Note

Zarin v. Commissioner: The Continuing Validity of Case Law Exceptions to Discharge of Indebtedness Income

I. INTRODUCTION

"Income from discharge of indebtedness" is included among the enumerated sources of gross income in section 61 of the Internal Revenue Code.[1] The basic concept of this rule is simple: If a debtor borrows a sum of money and the loan is forgiven by the creditor prior to repayment, the amount borrowed which is not repaid is considered income to the debtor.

United States v. Kirby Lumber,[2] considered the seminal case on the issue, illustrates the concept. In 1923, the Kirby Lumber Company issued $12,126,800 worth of bonds at par value.[3] The bonds may be thought of as loans to the company because they represented a debt for which Kirby Lumber was responsible. Later that year, after the bonds' value had fallen, the company repurchased a number of the same bonds in the open market at a savings of $137,521.30 below the issue price.[4] This savings may be likened to a situation in which a creditor forgives that amount on repayment of a debt. That was essentially the view of the Supreme Court in holding that the savings represented a gain, and therefore income, to Kirby

1. I.R.C. § 61(a)(12) (West Supp. 1991).
2. 284 U.S. 1 (1931).
3. *Id.* at 2.
4. *Id.*

Lumber.[5] As the facts of *Kirby Lumber* demonstrate, however, cancellation of indebtedness issues may transcend the simple debtor-creditor relationship into far more complex transactions. The deciding factor for the *Kirby Lumber* court in such transactions was whether assets were freed as a result.[6] Like many rules, the determination that discharged debt represents a taxable gain is one that is rife with exceptions. Several are codified in section 108 of the Internal Revenue Code (IRC).[7] This provision elaborates on section 61(a)(12) and gives a statutory definition of discharge of indebtedness income.[8] There are a number of case law exceptions as well.[9] *Kirby Lumber* reserved an exception even as it enunciated the rule.[10] It preserved the "diminution of loss theory" from the earlier case of *Bowers v. Kerbaugh-Empire Co.*,[11] which held that discharged debt was not income if "[t]he result of the whole transaction was a loss."[12] Other case law exceptions include the "contested liability doctrine" of *N. Sobel v. Commissioner*,[13] which held that income would not be imputed on discharged debt except where a fixed amount is acknowledged between the parties. Also, the suggestion of

---

5. *Id.* at 3.

6. *Id.*

7. *See, e.g.*, I.R.C. § 108(a)(1)(A) (West Supp. 1991) (discharge in a title 11 case); § 108(a)(1)(B) (discharge when taxpayer is insolvent); § 108(a)(1)(C) (qualified farm indebtedness); § 108(e)(5) (purchase money price reduction); § 108(e)(6) (indebtedness contributed to capital); § 108(f)(special rules for discharge of certain student loans).

8. I.R.C. § 108(d)(1) (West Supp. 1991). This provision defines the requisite indebtedness as that for which the taxpayer is either liable or subject to the creditor for property held. *See also infra* note 85.

9. *See* Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber, 66 CALIF. L. REV. 1159 (1978). This article is a critique of the case law exceptions and gives a good overview, citing numerous cases.

10. United States v. Kirby Lumber, 284 U.S. 1, 3 (1931). The *Kirby* court, in ruling that discharged debt is income, distinguished the earlier *Kerbaugh-Empire* case.

11. 271 U.S. 170, 175 (1926).

12. *Id.* The taxpayer in *Kerbaugh-Empire* borrowed money from a German bank, prior to World War I, which was repayable in German Marks. *Id.* at 172. Because of the postwar inflation, the loan was satisfied by a much smaller amount of money than its initial value represented. *Id.* at 173. Because the taxpayer had lost the original loan in a business venture, however, the Supreme Court held that the difference in the amount repaid was not taxable. *Id.* at 175. This has come to be known as the "diminution of loss theory" with regard to discharge of indebtedness income. *See* Bittker & Thompson, *supra* note 9, at 1161.

13. 40 B.T.A. 1263, 1265 (1939). In *Sobel*, the taxpayer, a New York fur dealer, was pressured into buying 100 shares of stock from its bank. *Id.* at 1263-64. Since the stock was issued on the dealer's good credit, it was not yet paid for when the bank failed in the Great Depression. *Id.* The taxpayer refused to pay and immediately sued for rescission of the purchase contract when the note on the stock became due. *Id.* Settlement for half the amount due was finally reached five years later. The Supreme Court held that the amount of the debt, because of the dispute, was not determined until it was fixed by the settlement. *Id.* at 1265. Under this reasoning, the amount of the debt that was forgiven was too nebulous for a finding of cancellation of indebtedness income. *Id.*

United States v. Hall[14] was that the enforceability of a debt will weigh heavily in the determination of whether its cancellation results in income.[15]

These case law exceptions to the *Kirby Lumber* rule, and the statutory exceptions of section 108, have been the object of scholarly criticism asserting that their results are unfair or anomalous in contrast to the general theory of cancellation of indebtedness income.[16] The *Kerbaugh-Empire* case, which is to some extent the progenitor of these exceptions, has been criticized as having been severely limited or invalidated by subsequent decisions.[17]

The United States Court of Appeal for the Third Circuit, in *Zarin v. Commissioner*,[18] recently had the opportunity to consider each of these exceptions to the general rule, as well as their continuing validity. This Note will demonstrate that the court's reasoning assures both that its decision will have implications well beyond the facts of the case, and that the exceptions represented by *Kerbaugh-Empire*, *Hall* and *Sobel* are both reinforced and expanded.

By relying on these exceptions, rather than summarily disposing of the issues through statutory interpretation, the law of the cases is reinforced. The Third Circuit, in *Zarin*, treated the *Hall* court's emphasis on enforceability, the *Sobel* court's concern with liquidity, and the *Kerbaugh-Empire* court's focus on the net effect of the transaction as considerations, rather than rigid rules, in determining whether any debt which appears to be settled for less than value received represents a contested liability or income. The result is a more flexible approach to such issues which reaches beyond the facts of the case and should contribute to more rational decisions in the area of debt cancellation income.

---

14. 307 F.2d 238 (10th Cir. 1962).
15. *Id.* at 241-42.
16. Bittker & Thompson, *supra* note 9, at 1160. The basic premise of the article is that exceptions to the rule should not be recognized because the taxpayer has always received something of value tax free in such situations. *Id.* Other concerns are unfair tax benefit problems when business loans are cancelled, spurious cancellations of indebtedness which should be treated as earned income, and non-recourse indebtedness problems arising from secured real estate transactions. *Id.*
17. Vukasovich, Inc. v. Commissioner, 790 F.2d 1409, 1414-15 (9th Cir. 1986). For an explanation of this court's reasoning, see *infra* note 50.
18. 916 F.2d 110 (3d Cir. 1990).

II. FACTS OF THE CASE

David Zarin was a welcome patron at Resorts International in Atlantic City, New Jersey during 1978 and 1979. He had complimentary use of a luxury three-room suite, free meals, entertainment, and access to a twenty-four hour limousine.[19] This is not surprising, however, since he gambled and lost $ 2.5 million dollars on crap games at the resorts during that period and all of those debts were paid in full.[20]

One might be inclined to forgive the management of the resorts for less than strict attention to credit verification procedures for such a reliable customer. However, the State of New Jersey has strict requirements which must be met before extending credit to gambling patrons. The neglect of these brought the resorts under the scrutiny of the New Jersey Casino Control Commissioner.[21] In October of 1979, in response to allegations of 809 violations of the credit laws, 100 of which pertained to Zarin, the Commissioner issued an order which made further extension of credit illegal.[22] Apparently, the prospect of the $130,000 fine, which was ultimately levied against the resorts, was not enough to prevent them from continuing to extend credit to a millionaire compulsive gambler who paid his bills.[23] As Zarin gambled twelve to sixteen hours per day, seven days per week, between January and April 1980, the casino continued to feed him chips in exchange for negotiable drafts known as "markers."[24] The markers were payable to Resorts and drawn on Zarin's bank account.[25] Zarin lost track of how much he was betting and assumed he had no credit limit.[26]

When $3,435,000 in personal checks and markers bounced in April 1980, Zarin initially promised to make good on the loans.[27] When he had not done so by November, Resorts filed suit in New Jersey State Court.[28] In March 1981, Zarin filed an answer denying

19. Zarin v. Commissioner, 92 T.C. 1084, 1085-88 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990) (This is the opinion of the Tax Court which gave a more detailed account of the facts).

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* at 1087.

24. *Id.* at 1086-87. Markers are essentially checks, payable to the casino and drawn on the bank of the individual gambler. *Id.* In Zarin's case, the markers made no reference to chips, but did state that cash was received. *Id.*

25. *Id.*

26. *Id.* at 1087-88.

27. *Id.* at 1088. The situation was probably allowed to deteriorate to the extent that it did because of Zarin's agreement with the credit manager of Resorts to hold his markers for the maximum statutorily allowable period of 90 days. *Id.* at 1086. This, in effect, was the extension of credit that had been prohibited by the New Jersey Casino Control Commissioner, thus rendering the debt illegal and unenforceable.

28. *Id.* at 1088.

the allegations.[29] In September of that year the suit was settled for $500,000.[30] The Internal Revenue Service determined a tax deficiency in discharge of indebtedness income based on the $2,935,000 difference between the $3,435,000 lost and the $500,000 settlement.[31]

III. CONFUSION IN THE TAX COURT BELOW

The decision of the U.S. Tax Court judges was split eleven to eight with four separate opinions.[32] The majority, which was later reversed on appeal, rejected the validity of the *Kerbaugh-Empire* "diminution of loss" reasoning and raised a policy concern regarding enforceability.[33] One dissent was substantially adopted as the basis of the Third Circuit's opinion on appeal.[34] The other two dissents articulated cogent statutory arguments which, but for perhaps unstated policy reasons, might just as well have resolved the issues on appeal.[35] The disparity among the Tax Court opinions contrasted against that of the appeals court demonstrates the complexity of discharge of indebtedness issues and the resulting confusion among courts as to what exceptions are valid and when to apply them.[36]

A. The Tax Court Majority

Zarin argued that the facts of his case fell under four exceptions to IRC sections 108 and 61(a)(12): first, the principal derived from *Hall* that a taxpayer suffering a substantial loss from an unenforceable gambling debt was not required to recognize income from its discharge;[37] second, the disputed liability doctrine of *Sobel*;[38] third, a section 165(d) limitation on the wagering losses argument;[39] and finally, a purchase price reduction argument under section 108(e)(5).[40] The majority was the only opinion of the Tax Court to

29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at 1084.
33. *Id.* at 1093-94.
34. *Id.* at 1100-04 (Tannenwald, J., dissenting).
35. *Id.* at 1105-16 (Jacobs, J. and Ruwe, J., dissenting).
36. *See* Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959).
37. *Zarin*, 92 T.C. at 1090.
38. *Id.* at 1095.
39. *Id.* at 1096.
40. *Id.* at 1090.

address all four issues. It denied the applicability of any of these exceptions and found a tax liability on $2,935,000 of income.[41]

1. The Hall *Argument*

United States v. Hall was the only case presented by the parties with facts similar to *Zarin*.[42] In that Tenth Circuit opinion, the court found that the transfer of $148,110 worth of cattle, in settlement of a Las Vegas gambling debt of $225,000, resulted in only slightly more than $1,000 in debt cancellation income.[43] The cancellation amounted to $1,000 because the parties had fixed the debt at $150,000 just prior to the transfer.[44]

The *Hall* court relied on both the unenforceable nature of the debt and the reasoning of *Kerbaugh-Empire*.[45] Because gambling debts are unenforceable, the *Hall* court found, they do "not meet the requirements of debt necessary to justify the mechanical operation of general rules of tax law relating to cancellation of debt."[46] Citing *Kerbaugh-Empire*, the court stated that it was unnecessary to "apply mechanical standards which smother the reality of a particular transaction."[47] The *Hall* court acknowledged that the validity of *Kerbaugh-Empire* had been questioned, but maintained that it survived *Kirby Lumber* nonetheless.[48] *Hall* did not stand for the proposition that unenforceable gambling debts which were settled would per se deny a finding of cancellation of indebtedness income, but rather, the court indicated that it would accord enforceability of the debt great weight in an analysis of the entire transaction at issue.[49]

The Tax Court majority in *Zarin* only briefly addressed the enforceability aspect of the *Hall* decision. Although the Tax Court entitled that portion of its opinion "Enforceability," it focused instead on cases which hold that the principles of *Kerbaugh-Empire* have been rejected, though not overruled, by the Supreme Court.[50] This

41. *Id.* at 1100.
42. Zarin v. Commissioner, 916 F.2d 110, 115 (3d Cir. 1990).
43. United States v. Hall, 307 F.2d 238, 240 (10th Cir. 1962).
44. *Id.*
45. *Id.* at 241.
46. *Id.*
47. *Id.*
48. *Id.* at 242.
49. *Id.*
50. *Zarin*, 92 T.C. at 1091-95. The Tax Court acknowledged that *Kerbaugh-Empire* was not specifically overruled and relied on the reasoning of Vukasovich, Inc. v. Commissioner, 790 F.2d 1409 (9th Cir. 1986), and Bittker & Thompson, *supra* note 9. Two of the cases relied on by *Vukasovich* as discrediting *Kerbaugh-Empire* are dubious authority for such a premise: Neither Commissioner v. Tufts, 461 U.S. 300 (1983), nor Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955), made any mention of *Kerbaugh-Empire*. The former case held that non-recourse indebtedness secured by real estate is includable in basis regardless of the value of the property, *Tufts*, 461 U.S. at 317, while the latter expanded the definition of income to include "undeniable accessions to wealth,

portion of the majority's opinion did, however, voice a concern that unless David Zarin was found to have received debt cancellation income, a "symmetry" problem would result.[51] There were two aspects to this problem with which the majority was concerned. First, that Zarin's receipt of chips and an "opportunity to gamble" worth $2,935,000 in value, tax free in one year because it was a loan, should not continue to be characterized as tax free when the loan was forgiven in another year.[52] The second concern was that, because enforceability of the loan had no effect on the recognition of the debt as income to the casino, it should not be used to affect a non-recognition of income to Zarin.[53] This was the only policy rationale put forth for the majority's decision.

2. *The Disputed Debt Argument*

Having articulated the policy concern, the Tax Court majority proceeded to dispose of the remaining issues in a summary technical fashion. Because there was a stipulation between the parties as to the original amount of the debt, the court distinguished both *Hall* and *Sobel*.[54] The debt in *Hall*, it claimed, was unliquidated, whereas the

---

clearly realized," *Glenshaw Glass*, 348 U.S. at 431. Both cases expanded the concept that clearly realized gains should be taxed in all circumstances. The *Kerbaugh-Empire* court held that there was only a loss resulting from the transactions in issue and, therefore, appears to be a clearly distinguishable case. 271 U.S. at 175. The *Vukasovich* court also cited *Kirby* for the proposition that *Kerbaugh-Empire* was no longer good law. *Vukasovich*, 790 F.2d at 1414-15. This seems strained in light of the fact that *Kirby* specifically upheld the rule of *Kerbaugh-Empire*.

51. Zarin v. Commissioner, 92 T.C. 1084, 1092. This is not "tax symmetry" in the sense of a congressionally or otherwise mandated balance between two taxpayers. Here the court used the word "symmetry" to denote the concern of the cancellation of indebtedness issue in general, that Zarin should be taxed on that value which he received tax free in 1980 if the loan was forgiven in 1981. *Id.*

52. *Id.*

53. *Id.* at 1093. The Tax Court majority seems to be focusing solely on the enforceability issue here, *but cf.* Sheppard, *News Analysis, A Gambling Exception to Cancellation of Indebtedness Income?*, 49 TAX NOTES 1516, 1517 (Dec. 1990). Sheppard cites Flamingo Resort Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982), relied on by the tax court in this portion of its *Zarin* opinion, to assert that the rule of that case requiring an accrual method taxpayer (presumably Resorts International in the instant case) to take the debt as income somehow allowed an improper loss deduction to Resorts from the settlement because Zarin paid no corresponding tax. Sheppard, *supra*, at 1516-17. This assessment seems difficult to justify in the absence of a congressional or other mandate for tax symmetry in the particular situation. If Resorts claimed the debt as income in 1980, then they were taxed in that year and it would be proper for them to claim a deduction for the bad debt loss which resulted from the settlement in 1981. *See also* I.R.C. §166 (West Supp. 1991).

54. *Zarin*, 92 T.C. at 1095.

Zarin debt was for a fixed amount.[55] Because the court believed that Zarin received full value for that amount, and *Sobel* required that discharge of liquidated debts be recognized as income,[56] the disputed liability argument was rejected.[57]

3. *The IRC Section 165(d) Argument*

IRC Section 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."[58] Zarin claimed that because he had lost $3,435,000 gambling, he should have been allowed to offset it against the $2,935,000 in cancellation of indebtedness income which the Commissioner claimed he had gained through his gambling transactions.[59] Such a result would have resolved the issue without much analysis of the discharge of indebtedness question. However, the majority relied on section 1.165-10 of the Treasury Regulations to deny this exception. That section states that wagering losses "shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions."[60] Because the gambling losses were incurred in 1980, and Zarin settled the debt in 1981, this interpretation of the regulation operated to deny a deduction of the losses against the gain which the court found from the discharge of debt.

4. *The Purchase Money Debt Reduction Argument*

Section 108(e)(5) of the Code provides that, under certain conditions, a purchase money debt reduction between the purchaser and seller of property will be treated as a price reduction rather than as a taxable event.[61] The majority had to struggle at some length to

---

55. *Id.* This characterization of the *Hall* facts is not entirely correct. The debt was determined by the jury in *Hall* to have been liquidated by the settlement amount. *Hall*, 307 F.2d at 240. The actual gambling debt incurred by the taxpayer was agreed to be at least $75,000 above the $150,000 settlement. *Id.* at 239.

56. *Sobel*, 40 B.T.A. at 1265.

57. *Zarin*, 92 T.C. at 1096.

58. I.R.C. § 165(d) (West Supp. 1991).

59. *Zarin*, 92 T.C. at 1090.

60. Treas. Reg. § 1.165-10 (1990).

61. I.R.C. §108(e)(5) (West Supp. 1991):

(5) PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION. -If-

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur -

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.

The Tax Court elaborated on the requirements of this exception as follows:

overcome the existence of a stipulation between the parties that the chips were property and Zarin's claim that what he had purchased with the money was an "opportunity to gamble."[62] The court dismissed the stipulation as overemphasizing the significance of the chips.[63] While it agreed that the "opportunity to gamble" was property, it determined that this was intangible property and "not useful, however, in deciding whether what petitioner received is within the contemplation of the section."[64]

B. The Tannenwald Dissent

One other judge joined in this opinion which, with some exceptions, was substantially the same as that of the court of appeal majority. Unlike the Third Circuit's opinion, however, this opinion did not include an application of *Kerbaugh-Empire* in the analysis. Focusing on the enforceability of the debt, Judge Tannenwald addressed the policy concerns of the majority by citing the *Flamingo*

For a reduction in the amount of a debt to be treated as a purchase price adjustment under section 108(e)(5), the following conditions must be met: (1) The debt must be that of a purchaser of property to the seller which arose out of the purchase of such property; (2) the taxpayer must be solvent and not in bankruptcy when the debt reduction occurs; and (3) except for section 108(e)(5), the debt reduction would otherwise have resulted in discharge of indebtedness income. Sec. 108(e)(5); 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts, 6-40 to 6-41 (2d ed. 1989); see also *Sutphin v. United States*, 14 Cl. Ct. 545, 549 (1988); *Juister v. Commissioner*, T.C. Mem. 1987-292; *DiLaura v. Commissioner*, T.C. Mem. 1987-291.

In addition to the literal statutory requirements, the legislative history indicates that section 108(e)(5) was intended to apply only if the following requirements are also met: (a) The price reduction must result from an agreement between the purchaser and the seller and not, for example, from a discharge as a result of the bar of the statute of limitations on enforcement of the obligation; (b) there has been no transfer of the debt by the seller to a third party; and (c) there has been no transfer of the purchased property from the purchaser to a third party. S. Rept. 96-1035 (1980), 1980-2 C.B. 620, 628 1 B. Bittker & L. Lokken, *supra* at 6-40 - 6-41.

Arin, 92 T.C. at 1097-98.

62. *Zarin*, 92 T.C. at 1099.

The "opportunity to gamble" would not in the usual sense of the words be "property" transferred from a seller to a purchaser. The terminology used in § 108(e)(5) is readily understood with respect to tangible property and may apply to some types of intangibles. Abstract concepts of property are not useful, however, in deciding whether what petitioner received is within the contemplation of the section.

Id. at 1099-1100.

63. *Id.*

64. *Id.* at 1100.

Resorts case.[65] The majority had relied on that case to hold that, since lack of enforceability did not affect accrual by the creditor of income from the debt, then that fact should not affect accrual of income to the debtor when there is a discharge for less than face value.[66] Tannenwald maintained that the *Flamingo Resorts* rule depended on a "reasonable expectancy" of collection for the creditor to claim it as income and, therefore, in a case such as *Zarin*, where there was no such expectancy, neither party should regard the debt as income.[67] Because there was no such expectancy, the majority's assertion that the debt had been liquidated prior to the settlement, thus obviating the disputed liability doctrine of *Sobel*, was negated.[68]

Judge Tannenwald pointed out that the majority's opinion "that petitioner received his money's worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger his increase in wealth."[69]

C. *The Jacobs Dissent*

Judge Jacobs' dissent was based on the gambling loss argument under section 165(d). Acknowledging the limitations of the regulations, his dissent emphasized the definition of the phrase "gain from a wagering transaction."[70] Because, as the majority conceded, there is nothing in the regulations or the statute defining this phrase, Judge Jacobs included Zarin's loans within that ambit. Reasoning that the chips were a form of income that would not have been realized but for the gambling transactions within which the losses occurred, he would have allowed a deduction to offset those gains in the same year.[71]

D. *The Ruwe Dissent*

A total of five justices joined in what is, from a purely technical standpoint, probably the best legal argument applied to the *Zarin* facts.[72] Ruwe perceived the question as a simple section 108(e)(5)

65. *Id.* at 1102-03 (citing Flamingo Resorts, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982)).
66. *Id.* at 1095.
67. *Id.* at 1102-03.
68. *Id.* at 1101.
69. *Id.*
70. *Id.* at 1106.
71. *Id.*
72. *Id.* at 1107. It is difficult to challenge this dissent as being anything other than a correct statutory interpretation of § 108(e)(5). There are, however, sound policy considerations, explored in the analysis of the Third Circuit opinion, for not applying the argument.

purchase price reduction issue.[73] Even the Tax Court majority acknowledged that all the elements were present if what Zarin received could be defined as property within the meaning of the statute.[74] Like the majority, he concentrated both on the stipulation that the chips were property and the claim that an "opportunity to gamble" had been purchased. Establishing first that, unlike the contention of the Tax Court majority, the statute in no way limited the type of property to which it applied, the opinion then proceeded to define "property."[75] Analyzing the chips as representative of a promise to provide a gambling opportunity, Ruwe analogized to "valuable and assignable contract right[s]" such as licenses and options.[76]

Responding to the majority's argument that the chips were merely "a credit balance reflecting the obligation of the casino,"[77] Ruwe analogized them to corporate debt. "A corporate bond represents an obligation of the corporation, but surely no one would deny that the bond is property."[78]

Finally, the dissent drew on Supreme Court authority to demonstrate the breadth of the term:

> "Property" is more than just the physical thing - the land, the bricks, the mortar - it is also the sum of all the rights and powers incident to ownership of the physical thing. It is the tangible and the intangible. Property is composed of constituent elements and of these elements the right to use the physical thing to the exclusion of others is the most essential and beneficial.[79]

It seems clear that if David Zarin received nothing else with the chips, he received the right to use them to the exclusion of others.

This definition of property does not stem from a tax case, however, and the narrower policy goals of section 108(e)(5) would seem to be the appropriate analysis for *Zarin*. There are no regulations on the section, and there seems to be a dearth of legislative history.[80] The

---

73. *Id.*
74. *Id.* at 1099.
75. *Id.* at 1108-09.
76. *Id.* at 1109-10.
77. *Id.* at 1100.
78. *Id.* at 1112 n.3.
79. *Id.* at 1110-11 (citing Dickman v. Commissioner, 465 U.S. 330, 336 (1984); Passailaigue v. United States, 224 F. Supp. 682, 686 (M.D. Ga. 1963)) (emphasis in original).
80. *See* H.R. REP. No. 794, 97th Cong., 2d Sess. (1980). Consideration of the bill may be found for the House in the Congressional Record, May 24 and December 13, 1980, for the Senate on December 13, 1980.

case law prior to the addition of the section supports a strong argument that the language "purchase-money debt reduction" is intended to refer to physical property secured by a mortgage.[81] There is case law, however, to support the inclusion of such intangible property as securities[82] and, by way of example, in the context of another area of the tax code, the Third Circuit has included accounts receivable while enunciating a very broad definition of property.[83]

IV. The Third Circuit's Approach on Appeal

Because a section 108(a)(1)(B) issue was raised after the Tax Court's decision was rendered, the appellate court need not have addressed any of the arguments presented in that case.[84] The Third Circuit's decision to analyze the case without applying either of the possible statutory arguments, and the strained reasoning which it applied to avoid them, resulted in a holding which reached beyond the facts of the case while it expanded and reinforced the case law exceptions represented by *Kerbaugh-Empire*, *Sobel*, and *Hall*.

A. Substance of the Opinion

The court first held that the facts of the case were not controlled by the Code definition of cancellation of indebtedness income. Section 108(d)(1) defines such income as deriving from debts for which the taxpayer is either liable or holds property.[85] The court determined that Zarin was not liable because the debt was unen-

---

81. Eustice, *supra* note 36, at 244-46 (1959). Eustice cites Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940), as one of a series of paradigm cases for the concept that the adjustment of purchase price exception to debt cancellation income developed to resolve situations where property secured by a debt devalued below the amount of the loan. *Hirsch*, and a number of other cases cited by Eustice, involved real property secured by a mortgage.

82. Nutter v. Commissioner, 7 T.C. 480 (1946). This case involved the taxpayer debtor transferring worthless securities to the creditor in satisfaction of the loan. Eustice cites this case as an application of the adjustment to purchase price theory. Eustice, *supra* note 36, at 245 n.67.

83. Hempt Bros. v. United States, 490 F.2d 1172 (3d Cir. 1974).

84. *Zarin*, 916 F.2d at 112 n.6. Zarin filed a motion subsequent to the Tax Court's decision claiming that he had been insolvent at the time of the discharge and therefore exempt from cancellation of debt income under I.R.C. § 108(a)(1)(B). The Tax Court denied this motion and the Court of Appeal refused to rule on whether the denial was an abuse of discretion. *Id.*

85. I.R.C. § 108(d)(1) (West Supp. 1991):

(d) MEANING OF TERMS; SPECIAL RULES RELATING TO SUBSECTIONS (a), (b), and (g). -

(1) INDEBTEDNESS OF TAXPAYER. - For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness-

(a) for which the taxpayer is liable, or

(b) subject to which the taxpayer holds property.

Because the application of this subsection is specifically limited to subsections (a), (b),

forceable.[86]

Because the appellate court found that neither the chips nor the "opportunity to gamble" were property, the possibility of applying a purchase price reduction argument was foreclosed.[87] By reversing the Tax Court and applying the disputed liability doctrine,[88] the court reached the same net result as if it had characterized the chips as property: Zarin was not taxed on the transaction. Enforceability was not the sole determinant in the reasoning of whether income was created by the settlement of the debt.[89]

The court relied on both the *Sobel* disputed liability doctrine and the "net effect of the transaction" reasoning which *Hall* derived from *Kerbaugh-Empire*. It further rejected the Tax Court's contention that the disputed liability doctrine required an unliquidated debt in order for that exception to apply.[90]

B. Analysis

The statutory arguments of the Tax Court dissents were perhaps better written than, and certainly not incompatible with, the case law analysis that the court of appeal actually applied. Had the court found that the chips did constitute property, it would have been difficult to reject the Ruwe dissent which advocated the purchase price reduction argument. Such a result would not have precluded a simultaneous application of the contested liability doctrine.[91]

In light of the succinctly reasoned Ruwe's dissent in the court below, the Third Circuit's characterization of the chips as something other than property appears strained and convoluted. It is also inconsistent with the Tax Court majority opinion that "[t]he property argument simply overemphasizes the significance of the chips."[92]

Unable to ignore the issue of the chips, because of the stipulation that they were property, the court cited a New Jersey statute which asserted that gaming chips were considered "solely as evidence of a

---

and (g), the Third Circuit's application of it to § 108(e)(5) appears questionable.

86. *Zarin*, 916 F.2d at 113.

87. *Id.*

88. *Sobel*, 40 B.T.A. at 1265.

89. *Zarin*, 916 F.2d at 116-17 n.12.

90. *Id.* at 116.

91. *Sobel*, 40 B.T.A. at 1263. *Sobel* involved the disputed liability on a purchase-money loan for stock.

92. *Zarin*, 92 T.C. at 1099.

debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them."[93] Since "Zarin could not do with the chips as he pleased," he had no interest in them other than as an accounting mechanism.[94] Using this same reasoning, the court reached the incongruous conclusion that once the casino relinquished the chips to Zarin they ceased to be property at all.[95]

This reasoning seems difficult to justify in light of Ruwe's characterization of the chips as, like corporate bonds, evidence of valuable property rights, regardless of how the instrument itself is construed. It also ignores the Supreme Court's definition of property in which "the right to use the physical thing to the exclusion of others is the most essential and beneficial."[96] Although the narrower policy definition of property for section 108(e)(5) purposes is not entirely clear, if the broader definition of such cases as *Nutter* and *Hempt Bros.* is accepted, it seems a logical fallacy to argue that the chips ceased to be property when they entered Zarin's hands, in spite of the fact that they evidenced his debt and his exclusive right to use them for whatever they might be negotiable for.[97]

The appellate court's reluctance in *Zarin* to dispose of the case by simply either acknowledging Zarin's insolvency or accepting one of the statutory arguments from the Tax Court dissents suggests a rejection of the broad view. Though no policy motive was articulated in the case, it may be extrapolated that application of the statutory arguments would have had different legal ramifications.

Had either of the statutory arguments been applied separately, or both together, the decision would be more closely limited to the gambling sphere and the facts of the case. However, such an approach might also be considered to have negative policy implications. Allowing Zarin to deduct all of his losses for 1980 against gains which were arguably not realized until 1981 might violate the spirit of Treasury Regulation section 1.165-10. Characterizing all gaming chips as property, representing an opportunity to gamble without regard to enforceability, could be an open invitation to gamblers with

93. *Zarin*, 916 F.2d at 114.
94. *Id.*
95. *Id.*
96. *See supra* note 79 and accompanying text.
97. *Zarin*, 916 F.2d at 114. The court went into an extensive analysis of what Zarin could *not* do with the chips in order to avoid defining them as property. This included a determination that Zarin could not have used them outside the casino, the management would not have allowed him to cash them in while he still had outstanding markers, and he would not have purchased food or entertainment with them since those services were provided free of charge. *Id.* Two relevant property-like uses were overlooked by the court: It was likely that he could have discounted the chips to another patron of the casino and thereby received cash; or he could have returned them to the casino to satisfy the debt.

legitimate lines of credit to bargain down debts when they lose. These considerations could have accounted for the Third Circuit's reluctance to apply these arguments in conjunction with the case law-based approach it ultimately took.

C. *Implications*

The effect of the solution which the court did apply is to both reinforce and expand the case law exceptions derived from *Kerbaugh-Empire*, *Hall*, and *Sobel*. The court claimed not to pass on whether *Kerbaugh-Empire* was good law, but it accepted the proposition which *Hall* drew from that case: that "a court need not in every case be oblivious to the net effect of the entire transaction."[98] Whether the "transaction as a whole was a loss" or a "diminution of loss" seems to be a reasonable consideration for judges in analyzing the "net effect of the entire transaction."[99] In this sense, the principle of *Kerbaugh-Empire* is reinforced.

The "net effect" analysis, in conjunction with enforceability of a debt, appears now to be, at least in the Third Circuit, comprised of factors which are weighed in the determination of whether a good faith challenge has been made to a taxpayer's liability for a debt which otherwise would seem to have been settled for less than the value received. To the extent that unenforceable but liquidated, as well as unliquidated, debt is included within the scope of the contested liability doctrine, that exception to section 61(a)(12) is expanded by the case.[100]

Because the court chose to apply the disputed liability doctrine in conjunction with enforceability and diminution of loss type considerations, the reach of the case is much broader than it would have

98. *Id.* at 116 n.11.

99. *Hall*, 307 F.2d at 241-42; *Kerbaugh-Empire*, 271 U.S. at 175. This is language which *Hall* derived from *Kerbaugh-Empire*.

100. *Zarin*, 916 F.2d at 116. "When a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon is in dispute. Although a debt may be unenforceable, there still could be some value attached to its worth." *Id.* What the court seemed to be allowing was that no liquidations between the parties, short of the final settlement (i.e. Zarin's markers in the amount of $3,435,000), would be recognized when the debt is unenforceable. The court made clear, however, that enforceability was not the sole consideration in the analysis: "Although unenforceability is a factor in our analysis, our decision ultimately hinges upon the determination that the 'disputed debt' rule applied, or alternatively, that chips are not property within the meaning of I.R.C. section 108." *Id.* at 116-17 n.12.

been had the narrower statutory arguments been used. Enforceability, liquidity, and the net effect of the transaction are all considerations which will enter the calculus in a determination of whether any debt which appears to be settled for less than the value received is a contested liability.

Although the strained reasoning used to avoid recognizing the chips as property would seem to indicate such a decision, it is unclear whether the above stated effect is the result of a conscious intent on the part of the court. The court's criticism of case law exceptions to debt cancellation income which evolved from the *Kirby Lumber* case and commentary by Bittker and Thompson points to the misunderstanding, confusion, and the anomalous results of courts attempting to apply them.[101]

Bittker and Thompson criticized any deviation from their maxim: "Debtors who ultimately pay back less than they received enjoy a financial benefit whether the funds are invested successfully, lost in a business venture, spent for food and clothing, or given to charity."[102] Among the many exceptions to this rule which they claimed would create unfair or anomalous results were the diminution of loss theory of *Kerbaugh-Empire* and the disputed liability doctrine from *Sobel*.[103]

This critique asserted that there was no difference to the overall results of either *Kirby Lumber* or *Kerbaugh-Empire*.[104] In *Kerbaugh-Empire*, the taxpayer borrowed money from a German bank before World War I.[105] The loan was repayable in German Marks which, by the time of repayment, had severely depreciated against the U.S. Dollar as a result of the post-war inflation.[106] Although the loan was satisfied by a much smaller amount of money

101. Bittker & Thompson, *supra* note 9, at 1161. *See also supra* note 8. Interestingly, one of the criticisms which this article raises regarding the application of case law exceptions to cancellation of indebtedness income is the problem of confused courts mischaracterizing "spurious debt cancellation income." This involves a characterization of what is really a reimbursement for services, and therefore earned income, as debt cancellation income. Bittker & Thompson, *supra* note 9, at 1174. In *Zarin*, the Tax Court found that "[w]hen petitioner gambled at Resorts, crowds would be attracted to this table by the large amounts he would wager. Gamblers would wager more than they might otherwise because of the excitement caused by the crowds and the amount petitioner was wagering." *Zarin*, 92 T.C. at 1086. That court suggested that by giving Zarin free services and easy access to credit, "Resorts sought to preserve not only petitioner's patronage, but also the attractive power his gambling had on others." *Id.* This suggests the possible issue of whether Resorts forgave the debt in consideration of Zarin's services. Although the question was not raised by the government, if the chips were supplied for services rendered instead of advanced on credit, the issue of enforceability might be obviated.

102. Bittker & Thompson, *supra* note 9, at 1165.

103. *Id.* at 1162-65, 1169.

104. *Id.*

105. *Kerbaugh-Empire*, 271 U.S. at 172.

106. *Id.* at 173.

than its initial value represented, the taxpayer had lost the original loan in a business venture.[107] The Supreme Court elected to consider that "[t]he result of the whole transaction was a loss."[108]

In *Kirby Lumber*, the taxpayer corporation which purchased its outstanding bonds for less than par value was found to have debt cancellation income as a result.[109] The Supreme Court distinguished *Kerbaugh-Empire* as not only involving an overall loss, but a "shrinkage of assets" as well.[110] Bittker and Thompson maintain that a reduction in the value of Kirby Lumber's bonds signified a corresponding reduction in the corporation's assets.[111] Because this reasoning suggests that both *Kirby Lumber* and *Kerbaugh-Empire* resulted in an overall loss to the taxpayer, Bittker and Thompson are unable to reconcile the two holdings.[112]

This reasoning, however, ignores a fundamental principle of the

---

107. *Id.* at 172.
108. *Id.* at 175.
109. *Kirby Lumber*, 284 U.S. at 2-3.
110. *Id.*
111. Bittker & Thompson, *supra* note 9, at 1164.

> If the bonds in *Kirby Lumber* dropped in value because of creditor doubts about the taxpayer's financial stability, there presumably was a decline of at least an equal amount in the value of the taxpayer's business as a going concern. A similar loss of going concern value would result from an increase in the market rate of interest; one of the few reliable stock market phenomena is that an increase in interest rates almost invariably causes stock prices to drop, reflecting a lower present value for the stream of income expected from corporate assets. Whichever of these events accounted for the taxpayer's ability in *Kirby Lumber* to repurchase its bonds at a discount, "the transaction as a whole" was not necessarily any more profitable in *Kirby Lumber* than in *Kerbaugh-Empire.*

Id.

Although this analysis of the effect of the transaction in *Kirby* is correct, it ignores the fact that the underlying assets of the Kirby Lumber company were still part of the "going concern." Since they were not liquidated by the transaction, they still had the potential for future appreciation, and there was no loss for tax purposes. In *Kerbaugh-Empire*, conversely, the taxpayer borrowed money to invest in a business venture, the liquidated losses from which exceeded the debt. *Kerbaugh-Empire*, 271 U.S. at 170. *But cf.* United States Steel Corp. v. United States, 11 Cl. Ct. 375 (1986), where the distinction was made between fluctuations in the value of preferred stock received as consideration for an issue of debentures and the situation where the bonds are sold and repurchased for cash. In Bittker, *Income From the Cancellation of Indebtedness: A Historical Footnote to the* Kirby Lumber Co. *Case*, 4 J. CORP. TAX 124 (1977), Bittker points out that Kirby actually did not issue the bonds for cash, but rather for its own preferred stock with dividend arrearages. This may prove that *Kirby* was wrongly decided in light of the *U.S. Steel* decision, but in the fact situation in which bonds are both issued and repurchased for cash, there is no "overall loss" from the transaction in the sense of *Kerbaugh-Empire.*

112. Bittker & Thompson, *supra* note 9, at 1164.

tax code: It is transactional in nature. In *Kerbaugh-Empire*, the taxpayer could point to a series of transactional events in which the money was lost.[113] Conversely, although Kirby Lumber's assets may truly have depreciated, no taxable event occurred which fixed the value of that loss. The corporation continued to hold the assets which continued to fluctuate and could theoretically have appreciated beyond their original value before they were disposed of. The only taxable transaction which occurred in *Kirby Lumber* was the buy back of bonds for less than par value which freed its assets, the liquidated value of which was yet to be determined by the market.

Bittker and Thompson also criticized the disputed liability doctrine. Their concern is with "[d]ebtors who ultimately pay back less than they received."[114] The premise of the disputed liability doctrine, however, is that the value of what the debtor received is in doubt. This was precisely the analysis of the Third Circuit in *Zarin*.

The Tax Court majority expressed concern that Zarin received something worth $2,935,000 in 1980 for which he paid no taxes, because it was then characterized as a loan.[115] While *Zarin* involved a personal loan, Bittker and Thompson demonstrated how the problem is exacerbated in the context of a business debt.[116] Because the Third Circuit's solution was a determination that the settlement fixed the value of what was received by the taxpayer, it applies to both situations. By focusing on the "net effect of the transaction," rather than strict adherence to the technicalities of liquidity or enforceability, the decision makes for a more flexible rule which should yield more rational results.

V. Conclusion

The complexity of issues involving cancellation of indebtedness income is reflected in the *Zarin* case by the four separate opinions of the Tax Court below and a fifth, wholly different approach, by the Third Circuit majority. These five opinions gave five different legal characterizations to the same set of facts.

A thorough analysis of the transactions might yield further arguments which point out the confusion that has resulted in criticism of such cases. Those courts which have chosen to apply exceptions to

113. *Kirby Lumber*, 284 U.S. 1.

114. Bittker & Thompson, *supra* note 9, at 1165.

115. *Zarin*, 92 T.C. at 1092.

116. Bittker & Thompson, *supra* note 9, at 1163. The article points out that a business which borrows funds and loses them will have a business loss deduction under I.R.C. § 165(a). If the loan is then forgiven under a *Kerbaugh-Empire* rationale, the taxpayer will have realized an untaxed gain which is not realized by the taxpayer who uses her own funds in the transaction.

the rule that discharged debt is income have been criticized for failing to account for problems arising from mischaracterizations of debt cancellation income and a lack of attention to concerns of symmetry between value received and tax paid. This was the concern of the Tax Court in its determination that David Zarin's settlement with Resorts International created income.

The Third Circuit's majority opinion is similar to the Tax Court majority opinion only to the extent that it refused to countenance a statutory exception to the cancellation of indebtedness rule as a solution. The willingness of the appellate court to utilize an exception born out of case law, however, implicitly suggests a continued validity of both the diminution of loss theory of *Kerbaugh-Empire* and the contested liability doctrine of *Sobel.*

Both cases embody recognized, and criticized, exceptions to IRC sections 61(a)(12) and 108 and the *Kirby Lumber* rule. In addition to the *Zarin* majority's reasoning supporting the continued application of the disputed liability exception, the continuing application of a rule derived from *Kerbaugh-Empire* may be justified by distinguishing such fact situations from *Kirby Lumber*, based on the transactional nature of the tax code. The effect of the case is to expand and reinforce these principles. The result is a more flexible approach to disputed liability issues which should engender more rational decisions.

JON D. RIGNEY