Michigan Law Review

Volume 47 | Issue 8

1949

TAXATION-INCOME TAX-INCOME FROM DISCHARGE OF INDEBTEDNESS

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TAXATION—INCOME TAX—INCOME FROM DISCHARGE OF INDEBTEDNESS—In 1925 taxpayer obtained a loan of $90,000 from a bank, executing in return 200 bonds secured by a mortgage on certain of his property. The bank sold the bonds to the public. Until 1932 taxpayer was able to pay the interest and retire the bonds according to schedule, but in that year, compelled by a "straitened" (but solvent) financial condition, he obtained an extension of interest and principal payments. During 1938, 1939 and 1940 (prior to maturity) taxpayer repurchased a portion of the bonds at considerably less than face value, some of the purchases being made through a bondholders' committee, some through security houses and others directly from the bondholders. The commissioner ruled that the difference between the face value and the repurchase price of each bond constituted taxable income, and adjusted taxpayer's returns for those years accordingly. On taxpayer's petition for redetermination, the Tax Court[1] held that the gains resulting from the purchases directly from the bondholders were gifts within the meaning of *Helvering v. American Dental Co.*;[2] but that the gains resulting from the purchases through the bondholders' committee and the security houses were taxable income because, these purchases being analogous to those on the "open market," the "personal element . . . necessary to make a gift within the meaning of the *American Dental Co.* case was absent."[3] Both the commissioner and the taxpayer appealed to the Seventh Circuit Court of Appeals which held that none of the purchases was made in the "open market" since each bondholder knew he was selling, directly or indirectly, to the taxpayer, the only market for these securities, and there-

[1] Jacobson v. Comm., 6 T.C. 1048 (1946).
[2] 318 U.S. 322, 63 S.Ct. 577 (1943).
[3] Jacobson v. Comm., 6 T.C. 1048 at 1054 (1946).

fore all gains were gifts.[4] On certiorari to the United States Supreme Court, *held,* reversed. Discharge of indebtedness may result in income or a gift depending upon the factual question whether the creditor intended to make a gift of part of his claim as distinguished from a sale of his whole claim for the highest price available. In the absence of a finding on this question, the commissioner was sustained. *Commissioner v. Jacobson,* (U.S. 1949) 69 S.Ct. 358.

In 1931 the Supreme Court held in the *Kirby Lumber Co.* case[5] that a solvent taxpayer realized taxable income when it repurchased its own bonds at a discount in the open market. While this decision firmly established the principle that discharge of indebtedness at less than par may result in income within the meaning of I.R.C., sec. 22(a),[6] it was inevitable that sooner or later the question would arise whether the gain accruing on discharge of indebtedness might not be regarded as a gift from the creditor, excludable from income under I.R.C., sec. 22(b) (3). The answer to this question was clear where an unfettered donative intent could be found, but considerable doubt surrounded "gratuitous" cancellations of indebtedness classifiable as "astute business practice." In 1943 the question finally came before the Supreme Court in *Helvering v. American Dental Co.*[7] In that case a solvent but financially pressed taxpayer negotiated directly with its creditors and secured a full cancellation of interest owed on trade notes and a partial cancellation of back rent. Although the taxpayer had benefited taxwise in accruing and deducting the cancelled obligations in previous years, the Court held that the gain from cancellation of indebtedness was a gift from the creditors. Discerning an intent on the part of Congress in sec. 22(b) (3) that "gifts" be broadly construed where discharge of corporate indebtedness was involved,[8] the Court declared that if the "forgiveness was gratuitous, a release of something to the debtor for nothing," it was "sufficient to make the cancellation here gifts within the statute."[9] The *Kirby* case was cited and approved, but distinguished, indirectly, by a later remark about an "arm's-length transaction."[10] Determining where the dividing line between these two cases lay, was the problem which led the lower courts to develop the tenuous "degree of acquaintance" and "open market" tests.[11]

[4] Comm. v. Jacobson, (C.C.A. 7th, 1947) 164 F. (2d) 594.

[5] United States v. Kirby Lbr. Co., 284 U.S. 1, 52 S.Ct. 4 (1931). It was in this decision that Justice Holmes enunciated the famous "release of assets" theory as the basis for holding that income arises from discharge of indebtedness. The "tax benefit" theory of income was not finally perfected until Dobson v. Comm., 320 U.S. 489, 64 S.Ct. 239 (1943).

[6] At the time the Kirby case was decided the definition of gross income was found in §213(a), 42 Stat. L. 227 at 237 (1921). In effect, the language is the same as in the cited code section.

[7] Supra, note 2.

[8] Referring to I.R.C., §§22(b)(9) and 113(b)(3), as originally promulgated in §215, 53 Stat. L. 862 at 875 (1939), and as amended by §114, 56 Stat. L. 798 at 811 (1942), pertaining to the discharge of certain corporate indebtedness, the Court was able to find a benevolent attitude on the part of Congress toward the whole field of corporate debt reduction.

[9] 318 U.S. 322 at 331, 63 S.Ct. 577 (1943).

[10] Id. at 330. See MAGILL, TAXABLE INCOME, rev. ed., 255 (1936).

[11] See Tax Court and Circuit Court of Appeals decisions in principal case, cited above in notes 2 and 4. See also Fifth Ave. -14th Street Corp. v. Comm., (C.C.A. 2d, 1944) 147 F. (2d) 453; Bulkley Bldg. Co., P-H MEMO. DEC. ¶44,342 (1944).

The line as established lay dangerously close to the *Kirby* case.[12] It was in this setting that the principal case was decided. Although relying upon the same statutory references which had persuaded the Court in the *American Dental* case to give a broad connotation to the word "gifts,"[13] the Court here concludes that where discharge of indebtedness is concerned, Congress intended the word "gifts" in sec. 22(b) (3) to be strictly construed in accordance with the normal policy toward sec. 22(b) exclusions in general. Then, brushing aside the "tests" employed by the lower courts, the Court declares that the question in each case "turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.' The latter situation is more likely to arise in conection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Co.* . . than in the sale of outstanding securities. . . ."[14] The manner in which the *American Dental* case is distinguished seems inadequate in light of the holding in that case that the "receipt of financial advantages gratuitously" is a gift within the meaning of sec. 22(b) (3)[15]; but this only serves to emphasize the retreat the Court is making from its prior decision. The present position does not eliminate the possibility of a gift in the cancellation of indebtedness, for the Court clearly indicates that in the cancellation of indebtedness by a creditor, sound business judgment and a donative intent are not incompatible. However, it does seem clear that the effect of the principal case is to limit the rule of the *American Dental* case and, in turn, restore much of the lost prestige of the *Kirby* decision.[16]

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[12] See a thorough discussion of the cases involving the Kirby and American Dental decisions in Friedman, "Cancellation of Obligations," 24 TAXES 875 (1946).

[13] See note 8, supra. In the principal case the Court reasons that since Congress considered it necessary to add I.R.C., §22(b)(9) in order to relieve the discharge of certain corporate indebtedness from income taxation, it must follow that §22(b)(3) was considered inadequate, without more, for the purpose; and therefore, *a fortiori*, a natural person, such as Jacobson, who had derived gains precisely within the specifications of §22(b)(9) could not qualify, without more, for the gift exclusion in §22(b)(3). Query whether the Court should give retroactive effect to expressions of Congressional intent?

[14] Principal case at 370.

[15] This conclusion is expressed by Justice Rutledge in his concurring opinion in the principal case, and by Justices Reed and Douglas in their dissent.

[16] For a discussion of the broader aspects of discharge of indebtedness, including a discussion of the principal case while in the lower courts, see 46 MICH. L. REV. 1091 (1948). See also Warren and Sugarman, "Cancellation of Indebtedness and its Tax Consequences," 40 COL. L. REV. 1326 (1940), 41 COL. L. REV. 61 (1941).