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Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation.

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IS COMPROMISE OF A TAX LIABILITY ITSELF TAXABLE? A PROBLEM
OF CIRCULARITY IN THE LOGIC OF TAXATION

Richard C.E. Beck*

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I. INTRODUCTION

In 1992, the Internal Revenue Service (the "Service") instituted a major change in policy with respect to Offer in Compromise (OIC) agreements.¹ The Service now actively encourages taxpayers to settle delinquent accounts and is willing to extinguish tax debts of doubtful collectibility in exchange for partial payment. The new program is designed to reduce the Service's backlog of accounts receivable, to generate immediate revenue not otherwise available, and to afford troubled taxpayers a fresh start. The Service's initiative has been highly successful, and the volume of OIC agreements has skyrocketed.

A technical cloud hangs over the new OIC program, however. In the past, the Service has insisted that discharge of a tax debt through an OIC agreement gives rise to cancellation of indebtedness (COD) income, or to income under the tax benefit rule. Reported case law reflects both theories, but the results are in conflict. In its most recent decision, *Yale Avenue Corp. v. Commissioner*,² the Tax Court upheld an assessment for COD income, albeit indirectly.³ The Service has not indicated any change

¹ Internal Revenue Code § 7122.

² 58 T.C. 1062 (1972).

³ The other three reported cases are: *Eagle Asbestos & Packing Co. v. Commissioner*, 348 F.2d 528 (Ct. Cl. 1965) (cancelled liability for accrued deductions on tax debt did not give rise to income under tax benefit rule because intent of parties to OIC agreement was to

in its position since *Yale Avenue*. If OIC relief is taxable, the goals of the new program would be frustrated and the program itself endangered. It would be futile for the Service to impose a second uncollectible tax as the price for relief from the first. Moreover, from the taxpayer's perspective the new tax debt would contradict the promise of a fresh start.

This article offers two reasons why an OIC agreement should not create income. The first reason derives from the principle that COD income cannot arise unless the debtor received loan proceeds in the form of money, goods, or services. Because taxpayers ordinarily do not receive any identifiable proceeds in exchange for incurring a tax debt, no income can arise upon its forgiveness. This explanation does not cover all situations, however, because the taxpayer may have assumed the tax debt as a condition of acquiring property,⁴ or the tax benefit rule may apply to accrued interest.⁵

The second reason why OIC relief should not be taxed is that it would lead to absurd results which neither Congress nor the parties to the agreement could have intended.⁶ The paradoxical effect of taxing tax relief results from violating a circularity principle. Application of a rule of tax law is never treated as an item of gain or loss and then subjected to other tax rules. An OIC agreement can be viewed as the application of a structural tax rule, just like a

cancel all obligations to the government); *Denman Tire & Rubber Co. v. Commissioner*, 192 F.2d 261 (6th Cir. 1951) (compromise of 1941 excess profits tax liability held not a gift from Service, but collection of best settlement obtainable from taxpayer in straitened financial circumstances); *Manhattan Soap Co. v. Commissioner*, 3 T.C.M. (CCH) 257 (1944) (cancellation of accrued and deducted manufacturers excise taxes and interest not taxable as a gift under the doctrine of *Helvering v. American Dental Co.*, 318 U.S. 322 (1943)).

⁴ See *Denman*, 192 F.2d at 262.

⁵ To the extent the OIC cancels an accrued and deducted item such as interest, the COD is a recovery of the deducted item for purposes of the tax benefit rule. See I.R.C. § 111; see also *infra* Part III.D.2. An OIC agreement relates to the entire liability of the taxpayer, including interest and *ad valorem* penalties. Treas. Reg. § 301.7122-1(c).

At least in this limited situation, the technically correct answer appears to be that COD income is required under the tax benefit rule. This technically correct answer is negated, however, by the other reasons for treating OIC relief as nontaxable.

⁶ The unintended consequences cannot be avoided even by an explicit nontaxability clause, because I.R.C. § 7122 does not authorize the Service to compromise a tax liability which does not arise until the following year. The Service lacks the power under any provision to waive a tax which will clearly become due. If future liability for a tax is doubtful, assurance can be provided by means of a closing agreement under § 7121 or a private letter ruling, but not under § 7122. See *infra* Part IV.A.3.

discharge by means of a tax statute of limitations. If an OIC agreement is taxable, the running of a tax statute of limitations should also produce COD income because there appears to be no principled way to distinguish the two situations.

Turning to more concrete matters, this article observes that the Service's enforcement efforts have been selective to a degree which raises troubling questions of fairness. The Service has targeted taxpayers who emerged from an OIC with loss carryforwards (NOLs) intact and who used the NOLs to avoid tax on unexpected post-agreement profits. Because the Service has the authority to negotiate a reduction of NOLs as part of an OIC agreement, an assessment of COD income after the settlement has become final has the same effect as an illegitimate and *ad hoc* attempt to reopen the agreement itself.

Loss carryforwards in this situation do present a problem, but it does not involve COD income. Rather, the problem is one of equitable setoff. NOLs in effect represent a claim of the taxpayer against the government for reduced taxes in the future. Equity would seem to require the taxpayer to abandon some or all of these claims as a setoff against the government's claims for past taxes, without regard to whether the NOLs relate to accruals of the cancelled tax debt or derive from deductions of items unrelated to the tax debt. This article proposes that the Treasury promulgate such regulations.

II. BACKGROUND

A. *Offer In Compromise Agreements*

An OIC agreement is a statutory procedure whose validity depends upon strict conformity to the requirements of the Code.⁷ If the OIC agreement does so conform, it is also a binding contract which is enforceable according to its terms.⁸ The Service is authorized to enter into an OIC agreement either because of doubt as to the taxpayer's liability for the tax, or doubt as to its collectibility.⁹

⁷ See *Botany Worsted Mills v. United States*, 278 U.S. 282, 288 (1929) (approval by an official other than the official designated by statute renders agreement invalid).

⁸ See, e.g., *Golub v. United States*, 204 Ct. Cl. 935 (1974) (not officially reported) (taxpayer who failed to make installment payment required by OIC agreement can be sued for breach of contract without regard to statute of limitations on assessments).

⁹ Treas. Reg. § 301.7122-1. The Service has no authority to compromise a tax obligation

This article will focus exclusively on the second type of agreement,¹⁰ which is by far the more common.¹¹

The Service has had the authority to compromise tax debts since the first enactment of the income tax.¹² Until recently, however, the processing requirements for OIC agreements were slow and cumbersome, and relatively few taxpayers took advantage of the procedure.¹³ The Service announced an entirely new OIC program in 1991 which allows collection personnel vastly greater flexibility to negotiate OIC agreements.¹⁴ The program was adopted largely in response to prodding by the General Accounting Office (GAO). During the 1980s, the GAO made a series of reports to Congress asserting that the Service's backlog of uncollectible accounts receivable was unacceptably large and growing ominously.¹⁵ In addition to urging better accounting controls, the GAO recommended that the Service settle more of its delinquent accounts in a businesslike way in order to realize at least some revenue and to reduce the backlog. The Service has added to these goals the commendable policy of providing taxpayers with a fresh start. This will enable taxpayers who are hopelessly in arrears to reenter the system as current contributors.¹⁶ The initiative has resulted in a cultural

which is certain and which is collectible. *Id.* Hardship is not a factor which may be considered if the debt is collectible.

This regulation derives from two 1933 opinions of the Attorney General construing the statutory predecessor of current I.R.C. § 7122 (§ 3229 of 1933 Revised Statutes). The opinions are reported as Op. A.G. 6, XIII-2 C.B. 442 (1934) and Op. A.G. 7, XIII-2 C.B. 445 (1934).

¹⁰ Where liability is in doubt, a compromise raises no issue of COD income because the cancellation will be subject to the disputed debt doctrine. See *infra* note 32.

¹¹ See Michael I. Saltzman, *IRS Practice and Procedure* ¶ 15.03[4][a] (2d ed. 1991).

¹² Such authority existed at least as far back as 1868. See Jacob S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws 1861-1938*, at 1055 (1938).

¹³ See generally Daniel T. Maggs, Section 7122 of the Internal Revenue Code: The Offer in Compromise, 11 *Gonz. L. Rev.* 481 (1976).

¹⁴ See Saltzman, *supra* note 11, at ¶15.03[4][a] (2d ed. 1991 & Supp. No. 1 1993). Authority to accept an OIC was formerly restricted to the Chief, Collection Division. Under Deleg. Order No. 11 (Rev. 23, Dec. 7, 1993). Now, however, acceptance authority for liabilities of \$100,000 or less has been delegated to Collection Field Branch Chiefs, two management levels below. See also James Bitoni & Melissa Kearney, *Offers in Compromise*, A.B.A. Sec. Tax'n, Midyear Meeting, at 157 (1994).

¹⁵ See Rita Zeidner, *Taxpayer Debts Put IRS in Compromising Position*, 57 *Tax Notes* 161, 162 (Oct. 12, 1992). See also David Grossman, *Offers in Compromise—Past and Present: Changes to the Internal Revenue Service's Offer in Compromise Policy 1* (unpublished manuscript, on file with the author).

¹⁶ See I.R.S. Doc. No. 7917, *Highlights of the Offers in Compromise Program*, at 2-3 (Feb.

sea change within the Service. Traditional unbudging attitudes toward collection have given way to an official policy of compromise and accommodation.¹⁷

The Service has been very successful in encouraging taxpayers to submit OICs under the new program. Both the volume of OICs and the rate of acceptance rose dramatically in the program's first full year.¹⁸ Similar increases are expected in 1994.¹⁹ Thus, the question whether an OIC agreement has further tax consequences is of great importance to an ever-increasing number of taxpayers.

Because the question requires exploration into the theory of COD income, it is appropriate to begin with the origins of COD doctrine.

B. *KIRBY LUMBER and its Progeny*

In 1921, the Treasury first published regulations asserting that gains from a taxpayer's repurchase of its own bonds were taxable,²⁰ and that forgiveness of other debts was taxable as well.²¹ The courts did not agree, and consistently held against the government on the ground that gain from debt cancellation does not provide

1992). See also I.R.S. Policy Statement P-5-100 (Jan. 30, 1992); I.R.S. Manual § 57(10)1.1 (Feb. 26, 1992).

¹⁷ Robert Wenzel, Assistant Commissioner, Collections, announced at the midyear meeting of the Tax Section of the American Bar Association on January 29, 1994 that 6,000 revenue officers have already been trained in the new procedures. Among other changes, revenue officers are now instructed to inform taxpayers of the OIC program, to help taxpayers file the necessary paperwork, and to suggest sources of funds from which to make the offer.

¹⁸ According to I.R.S. News Release IR-93-45 (May 17, 1993), the volume of offers received rose by 104% from Fiscal Year ("FY") 1991 to 1992, from 8,711 to 17,749; of these the number accepted went up by 118% from 1,995 to 4,356; the rate of acceptance increased from 25% to 45%, and the dollar volume nearly tripled from \$37 to \$106 million. *Id.*

Comparing the first six months of FY-93 with the same period of FY-92, the increases are still more dramatic. Offers received increased by 323%, offers accepted by 377%, and the rate of acceptance rose to 55%. *Id.* Some geographic unevenness has been reported, however. See George Guttman, *Compromise Offer Acceptance Rates Vary by Location*, 62 *Tax Notes* 257, 257-67 (Jan. 17, 1994).

The average amount received by the Service has dropped from \$.25 - \$.30 per dollar compromised in FY-91 to \$.15. *Id.* at 266. The decline is probably due to a more businesslike treatment of inflated assessments which were never realistically payable in the first place. *Id.*

¹⁹ Wenzel, *supra* note 17, estimated that about 60,000 OIC's would be processed in FY-94.

²⁰ Treas. Reg. § 45 (1921).

²¹ *Id.*

the taxpayer with any money or property and is therefore equivalent to unrealized appreciation.²² The government's position was not vindicated until 1931, when the Supreme Court held in *United States v. Kirby Lumber*²³ that a solvent corporation's profit from repurchase of its own bonds at a discount on the open market was taxable because it produced a "freeing-up of assets" and a "clear gain."²⁴

The government immediately interpreted *Kirby Lumber* as vindicating its longstanding position that cancellation of any and all other debts is taxable as well. This sweeping interpretation hardly follows from the holding in *Kirby Lumber*,²⁵ but it has never been

²² The early decisions invoked the definition of income in *Eisner v. Macomber*, 252 U.S. 189 (1920), which on constitutional grounds had limited income to gains in the form of money or property which are fully realized. Mere balance-sheet improvement resulting from COD was not regarded as such gain. See, e.g., *Kerbaugh-Empire Co. v. Bowers*, 300 F. 938 (S.D.N.Y. 1924), (bargain discharge of loan with depreciated foreign currency was not realized gain from labor or capital), *aff'd* on other grounds, 271 U.S. 170 (1926); *Meyer Jewelry Co. v. Commissioner*, 3 B.T.A. 1319, 1322 (1926) (forgiveness of 40% of taxpayer's debts through composition with creditors not realized gain).

Although the unrealized appreciation theory of these cases has been eclipsed by *United States v. Kirby Lumber*, 284 U.S. 1 (1931), the theory survives indirectly in the form of various elections or requirements of the taxpayer to reduce basis in property as an alternative to current taxability of COD. See *infra* notes 38-45 and accompanying text.

²³ 284 U.S. 1 (1931).

²⁴ *Id.* at 3. The transaction in *Kirby Lumber* resembled a short sale, and would have resulted in gain no matter what was sold and repurchased at a profit, except for the corporation's own stock, which was protected by the predecessor of I.R.C. § 1032.

Gains from repurchase of bonds seem very similar to gains from repurchase of stock, and thus it is not clear why the immunity of § 1032 was not extended to transactions like that in *Kirby Lumber*. There would be no apparent abuse potential in such a rule. Ordinarily, the conditions which reduce the market value of corporate debt are either outside the corporation's control (increases in general interest rates), or undesirable to create (increased risk due to decline in corporate prospects).

If recognition of gain is justified, it is unclear why such gain should not be treated as capital gain from a short sale, rather than ordinary income.

²⁵ This was a very expansive reading of a very narrow decision. The decision did not even mention discharge of indebtedness, much less announce any general rule on the subject. Furthermore, it is not entirely clear why the gain in *Kirby Lumber* was regarded as a discharge of debt rather than as gain from a securities transaction.

Most cancellations of debt bear no resemblance to the *Kirby Lumber* situation. *Kirby Lumber* cancelled its own debt (if that is what it did) in an anonymous securities transaction which was completely voluntary on both sides. By contrast, most other kinds of debt cancellation are caused by the debtor's inability or unwillingness to pay, and involve some degree of dispute which must be resolved through compromise, coercion, or resignation to the inevitable.

seriously questioned.²⁶ It is perhaps worth pointing out that other countries which impose a tax in the *Kirby Lumber* situation of open market trading profits generally do not extend the rule to negotiated relief from indebtedness.²⁷

The government has always allowed exceptions if the taxpayer is insolvent or bankrupt,²⁸ or where the cancellation is in effect a gift or a contribution to the capital of a corporation.²⁹ The courts, in turn, quickly added other exceptions for purchase price adjustments,³⁰ exchanges of stock to retire debt,³¹ disputed or contingent debts,³² and debts incurred without consideration received.³³

²⁶ Unless the "commercial gift" doctrine of *Helvering v. American Dental Co.*, 318 U.S. 322 (1943) can be so construed. See *infra* note 48 and accompanying text.

²⁷ Discharge of indebtedness is not taxable in the U.K. See *British Mexican Petroleum Co. v. Commissioners*, 16 T.C. 570 (H.L. 1932); *Butterworths U.K. Tax Guide* ¶ 2:14 (1992). Similarly, in Germany, COD is not taxable at all to individuals, nor to corporations if the forgiveness is intended to rehabilitate the debtor ("Sanierungsgewinn") and the forgiveness is substantially uniform among creditors. There is no price to be paid under German law in the form of loss of basis or other attributes. See *Einkommensteuergesetz* § 3(66); *Koerper-schaftsteuerrichtlinien* § 26(1)(1). In Canada, COD is not taxable, but attribute reductions similar to I.R.C. § 108(b) are required instead. See *Stikeman, Income Tax Act Annotated* § 80(1) (1990). In France, however, COD is taxable, but only if it arises in connection with a trade or business. See *Memento Pratique Francis Lefebvre* ¶ 668.

²⁸ The government had ruled long before *Kirby Lumber* that discharges in bankruptcy do not trigger COD income. *I.T. 1564*, II-1 C.B. 59 (1923). The following year it expanded the ruling to include discharges through composition with creditors if the taxpayer is left without assets. *S.M. 1495*, III-1 C.B. 108 (1924).

²⁹ These exceptions were already included in *Treas. Reg. § 45* (1918). The regulations in effect acknowledge that forgiveness of debt may be an indirect method of effecting a payment to the debtor, and that such an indirect payment should be treated for tax purposes in the same manner as if the payment had been made directly. Such indirect payments have been aptly termed "spurious" COD, because the debt is not cancelled, but paid in full. See *Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts* ¶ 6.4.4 (2d. ed. 1990).

³⁰ *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) (where taxpayer acquired property for cash and assumption of existing debt and property later declined in value, mortgagee's agreement to accept less than remaining balance in full satisfaction of debt was non-taxable price reduction, not COD income). A safe harbor for such price adjustments was codified in 1954 under I.R.C. § 108(e)(5).

³¹ *Commissioner v. Capento Securities Corp.*, 140 F.2d 382 (1st Cir. 1944) (taxpayer's issuance of stock to retire bonded debt held not taxable but a mere change in form of its continuing liability).

³² *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939) (cancellation of purchase-money debt for purchase of stock which became worthless not taxable as dispute over securities fraud). The case might just as well have been decided under the purchase-price adjustment exception. See *supra* note 30.

Decisional law regarding the disputed debt doctrine is sparse but controversial. For a fascinating example of confusion in this area, see *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir.

The rule of *Kirby Lumber* was first codified in the Internal Revenue Code of 1954 section 61(a)(12).³⁴ This had no appreciable effect upon the law, and the existing judge-made exceptions continued in effect as before.³⁵ Many, but not all of the exceptions were later codified in 1980 under section 108 of the Code.³⁶

Under present law, bankrupt and insolvent taxpayers are not required to recognize COD income currently.³⁷ Instead, the tax is deferred by mandatory reduction of the taxpayer's NOLs and other

1990) (compromise of gambler's casino debt of \$3.4 million for \$500,000 did not create COD income because debt was disputed and of doubtful enforceability under New Jersey statute prohibiting casino from extending excessive credit), rev'g 92 T.C. 1084 (1990). See also Daniel N. Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 Tax L. Rev. 215 (1990); Joseph M. Dodge, *Zarin v. Commissioner: Musings About Debt Cancellations and "Consumption" in an Income Tax Base*, 45 Tax L. Rev. 677 (1990); Calvin H. Johnson, *Zarin and the Tax Benefit Rule: Tax Models for Gambling Losses and the Forgiveness of Gambling Debts*, 45 Tax L. Rev. 697 (1990); Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 Tax L. Rev. 707 (1990); Alan Gunn, *Another Look at the Zarin Case*, 50(8) Tax Notes 893 (Feb. 25, 1991).

The commentators are about evenly divided as to whether *Zarin* should have been taxed. It is doubtful whether *Zarin* was a case of COD income at all. The purpose and effect of the New Jersey statute was to cancel the gambling losses as unfairly incurred by the casino's overreaching. *Zarin* simply got his money back. See Johnson, *supra*.

³³ *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) (repurchase of bonds for less than par not taxable where bonds had been issued as a dividend and without value received). This latter exception is of particular significance for this article. See *infra* Part III.A.

³⁴ The codification was accomplished by adding to the list of items of gross income under I.R.C. § 61(a) "(12) Income from discharge of indebtedness."

³⁵ The House attempted to codify the existing exceptions and liberalized several of them, but the Senate Finance Committee rejected the changes and decided to leave matters "to be settled according to rules developed by the courts." S. Rep. No. 1622, 83d Cong., 2d Sess. 14, *reprinted in* 1954 U.S.C.C.A.N. 4621, 4643. See Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 Cal. L. Rev. 1159, 1180 n.79 (1978); James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 275 (1959).

³⁶ The Bankruptcy Tax Act of 1980, Pub.L. No. 96-589, 94 Stat. 3389 ("BRTA 1980") codified the exceptions for insolvency, and for stock-for-debt exchanges. The exception for debts incurred without consideration was not codified, nor was the exception for disputed or contingent debts. The exception for purchase price adjustments was codified only in part in the form of a safe harbor under I.R.C. § 108(e)(5).

³⁷ I.R.C. § 108(a). A taxpayer outside of formal bankruptcy proceedings is taxed currently, however, to the extent it is or becomes solvent as a result of a composition agreement. Solvency for this purpose is measured by the excess of the value of the taxpayer's assets over the taxpayer's remaining indebtedness. I.R.C. § 108(d)(3).

valuable tax attributes.³⁸ If the taxpayer has none, the immunity is in effect permanent.³⁹ Congress has frequently changed the law in this area, but has been unable to strike a satisfactory balance between the interests of debtors, creditors, and the fisc.⁴⁰

Solvent taxpayers must generally recognize COD currently, even if they remain financially troubled. Under former law, an election was generally available to solvent taxpayers to defer tax by reducing the basis of their assets instead.⁴¹ The election was repealed in 1986,⁴² and is currently available only to farmers⁴³ and taxpayers in the real estate business.⁴⁴ Congress has frequently oscillated

³⁸ I.R.C. § 108(b). From 1939 until 1980, however, the sole price of forgiveness of COD income for insolvent and bankrupt taxpayers was a reduction of the taxpayer's basis in its assets. BRTA 1980 steeply increased the price by requiring a reduction of NOLs and other tax attributes in a fixed order, beginning with (i) NOLs, then (ii) tax credits, (iii) capital losses, (iv) reduction of basis of depreciable and nondepreciable property, and (v) foreign tax credit carryovers. For details of prior law, see Eustice, *supra* note 35, at 254-64, 276-77.

The list of tax attributes subject to reduction was recently expanded by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 ("OBRA 1993") to include minimum tax credits and passive activity losses and credit carryovers.

³⁹ A similar permanent immunity occurs if the taxpayer has insufficient attributes to absorb the COD in full, or if reduction does not increase future taxes. Thus some insolvent taxpayers must pay a price for relief from debt, but not others. True deferral would require all taxpayers to pay the tax on COD income at some point in the future.

⁴⁰ Attribute reduction under I.R.C. § 108(b) was designed to tax the debtor by deferral, but the actual incidence of the tax is more likely to fall on creditors instead. Tax attributes, especially NOLs, usually increase the ability of the debtor to pay its creditors. See Robin E. Phelan & William M. Sharp, *Kick 'Em While They're Down — A Taxation and Bankruptcy Critique of the Technical and Policy Aspects of the Bankruptcy Tax Act of 1980*, 35 Sw. L.J. 833, 876-78 (1981).

⁴¹ I.R.C. § 108(a)(1)(c) (repealed in 1986). The election was first enacted in 1939 for corporations and was extended to individuals in 1954. Thus, before BRTA 1980, insolvent and solvent taxpayers were treated roughly alike to the extent the election was available to solvent taxpayers. See *supra* note 38. The election was limited to business-related debt and was subject to constantly changing restrictions. For details of prior law, see Eustice, *supra* note 35, 254-64 and 276-77; Fred T. Witt, Jr., & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 Va. Tax Rev. 1, 42-43 (1990).

⁴² Pub. L. No. 99-514, § 822(c), 100 Stat. 2085 (1986).

⁴³ I.R.C. § 108(g). COD of farmers was excepted from the 1986 repeal of the election to reduce basis. This was a complete flip-flop, because farmers had not generally been eligible for the election provided in BRTA 1980 due to the fact that farmland is nondepreciable. Thus, in 1986 most non-farm businesses lost their election, and farmers who had not previously enjoyed the election first acquired it. See generally Dirk A. Williams, *The Qualified Farm Indebtedness Exception to Discharged Debt: Making Hay Under TRA*, 50 Mont. L. Rev. 279 (1989).

⁴⁴ I.R.C. §§ 108(a)(1)(D), (c) (1993). OBRA 1993 revived the election to reduce basis, but only for non-corporate debts incurred in the business of real estate. Like the exception for farmers, the election applies only to the extent the taxpayer has qualifying basis which can

without apparent reason between taxing solvent taxpayers currently, and allowing basis reduction instead.⁴⁵ The present state of the law of COD income is unstable and in great confusion.⁴⁶

1. *Tax Treatment of OIC Agreements*

There are four reported decisions in which the issue of COD income has arisen in connection with an OIC agreement. The first was *Manhattan Soap Co. v. Commissioner*,⁴⁷ in which cancellation of accrued and deducted manufacturer's excise taxes and interest was held to be gratuitous and thus a nontaxable gift under the authority of the Supreme Court's decision in *Helvering v. American Dental Co.*⁴⁸ The commercial gift doctrine was short-lived,⁴⁹ and it is doubtful that decisions made under the authority of *American Dental* have any continuing validity.⁵⁰ The second decision was

be reduced, but unlike the exception for farmers, the property must be depreciable.

⁴⁵ It seems irrational to condition availability of the election upon the taxpayer's line of business. See *supra* notes 43-44.

⁴⁶ For a comprehensive review of the law of COD income, see Chris Trower, *Federal Taxation of Bankruptcy and Workouts* (1993). See also Witt & Lyons, *supra* note 41, at 1. A thorough analysis of the dismaying degree of uncertainty surrounding I.R.C. § 108 may be found in Fred T. Witt, Jr., Report of the Section 108 Real Estate and Partnership Tax Force, Part I, 46(1) Tax Law. 209 (1992) and Part II, 46(2) Tax Law. 397 (1993).

For problems under the 1954 Code, see Eustice, *supra* note 35; Victoria Powell, *A Review of Judicial Exceptions to the Kirby Lumber Rule*, 30 Fla. L. Rev. 94 (1977); Phelan & Sharp, *supra* note 40.

New problems appear as Congress relentlessly extends the reach of debt discharge income with each new tax act. OBRA 1993 made two such amendments. First, attribute reduction was enacted, without public debate, for stock-for-debt exchanges of insolvent corporations. The new rule has been severely criticized. See, e.g., *Cancellation of Indebtedness — Stock-for-Debt Exception*, Association of the Bar of the City of New York, 59 Tax Notes 573 (Apr. 26, 1993). Second, new I.R.C. § 6050P requires lending institutions to report COD of \$600 or more without regard to whether the bankruptcy exception (or any other exceptions) might apply. Because most COD is excludible under the I.R.C. § 108(a) bankruptcy/insolvency exception, the reporting requirement seems very likely to impose far greater compliance costs on banks and thrifts than any revenue it might raise. The reports to debtors are also likely to create unnecessary confusion and friction with the Service.

⁴⁷ 3 T.C.M. (CCH) 257 (1944).

⁴⁸ 318 U.S. 322 (1943).

⁴⁹ *American Dental* was effectively overruled only six years later in *United States v. Jacobson*, 336 U.S. 28 (1949) (discount repurchase of financially distressed individual's debt not a gift, but best available settlement).

Manhattan Soap was also found to be insolvent both before and after the cancellation, so that no income would have arisen in any event under the doctrine of *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937), which is now codified at I.R.C. § 108(d)(3).

⁵⁰ Professor Eustice has written that *Manhattan Soap* was "the height of absurdity."

Denman Tire & Rubber Co. v. Commissioner,⁵¹ in which the government compromised a 1941 liability for accrued and deducted manufacturers' excess profits taxes and interest. The court noted the demise of *American Dental* and held that the cancellation was not a gift, but rather a collection of the best settlement obtainable from a taxpayer in straitened financial circumstances. The court found Denman to be solvent and upheld the assessment for COD income.⁵²

Next came *Eagle Asbestos & Packing Co. v. Commissioner*,⁵³ in which unpaid income and excess profits taxes were cancelled together with interest on the tax debts. The Service invoked the tax benefit rule and assessed taxes only for the cancelled interest, not the cancelled principal.⁵⁴ The Court of Claims decided the case by analyzing the OIC agreement as a contract, and held that the tax benefit rule did not apply because the intent of the contracting parties was to extinguish all obligations to the government.⁵⁵ The *Eagle Asbestos* court did not cite either *Manhattan Soap* or *Denman*, perhaps because the earlier cases involved assessments on the theory of COD income rather than the tax benefit rule.⁵⁶

The most recent decision was *Yale Avenue v. Commissioner*,⁵⁷ in

Eustice, *supra* note 35, at 249. Indeed, it was as if the tax collector is viewed as making a gift out of detached and disinterested generosity. But, if the purpose of tax forgiveness was to allow Manhattan Soap to continue in business and provide employment and tax revenues in the future, the forgiveness might be viewed as a contribution to capital. From this perspective, tax-free treatment seems perfectly natural.

If the creditor has a continuing financial interest in the debtor, say as a regular customer, supplier or tenant, as was the case in *American Dental*, it is not unreasonable to regard a cancellation of debt as a tax-free contribution to the debtor's capital even where the creditor has no proprietary interest in the debtor. Such a rule was in fact proposed in the House bill which led to the 1954 Code, but was dropped by the Senate. Section 76(a)(3) of Proposed House Bill 8300, H.R. Rep. No. 1337, 83d Cong., 2d. Sess. 12 (1954).

This is also the rule under the German income tax. See *supra* note 27.

⁵¹ 192 F.2d 261 (6th Cir. 1951), *aff'd* 44 T.C. 706 (1950).

⁵² Another issue was raised in the court below but dropped on appeal, which was whether the debt was subject to the exception for purchase price adjustments now codified at I.R.C. § 108(e)(5). See *infra* Part III.D.

The *Denman* case is usually cited for a third issue, however. That was whether Denman's election to reduce its basis in corporate assets was timely and thus effective to avoid current COD income.

⁵³ 348 F.2d 528 (Ct. Cl. 1965).

⁵⁴ See I.R.C. § 111. See also *infra* Part III.D.2.

⁵⁵ The contract issues are explored in more depth *infra* Part IV.A.1.

⁵⁶ In the *Eagle Asbestos* situation, the two rules overlap. See *infra* note 152.

⁵⁷ 58 T.C. 1062 (1972).

which the parties had stipulated that COD income would arise unless the taxpayer was insolvent. The court found the taxpayer to be solvent and upheld the assessment. The facts indicate that Yale Avenue paid the principal amount of tax in full and that the OIC agreement cancelled only accrued interest. Although the factual situation was on all fours with *Eagle Asbestos*, the *Yale Avenue* court did not cite it, nor did it mention the tax benefit rule.

Because the Service has published nothing in this area since *Yale Avenue*, its litigating position apparently remains that an OIC agreement is taxable.

III. IS CANCELLATION OF A TAX DEBT INCOME?

Part A of this section will establish that COD income cannot arise unless the debtor originally received loan proceeds in exchange for incurrence of the cancelled debt. Part B argues that taxpayers generally do not receive any such loan proceeds in exchange for incurring tax liabilities. Counterarguments to Part B are discussed and rejected in Part C, and Part D explores two limited exceptions in which taxpayers do receive loan proceeds or their equivalent.

A. *Requirement of Otherwise Taxable Loan Proceeds*

The most satisfactory explanation of why debt discharge should be treated as income or gain is a tax benefit argument. Receipt of borrowed money is excludible because it must be repaid. Forgiveness of the debt at a later date is inconsistent with the reason for the initial exclusion, and should therefore result in gross income.⁵⁸ From this point of view, COD income may be seen as a variant of the tax benefit rule.⁵⁹ The prior tax benefit is the exclusion which should be reversed when it becomes clear that the funds will not be repaid. It follows from the tax benefit principle that to the ex-

⁵⁸ This explanation is most forcefully argued in Bittker & Thompson, *supra* note 35. A more direct approach would be to tax the loan proceeds in the year of receipt, but in many instances that year would be closed by the statute of limitations. I.R.C. § 111 similarly creates income in the year of recovery, and does not reverse deductions of prior years.

⁵⁹ For this view see Louis A. Del Cotto, *Debt Discharge Income: Kirby Lumber Co. Revisited Under the "Transactional Equity" Rule of Hillsboro*, 38 *Buff. L. Rev.* 777 (1990). The similarity to the tax benefit rule is theoretical only, however. The practical realities are quite different. The tax benefit rule usually (but not necessarily) involves a recovery of cash which increases the taxpayer's present ability to pay, but the COD rule does not.

tent the debtor did not originally receive cash or other loan proceeds in exchange for incurring the debt, its cancellation should not be taxable.⁶⁰

The Code does not provide an adequate definition of "indebtedness" under section 61(a)(12)⁶¹ or any other section of the Code.⁶² Section 61(a)(12) does not explicitly limit "indebtedness" to debt incurred in exchange for value, nor did *Kirby Lumber's* "freeing of assets" theory imply such a requirement. Read literally, the Code treats all cancellation of debt as income, and because all relief from debt does undeniably improve the debtor's economic condition, such a literal interpretation is not inherently implausible. On the other hand, the economic benefit of COD should not automatically be regarded as profit or gain for tax purposes, because the benefit may be equivalent to a tax-free return of capital.⁶³ If the

⁶⁰ Bittker & Lokken put the case succinctly that "[i]n actuality, income results from the discharge of indebtedness because the taxpayer has received more than is paid back. . . ." Bittker & Lokken, *supra* note 29, ¶6.4.1, at 6-31.

⁶¹ The outer limits of what constitutes "indebtedness" under I.R.C. § 61(a)(12) are murky. In circular fashion, the statute defines "indebtedness" at I.R.C. §§ 108(d)(1)(A), (B) as including "any indebtedness for which the taxpayer is liable," and "any indebtedness subject to which the taxpayer holds property."

Treas. Reg. § 1.108(b)-1(c), which is no longer in effect, provided a more illuminating, but still inadequate definition:

(c) As used in 108(b) and this section, the term "indebtedness" means an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.

This regulation interpreted former I.R.C. § 108(b), repealed in 1976, which applied by its terms only to railroad corporations. It has been asserted (without examples, however) that this definition has effectively been adopted by the courts for purposes of I.R.C. § 61(a)(12) generally. Bittker & Lokken, *supra* note 29, at ¶ 6.4.2. The definition does not address the loan proceeds problem.

⁶² Unsuccessful attempts at formulating proposed regulations defining debt have been made and withdrawn again under I.R.C. §§ 385 and 752, for the purposes of distinguishing corporate equity from debt, and distinguishing debt which increases a partner's basis in a partnership from debt which does not. It is not clear that a general definition of debt would be useful, because different problem areas probably require different solutions. For example, neither of the proposed regulations above would have provided useful guidance on the questions of loan proceeds arising under I.R.C. § 61(a)(12). Much of the doubt and confusion described in the text might be avoidable if Congress provided a carefully limited definition under § 61(a)(12), or if the Treasury promulgated regulations to rationalize the existing case law.

⁶³ Indeed, cancellation of debt often has the intended effect of a reimbursement of loss which is economically a return of capital. Where this is the case, the COD should be taxfree. For example, under the law of securities fraud, a purchase-money debt for securities may be unenforceable due to the seller's noncompliance with applicable securities regulation. Cancelling such a debt has the same economic effect as recovery of a cash loss from securities

debtor buys or borrows nothing in exchange, incurrance of a debt is a loss of net worth. Cancellation of such a debt does no more than restore former net worth,⁶⁴ and is not gain for precisely the same reason that a return of capital is not gain.

The tax benefit explanation implies that even if the debtor does receive value, no COD income should arise unless that value would have been taxable absent the debt. If the value received would have been excludible in any case, the debt provided no prior tax benefit, and its cancellation creates no inconsistency. I will refer to this as the requirement of a "debt-related" exclusion.

Under case law, COD income may arise from discharge of debts incurred for property as well as cash.⁶⁵ There are no cases reported where services have been treated as loan proceeds, unless interest or rent is considered a service charge for providing the use of capital or other property.⁶⁶ Logically, services should be treated in the

fraud through a suit for rescission or damages, and in both cases the relief is taxfree. Compare Sobel, *supra* note 32 (cancellation of debt for worthless stock sold in violation of Blue Sky law not taxable) with *Dobson v. Commissioner*, 320 U.S. 489 (1943) (cash recovery of loss due to securities fraud excluded as return of capital).

A similar point was overlooked in the *Zarin* litigation. Under the anti-gambling law of at least four states, cash gambling losses are recoverable from the winner if a timely claim is made. See Ky. Rev. Stat. Ann. Title XXX, Chap. 372.020; N.H. Rev. Stat. Ann. Title XXXI, Chap. 338:1; Ore. Rev. Stat. § 30.740; and Tenn. Code Ann. § 29-19-104. There can be little doubt that recovery of a loss under such a statute would be excludible for tax purposes as a return of capital. The same would be true for recovery of a gambling loss by means of a suit based on common law fraud. If recovery of a cash gambling loss is a tax-free return of capital, it follows that cancellation of an unpaid gambling debt pursuant to anti-gambling law must also be taxfree to the debtor. If it were not, the debtor could achieve the same tax-free result simply by paying the gambling debt and recovering it again as damages. Transactions which are economically identical should not be taxed differently.

⁶⁴ By contrast, if the debtor borrows value equal to the amount of debt, the debtor's net worth is unchanged by the borrowing, and discharge of the debt increases the borrower's net worth.

⁶⁵ In other words, the symmetry theory of COD appears to apply to purchases of goods or services through borrowing, as well as to cash loans. It is worth noting that Kirby Lumber's bonds were not issued for cash, but to retire preferred stock with dividend arrearages. This fact was not mentioned in the decision. See Boris I. Bittker, *Income from the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Co. Case*, 4 J.Corp. Tax'n 124, 126 (1977).

However, in subsequent decisions involving bonds issued for preferred stock, the courts have held that the measure of loan proceeds is the cash originally received for the preferred stock, not the value of the preferred stock at the time of its exchange for the bonds. See *United States Steel v. United States*, 848 F.2d 1232 (Fed. Cir. 1988).

⁶⁶ Forgiven debts for rent or interest has been held to be taxable only if the taxpayer had accrued and deducted the expense with tax benefit. See Rev. Rul. 67-200, 1967-1 C.B. 15.

same way as money or property,⁶⁷ but practical reasons have probably prevented cases from arising. Services are generally paid for when performed rather than over time,⁶⁸ and thus if an obligation for services is cancelled, the reason is likely to be a dispute or price adjustment, rather than inability to pay.⁶⁹

See also *infra* Part III.D.2. No authority seems to be reported on the question whether cancelled debts for interest trigger COD income if the interest was nondeductible. Arguably, the forgiveness might be taxfree if it can be regarded as a price reduction for the service of providing funds. The same uncertainty exists for other services which are nondeductible, such as a debt for personal rent. However, if payment for the services would be deductible by a cash-method taxpayer, the COD is excluded under I.R.C. § 108(e)(2).

It is improbable that services were the consideration for the debts in *Zarin*, despite the assertion by many commentators that *Zarin's* debts at craps were for consumption of the casino's gambling services. Casinos bet against customers directly, and do not provide betting "services" other than those necessary to complete the betting transactions. The point of gambling is not to purchase the services of a croupier. That is like saying investors buy securities in order to enjoy the services of a broker.

⁶⁷ Thus, in principle, compromise of a fixed liability in liquidated amount for nondeductible legal, medical or educational services should be taxable.

⁶⁸ An exception is educational loans. Such loans should logically create COD income when cancelled, unless the cancellation has the intended effect of providing a tax-free scholarship. However, in *Porten v. Commissioner*, 65 T.C.M. 1993-73, forgiveness of a college tuition loan pursuant to a program intended by the State of Alaska as a tax-free educational grant was held to be taxable on the ground that forgiveness was conditioned on the borrower's continuing residency in Alaska. The *Porten* case appears to be wrongly decided. Treas. Reg. § 1.117-4(c) clearly intend disallowance of the scholarship exclusion only where the scholarship is earned through "employment" services or services "subject to the direction or supervision of the grantor." Mere residency cannot be regarded as providing such services to the State of Alaska.

I.R.C. § 108(f) excludes from income forgiveness of student loans pursuant to certain professional training programs, chiefly in medicine, and seems to imply that absent the provision, the forgiveness would be taxable as COD income. Actually, however, the forgiveness to which § 108(f) applies is a species of "spurious" COD income. See *supra* note 29. Typically, the beneficiary must earn the forgiveness by practicing medicine in an underserved area for some number of years, and thus indirectly repays the loans in full. The tax prevented by § 108(f) rests upon income from compensation, rather than COD. This was correctly analyzed in Rev. Rul. 73-256, 1973-1 C.B. 56, published before enactment of § 108(f).

⁶⁹ It was perhaps for these reasons that the American Law Institute's Draft of a Federal Income Tax Statute proposed a codification of the COD income rules which would have defined "indebtedness" as including only those obligations which are incurred for cash, or for the acquisition of property where the debt was included in basis. See Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 Harv. L. Rev. 761, 816 (1953).

Note also that purchased services ordinarily have no basis to adjust in lieu of current taxability. A taxpayer might have basis in prepaid services to be received in the future, but if the liability to pay for them is cancelled before performance, it is unlikely that the services will actually be received.

The courts have consistently refused to tax COD in the absence of loan proceeds since the issue was first litigated in 1932. The leading case is *Commissioner v. Rail Joint Co.*,⁷⁰ decided less than a year after *Kirby Lumber*. Rail Joint had issued a dividend to its shareholders in the form of its own bonds and subsequently redeemed some of the bonds for less than par. The Second Circuit held that Rail Joint realized no gain because it had received nothing of value in exchange for the original issuance of the bonds.⁷¹ In *Aftergood v. Commissioner*,⁷² an accommodation guarantor who originally received nothing of value for the guarantee and who settled the resulting liability for less than the full amount owed did not incur COD income for the amount compromised.⁷³ Presumably, it is the primary obligor who incurs COD income to the extent of money received, but not repaid.⁷⁴ In *Bradford v. Commis-*

⁷⁰ 61 F.2d 751 (2d Cir. 1932).

⁷¹ The decision has been attacked on the ground that the transaction had the same economic effect as if the corporation first sold its bonds to the public, and then paid the proceeds to its shareholders as a dividend. See Bittker & Thompson, *supra* note 35, at 1167. Their analysis has been persuasively criticized on the ground that the transactions are not equivalent: a bond dividend merely promises shareholders a future benefit, whereas a sale of bonds to the public and distribution of the proceeds to shareholders effects a present transfer of wealth from outsiders to the corporate shareholders. See Alan Gunn, *Reconciling United States Steel and Kirby Lumber*, 50 Tax Notes 851, 852 n.10 (Feb. 13, 1989).

The result in *Rail Joint* has also been questioned on the related and equally dubious ground that payment of a dividend is the corporate equivalent of "consumption" because the corporation enjoyed the benefits of making a payment which normally can be done only with money or money's worth. See Del Cotto, *supra* note 59, at 792.

It should be observed that these objections do not concern whether I.R.C. § 61(a)(12) requires a prior receipt of loan proceeds, but only whether Rail Joint should be regarded as having in fact received value equivalent to loan proceeds under the circumstances.

⁷² 21 T.C. 60 (1953), acq in result 1954-1 C.B. 3.

⁷³ Settlement of the guarantor's \$5,000 accommodation note for \$2,000 did not result in \$3,000 of COD income. Rather, he was entitled instead to a nonbusiness bad debt deduction for the \$2,000 paid in compromise. The guarantor has not made a gain; he has merely avoided a further loss. Cf. *Hunt v. Commissioner*, 69 T.C.M. (CCH) 635, 649-50 (1990):

Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, *pro tanto*, from being decreased. The guarantor no more realizes income from the transaction than he would if a tornado, bearing down on his house and threatening a loss, changes course and leaves the house intact.

Id.

⁷⁴ It may be argued that although an accommodation guarantor does not receive cash or property, some benefit must be received. The guarantor's purpose may be to benefit a related business enterprise, or to assist a family member or friend. The satisfaction of providing such assistance is not taxable under any circumstances, however, and is excludible for reasons having nothing to do with the incurrence of debt. Thus, the requirement of a debt-related exclusion precludes COD income.

sioner,⁷⁵ a taxpayer who gratuitously assumed her husband's liability of \$100,000 was held not to incur COD income when she settled with the bank for \$50,000, because she originally received nothing of value for her assumption of the debt.⁷⁶ According to dictum in *Rail Joint*, if a taxpayer promises to make a charitable contribution, and after a change of heart is forced to pay part of the debt nonetheless, COD income should not be incurred for the cancelled balance.⁷⁷

Although no reported authority is on point, it is reasonably clear that a tortfeasor should not incur COD income from compromise of a final judgment of damages for a personal injury, again because the tortfeasor has received no loan proceeds.⁷⁸ If it is argued that the tortfeasor may have enjoyed the pleasure of speeding, or a valuable saving of time, it may be answered that neither type of benefit is taxable under any circumstances, and so their exclusion from income was not caused by an offsetting debt.⁷⁹ The requirement of

⁷⁵ 233 F.2d 935 (6th Cir. 1956), acq. in part, 1958-2 C.B. 4, nonacq. in part, 1958-2 C.B. 9.

⁷⁶ It has been questioned whether this should perhaps have been recharacterized as a borrowing of cash by the wife in order to pay down the husband's loan. See Bittker & Lokken, *supra* note 29, at ¶ 6.4.2. Perhaps so, but this seems not easily distinguishable from the case of the accommodation guarantor in the preceding note. In any case, Bittker & Lokken do not go so far as to suggest that the accommodation guarantor in *Aftergood* should be subject to a similar recharacterization.

⁷⁷ 61 F.2d at 752. Under current I.R.C. § 108(e)(2), the COD would not be taxable because payment of the charitable pledge would have given rise to a deduction. If the charitable pledge would not have provided any tax benefit when paid, however, if for example, the taxpayer's standard deduction would have exceeded itemizable deductions, the hypothetical would regain its force.

⁷⁸ Income treatment would also lead to the bizarre paradox that for any given compromise amount, the larger the judgment against the tortfeasor, the greater the "gain" for tax purposes. The same paradox arose in *Zarin*. According to the government's theory, the more Zarin lost, the more taxes he owed. The error here is to treat a mere avoidance of loss as if it were taxable gain. If it were, an insurance company's payment of a judgment pursuant to a liability policy would be taxable to the insured. If the idea is pursued further, gain might be created by escaping a mugger, selling stock before a crash, or changing the oil in one's car. See *supra* note 73.

⁷⁹ It may appear farfetched to argue that the judgment debtor has received consideration in the form of, say, the joy of speeding or running red lights. And yet such exhilaration in destructive risk-taking seems hardly distinguishable from the thrills of reckless gambling which were implausibly labeled income from "consumption" by Professor Shaviro, *supra* note 32.

Apart from appeals to psychic consumption, it is true that speeding saves time, and proverbial that time is money. The tortfeasor might be viewed as making a cost/benefit calculation of the time saved versus the discounted probability of fines or accidents, and as enjoying utility of some sort if the calculation is correct. This may be a perfectly reasonable

a debt-related exclusion is not met.⁸⁰ Similarly, no COD income should arise from cancelled debts which were incurred for "moral" consideration, as in the venerable case of *Webb v. McGowan*,⁸¹ or by reliance of the promisee, as in the immortal decision *Hamer v. Sidway*.⁸² No authority is reported treating such questions.

A more perplexing tax question is raised by a debt which previously had been discharged in bankruptcy and is revived by a new promise to pay. Whether cancellation of such a reaffirmed debt should result in COD income would appear to turn upon the controversial question whether enforceability arises principally from the promise itself, or from the past consideration for the underlying debt (or portion thereof) which is revived by the promise.⁸³

analysis, but it is not a ground for taxing COD.

⁸⁰ Another application of this principle seems to have been overlooked in the *Zarin* case. Because Zarin received only chips which could not be exchanged for cash, their sole value lay in the chance that he might win something over and above his \$3 million free line of credit. Zarin was obligated to return that amount before keeping any winnings.

The maximum value of that opportunity is calculable. Using the best possible betting strategy, that value was less than \$200,000. See Michael Orkin & Richard Kakigi, *What Is the Worth of Free Casino Credit?* (1992) (unpublished article on file with the author).

Even that \$200,000 should not be taxed, however, because a mere opportunity to win money is not taxable, with or without an offsetting debt. Even if Zarin had received his free line of credit as a prize, or as compensation, the opportunity would not have been taxable upon receipt, for the same reason that one is not taxed on receipt of a valuable employment contract. The cash proceeds (if any) of both kinds of opportunity will be taxed in full when actually received.

⁸¹ 168 So. 196 (Ala Ct. App. 1935) (promise motivated by gratitude to pay plaintiff \$15 biweekly for life held enforceable where plaintiff became permanently crippled saving defendant's life).

The heroic act in *McGowin* was surely of great value to the debtor, and if he had the opportunity to bargain for the service, McGowin would gladly have agreed to pay for it. That does not mean receipt of the service was an accession to wealth for tax purposes, however, because it had no transferable value. Even if it had value, McGowin's promise, like Webb's rescue, should probably be treated for tax purposes as a gift.

⁸² 27 N.E. 256 (N.Y. 1891) (promise held enforceable where uncle promised to pay nephew \$5,000 if nephew, then 15 years old, would refrain from drinking, smoking, and gambling until 21). The nephew's performance of the conditions had no apparent economic value to the uncle, and so cancellation of the debt presumably should not give rise to COD income.

Actual payment of the \$5,000 should probably be taxfree to the nephew as a gift notwithstanding the fact that payment was coerced, because the original promise seems to have been motivated by the disinterested generosity and affection of a family member. Thus the case is similar to the charitable pledge. See *supra* note 77.

⁸³ If one believes that such contracts are enforceable largely upon the moral weight of the promise alone, as Professors Thel and Yorio persuasively argue, then no COD should arise. If one prefers the strict consideration view of Corbin that the enforceability of such debts

Under contract law, the question is largely academic, because such reaffirmed debts are enforceable in any event.⁸⁴ If the question is raised in the tax context, however, this otherwise academic question might determine whether the COD is taxable.⁸⁵ The issue has never been litigated.⁸⁶

Another question which has never been litigated is whether compromise of a judgment debt for overdue child support is taxable. It seems doubtful that the support obligor has received any loan proceeds in exchange for the debt.⁸⁷ A child may be more precious than rubies and emeralds, but it is not lawful consideration, nor is its birth taxable to anyone as income. Furthermore, one can incur liability for child support even if the obligor is not a legal parent at all.⁸⁸ The value of child care provided by the custodial parent does not qualify as loan proceeds to the support obligor, because the

rests essentially on the fact of past consideration (the original loan proceeds), perhaps the answer should be yes. As to the contracts question, see Steve Thel & Edward Yorio, *The Promissory Basis of Past Consideration*, 78 Va. L. Rev. 1045 (1992).

⁸⁴ See Arthur L. Corbin, *Corbin on Contracts* § 222.

⁸⁵ The outcome should be in doubt only if the first cancellation had no tax consequences, say because the debtor excluded the COD from income under I.R.C. § 108(a) and had no attributes to reduce. If the first COD was taken into income or caused attribute reduction, it would be taxed doubly if the same debt were to pass through the COD rules a second time.

⁸⁶ A related question, also unanswered, is whether COD income arises from cancellation of a reaffirmed debt which has been rendered unenforceable by a statute of limitations. Here the analysis might be different, because the running of the statute does not discharge the debt itself, but serves only as an affirmative defense against the remedy. Thus, COD income might be appropriate. If so, the COD tax liability might be postponed forever by a succession of reaffirmations, as long as the creditor does not abandon hope of collection and forgive the debt or claim a bad debt deduction.

⁸⁷ It has been asserted unpersuasively that a defaulting support obligor should incur COD income (and also that the obligee should be entitled to a bad debt deduction). See William A. Klein, *Tax Effects of Nonpayment of Child Support*, 45 Tax L. Rev. 259 (1990). Professor Klein did not discuss the loan proceeds issue. Even before any court order, the obligor has a support obligation which is imposed upon parents by law. A court order for child support is in principle simply a substitute (in definite amount) for the earlier indefinite obligation. There was no apparent consideration for the earlier obligation.

⁸⁸ Under some circumstances, a promise to support cannot be avoided even if the promisor establishes that he is not the father. See *Hays v. McFarlan*, 32 Ga. 699, 703 (1861), cited in Thel & Yorio, *supra* note 83, at 1098. The enforceable debt does not replace any prior obligation, and thus the debt rests upon the promise alone, just as in the case of a charitable pledge.

In some states, a support obligation is placed upon step-parents even in the absence of any express or implied promise. See Homer H. Clark, Jr., *The Law of Domestic Relations in the United States*, 2d ed. (1988) at 263-64. In such situations, the support obligation arises solely from legislative fiat, much like a tax.

benefit to the obligor, if any, is not taxable even in the absence of any offsetting debt.⁸⁹ Moreover, custodial parents ordinarily do not provide child care for the benefit of support obligors in direct exchange for support payments.⁹⁰ The reverse is true if a parent pays a third party for professional child care on a contractual basis. This lack of connection between the duties of the support obligor and obligee is analogous to a similar lack of connection between the duties of the taxpayer to pay taxes and of the government to provide services, which is the subject of Part B.

B. Are Tax Debts Incurred for Value Received?

The loan proceeds issue has never been directly litigated despite the four reported cases which consider the tax effect of OIC agreements. The *Yale Avenue* court saw that there was a possible problem of lack of consideration to the taxpayer, and cited the *Bradford*⁹¹ decision, but did not consider the issue further because it had not been raised by the parties.⁹²

In the following discussion, the issue is divided into two questions: (1) whether government-provided benefits may be considered a *quid pro quo* in exchange for tax obligations, and (2) whether such benefits would be taxable in the absence of an offsetting tax obligation.

1. Taxes Are Not a Purchase of Government Services

Grandpa (to Henderson, IRS agent): Well, what do I get for my taxes? If I go into Macy's and buy something, there it is - I see it. What's the Government give me?

⁸⁹ Custodial parents sometimes do not seek a support order from the absent parent, and in such cases the absent parent is not taxable for the value of the child care provided by others, and correctly so. The care is not transferable value and does not increase the absent parent's ability to pay tax. Thus the exclusion of such benefits is not debt-related.

⁹⁰ The duties are not interdependent. The custodial parent must provide care and support regardless of whether she receives payment from the obligor. Conversely, the support obligor must pay despite the fact that he ordinarily has no right to an accounting to assure the payments are actually spent for the child's benefit and no right to direct the custodial parent's choices regarding the child's care.

⁹¹ *Supra* note 75.

⁹² *Yale Avenue*, 58 T.C. 1062 n.5. Even if the issue had been raised, the correct answer would probably have been that the equivalent of loan proceeds was in fact received through the taxpayer's accrued deductions of the unpaid interest on the tax debts. See *infra* Part III.D.2.

From "You Can't Take it With You," by George S. Kaufman & Moss Hart (1937)

The government does not provide its services to taxpayers in direct exchange for tax liabilities. If a taxpayer does receive specific goods or services in exchange for a governmental exaction, payment is generally not regarded as a "tax" at all, but rather as a distinct charge such as a user fee or special assessment. I do not mean to suggest that all user fees and special assessments should result in COD income if cancelled. COD income should arise only if the taxpayer received something of commercial value in exchange for the debt, which is by no means always the case.⁹³

It is in the nature of a general tax that the payor receives no exact *quid pro quo*: revenue is pooled for general public purposes and it is impossible to trace or value the benefits to any particular taxpayer. This distinction was once important for purposes of section 164 of the Code which formerly permitted a deduction for a

⁹³ A few examples will illustrate some of the possibilities. A purchaser of stamps from the Post Office surely receives transferable value, and if the purchase were somehow to be on credit which is later cancelled, COD income should result. Similarly, if the taxpayer rents parking space from a public authority on the same basis as from a private concern, COD income should result from the one if it does from the other. Whether a city's cancellation of parking tickets should create COD income would seem to depend in part upon whether the parking tickets are regarded as a form of rental charge, or simply as a penalty.

Regulatory charges such as for automobile registration are less likely to resemble a commercial purchase. Automobile registration, for example, is compulsory if one cannot avoid driving, and the purchased license plates have no obvious commercial value. If such a debt is cancelled, it should probably not create COD income for the same reason a tax should not.

Special assessments upon real property are in principle payments for improvements to the property which are of commercial value. And yet the property owner usually has no choice whether to enter into the transaction, and the law does not require proof that the increase in value of the realty is equal to the amount of the assessments. See, e.g., *Simmons v. City of Moscow*, 720 P.2d 197 (Idaho 1986) (special assessments calculated by proximity to downtown improvements a reasonable method of estimating benefits to be derived, even if benefits are not immediately measurable). If an assessment is abated, COD income should only arise to the extent full value was actually received. Even then, the purchase price adjustment rule underlying I.R.C. § 108(e)(5) might arguably apply.

An interesting question would be raised by cancellation of a user fee owed to the Service for special services, such as for a Private Letter Ruling. If this provides a valuable benefit akin to insurance against increased taxes, or a tax attorney's opinion and indemnification, perhaps the taxpayer receives something of commercial value. On the other hand, the need for this "insurance" is caused entirely by the government's own hunger for revenues. The question would be mooted by I.R.C. § 108(e)(2) to the extent the fee may be deductible. The price adjustment rule might apply as well. No authority exists regarding this or any other of the above questions.

variety of state and local taxes, but not for user fees or assessments. The Service has described the distinction as follows:

A tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and not as a payment for some special privilege granted or service rendered. Taxes are, therefore, distinguishable from various other contributions and charges imposed for particular purposes under particular powers or functions of the government. In view of such distinctions, the question whether a particular contribution or charge is to be regarded as a tax depends upon its real nature. If it is in the nature of a tax, it is not material that it may be called by a different name; and, conversely, if it is not in the nature of a tax, it is not material that it may be so called.

A charge primarily imposed for the purpose of regulation is not a tax, even though it produces revenue.⁹⁴

This same distinction is in accord with general legal usage as well,⁹⁵ and has been the ground of court decisions outside the tax area.⁹⁶

The usual presumption that equal value is exchanged in an arms-length transaction does not apply to taxes, because taxes are not paid at arms length, but under coercion. Taxpayers cannot choose what to buy, nor how much to pay, nor even whether to enter the transaction in the first place. Tax payments, willing or

⁹⁴ Rev. Rul. 57-345, 1957-2 C.B. 132, revoked on its facts by Rev. Rul. 60-366, 1960-2 C.B. 63. The deduction under I.R.C. § 164 is now limited to income and property taxes.

⁹⁵ See Black's Law Dictionary under "Tax" where substantially the same distinction is drawn and stated to be general usage:

"Taxes," as the term is generally used, are public burdens. . . without reference to peculiar benefits to particular individuals or property. "Assessments" have reference to impositions for improvements which are specially beneficial to particular individuals or property, and which are imposed in proportion to the particular benefits supposed to be conferred.

Black's Law Dictionary 1457 (6th ed. 1990).

See also Richard A. Westin, *Shepard's Tax Dictionary for Business* 428 (1993), which defines "tax" in part by quoting portions of Rev. Rul. 57-345, *supra* note 94.

⁹⁶ For example, the Fair Debt Collections Act (FDCA), 15 U.S.C. § 1692 et seq., has been held inapplicable to harassment of a tax debtor on the ground that the FDCA defines "debt" as a consumer obligation to pay for goods or services which are primarily for personal or household purposes. Taxes finance general governmental functions and do not involve an exchange of goods or services to individuals. See *Staub v. Harris*, 626 F.2d 275 (3d Cir. 1980).

not, provide the taxpayer with none of the rights of a purchaser. Dissatisfaction with the government's services or lack of benefit from them⁹⁷ do not provide grounds for a refund of taxes already paid or for an offset against past⁹⁸ or future taxes.⁹⁹ Taxes are not earmarked to the taxpayer's account and create no rights in the expenditure of government funds.¹⁰⁰ The obligation to pay taxes is entirely unrelated to the level of governmental benefits received.¹⁰¹

In fact, for most benefits it is irrelevant whether a person pays taxes at all. Everyone is sheltered by the nuclear umbrella, protected by the Food and Drug Administration, and provided with access to the federal courts and federal highways. Persons who pay no taxes receive the same, if not more benefits than those who do, which makes it difficult to argue that the benefits are received in exchange for taxes.¹⁰²

One might counter that the private sector also provides examples of differential pricing for identical services where price depends solely upon the buyer's income or wealth. College tuition provides a striking example.¹⁰³ It is at least arguable, however, that

⁹⁷ A United States citizen who resides and is permanently domiciled abroad, and who receives all his income from sources abroad, is taxed on his worldwide income, despite the meager benefits, if any, the taxpayer enjoys in exchange. Cf. *Cook v. Tait*, 265 U.S. 47 (1924), where the Court stated somewhat implausibly that taxing power "is based on the presumption that government by its very nature benefits the citizen and his property wherever found. . . ." *Id.* at 56.

⁹⁸ See, e.g., *Akins v. Commissioner*, 65 T.C.M. (CCH) 2937 (1993) (physically and mentally disabled taxpayer who was robbed and stabbed through the heart in 1982 had not filed returns since 1989 on the ground that government's negligent enforcement of criminal law was directly responsible for the devastating attack. The Tax Court held it has no jurisdiction to grant offset, and taxpayer remains liable for taxes, penalties and interest).

⁹⁹ Cf. *Flast v. Cohen*, 392 U.S. 83, 128 (1968) (Harlan, J., dissenting).

¹⁰⁰ *Id.* at 118-19.

¹⁰¹ Allocation of the tax burden is now regarded as based simply upon ability to pay. It was sometimes argued by early tax theorists that taxes should be apportioned according to benefits received, but, as Henry Simons pointed out:

Where the government distributes goods and services which may be bought and sold in the open market, pricing according to cost is feasible. Where expenditure is made for purposes of general welfare (national defense, internal security), the benefit principle leads nowhere at all; and, where the government undertakes deliberately to subsidize certain classes (the economically unfit) or certain kinds of consumption (education, recreation), taxation according to benefit is sheer contradiction.

Henry Simons, *Personal Income Taxation* 4 (1938).

¹⁰² Many government-provided welfare benefits are specially aimed at the poor, who are unlikely to pay any federal income taxes.

¹⁰³ Tuition at private colleges is usually presented as a single price, say \$20,000 per year. But most schools also provide financial aid on the basis of need. The effect of purely need-

all buyers in the private sector receive their money's worth nonetheless. At any of the prices tuition may command, it is still the case that the parties engage in a voluntary exchange. Not so for taxes, which are neither voluntary, nor an exchange.¹⁰⁴

2. *Government Services Are not Otherwise Taxable*

Even if taxpayers did receive full value in exchange for their tax liabilities, COD income would still be inappropriate because government-provided benefits are generally not taxable and their exclusion is therefore unrelated to tax indebtedness.¹⁰⁵ There are several reasons why government services are not treated as income. Many federal services are impossible to value and to allocate to particular taxpayers. National defense, regulatory protection, and scientific research are obvious examples. Even if such federally-funded programs could be valued and accurately allocated to each taxpayer, the benefits would not be taxable under current law because they are not accessions to wealth over which the taxpayer has dominion and control and they are not transferable or convertible to money or money's worth.

Other federal benefits which could easily be valued and charged for are free simply because Congress has chosen to subsidize them by failing to exact a user fee. Such benefits are generally not taxable,¹⁰⁶ but similar benefits are not taxable in the private sector ei-

based scholarships is the same as posting a differential pricing system: tuition costs, say, \$20,000 for the well-off, \$10,000 for most of the middle class, and nothing at all for the poor. See Joseph M. Dodge, *Scholarships under the Income Tax*, 46 *Tax Law* 697 (1993); Charlotte Crane, *Scholarships and the Federal Income Tax Base*, 28 *Harv. J. on Legis.* 63 (1991).

A similar pattern, though less visible, may sometimes be found in charges by physicians and hospitals. A surgeon's bill may be intended more as a first offer than as a fixed demand, the true price being whatever the patient's insurer will actually allow. If the patient is uninsured, the provider will often write the bill down to whatever the patient can pay, or even down to zero. Thus the wealthy subsidize the poor in a system of private discriminatory pricing for medical and educational services which mimics progressive taxation.

¹⁰⁴ Taxpayers must accept the benefits of federal expenditures as a package, and have no choice about its contents. Each of us would surely spend the Treasury's money differently, if we had the choice. It is doubtful that anyone but a farmer would spend billions of federal dollars on agricultural supports whose intended effect is to raise the prices the rest of us must pay for essential foodstuffs. See David Schoenbrod, *Power Without Responsibility: How Congress Abuses the People Through Delegation* 7 (1993).

¹⁰⁵ If most government benefits are excludible by everyone, without regard to whether taxes are owed, the exclusion is not debt-related, and, thus, no COD income can arise.

¹⁰⁶ The user of a free highway or bridge does not incur income merely because other roads may charge a toll. If a token charge is required, the benefit might be characterized as a non-

ther. For example, admission to the (government-owned) Hirschhorn Museum is free and has obvious value, but admission to a privately-subsidized museum which charges little or nothing for admission does not create income simply because other comparable museums may require a high admission price.¹⁰⁷

Most non-cash benefits¹⁰⁸ probably fall into the category of "psychic" income,¹⁰⁹ such as the feeling of comfort and security derived from the government's protection. Psychic income of this sort is not taxable because it is not an accession to economic wealth and cannot be measured. Moreover, one cannot assume the psychic "income" is positive rather than negative, because many persons feel that at least some federal programs are outright harmful, either to themselves, or to others, or to both.¹¹⁰

Justice Holmes' apothegm that taxes are the price we pay for civilized society¹¹¹ suggests an argument that nonpayment of the price should be taxable. If the enjoyment of civilized society can be labelled "consumption," it will appear to be taxable under the authority of the Haig-Simons definition of income as consumption plus savings.¹¹² One might also reason directly from the fact that

taxable bargain purchase of consumption. See Dodge, *supra* note 32. If admission is free, however, a different explanation is needed. A more general rationale is that such benefits are simply gifts.

¹⁰⁷ If one pays any part of the \$ 7.00 voluntary suggested admission charge at the Metropolitan Museum in New York City, it is deductible as a charitable contribution. Admission to the Met is not less valuable than to the Museum of Modern Art, however, which requires a (nondeductible) \$8.00 admission charge.

¹⁰⁸ Welfare cash benefits such as Aid For Dependent Children are taxfree because they are payments for relief of hardship and considered to be for the welfare of the general community. Other cash benefits may be partially taxable on a means basis, such as social security payments. I.R.C. § 86. Still other cash benefits are fully taxable, such as unemployment compensation. I.R.C. § 85.

¹⁰⁹ See R. M. Haig, *The Concept of Income — Economic and Legal Aspects*, in *Readings in the Economics of Taxation* (R. Musgrave & C. Shoup eds. 1959).

¹¹⁰ For example, many people think nuclear weapons pose much greater hazards to life and health than they avert. Others deplore the War on Poverty as the misguided cause of permanent dependency and crime. Many believe that the staggeringly expensive War on Drugs is as futile as Prohibition was, and that, like the first Noble Experiment, it has created far more crime than it prevents. Dissidents must pay for these programs nonetheless.

¹¹¹ See *Compania de Tabacos v. Collector*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

¹¹² Not all consumption is taxable, however, despite the Haig-Simons definition of income as consumption plus savings. Simons, *supra* note 101, at 50. Consumption is indirectly taxed by taxing the earnings with which consumables are purchased. "Consumption" is not a defined term in the Code, nor has it any agreed definition in the tax literature, although it is

federal taxes are not deductible¹¹³ to the conclusion that taxes are personal consumption expenses, as tax theorists have done in some other contexts.¹¹⁴ Consumption of goods and services for personal purposes is not deductible because that would leave little or nothing in the income tax base except savings. It does not follow, however, that just because an item is nondeductible, it is a form of consumption. Taxes reduce disposable spending power and therefore reduce the taxpayer's ability to consume purchasable goods and services. For that reason, Professor Bittker was surely correct in concluding that taxes should not be considered "consumption" within the meaning of the Haig-Simons definition.¹¹⁵

Because taxes are neither consumption nor savings, the current deduction for state and local income taxes appears fully justified.¹¹⁶ In principle, federal taxes should be deductible for precisely the same reason as state taxes, and in fact federal income taxes were deductible from 1913 to 1917. The deduction was repealed in 1917 to help finance the cost of World War I.¹¹⁷ The repeal became permanent, which was perfectly sensible, but for a reason deriving from the fundamental logic of tax, rather than from recognition that taxes are neither consumption nor savings. Allowing a deduction for federal income taxes is circular and therefore pointless.¹¹⁸

usually employed to denote, roughly, the using up of economic resources for personal enjoyment. If consumption is independent of any earnings in the marketplace it is generally tax-free, as for example consuming home-grown produce. Similarly a bargain purchase is not taxable, unless the bargain element is in effect a disguised transfer of earnings. See Dodge, *supra* note 32.

¹¹³ See I.R.C. § 275.

¹¹⁴ E.g., many commentators on *Zarin*, *supra* note 32, have characterized casino losses as "consumption," chiefly on the ground of their nondeductibility. But, if "consumption" means a using-up of economic resources, this cannot be accurate, because nothing is used up in gambling. There is only a transfer of money from loser to winner. In fact, if something of value is transferred on both sides, the transaction is not gambling, because the essence of gambling is the promise of something for nothing. See Samuel Williston, *A Treatise on the Law of Contracts* § 1665 (3d ed. 1972).

¹¹⁵ Boris I. Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 *J.L. & Econ.* 193 (1973), *reprinted in* Boris I. Bittker, *Collected Legal Essays* 431, 439 (1989).

¹¹⁶ Note that state income taxes are also deductible by corporations, which by definition do not "consume" in the sense of incurring personal living expenses. See *supra* note 112.

¹¹⁷ See Seidman, *supra* note 12, at 943-44 (annotations to § 1201 of Revenue Act of 1917).

¹¹⁸ See Richard C.E. Beck, *The Deductibility of a Worthless Right to Contribution for Joint Income Taxes: The Mistaken Line of Cases Under Rude v. Commissioner*, 9 *Va. Tax Rev.* 313, 327-28 (1989).

The same result can be achieved by lowering the rate of tax,¹¹⁹ which is much simpler and easier to administer.¹²⁰

C. Counterargument: Tax Debt as Loan From the Government

It might be argued that as long as a tax obligation remains unpaid, the taxpayer is effectively in possession of a cash loan from the government in the amount of the debt. This seems plausible at first blush because the taxpayer enjoys the use of money which ought to be paid to the government, and the taxpayer must pay interest on the debt.¹²¹ Also, in a different context, tax theorists are accustomed to viewing deferral of gain as the equivalent of a loan from the government. These analogies are misleading when applied to the COD question, however, and the arguments which can be drawn from them are weak.

Deferral of a tax liability (as opposed to simple nonpayment of taxes due) may indeed resemble an interest-free loan from the government insofar as the time value of money is the issue,¹²² but the

¹¹⁹ The equivalence is precise if the taxes are paid currently as in the present system and are deductible in the current year. If taxes are payable in the following year, as they were before enactment of mandatory withholding and estimated payments, the equivalence is not exact, because of possible fluctuations in the taxpayer's income between the payment year and the deduction year, or changes in tax rates. In the long run, however, the effect would be the same. The significance of this circularity principle for OIC agreements is explored *infra* Part IV.C.

¹²⁰ See Dodge, *supra* note 103, at 712 n.89. State income taxes are not deductible from state income taxes for the same reason.

¹²¹ I.R.C. § 6601. The interest is to be assessed, collected and paid in the same manner as taxes. Also, all references to any tax are deemed also to refer to the interest imposed. I.R.C. § 6601(e)(1). Thus, cancellation of taxes in bankruptcy or through a tax statute of limitations also cancels the interest owed.

¹²² Deferral of the liability itself, rather than deferral of payment, arguably does have the value of an interest-free loan from the government if the gain "should" be taxed. Thus, for those who believe, e.g. that unrealized gains ought to be currently taxed, the "deferral" of gain has the value of an interest-free loan from the government in the amount of the tax on the unrealized gain. The concept has recently found its way into the Code itself. For example, under I.R.C. § 453A, the taxpayer is required to pay interest currently on the deferred tax liability for gains from certain installment sales, despite the fact that the tax itself is not due until actual receipt of the installment payments. See generally H.R. Rep. No. 495, 100th Cong., 1st Sess. 926-31 (1987), *reprinted in* 1978 U.S.C.C.A.N. 2313-1245, 2313-1672 to 2313-1677. Section 453A was enacted to replace § 453(C), which was enacted in 1986 and repealed in 1987.

By contrast, postponing payment of taxes already assessed and due is rarely profitable, because in addition to statutory interest, the taxpayer will ordinarily be liable for nonpayment penalties as well. I.R.C. §§ 6651, 6654.

usefulness of this metaphor does not extend to the question under discussion. The question for COD purposes is whether the taxpayer receives loan proceeds in exchange for a tax debt, not whether the debt may be postponed, or the value of such postponement.¹²³

If existing tax debts are to be regarded as "loans" solely on the ground of the benefit of nonpayment, it would be difficult to distinguish tax debts from other debts which clearly fail the loan proceeds test. For example, a tort judgment could be characterized with equal justice as a "loan" to the tortfeasor as long as it remains unpaid, because the benefit of nonpayment depends upon the interest cost of delay, just as in the case of a tax debt.¹²⁴ But a taxpayer does not receive money from the government in exchange for incurring a tax debt any more than a careless driver receives money in exchange for incurring a liability for personal injury.

One might argue that forgiveness of tax is the equivalent of borrowing money from a bank to pay the tax and then compromising the bank debt. Compromising the bank debt would clearly create COD income. The analogy is not probative, however, because the transactions are not equivalent. The borrower does receive money or money's worth from the bank,¹²⁵ but not from the government. Moreover, the argument proves too much. A tortfeasor would similarly incur COD income from compromising a bank debt used to pay a tort judgment, but it does not follow that a direct compromise with the judgment creditor will result in taxable COD. It will not, because the two debts are entirely distinct.¹²⁶

¹²³ See supra note 60 and accompanying text.

¹²⁴ Statutory interest accrues on many judgment debts, including tort judgments. The fact that interest may run does not imply that the obligation underlying a tort judgment is a loan, nor should it in the case of tax debts.

¹²⁵ The taxpayer receives value for the bank loan - either the cash itself, or the cash value of the bank's payment of the tax debt. This benefit is clearly distinguishable from the benefit of whatever services the government may have provided, if any, in exchange for the taxpayer's original incurrence of the tax debt. COD income should result from cancellation of the bank loan for a reason similar to the rationale of *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (employer's payment of employee's income taxes held additional income to employee). In *Old Colony*, the employee received value in the form of the employer's payment of his tax debts. If a bank pays tax debts in exchange for the taxpayer's IOU, the taxpayer is similarly benefitted and should be taxed if the IOU is later cancelled. See also William D. Popkin, *Taxing Personal Insurance: The Case of Tax Audit Insurance*, 4 Va. Tax Rev. 379 (1985) (concluding that the proceeds of audit insurance should be taxable).

¹²⁶ A related objection might be raised by the fact that payment of a tort judgment with

If there is a difference between tax debts and other debts for which the creditor has not provided any value in exchange, the difference would appear to lie in the fact that the government's tax claim, generally arises out of income-producing transactions which increase the taxpayer's wealth.¹²⁷ One might argue that this increase in wealth is the equivalent of loan proceeds. The difficulty with this line of reasoning is that the increase in wealth derives from the taxpayer's employer, customers or clients, and not from the government.¹²⁸ To avoid this difficulty, one would have to argue that private gains do indirectly derive from the government, either because the government has a kind of ownership interest in the taxpayer's income¹²⁹ or in the private property which produces such income.¹³⁰ Such propositions are at best metaphorical. The

appreciated property would produce taxable gain to the extent of the appreciation in the property. Extinguishment of the debt would thus be treated as an amount realized, despite the fact that nothing was originally received in exchange for incurring the debt. This treatment is not in conflict with the COD rule requiring loan proceeds, however, because the debt is actually paid, much like the third-party payment in *Old Colony*. Payment of debt with appreciated property is correctly treated as a barter, and is first parsed into a hypothetical sale for cash, and then as a hypothetical payment of the cash to extinguish the debt. The gain arises from the first step alone. The second step, payment of the debt, is a loss, and would be deductible if incurred in a business context. Loss treatment is perfectly consistent with a no-tax result if the debt is cancelled rather than paid. See *supra* notes 73, 78.

¹²⁷ Note, however, that taxpayers incur gift and estate tax liabilities without the receipt of any earnings or other property. The Code also imposes income taxes upon persons who acquired no accession to wealth if they run afoul of a provision charging them with a duty to pay the taxes of the true earner. For example, taxpayers are often required to pay taxes for income earned by their spouses under I.R.C. § 6013(d) if they file jointly, or if they reside in a community property state under the doctrine of *Poe v. Seaborn*, 282 U.S. 101 (1930) (wife held liable for one-half of taxes on husband's income in community property state). Similarly, although not called a "tax," the 100% penalty against responsible persons under § 6672 imposes a personal liability upon a corporate officer who fails to pay over trust fund taxes, even if the officer received no personal benefit.

¹²⁸ The case is not different for unpaid trust fund taxes, where it might appear that the employer, as collection agent, acquires possession of funds which belong to the government. It is still apparent that the employer alone is the actual source of the funds. The employer is in effect required to collect money from itself. If it fails to do so, the employer has not received any funds from the government or from third parties for the benefit of the government.

¹²⁹ Thus, if the taxpayer fails to distribute to the government its rightful share of the joint gains, the taxpayer will have received and converted the government's money to its own use.

¹³⁰ Some philosophers believe that the community or its agent—the state—has rights to private property which are prior and superior to any and all individual rights. The state could, if it wanted, and as Stalin demonstrated, confiscate everything.

This collectivist vision bears little resemblance to our present constitutional system and

government is of course not legally a partner of the taxpayer, and it cannot acquire ownership of private property without paying compensation. The government does not pay for its interest in taxpayers' profits¹³¹ because that would defeat the purpose of taxation. Taxpayers provide money to the government, not the other way around. That is the purpose of taxes.

A taxpayer who enjoys relief under an OIC agreement does not avoid repayment of anything, but rather avoids payment in the first instance. Because taxes are neither savings nor consumption,¹³² the actual payment of taxes can be regarded as a form of nondeductible expense which is in effect a loss.¹³³ Avoidance of loss is of course economically beneficial, but it is not a form of taxable gain.¹³⁴

D. Exceptions

Despite the conclusion that tax debts are generally not incurred for value, there are two exceptions: (1) where assumption of a third party's tax debt is a condition of acquiring property, and (2) where the tax benefit rule applies to cancellation of previously deducted items such as unpaid interest on the tax debt.

1. Receipt of Assets as Loan Proceeds: Denman Tire & Rubber Co.

In *Denman Tire & Rubber Co. v. Commissioner*,¹³⁵ the Sixth

much less to our historical one, but that has not prevented academic tax thinkers from making use of the idea. For example, Henry Simons, the most influential of all American tax theorists, wrote in connection with his argument that gifts ought to be taxed as income: "[t]he whole return from property is, in a sense, a gift from the community." Simons, *supra* note 101, at 134. If the entire return on property belongs to the community, the community must in some sense own all "private" property.

¹³¹ The government's contribution to private enterprise, both employers and employees, is the same as it is to tax-exempt organizations and to persons who pay no taxes; viz. the familiar government-provided benefits of defense, highways, courts, and the like. This infrastructure may be a necessary precondition for commerce and wealth production, but it does not provide the government with an ownership interest in private income or wealth.

¹³² See *supra* notes 115-16 and accompanying text.

¹³³ See *Clark v. Commissioner*, 40 B.T.A. 333 (1939), acq. 1944 C.B. 5 (client's reimbursement from tax lawyer of taxes which were imposed solely because of lawyer's bad advice held nontaxable return of capital replacing client's loss).

¹³⁴ See *supra* notes 73, 78.

¹³⁵ 192 F.2d 261 (6th Cir. 1951).

Circuit held that an OIC agreement was taxable, but the unusual facts of the case indicate that the taxpayer probably did receive loan proceeds. In *Denman*, the corporate taxpayer purchased all the assets and assumed all the liabilities of a predecessor corporation in a bankruptcy proceeding.¹³⁶ Among the liabilities Denman assumed was a federal excise tax debt of \$125,000, which Denman later satisfied for \$50,000 under an OIC agreement. Because assumption of the tax debt was part of the price Denman paid for the acquired assets, Denman should probably be viewed as having received loan proceeds in the form of the assets. If so, the tax debt should be treated just as any other purchase-money debt would be treated in this situation.¹³⁷

For just that reason, Denman argued that it was protected by a line of cases holding that renegotiation and reduction of purchase-money debt does not create income, but is treated instead as reducing the purchase price and basis of the assets.¹³⁸ The argument was rejected by the Tax Court, on the grounds that the government was not the seller of the property,¹³⁹ and that no proof had

¹³⁶ *Id.* Denman itself had never deducted the forgiven taxes or interest, and so, unlike the other three reported OIC cases, the COD issue did not involve the tax benefit rule.

¹³⁷ If the acquisition is taxable, for example, the tax debts assumed should provide the taxpayer with basis in the assets, for the same reason as would the assumption of debts to any other creditor. See *Crane v. Commissioner*, 331 U.S. 1 (1947) (debt included in basis where property acquired was subject to mortgage).

¹³⁸ See *supra* note 30 and accompanying text. See also *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943) (renegotiation of purchase money indebtedness held reduction in purchase price rather than taxable gain); *Helvering v. A. L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942) (same).

¹³⁹ Relief under current I.R.C. § 108(e)(5) requires the purchase-money lender to be seller. Some early case law apparently imposed no such limitation. See *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934) (mortgagee's reduction of nonrecourse debt subject to which purchaser acquired property held not taxable). Other decisions required not only that the creditor be the seller, but also that debt reduction must result from direct negotiations between buyer and seller and concern the property rather than the debt. See *Fifth Avenue-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453 (2d Cir. 1944) (questioning rationale of price adjustment doctrine altogether).

The seller-financing limitation is difficult to justify. Ordinarily it makes no economic difference to a buyer whether purchase-money debt is held by the seller or a third party. Note also that a price rebate in cash is treated as a tax-free return of capital even when it is received from a third party. See *Rev. Rul. 76-96*, 1976-1 C.B. 23 (cash rebate from manufacturer to purchaser of automobile not gross income, but basis in auto must be reduced). There is no apparent reason why a purchaser for debt should not be treated in the same way. The seller-financing limitation on price adjustments seems to remain the law, however. See *Sutphin v. United States*, 14 Cl. Ct. 545 (1988) (prepayment discount on home mortgage

been offered that the property had declined in value.¹⁴⁰ The price adjustment issue perhaps deserved more consideration than it received in the Tax Court's cursory dismissal.¹⁴¹

In *Denman*, as in *Yale Avenue*, it was apparently assumed by both the taxpayer and the Service that the OIC agreement created COD income. *Denman* actually reported the COD on its original return for 1941, the year of the agreement. The COD income was more than offset by losses, however, so that the return showed an overall loss. In subsequent years the company became profitable, and in 1944 it decided to amend its 1941 return by electing to reduce its basis in assets rather than recognize COD income.¹⁴² This had the effect of creating additional loss carryforwards which reduced *Denman's* taxes for 1942, and *Denman* claimed a refund for that year.¹⁴³ The Tax Court held that it was too late to make the election, and stated that the election was intended to postpone taxes for the year of debt restructuring, not to allow the taxpayer to reduce taxes in later years by increasing its loss carryfor-

created COD income rather than price adjustment because lender Savings & Loan was not the seller of the home, nor had home fallen in value to less than face amount of debt). See also Rev. Rul. 92-99, 1992-2 C.B. 35; Richard M. Lipton, *New Rulings on Purchase Price Reductions Do Not Provide Much Relief*, 78(2) *J. Tax'n* 68 (1993). If the home in *Sutphin* had been seller-financed, the prepayment discount might have been excludible.

¹⁴⁰ This limitation also derives from early case law. See *Commissioner v. Coastwise Transp. Co.*, 71 F.2d 104 (1st Cir. 1934) (negotiated purchase-money debt reduction held taxable because value of property remained sufficient to pay debt in full); *Codden Bros. Inc. v. Commissioner*, 37 B.T.A. 393 (1938) (same). It is not easy to understand the rationale for this limitation, but it too appears to remain the law. See *Sutphin*, *supra* note 139. A price rebate in cash is treated as a return of capital without regard to any change in the value of the property.

Although no proof of loss of value was offered in *Denman*, it is reasonable to surmise that the assets had less value at the time of the compromise than they appeared to have at the time of purchase, because the purchaser evidently received less income from the assets than expected. One does not purchase income-producing assets in order to suffer foreseeable losses.

¹⁴¹ The Tax Court opinion states outright that assumption of the tax debt was part of the purchase price of the assets. *Denman*, 14 T.C. at 714. As a result, this aspect of the Tax Court decision seems to conflict with the holdings in *Hirsch* and in *Fulton Gold*. See *supra* note 139 and accompanying text. The taxpayer apparently dropped this issue on appeal, because it was not reconsidered in the Sixth Circuit's opinion.

¹⁴² Under § 22(b)(9) of the 1939 Code, a corporation could exclude COD income by electing instead to reduce the basis of its assets. See *supra* note 41.

¹⁴³ 192 F.2d at 253. In *Denman*, the ultimate issue might be regarded as whether the taxpayer should be permitted to retain live NOL carryovers to years after the OIC agreement. It will be seen that all the other three OIC cases involved precisely this same situation. See *infra* Part V.

wards.¹⁴⁴ The election was unnecessary, however, if no COD income arose in the first place. If the cancellation were properly viewed as a price adjustment, as the taxpayer argued, the resulting adjustment to basis would have had an effect identical to that of the election.

2. Tax Benefit of Accrued Deductions as Loan Proceeds

Cancellation of a debt for an accrued and deducted item is treated as a recovery of that item for purposes of the tax benefit rule.¹⁴⁵ According to Revenue Ruling 67-200,¹⁴⁶ forgiveness of unpaid interest which had been accrued and deducted in a prior year is treated as COD income to the extent the deductions provided a tax benefit.¹⁴⁷ The income was held eligible for exclusion under section 108(a) of the Code if the taxpayer elected to reduce basis,¹⁴⁸ thus confirming its characterization as COD income.¹⁴⁹ Al-

¹⁴⁴ Id. at 262-63. Despite the court's assertion, however, precisely such an increase in NOLs and reduction of future taxes would have been the apparent effect of the election if it had been timely made. The court seemed principally concerned with the fact that the taxpayer changed its mind about how to report the COD income (whether to make the election) using the hindsight of later years to determine which choice produced the greater tax advantage.

¹⁴⁵ I.R.C. § 111.

¹⁴⁶ 1967-1 C.B. 41.

¹⁴⁷ The same rule should apply to forgiven interest which was accrued and deducted on a tax debt. This is a necessary corollary to the rule that a refund of interest on a tax overpayment is income under the tax benefit rule to the extent it was deducted with tax benefit. See *Bird v. United States*, 241 F.2d 516 (1st Cir. 1957). Treating such a refund of interest as income results in a net refund after tax of \$.66 on the dollar at a 34% tax rate, and that is precisely the amount the taxpayer was out of pocket, assuming the deduction was enjoyed at the same rate. Cancellation of accrued but unpaid interest should result in tax of \$.34 on the dollar, which again is precisely the amount of tax the taxpayer avoided in the deduction year.

¹⁴⁸ The election referred to in the ruling has since been repealed. See *supra* note 41. Similar elections have since been enacted, however, in 1986 for qualified farm indebtedness under I.R.C. § 108(g), and in 1993 for qualified real estate indebtedness under §§ 108(a)(1)(D) and 108(c). See *supra* notes 43-44.

¹⁴⁹ The Treasury's conclusion seems correct, but it is at least arguable that the income might have been held to be outside the protection of I.R.C. § 108, on the ground that income under the tax benefit rule is *sui generis* and distinct from COD income. Just such a rule was proposed in the House bill which led to the 1954 Code, but it was dropped by the Senate. Under the proposed House bill, a solvent debtor could elect to reduce basis rather than recognize COD income currently, but the election would have been explicitly inapplicable where the taxpayer had derived a tax benefit by deducting the debt. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 13 (1954).

Cf. the context of transfers of over-encumbered property to creditors, where the Service has flip-flopped from its earlier position that the cancelled portion of the debt is shielded by

though the point was not discussed in the ruling, it seems clear that the prior tax benefit serves as the equivalent of loan proceeds for purposes of applying section 61(a)(12). This seems correct, because the tax benefit of a deduction has exactly the same value as an exclusion of cash from income.¹⁵⁰ Thus, to the extent the inclusionary side of the tax benefit rule applies, cancellation of a tax debt apparently should be treated as income.¹⁵¹

The tax benefit rule is potentially applicable to nearly all OIC agreements involving accrual method taxpayers, because at least some previously accrued and deducted interest on the tax debt is normally forgiven. Three of the four reported OIC decisions involved precisely this factual situation, although only one, *Eagle Asbestos & Packing Co. v. United States*,¹⁵² involved an assessment explicitly based upon the tax benefit rule. The rule was apparently applicable in both *Manhattan Soap*¹⁵³ and *Yale Avenue*¹⁵⁴ as well, because the OIC agreements cancelled only those

the § 108(a) insolvency exception, to its current position that the cancellation is "gain" rather than COD income and thus includible income even to taxpayers who are in bankruptcy. See Rev. Rul. 90-16, 1990-1 C.B. 12, which announces the change of position. See also Timothy M. Larason, *Is Gain on Transfer of Property to Creditor by Insolvent Taxpayer Subject to Income Tax?*, 49 Tax Notes 1135 (Dec. 3, 1990).

¹⁵⁰ At a 34% tax rate, an exclusion of \$1.00 is worth \$.34 to the taxpayer, and a deduction of \$1.00 is worth in principle exactly the same \$.34. Nothing is ever quite so simple, however. For example, an exclusion may often be more valuable than an itemized deduction to individual taxpayers, because the exclusion reduces adjusted gross income which causes phaseouts of other deductions and exemptions under I.R.C. §§ 67, 68(a) and 151(d)(3).

¹⁵¹ Although both I.R.C. §§ 111 and 61(a)(12) apply to this situation, characterization of the income as COD is narrower and perhaps more accurate because it is excludible under § 108(a), which applies only to COD. On the other hand, similar income was characterized as tax benefit rule income rather than COD in *Schlifke v. Commissioner*, 61 T.C.M. (CCH) 1697 (1991) (previously paid and deducted interest held income under tax benefit rule where interest was credited toward repayment of principal pursuant to rescission of home equity loan under Truth in Lending Act). In *Schlifke*, the government assessed tax under both theories in the alternative. After citing *Zarin* and commenting that the law of COD was controversial and murky, the court applied the tax benefit rule without further consideration of the COD alternative. No issue of insolvency or of other exceptions to COD was present, however, and so it was unnecessary to decide between the two theories.

¹⁵² 384 F.2d 528 (Ct. Cl. 1965).

¹⁵³ 3 T.C.M. (CCH) 257 (1944). In *Manhattan Soap*, an accrued and deducted manufacturers' excise tax liability together with interest totalling \$319,256 was settled for a \$35,000 cash payment. Both the principal and the interest were deductible.

¹⁵⁴ 58 T.C. 1062 (1972). There were two taxpayer corporations in *Yale Avenue* with nearly identical factual issues. Both OIC agreements cancelled only accrued and deducted interest and no principal. The parties failed to perceive that *Eagle Asbestos* was directly contrary authority, perhaps because the assessment in that case was made under the tax benefit rule

portions of the debts which had been accrued and deducted. Despite the fact that the tax benefit rule should apparently create income to the extent of the prior deductions, in *Eagle Asbestos*, the one reported decision which squarely faced this issue, the Court of Claims rejected an assessment based on the tax benefit rule. The decision appears to be correct, and the reasons why it appears correct form the subject of Part IV.

IV. UNINTENDED CONSEQUENCES OF COD INCOME

Part A will explore some paradoxes raised by taxing OIC agreements. Part B will examine the similarity between these difficulties and even greater ones which would be raised by taxing other cancellations of tax debt. Part C proposes a general explanation of both sets of problems.

A. OIC Agreements

This Part explores three difficulties in taxing OIC agreements: (1) it is futile if the taxpayer cannot pay; (2) if the taxpayer can pay, it unfairly defeats expectations; and (3) even if the Service recognizes these difficulties, it is apparently powerless to prevent them.

1. Futility

As shown in the preceding section, income appears to arise from an OIC agreement where the tax benefit rule applies. But the result is somewhat paradoxical, if not outright self-defeating, because the very act of cancelling the old tax would create a new tax. If the Service has made the best possible compromise, the taxpayer will be unable to pay anything more than the settlement amount. Any new tax debt presumably would be uncollectible as well and would only provoke new negotiations and a new compromise, which in turn would trigger a second round of COD income and a third compromise, and so on.¹⁵⁵

The paradox is magnified by the fact that the less the taxpayer can afford to pay, the greater the COD tax. For example, if the

rather than as COD income.

¹⁵⁵ This series of compromises and taxes would go on infinitely, although it approaches a limit of zero.

taxpayer can pay only \$.10 on the dollar toward the old debt, the tax on \$.90 of COD might be three times greater than the compromise payment.¹⁵⁶ Neither Congress nor the parties to the OIC agreement could have intended such a bizarre result.

2. *Finality of OIC Agreements*

An OIC agreement effects a settlement of the taxpayer's liability which is final. The case may be not be reopened unless the taxpayer has misrepresented its present or expected future financial condition.¹⁵⁷ Treating the settlement as COD income can be viewed as simply restoring one-third¹⁵⁸ of the debt which was just extinguished, and thus as violating the guaranty of finality.¹⁵⁹

If a taxpayer who has entered into an OIC agreement is able to pay an additional tax on COD income, that probably indicates that the Service failed to negotiate the best available compromise. The Service can easily negotiate access to the taxpayer's future wealth, because the taxpayer must submit a collection information statement with the OIC listing its assets, income and expected future income. The possibility of future increases in the taxpayer's ability to pay is a required subject of negotiation.¹⁶⁰ Compromise amounts can be made payable over time rather than in a lump sum,¹⁶¹ and collateral agreements may be negotiated to provide that some percentage of any contingent or unexpected income of the taxpayer must be paid toward the old debt in addition to the compromise amount.¹⁶²

¹⁵⁶ Because \$.90 was forgiven, the tax at 33% would be \$.30, or three times the compromise amount of \$.10. It is perhaps unrealistic to assume such a high tax rate for a distressed taxpayer, but even at a 15% rate, the unexpected COD tax brings the total payments to nearly two and one-half times the maximum amount the taxpayer was deemed able to pay. If the assessment itself was unrealistically high, the COD "gain" alone could push the taxpayer into the highest bracket. See *supra* note 18.

¹⁵⁷ Treas. Reg. § 1.7122-1(c); I.R.S. Manual §§ 57(10)1.4, 57(20)1 (Feb. 26, 1992).

¹⁵⁸ The exact amount depends on the rate of tax applicable to the COD.

¹⁵⁹ I.R.S. Form 656, Offer In Compromise, makes no mention of and gives no protection from this possibility.

¹⁶⁰ See I.R.S. Doc. No. 7917 (2-92), *supra* note 16, at 13-19. See also I.R.S. Manual § 57(10)(13).(12) (Feb. 26, 1992).

¹⁶¹ See I.R.S. Manual § 57(10)6.4 (Feb. 26, 1992).

¹⁶² I.R.S. Manual § 57(10)(15). Under the new program of streamlined procedures, however, collateral income agreements are disfavored because they are thought to require complex monitoring. I.R.S. Doc. No. 7917, *supra* note 16, at 21. Where feasible, lump sum settlements are preferred over installment plans. For this purpose, the taxpayer's estimated

If the Service miscalculated the taxpayer's financial situation despite its ample powers of discovery, assessment of COD income to correct its mistake may appear to be an unfair reopening of the final settlement through a back door. This would defeat the taxpayer's expectations, if not its contractual rights as well. The question then arises whether the agreement itself can be construed as preventing the tax, and if not, whether the parties might prevent the tax by explicit agreement.

3. *Can COD Income be Avoided by Agreement?*

In *Eagle Asbestos*, the Court of Claims rejected an assessment for COD income under the tax benefit rule as violative of the OIC agreement on the ground that the apparent intention of the parties was to extinguish all obligations to the government for the years covered.¹⁶³ In reaching this conclusion, the court stressed the fact that the government was in possession of the taxpayer's returns and must have known of the taxpayer's accrued deductions.¹⁶⁴ If the parties had intended the compromise agreement to disallow the taxpayer's prior accruals, the agreement would have said so explicitly. Because it did not, the court concluded that the parties must have intended to leave the deductions undisturbed.¹⁶⁵

ability to make payments over time is generally treated as an asset which may be valued by discounting to present value. *Id.* at 19. The period to consider for this asset is the remaining collection period or five years, whichever is less.

¹⁶³ 348 F.2d at 531-33.

¹⁶⁴ *Id.* at 531. *Eagle Asbestos* had accrued interest on the cancelled debt, and the accruals resulted in NOLs which the taxpayer applied to offset income in years following the OIC agreement. The assessment would have created income in the year of the compromise, which in turn would have used up the NOLs. The actual assessment was for years after the OIC to which the NOLs were carried forward.

¹⁶⁵ *Id.* at 531. As an alternative ground of decision, the court asserted that it was impossible to determine which part of the lump-sum settlement, if any, was allocable to cancelled interest, and thus whether any interest was cancelled at all. Under I.T. 3852, 1947-1 C.B. 15, a lump-sum settlement for a deficiency including penalties and interest was ruled a payment in lieu of the liability, and that no part of such payment was deductible as interest.

This ruling was reversed and superseded by Rev. Rul. 73-304, 1973-2 C.B.42 which acquiesced in the reasoning of *Robbins Tire & Rubber Co. v. Commissioner*, 52 T.C. 420 (1969) and 53 T.C. 275 (supplemental opinion 1969). According to Rev. Rul. 73-304, compromise payments are to be applied first to tax, penalty, and interest, in that order, for the earliest taxable period, then to tax penalty, and interest, in that order for the next succeeding taxable period, until the payments are absorbed. If the compromise payment is less than the total liability for taxes and penalty, however, no amount will be allocated to interest. These rules are now stated on I.R.S. Form 656, Offer in Compromise, at clause 6. Under these

The result in *Eagle Asbestos* seems correct, but the court's reasoning is not altogether satisfying.¹⁶⁶ If COD income is in fact required, even an explicit agreement to waive the tax would probably be ineffective for two reasons. First, the Service is not authorized to compromise liabilities under section 7122 of the Code unless the taxes are already assessed and due.¹⁶⁷ Because tax on the COD would not be due until the following year, the tax would not be assessable until then. Section 7122(b) requires the Service to file a statement of the amount of tax assessed and the amount compromised.¹⁶⁸ If the amount compromised includes forgiven taxes on COD, that amount cannot be determined at the time of the OIC agreement, and must await the end of the year of the OIC agreement, when the taxpayer's remaining items of income and deduction for that year become known.

Second, the Service has no apparent authority under any other Code provision to waive a future tax which would otherwise be required.¹⁶⁹ Thus, even if the taxpayer did obtain an explicit protective clause, it would not be binding unless on an theory of estoppel, and estoppel is very rarely applied against the government.¹⁷⁰ The

current rules, interest is in effect cancelled first.

¹⁶⁶ Even if the Service had the authority to waive COD income, the facts do not indicate that it was exercised. The parties simply failed to consider the issue. This failure almost certainly rested on an unstated mutual assumption that no income arises. If the Code does require income treatment, however, the parties' mistaken assumption to the contrary cannot prevent a subsequent correct assessment of the tax due.

¹⁶⁷ See *Barnes v. United States*, 201 Ct. Cl. 879 (1973) (compromise agreement has no effect upon tax items of future tax years). See also *Kennedy v. United States*, 965 F.2d 413, 420 (7th Cir. 1992).

¹⁶⁸ I.R.C. § 7122(b) requires the General Counsel to file with the Secretary a statement of the amount of tax, interest, and penalties assessed, the amount actually paid, and the reasons for the compromise. Such a report obviously cannot be filed with respect to liabilities which have never been assessed. By implication, it follows that Congress did not intend to authorize compromise of unassessed liabilities under § 7122.

¹⁶⁹ By contrast, taxpayers are not bound to exercise their rights against the government, and may waive them voluntarily with or without an agreement. For example, a taxpayer is not bound to claim a deduction merely because it may legally do so, and for that reason it may also bind itself to waive its rights to deductions or other tax attributes by contract.

¹⁷⁰ Estoppel is traditionally said to be ineffective against the government on the ground of separation of powers. An administrative agent of the executive branch has no authority to contravene the will of Congress. On the other hand, the courts have occasionally protected taxpayers from unconscionably harsh consequences of good-faith reliance upon erroneous official assurances. See, e.g., *Shuster v. Commissioner*, 312 F.2d 311 (9th Cir. 1962). See also Theodore Lynn & Mervyn Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 Tax L. Rev. 487 (1964); Com-

Service can bind itself to the future tax treatment of a contemplated transaction by means of a Private Letter Ruling (PLR),¹⁷¹ or by a closing agreement,¹⁷² but as noted above, it has no authority *de jure* to waive a tax which would otherwise clearly become due.¹⁷³ On the other hand, the Service can be regarded as having *de facto* the power to make law in taxpayers' favor, because the favored taxpayers have no incentive to contest the result. As long as other similarly situated taxpayers are treated with consistent lenience, no one would have standing to compel the Service to impose the tax.¹⁷⁴ Closing agreements and PLRs are costly and time-consuming, however. Even assuming the Service would be willing to grant them, their use would undercut the purpose of the new streamlined OIC procedures. Also, reliance on PLRs or closing agreements, like mere forbearance, would leave the Service free to adopt the "correct" position at any time for other taxpayers, provided that it did so consistently.¹⁷⁵

The COD problem would thus appear to require a legislative solution such as enactment of a new exception under Code section 108 for OIC agreements, or a grant of authority to the Service to waive COD in appropriate situations. The need for such legislation seems doubtful, however, when other forms of statutory tax relief

ment, Unauthorized Conduct of Government Agents: A Restrictive Rule of Equitable Estoppel Against the Government, 53 U. Chi. L. Rev. 1026 (1986).

It does not appear that liability for COD which is correctly assessed would rise to the level of unconscionable injury under the case law. Estoppel has usually been applied where the tax would have been avoidable if the taxpayer had not abandoned a valid defense in reliance upon the official assurance. See, e.g., *Walsonavich v. United States*, 335 F.2d 96 (3d Cir. 1964). A mutual mistake of law is generally insufficient ground for estoppel. See *Badger Materials, Inc. v. Commissioner*, 40 T.C. 725 (1963). Moreover, good-faith reliance might be difficult to establish because a taxpayer who solicits a no-tax clause is obviously aware of the issue and may well be better informed on the legal question than the government agent. In any event, *ad hoc* reliance on estoppel can hardly provide a general solution to the COD problem.

¹⁷¹ If the taxpayer has made no material misrepresentation of fact, a PLR will not be retroactively revoked "[e]xcept in rare or unusual circumstances." Treas. Reg. § 601.201(l)(5). Other taxpayers may not rely on the PLR, however. Treas. Reg. § 601.201(l)(1).

¹⁷² I.R.C. § 7121.

¹⁷³ Apparently, the only way the Service could assure taxpayers of a no-tax result is by issuing the taxpayer in good faith a (mistaken) PLR or closing agreement.

¹⁷⁴ See Lawrence Zelenak, Should Courts Require the Internal Revenue Service to Be Consistent?, 40 Tax L.Rev. 411, 429 (1985).

¹⁷⁵ *Id.* at 430.

are considered. In the following two sections, a general solution to the problem will be developed on the basis of a principle of tax logic.

B. *Other Statutory Cancellations of Tax*

If an OIC agreement is taxable, there is no obvious reason why tax forgiveness via other provisions of the Code should not be taxable as well.¹⁷⁶ This would have consequences even more surprising than for OIC agreements. For example, if Code sections 61(a)(12) and/or 111 applied to the ten-year statute of limitations on collections after assessment,¹⁷⁷ the statute would in effect extinguish only two-thirds of a tax debt, because it would reinstate one-third¹⁷⁸ of the debt for a new life of ten years as a tax on COD.

¹⁷⁶ Some tax debts may also be discharged outside the Code in bankruptcy proceedings. For example, income taxes assessed more than 240 days before filing a petition in a Chapter 7 proceeding may be dischargeable. 11 U.S.C. § 507(a)(7)(A)(ii) (1988).

Although the insolvency exception under I.R.C. § 108(a) precludes current taxation of COD, a different question lurks behind the exclusion. Under I.R.C. § 108(b), insolvent taxpayers must reduce tax attributes by the amount of COD excluded under § 108(a). If cancellation of a tax debt is not income in the first place, it was not excluded under § 108(a), and the taxpayer should not be required to surrender tax attributes. This issue has apparently never been litigated, and has not been mentioned in the tax literature.

¹⁷⁷ I.R.C. § 6502. Statutes of limitation in the Code extinguish the taxpayer's liability altogether, unlike most other statutes of limitation which only bar the creditor's remedy when raised as an affirmative defense. See Bittker & Lokken, *supra* note 29, ¶ 113.2.

The running of a statute of limitations is often said to be a triggering event for COD income. It is not entirely clear that this is correct, however, because a creditor in this situation has probably abandoned hope and effectively forgiven the debt long before the running of the statute, so that any COD should have been taxed in an earlier year. All the reported litigation concerns the recurrent situation of estates of decedent shareholders who had taken out loans from their own corporations many years earlier. See, e.g., *Estate of Bankhead v. Commissioner*, 60 T.C. 535 (1973); *Estate of Miller v. Commissioner*, 37 T.C.M. (CCH) 1547 (1978); *Miller Trust v. Commissioner*, 76 T.C. 191 (1981). When the creditor corporation (still owned by the family of the decedent) fails to make a claim against the estate within the very short (usually six-month) nonclaim statute, COD income is taxed to the estate. If the purported loans were not evidenced by written agreements and required no interest, it might be more realistic to regard them as dividends instead. See *Treas. Reg. § 1.301-1(m)*. It is noteworthy that the Service does not allow the corporate creditor a bad debt deduction in this situation, despite the "debt" treatment of the shareholder. See *Bankhead*, 60 T.C. 535. If the advance was a dividend, however, it should have been taxed when paid, and it may never be taxed if the statute of limitations on assessments runs before audit of the estate.

¹⁷⁸ The precise amount would depend upon the tax rate applicable to the COD income. If the taxpayer is in the 31% bracket, each dollar of cancelled tax debt would create a new liability of \$.31, and so in effect only 69% of the tax debt will have been cancelled by the statute of limitations.

After ten years of interest compounding on the remaining third, two-thirds of that sum would be cancelled, and so on every decade forever until the taxpayer's death. The statute would never completely eliminate a tax liability, just as the Zeno's arrow never reaches its goal. This result is obviously absurd because it would defeat Congress' intention to provide repose.¹⁷⁹

The three-year statute of limitations on assessments under Code section 6501(a) would be subject to the same problem if an unassessed tax liability constitutes "indebtedness" within the meaning of Code section 61(a)(12). There is at least some reason to think that it does.¹⁸⁰ If so, the statute would never run on liabilities which have not been assessed.¹⁸¹ This would confer significant new powers upon the Service because no tax year would ever finally close. As a result, assessments might be made at any time for taxes due as far back as 1913. Very great burdens would be placed on taxpayers, who would be forced to retain their records forever.¹⁸² The effect would be equivalent to repealing the statute of limitations altogether and replacing it with a reduced rate of tax which declines with the age of the "closed" year. On the taxpayer's side, at least, income treatment would completely defeat Congress' intent to provide repose and freedom from the threat of prosecution of stale claims.¹⁸³

The Service has of course never made an assessment based on either statute of limitations, and it is difficult to believe that any

¹⁷⁹ See *United States v. Updike*, 281 U.S. 489, 496 (1930).

¹⁸⁰ For purposes of transferee liability under I.R.C. § 6901, at least, it is clear that a transferor is "liable" for unassessed taxes. See Saltzman, *supra* note 11, at ¶ 17.03.

¹⁸¹ Every three years two-thirds of the unassessed liability plus interest would be cancelled under I.R.C. § 6501, and the remaining third would be given new life under § 61(a)(12). The Service could always assess the remaining tax (plus interest and penalties) as new COD income in the current year.

¹⁸² In one respect, this may seem to be less of a departure from current law than it first appears. Under current law, it is sometimes necessary to examine long-closed years for specific items such as earnings and profits, basis and other tax benefit items which may affect the tax for a later year. Auditing a closed tax year to see if a liability should have been assessed is perhaps no different in principle. On the other hand, the field of potential inquiry would become limitless if any and all items of any and all closed years were to become fair game.

¹⁸³ See *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 301 (1946). The taxpayer would never enjoy repose, but the government would. Under I.R.C. § 6511(a), taxpayers would still be barred from bringing a suit for refund more than three years after filing. Thus, the statutory scheme of limitations would become a one-way street in favor of the government.

judge would uphold such an assessment because the result is absurd.¹⁸⁴ The absurdity is even more obvious than in the case of an OIC agreement, but nothing in the Code itself appears to prevent Code sections 61(a)(12) and/or 111 from applying to both situations alike.

In theory, the same issue also arises when Congress cancels a tax debt by means of a private bill. Congress occasionally uses private bills to reverse a court judgment or other final tax determination in order to provide *ad hoc* tax relief.¹⁸⁵ Congress has sometimes provided similar relief through a narrowly drawn retroactive provision of a revenue act which may or may not have general application.¹⁸⁶ Congress could easily insert a clause in private bills to prevent further tax, but it has never done so, undoubtedly because Congress did not expect tax relief to be taxable.

C. *The Circularity Principle*

Taxing statutory tax relief is inherently self-contradictory, which is obvious from the examples of the preceding section. Although an OIC agreement resembles a private compromise of debt to which Code section 61(a)(12) would normally apply, an OIC agreement is also a statutory method of granting tax relief in the same sense as

¹⁸⁴ Legislative intent is often said to be irrelevant if the plain meaning of a statute is clear on its face. On the other hand, if the "plain meaning" of I.R.C. § 61(a)(12) leads to an obviously absurd result, its meaning may not be so plain after all. See Bittker & Lokken, *supra* note 29, at ¶ 4.2.2.

¹⁸⁵ Congress has occasionally done so in order to mitigate the harsh effects of joint and several liability under I.R.C. § 6013(d). For examples of such private laws waiving statutes of limitations and *res judicata*, see Richard C.E. Beck, *The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should Be Repealed*, 43 *Vand. L. Rev.* 317, 349 n.140 (1990). For accounts of the problems raised by such legislation, see also Note, *Tax Equity and Ad Hoc Tax Legislation*, 84 *Harv. L. Rev.* 640 (1971); Stanley S. Surrey, *The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted*, 70 *Harv. L. Rev.* 1144 (1957).

¹⁸⁶ For example, Congress provided additional innocent spouse relief in § 6004 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, which was retroactive for any taxpayer who filed before January 1, 1985. The relief was termed a "transitional rule" and seems aimed at one taxpayer, but apparently because of the outcry over "rifle-shot" transitional rules in the Tax Reform Act of 1986, the provision is drafted broadly enough so that it should apply to at least some other taxpayers. See Beck, *supra* note 185, at 350 n.141.

On the question whether such legislation is constitutional, see Lawrence Zelenak, *Are Rifle Shot Transition Rules and Other Ad Hoc Legislation Constitutional?*, 44 *Tax L. Rev.* 563 (1989) (arguing that they probably are constitutional).

a statute of limitations, and it would be just as illogical to require a tax on one as on the other. In fact, if the law did require a tax on OIC agreements, the Service would want the power to waive the tax, and logically should always exercise it.¹⁸⁷

To illustrate, consider the following example. A taxpayer owes \$200 in back taxes, but is able to pay only \$100 over the next three years. If the Service accepts an offer of \$100 and COD income arises, the taxpayer will owe an additional \$33 in the following year. This result is futile if the taxpayer cannot pay the additional tax. If the taxpayer can pay \$133, the Service's determination that the taxpayer can pay only \$100 must be wrong. No additional revenue is produced unless the Service has made an error. On the other hand, if the Service agrees to leave the taxpayer with funds to pay the COD liability, the compromise amount should be only \$50. In that case, \$150 of debt will be cancelled, and the COD liability for the following year will \$50, which equals the taxpayer's remaining ability to pay.¹⁸⁸ But, a \$50 payment is not the best compromise available if the taxpayer can in fact pay \$100. It would be poor business judgment for the Service to reject \$100 in hand in order to collect \$50 now and a doubtful promise of \$50 later, and it would be contrary to Congress' intention that the Service should collect the maximum amount available. In short, taxing OIC agreements would probably raise no more revenue than not taxing them, and perhaps less. This paradoxical result resembles a proof *a contrario*. Assuming the premise to be true leads to an apparent contradiction, and the premise must therefore be false: no COD is created in the first place.¹⁸⁹

¹⁸⁷ Thus, the *Eagle Asbestos* court's inference that the parties did not intend COD income to arise does not rest on the particular facts of that case, as the court seemed to think, but rather on the fact that the parties to any OIC agreement would logically waive the tax.

¹⁸⁸ Where c = the amount of the compromise, a = the total amount the taxpayer can afford to pay, r = the expected rate of tax applicable to the COD income, and d = the tax debt to be compromised, the compromise amount is determined as follows:

$$c = a - r(d)/(1 - r).$$

Using the numbers in the text, $c = 100 - .33(200)/(1 - .33)$. At lower tax rates, the difference in the amount of the compromise is less dramatic, but the principle remains the same. If the expected tax rate is 15%, for example, and the other numbers remain the same, the compromise amount should be \$82 in order to leave the taxpayer with \$18 to pay the tax on \$118 of COD income in the following year.

¹⁸⁹ Thus, a legislative solution to the problem cannot be found by delegating to the Service the authority to waive COD income in appropriate circumstances. If the Service had such authority, it should always make the waiver, as shown above.

The paradox in the above example resembles a variety of problems which can arise when the outcome of a tax rule is treated as if it were a taxable event. An example of this principle has already been noted in connection with the deductibility of income taxes: although a deduction appears justifiable, it is pointless to allow it because it is circular in effect.¹⁹⁰ In general, tax detriments are not treated as losses¹⁹¹ and tax benefits are not treated as gains. Without this rule, similar problems would arise on the income side where a tax rule seems to yield an item which otherwise resembles gross income. For example, a tax credit is not treated as income even though a tax credit is a valuable receipt which otherwise appears to be squarely within the usual definitions of gross income.¹⁹² If the credit were treated as income, that would reduce the value Congress apparently intended for the credit.¹⁹³ If Congress wanted this result, it would presumably have enacted a

¹⁹⁰ See *supra* notes 118-20 and accompanying text.

¹⁹¹ A tax detriment (such as a penalty) which merely increases the amount of liability would not be deductible by a cash-method taxpayer in any case until the tax is actually paid, and an accrual-method taxpayer would not be permitted to accrue the deduction until economic performance. See *Treas. Reg.* § 1.461-4(g)(6). Thus, on the tax detriment side, the circularity principle boils down to the prohibition against deducting federal income taxes under *I.R.C.* § 275.

¹⁹² For example, the historical rehabilitation credit under *I.R.C.* § 47 permits the taxpayer to reduce its taxes by 20% of the amount expended. The credit is a direct reduction of the taxpayer's tax liability; it is earned by performance of the conditions under § 47; and it is the economic equivalent of a check from the government. The credit appears to be an accession to wealth which is clearly realized by and under the control of the taxpayer, and it is not excluded by any specific provision of the Code. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

It might be countered that items entering an initial computation of tax liability, such as tax credits, stand on a different footing from rules governing a later recomputation of liability such as OIC agreements or the 10-year statute of limitations. A tax credit arguably does not reduce a fixed liability already owed, but merely enters the computation of what will be owed. On the other hand, this distinction seems less persuasive if the benefit of an overlooked tax credit or deduction is obtained by amending a prior return to claim a refund. In that case the refund would also be a redetermination of a prior "fixed" liability.

¹⁹³ Congress has in fact limited the value of investment tax credits by requiring the taxpayer to reduce basis by the full amount of the credit. *I.R.C.* § 50(c)(1). The rationale for this rule has nothing to do with treating the credit as income, however. Basis reduction (by 50% of the credit) was first enacted in 1982 in order to overcome the effectively negative rate of tax on income from depreciable property under the 1981 rules, so that the combination of ACRS cost recovery and investment tax credit would be no more generous than expensing at a 10% after-tax discount rate. See *Staff of Joint Comm. on Tax'n*, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* 36 (Comm. Print 1983).

smaller credit in the first place.¹⁹⁴ Income treatment would also create tax accounting complications.¹⁹⁵

The nontaxability of credits and other tax benefits can also be explained by the fact that they are effectively equivalent to a tax refund, and a tax refund is always excludible as a return of capital.¹⁹⁶ The exclusion for tax refunds (and other tax benefits) is in turn arguably based upon the nondeductibility of income taxes, because a recovery of capital is excludible only in case it was not deducted with tax benefit.¹⁹⁷ In the final analysis, however, Code section 275 is itself based upon the larger principle of avoiding circularity.

This same circularity principle should prevent Code sections 61(a)(12) and 111 from applying to OIC agreements and other statutory tax relief. Tax provisions which are designed to determine the amount of liability are structural rules of the tax system. These structural rules cannot themselves be treated as taxable events without interfering with their purpose. Taxing tax relief is just such a circularity, and permitting it would have the effect not only of complication and inconvenience, but of outright self-contradiction.

The confusion over COD in the case law seems to have been

¹⁹⁴ On the other hand, it is conceivable that Congress might intend a credit to be taxable so that its value will diminish for high-bracket taxpayers. When Congress desires such a result, however, it always uses explicit statutory language to cap or phase out the credit as income increases. See, e.g., the credits for dependent care under I.R.C. § 21; for the elderly and disabled under § 22; and for earned income under § 32.

¹⁹⁵ For example, if a tax credit (or deduction or exclusion) were income, it would be unclear whether it should be taxed in the year that it is "earned," or (if different) in the year in which the economic benefit is actually enjoyed through tax reduction.

¹⁹⁶ If the taxpayer omits a claim of deduction, credit, or exclusion, and subsequently amends the return to claim a refund, the refund is clearly a return of capital. It would be very odd to argue that claiming such benefits in the correct year is income, if the tax could be avoided simply by claiming them in a subsequent year instead.

For the same reason, cancellation of a wrongly assessed tax is necessarily excludible. If it were not, the taxpayer could pay the tax instead, and sue for a refund which would be excludible. Transactions which are economically equivalent should be taxed alike.

¹⁹⁷ I.R.C. §§ 111, 275. Taken together, these rules in effect require taxes to be paid out of after-tax dollars. Put another way, the income tax is not imposed upon net income, but upon income grossed up to include the tax liability. This system is far simpler than the alternative of allowing a deduction for income taxes. I do not claim that this solution is inevitable, however. As pointed out *supra* note 117 and accompanying text, income taxes were in fact deductible from 1913 to 1917. Note also that gifts are not grossed up to include the gift tax.

caused by the dual nature of OIC agreements. On the one hand, an OIC agreement resembles any ordinary compromise of debt between a financially troubled debtor and a creditor attempting to make the best of a losing situation. From this perspective, the usual rules for COD income seem applicable. This has masked the fact that an OIC agreement is also a statutory procedure which determines the amount of the taxpayer's liability.¹⁹⁸ When it is recognized that the OIC procedure is itself a structural tax rule in the same sense as a statute of limitations, the circularity principle should apply.

One might counter that an OIC agreement is not a structural tax rule because an agreement requires a discretionary act of the Service, unlike the ten-year limitation on collections which seems to apply automatically. On closer inspection, however, this distinction appears illusory. The usual reason the Service allows the ten-year statute to run is that it has decided that collection is unlikely and that levy or suit would be futile. In short, it is almost always a discretionary act of the Service which permits enjoyment of the statutory relief, just as in the case of OIC agreements.

In the final analysis, there is no more reason to tax an OIC agreement than the running of a tax statute of limitations. No explicit statutory authority provides for either exclusion, but none is needed because these exclusions are implicit in the logic of taxation.

V. THE OIC CASES REVISITED: TURNAROUNDS AND LIVE NOLs

A. *Past and Future Deductions: The Ulterior Purpose*

All of the taxpayers in the four reported cases emerged from an OIC agreement with live NOLs which they used to offset substantial unexpected post-agreement income. The taxpayer in *Manhattan Soap* became very profitable within a year after the OIC agreement, and was able to reduce its taxes otherwise due by means of loss carryovers which survived the OIC agreement. The same was true in *Eagle Asbestos*.¹⁹⁹ In *Yale Avenue* as well, it appears that

¹⁹⁸ See *supra* note 7.

¹⁹⁹ 348 F.2d at 529-30. In *Eagle Asbestos*, the 1951 OIC agreement cancelled interest which the taxpayer had accrued and deducted in 1948. It appears that the 1948 deduction did not reduce the taxpayer's taxes, but instead had the effect of creating a loss carryforward to the years 1956, 1957 and 1958. The assessment at issue was for these later years.

the deductions had created or increased NOLs which remained alive after the OIC agreement.²⁰⁰ In *Denman*, the taxpayer's election to reduce basis would have permitted it to apply loss carryforwards to offset post-agreement income, and the assessment for COD income had the effect of disallowing the NOLs.

Under Code section 111(c), if a deduction creates or increases a loss carryforward of the taxpayer, the NOL is treated as a tax benefit despite the fact that the deduction has not yet provided any reduction in taxes and will do so only in the future when it may be applied to offset future income.²⁰¹ All three tax benefit cases involved precisely this situation: the taxpayer had accrued and deducted, but not yet paid interest on the cancelled debt, and the accruals created NOL carryforwards (rather than reductions of current tax) which remained alive at the time of the agreement.²⁰²

The Service can easily require taxpayers to reduce NOLs by negotiating a collateral agreement as part of the OIC agreement. Special tax forms exist for this precise purpose.²⁰³ The common denominator of all the reported OIC cases appears to be that the Service miscalculated by failing to require the taxpayers to reduce

²⁰⁰ 58 T.C. at 1069-70. The taxpayer claimed the deductions in the year preceding the compromise when it had no income. No mention was made of a refund of tax from a carryback of the loss to a previous year, and in any case such a refund would surely have been applied against the outstanding tax debts. Thus, it appears that the accruals created NOLs which remained alive, just as in *Eagle Asbestos* and *Manhattan Soap*.

²⁰¹ I.R.C. § 111(c) was originally enacted as § 111(d) by BRTA 1980, Pub. L. No. 96-589, § 2(c), 94 Stat. 3389, reprinted in 1980-2 C.B. 607, 611. The Senate Report explains that the measure "clarifies current law." S. Rep. No. 96-1035, 94th Cong., 2d Sess. 630 (1980), reprinted in 1980-2 C.B. 620, 630. I.R.C. 111(c) appears to reverse rather than clarify prior law, however. See Rev. Rul. 58-546, 1958-2 C.B. 143 (deductions which increased an unexpired NOL did not give rise to a tax benefit). See also Robert A. Bergquist & Alfred C. Groff, *Reorganizing the Financially Troubled Corporation After the Bankruptcy Act of 1980*, 36 Tax L. Rev. 517, 526-27 (1981).

²⁰² This situation will continue to arise because the economic performance rules under I.R.C. § 461(h), enacted in 1984, do not prevent an accrual method taxpayer from deducting interest as it accrues over time regardless of whether the interest is actually paid. Treas. Reg. § 1.461-4(e).

²⁰³ There are two such standard forms. I.R.S. Form 2261-C Collateral Agreement — Waiver of Net Operating Losses, Capital Losses, and Unused Investment Tax Credits, explicitly provides for the taxpayer's waiver of some or all of its existing net operating losses. I.R.S. Form 2261-A Collateral Agreement - Future Income - Corporation, includes under clause (3) a specific waiver of all existing net operating losses so that they cannot be used to offset any future income. Form 2261-A is used when the taxpayer promises to pay, in addition to the fixed sum compromise amount, contingent amounts of future income for a number of years.

their existing NOLs.²⁰⁴ When the taxpayers unexpectedly became profitable, the Service apparently regretted its earlier lenience and attempted to recoup whatever it could from a bad bargain by assessing additional taxes for COD (or tax benefit rule) income. The Service seems to have assessed COD income selectively for this purpose, and for this purpose alone.²⁰⁵ In short, the Service's *ad hoc* assessments for COD income appear to have been a ploy for the ulterior purpose of extricating itself from an unfavorable agreement, or from a mistake of its own making. The COD assessments had precisely the same effect as reopening the agreements to demand *nunc pro tunc* a waiver of the NOLs. Thus, the Court of Claims' view in *Eagle Asbestos* seems confirmed that at bottom, the Service was simply attempting to reopen a final agreement.

The Service's inaction in this area since *Yale Avenue* seems to indicate that the Service also believes *Eagle Asbestos* is correct.²⁰⁶ Until the Service decides to publish its policy, however, taxpayers must live with the threat that the Service may at any time decide to employ its COD theory again. Because taxation should administered by clear and general rules rather than by *ad hoc* measures applied selectively, the Service should formally repudiate *Yale Avenue*.

²⁰⁴ In *Denman*, the facts were somewhat different because the taxpayer initially reduced its existing NOLs voluntarily by taking the COD into income, and later attempted to create additional NOLs by amending its return to exclude the COD. See *supra* note 142 and accompanying text. However, it appears that there was no collateral agreement applicable to future income, and if the Service had negotiated such an agreement, the litigation caused by *Denman*'s unexpected turnaround might have been avoided.

²⁰⁵ This despite the fact that the Service's assessments used broad language, and appear on their face to apply to all cancellations of tax debts. It seems probable that many corporations entering into OIC agreements had accrued and already enjoyed the benefits of interest deductions, but none has ever been assessed. As a practical matter, there would be no reason to do so, because the prior tax benefit is water under the bridge, and cannot affect the taxpayer's present ability to pay.

²⁰⁶ A senior Service official (who requested anonymity) has confirmed this. He stated on the telephone that an IRS internal memorandum of law concludes that *Eagle Asbestos* is correct, and that on the basis of that memorandum, it is now Service policy not to assess additional tax upon OIC agreements. He refused to send a copy of the memorandum, however, which he stated is for internal use only.

B. A Proposal to Reduce Tax Attributes

1. OIC Agreements

There is no apparent reason why loss carryforwards should not always be reduced in exchange for cancellation of tax debts under an OIC agreement, regardless of the origin of the losses. An NOL is in effect an obligation of the government to reduce future taxes of the holder. When the government cancels a taxpayer's delinquent tax obligations, equity would seem to require cancellation of the government's future obligations to the taxpayer as well.²⁰⁷

The setoff should probably not be dollar-for-dollar, as it is under Code section 108(b) for cancellations of non-tax debts, because that would provide the government only \$.34 of benefit in exchange for giving up its claim to a full dollar. The reduction of NOLs should be three-for-one²⁰⁸ if the dollar values are to offset equally.²⁰⁹ The setoff should be calculated at the highest marginal rate in order to prevent any possible overtaxation.²¹⁰ Thus, if the maximum rate in effect for corporations is 34%, it would be reasonable to reduce NOLs by three dollars for each dollar of debt

²⁰⁷ The setoff might also be viewed as an equitable relaxation of the timing requirements under I.R.C. § 172. If the taxpayer has unused loss carryforwards and at the same time also owes back taxes, it ordinarily means that a timing rule prevented the income underlying the tax debt from offsetting the loss. If the loss could be carried back forever, rather than only three years as under the current rules, the loss could be netted against the prior income to extinguish the debt.

²⁰⁸ The correct ratio depends on the taxpayer's expected marginal rate. If the taxpayer is expected to be in the 15% bracket, perhaps the NOLs should be reduced at the rate of 6.7-for-one.

²⁰⁹ This ignores the time value of money, which is also relevant. If the taxpayer is an individual who has large capital loss carryovers which are deductible only at the rate of \$3,000 per year, it may take many years to enjoy them, unless the taxpayer has offsetting capital gains. See I.R.C. § 1211(b).

²¹⁰ Unfortunately, it is often difficult to estimate the dollar value of NOLs with precision. On the other hand, nearly all required adjustments reduce the value of NOLs. It is unlikely that an NOL carryforward can ever be worth more than the value of a current deduction at the highest marginal rate, unless rates are later raised. The value of NOLs is affected by the taxpayer's bracket, by the timing of their use, and also by the fact that, for individuals at least, they may be "absorbed" by intervening years without providing any tax benefit at all. See I.R.C. §§ 172(b)(2), (d); Treas. Reg. § 1.172-4.

A more exact way of calculating the setoff might be to require the taxpayer to use up NOLs against post-agreement income according to existing rules, but without allowing any actual deductions for them until the amount of extra taxes paid because of the foregone deductions equals the taxes forgiven under the OIC agreement. This method would be more accurate, but has the disadvantage of requiring extensive recordkeeping and monitoring.

cancellation under an OIC agreement. The proposed rule should also apply to capital loss carryforwards, suspended passive losses and investment interest deductions, charitable contribution carryovers and the like, all of which represent claims for future tax reduction.²¹¹

The proposed rule should apply as the default rule just in case the OIC agreement does not itself contain an explicit collateral agreement to reduce tax attributes. This would protect the Service from the kind of surprises or mistakes which provoked the reported litigation. The proposed rule would give the Service more than it asked for under its COD income theory, and without distorting the law. The rule could be implemented by regulation because the Commissioner already has discretion to demand a reduction of tax attributes in negotiating OIC agreements.

2. *Statute of Limitations on Collection*

The foregoing analysis suggests a more difficult question: whether attribute reduction should be required in exchange for relief under the ten-year statute of limitations. Legislation would be required to institute such a rule because the Service has no authority to demand such reduction as it does for OIC agreements. The circularity principle should prevent COD or tax benefit rule income in this situation.²¹² Nevertheless, the same equitable argument that was made for OIC agreements can also be made in favor of setting off NOLs against taxes cancelled under Code section 6502. The repose Congress intended to afford through Code section 6502 would not necessarily be undercut by such a rule, because a present setoff of attributes would not ordinarily require investiga-

²¹¹ An alternative solution might be to require the taxpayer to surrender all such tax attributes in exchange for an OIC agreement, even if the value of the attributes exceeds the amount of tax forgiven. Because the OIC is intended to wipe the slate clean of past taxes, this arguably should imply that the debtor's entire tax history should be wiped clean as well. This fresh-start-for-fresh-start approach has the advantage of simplicity, and avoids the need for estimating the current value of NOL's and other attributes.

On the other hand, where the taxpayer has suffered further losses for years subsequent to those governed by the OIC agreement, the effect of this rule might be too harsh. This objection would be overcome if the clean-slate rule applied only to those attributes which were in existence at the end of the last year governed by the OIC agreement, rather than to all attributes existing at the time of the OIC agreement itself. This might not fully compensate the government, but it is perhaps the best compromise.

²¹² See supra Part IV.C.

tion of the taxpayer's liability for the ten-year-old assessment. All that would be required is reduction of any existing NOLs (in an appropriate amount) to the extent of the cancelled liability. In cases where liability is clear because the discharged tax debt was self-assessed or the taxpayer agreed to the assessment, it might well be appropriate for Congress to consider enacting such a rule.

In other cases, however, setoff would probably be inappropriate because it may not be clear that the discharged liability was ever in fact owed. Even if the taxpayer never contested the assessment, the taxpayer still retains the right to pay the tax at any time and to sue for a refund to contest the asserted deficiency. If the matter is never adjudicated, liability would remain doubtful, and resolution of the matter after running of the statute would violate Congress' guarantee of repose.

VI. IMPLICATIONS FOR OTHER COD ISSUES

A. *A New Exception?*

The conclusion that statutory cancellation of a tax debt does not create COD income even where the tax benefit rule would apply rests ultimately on the common sense principle that it would be self-defeating. This principle has potentially wide application. A great variety of non-tax debts may be cancelled or rendered unenforceable by debtor or consumer protection statutes and under common law as well. If all such debt cancellation is taxable, the intended relief would be undercut to the extent of the tax imposed. The problem implicates the entire panoply of state and federal debtor protection law.²¹³ Most such legislation is designed either to prevent or redress debtors' losses due to creditors' overreaching,²¹⁴

²¹³ This potentially includes a great variety of state and federal statutes in the areas of consumer protection, professional ethics and licensing, usury and truth in lending, statutes of fraud, statutes of limitation, anti-deficiency legislation, statutes protecting minors and incompetents, and of course bankruptcy. A complete treatment of the interplay of COD income and consumer or debtor protection law is far beyond the scope of this article. The general problem has received no scholarly recognition at all, nor have particular instances been discussed, except in the bankruptcy area. Very little litigation has been reported involving such cases, and even then, the larger issue has gone unrecognized, as in the *Zarin* decisions and commentaries. See *supra* note 32.

²¹⁴ The New Jersey Casino Credit Act which prohibits extension of excessive gambling credit belongs in this category. See N.J. Stat. Ann. §§ 5:12-101(b), (f) (West 1988). The purpose of rendering such debts unenforceable is to prevent casinos from encouraging com-

or simply to alleviate hardship, and generally is not intended to enrich the debtor.²¹⁵

Section 61(a)(12) of the Code should not be applied literally and automatically where it might conflict with the purpose of statutory debt relief. In most such cases a no-tax outcome may be independently determined either by an absence of loan proceeds received, or by the disputed debt doctrine.²¹⁶ In close cases, however, some weight should be given to the intended purposes of the relief statute in determining whether taxation is appropriate.²¹⁷ This is not to say that federal tax law should automatically defer to non-tax policy, but rather that tax rules should not be applied mechanically as if the Code were a closed system operating in a void.

In any event, the example of tax debts provides a very clear instance where the reason for cancellation must be regarded as determinative of whether COD should result in income. This conclusion is directly contrary to the literalist view that the reason for cancellation of a debt is irrelevant to the question of its taxability. A strictly literal interpretation of Code section 61(a)(12) without regard to the circumstances of cancellation can easily lead to results which are obviously unfair and unintended.²¹⁸

pulsive gamblers to ruin themselves. See *Resorts Int'l Hotel, Inc. v. Salamone*, 429 A.2d 1078, 1080 (N.J. Super. 1981). It makes little sense to tax the relief, because the gambler will still be ruined, except now by tax debts rather than casino debts. The taxes assessed against Zarin, together with interest and penalties, actually exceeded his original debt to the casino. *Zarin*, 916 F.2d at 111-12.

²¹⁵ Exceptions might be appropriate where the legislation prescribes a penalty which does clearly enrich the debtor, such as where the principal of a usurious loan must be forfeited by the lender to the debtor. Strictly speaking, this should probably not be regarded as an exception to I.R.C. § 61(a)(12), but rather as a taxable penalty payable by "spurious" COD. See *supra* note 29.

²¹⁶ Both of which applied in *Zarin*.

²¹⁷ In *Zarin*, such an inquiry into purpose of the statute which voided Zarin's debt would have made it much easier to see that the exceptions for lack of loan proceeds and for disputed debts were both applicable. That purpose was to prevent casinos from overreaching compulsive gamblers. See *supra* note 214. Recognition that state law viewed the receipt of excessive credit by a compulsive gambler as worthless, if not outright harmful, would have led easily to the conclusions that the dispute was valid, and that Zarin received nothing of taxable value.

²¹⁸ Consider the following hypothetical example: a person is erroneously convicted of a felony which he did not commit and spends years in prison before the error is discovered and the prisoner is pardoned by the governor. The governor's pardon is interpreted as releasing the prisoner from the following debts imposed by state law: (1) a fine imposed for the felony, (2) restitution of money to the victim of the felony, (3) restitution of the state's expense for the public defender who originally represented the prisoner, and (4) restitution

B. Equal Treatment for Solvent and Insolvent Taxpayers

The principal reason for the Service to compromise a tax debt is the taxpayer's inability to pay. The same rationale underlies the insolvency exception under Code section 108(a) which excludes the COD income of taxpayers who are insolvent or bankrupt. This similarity invites comparison of the two relief provisions. Most OIC agreements are probably made with taxpayers who are insolvent in the sense that their liabilities exceed the value of their non-exempt assets both before and after the agreement. However, OIC agreements can be and often are made with taxpayers who are technically solvent, as was the case in three of the four reported cases examined in this article. The Service's reason for compromising a tax debt despite the taxpayer's solvency is just the same as that of any other creditor, namely, to make the best possible settlement. If the taxpayer's assets are for some reason unavailable to satisfy the debt, they are quite sensibly ignored.

This policy stands in stark contrast with the insolvency exception codified under Code section 108(a). Bankrupt and insolvent debtors may exclude COD from income, although at the price of attribute reduction under Code section 108(b). To the extent the taxpayer is or becomes solvent as a result of debt forgiveness, the exclusion provided by Code section 108(a) is inapplicable, and the COD income must be taxed currently. Creditors may be expected to strike the best possible compromise, however, which makes it unlikely that the debtor will have any foreseeable liquidity to pay tax on the COD.

This suggests that the current rules under Code section 108(a) are overly stringent. Where creditors have forgiven uncollectible debts in order to realize the best available settlement, or to facilitate the rehabilitation of a financially troubled taxpayer, it seems reasonable to avoid imposing a current tax regardless of whether the taxpayer is technically solvent. This would be realistic, and would also remove some difficult obstacles faced by taxpayers contemplating workouts outside of bankruptcy. If the taxpayer is in doubt whether it can prove that its liabilities exceed the value of its assets, which is a difficult and frequently litigated question, the

to the state for the costs of confinement. No COD income can result from discharge of the first two debts because the prisoner never received anything of value in exchange. But the prisoner did receive valuable legal services and costly room and board. Should he be taxed?

taxpayer has an incentive to resort to formal bankruptcy proceedings for the sole purpose of avoiding current taxes on COD.²¹⁹ Once in bankruptcy, the technical question of solvency becomes irrelevant because all COD is excludible. This incentive to resort to formal bankruptcy seems undesirable from a policy point of view if the creditors can otherwise negotiate a settlement out of court. For the sake of both simplicity and fairness, it might be better to treat all cases of inability to pay alike, without regard to technical solvency. That would entail extending the relief Code section 108(a) to all such debt cancellations.²²⁰

²¹⁹ A person need not be insolvent for eligibility to file a voluntary petition for bankruptcy under Chapter 7, 11, 12, or 13. Bankruptcy relief is available whether or not the debtor can prove its insolvency. See Thomas D. Crandall, et al., *Debtor-Creditor Law Manual* ¶ 12.03[1](1991).

²²⁰ Equal treatment for troubled but solvent taxpayers would mean subjection to the attribute reduction rules of current I.R.C. § 108(b), however, and these rules are also problematic. The policy reasons for attribute reduction under current § 108(b) appear questionable because the deferred tax arises from creditors' agreements or bankruptcy relief itself, rather than from earnings. Attribute reduction in this situation might be viewed as a questionable toll charge for the privilege of availing oneself of such relief. Moreover, the loss of NOLs in this situation is often at the expense of creditors, because NOLs are valuable assets which might otherwise be employed directly or indirectly to reduce creditors' losses. See generally Bergquist & Groff, *supra* note 201 (arguing vigorously that the BRTA 1980 reforms which introduced NOL reduction were a mistake because they interfere with the fresh start policy of bankruptcy law). See also Phelan & Sharp, *supra* note 40.

If attribute reduction is justified for non-tax debts at all, perhaps it would be better to return to the rules in effect before 1980, and require only reduction of basis down to a limit of fair market value, or to the amount of the taxpayer's remaining indebtedness, whichever is greater. See *supra* note 41. This would reflect the pre-*Kirby Lumber* view that COD is a form of unrealized appreciation. See *supra* note 22. It might be better still to limit COD income to the original facts of *Kirby Lumber* and to require no basis adjustment at all in uncollectibility cases, as in Germany and the U.K. See *supra* note 27. An enormous simplification would be achieved by repealing other attribute reductions. The rules for determining whether NOLs may be preserved in corporate bankruptcy and workouts are complex, uncertain, and constantly changing. Vast amounts of specialized legal labor are consumed in efforts to plan for the survival of corporate NOLs. One of the principal reasons for the instability of the rules is the lack of clear consensus about what, if anything, should be a fair tax price for insolvency relief.

Under these circumstances, it might be better to let simplicity and administrability decide these issues, rather than abstract theory and a vain search for the "right" answer. The advantages of simple, predictable and unchanging rules might easily outweigh any revenue losses. Moreover, the revenue losses might be less than first appears. To the extent the debtor's continued use of NOLs permits larger payments to creditors, that in turn should reduce the creditors' bad debt deductions.

VII. CONCLUSIONS

Compromising a tax debt should not create COD income because no loan proceeds are received in exchange for incurrence of tax debts. Where some part or all of the cancelled debt has been accrued and deducted, however, the tax benefit rule does appear to create COD income. Nevertheless, this result must be rejected as unintended and contrary to the purpose of granting tax relief. The Service should repudiate *Yale Avenue* as erroneous so that taxpayers may enjoy certainty as to the tax consequences of OIC agreements.

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