70,000.¹¹² Yet the unsound financial condition may have been caused by heavy operating losses in prior years which were in excess of gross income so that they had no tax utility. Non-taxation of the \$70,000 is merely a rough balance for these earlier losses. It might be argued on the side of complete tax forgiveness that the Government should, like the cancelling creditors, forego its debt once and for all so that the debtor may be rehabilitated. Such an argument, however, may be met by the assertion that the question of ability to pay at such a time properly belongs in the field of compromise of tax liability where it can be elastically handled, and is not the occasion for an automatic forgiveness by refusing to recognize income on the cancellation of indebtedness.

The argument narrows to the policy question, uncomplicated by other aspects of the tax laws, whether the relief should be permanent or merely

112. This situation was presented in some of the cases. See *Comm'r v. Simmons Gin Co.*, 43 F. (2d) 327 (C. C. A. 10th, 1930); *Burnet v. Campbell Co.*, 50 F. (2d) 487 (App. D. C. 1931).

temporary. Temporary relief will turn the immediate trick: rehabilitation of the debtor that makes it unnecessary that he close his business, discharge his workers and go into bankruptcy. But every tax which the Government foregoes with respect to one taxpayer must be met by other taxpayers. These other taxpayers might applaud the extension of the helping hand at the crucial moment, but they might also require that the rescued taxpayer, if he turns the corner and commences to profit, should repay his debt to the Government and to them. Perhaps this contention may be answered by the observation that merely keeping the debtor in business prevents an increase in the load on the other taxpayers. Yet they — joined by the debtor's immediate competitors — may still contend that the relief be treated as a temporary loan to be repaid when the debtor regains his feet.¹¹³ Whatever the validity of these arguments, Congress has decided that the relief should be temporary by inserting a *quid pro quo* in the form of a reduction in basis.

Two methods of regaining the tax lost for the year of cancellation are sufficiently automatic in application to debtors as a group to make them administratively feasible. One is to allocate the amount excluded from gross income as a result of the discharge of indebtedness over the next five or ten years in equal installments includible in gross income. This method involves no administrative problems but has as a disadvantage the effect of a possibly burdensome tax in the very next year and each succeeding year. It is also unorthodox in approach, being too obviously a *quid pro quo*. The other method, adopted by Congress, involves a reduction in the basis of the property held by the taxpayer. Such reduction cannot be limited to property purchased with the cancelled debt, assuming such a case to be involved, for the property may have been sold or become worthless, but must be possible of extension to all the property of the debtor. This necessitates a complex procedure under which reduction in basis will proceed down through the various types of property according to their susceptibility to such reduction, until the amount to be so applied has been used up. Except for unusual situations, however, such as where property whose basis has been reduced may be sold at a profit in the next year, this method is more likely to postpone the tax until a sunnier day. Similarly, the Commissioner has been vested with considerable discretion in regard to the actual reduction to be made, so that he is in a position to prevent hardships from occurring by reason of the *quid pro quo* decided upon by Congress.¹¹⁴

113. The temporary nature of the relief also acts as some safeguard against manipulation of § 22(b) (9) in the interests of tax avoidance.

114. H. R. REP. No. 855, *op. cit. supra* note 111, states, at 24: "The Commissioner is permitted not to reduce basis or to allocate all or a part of the reduction to some property and a part or none to other property and the amount of reduction to be allocated to a particular property may be fixed by him." The exclusion from income under § 22(b) (9) is conditioned upon consent to the Regulations prescribed under § 113(b) (3).

C. BANKRUPTCY ACT PROVISIONS REGARDING CANCELLATION OF
INDEBTEDNESS

The question of cancellation of indebtedness has been discussed so far in terms of the applicable provisions of the Revenue Acts. There exist, however, a number of Bankruptcy Act provisions which deal with the tax consequences of a cancellation of indebtedness. These provisions, for the most part adopted in 1938 and not affected by Section 215 of the Revenue Act of 1939,¹¹⁵ may be summarized as follows:

A. With respect to

(a) A plan of corporation reorganization confirmed under either Section 77B of the old Bankruptcy Act or Chapter X of the Chandler Act;¹¹⁶

(b) A composition agreement confirmed under either Section 12 or 74 of the old Bankruptcy Act, or an arrangement under Chapter XI of the Chandler Act;¹¹⁷ and

(c) A "real property arrangement," under Chapter XII of the Chandler Act,¹¹⁸

no income is to be realized as a result of the modification or cancellation of any indebtedness. However, the basis of the debtor's property, or of such property as is transferred to any person required to use the debtor's basis in whole or in part, is decreased by an amount equal to the amount of the indebtedness cancelled. The Regulations state that

These Regulations provide the following order of basis reduction: the property for whose purchase the cancelled indebtedness was incurred, property against which the cancelled indebtedness was a lien, other property excluding inventory and notes and accounts receivable, the amount being spread ratably over such property; inventory, notes receivable, and accounts receivable, the reduction being made ratably. In filing his consent, the taxpayer may request a variation from the general rule which the Commissioner may grant. If the Commissioner rejects the proposed variation, the taxpayer will be held to the general rule, unless it specifically did not consent to such application, in which event the income would be taxable. The taxpayer may not treat part of the income as taxable and part as subject to the relief afforded by § 215, for, if a consent is filed, the Commissioner may reduce basis by the entire amount of income resulting from the discharge. U. S. Treas. Reg. 103, § 19.113(b)(3)-1, 2. Section 215 neglected to amend § 113(b)(2) to conform with the addition of new § 113(b)(3). As § 113(b)(2) is probably declaratory of the proper rule, the slip should not be harmful. See SEN. REP. No. 665, 72d Cong., 1st Sess. (1932) 23-25.

115. The House Ways and Means Committee Report expressly states that the provisions of the 1939 Act do not apply to a discharge of corporate indebtedness occurring in any proceeding under § 77B or under Chapters X or XI of the Bankruptcy Act of 1898, as amended. *Op. cit. supra* note 111, at 25. Chapter XV of that Act, enacted after the Revenue Act of 1939, is likewise not affected by its provisions.

116. BANKRUPTCY ACT OF 1938, §§ 268, 270, 276(c)(3). Presumably reorganizations under § 77 of the Bankruptcy Act are subject to the Internal Revenue Code, as amended by REVENUE ACT OF 1939, § 215.

117. BANKRUPTCY ACT OF 1938, §§ 395, 395, 399(4).

118. BANKRUPTCY ACT OF 1938, §§ 520, 522.

the amount of reduction is the dollars and cents amount of the cancellation, without regard to how much of that amount would be considered income by the courts.¹¹⁹

B. With respect to

(a) A "wage earner's plan" confirmed under Chapter XIII of the Chandler Act, as amended,¹²⁰ and

(b) A railroad adjustment under Chapter XV of the Chandler Act, as amended,¹²¹

no income is to be realized as a result of the modification or cancellation of any indebtedness, but the basis of the debtor's property is not reduced.

The statutory picture may be completed by a summary of the results under the Internal Revenue Code, as amended by Section 215 of the Revenue Act of 1939:

C. With respect to

(a) A corporation in an unsound financial condition whose indebtedness, evidenced by a "security" as defined in Section 22(b)(9), is discharged in accordance with the conditions specified therein,

the amount of income attributable to the discharge may at the corporation's option be excluded from gross income, but in the event of such exclusion the basis of the corporation's property is subject to reduction in accordance with the Commissioner's Regulations, the maximum amount of reduction being the amount of income so excluded.

D. With respect to

(a) A taxpayer other than a corporation;

(b) A corporation in a sound financial condition; and

(c) The indebtedness of a corporation in an unsound financial condition not evidenced by a security as defined in Section 22(b)(9),

the amount of income realized on a cancellation of indebtedness must be included in gross income.

119. U. S. Treas. Reg. 103, § 19.113(b)(1)-2. This interpretation has been criticized as contrary to the Congressional purpose of debtor relief. See SEN. REP. NO. 1916, 75th Cong., 3d Sess. (1938) 7, which may possibly be read as justifying a reduction in basis only if the amount of forgiven indebtedness prevented by the Bankruptcy Act from resulting in taxable income would in the absence of such Act actually constitute taxable income. Note also that no reduction is to be made on account of any accrued interest unpaid which has not resulted in a tax benefit on any income tax return. On the other hand the wording of the particular bankruptcy sections is clear—"an amount equal to the amount by which the indebtedness of the debtor . . . has been cancelled or reduced." (§ 270).

120. BANKRUPTCY ACT OF 1938, § 679.

121. BANKRUPTCY ACT § 735, as added by Pub. Res. No. 242, 76th Cong., 1st Sess.

D. GENERAL PROBLEMS PRESENTED

The diversity of treatment indicated by the summary in the preceding Section cannot be justified. It demonstrates that while Congress desires to relieve financially embarrassed debtors, it has no clear idea of the relief to be granted. This mixture of tenderness and perplexity has thoroughly confused the statutory treatment of cancellation of indebtedness. A few of the pressing problems which have resulted may be briefly sketched.

The Bankruptcy Act, as stated above, relieves the debtor of any immediate tax by providing that the cancellation of its indebtedness shall not result in income. To allow eventual recovery of the tax, this Act requires that the basis of the debtor's property shall be reduced by the amount of indebtedness cancelled. This provision frequently makes the cure worse than the disease. Bankrupt corporations with large amounts of indebtedness may emerge from bankruptcy with a zero basis, for the indebtedness cancelled will often exceed the former basis of the property. To avoid this ridiculous situation such corporations may urge that a large part of the indebtedness be continued, although this may mean the retention of an unwise financial structure. Sometimes the argument that a thoroughgoing reduction in indebtedness results in undesirable tax consequences is used to cloak a preference for continuing an excessive indebtedness. The automatic reduction in basis required by the Bankruptcy Act thus serves either to block or hamper sound reorganizations if the old corporation is retained. If a new corporation is formed to acquire the assets, its basis will be either cost to it—generally fair market value and hence a proper basis—or the debtor's basis, depending on the applicability of the tax-free exchange provisions of the Internal Revenue Code. If these provisions require a substituted basis, the difficulties discussed above are presented, since the basis must be reduced by the indebtedness cancelled. The confusion existing in regard to the applicability of these provisions will be mentioned later. The unresolved interpretative problem presented by an exchange of stock for bonds or other debts has also muddled many a reorganization. Is the amount of indebtedness cancelled the face amount of the bonds or the difference between such amount and the value of the stock?¹²²

The Bankruptcy Act provisions have been criticized for requiring a reduction in basis of the full amount of the indebtedness cancelled without regard to whether income would otherwise be realized on the transaction. It has been suggested that the reduction be limited to the income otherwise present.¹²³ But this hardly solves the present difficulties, for

122. The problem here is not whether the difference is income or a contribution to capital, as under § 215, but whether indebtedness has been cancelled and if so in what amount. As many reorganizations under the Bankruptcy Act involve the exchange of stock for bonds and other indebtedness, the point is of great importance.

123. Compare note 119 *supra*.

under one possible approach the full amount of the indebtedness is the income realized, except where a contribution to capital is present. The results desired — prevention of an immediate tax and the fixing of a sound basis for the property — may perhaps be obtained by retaining both the present provisions relieving from tax any income realized on the cancellation and those requiring reduction in basis by the amount of indebtedness cancelled, but adding a proviso that the basis of any particular property shall not be reduced below its fair market value.

The feasibility of such a rule for taxpayers subject to the Bankruptcy Act depends in large part upon the rule for non-Bankruptcy Act cases. Taxpayers who can secure more favorable tax treatment outside the Bankruptcy Act will strive to keep their reorganizations from becoming subject to that Act. The tax-free exchange sections of the Revenue Acts seem to have been applied by the courts with the purpose of providing insolvent corporations with a basis windfall upon their reorganization. Two circuit courts of appeals and the Board have ruled that a tax-free exchange exists if a corporation's bondholders, through a committee, buy in its assets at a foreclosure sale and transfer such assets to a new corporation.¹²⁴ The new corporation thus obtains the old corporation's basis, which generally is far above the market value of the assets. This rule, known as the *Kitselman* doctrine, encourages corporations in need of reorganization to avoid the Bankruptcy Act if possible, as the basis result is so much more favorable than that prevailing under the Bankruptcy Act. The refusal of these decisions to give effect to the foreclosure and judicial sale is subject to valid criticism,¹²⁵ and the decisions can scarcely be accepted as properly interpreting the reorganization provisions of the various Revenue Acts. At the very least, the Supreme Court's recent decision in *Le Tulle v. Scofield*¹²⁶ warrants their reexamination.

If the *Kitselman* doctrine is overruled, reorganizations by foreclosure and judicial sale will be governed by the rules applicable to ordinary foreclosures. This part of the law is an almost impossible tangle of judicial decisions and administrative regulations occasioned by an absence of explicit statutory rules. The bondholders obtaining the property may find themselves simultaneously realizing both a deductible ordinary loss and a taxable capital gain as a result of their purchase. By their control

124. *Commissioner v. Kitselman*, 89 F. (2d) 458 (C. C. A. 7th, 1937), *cert. denied*, 302 U. S. 709 (1938); *Commissioner v. Newberry Lumber & Chem. Co.*, 94 F. (2d) 447 (C. C. A. 6th, 1938); *Southwest Consol. Corp.*, B.T.A. Memo. Op. Docket No. 93321 (Aug. 25, 1939); *Marlborough House, Inc.*, 40 B.T.A. No. 133 (1939); *Frederick L. Leckie*, 37 B.T.A. 252 (1938).

125. *Cf. Helvering v. Midland Mut. Life Ins. Co.*, 300 U. S. 216 (1937).

126. *Le Tulle v. Scofield*, 60 Sup. Ct. 313 (U. S. 1940). Since the *Le Tulle* decision, however, the Board has extended the *Kitselman* doctrine to include the acquisition of the assets by the holders of unsecured notes of the insolvent corporation. *Alabama Asphaltic Limestone Co.*, 41 B.T.A. No. 51 (1940) (seven members dissented).

over the bid price, however, they will often be able to manipulate the tax consequences to their satisfaction.¹²⁷ Judicial overruling of the *Kitselman* doctrine should therefore be accompanied by a legislative correction of the tax difficulties now presented in the case of foreclosures. Such legislative solution should be along the lines (at least in the cases which could otherwise be brought under the Bankruptcy Act) of providing a basis of fair market value for the assets to be held by the new corporation and of giving the bondholders a deduction for their losses at the time of foreclosure.

Even if the non-Bankruptcy Act transactions involving insolvent corporations which do not properly come within the tax-free exchange provisions are thus treated in conformity with the transactions governed by the Bankruptcy Act, many reorganizations of insolvent corporations may still be carried out so that the tax-free exchange sections are applicable — *e.g.*, statutory mergers or consolidations. The new corporation will thus obtain the old corporation's high basis for the transferred assets. Any tax on the cancellation of indebtedness may be avoided by the old corporation's exercising the option afforded by Section 22(b)(9) and by having the cancellation occur in such a way that only the basis of assets, if any, retained by the old corporation is reduced under Section 113(b)(3). This problem could be sweepingly met by amending the basis provisions applicable to all tax-free exchanges to provide that the transferee's basis shall be either the transferor's basis or the fair market value of the transferred assets at the time of the exchange, whichever is lower. Such an amendment would also prevent the double deduction of losses now made possible through a tax-free exchange.¹²⁸ In the instant situation it would, as respects the basis of the assets, conform tax-free exchange reorganizations of insolvent corporations with other reorganizations both in and out of the Bankruptcy Act.

The restricted scope of Section 215 of the Revenue Act of 1939 raises other problems. While that Section relieves corporations in unsound

127. U. S. Treas. Reg. 103, § 19.23(k)-3 provides that if mortgaged property is sold to the creditor for less than the amount of the debt, and the creditor charges off the portion of the indebtedness remaining unsatisfied as uncollectible, he may deduct such amount as a bad debt. Loss or gain is measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property and the fair market value of the property. The fair market value of the property is presumed to be the bid price, and such value becomes the creditor's basis for the property. See Paul, *Federal Income Tax Problems of Mortgagors and Mortgagees* (1939) 48 YALE L. J. 1315, 1325 *et seq.*

128. *E.g.*, *W. & K. Holding Corp.*, 38 B.T.A. 830 (1938). By limiting the transferee's basis down to the transferor's basis and the consequent possible double tax on the gain are necessary to insure a single tax on the gain. The parties can generally avoid a second tax. But as the parties could always secure the double deduction, there is no force to the argument that both gain and loss be treated alike, and it is therefore fair to permit only the transferor to obtain the loss deduction.

financial condition, it leaves all other taxpayers subject to the prior provisions of the Internal Revenue Code. There is no justification for confining that relief to corporate taxpayers. Every argument advanced in support of the amendments made by the Revenue Act of 1939 can be made on behalf of individuals and other non-corporate taxpayers.¹²⁹ While it may be contended that the realization of income should not be affected by the debtor's general financial condition, there is a strong emotional pull toward either the net assets theory of the Board or the entire non-realization of income where the debtor is insolvent or financially embarrassed. To press a tax upon the debtor under such conditions is to work an obvious hardship. If Congress refuses to grant statutory relief through a postponement of tax, the courts may afford the needed relief by judicial construction of the term "income" in the Revenue Acts, and perhaps in the Sixteenth Amendment. As this may involve either a distortion of statutory provisions or a restriction on the scope of the taxing power, it is preferable that Congress deal with the situation through ameliorative legislation.

The new provisions added by the 1939 Act should therefore be extended to all taxpayers in an unsound financial condition. They should likewise be applied to all forms of indebtedness. The Commissioner, in addition, should exercise his discretion to prevent the reduction in basis provided for in Section 113(b)(3) from bringing the basis below fair market value, in order to avert any hardship on this score. Fair market value might be made a floor by statute. Such further amendments, or the Committee Reports accompanying them, should state that the debtor's financial condition is not material to the question of the realization of income or its amount, so that the Congressional desire to obtain a *quid pro quo* through reduction of basis may be accomplished.¹³⁰ While the new provisions in the 1939 Act were on adoption thought to be experimental and were limited largely to discharges occurring in the latter part of 1939, and in 1940-1942, it seems clear that there will be no turning back of the clock with respect to the granting of relief in these situations. It is therefore desirable to make them all-inclusive for such years,

129. While problems presented by the reduction in basis may be more difficult in the case of individuals, they may safely be left to the Commissioner's discretion.

130. Alternatively, the "income" realized on a cancellation could be made non-recognizable and basis required to be reduced (but not below fair market value) in all cases by the amount cancelled, except where a gift or a contribution to capital is present. This eliminates the option and carries over the Bankruptcy Act approach. Either suggestion would eliminate many questions as to the "income" realized on a cancellation. The mandatory reduction in basis seems constitutional in the case of a corporation, where the debt was presumably incurred in the business and the reduced cost occasioned by the cancellation can be reflected in a reduced basis. Difficult cases presented by individual and other taxpayers where the debt is not related to the cost of an asset or a business can be avoided by a sensible exercise of the Commissioner's discretion.

and then to determine on the basis of experience what further modifications are necessary before the provisions are made permanent.

These suggested solutions regarding the tax consequences of a cancellation of indebtedness are far from complete. But enough has been said to support the proposition that this problem is as pressing as any now facing us under the income tax. Piecemeal attempts by Congress and the courts have brought taxpayers some relief, but the relief has been balanced by the confusion and uncertainties these efforts have created. The stage is now set for a thoroughgoing statutory solution.