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Debt Discharge Income: *Kirby Lumber Co.* Revisited Under the "Transactional Equity" Rule of *Hillsboro**

LOUIS A. DEL COTTO**

The holding of *United States v. Kirby Lumber Co.*,[1]—that income arises from the satisfaction of debt at less than its face amount—has become riddled with exceptions and qualifications to the point where the holding is, perhaps as often as not, found inapplicable to debt discharge gain.[2] This article will investigate a problem which has the potential for becoming a major exception to the holding of *Kirby Lumber*, the discharge of debt the consideration for which did not increase debtor's assets—such as debt issued in a corporate reorganization where bonds are exchanged for stock—or debt for which no consideration whatsoever is seen as having been received, such as bonds issued as a dividend on corporate stock, or debt assumed by one person as a gift to another. As we shall see, in all these examples it has been held that, viewing the entire transaction, there was no gain and hence there was no income despite the presence of a clear gain from the discharge of debt. *Kirby Lumber* was limited to situations where asset value was increased by consideration paid for the debt.

The position is taken here that such a limitation on the principle of *Kirby Lumber* is improper whether *Kirby Lumber* is viewed strictly as resting entirely on the "freeing of assets" principle, without regard to the nature and amount of any consideration received for the discharged debt, or whether it is viewed as requiring a look at the "transaction as a whole," from the time the debt is issued to the time of its discharge, in an attempt to find a gain or benefit to the debtor from the entire transaction.

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** Professor of Law, State University of New York at Buffalo. For valuable comments on this topic, thanks to my colleague Kenneth F. Joyce, to my research assistant Douglas M. Secular, and to my many students throughout the years.

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

2. *See generally*, BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 6.4 (2d ed. 1989)[hereinafter B.BITTKER & L.LOKKEN]; Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL. L. REV. 1159 (1978)[hereinafter Bittker and Thompson].

In the search for "gain" or "benefit," however, under the position taken here the transactional approach as viewed by the decided cases has been both limited—to prevent the taxpayer from enjoying impermissible double benefits—and, at the same time, broadened, —to extend the meaning of "benefit" beyond traditional notions which require enhancement of asset value.

THE RELATIONSHIP BETWEEN *KIRBY LUMBER* AND *KERBAUGH-EMPIRE*

The principle of *Kirby Lumber*[3] is readily stated: if bonds are redeemed by a debtor at less than their issue price, the excess of the issue price over the cost of repurchase is gross income to the debtor. In *Kirby Lumber*, the Court stated the problem and the result:

> In July 1923, the plaintiff, *Kirby Lumber* Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923.[4]

The Court then applied the then applicable Treasury Regulation "If the corporation purchases and retires any . . . bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year,"[5] and held the $137,521.30 to be income:

> As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of the bonds now extinct. . . . The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.[6]

The Court distinguished *Bowers v. Kerbaugh-Empire Co.*,[7] where the borrowed funds had been lost in the debtor's business operations and no income was found. But there, said the Court in *Kirby Lumber*, "The transaction as a whole was a loss. . . . Here there was no shrinkage of assets and the taxpayer made a clear gain."[8]

There is an apparent tension between the general principle applied by the Court—the excess of issue price over repurchase price is income

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3. United States v. Kirby Lumber Co., 284 U.S. 1 (1931).
4. 284 U.S. at 2.
5. 284 U.S. at 3. *Cf.* Treas. Reg. § 1.61-12.
6. 284 U.S. at 3 citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364 (1930).
7. 271 U.S. 170 (1926).
8. 284 U.S. at 3.

(the so-called "freeing of assets rule")—and the Court's failure to repudiate *Kerbaugh-Empire* which creates an exception to that principle where "the transaction as a whole" shows no gain. This apparent approval by the Court of the *Kerbaugh-Empire* case has led to the lower courts attempting a reconciliation of the two cases, and to a dispute over what the Court meant in using the term "issue price." Thus, where the bonds are issued for non-cash consideration, such as the debtor's stock, or for no consideration whatsoever, such as bonds issued as a dividend on the corporation's stock, or where the original debtor's debt is assumed by another in order to make a gift to the debtor, courts, in searching for "income," or "gain", have gone beyond the freeing of assets principle of *Kirby Lumber* and have searched the entire transaction to see whether the net effect of the transaction viewed as a whole, produced a gain to the debtor.

The tension between the "freeing of assets" principle—which looks only to the year of the bond repurchase to find gain—and the transactional approach—which looks at all years involved, from issuance of the bonds to repurchase, as was done in *Kerbaugh-Empire*—was created largely by the lower courts who, in applying *Kirby Lumber*, perceived it as involving bonds issued for full cash consideration.[9] In fact, as Professor Bittker has pointed out,[10] those bonds were issued in exchange for taxpayer's preferred stock and in cancellation of dividend arrearages on that stock. A problem arose because in *Kirby Lumber* the findings of the trial court, the Court of Claims, were only that the company received "par value."[11] This was raised in the Supreme Court by taxpayer's motion to remand to find the actual facts, "if the Court believes the consideration received for the bonds is material. . . ."[12] Although the government originally asserted there had been cash consideration in its petition for certiorari, both parties eventually agreed in their briefs that the nature of the consideration was immaterial.[13] Thus, the formal record did not show that cash consideration was paid for the bonds and the parties in effect stipulated to the Court that the nature of the consideration was immaterial. Nowhere was it suggested that the value given was not equal to the face amount of the bonds.

In light of the proceedings in the Supreme Court, the opinion in

9. See the full discussion of this point in Bittker, *Income From Cancellation of Indebtedness: A Historical Footnote To The Kirby Lumber Co. Case*, 4 J. CORP. TAX 124 (1977)[hereinafter Bittker].

10. *Id.* at 126.

11. Kirby Lumber Co. v. United States, 44 F.2d 885 (Ct. Cl. 1930), *rev'd*, 284 U.S. 1 (1931).

12. See, Bittker, *supra* note 9, at 127.

13. *Id.* at 127-28.

Kirby Lumber is revealing. Nowhere does the Court say that the bonds were issued for cash; the Court used the terms "par value," "face value" (in quoting the Regulations) and "issuing price," (again in quoting the regulations). These terms reveal nothing about the nature of the consideration received, whether it was cash or preferred stock, although the statement that the corporation issued bonds "for which it received their par value" indicates the Court understood that whatever the consideration was, its market value was equal to the face amount of the bonds. Also, the "freeing of assets" principle itself—that the debt discharged was greater than the repurchase price resulting in gain from freed assets—is neutral on the point of consideration received since the freed assets could consist of cash or other assets received for the bonds, or simply the corporate assets unenhanced by consideration, if any, received for the bonds.

Given the proceedings before the Court and the language of the opinion, Professor Bittker concludes:

> Having been argued by both parties on the premise that the nature of the consideration received for the bonds was irrelevant (and on a record that did not address itself to this issue), the case almost certainly was decided on the same assumption.[14]

Under this view, *Kirby Lumber* means simply that freeing of assets, or balance sheet improvement through an increase in net worth, is income irrespective of the nature of the consideration received (whether appreciated preferred stock or cash), indeed whether any consideration was received, and, if cash or property was received, the fact that it may have been lost in business or used for personal consumption.

What has prevented *Kirby Lumber* from having such sweep is the Court's apparent endorsement of the *Kerbaugh-Empire* principle. There, the Court held that no income was realized by a corporate borrower which repaid a loan in devalued German marks that cost less to purchase in American dollars than the value of the marks received in the borrowing. Noting that "the whole transaction was a loss", the Court said: "The loss was less than it would have been if marks had not declined in value but the mere diminution of loss is not gain, profit or income."[15]

If *Kirby Lumber* had overruled or criticized *Kerbaugh-Empire* it could be easily read as a "freeing of assets" case. Instead the Court confused the issue by distinguishing *Kerbaugh-Empire*:

14. *Id.*at 129. *But see* Gunn, *Reconciling United States Steel and Kirby Lumber*, 42 TAX NOTES 851, (1989).

15. 271 U.S. at 175.

> But the transaction as a whole was a loss. . . . Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of [the] bonds now extinct. . . . The defendant in error has realized within the year an accession to income. . . .[16]

Here we have a curious blend of language which looks first to the transaction as a whole, suggesting a transactional approach which would look beyond the balance sheet gain from the debt discharge, and trace the borrowed funds to determine whether there was an overall gain or loss. Although the Court returns to the notion of freed assets it does so in the context of there having been "no shrinkage of assets," again suggesting the transactional approach. This suggestion, in turn, is clouded by the Court's allusion to the annual accounting system in stating the income was realized "within the year."[17]

And so we have this tension between the transactional approach which looks at the entire borrowing transaction for an overall gain or loss, and the freeing of asset theory which looks only at balance sheet improvement in the year of debt discharge, disregarding any loss of the borrowed funds, and indeed whether there was any amount at all received through borrowing.

In 1954, as part of the overall enactment of the 1954 Internal Revenue Code, Congress had the opportunity to address this tension. Instead it merely enacted section 61(a)(12) which states simply that gross income includes "Income from discharge of indebtedness," at the same time enacting the predecessors of sections 108 and 1017, which basically contain certain definitional and relief provisions which depend on a judicial finding of debt-discharge income in order to be operative. Nowhere has Congress made a comprehensive attempt to define such income. Instead the problem has been left to the courts.[18]

FREEING OF ASSETS: A VIABLE THEORY?

In *Kerbaugh-Empire* the Court refused to find income despite the presence of freed assets arising from debt discharge. This, of course, is the perceived conflict between the freed asset rule and the transactional view. Given this conflict, is there an argument that the freeing of assets

16. 284 U.S. at 3.

17. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-31.

18. *See* B.BITTKER & M.MCMAHON, FEDERAL TAXATION OF INDIVIDUALS, ¶ 4.4, at 4-13 (1st ed. 1988); B.BITTKER & L.LOKKEN *supra* note 2, ¶ 6.4.1, at 6-33 especially note 22.

rule *simpliciter* should control the issue of debt discharge income, disregarding the transaction as a whole?

Certainly a forcible argument can be made that a balance sheet increase in net worth, by itself and without regard to other factors or transactions, as Justice Holmes expressed it in *Kirby Lumber* is ". . .an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet v. Sanford & Brooks Co.*, . . ." The cite to *Sanford & Brooks* is especially revealing since it is the leading case affirming the annual accounting system and rejecting transactional accounting on facts remarkably similar to those in *Kerbaugh-Empire*: income from damages recovered for breach of contract could not be offset by losses suffered in earlier years in performing the contract.[19]

Is such a rule fair to the taxpayer? Arguably, yes because the rule makes economic and tax sense. Relief from debt without asset depletion makes available to the taxpayer assets previously burdened by—i.e., dedicated to paying—the debt. If this increase in net worth is not, to paraphrase Mr. Justice Holmes, in plain words an accession to wealth, what is it? The fact that the borrowing was lost in business in a prior year as in *Kerbaugh-Empire*, or that no cash or other asset was received for the debt, even without regard to the *Sanford & Brooks* stress on the importance of the annual accounting system, is simply irrelevant to the economic and tax fact that the debt discharge increases wealth at no cost to the taxpayer.[20]

THE TRANSACTIONAL APPROACH

Another way to view the problem is that on the facts of *Kerbaugh-Empire*, the holding of that case represents an improper application of transactional accounting;[21] that the transactional approach properly applied would give a *Kirby Lumber* taxable income result in *Kerbaugh-Empire* itself.

The Supreme Court's recent encounter with transactional accounting occurred in *Hillsboro Nat'l Bank v. Commissioner*[22] where a diary

19. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-31; 4 B.BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 105.1.4 (1st ed. 1981).

20. For the view that application of *Kirby Lumber* does not depend on the presence of a prior tax benefit, such as a deduction, because the "freeing of assets" rule operates independently of the tax benefit rule, see B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.5, at 6-55; Bittker and Thompson, *supra* note 2, at 1179-1182.

21. Also, there is a view that *Kerbaugh-Empire* has been implicitly rejected by later Supreme Court cases, see Vukasovich v. Commissioner, 790 F. 2d 1409, 1413-16 (9th Cir.1986).

22. 460 U.S. 370 (1983).

company deducted the entire cost of cattle feed and in the following year distributed a substantial amount of the feed in liquidation. The issue before the Court was whether the tax benefit rule required the corporation to take into income for the year of liquidation the value of the grain distributed. The Commissioner argued that a "recovery" of a previously deducted item was not required to invoke the tax benefit rule; that the only requirement was an event "inconsistent" with the deduction. The Court agreed, holding that the purpose of the tax benefit rule is not simply to tax "recoveries," but "to approximate the results produced by a tax system based on transactional rather than annual accounting."[23] In other words to do "transactional equity."[24] Thus the tax benefit rule is triggered when a later event is "fundamentally inconsistent with the premise on which the deduction was initially based."[25] Such inconsistency was present because the deduction was premised on the assumption the grain would earn income for the corporation by being consumed in its business.

The notion behind a requirement of "transactional equity" in the operation of the tax benefit rule seems to apply with equal force to the area of debt discharge income. The clearest case for such application would be *Kirby Lumber* itself if we assume the bonds had been sold for cash at par value. In such case the result of *Kirby Lumber* would be correct under both the freeing of assets theory and under the transactional approach: since the borrowing was received tax free (was excluded from gross income) on the assumption all of it would be repaid,[26] failure to repay is fundamentally inconsistent with the premise of the prior exclusion from gross income, and the portion of debt forgiven is income.

Thus the "transactional equity" notion of the tax benefit rule is expanded to reach debt forgiveness where such forgiveness is inconsistent with a past benefit—in *Kirby Lumber* the exclusion from gross income of the borrowing—in order to do equity for the Government. Of course, *Hillsboro* itself involved a prior deduction rather than an exclusion. We could view the exclusion for the borrowing as a combination of a contemporaneous inclusion and an accrued deduction so that it fits literally within the *Hillsboro* rationale. Such reconstruction is not necessary, however, under the view here proposed, *to wit*, that the "transactional

23. 460 U.S. at 381.

24. *See* 460 U.S. at 377.

25. 460 U.S. at 383.

26. The presence of the offsetting liability is usually cited as the reason for the exclusion from income; that is restated here as an assumption that the borrowing will be repaid. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-31 to 6-32.

equity" principle of the tax benefit rule should apply in all cases where transactional equity is to be done: that is, *in order to prevent all impermissible double benefits.*[27] A borrowing excluded from gross income coupled with failure to tax freed assets arising from later forgiveness of the debt would clearly be a double exclusion and an impermissible double tax benefit.

Although such a rule appears inconsistent with the annual accounting principle of *Sanford & Brooks*, it is a long standing exception to that principle in applying the tax benefit rule, which has always looked back at the entire transaction to find a recovery, and now under *Hillsboro*, to do transactional equity without regard to a recovery. The proposal made here is simply to expand the transactional approach beyond deduction transactions to debt discharge transactions in order to do equity and achieve fairness. Indeed, just such an application of the tax benefit rule is illustrated by I.R.C. § 1001. The gain from the sale of property is not measured merely by the amount received in the year of sale; rather the entire transaction is taken into account including the cost of the property upon acquisition, capital improvements to the property and depreciation deductions, all in order to reduce such amount realized by the remaining investment in the property. Not to do so would result in a tax on capital rather than income; an unfair and improper double tax; the second tax being inconsistent with the prior tax on the investment.[28]

KERBAUGH-EMPIRE: THE TRANSACTIONAL VIEW MISAPPLIED

The *Kerbaugh-Empire* case neatly illustrates how the transactional approach can be misused to allow an impermissible double benefit. Assume that the corporation borrows $100, loses that amount in the operation of its business and in a later year discharges the $100 debt for $75. Under *Kerbaugh-Empire* it would be held that "the mere diminution of loss is not gain, profit or income," i.e., that the $25 debt discharge gain arising from the freeing of assets merely diminishes the business losses from $100 down to $75, and therefore is not a gain.

This analysis gives rise to a number of difficulties. First of all, in

27. *See generally*, Del Cotto & Joyce, *Double Benefits and Transactional Consistency Under The Tax Benefit Rule*, 39 TAX L. REV. 473 (1984).

28. *See*, Gunn, *Reconciling United States Steel and Kirby Lumber*, 42 TAX NOTES 851, 853 (1989). Compare B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.5, at 6-55 for the view that *Kirby Lumber's* application does not depend on the presence of prior tax benefit. *See also*, *supra* note 20.

This article sees the "transactional equity" rule of *Hillsboro* as broadening the tax benefit rule to encompass such prior benefits as personal consumption. See discussion of *Bradford v. Commissioner*, 233 F. 2d 935 (6th Cir.1956), *infra* notes 34-38 and accompanying text.

Kerbaugh-Empire, the cash borrowed was traced to a particular project,[29] which is not typical since ordinarily borrowed cash makes available other cash funds which can finance other projects. Thus the "transaction as a whole" would require a look not only to projects directly financed with the borrowing, but also to those indirectly financed.[30] This tracing problem could be avoided if the transactional approach were bottomed on a theory that the very fact of a decline in value of the taxpayer's bonds, whether due to a rise in interest rates or the financial instability of the debtor, demonstrates a decline in the debtor's going concern value which would offset the gain from debt discharge.[31] The holding of *Kirby Lumber*, however, would reject such a broadening of the transactional view.[32]

If the taxability of the debt discharge income is linked to the loss of the borrowed funds there is also the problem of giving a double tax benefit for a single loss. In the above example, the $100 loss gives a double benefit to the extent of $25 since the $100 is deducted as business expense under I.R.C. section 162 (or as a business loss under section 165) and also gives rise to an exclusion from gross income.[33] Thus the $100 loss generates $125 of tax benefits (and could generate as much as $200 if the debt had been settled for $0), whereas under any sensible application of a transactional approach the net loss from the entire transaction should be only $75. It seems clear that the *Kerbaugh-Empire* view of the transactional method violates the express holding of *Hillsboro* that a deduction and later exclusion of the same item are fundamentally inconsistent because an impermissible double benefit is allowed. Another way to view the analysis is that the $100 loss deduction fully depletes all basis in the borrowed funds, leaving no basis to offset the $25 of debt discharge income. Under *Hillsboro*, a second use of the same basis would be fundamentally inconsistent.[34] Similarly, if the borrowing is consumed in a non-deductible manner then such consumption should be viewed as a benefit which depletes all basis in the borrowed funds. A second use of

29. 271 U.S. at 171-173.

30. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-29.

31. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-30.

32. *Id.*

33. *See* Bittker & Thompson, *supra* note 2, at 1163; B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-29 (especially note 12), indicating it is not clear whether a double benefit was in fact allowed in the actual *Kerbaugh-Empire* case.

34. *See generally*, Del Cotto & Joyce, *Double Benefits and Transactional Consistency Under the Tax Benefit Rule*, 39 TAX L. REV. 473, 488 (1984).

that basis against the debt discharge gain would, under *Hillsboro*, be an impermissible double benefit.

THE TRANSACTIONAL VIEW AND PERSONAL CONSUMPTION: THE *BRADFORD* CASE

In *Bradford v. Commissioner*,[35] Mr. Bradford, a member of a brokerage firm with a seat on the New York Stock Exchange, owed a longstanding business debt to a bank. Because of his fears that the Exchange would frown on the amount of debt he was carrying, in 1938 the bank agreed to release him from an unsecured portion of the debt in the amount of $100,000 in return for his wife's note in the same amount. Some years later, in 1946, after bank examiners required the bank to write the value of the note down to $50,000, she was able to discharge it by paying $50,000 to the bank. The Commissioner contended she had income of $50,000 under the "freeing of assets" rule of *Kirby Lumber* and that view prevailed in the Tax Court.[36] The Court of Appeals acknowledged the general rule of annual accounting under *Sanford & Brooks*, but refused a "mechanical application" of that principle, relying on *Kerbaugh-Empire*:

> The *Kerbaugh-Empire Co.*, case was decided before the *Kirby Lumber Co.*, and *Sanford & Brooks Co.*, decisions. The case has been called "a frequently criticized and not easily understood decision." It is nonetheless a decision which has not been overruled. Whatever validity the . . . decision may now have on its own facts, it remains an authority for the proposition that in deciding the income tax effect of cancellation of indebtedness for less than its face amount, a court need not in every case be oblivious to the net effect of the entire transaction. . . .[37]
>
> The fact is that by any realistic standard the petitioner never realized any income at all from the transaction in issue. In 1938 "without receiving any consideration in return," she promised to pay a prior debt of her husband's. In a later year she paid part of that debt for less than its face value. Had she paid $50,000 in 1938 to discharge $100,000 of her husband's indebtedness, the Commissioner could hardly contend that she thereby realized income. Yet the net effect of what she did was precisely the same. We cannot agree that the transaction resulted in taxable income to her.[38]

The Court also relied on *Commissioner v. Rail Joint Co.*,[39] where a corporation which issued its own bonds as a dividend to its shareholders

35. 233 F.2d 935 (6th Cir.1956).
36. 22 T.C. 1057 (1954).
37. 233 F.2d at 938-939 (citations omitted).
38. 233 F.2d at 938 (citation omitted).
39. 61 F.2d 751, (2nd Cir.1932).

and subsequently redeemed some of the bonds at less than face value was held to have no income:

> Stripped of superficial distinctions, the *Rail Joint Co.* case is identical in principle with the present case. In that case, as in this, the taxpayer received nothing of value when the indebtedness was assumed. Although the indebtedness was discharged at less than its face value, the taxpayer was in fact poorer by virtue of the entire transaction. . .[40]

The Court in attempting to find the "net effect of the entire transaction" said it was the same as if in 1938 she had paid off her husband's $100,000 note for $50,000. If such were the case, it would be correct to say that the transaction results in no income to her because a gift is not an event taxable to the transferor.[41] In such case it would be her husband who received $50,000 of debt discharge income since the transaction should be treated as if he received a non-taxable gift from Ms. Bradford of $50,000, and used that money to discharge his $100,000 debt to the bank. But none of this is what happened; it was not her husband's $100,000 note that was discharged by Ms. Bradford for $50,000 in 1938; the pertinent discharge occurred in 1946 when the bank took $50,000 in discharge of *her own* $100,000 note which the bank had taken in discharge of the husband's original note in 1938. Thus a $100,000 gift to her husband was made by her in 1938 when she assumed his liability of $100,000. There was no debt discharge income resulting from that transaction. The later discharge in 1946 of her $100,000 note for $50,000 resulted in a freeing of her assets, not his.[42]

Although that analogy made by the Court seems to miss the mark, the result achieved arguably is supported by the *Rail Joint* case, as the Court notes. In *Rail Joint,* the rationale for finding no income was that in issuing the bond dividend the corporation "never received any increment to its assets,"[43] and hence gained nothing from the transaction as a whole. The *Bradford* Court found that the taxpayer "received nothing of value" for the indebtedness, and that the taxpayer was "in fact poorer by virtue of the entire transaction." Hence there was no gain from the transaction as a whole.

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40. 233 F.2d at 939.

41. *Compare* Campbell v. Prothro, 209 F. 2d 331 C.A. 5 (1954), *and* I.R.C. § 84. *Compare also* I.R.C. § 108(e)(4): if instead of discharging the note she had acquired from the bank for $50,000 her husband's $100,000 note, the purchase would be treated as made by the husband, giving him $50,000 of debt discharge income at the time of her purchase. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.3, at 6-47 to 6-48.

42. *Cf.* B.BITTKER & L.STONE, FEDERAL INCOME TAXATION 127 (5th 1980).

43. 61 F.2d at 752.

It is submitted that this view of economic and tax effects in *Bradford* overlooks the fact that Ms. Bradford, in 1938, by making a gift to her husband of $100,000, engaged in an act of personal consumption from which she derived the benefit (presumably) of receiving satisfaction and gratification, not to mention the fact that she was probably improving or at least protecting, the family's economic condition by taking the debt off her husband's balance sheet. This gift, hypothetically, could have been made to him by Ms. Bradford directly borrowing $100,000 from the bank and giving it to her husband to pay his debt, or by paying the $100,000 directly to the lender-bank in discharge of his debt. Either way, the rationale of *Rail Joint* requiring an "increment" to her assets, and of *Bradford* that she receive value for the debt, would have clearly been met.

Although there was no apparent direct borrowing, in terms of the tax law Ms. Bradford did have an implicit borrowing with which she paid her husband's debt. The self-imposed debt was an exercise of her power to create real economic wealth and transfer it to her husband. In order to transfer this wealth, necessarily she implicitly received it by way of a borrowing which was excluded from her gross income because of the obligation to repay.[44] Failure to repay thus is a taxable event under the view of transactional equity. Indeed, if at the time of the gift it could be known that she would not repay, a tax could then be imposed on the implicit borrowing to the extent the debt would be forgiven.[45] Thus, a broad view of transactional equity would also find income of $50,000 because failure to repay $100,000 was inconsistent with the "benefit" derived from making the prior $100,000 gift. Or, using the similar "net effect" approach, if the actual transaction in *Bradford* is viewed as having

44. *See* Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948) where a bank paid as a dividend in kind to its shareholders certain notes it had deducted as worthless bad debts, and was held taxable on the later collection by the shareholders on the notes:

> Even though the bank never received the money, it derived money's worth from the disposition of notes which it used in place of money in procuring a satisfaction that was procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit was realized as completely as it would have been if the bank had collected the notes in dollars and cents and paid the money as a dividend to its shareholders. To say that a bank, which has declared a dividend in kind consisting of notes representing interest or earnings, subsequently paid to its shareholders, has not realized the fruits of its investment or labor, because it has assigned the notes instead of collecting them itself and then paying the proceeds over to its shareholders, "is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws."

Id. at 1009 (citing to Helvering v. Horst, 311 U.S. 112, 117-118).

45. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.1, at 6-32.

the same economic effect as the hypothetical transaction where she borrowed directly to pay his debt, then there should have been debt discharge income under *Kirby Lumber*, using either the transactional view or the freed assets rule. Having the same economic effect, the transactions should have the same tax effect because the difference in form should not be allowed to obscure the fact that the substance is the same: in both the actual *Bradford* transaction and the restructured alternative there is the same net effect because in each situation when the year 1938 transaction is done, Ms. Bradford is left with no additional cash, but has had only the personal and familial satisfaction of making a gift to her husband, and she owes a debt of $100,000 to the bank. It matters not whether the debt was incurred by an actual direct borrowing of funds or by being an indirect borrowing through substitution as debtor for funds originally borrowed by her husband, the economic effect to all parties is identical. Therefore, the tax result should be the same.[46]

Indeed, there is another and very practical argument for this result. Since Ms. Bradford was dealing with the same bank as held her husband's debt, had she requested a direct loan of $100,000 to pay that debt, undoubtedly a substitution of her note for her husband's would have been done instead. Why would the bank hand her $100,000 cash in order for her to hand it right back together with her note? And if she had to raise the cash by taking a direct loan from a different bank, the later discharge would clearly produce income. On its facts should *Bradford* apply to produce no income despite the economic equivalence of the transactions? Despite the factual differences being purely formal, and arising only from happenstance?

Looking at this problem from the viewpoint of basis, as was done with *Kerbaugh-Empire*, Ms. Bradford's cost basis in the borrowed funds (whether actually or constructively borrowed) was fully depleted by her act of personal consumption in making the gift to her husband. Even lacking deductibility, personal consumption as much as the business deduction in *Kerbaugh-Empire*, causes loss of basis in the asset consumed leaving no basis to offset the later debt discharge income under the approach of *Kerbaugh-Empire*.

CORPORATE CONSUMPTION: THE *RAIL JOINT* PROBLEM

The *Rail Joint* case, upon which *Bradford* relied, was decided less than a year after the decision of the Court in *Kirby Lumber*. In *Rail*

46. *Id.* ¶ 6.4.2, at 6-35, note 27.

Joint the corporation declared and paid a dividend in its own bonds out of a reevaluation surplus. Some years later, certain of these bonds were redeemed at less than face value. The Court refused to find a taxable gain on the debt discharged, distinguishing *Kirby Lumber* as a cash consideration case:

> In the *Kirby* Case a corporation issued its bonds at par and later in the same year repurchased some of them at less than par. It was held that the sum thus saved was taxable income. The taxpayer's assets were increased by the cash received for the bonds, and, when the bonds were paid off for less than the sum received, it is clear that the taxpayer obtained a net gain in assets from the transaction. The cost of the money acquired by issuing the bond was decreased when the bond was retired at less than the issuing price. In other words, the consideration received for the obligation evidenced by the bond as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed, i.e., when the bond is retired. . . .
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> But that decision is not applicable to the case at bar. In paying dividends to shareholders, the corporation does not buy property from them. Here the respondent never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired. They were issued against a surplus created by reappraising assets already owned; and no one suggests that in writing up the book value of property which had appreciated the corporation received anything. The bonds were merely a way of distributing a part of such surplus among shareholders. When certain of the bonds were retired at less than par, all that happened was that the corporation retained a part of the surplus it had expected to distribute, because it paid those shareholders whose bonds were redeemed at a discount, less than it had promised to pay them. Hence it is apparent that the corporation received no asset which it did not possess prior to the opening and closing of the bond transaction, and it is impossible to see wherein it has realized any taxable income. In such circumstances the *Kirby* Case cannot be regarded as controlling.
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> It is true that the purchase and retirement of the bonds . . . resulted in decreasing the corporation's liabilities without a corresponding decrease in its assets, and the petitioner contends that the difference should be deemed income. . . . But it is not universally true that by discharging a liability for less than its face the debtor necessarily receives a taxable gain . . . *Bowers v. Kerbaugh-Empire*. . . . This may be demonstrated by a simple illustration: Suppose that a taxpayer validly contracts in 1930 to give $1,000 to a charity in 1931, and in the latter year compromises the obligation by paying $500 in full settlement. If the taxpayer returns his income on a cash basis, this transaction cannot possibly increase his income. The giving of the obligation certainly added nothing to income in 1930, and the payment of it in 1931 will appear only as a deduction of the sum actually paid in that year to the use of a charitable corporation. If he were to report on an accrual basis and were allowed to deduct from gross income for 1930 the $1,000 liability

> incurred in that year, then it might be said that the settlement of the liability in 1931 for a less sum had released the difference to the general uses of the taxpayer and the sum so released should appear as income then received in order that the returns for both years might truly reflect the effect of the whole transaction upon the net income. But . . . the dividend obligation evidenced by the bonds was not a liability deductible from gross income. Here neither the amount written up to surplus nor the bonds issued against it had ever been deducted from gross income for taxation purposes. Hence the entries in the surplus account are only bookkeeping entries, and do not reflect a realized taxable gain.[47]

The reasoning of the opinion in *Rail Joint Co.* is questionable. The first leg of the opinion assumes that the *Kirby Lumber* bonds were issued for cash consideration, facts which were not in evidence in *Kirby Lumber*, and which arguably, as discussed above, the Supreme Court itself was careful not to rely upon. The second leg relies on the charitable pledge illustration which, although properly analyzed, is simply irrelevant to the decision. The reason why the cash method pledger in the illustration has no debt discharge income is the same as for the presence in the Code of section 108(e)(2):[48] the debt discharged, if paid, would have been deductible. The only tax consequence of non-payment is loss of the tax deduction to that extent.[49] Thus, in the illustration, the year 1931 deduction is reduced to $500, which gives the same tax effect as if the full $1,000 had been paid in 1931 and $500 had then been returned to the pledger by the charity. The 1931 deduction would be $1,000, but gross income would also be increased by $500. Extension by the court of the illustration to the accrual method pledger simply illustrates the flip side of § 108(e)(2): since payment of the pledge would not be deductible, the debt discharged should be income. And it would be income under the tax benefit rule. The $1,000 deduction taken in 1930 is conditioned on payment of the full amount being made in 1931. A 1931 payment of only $500 is fundamentally inconsistent with the premise of the 1930 deduction to the extent of the unpaid portion, and so $500 must be included in 1931 to achieve transactional consistency (as is clearly noted by the opinion in *Rail Joint.*)

What is the importance of the § 108(e)(2) principle to the *Rail Joint* problem? If the bonds had given rise to a deduction for the face amount

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47. 61 F.2d at 751-752.

48. I.R.C. § 108(e)(2) provides: "No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction."

49. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.2, at 6-41.

on issue,[50] then, as with the accrual method pledger in the illustration, failure to pay the face amount on redemption would give rise to income under the tax benefit rule for the unpaid portion. If, on the other hand, payment of the bond principal was tax deductible, than failure to pay the full face value on redemption would not give rise to income under the principle of § 108(e)(2). But *Rail Joint* falls under neither hypothesis since the bonds were deductible neither when issued (as noted by the court),[51] nor when paid on redemption. Therefore § 108(e)(2), as with the cash method pledger in the illustration, does not prevent the debt discharge from being income. Nor, on the other hand, does a traditional view of the tax benefit rule require a finding of income because, arguably, the discharge of debt on the redemption of the bonds is not an event inconsistent with a prior year's tax benefit. Although not so stated by the opinion in *Rail Joint,* the thrust of the holding seems to be that discharge of a non-deductible debt is not income under § 108(e)(2) without the presence of some prior tax benefit, such as an exclusion for a cash borrowing received on the issuance of the bonds, as the Court assumed was the case in *Kirby Lumber.* Put slightly differently, the *Rail Joint* court rested its decision on the fact that the corporate taxpayer received no increment in its assets as consideration for issuing the dividend bonds. The effect of the Court's no income holding is to rely on the absence of any economic benefit (no funds were received so there was no addition to assets) or tax benefit (by way of a deduction on the issuance of the bonds), despite the acknowledged gain present under the freeing of assets theory.

There are a number of responses to the doctrine of *Rail Joint.* Since the facts resemble *Bradford,* some of the responses will be somewhat similar to the *Bradford* responses, but with a corporate twist. First, the deal can be restructured to provide an economic and tax benefit. Simply have the corporation sell the bonds for cash in the face amount of the bonds and pay the cash as a dividend.[52] So viewed, as stated by Professors Bittker and Lokken, "the bonds gave the distributing corporation the same corporate benefits as a distribution of cash, and a later discharge of

50. See the taxpayer's position in Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969); *cf.* I.R.C. § 461(h); I.R.C. §§ 1272, 163(e).

51. I.R.C. § 162(k).

52. *See* B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.2, at 6-35; *But see* Gunn, *Reconciling United States Steel and Kirby Lumber,* 42 TAX NOTES 851, 852 n.10 (1989), arguing that the analogy is misleading because the transaction presented shifts wealth from outsiders (bond purchasers) to the corporation and its shareholders as a group, whereas in the actual transaction no outsiders were involved at all.

the bonds for less than this amount should have been taxed in the same way as a redemption of bonds issued for cash."[53] The argument seems to be that the corporation has received the corporate benefits of paying a cash dividend after a sale of the bonds for cash. Thus, as in *Bradford*, there is an implicit borrowing of cash which is used to pay the dividend. The benefits of paying a dividend are the same, therefore, whether it is paid in cash or bonds, and the tax result should be the same. Under the transactional method, there is debt discharge income.[54]

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53. B.BITTKER & L.LOKKEN, *supra* note 2, ¶ 6.4.2, at 6-35.

54. The "corporate benefits" arguably arise because the declaration and payment of the dividend whether in cash or bonds is "corporate consumption," *i.e.*, the corporate equivalent of an act of "personal consumption," very much akin to the gift made by wife to husband in assuming his liability in *Bradford*. Like that gift, the dividend is an implied borrowing the distribution of which gives rise to corporate satisfaction and gratification arising from the business necessity of providing a shareholder return on investment, not only to keep shareholders content, but in order to have shareholders at all:

> Typically, corporations over the long haul will pay out less than all their earnings as dividends. A portion of earnings will be retained and reinvested in the business. But all that the shareholders see is the dividend. That is their return. It is now widely accepted in the sophisticated academic financial literature that the value of shares of common stock is best thought of as a function of the dividends (including any final, liquidating dividend paid when the corporation's existence ends) that the corporation can be expected to pay out over its life. Many people consider this to be a peculiar proposition because they think instinctively about capital gain (sale price less cost) as part of the return on common stock.
>
> The fact is, nonetheless, that capital gain must be a function of expectations about future dividends. Imagine a series of shareholders. The first shareholder pays a given amount for the shares, based on an estimate of the amount of cash dividends plus a gain (or loss) at some time in the future. The next shareholder makes the same kind of calculation. That is, the gain, if any, will depend on the next shareholder's expectation as to cash dividends plus capital gain (or loss). And so on. If we think of the entire series of shareholders, some may have greater capital gains or losses than others, depending on the timing of their purchases and sales and on collective expectations, reflected in market prices, at the time of those purchases and sales. But the gains and losses are transfers among all the shareholders who hold the shares over the entire time that they are outstanding. Those gains or losses do not increase or decrease the total return on the shares over that time. The only return that shareholders collectively can expect over the life of the shares in which they invest is the dividends (including, as indicated above, any final or liquidating dividend) paid on those shares. It can be seen, then, that if people are rational the value of the shares at any point in time must be derived solely from the series of expectations about dividends. Any gain in the value of shares must be based on expectations concerning dividends to be paid at some point in the future.
>
> To see the same point from a different perspective, suppose that someone offered to sell you some shares of stock and that you were certain that the corporation would never, ever pay any dividends (including disguised dividends in the form of an excessive salary or the like) or any proceeds from liquidation or other distributions. You would be foolish to pay anything at all for those shares. And if you did buy them, you would have to find an equal fool to buy them from you at your cost and a greater fool to buy them

The same idea expressed in this argument is also reflected in the "net effect" argument made above with respect to the reconstruction of events in *Bradford* to assume an actual direct borrowing and a gift of cash: the corporation is in the exact same position from an economic point of view as if it had sold the bonds and paid a cash dividend. At the end of the dividend transaction it is left with no cash or assets additional to what it had before the transaction, with a debt to its shareholders in

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> from you at a gain to you. The only thing that makes shares valuable is the expectation of payments of some sort at some time in the future.
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> This does not mean that the shares of a corporation that pays no dividends *currently* are worthless. Many companies have operated for years without paying dividends. Many of these have been successful, growing companies that were retaining all of their earnings in order to take advantage of attractive investment opportunities. People do, rationally, pay money for shares of such companies. They do so because they expect that at some point in the future dividends will be paid.

W.KLEIN AND J.COFFEE, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES, 251-252 (4th ed.1990).

A similar view was presented in Commissioner v. First State Bank of Stratford, 168 F. 2d 1004 (5th Cir. 1948) where a bank paid as a dividend in kind to its shareholders certain notes it had charged off as worthless. The bank was held taxable on amounts later collected by the shareholders on the notes:

> The avoidance of taxes may be perfectly legitimate, but it cannot be done by the anticipatory assignment of notes representing income, as a dividend in kind, and the subsequent collection of said notes by the assignees. The respondent is a banking corporation, organized and operated for profit. The acquisition of profits for its shareholders was the purpose of its creation. The collection of interest on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the "life-rendering pelican" it feeds its shareholders upon dividends. Whether they are in the form of notes or money is immaterial if the dividend is from earnings. . . . The respondent exercised its power to procure payment of its income to another, which was "the enjoyment, and hence the realization," of its income. (at 1009).

See also Rudco Oil and Gas v. United States, 82 F. Supp. 746 (1949), where a family corporation with a cash position justifying a dividend temporarily transferred certain leases to its shareholders until they collected a stated amount of rentals at which time the shareholders reconveyed the leases. The shareholders' receipts were held to be income to the corporation (and a dividend to the shareholders), the corporate conveyance being merely "the assignment of future income to satisfy a moral and near-legal obligation of the assignor. . . ." *Id.* at 751.

See also I.R.C. § 312(a)(2) which allows a corporation's earnings and profits account to be reduced by the principal amount of its own obligations distributed as a dividend.

> "Assume a corporation distributes a $100 bond as a dividend, and sometime later, after interest rates have risen, the corporation redeems the bond for $80. The corporation is out of pocket $80, but its earnings and profits have been reduced by $100. If $20 of discharge of indebtedness income is recognized on the redemption, however, this income generates additional earnings and profits that square the earnings and profits account with the economics of the transaction. The earnings and profits rule, in other words, implies that discharge of indebtedness is recognized on a repurchase at less than face of a bond distributed as a dividend.

B.BITTKER & L.LOKKEN, *supra* note 2, at ¶ 6.42,6-35.

the face amount of the bonds, and with the corporate satisfaction of having paid a dividend to its shareholders. Since the net effect, or economic effect of the two transactions is the same, the tax results for both transactions should be controlled by the cash dividend example.

Returning to I.R.C. section 108(e)(2) (discharge of a debt, payment of which would be deductible, is not income), the negative implication of this section is that the debt discharge in *Rail Joint* is income because payment of the amount of discharge would not have been deductible. The presence of income despite lack of a deduction anywhere in the transaction, which as noted above proved a stumbling block for the court in *Rail Joint*, is explained by the fact that the bond dividend payment is an act of corporate consumption as much as the gift in *Bradford* was an act of personal consumption. The benefit of this consumption, or the implicit borrowing which is "distributed" as a dividend, gives rise to an exclusion which is conditioned on repayment of the borrowing, as we have seen. From the viewpoint of basis, the consumption depletes the corporation's basis in earnings and profits as much as if the dividend had been paid in cash. Thus, the act of consumption depletes basis in the item consumed (the amount borrowed by the wife in *Bradford* and the corporate earnings in an amount equal to the face amount of the bonds in *Rail Joint*), just as did the business loss deduction in *Kerbaugh-Empire*.

Some may argue that the imposition of a tax on the debt discharge gain in *Rail Joint* is really a tax on capital rather than income because it is a second tax on the same money - i.e., a tax on wealth which has already been taxed as corporate operating profits. But this argument should not succeed. Once the operating profits are allocated to the bond dividend, as discussed above, basis is lost due to corporate consumption. When the profits are unburdened by the debt discharge they in effect become a receipt against which there is no basis offset. In other words their character as tax-paid capital is lost due to loss of basis, or "tax-cost", and when unburdened by the debt discharge become income a second time.

In one respect *Rail Joint* is somewhat dissimilar to *Bradford* in that the rule of *Rail Joint* gives to the corporation an option either to sell bonds and pay a cash dividend, or to pay the dividend with bonds in kind. Especially in a rising interest market, declaring the bond dividend is similar to selling short in that less cash will eventually be paid on principal than was promised. And the shareholders are not necessarily disadvantaged because bonds of public corporations are easily marketable and can quickly be converted to cash. This creates a great potential for the

business community to exploit the fisc, even though the tax advantage present is not given to the economically identical cash dividend paid from the proceeds of a bond sale. And for those corporations who are not fully advised, there is also the proverbial "trap for the unwary."

Again in the corporate setting we have the cases of *Fashion Park, Inc. v. Commissioner*[55] and *United States Steel Corporation v. The United States*.[56] In *Fashion Park*, in a tax-free reorganization, bonds with a face value of $50 were exchanged for preferred stock which had cost $5 a share in order to replace the preferred stock with a security carrying a less burdensome dividend or rate of interest. The bonds were eventually redeemed for a price in excess of $5. The Tax Court found there was no debt discharge income because the corporation did not receive more than the $5 originally paid for the preferred stock so that the transaction as a whole gave it no gain. *Kirby Lumber* was rejected as a case where full value had been received for the bonds so that less was paid out in assets than had been received for the bonds. *Rail Joint* was relied upon and found properly to distinguish *Kirby Lumber.*

In *United States Steel Corp.*, a similar case, in 1901 preferred stock had been issued for an assumed price of $100 per share. In 1966, in a tax-free merger, U.S. Steel exchanged a $175 face value debenture for each share of the preferred stock, the value of the bonds and the preferred stock being $165 each. In 1972 some of the bonds were redeemed at $118 per bond. The Claims Court found debt discharge income of $47 per bond ($165 issue price less $118 repurchase price). It rejected a gain of $57 per bond ($175 par value less $118) under *Kirby Lumber*, finding that, under the rationale of Professor Bittker's article[57] disclosing that the *Kirby Lumber* bonds were not issued for cash but for preferred stock and dividend arrearages, the issue price of the bonds was the fair market value of the consideration received. In *Kirby Lumber* that value was assumed both by the Court of Claims and the Supreme Court to be the par value of the bonds received in exchange. In *U.S. Steel*, that value was less than the par value of the bonds, so the $165 market value of the preferred rather than par value of $175 was held to be the issue price. The Claims Court rejected *Rail Joint* and *Fashion Park*, which would have found income only if the repurchase price of the bonds had been

55. 21 T.C. 600 (1954).

56. 11 Cl. Ct. 375 (1986), *motion for reconsideration granted in part*, 11 Cl. Ct. 541 (1987), rev'd, 848 F.2d 1232 (Fed. Cir.1988).

57. 11 Cl.Ct. 375 at 379, 385, relying on Bittker, *supra* note 9.

below the $100 cost of the preferred.[58]

The Claims Court reading of *Kirby Lumber* is defensible. The Supreme Court, as noted by Professor Bittker, seems not to have assumed a cash consideration and that the only pertinent factor was that full value had been received *whether or not that value increased the assets of the corporation*. So viewed, *Kirby Lumber* in fact supports the holding of the Claims Court in *U.S. Steel*, that the issue price was the value of the preferred stock received in consideration of the bond transferred, despite the fact that no additional asset value accrued to the corporation from such consideration.[59]

Under the Claims Court reading of *Kirby Lumber*, the facts in *U.S. Steel* and *Fashion Park* are clearly controlled by the *Kirby Lumber* holding, and, under that reading the Court of Appeals in *U.S. Steel* should have affirmed the Claims Court. Instead the lower Court's decision was reversed, the Court of Appeals stating:

> *Kirby Lumber* sheds little light of the question before us regarding the "issue price" of the. . .debentures. In *Kirby Lumber*, the Court stated that the corporation had received the par value of the bonds upon their issuance, which therefore was their issue price. The question in *Kirby Lumber* was whether, upon repurchase of the bonds for less than their issue price, the corporation realized taxable income. In contrast, the issue in the present case is whether the issue price of the debentures was the market value of the preferred stock at the time it was exchanged for the debentures or the amount the company received when the stock originally was issued.[60]

The Court of Appeals then relied on *Fashion Park* and *Rail Joint* that "the critical inquiry is whether the effect of the cancellation is to increase the corporation's assets" and in applying that standard the issue price of the debentures "was the amount the company received when it originally issued the preferred stock in 1901 and not the market value of the preferred when the debentures were issued in exchange for the stock in 1966."[61]

In applying the methodology of the transactional view in *United States Steel*, the Court adopts the same view as *Rail Joint*, *Fashion Park*

58. 11 Cl.Ct. 375 at 381-382.

59. *Cf.* Gunn, *Reconciling United States Steel and Kirby Lumber*, 42 TAX NOTES 851 (1989) together with Shakow, *United States Steel and Kirby Lumber: Another View*, 42 TAX NOTES 1371 (1989). *Cf., also* Gunn, *United States Steel And The Functional Approach To Legal Problems*, 43 TAX NOTES 213 (1989); Shakow, *A Short Retort on United States Steel*, 43 TAX NOTES 1173 (1989); Gunn, *Gunn's Reply*, 43 TAX NOTES 1174 (1989); Pisem, *More on United States Steel Corporation*, 43 TAX NOTES 1414 (1989).

60. 848 F.2d at 1234-1235.

61. 848 F.2d at 1236.

and *Bradford*, and looks for an increase in asset value as consideration for the bonds, disregarding the business and economic benefits of doing a desired nontaxable reorganization to get rid of dividend arrearages as in *Kirby Lumber* and *Fashion Park*, or to obtain the tax advantages of an interest deduction instead of paying non-deductible dividends, as suggested by the Court of Appeals in *United States Steel* in response to a Government argument that seemed to confuse market value with par value.[62] Not only are corporate consumption benefits ignored; also disregarded is the point made above with respect to zero basis for the corporate earnings unburdened by the debt discharge. And, of course, it strengthens the option to avoid tax by doing deals with bonds instead of cash.[63]

Conclusion

After the decision in *Kirby Lumber*, the lower courts held that income from debt forgiveness had to be supported by an increase in assets received in consideration for the debt. This result was felt to be required by a proper reading of *Kerbaugh-Empire*, seemingly approved by *Kirby Lumber* in viewing the "transaction as a whole." This view, however, if too broadly applied could permit an improper double benefit; also, it overlooks the fact that value or benefit arises from the implicit borrowing inherent in consumption, whether it be personal or corporate consumption, as much as it does from money or asset consideration received on an express borrowing for which the debt is issued. Expressed as the "net effect" theory, indirect and direct borrowing have the same economic "net effect," and the borrowed funds are "consumed" in both cases causing a loss of basis therein. That basis, therefore, cannot be used a second time to offset the gain from debt discharge. Thus the view of "transactional equity," originating under the tax benefit rule, is extended to debt-discharge cases in order to prevent an impermissible double-benefit. Debt-discharge income is present under both a strict "freeing of assets" view, or under the transactional view.

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62. The Court of Appeals suggested it was done to obtain the tax advantage of an interest deduction. *See* 848 F. 2d at 1237.

63. Also ignored is the "net effect" argument: similar to the reconstruction of events in *Rail Joint* and *Bradford*, the reorganization had the same economic effect as a sale of the bonds for cash and a redemption of the preferred stock with the cash. Both transactions leave the taxpayer without the borrowed cash and with bonds outstanding, giving rise to income when redeemed for less than par. The fact that a tax-deferred transaction (the reorganization) has been reconstructed as a taxable transaction does not obviate the fact that the two are economic equivalents, and, with respect to the redemption of the bonds at less than par value, should give the same tax effect.

Also, especially in the business context, making a tax law distinction between direct and indirect borrowing despite the economic identity of the two, gives an unwarranted option to avoid tax, especially during inflationary periods when interest rates are rising.

Hence, whether from the viewpoint of a "net worth" analysis, or notions of economic reality and proper tax policy, the "increase in asset value" rationale should be discarded.