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REALIZATION OF INCOME THROUGH CANCELLATIONS, MODIFICATIONS, AND BARGAIN PURCHASES OF INDEBTEDNESS: I

L. Hart Wright[*]

Introduction

TREASURY regulations bearing on the tax consequence of a cancellation, modification, or bargain purchase of one's outstanding indebtedness date back to those issued in connection with the Revenue Act of 1918. Thirteen years elapsed after their issuance before the Supreme Court in 1931 finally approved, at least with respect to the bargain purchase with which it was concerned, the principal which the regulations incorporated, namely, that the savings effected by such debtors could, as a constitutional as well as a statutory matter, involve the realization of taxable income. Competing interpretations of that decision, the government insisting on a sweeping application of its philosophy while debtors quite naturally argued that it should be confined pretty much to its facts, forced the courts, principally the lower ones, to inquire into the significance of each of the major aspects of those situations where some kind of gain is derived by a debtor from an adjustment or bargain discharge of his indebtedness. Those aspects on which the greatest attention has been focused might be grouped as follows:

(1) The creditor's motives and intention: whether, for example, the adjustment was in the nature of a gift or was instead an income tax producing transaction;

(2) The debtor's general unsound financial condition: for example, should an adjustment of an insolvent's indebtedness involve a realization of income;

(3) Matters involving the particular consideration received on incurring the obligation: in determining the taxability of a particular saving from a debt adjustment, what significance should

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be attached, for example, to a loss or decline in value of the matter originally borrowed;

(4) The character of the obligation: whether, for example, a distinction was to be drawn in connection with the problem under discussion between obligations *in personam* and those *in rem;*

(5) The kind of property used in effecting the adjustment or discharge: is it significant, for example, that property other than cash is transferred in effecting the adjustment; and

(6) Features of a transaction which have an effect equivalent to retirement of indebtedness.

A bantam-size summary of the results reached with respect to these matters during the twenty-year period which followed the Supreme Court's original finding of taxability reveals that the broad philosophy originally attributed by the government to that finding has met, sometimes justifiably and sometimes not, with something considerably less than wholesale favor. This has not only been reflected in the reluctant attitude of the lower courts, but also in occasional patch-work legislation, the first of which was designed only to cushion the impact of the Supreme Court's doctrine on those suffering real financial embarrassment. Some of this legislation, however, has been so amended in an effort to accomplish its original mission that the exception has almost swallowed the whole.

A chronological and critical discussion of the significance attached by the courts and the Congress to the matters enumerated above follows the description below of the events which led to the original determination that the saving effected by a bargain discharge was realized income. Consideration of these early matters is indispensable to a total evaluation of the doctrine as now shaped, for some of those matters "fathered" a number of the limitations which the lower courts later appended to the notion which the government had attributed to the Supreme Court.

An overall evaluation of this general problem is timely, both because of recent landmark decisions and because Congress contemplates a reconsideration of it in connection with the anticipated piecemeal revision of the code.[1]

[1] See also Dunham, "Cancellation or Adjustment of Indebtedness," 7 NEW YORK UNIVERSITY INSTITUTE ON FEDERAL TAXATION 1346 (1949); Lynch, "Some Tax Effects of Cancellation of Indebtedness," 13 FORDHAM L. REV. 145 (1944); Warren and Sugarman, "Cancellation of Indebtedness and its Tax Consequences," 40 COL. L. REV. 1326 (1941); Darrell, "Discharge of Indebtedness and the Federal Income Tax," 53 HARV. L. REV. 977 (1940); Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 YALE L.J. 1153 (1940).

Developments Leading to the Determination That Income May Be Realized on Bargain Discharges of Indebtedness 1918-1931

Early administrative practice (1918-1926). That profitable discharges of various kinds could involve a realization of income had been frequently asserted by the Treasury in the period before 1926, the year in which the Supreme Court first considered the matter. A corporation, for example, had been said to be taxable when it purchased its outstanding bonds for a sum less than their issue price.[2] And a like result was reached when an ordinary debt was composed or forgiven.[3] However, administrative rulings did recognize a few important limitations, and perhaps there would have been more had there been a greater variety of situations. The first of these involved the situation where the arrangement in question consumed all of the assets of the debtor. For example, discharges in bankruptcy,[4] and a composition within[5] or outside that act[6] which left the debtor without assets, were not thought to be income-producing transactions. Though of real benefit to him, of more importance was the fact that these arrangements left the debtor without tangible evidence of economic gain. Another limitation provided immunity from tax if the cancellation of the obligation was intended as a gift.[7] Closely akin to this was the provision in the regulations to the effect that a gratuitous cancellation of a debt which a corporation owed a stockholder-creditor was a contribution to the corporation's capital structure, rather than income.[8] There was, however, as we shall see, one important difference between the last two of these situations.

The equivocal decision in Bowers v. Kerbaugh-Empire Co. The Supreme Court's first reaction to the general administrative practice outlined above was stated in such an equivocal fashion that one could not be certain whether it disapproved in toto or was merely adding another limitation. In *Bowers v. Kerbaugh-Empire Co.,*[9] a borrower was able to effect a saving in 1921 in an amount of $600,000 by satisfying

[2] Treas. Reg. 45, art. 544, Revenue Act of 1918; A.R.R. 545, 5 Cum. Bul. 211 (1921). Similar regulations have appeared in connection with all succeeding acts and the code. See, e.g., the present provision in Treas. Reg. 111, §29.22(a)-18.

[3] Treas. Reg. 45, art. 51, Revenue Act of 1918. Similar provisions have been contained in all succeeding regulations. See, e.g., Treas. Reg. 111, §29.22(a)-14.

[4] I.T. 1564, II-1 Cum. Bul. 59 (1923).

[5] Ibid.

[6] S.M. 1495, III-1 Cum. Bul. 108 (1924).

[7] Treas. Reg. 45, art. 51.

[8] Ibid.

[9] 271 U.S. 170, 46 S.Ct. 449 (1926).

an eight-year-old foreign loan, one calling for payment in German marks, with the dollar equivalent, the amount being calculated according to the currently prevailing, unusually favorable rate of exchange. With respect to these facts, the lower court had been quite explicit;[10] a bargain discharge, according to it, could not involve a realization of income since the gain which resulted failed to satisfy the constitutional requirements which were thought to have been established by the Supreme Court in *Eisner v. Macomber*.[11] Such a gain fell short of the mark for two reasons. It was not in the traditional sense derived from one of the previously approved sources of income, i.e., it did not spring " 'from capital, from labor, or from both combined.' "[12] Moreover, the improvement which resulted in the debtor's balance sheet was not attributable to something received for the company's separate use, benefit and disposal, but was due instead to " 'enrichment through increase in the value of the capital investment,' "[13] and this was " ' not income in any proper meaning of the term.' "[14]

On review, the Supreme Court agreed that the question was whether such a discharge could involve a realization of income. But it then proceeded to ignore the issue as framed. It lumped together the entire series of years 1913 through 1921, algebraically added a subsidiary's losses in the earlier years (sustained in fulfilling contracts for which the money had been borrowed) to the parent's gain in 1921, and, emphasizing that the one word, income, was limited to gain (presumably without regard to those sections of the statute authorizing deductions), concluded that the parent was not taxable inasmuch as "the result of the whole transaction was a loss."[15]

Such equivocation provided only one unequivocal explanation. A bargain discharge in and of itself did not involve a realization of income. Even if it is assumed that some such discharges could result in taxability, the result, nevertheless, ultimately hinged on at least one other related financial consideration, for clearly this decision demonstrated that the loss of the asset which had been received by the debtor at the time the obligation was created left the obligor immune with respect to the subsequent saving.

Though the Treasury's practice and the shape of its regulations were

[10] Kerbaugh-Empire Co. v. Bowers, (D.C. N.Y. 1924). 300 F. 938.
[11] 252 U.S. 189, 40 S.Ct. 189 (1920).
[12] Kerbaugh-Empire Co. v. Bower, (D.C. N.Y. 1924) 300 F. 938 at 942.
[13] Id. at 943.
[14] Ibid.
[15] Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 at 175, 46 S.Ct. 449 (1926).

not influenced by the *Kerbaugh-Empire Co.* decision,[16] its efforts at enforcement were rendered ineffective, principally because of the construction attached to the above case by the Board of Tax Appeals. Obligors were, as a general proposition, said to be immune from tax whether the discharge grew out of a bargain purchase of bonds by a corporation[17] or arose from the composition of an ordinary debt.[18] In some of the cases the discharge was effected by an insolvent debtor.[19] And this circumstance did add to the argument against taxability. But other cases, relying in part on the language previously quoted from *Eisner v. Macomber*, supported an even more sweeping immunity,[20] one which was clearly stated by the Court of Claims:

> "In our opinion the question whether the person engaging in such transaction is solvent or insolvent, or whether he made a profit or suffered a loss through the use of the money for which the obligations were issued, is wholly immaterial."[21]

Some evidence that this was the correct interpretation of the Supreme Court's view was supplied when the latter, in *Burnet v. Sanford & Brooks Co.*,[22] upheld a practice which the government had generally followed, that of computing income on the basis of yearly accounting periods without regard to realized gains or losses of previous years. The *Kerbaugh-Empire Co.* case, one theory of which seemed opposite, was distinguished on two grounds. The first of these was clearly untenable, for it actually involved the one feature which was common to both cases. It was said that the Kerbaugh-Empire Company was freed of its deficiency because the company had not profited from the transaction considered as a whole. But this was hardly a distinction, for the same could have been said of the Sanford & Brooks Company, provided the Treasury there had been required, as it had been in the *Kerbaugh-Empire Co.* case, to take into account related losses which the taxpayer had realized in an earlier year. The actual decision concerning the former, however, permitted the government to disregard the earlier

16 See Treas. Reg. 69, arts. 49 and 545. This regulation was issued after the Kerbaugh decision.

17 American Tobacco Co., 20 B.T.A. 586 (1930); Eastern Steamship Lines, 17 B.T.A. 787 (1929); Independent Brewing Co. of Pittsburgh, 4 B.T.A. 870 (1926).

18 Meyer Jewelry Co., 3 B.T.A. 1319 (1926).

19 E.g., Simmons Gin Co., 16 B.T.A. 793 (1929), affd. (10th Cir. 1930) 43 F. (2d) 327.

20 There was no showing of insolvency in any of the cases cited in note 17 supra.

21 Kirby Lumber Co. v. United States, (Ct. Cl. 1930) 44 F. (2d) 885 at 887, revd., 284 U.S. 1, 52 S.Ct. 4 (1931).

22 282 U.S. 359, 51 S.Ct. 150 (1931).

losses. Consistency then would require a like disregard of the earlier losses of borrowed money which were sustained by the Kerbaugh-Empire Company.

The weakness indicated above in the first of the two theories by which the *Sanford & Brooks Co.* decision attempted to reconcile the *Kerbaugh-Empire Co.* case suggests that the bar was justified in attaching more than a little weight to the second distinction which was drawn, one based on the fact that the Kerbaugh-Empire Company had not "received any money or property which could have been made subject to the tax."[23] The implication seemed clear; the gain or saving derived from a bargain discharge of indebtedness lacked the qualities of the constitutional definition of income which had been framed in *Eisner v. Macomber.*

Bargain discharges established as a realizable event. In spite of the seemingly contrary implications contained in the *Sanford & Brooks Co.* decision, the Supreme Court did, within a year, in *United States v. Kirby Lumber Co.,*[24] sanction a tax on a corporation measured by the gain which it derived from the bargain discharge of its outstanding bonds. The regulations which had been rendered ineffective throughout the preceding five years because of numerous adverse lower court rulings were now said to be a "correct statement of the law."[25] And the *Kerbaugh-Empire Co.* case, one which had been thought by the lower courts to point in the opposite direction, was distinguished. The distinction, however, as indicated by the quotation which follows, rested on a theory which could not possibly have been more uncomfortable alongside the philosophy of the *Sanford & Brooks Co.* decision, a fact which was not referred to in the *Kirby Lumber Co.* opinion:

> "But... [that] transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligations of bonds now extinct."[26]

This clear cut inference that the result in the *Kerbaugh-Empire Co.* case survived the decision of the *Kirby* case in favor of the government, and the emphasis placed in the above quotation on the assets made

23 Id. at 364.

24 284 U.S. 1, 52 S.Ct. 4 (1931); 20 CALIF. L. REV. 441 (1932); 32 COL. L. REV. 137 (1932); 45 HARV. L. REV. 744 (1932).

25 United States v. Kirby Lumber Co., 284 U.S. 1 at 3, 52 S.Ct. 4 (1931).

26 Ibid.

available by this particular bargain discharge, constitute two of the original sources for the now prevailing notion that a bargain discharge of an obligation does not, *standing alone,* constitute a realization of income. In other words, whether or not income is realized on such occasions involves, as we shall see, something more than a subtraction of the amount paid on retirement from the face amount of the obligation.[27] In terms of the theory of income, as distinguished from certain practical problems facing the advocate, it makes little difference in a particular case whether the burden is on the taxpayer to produce evidence of the other circumstances which will render the *Kirby* doctrine inapplicable, or whether the burden is on the government in the first instance to show that the total circumstances do warrant an assessment on a particular saving. In either event, the final conclusion, special legislation aside, ultimately rests on the meaning or theory of the one word, income.

Aside from the reference to the resulting availability of assets, and to the fact that the *Kerbaugh-Empire Co.* case survived, various degrees of significance were also subsequently attached to the other facts present in the *Kirby* case: that the bonds were originally sold for *cash,* that the debtor was apparently *solvent* throughout, that the bonds evidencing *personal* liability were apparently purchased by the debtor on the *open market* for *cash* at a time when the obligation was neither *conditional* nor in *dispute,* and that they were immediately *retired,* are matters which later, at one time or another, seemed more or less critical.

Gifts and Capital Contributions Distinguished from Realized Income

Introductory note. As previously noted, the earliest regulations dealing with the cancellation of indebtedness expressly recognized that under proper circumstances such might amount to a gift[28] or, in the more limited instance where the creditor was also a stockholder of the debtor, to a contribution to the capital of the debtor-corporation.[29]

[27] In characterizing the results which have been reached, it would be equally accurate to say that a bargain discharge does, *with certain exceptions,* involve a realization of income. This statement, however, tends to obscure the rationale underlying the general proposition. See, e.g., the discussion, under the sub-title, "Significance of the kind and amount of consideration received on incurring the obligation," of Commissioner v. Rail Joint Co., (2d Cir. 1932) 61 F. (2d) 751. This appears in Part II of this article to be published in the March issue.

[28] Treas. Reg. 45, art. 51.

[29] Ibid.

A father, for example, might on an appropriate occasion choose cancellation as a method of effecting a gift to his son. And in that event the benefit would not be included in the latter's income.[30] But in the more troublesome instance in which a cancellation was effected between businessmen, it was not wholly clear from the regulations exactly where the line was to be drawn between taxable income on the one hand and an excludable gift on the other. It was hardly sufficient in such cases to say that taxability turned on whether or not a gift was intended, for this left open the character of the consequence which must have been contemplated by the parties. What exactly was a gift for this particular tax purpose? Was it sufficient, for example, that a cancellation was not supported by consideration? Or were the motives of the creditor also material? And in this connection, of what importance was the particular *form* of the adjustment?

The regulations were not, as we shall see, quite so obscure in drawing a line between a capital contribution on the one hand and an income-producing transaction on the other in the instance where the creditor was also a stockholder of the debtor.

Motive as the criterion (1918-1942). An administrative clarification of the early regulations insofar as they concerned cancellations by ordinary creditors confirmed what had previously been only hinted, namely, that the government, contrary to the usual common law notions relative to gifts, considered the creditor's motive as the criterion on which taxability of the debtor should be based. It distinguished the instance where cancellation was intended only to benefit the debtor from the case where it was due to the inability of the debtor to pay.[31] The Board of Tax Appeals subscribed to this same view as late as 1941 when it upheld the government's action against a solvent debtor on finding that his creditors acted from business rather than from altruistic motives.[32]

Room was not provided in the regulations, however, for a consideration of motive in the instance where a corporation retired its outstanding bonds at a saving. From all that appears, such a corporation was always taxable on its saving.[33] The implication, that the form of

[30] None of the modern revenue acts have included gifts in taxable income. See I.R.C. §22(b)(3). That a cancellation could be a gift was expressly recognized by the House report submitted in connection with the revival of the gift tax in 1932. H.R. No. 708, 72d Cong., 1st sess., p. 28 (1932).

[31] I.T. 1547, II-1 Cum. Bul. 58 (1923). Cf. Treas. Reg. 45, art. 51.

[32] American Dental Co., 44 B.T.A. 425 (1941), revd., 318 U.S. 322, 63 S.Ct. 577 (1943).

[33] Treas. Reg. 45, art. 544.

the debt adjustment might make a difference, did not become a subject of controversy, however, until after the Supreme Court's decision in 1943 of the *American Dental* case.[34] Consequently, this specific matter is more fully discussed below.[35]

Nor was account taken of motive in the regulation or in the early cases which freed from tax the benefit which a corporation derived from the cancellation of claims which stockholder-creditors held against it.[36] The absence of reference to motive by the courts in this instance may have been solely attributable to the fact that the example contained in the regulations implied that the peculiar relationship of the parties and the absence of consideration were together enough to warrant classifying the benefit as a non-taxable capital contribution.[37] Since the cases generally involved sole stockholders or those having at least a substantial interest in the corporation,[38] there was, of course, little pressure on the courts to evaluate the merits of the precise line attributed to the regulations, for the relationship and consequent mutual interest of the parties would have been some guarantee in many of the cases that the motive was in fact to improve the capital structure of the debtor.

[34] Helvering v. American Dental Co., 318 U.S. 322, 63 S. Ct. 577 (1943).

[35] At p. 470.

[36] The first case to arise concerned the Corporation Excise Act of 1909. United States v. Oregon-Washington Railroad & Navigation Co., (2d Cir. 1918) 251 F. 211. For early cases under the income tax acts, see Auto Strop Safety Razor Co., 28 B.T.A. 621 (1933), affd. (2d Cir. 1934) 74 F. (2d) 226; Smith Insurance Service, Inc., 9 B.T.A. 284 (1927).

[37] Treas. Reg. 45, art. 51. At first it seemed that some attention might be paid to motive in the reverse situation where a corporation forgave a claim which it held against one of its substantial stockholders. In Fitch v. Helvering, (8th Cir. 1934) 70 F. (2d) 583, the court held that the cancellation constituted a dividend. But it rejected the claimed characterization of a gift by stating, at 585, that such were " 'bestowed only because of personal affection or regard or pity, or from general motives of philanthropy or charity.' " A different court in the following year concluded, however, that the character of the distribution was not affected " 'by the personal motives which induced the respective stockholders or directors to approve such action, for it nevertheless remained in contemplation of law a distribution of dividends. It was made from the earnings or profits of the distributing corporation, and was divided among the stockholders of the distributing company in such proportions as was satisfactory to its directors and stockholders.' " Waggaman v. Helvering, (D.C. Cir. 1935) 78 F. (2d) 721 at 723, cert. den. 296 U.S. 618, 56 S.Ct. 139 (1935). In Gibson v. Commissioner, (3d Cir. 1936) 83 F. (2d) 869, the distribution was said to be a gift. But there the corporation was insolvent and did not, therefore, have earnings and profits from which a dividend could be paid.

The only other really important matter relating to cancellations by corporations of claims against stockholders concerns the question of whether a charge-off of such a claim will be treated as a dividend though there was no intention on the part of the corporation to cancel the debt. That this involves a distribution of a dividend, see Hudson v. Commissioner, (6th Cir. 1938) 99 F. (2d) 630, cert. den. 306 U.S. 644, 59 S.Ct. 584 (1939). *Contra,* Sala v. Commissioner, (2d Cir. 1944) 146 F. (2d) 228.

[38] United States v. Oregon-Washington Railroad & Navigation Co., (2d Cir. 1918) 251 F. 211; Auto Strop Safety Razor Co., 28 B.T.A. 621 (1933), affd., (2d Cir. 1934) 74 F. (2d) 226; Smith Insurance Service, Inc., 9 B.T.A. 284 (1927).

There was, however, one situation involving cancellation by a stockholder-creditor with respect to which the commissioner insisted that the foregoing construction of the regulation was inapplicable. He voiced objection to what was alleged to be an added tax benefit which would be achieved were the regulations applied to a debtor corporation which had taken an expense deduction in an earlier year for the amount of the debt in accordance with its accrual system of accounting. The government's contention, that the cancellation of the claim should be followed by a restoration to income of the amount previously offset by the deduction, was rejected in 1935 by the Court of Appeals for the Second Circuit in *Commissioner v. Auto Strop Safety Razor Co.*;[39] but it was then approved in 1940 by the Eighth Circuit in the *Jane Holding Corporation* case.[40]

In the interim between these decisions, much-needed legislation was passed to the effect that a debtor on the accrual basis could not deduct an accrued expense payable to an otherwise closely affiliated creditor who operated on the cash basis unless the item in question was actually paid by the succeeding March 15.[41] But while the most attractive avoidance possibilities were thereby eliminated, the legislation did not apply where the creditor was also on the accrual basis. And yet, even in that case, there was some argument, a matter more fully developed infra,[42] that the debtor should at the time of the cancellation be required to restore to income that amount previously offset.

By 1942 the creditor's motive was well on the way to becoming the critical factor in determining taxability in this situation, for the two circuit court cases above were actually distinguishable on that ground. In fact the two circuit courts in question attempted to explain away the possible conflict between them on this and one other basis; using iden-

[39] 74 F. (2d) 226 (1934).

[40] Helvering v. Jane Holding Corporation, 109 F. (2d) 933 (1940), cert. den. 311 U.S. 725, 61 S.Ct. 56 (1940). The circuit court reversed 38 B.T.A. 960 (1938), which had followed the Auto Strop case. Between the circuit courts' decisions in the Auto Strop and Jane Holding Corporation cases, the Treasury amended the relevant regulation, and should, therefore, be credited with an assist for the result reached in the second of the two decisions. The early regulations provided that "if a shareholder in a corporation which is indebted to him gratuitously forgives the *debt*, the transaction amounts to a contribution to the capital of the corporation." Treas. Reg. 65, art. 49 (italics added). The word "debt" could, of course, easily be construed to include interest as well as principal. The language was changed so as to read, "the principal of the debt." Treas. Reg. 101, art. 22(a)-14 first incorporated this change.

[41] Act of Aug. 26, 1937, c. 815, §301(a), 50 Stat. L. 813, 26 U.S.C. §24. The term "affiliated creditor" was used above to describe those whose relationship to the debtor was so intimate that losses from sales and exchange between them would not be allowable as deductions under I.R.C. §24(b).

[42] At p. 475 et seq.

tical language both pointed out that "improvement of capital structure was not the moving consideration" behind the cancellation which was taxed in the Eighth Circuit's *Jane Holding Corporation* case, whereas the opposite had been true in the tax immune case before the Second Circuit.[43] A subsequent related decision by the Seventh Circuit in 1942 eventually led, however, to the neutralization of motive as a factor in this as well as in those cases where an ordinary creditor cancelled an ordinary debt. This development, one providing an immunity for many debtors who would have been taxable had the creditor's motives continued to be decisive, is discussed below.

"Direct negotiations" or the "personal element" as criteria (1942-1949). The development just referred to has its origin in the Seventh Circuit's decision of 1942 in *American Dental Co. v. Commissioner.*[44] There the debtor, a corporation on the accrual basis, had failed for several years to meet its rentals and the interest on notes which it had given for merchandise. These items had been deducted by it, of course, in the years in which they accrued. Though solvent balance-sheet-wise, the debtor was not in a position to pay these sums. The rental agent, informed of this fact on the negotiation of a new lease, indicated that some adjustment would be made with respect to his overdue claim of $15,000. In the following year the debtor accepted that agent's offer to take $7500 in cash, the balance of the amount overdue being cancelled. The president of the debtor corporation then persuaded its note-creditors to cancel the back interest due them, his argument to them being that they had made similar arrangements with their other debtor-customers. Omission of the cancelled amounts from the debtor's return led the commissioner to assess a deficiency limited in amount to those items which had offset income when deducted in earlier returns.

The Board of Tax Appeals, by drawing the line according to motives, upheld the government's action on finding that "the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity."[45] The Seventh Circuit reversed, concluding now, in accordance with the common law doctrine, that motive was immaterial, and that "as long as there was no

[43] Helvering v. Jane Holding Co., (8th Cir. 1940) 109 F. (2d) 933 at 942; Carroll-McCreary Co. v. Commissioner, (2d Cir. 1941) 124 F. (2d) 303. The second ground upon which the cases were distinguished was that the cancellation in the Jane Holding Corporation case was not really gratuitous.

[44] 128 F. (2d) 254.

[45] 44 B.T.A. 425 at 428 (1941).

consideration for the cancellation, the intent to give necessarily followed."[46]

The Supreme Court, on further review, first took advantage of the occasion to re-affirm its decision in the *Kirby Lumber Co.* case.[47] The purchase by a corporation of its outstanding bonds at a discount did involve the realization of income. But it then noted that the lower courts and particularly the Congress, on recognizing that cancellations usually involved those in financial straits, had whittled away at the *Kirby* decision's general doctrine. In fact at the time of this review, Congress had provided a tax deferment scheme for the benefit of all corporations with respect to some such savings; this was applicable, however, to later taxable years than that here involved.[48] The result which was to be reached in the *American Dental* case, and the reasons therefor, were plainly evident when, after carefully listing the limitations which had evolved (matters which evidenced the unsympathetic attitude of the lower courts and the Congress for the *Kirby* doctrine), the Court stated:

> "*In the light of these views* upon gain, profit and income, we must construe the meaning of the statutory exemption of gifts from gross income by §22(b) (3). . . . 'Gifts,' . . . is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages *gratuitously*."[49]

This confirmation of the position which had been taken by the Seventh Circuit, one which by its tendency toward exclusion conformed to general prevailing tendencies, meant, of course, that the creditor's motives were immaterial. With this, the Supreme Court agreed.

> "The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."[50]

While it was perfectly clear from the opinion that a finding to the effect that "the forgiveness was gratuitous, a release of something to the

[46] American Dental Co. v. Commissioner, (7th Cir. 1942) 128 F. (2d) 254 at 256.
[47] Helvering v. American Dental Co., 318 U.S. 322, 63 S.Ct. 577 (1943).
[48] I.R.C. §22(b)(9), discussed infra at p. 484 et seq.
[49] Helvering v. American Dental Co., 318 U.S. 322 at 329, 63 S.Ct. 577 (1943). Italics added.
[50] Id. at 331.

debtor for nothing" left the debtor immune from tax whether or not he was solvent, the exact sweep of the quoted phrase was not equally clear. Exactly on what basis, for example, was the *Kirby* case to be reconciled?

The *American Dental* decision did not apply, of course, where new consideration, such as premature payment, actually induced a partial cancellation.[51] Nor was it thought by the Tax Court to apply where a cancellation resulted from the operation of the statute of limitations rather than from the voluntary act of the debtor.[52] It was applied, however, to cases involving stockholder-creditors[53] as well as to those concerning ordinary creditors, and without regard to the fact that the particular debtor had secured, as had the American Dental Co., an alleged added tax advantage by having previously deducted the item in question.[54] A general line was established by the Tax Court between bargain discharges which resulted from direct negotiations with a creditor and those which were achieved by over-the-counter or market purchases.[55] In short, the exact form of the cancellation in the *American Dental* case was not thought by the Tax Court to be controlling. Instead the philosophy of that case was considered equally applicable, in the case of direct negotiations, to bargain purchases of bonds and to situations involving a partial payment with the balance being expressly forgiven. That both instances satisfied the requisite "personal elements,"[56] the Tax Court's substitute for motive and donative intent, was demonstrated by its decision of *Lewis F. Jacobson*,[57] a difficult case which shared many common features with both the *Kirby* and *American Dental* situations.

[51] Reliable Incubator and Brooder Co., 6 T.C. 919 (1946). For conflicting decisions on the question of whether new consideration was furnished, compare Chenango Textile Corporation, 1 T.C. 147 (1942) with the same case on appeal, (2d Cir. 1945) 148 F. (2d) 296.

[52] Annis Van Nuys Schweppe, 8 T.C. 1224 (1947), affd. (9th Cir. 1948) 168 F. (2d) 284.

[53] National Ice and Cold Storage Co. of California, 6 T.C.M. 80 (1947); McConway & Torley Corporation, 2 T.C. 593 (1943). Brown Cab Co., Inc. was decided first by the Tax Court in 1 T.C.M. 448 (1943) on the basis of the Jane Holding Corporation case; it was then reversed on authority of the American Dental Co. decision, 2 T.C. 593 (1943). It should not be assumed from these cases, however, that the gift characterization of the American Dental Co. case would have been used by the Tax Court to deny a stockholder-creditor the right to increase the adjusted basis of his stock by the amount of the cancellation. See discussion infra p. 474.

[54] S. H. DeRoy & Co., 3 T.C.M. 451 (1944).

[55] Warner Co., 11 T.C. 419 (1948), affd. (3d Cir. 1950) 181 F. (2d) 599; Fifth Avenue-Fourteenth Street Corp., 2 T.C. 516 (1943), revd. (2d Cir. 1944) 147 F. (2d) 453. *Accord*, Chenango Textile Corporation v. Commissioner, (2d Cir. 1945) 148 F. (2d) 296; Pondfield Realty Co. v. Commissioner, (2d Cir. 1943) 43-2 U.S.T.C. 9600 (1943).

[56] Lewis F. Jacobson, 6 T.C. 1048 at 1054 (1946).

[57] 6 T.C. 1048 (1946).

There the taxpayer, owner of a leasehold and the buildings thereon, had borrowed $90,000 for which he had executed certain negotiable bonds. In 1938, 1939, and 1940, some of these were re-acquired for a sum less than their face amount. A portion of the acquisition resulted from direct negotiations between the bondholders and the debtor or his personal agent. Others were acquired through the offices of the secretary of a bondholders' committee and through a broker. There was, however, no open market, either over-the-counter or through exchanges, for these bonds. Nevertheless, the Tax Court concluded that the purchases through the secretary's office and through the security dealer were closely akin to open market transactions and were, therefore, subject to the *Kirby* doctrine. The "personal element" involved, however, in the other more direct negotiations rendered the remainder subject to the *American Dental* case.

The Court of Appeals for the Seventh Circuit, while rejecting the exact line which had been drawn by the Tax Court, did, nevertheless, substitute one which had much in common with it. It thought the controlling feature of the *Dental* case was the fact "that the debtor was dealing with its creditors in such a manner that they parted with their security at less than its face value with knowledge that the amount received was in discharge of the debtor's obligation."[58] In other words, its criterion was whether or not the creditor knew that the debtor was the purchaser, rather than the question of whether the adjustment resulted from personal negotiations between debtor and creditor.

The creditor's attempt to get the "best price available" as the criterion (1949-19 ?). The Supreme Court on reviewing the *Jacobson* case disagreed with the views which had been advanced by both lower courts. Its conclusion was as follows:

> "The situation in each transaction is a factual one. It 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 connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Co., Supra,* than in the sale of outstanding securities, either of a corporation as described in §22(b) (9), or of a natural person as presented in this case."[59]

[58] Commissioner v. Jacobson, 164 F. (2d) 594 at 598 (1947).

[59] Commissioner v. Jacobson, 336 U.S. 28 at 51, 69 S.Ct. 358 (1949); 61 HARV. L. REV. 1258 (1948); 43 ILL. L. REV. 496 (1948); 46 MICH. L. REV. 1091 (1948).

This analysis would have been wholly superficial had the Court really intended to distinguish between those transfers which were, from the creditor's point of view, "for the best price available," and those which simply took the *form* of a "release of only a part of a claim for cash and of the balance 'for nothing.' " The impossibility of that distinction stems from the fact that the matters contrasted are not mutually exclusive. The American Dental Company's situation, for example, had taken the form of a "release of only a part of a claim for cash and of the balance 'for nothing.' " But there is little reason to believe from the facts of that case that the creditors had received from the corporate debtor anything but "the best price available." In other words, there is no absolute assurance in the instance where the transaction takes the form of a partial payment with a cancellation of the balance for nothing that the creditor has received or intended to receive less, everything considered, than the best available price. That is not to deny, however, that the facts of life might statistically demonstrate that the best price available is less frequently obtained where the transaction takes the form of a partial payment coupled with a release of the balance than where the transfer is in the form of a bargain purchase. In any event the Supreme Court thought that there was, in terms of probability, some basis for believing that such could be demonstrated, and as a consequence, it did place more than a little emphasis on the form of the transaction. For example:

> "There is nothing in the evidence or findings to indicate that he intended to transfer or did transfer something for nothing. The form of the transaction emphasized this relationship. The seller assigned the entire bond to his purchaser. The seller did not first release the maker from a part of the maker's obligation and, having made the maker a gift of that release, then sell him the balance of the bond or vice versa. If the seller actually had intended to give the maker some gift the natural reflection of that gift would have been a credit on the face of the bond or at least some record or testimony evidencing that release."[60]

In spite of this emphasis, it was clear from the opinion that the Court was "not saying that the form of the transaction is conclusive,"[61] for the ultimate criterion was, as previously noted, whether or not the creditor attempted to secure the best price available, and this depended, as the Tax Court has since put it, "on the 'realities and actualities of the

[60] Commissioner v. Jacobson, 336 U.S. 28 at 50, 69 S.Ct. 358 (1949).
[61] Id. at 51.

dealings and transactions.' "[62] Accordingly it is possible, though such may be remote, for a court to find that a gift was involved though the particular transaction has taken the form of a bargain purchase.[63] The fact that this possibility is remote is due only in part to the evidentiary value of the way in which the transaction is clothed. Of greater importance, and this applies equally to the partial payment with a release of the balance, should be the judicial recognition of the fact that ordinary creditors seldom release debts short of the best price available.[64]

Though the gift characterization applied by the *American Dental* case should, in view of that fact, be much less frequently applied now in the case of ordinary creditors than it was in the years before the *Jacobson* decision, one should not necessarily also assume, legislation aside, that corporations would now, as a practical matter, be more frequently taxed when cancellations are effected by their stockholder-creditors. While the Tax Court has described some such cancellations as gifts,[65] that characterization should actually compete with realized income only in the case of an isolated adjustment with a minor stockholder.[66] The revised philosophy of the *American Dental* decision should be applicable in the event of an adjustment with a substantial stockholder only for the purpose of determining whether the cancellation involved a capital contribution (as distinguished from a gift)[67]

[62] Spear Box Co., 13 T.C. 238 at 252 (1949), affd. (2d Cir. 1950) 182 F. (2d) 844.

[63] The Supreme Court almost said as much in the Jacobson case: "In the *absence of proof to the contrary,* the intent of the seller may be assumed to have been to get all he could for his entire claim." Commissioner v. Jacobson, 336 U.S. 28 at 50, 69 S.Ct. 358 (1949). Italics added.

[64] This does not mean that creditors always insist on a price which they might secure if they were willing to proceed by individual or collective process. Nor did the Court in using the phrase in question have that connotation of "best" in mind. The Court, as well as the statement supra, used the term "best" in the sense of a creditor getting all that he could through bargaining.

[65] George Hall Corporation, 2 T.C. 146 (1943).

[66] See the discussion in note 63 supra.

[67] This distinction is not without significance. Cancellation by a substantial stockholder who did not seek the best price available should justify an addition to the basis of his shares, an addition which could not be justified if the cancellation is to be treated as a gift. The regulations specifically provide for such an addition only where there are pro rata assessments among stockholders. Treas. Reg. 111, art. 29.22(a)-16. This section has been construed to include a cancellation. O.D. 1034, 5 Cum. Bul. 277 (1921). The basis of the shares should not be increased, of course, if the claim had a zero basis in the creditor's hands. This circumstance would be present, for example, if the claim was for rent, interest, or compensation which the creditor, being on the cash basis, had not previously returned as income. See George Hall Corp. v. Shaughnessy, (D.C. N.Y. 1946) 67 F. Supp. 748. Nor should the addition be made where a minor stockholder effects an isolated cancellation without seeking the best price available, for his contribution does not increase the value of his own shares by anything approaching an equivalent amount. The benefit is spread over the interests of the other stockholders as well and is, therefore, more closely akin to a gift than to a contribution of capital.

or instead constituted a realization of income. In both of the foregoing situations, however, the ultimate answer should now depend, in line with the general philosophy of the *Jacobson* case, on whether or not the stockholder-creditor attempted to get the best price available. To be distinguished from the case of ordinary creditors, stockholder-creditors holding substantial equitable interests would probably adjust their claims short of that price with some frequency in order to improve the corporation's capital structure, for at the same time they would be increasing the value of their equity.

Conclusion. The *Jacobson* opinion, if finally interpreted in accordance with the foregoing analysis, reaches a desirable and realistic result. Any objection to its doctrine is really nothing more than a criticism of that provision in the code which excludes gifts from taxable income. The case itself is subject only to one basic criticism. The Court now assumed, what was probably contrary to the fact, that the creditors in the *American Dental* case had not attempted to get the best price available. But with respect to the future, little harm was done so long as it is recognized that such a fact had now been imputed to that case. In other words, there was every reason to suspect that the *American Dental* case had actually turned on the *form* of the transaction, i. e., payment of a part with a release of the balance for nothing, coupled perhaps with something akin to the "personal element" as defined by the lower courts; but it was now re-interpreted so that its holding for the taxpayer could be reconciled with a change in the law—one which keyed the result to whether or not the creditor had attempted to secure the best available price.

The *American Dental* case, as re-interpreted, will still be subject, according to the views of others, to one objection.[68] This involves the immunity provided for the saving effected by those debtors who had also previously taken an expense deduction when the obligation accrued. It is true that such debtors do derive greater tax benefit from the gift than do certain other taxpayers similarly situated from an economic point of view. For example, had the creditor donated one year's use of a business building at the outset, the debtor, while technically entitled to exclude the benefit itself from his taxable income,[69] would not, however, have been entitled to deduct the value of the service from the gross receipts of his business, a matter to which the use of the

[68] Note, 28 IOWA L. REV. 706 (1943).
[69] I.R.C. §22(b)(3).

building contributed.[70] As a practical matter then, the gift would have been taxed to the donee. The same overall tax consequence would presumably follow had the debtor operated on the cash basis, and this would be so whether the gift was made at the outset or by subsequent cancellation of a claim for the service.[71] It is true then that the American Dental Company as a debtor-donee did receive better treatment than those whose situations were just described, for its earlier deduction did offset a part of its gross receipts to which the use of the building contributed.

There is, however, a basic weakness in the foregoing argument. While the tax treatment which the American Dental Company received was better than that received by some taxpayers similarly situated from an economic point of view, it was not better than that accorded certain other debtor-donees whose situations furnished equally attractive analogies which competed with those described above. For example, the debtor whose loan from a creditor was cancelled received the same economic and exactly the same overall tax benefits as did the debtor in the *American Dental* case with respect to the cancelled overdue rent.[72] Again, and perhaps of more importance, any other result than that actually reached in the latter case would have placed the American Dental Company, a donee, on the same basis as that of another debtor whose situation was exactly the same except (and it is a most significant exception) that the cancellation which benefited the second debtor was an "out and out" business transaction controlled by the *Kirby* case. Indeed, as we shall later see, the *Kirby* case itself has been held applicable in those situations where the creditor sought the best price available only if the previous expense deduction actually offset other income.[73]

[70] Cf. McConway & Torley Corp., 2 T.C. 593 (1943). The difficulty is attributable to the fact that the year's use does not seem to have an adjusted or substituted basis.

[71] A deduction would not have been allowed at the time the debt was created, for nothing was paid out. The gross receipts to which the service may have contributed would then have been taxed. Subsequent cancellation would not have justified a deduction since at best the debtor would assume the creditor's adjusted basis for the service, and this would presumably be zero.

[72] Each debtor received but one economic benefit, cancellation of the loan in one case and cancellation of the obligation arising out of a year's use of the building in the other. Characterization of each of these benefits as a gift rendered both tax immune. The American Dental Co. had not previously enjoyed any tax advantage not enjoyed by the debtor who had secured the loan since the earlier deduction taken by the former simply freed from tax that part of its gross receipts into which the service had been converted.

[73] See discussion under the sub-title, "Significance of the fact that the consideration received was a deductible expense." This appears in Part II, to be published in the March issue.

In view of the above, perfect candor requires one to recognize that this aspect of the *American Dental* case falls in the middle of a very complex group of competing analogies. If they were unscrambled with a two-fold purpose, i.e., first, with the view of resolving them exactly according to their economic similarities, and secondly, with the view of maintaining immunity, i.e., preferential treatment, under the code for gifts, an overall result would be produced which would be just as questionable as that which was in fact produced by the actual decision in the *American Dental Company* case. For example, reversal of that decision because of the debtor's earlier tax benefits would, under the above thesis, be accompanied by a provision for a highly questionable double tax on a debtor whose cancellation was controlled by the *Kirby* case—assuming he also enjoyed earlier tax benefit from a deduction.[74] The prospect of the two assessments which would be required in such a case, though there was actually only one economic benefit, is probably enough to suggest that the result reached in the *American Dental* decision was quite satisfactory.

Significance of a Debtor's General "Unsound Financial Condition"

Introductory note. It seems almost needless to say that there are instances in which a perfectly solvent debtor can acquire his outstanding obligations at a bargain price. He may, for example, take advantage of the fact that the market price of his long term obligations have declined because of an increase in the current going rate of interest over that which prevailed at the time the obligation was incurred. In that event, of course, assuming the benefit did not involve a gift, the *Kirby* case will and should apply. But it is safe to assume that the most frequently recurring opportunities for bargain discharges of one kind or another present themselves to debtors whose financial condition is in jeopardy. While the varying plight of such debtors runs the gamut, they may for present purposes be divided into three classes: those who are currently solvent but whose present and future prospects leave much to be desired; those who are insolvent both before and after the bargain discharge; and finally those who are in an intermediate stage, i. e., are rendered solvent by the transaction but in an amount which is less than the technical saving which was effected. Before considering the developments which have taken place with respect to these three situations,

[74] Otherwise a person benefited by way of a gift would be treated exactly the same as is a person whose profit was attributable to a business transaction.

preliminary note should be taken of the fact that financial embarrassment or insolvency has never generally affected the question of whether income is or is not realized from a given transaction. Today, for example, the tax is withheld from the wage of the insolvent as well as from that of the solvent taxpayer. Nevertheless, the question arose, should those suffering various degrees of financial embarrassment be treated otherwise on securing a bargain discharge of their outstanding obligations?

The judicial view. As a judicial matter it has been conceded since the *Kirby* case that pre-cancellation financial embarrassment of a type less serious than insolvency would not affect the taxability of any gain which the obligor derived from the discharge of his indebtedness.[75] Nor was it generally of any significance that a shrinkage had been suffered by a solvent debtor in the value of his total holdings in the interval between the creation and the retirement of his indebtedness.[76] But the Board of Tax Appeals did take a different view of the situation where the debtor was actually insolvent immediately before the debt was rendered extinct. For a time, and for reasons which appeared to be wholly unsatisfactory, such debtors were held to be completely immune from tax even though the cancellation may have left them with assets which exceeded their liabilities.[77] The suggestion, that the latter discharges involved nothing more than a diminution of a loss,[78] was obviously an unsatisfactory basis upon which to reconcile the holding in the *Kirby* case.

The Board first departed from this early rule in *Dallas Transfer & Terminal Warehouse Co.*[79] There the debtor had transferred, not cash as in the *Kirby* case but, instead, an equity having an adjusted basis of $14,000 in discharge of a debt for back rent which amounted to $107,-000. The balance sheet improvement of $93,000 left the previously insolvent debtor with a surplus in an amount which was somewhat less than the theoretical saving in question. But the Board did not stop at the surplus; it upheld a deficiency which had been aimed at the entire $93,000, reasoning that "a corporation while insolvent may still

[75] Consolidated Gas Co. of Pittsburgh, 24 B.T.A. 901 (1931).

[76] Ibid.

[77] Tower and Sullivan Manufacturing Co., 25 B.T.A. 922 (1932); E. B. Higley & Co., 25 B.T.A. 127 (1932). It was not always clear from the relevant decisions handed down before the Kirby case whether or not the debtor was insolvent, for at that time even solvent debtors were immune. See note 17 supra. Nevertheless, in 1937 the Board of Tax Appeals on initiating a new formula, one discussed infra, reconciled the pre-Kirby cases as well as the two cited above by assuming that in those cases the debtor was insolvent both before and after the cancellation. Lakeland Grocery Co., 36 B.T.A. 289 (1937).

[78] Tower and Sullivan Manufacturing Co., 25 B.T.A. 922 (1932).

[79] 27 B.T.A. 651 (1933).

have income. The fact that the taxpayer may in prior years have operated at a loss and its debts exceed its assets does not prevent it in the taxable year from making a taxable gain by disposing of property for more than its cost."[80]

Situations involving the use of property other than cash to discharge an indebtedness and those which paralleled the *Kirby* case were, at least with respect to matters other than insolvency, later to go their separate ways.[81] But from one argument which was used in the *Dallas Transfer Co.* case, it appears that the Board intended with one possible exception to apply quite generally the foregoing rule bearing on the significance of a state of insolvency which existed prior to the adjustment.[82] In other words, there was reason to believe, except perhaps in the one instance where the value of the assets remaining in the debtor's hands was less than the theoretical saving, that the Board was shifting in such cases from a notion providing complete immunity to one of complete taxability so as to put such debtors more nearly on a par with insolvent taxpayers who were not concerned with cancellation problems.

The Court of Appeals for the Fifth Circuit, however, in what has become a leading case, reversed.[83] For some unknown reason, it equated the case before it with the situation where the debtor is insolvent both before and after the cancellation. And it then apparently assumed that it would be enough to show that the debtor last described should be completely free from tax. The argument which was made with respect to such a debtor has already been considered; his case was contrasted with that of the Kirby Lumber Co., the point being made that the former did not really possess assets which had been rendered free from offsetting liabilities. The mere fact that the liabilities against the assets would have been reduced was not, standing alone, thought to be sufficient to warrant a tax. The actual freeing of assets was thought to be the only approved substitute for the receipt of "something of exchangeable value" which, prior to the *Kirby* case, had been required by *Eisner v. Macomber.*"[84]

[80] Id. at 657.

[81] See discussion under the sub-title "Significance of the use of the debtor's non-cash 'assets' in effecting the discharge." This appears in Part II to be published in the March issue.

[82] The Board first considered the case as one which involved a transaction closely akin to and, therefore, to be treated as an ordinary sale of property. But later it fitted the case into the philosophy of the Kirby doctrine by stating, "But even treating the case for the sake of argument on the principle upon which the taxpayer relies, that is, a partial forgiveness of debt, in our opinion the taxpayer cannot prevail." Dallas Transfer & Terminal Warehouse Co., 27 B.T.A. 651 at 657 (1933).

[83] Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F. (2d) 95 (1934).

[84] 252 U.S. 189 at 207, 40 S.Ct. 189 (1920).

Its interpretation of the *Kirby* case aside, the circuit court's decision was hardly satisfactory since the equation of the situation which was actually before the court with that of a debtor who was insolvent both before and after the event was without justification; it depended on the inclusion of $200,000 in capital stock among the liabilities. This was hardly in accordance with the usual computation of insolvency; indeed, to the extent a part of the equity interest was restored, assets had been freed of offsetting liabilities.

The Board of Tax Appeals subsequently agreed, contrary to the philosophy underlying the position which it had taken in the *Dallas Transfer Co.* case, that a debtor should be immune if actually insolvent after, as well as before, the event.[85] It even accepted that view in a case where the cancellation was in consideration of services which the insolvent debtor had performed.[86] To the rationale supplied by the Fifth Circuit, the Board now simply added another of the maxims extracted from *Eisner v. Macomber*; such debtors had not really acquired anything for their "... '*separate* use, benefit and disposal.' "[87] But beginning in 1937 the Board took exception to that circuit's view to the extent the debtor was actually rendered solvent by the arrangement. It accomplished this by interpreting that court's decision in the *Dallas Transfer* case to be applicable only where the debtor was left after the cancellation without any net worth whatever. In what was to become the leading case on the subject, *Lakeland Grocery Co.*,[88] the Board reasoned that a debtor who was rendered solvent by a cancellation had to that extent actually acquired something of exchangeable value for his separate use, benefit and disposal, and was, therefore, to that extent taxable. This view, complemented by the rule providing complete immunity where the debtor remained insolvent, prevailed without competition until

[85] Springfield Industrial Building Co., 38 B.T.A. 1445 (1938); Madison Railways Co., 36 B.T.A. 1106 (1937); Porte F. Quinn, 31 B.T.A. 142 (1934).

[86] Porte F. Quinn, 31 B.T.A. 142 (1934). More recently the Tax Court has applied this doctrine to a case though the debtor was actually insolvent at the time the debt was created. Kramon Development Co., 3 T.C. 342 (1944). It is possible, however, that the case will eventually be limited to a more confining proposition, for the creation of the debt actually caused the insolvency, an inadequate consideration being received. In this connection, compare the discussion, under the sub-title "Significance of the kind and amount of consideration received on incurring the obligation," of Commissioner v. Rail Joint Co., (2d Cir. 1932) 61 F. (2d) 751. This appears in Part II of this article to be published in the March issue.

[87] Madison Railways Co., 36 B.T.A. 1106 at 1109 (1937).

[88] 36 B.T.A. 289 (1937). Some members of the Board indicated in their dissent that this was an erroneous interpretation of the Dallas Transfer Co case. That a mere "deficit," as distinguished from insolvency, will not today suffice to free the taxpayer, see Commissioner v. Coastwise Transportation Corporation, (1st Cir. 1934) 71 F. (2d) 104, cert. den. 293 U.S. 595, 55 S.Ct. 110 (1934).

1945, both with respect to outright cancellations[89] and the purchase of bonds at a discount,[90] and whether the transaction included a partial payment in cash[91] or the transfer of property.[92] In 1945, however, the Court of Appeals for the Second Circuit came forward with a new formula, one which was somewhat more favorable to the government. Insolvency was said to limit the applicability of the *Kirby* doctrine in only one respect:

> "If the insolvent taxpayer 'buys in' its debts, *or any of them*, for an amount equal to or greater than the amount which would have been paid to the creditors upon the taxpayer's liquidation, then there is no realized taxable gain; where, however, the taxpayer 'buys in' its debts for less than such an amount, then, to that extent, there is realized taxable gain."[93]

The italicized expression, "or any of them," was, of course, the key to the change which that court attempted to make. For had its rule been applicable only where a composition was made with all creditors, the end product would have been the same as that which would result from the application of the *Lakeland Grocery Co.* rule. The inclusion of the italicized expression, however, meant that, without regard to his continued insolvency, a debtor, on paying twenty cents on the dollar to one creditor for a discharge, would realize a taxable gain of fifteen cents per dollar discharged if the creditor could have expected thirty-five cents per dollar on a liquidation.

The Second Circuit's principle does not then require a freeing of assets for the debtor's use and benefit in the sense contemplated by the

[89] Haden Co. v. Commissioner, (5th Cir. 1941) 118 F. (2d) 285, cert. den. 314 U.S. 622, 62 S.Ct. 73 (1941).

[90] See The Bulkley Building Co., 3 T.C.M. 1127 (1944).

[91] Ibid.

[92] Texas Gas Distributing Co., 3 T.C. 57 (1944).

[93] Fifth-Avenue-Fourteenth Street Corporation v. Commissioner, 147 F. (2d) 453 at 457. (Italic added). It should be noted that the Supreme Court has, with respect to these matters, done nothing more than refer to the cases from the Tax Court and elsewhere which preceded the above cited case. Helvering v. American Dental Co., 318 U.S. 322, 63 S.Ct. 577 (1943). Interestingly enough, while the Second Circuit seemed to think that the Supreme Court's passing reference to those cases was "of importance," it chose, without a very complete explanation, to modify the rule of those cases.

It should not be assumed that the Second Circuit intended by the use of the phrase "buys in" to confine its rule to cases involving bargain purchases of indebtedness as distinguished from situations involving partial payment and partial cancellation. It seems more logical to assume that the quoted phrase was used only because at the time of the decision, the American Dental Co. case was thought to have immunized cancellations of indebtedness, whether partial or complete. We know today, however, that it did not have such a sweeping effect. See discussion supra p. 472 et seq. And in this connection it seems important that the language of the Fifth Avenue-Fourteenth Street Corporation case supports the thesis that its rule was actually intended to apply to any situation controlled by the Kirby case.

Lakeland Grocery Co. decision. And it is on this account, as we shall see, that the Second Circuit's motion includes an inner contradiction. Whether the Tax Court or other circuits will eventually acquiesce in this change remains to be seen.

In evaluating these judicial developments, one must readily admit that a debtor who goes through the mill of old style bankruptcy should be free of the *Kirby* doctrine. Otherwise, we either fail to accomplish one of the basic purposes of bankruptcy proceedings, namely, rehabilitation, or the creditors themselves will be bearing the tax out of the trustee's estate—a wholly impossible result since, inter alia, the magnitude of the tax would be in inverse proportion to the percentage which the already oppressed creditors actually receive on their claims.

The bankruptcy situation furnishes a sufficiently attractive analogy to warrant a like result in the case where the debtor makes a general assignment for the benefit of his creditors, the latter agreeing to a voluntary discharge. However, the result incident to bankruptcy is not quite so compelling as an analogy in the instance where an insolvent debtor secures a bargain discharge of but one claim, other claims and his general state of insolvency being left undisturbed. All would probably concede in such case that, if the tax is to be immediately assessed, the taxable gain should at least be limited to the amount of assets remaining in the debtor's hands. However, answers to the questions whether or not the debtor should really be taxed at all and, if so, when, may depend in some part on the answer to the further question, whether the existence and the amount of gain is to be determined from the point of view of the remaining creditors or from that of the debtor. Indeed, the matter is even more complex than the preceding statement suggests, for each of these parties has a split personality, only the more important of which can be considered here.

Should one of the remaining creditors be so inconsiderate as to assess the situation solely from the standpoint of the returns which *he* could expect from the use of individual process, he would, of course, conclude that the debtor has not been enriched at all. Nothing has been added to the asset side of the ledger. But from the collective viewpoint of *all* of the remaining creditors, the debtor has achieved a very real gain, for by virtue of the earlier bargain exclusion of one of their number, they will now, for example, be in a better position in the event of a voluntary or involuntary liquidation. From the remaining creditors' point of view, the gain in question is to be distinguished from any possible gain which might be said to arise out of the cancellation of *their own* debts in the course of a liquidation proceeding. The improvement

which arose out of the earlier bargain discharge of one obligation is, from the remaining creditors' point of view, just as real as it is in the instance where an insolvent debtor realizes money income.

If we assess the question of enrichment from the debtor's point of view, account must be taken of the fact that he may, unlike a bankrupt, wholly disregard his other creditors and actually consume for his own personal benefit all of the assets which he retained. But that fact alone should not warrant a tax, for the bargain discharge itself had no real effect on that possibility, nor did it add to the assets which might be consumed. A debtor so situated is to be distinguished from his equally inconsiderate counterpart who realizes money income—something which can be converted into current consumption. Nor does the most considerate of all debtors, i.e., one who intends to carry out, perhaps in piecemeal fashion, a composition program with his other creditors, really feel enriched by the earlier bargain discharge, for he will not enjoy in any really personal sense the alleged earlier gain. The situation is, from his point of view, closely akin to that of a bankrupt or to that of an assignor of a general assignment. The debtor will feel enriched only if he follows a middle road, i.e., if by utilizing his remaining assets in business, he prospers to such a point that he crosses the line into a state of solvency. In retrospect, he will then agree, as wealth is acquired which is free from indebtedness, that, if the whole process were to be telescoped within one taxable period, he would be, to the extent of the amount previously forgiven, the beneficiary of a real untaxed gain.

On the whole, it would seem that the determination of the matter of enrichment should be made from the debtor's point of view. In the absence of a pending liquidation proceeding, the creditors are not formally in control of his affairs and may never be. But even so, the analysis in the preceding paragraph suggests that *at most* a tax should be levied on the earlier gain only if the debtor eventually becomes solvent, and then only as free additions to his wealth are made.

Formulation of this latter view into a rule would, by virtue of the different taxable years which are likely to be involved, come very close to putting the reverse twist on the tax benefit doctrine. It would also be attended by certain administrative burdens; it would be necessary to impose on the government the burden of making successive valuations of the debtor's estate to determine when he has reached a state of solvency. Finally, the rule would also involve some hardship on the debtor. After reaching the state of solvency he would not only pay a tax on his ordinary income but would, in addition, be required to pay a second tax on the balance until he had compensated for the amount previously saved

on the adjustment of his indebtedness. In view of today's high rates, this result may well suggest that the present view of the Tax Court is quite satisfactory. In this connection, account should also be taken of the further proposition that the tax premium on bankruptcy discharges should not exceed those available to insolvent debtors using voluntary methods of adjustment unless we are anxious to force all cases of attempted rehabilitation into the bankruptcy courts.[94]

The view of the Tax Court is clearly to be preferred over the view of the Second Circuit which would tax an insolvent debtor if the payment to one creditor was in an amount less than that which the particular creditor would have received on liquidation. That rule contains an inner contradiction in that the assets retained are not considered free for the insolvent debtor's use where one obligation has been discharged at what would have been its liquidation value. If the theoretical attribution of the retained estate to remaining creditors is sound in this instance, why should not the same theoretical attribution be made and the same result be reached where the creditor settles for less than liquidation value, for the outstanding claims—assuming continued insolvency—would still exceed the liquidation value of the remaining assets.

The legislative view: first developments. Congress first took account of the implications of the *Kirby* doctrine on financially embarrassed debtors when in 1938 it passed the Chandler Act,[95] the last wholesale revision of the bankruptcy laws. What was later said by the Supreme Court of the relevant sections of that act, "a plain blunder, the consequences of which were not foreseen, understood or intended by those who finally gave it the form of law,"[96] was also applicable, though in less severe terms, to the second and eventually much more comprehensive cushion supplied by Congress, one which was intended to apply in instances which were not reached by the bankruptcy provisions. This second remedial measure, first passed in 1939,[97] was given a temporary place in sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code.

The pertinent sections in the Chandler Act were designed to provide some relief from the *Kirby* doctrine for those debtors undergoing one of the more fancy procedures which supplemented old style

94 Compare in this connection the discussion infra, p. 488 et seq., of the reasons for modifying the rule as it related to reorganizations.

95 Act of June 22, 1938, c. 575, 52 Stat. L. 840.

96 Claridge Apartments Co. v. Commissioner, 323 U.S. 141 at 151, 65 S.Ct. 172 (1944).

97 Act of June 29, 1939, c. 247, §215(a), 53 Stat. L. 862, 26 U.S.C. (1946) §22(b)(9).

bankruptcy.[98] Involvement in these proceedings was attributable either to a debtor's insolvent condition balance-sheet-wise or, perhaps more frequently in the case of some of the procedures, to an inability to meet obligations as they matured.[99] Provision was made with respect to reorganizations,[100] arrangements (compositions) of unsecured[101] and secured indebtedness,[102] wage earners' plans,[103] and railroad adjustments,[104] whereby no income would be realized by the debtor, trustee, or a corporation made use of in effectuating a plan, by reason of the modification or cancellation in the proceeding of any indebtedness running against the debtor.[105] However, with respect to certain of the proceedings, the forgiveness feature of these provisions was only temporary in character.[106] In this connection, in the course of the pre-enactment discussion of the provision affecting corporate reorganizations, a representative of the Treasury took the position that "if this remedial provision is written into the law, it should be connected up with a provision for the reduction of the basis of the assets of the debtor to the extent that Congress refrain from taxing income which it would be entitled, under the law, to tax."[107] In other words, the Treasury wanted to substitute for complete immunity a tax deferment formula, one which would do nothing more in the usual case than spread over a series of years the otherwise telescoped effect of the *Kirby* doctrine.

Section 270 of the Bankruptcy Act, a provision dealing with reorganizations, and a counterpart with respect to both kinds of arrangements,[108] developed from this suggestion. The section referred to provided that "the basis of the debtor's property (other than money) or of such property (other than money) as it transferred to any person required to use the debtor's basis in whole or in part [by virtue of the 'basis' provisions of the Internal Revenue Code] *shall be decreased in*

[98] The regulations had previously provided immunity with respect to discharges under old style bankruptcy. Treas. Reg. 94, art. 22(a)-14. This is currently provided for in Treas. Reg. 111, §29.22(a)-13.

[99] See e.g., Bankruptcy Act of 1938, §130.

[100] Id., §268.

[101] Id., §395.

[102] Id., §520.

[103] Id., §679.

[104] Id., §735.

[105] Provision was also made whereby the court could refuse confirmation of a plan should it find that the plan had "for one of its principal purposes the avoidance of taxes." Bankruptcy Act of 1938, §269. See also §§395, 521, 679, 735.

[106] Complete immunity was initially provided only with respect to wage earners' plans and railroad adjustments.

[107] Arthur H. Kent, Assistant General Counsel, Treas. Dept., Hearings before Commitee on The Judiciary on H.R. No. 6439 and 8046, 75th Cong., 1st sess., p. 353 (1937).

[108] Bankruptcy Act of 1938, §§396, 522.

an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, *has been cancelled or reduced. . . .*"[109] We shall later see that both of the major difficulties which were encountered in connection with this provision involved that language which was italicized.

As previously noted, in the following year Congress, by enacting sections 22(b)(9) and 113(b)(3) of the code, made provision for another class of corporations. These two sections evolved from a request made by the Association of American Railroads to the House Ways and Means Committee for remedial legislation which would free from the *Kirby* doctrine those railroads which, while solvent and free from reorganization proceedings, were, nevertheless, "in distress."[110] It was proposed that the immunity be granted for a period, five years being suggested, which would enable affected roads to acquire such part of their outstanding bonds, then averaging on the market 56.6% of par, as their resources would permit. Counsel for the association suggested further that like relief might well be extended on the same basis to corporations other than railroads.[111]

The provisions which emerged from the consideration given this request were designed, in contrast with sections 268 and 270 of the Bankruptcy Act, to deal only with a select type of bargain discharges. Where proper consents were filed and a corporation was shown to be in an "unsound financial condition" (a phrase intended to cover situations which fell short of insolvency[112]), section 22(b)(9) excluded "the amount of any income of the taxpayer attributable to the discharge" prior to December 31, 1942, "of any indebtedness . . . evidenced by a security. . . ."[113] Section 113(b)(3) then called for a reduction in the basis of the debtor's property in accordance with regulations to be issued

[109] Italics added.

[110] R. V. Fletcher, Hearings before the Committee on Ways and Means on the Revenue Revision, 1939, 76th Cong., 1st sess., p. 232 at 243 (1939).

[111] Ibid.

[112] H.R. No. 855, 76th Cong., 1st sess. (1939) contained the following at p. 23: "It is not necessary, for the purposes of section 215, that a corporation must establish that its liabilities exceed its assets or it is unable to meet its current obligations as they fall due. Under the section, if a taxpayer could show the Commissioner that its obligations were selling in a free market at prices substantially below their issue price and below the market price of similar issues of similar businesses, it would be highly indicative of its unsound financial condition."

[113] The act also provided "that the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount . . . with respect to such indebtedness shall not be allowed as a deduction."

by the Treasury.[114] In effect, then, corporations which could satisfy the necessary conditions were afforded an election, the application of one or the other of the alternatives, the *Kirby* doctrine or this statutory formula, hinging on whether the corporation chose to file the statutory consents to reduction in basis.

Contrasted with the Bankruptcy Act, these code provisions could not under any circumstances, by virtue of the fact that they were addressed specifically to matters to be excluded from income, involve a reduction in basis by an amount which would exceed the income which would have been taxable except for the act as a result of the discharge.[115] The bankruptcy provisions relating to reorganization on the other hand, by requiring a reduction in basis without regard to whether or not the amount of the cancellation would have been taxable as a matter of general doctrine, deprived a debtor of any chance to show that the cancellation should be treated as a completely neutral factor because of the possible applicability of one of the judicially approved exceptions to the *Kirby* doctrine, for example, the *Lakeland Grocery Co.* rule dealing with insolvents.

The two acts were alike, however, in that the required reduction, depending on the scale of the modification or cancellation, could involve the establishment of a zero basis for the debtor's property, or in the case of the bankruptcy provisions, for that property which was also in the hands of one required to use the debtor's basis. A drastic reduction of this sort would, of course, preclude future deductions for depletion or depreciation, and would render the proceeds of any sales of such property taxable in toto.[116] While this could be avoided in section 22(b)(9) cases if the Treasury chose, as it was authorized to do, to establish a floor below which reduction would not be required, there was no escape from the compelling language requiring a full compensatory reduction in bankruptcy matters.

Such a reduction meant that a corporation, supposedly revitalized by Chapter X proceedings, actually entered into the competitive busi-

[114] H.R. No. 855, 76th Cong., 1st sess. (1939) included the following at p. 24: "It is not necessary that the regulations so prescribed by the Commissioner require a reduction in basis of all the property held by the taxpayer during the taxable year in question. The Commissioner is permitted not to reduce basis or to allocate all or a part of the reduction to some property and a part or none to other property and the amount of reduction to be allocated to a particular property may be fixed by him." The regulations themselves did not, however, spell out instances where mercy would be shown. See e.g. Treas. Reg. 103, §19.113(b)(1)-2.

[115] The Treasury subsequently so ruled. Treas. Reg. 103, §19.113(b)(1)-2.

[116] That this had not been intended by the sponsors of the bankruptcy provisions, see Paul, "Debt and Basis Reduction under the Chandler Act," 15 TULANE L. REV. 1 at 3, note 1 (1940).

ness struggle ahead at a real disadvantage. Consequently this formula for reduction in basis furnished an incentive to reorganize outside the Bankruptcy Act, for in such case any new corporation which was formed could either take on the adjusted basis of its predecessor corporation or its own cost basis, normally the fair market value of the property, the choice depending on whether or not the plan conformed to those reorganization provisions of the Internal Revenue Code which dealt with substituted basis.[117] For these various reasons Congress was led in 1940 to revise the Chandler Act.

The legislative view: recent developments with respect to reorganization. Some proposed that the contemplated revision referred to above be addressed to that language in the act which required a reduction in basis whether or not the cancellation would have as a matter of general doctrine involved the realization of income.[118] Others argued more successfully that instead a floor should be established below which the basis of the property in the debtor's hands, or in the hands of one required to use a substituted basis, would not be reduced.[119] The reduction formula was so limited; a floor was established at the fair market value of the property.[120]

This revision was most appropriate in the case of insolvent (balance-sheet-wise) corporations entering reorganization proceedings. By virtue of the absolute priority rule of the *Boyd* case,[121] creditors, and in actual practice usually secured creditors, necessarily occupied the saddle once reorganization began. Accordingly, the property, now under their control, was at least entitled to a fair market value basis for this was equal to what the basis should have been had their acquisition resulted from foreclosure.[122]

117 For a good discussion of the obstacles which managers of reorganizations faced in satisfying the old reorganization provisions of the code and a thorough discussion of the judicial developments, see Fahey, "'Relief' Provisions in The Revenue Act of 1943," 53 YALE L.J. 459 at 460 (1944).

118 Charles S. Banks, Hearings before the Committee on the Judiciary on H.R. No. 9864, 76th Cong., 3d sess., p. 56 (1940). Mr. Banks represented the National Bankruptcy Conference.

119 John Gerdes, id. at 5. Aside from the other arguments which will appear in the discussion supra, it was thought that the first suggestion would leave the tax status of reorganized corporations too uncertain, for the Supreme Court had not yet indicated its attitude toward the exceptions which had developed to the Kirby doctrine.

120 Act of July 1, 1940, c. 500, §1, 54 Stat. L. 709, 11 U.S.C. (1946) §670.

121 Northern Pacific Railway Co. v. Boyd, 228 U.S. 482, 33 S.Ct. 554 (1913). One of the principles of this case, that shareholders could not participate in a reorganized corporation at the expense of creditors who are entitled to the entire going concern value if such is required for them to be made whole, was carried over from equity reorganizations to statutory reorganization proceedings. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1 (1939).

122 See the discussion by Fahey, "'Relief' Provisions in The Revenue Act of 1943," 53 YALE L.J. 459 (1944).

On the other hand, the propriety of this formula would be open to question in the case of a corporation which was solvent balance-sheet-wise on going into reorganization if the old stockholders were really able, by virtue of the debtor's solvency, to maintain their position without contribution while the corporation's indebtedness was being reduced by a favorable settlement. It would be difficult under such circumstances to justify the advantage which such a corporation would enjoy under this statute—wholly apart from its tax deferment feature—in contrast to the treatment to which it would have been subjected had the first suggested proposal above been adopted and had, as a consequence, the *Lakeland Grocery Co.* rule been applied. The old equity holders were simply not entitled to enjoy even indirectly such preferential treatment. Actually, however, compliance with the absolute priority rule in such cases would normally mean that instead of bargain reductions in indebtedness, newly issued stock would be exchanged for indebtedness. We are told by the lower courts that this would not involve the type of cancellation or reduction referred to in the statute.[123] Consequently, under that interpretation there would be neither gain under section 268 nor the reduction in basis called for under section 270. The fair market value limitation would not then be involved.

While the principle of the Bankruptcy Act requiring reduction in basis with a limitation set at the fair market value of the property remains intact today, the interpretative decisions just mentioned and subsequent amendments to the Internal Revenue Code have so narrowed its sweep, at least with respect to reorganizations, that it is now of relatively little importance in that context. One must understand in this connection that there are several ways in which a corporation may by way of reorganization rid itself of some of its indebtedness. In addition to the less sophisticated re-adjustment of capital and of indebtedness within the framework of the old corporate shell there is the case where readjustment is accomplished by an eventual transfer of assets to a new corporation. Before 1943 the applicability of section 270 to the latter case had generally depended on the question of whether the tax-free reorganization provisions of the Internal Revenue Code were applicable, i.e., whether such provisions required the new company to assume the basis of the old. Only when such was required was the reduction rule of section 270 generally applicable. Now, however, in at least one sense, the reverse is true. But that is only part of the story.

In 1942 Congress provided a tax-free reorganization formula for

[123] Tower Building Corporation, 6 T.C. 125 (1946); Motor Mart Trust, 4 T.C. 931 (1945), affd. (1st Cir. 1946) 156 F. (2d) 122.

railroads undergoing reorganization under which the assets of the road retained their original adjusted basis without any reduction whatever.[124] It then chose in 1944, over a presidential veto, to make this formula available to any corporation undergoing a judicially supervised reorganization, the only requirement being that the plan of reorganization include the transfer of assets to a new entity in exchange for its stock or securities.[125] Eligibility did not depend then on compliance with the previous and more confining definition of reorganization which had appeared in the code.[126]

This formula is, of course, much more attractive to an insolvent (balance-sheet-wise) corporation undergoing reorganization than was the rule of the Chandler Act which required reduction in the basis of its property.[127] For the new company, though shorn of the old stockholders and even of liability to some old creditors—the former secured creditors now being in the saddle—is able to depreciate and to take depletion according to the adjusted basis of the property in the hands of the old corporation. And in the usual case this figure will, of course, be higher than the fair market value of the property. This led the late President Roosevelt to remark by way of criticism at the time of his subsequently overridden veto:

> "Among these special privileges are: (*a*) Permission for corporations reorganized in bankruptcy to retain the high excess-profits credit and depreciation basis attributable to the contributions of stockholders who are usually eliminated in the reorganization. This privilege inures to the benefit of bondholders who, in many cases,

[124] I.R.C. §§112(b)(9) and 113(b)(20) were added by Act of Oct. 21, 1942, c. 619, §§142 (a) and (b), 56 State. L. 798, 26 U.S.C. (1946) §112(b)(9) and §113(a)(20).

[125] I.R.C. §§112(b)(10) and 113(b)(22) were added by Act of Feb. 25, 1944, c. 63, §§121(a) and (c), 58 Stat. L. 21, 26 U.S.C. (1946) §112(b) and §113(a).

[126] For a thorough discussion of this aspect of the problem see Fahey, "'Relief' Provisions in The Revenue Act of 1943," 53 YALE L.J. 459 at 465 (1944). Two judicial requirements over and above literal compliance with the statutory reorganization provisions apply here just as they do with respect to other reorganizations. The first, the continuity of interest requirement, is deemed satisfied, however, though old bondholders succeed to the equity interests in the new corporation. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 62 S.Ct. 540 (1942); Helvering v. Southwest Consolidated Corporation, 315 U.S. 194, 62 S.Ct. 546 (1942). Also of relevance in this respect is the following statement taken from S. Rep. No. 627, 78th Cong., 1st sess. (1943) p. 50: "It is intended that only an actual reorganization of a corporation will be covered as distinguished from a liquidation in a bankruptcy proceeding and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. In other words, the type of transaction which was held not to be a reorganization under section 112(g)(1) in the *Mascot Stone Co.* case (120 F. (2d) 153) or in *Templeton Jewelers Inc.*, (126 F. (2d) 251) would likewise not be covered under these amendments."

At the same time the committee stated that the business purpose requirement of Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935) was also intended to apply.

[127] The discussion supra at p. 489 relating to solvent corporations (balance-sheet-wise) is as applicable to the new statute as it was to the old.

have purchased their bonds in the speculative market for far less than their face value. It may open the door to further windfall profits in this market because of the undeserved benefit received by reorganized corporations."[128]

There was, in addition to this particular criticism, one other closely related objection to the unreduced substituted basis following the reorganization of insolvent corporations. This, too, concerned the case where speculators had purchased the outstanding bonds of a financially embarrassed corporation shortly before the foregoing change in law, and subsequently acquired the equitable interest by virtue of a reorganization. Under such circumstances the newly reorganized corporation would have a real advantage over a more stable corporate competitor which utilized an adjusted basis bearing a somewhat closer relationship to the actual investment of its stockholders. To state the extreme case, the tax advantage derived by the former from its artificial depreciation rates might enable it through price warfare to drive the latter to the wall.

It is significant that both of the above criticisms related to those cases where creditors had acquired their bonds from other bondholders prior to the change in law. For it can be theoretically demonstrated that in other cases the statutory change to an unreduced substituted basis on the reorganization of an insolvent corporation is quite satisfactory. The ultimate effect of the statutory change on a particular reorganization is to increase the going concern value of the newly formed corporation over that which it would have been had a reduction in basis been required. If, as a matter of priority, creditors are still entitled, even after such an increase, to the equitable interest of the new corporation, then the greater going concern value actually serves only to minimize the unrecognized loss suffered, first, by those creditors who have retained the bonds which were originally issued to them.[129] And in theory, if original creditors of this sort should in the future (after the change in law) sell their bonds after the issuing corporation becomes insolvent but before reorganization, the price to the purchaser will be greater than it would have been had the President's veto been sustained. So again, the consequence of the change in law is simply to minimize a loss, one which in this instance would be recognized for tax purposes.

According to this evaluation then, time can be expected to cure any objections to the statutory change in question.[130]

[128] H.R. Doc. 443, 78th Cong., 2d sess., p. 2 (1944).

[129] That the loss is unrecognized at this point, see I.R.C. §112(1).

[130] There are other provisions in the code which limit the applicability of §270 of the Bankruptcy Act of 1938 besides §§112(b)(9) (railroads) and 112(b)(10) (corporations

The legislative view: recent developments with respect to 22(b)(9) cases. The relief provided by code amendments with respect to some of the section 270 cases has not been expressly carried over to the more generally applicable formula provided in sections 22(b)(9) and 113(b)(3) where, of course, the re-adjustment is made within the old corporate shell. However, at the same time that the railroads secured the kind of relief eventually granted to others with respect to section 270 of the Bankruptcy Act, counsel for the Association of American Railroads revealed that no class "A" road had actually taken advantage of the relief provided by sections 22(b)(9) and 113(b)(3).[131] Because of the possible consequence to their general credit rating, none had been willing to certify that they were in an "unsound financial condition," the first prerequisite to eligibility. The association requested that the quoted expression be deleted, and that the life of the provision be extended. These suggestions, reflected in the Revenue Act of 1942, meant that any corporation, financially embarrassed or otherwise, might now secure at least temporary immunity from the *Kirby* doctrine with respect to those debts evidenced by a security, the same to be compensated for by a reduction in basis of its property according to the Treasury's regulations.[132] Successive extensions have since been provided,[133] committee reports indicating that further substantive change will be postponed to the anticipated wholesale revision of the Internal Revenue Code.[134]

This tax deferment formula represents, even when applied to solvent debtors, a wise concession to business needs. The awkward cash position of such a debtor may very likely be one of the reasons why it is given the chance to effect a bargain discharge. The more awkward its position, the more profitable its settlement is likely to be. That type of voluntary rehabilitation will be sharply curtailed if cash must also be retained with which to pay a tax. The only real objection to the deferment provisions of these two sections involves their restriction to corporations. There is no reason whatever for denying the privilege to natural persons.

[To be concluded]

in general). These are §§113(b)(4) (corporate reorganizations under section 77B) and 113(a)(21) (reorganizatoins under section 77B of street, suburban, or interurban electric railway corporations).

131 R. V. Fletcher, Hearings before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d sess., p. 1797 (1942).

132 Act of Oct. 21, 1942, c. 619, §114, 56 Stat. L. 798, 26 U.S.C. (1946) §22(b)(9).

133 The last of these was provided for by §201, Revenue Act of 1950.

134 S. Rep. No. 685, 81st Cong., 1st sess., p. 3 (1949).