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When Junk Bonds go Bad: Protecting the Corporate Tax Base on Repurchases and Defaults

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WHEN JUNK BONDS GO BAD: PROTECTING THE CORPORATE TAX BASE ON REPURCHASES AND DEFAULTS

*Patricia L. Bryan**

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I. INTRODUCTION

During the last decade, corporate debt has flooded the market.[1] The issuance of junk bonds — high-yield, high-risk securities that are typically rated well below investment grade — has increased at an explosive rate, financing leveraged buyouts and other forms of acquisitions.[2] In the last few years, however, the junk bond market has experienced several serious price declines.[3] Financial analysts have

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1. Corporations added almost $1 trillion in debt during the 1980s, with interest payments absorbing up to 30% of their cash flow. *See* Farrell & Nathans, *The Bills Are Coming Due*, BUS. WK., Sept. 11, 1989, at 85. Illustrative of the high rate of increase in corporate debt during this period is the fact that nonfinancial companies nearly doubled the amount of their debt between 1982 and 1988. Farrell, *Learning to Live With Leverage*, BUS. WK., Nov. 7, 1988, at 138; *see also Taking the Strain of America's Leverage*, ECONOMIST, Nov. 5, 1988, at 87; Vasoff, *LBO's, Junk Bonds and Poison Pills*, CA. MAG., Dec. 1988, at 11.

2. *See* Farrell & Nathans, *supra* note 1, at 85 (junk bond market grew at an explosive 34% annualized rate between 1981 and 1989); Winkler, *Poor Results in '89 May Show Profit Erosion for Junk Bonds*, Wall St. J., Jan. 2, 1990, at R26, col. 1 (during the 1980s, junk bond market grew to $210 billion from less than $2 billion at the start of the 1980s).

3. The junk bond market suffered serious price shocks after Ivan Boesky's guilty plea on insider trading charges in November 1986 and following the stock market crash in October 1987.

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attributed the market fall to a variety of causes, including rising interest rates of less risky investments, an excess supply of junk bonds and an increasing number of defaults by issuers.[4] Many commentators predict that the junk bond market will remain in serious disarray, especially if overleveraged firms are forced to deal with an economic recession.[5]

As prices of junk bonds have plummeted, more issuers have taken advantage of the opportunity to repurchase their outstanding debt at significant discounts.[6] The general rule for tax purposes is that the issuer realizes gain on such a transaction when the repurchase price is less than the "issue price," which typically is equal to the initial value of the debt.[7] A case decided two years ago by the Federal Circuit Court of Appeals, however, has introduced a dramatically dif-

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Weiss, *Does Junk Have Lasting Value? Probably*, BUS. WK., May 1, 1989, at 118. The market also nosedived during the summer of 1988. Bremner, *Interco: Another Day Older and $1.4 Billion in Debt*, BUS. WK., Jan. 22, 1990, at 58.

The most distressing junk bond performance of the decade, however, occurred in 1989. First, there was a market break in April 1989. Newport, *Junk Bonds Face the Big Unknown*, FORTUNE, May 22, 1989, at 129. The market then crashed in September, following the announcement of Campeau Corporation's financial problems. Zigas & Light, *Don't Put Away the Smelling Salts Yet*, BUS. WK., Oct. 2, 1989, at 92.

4. *See* Newport, *supra* note 3, at 129 (the price declined in April 1989 due to the narrowing of the difference between the yield on junk bonds and on risk-free Treasury bonds as interest rates rose on the latter); Serwer, *How to Find Gems in a Rough Bond Market*, FORTUNE, Jan. 1, 1990, at 25 (highly publicized defaults caused investors to exit the market in droves, driving down prices); Hilder, *Firms Begin Cash Offers for Junk*, Wall St. J., Mar. 26, 1990, at 15, col. 1 (lack of buyers helped push prices to unusually depressed levels).

5. *See, e.g.*, Mitchell, *Junk Market Could Stay in Disarray: But Buy-Backs Are Ray of Hope*, Wall St. J., Feb. 20, 1990, at C1, col. 3; Winkler, *Junk Bond Market Is Seen Showing 38% Default Rate*, Wall St. J., Jan. 25, 1990, at C10, col. 1; *Junk Bond Default Rate Expected to Rise in 1990*, Wall St. J., Jan. 19, 1990, at C11, col. 6; Hylton, *Corporate Bond Defaults Up Sharply in'89*, N.Y. Times, Jan. 11, 1990, at D17, col. 4.

6. *See, e.g.*, Light & Nathans, *Corporate America Wants Out from Under Its Junk Pile*, BUS. WK., Aug. 21, 1989, at 80-81. The first quarter of 1990 saw "a flock of companies buying back their own depressed junk bonds." Mitchell, *supra* note 5, at C1, col. 3; *see also* Mitchell, *Junk Buy-Backs Take Off; Issuers Spring at Discounts*, Wall St. J., June 1, 1990, at C1, col. 3; Hilder, *supra* note 4, at C1, col. 6; Mitchell & Raghavan, *Junk Bonds Rebound, Post Gains*, Wall St. J., Feb. 14, 1990, at C19, col. 1.

7. *See* Treas. Reg. § 1.61-12(c)(3) (CCH 1990). Under that regulation, the issue price is adjusted by adding any amount of discount already deducted or subtracting any premium already included as income. *Id.* The regulations under I.R.C. § 61 do not define "issue price" but typically it is defined to mean the value of the consideration received in exchange for the debt. *See* Blattner, *Debt Cancellation*, 30th N.Y.U. Inst. 237, 241-42 (1971). That amount generally will be equivalent to the value of the debt on issuance. The definition of "issue price" for cancellation-of-debt purposes was the question posed in *United States Steel*.

ferent rule for corporations repurchasing debt that originally was issued to shareholders.

In *United States Steel Corp. v. United States*,[8] the Federal Circuit Court of Appeals held that United States Steel realized no gain when it repurchased for cash its own outstanding debt at a significant discount from the value of the debt when issued.[9] The opinion appeared inconsistent with long-standing precedent in the cancellation-of-debt area.[10] However, the court distinguished the facts in *United States Steel* on the grounds that the debt in that case originally had been issued to shareholders in exchange for their stock rather than to third party creditors in exchange for cash.[11]

In such a case, the court held, the repurchase of the debt could not simply be related back to its issuance, with gain computed by deducting the repurchase price of the debt from the value of the consideration received in exchange for the debt. Instead, the repurchase of the debt must be related back to the original issuance of the stock, which had occurred more than seventy years earlier.[12] Gain from the repurchase of the debt should occur, according to the court, only if the entire transaction, from the issuance of the stock to the repurchase of the debt, increased the debtor's assets. If the repurchase price exceeded the capital originally paid in for the stock, as it did in *United States Steel*, the court held that no gain resulted regardless of the debt's decline in value.[13]

The opinion, which reversed the holding of the Claims Court, generated considerable controversy.[14] Despite the debate on the theoret-

8. 848 F.2d 1232 (Fed. Cir. 1988).

9. *See United States Steel*, 848 F.2d at 1238.

10. *See, e.g.*, United States v. Kirby Lumber Co., 284 U.S. 1 (1931), where the Supreme Court held that a debtor realized taxable gain upon the discharge of debt at less than its face amount.

11. *See United States Steel*, 848 F.2d at 1236.

12. *See id.*

13. *See id.* at 1236-37.

14. A series of articles debating the United States Steel case appeared in Tax Notes. *See* Gunn, *Reconciling* United States Steel *and* Kirby Lumber, 42 TAX NOTES (TAX ANALYSTS) 851 (Feb. 13, 1989) [hereinafter Gunn, *Reconciling*]; Shakow, United States Steel *and* Kirby Lumber: *Another View*, 42 TAX NOTES (TAX ANALYSTS) 1371 (Mar. 13, 1989); Gunn, United States Steel *and the Functional Approach to Legal Problems*, 43 TAX NOTES (TAX ANALYSTS) 213 (Apr. 10, 1989) [hereinafter Gunn, *The Functional Approach*]; Shakow, *A Short Retort on* United States Steel, 43 TAX NOTES (TAX ANALYSTS) 1173 (May 29, 1989); Gunn, *Gunn's Reply*, 43 TAX NOTES (TAX ANALYSTS) 1174 (May 29, 1989); *see also* Peyser, *Determining Income from Cancellation of Indebtedness*, 66 TAXES 866 (1988); Pisem, *More on* United States Steel Corporation, 43 TAX NOTES (TAX ANALYSTS) 144 (June 12, 1989).

ical correctness of the court's holding, however, scholars paid little attention to the practical impact of the court's decision. With the collapse of the junk bond market and the increasing popularity of issuer repurchases, the *United States Steel* decision has become much more significant.

Under the holding in *United States Steel*, a corporate issuer repurchasing bonds that were issued to shareholders in redemption of stock will escape the realization of gain except in the rare case in which the repurchase price is less than the amount originally paid in for the stock.[15] If the bonds were issued to shareholders as dividends, *United States Steel* provides authority for the issuer to realize no gain on the repurchase of the debt regardless of the size of the discount.[16]

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15. *See United States Steel*, 848 F.2d at 1236.

16. *See id.*; *see also* Rail Joint Co. v. Commissioner, 22 B.T.A. 1277, 1278-79 (1931) (corporation realized no gain when it repurchased at a discount notes that it previously had distributed to shareholders as dividends), *aff'd*, 61 F.2d 751 (2d Cir. 1932). For a discussion of *Rail Joint*, see *infra* text accompanying notes 81-104. The Federal Circuit in *United States Steel* relied upon the *Rail Joint* decision in its opinion. *United States Steel*, 848 F.2d at 1236.

One commentator has argued that the question in *United States Steel*, *i.e.*, the issue price of debt that originally is issued in exchange for or with respect to stock, has now been resolved statutorily. *See* Pisem, *supra* note 14, at 1415. This argument is based upon the section of the Internal Revenue Code that defines "issue price" for purposes of the determination of original issue discount. I.R.C. § 1273(b) (1990) (unless otherwise stated all references to the Internal Revenue Code will be to the Internal Revenue Code of 1986, as amended and in effect for 1990). Under § 1273(b)(3), the issue price of debt issued for property (including stock or securities) is defined as the fair market value of the property where the debt or the stock or securities for which the debt is exchanged are traded on an established securities market. I.R.C. § 1273(b)(3). Under I.R.C. § 1275(a)(5), debt issued with respect to stock is treated as if it had been issued for property. I.R.C. § 1275(a)(5). Accordingly, § 1273 would appear to define the issue price of debt distributed as a dividend to be the fair market value of the debt if it was traded on an established securities market. *See* I.R.C. § 1273(b)(3). If the definition under § 1273 had controlled for cancellation-of-indebtedness purposes, the Federal Circuit's decision in *United States Steel* (holding that the issue price of the debt was the amount received initially for the preferred stock) clearly would be inconsistent with the statute, and that court would have affirmed the Claims Court decision (holding that the issue price of the debt was the fair market value of the preferred stock, which was publicly traded).

Section 1273, however, specifically states that its definition of issue price applies "for purposes of this subpart." I.R.C. § 1273(b). That subpart (subpart A, part V, subchapter P) does not include § 61, which governs the question of cancellation-of-indebtedness income. I.R.C. § 61(a)(12). Although the limiting language in the statute defining issue price for original issue discount purposes did not exist at the time of the decision in *United States Steel*, the Federal Circuit did not apply that definition of issue price, reasoning that a different analysis was necessary depending upon whether the question was one of original issue discount or cancellation-of-indebtedness income. *United States Steel*, 848 F.2d at 1237-38.

Pisem argues that changes since the relevant date in *United States Steel* (1966, when the bonds were issued) make it clear that the original issue discount definition should now control

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Since many junk bonds originally were issued to shareholders in the course of takeovers or as dividends,[17] the decision in *United States Steel* could result in a substantial tax revenue cost to the government. In addition, the *United States Steel* decision introduces an unwarranted and unnecessary distinction between corporations that have achieved identical results in different ways. A corporation that borrows from third parties to finance either stock redemptions or dividends will be subject to tax on a later repurchase of the debt to the extent that the repurchase price is less than the amount of the borrowed cash.[18] Under *United States Steel*, however, a corporation that borrows directly from its shareholders, issuing the same amount of debt to finance stock redemptions or dividends, will receive much more favorable treatment on a subsequent repurchase of that debt. For a corporation borrowing from shareholders, the amount borrowed will be irrelevant;

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questions of cancellation-of-indebtedness income. Pisem, *supra* note 14, at 1415. Specifically, he points to the fact that controversy no longer exists in the courts (as it did in 1966, despite the broad language of the statute) about whether original issue discount could arise when debt is issued in exchange for property. *Id.* He also points to the changes in the cancellation of-indebtedness regulations under § 61, which now make explicit reference to the original issue discount definition of issue price. *Id.*; *see* Treas. Reg. § 1.61-12(c)(4) (CCH 1990) (citing the definition of "issue price" in the regulations under § 1232, the statute that previously defined "issue price" for purposes of original issue discount). Although the reference is in connection with computing bond premium, Pisem argues that since bond premium is an adjustment to issue price for § 61 purposes, the reference implies that the Treasury intended that the original issue discount definition of "issue price" control for all purposes. Pisem, *supra* note 14, at 1415.

It is not clear that a court in a future case would agree with Pisem's argument and conclude that the question posed in *United States Steel* — the amount of gain realized by a corporation that repurchased debt which originally had been issued in exchange for stock — has been answered definitively by the relevant statute and regulations. Certainly, a court could decide that Congress has not addressed the question because the statutory definition of "issue price" is specifically applicable only to the computation of original issue discount. I.R.C. § 1273(a)(1). Furthermore, attorneys have made strong arguments that the rules governing original issue discount and cancellation of indebtedness are based on fundamentally different theories, so that "issue price" should have different meanings in the two contexts. *See* Reply Brief for Appellant at 18-19, United States Steel v. United States, 848 F.2d 1232 (Fed. Cir. 1988).

This article attempts to provide a theoretical basis for determining the question of cancellation-of-indebtedness income under the *United States Steel* facts.

17. *See* D. POSIN, CORPORATE TAX PLANNING 949-1304 (1990). Posin describes some transactions in which junk bonds were to be issued directly to shareholders. *See id.* at 1064 (U.S.G. Corporation/Desert Partners); *id.* at 1118 (Trans World Airlines/Icahn); *id.* at 1212 (Malrite). Dividend distributions of a corporation's own debt have become increasingly popular recently as a takeover defense, with the new debt making the company less attractive to a raider. *See* D. POSIN, *supra*, at 303.

18. *See* Treas. Reg. § 1.61-12(c)(3) (CCH 1990) (requiring adjustments to the issue price for previously deducted discount or previously reported premium).

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gain will never be realized on a repurchase of debt issued directly as a dividend and only rarely on a repurchase of debt issued in redemption of stock.

The disparate treatment resulting from the holding in *United States Steel* extends beyond solvent corporations that repurchase debt at a discount. It also significantly impacts insolvent or bankrupt firms that default on junk bonds, an occurrence that has become increasingly frequent in the last few years.[19] Once again, a corporation that finances redemptions or dividends by issuing debt to shareholders will receive more favorable treatment than a corporation that issues debt to third parties, and subsequently distributes the borrowed cash to shareholders.

While neither corporation will be subject to tax on gain from the cancellation of debt, the Bankruptcy Tax Act of 1980 requires that a corporation's tax attributes, representing tax benefits in the future, be reduced by the gain that would have been recognized were it not for the insolvency or bankruptcy.[20] Under *United States Steel*, that gain would be computed differently depending only upon the form of the prior dividend or redemption transaction.[21] The two corporations thus will reduce their tax attributes by different amounts, despite the fact that the issuance of the debt in the two cases achieved identical results. The corporation that issued the debt directly to its shareholders will emerge from bankruptcy with an unwarranted "head start," a result inconsistent with the goals of the Bankruptcy Tax Act.[22]

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19. *See, e.g.*, Hylton, *supra* note 5, at D1, col. 3; Winkler, *supra* note 2, at R26, col. 1; Vise & Mufson, *Defaults Add to Burden of Buyouts: Heavy Debts Strain Leveraged Companies*, Wash. Post, Aug. 21, 1989, at A8, col. 1; Sandler, *Junk Bond Defaults Are Spreading; Investors Debate Next Casualties*, Wall St. J., July 20, 1989, at C1, col. 4.

20. *See* I.R.C. § 108(a), (b). *See generally* B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 6.4.6 (2d ed. 1989).

21. *See United States Steel*, 848 F.2d at 1236. If the corporation had borrowed from a third party creditor and distributed the loan proceeds to shareholders as dividends or in redemption of stock, the gain that would have been recognized, were it not for the insolvency or bankruptcy, will be the cash borrowed (typically equal to the original value of the debt) plus any deductions that the corporation had taken as original issue discount. In the case of debt issued to shareholders as dividends, the issue price as determined under *United States Steel* would be zero, since the corporation received no new assets in exchange for the debt. In the case of debt issued in redemption of stock, the issue price under *United States Steel* would be the amount originally paid in for the stock rather than the initial value of the debt. *See infra* text accompanying notes 51-59.

22. In connection with the Bankruptcy Tax Act of 1980, Treasury representatives and others, testifying in favor of deferral of gain through attribute reduction instead of total exclusion, argued that a bankrupt debtor was entitled to a "clean slate" but not to undue tax advantages. *See, e.g., The Bankruptcy Tax Act: Hearing on H.R. 5043 Before the Subcomm. on Select*

Clearly, the tax law has other instances in which taxpayers are treated differently depending on the form of the transaction, even though the different transactions achieved identical results.[23] Nevertheless, most would agree that such distinctions lead to increased levels of manipulation and complexity which, although sometimes inevitable, are unfortunate. The need for certainty justifies some distinctions based on form, while other distinctions result from judicial attempts to adhere to congressional intent.[24] Neither rationale, however, applies to the distinction produced by the Federal Circuit Court of Appeals' opinion in *United States Steel*, which cannot be defended on the grounds of theory, policy or statutory language.

This article will show that the holding in *United States Steel* was wrong and displays a general misunderstanding of both the cancellation-of-indebtedness area and the corporate tax base. In its opinion, the Federal Circuit Court of Appeals justified cancellation-of-indebtedness income on the grounds of a net increase in the debtor's assets, concluding that gain would result only when cash received by the debtor exceeded cash paid. Since the firm in *United States Steel* had received "no new capital" on the issuance of the debt in exchange for the stock, the court made the cash comparison by relating the repurchase of the debt back to the original issuance of the stock.[25] That

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Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 8-9 (1979) (statement of Daniel Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury). Under the Federal Circuit's decision in *United States Steel*, bankrupt debtors who issued debt directly to shareholders would be given undue tax advantages over those who borrowed from third parties and distributed the proceeds to shareholders.

23. *E.g.*, I.R.C. § 332. This section provides that a corporation will not recognize gain or loss on the liquidation of a subsidiary if it owns more than 80% of the subsidiary. *Id.* If, however, the parent corporation sells enough of its stock to reduce its holdings below 80% and then liquidates, the parent corporation generally will recognize gain or loss on the sale and on the liquidation under I.R.C. § 331. *See* Granite Trust Co. v. United States, 238 F.2d 670, 676 (1st Cir. 1956) (stating that there was, in the context of § 332, "a legislative understanding . . . that taxpayers can, by taking appropriate steps, render the subsection applicable or inapplicable as they choose"); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.41 (5th ed. 1987); *see also* examples cited in Guerin, *A Proposed Test for Evaluating Multiparty Like Kind Exchanges*, 35 TAX L. REV. 547 (1979-80); Isenbergh, *Musings on Form and Substance in Taxation* (Book Review), 49 U. CHI. L. REV. 859, 869 n.47 (1982) (reviewing B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981)) (asserting that the Code creates numerous tax differences between economically equivalent transactions).

24. *See* Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149-51 (1974); Blum, *The Importance of Form in the Taxation of Corporate Transactions*, 54 TAXES 613, 614 (1976); Guerin, *supra* note 23, at 559.

25. *See United States Steel*, 848 F.2d at 1236.

conclusion, however, ignores the effect to the corporation of the issuance of the debt to its shareholders and is inconsistent with the corporate tax base under current law.

This article illustrates that corporate income, which underlies the corporate tax base, is not measured by asset increases alone. Rather, corporate income under current law includes both distributions to shareholders and changes in corporate net worth.[26] A corporation's distributions to shareholders are analogous to an individual taxpayer's expenditures for consumption: both transactions reduce the taxpayer's retained assets, and yet both are nondeductible and require the use of after-tax dollars.[27]

The decisive point here is that increases in corporate income, whether represented by distributions to shareholders or by increases in net worth, must be taxed in order to maintain the corporate tax base. As explained below, shareholder contributions to the corporate entity are excluded from the tax base,[28] but any other increase in corporate income must be regarded as corporate gain, taxable when realized.

Given the inclusion of distributions to shareholders in corporate income, a corporation that issues its debt to shareholders, achieving either a dividend distribution or a redemption of stock, should be deemed to have realized economic benefit to the full extent of the value of the debt when issued. If the debt subsequently declines in value, the debtor will enjoy an increase in net worth and so in corporate income. If the corporation subsequently repurchases the debt at a discount, the corporation will realize the increase in income to the extent of the discount and must be taxed. Otherwise, the corporation will accomplish the prior distribution to shareholders out of pre-tax dollars to the extent of the discount, a result that is clearly inconsistent with the corporate tax base. Arguments made by United States Steel and by commentators against taxing the discount are based upon incorrect reasoning and faulty precedent.[29]

As the number of junk bond buy-backs and defaults increases, the potential revenue impact and the discriminatory effect of the incorrect decision in *United States Steel* escalate. It is hoped that the next court faced with the *United States Steel* issue will disregard the *United States Steel* opinion and instead embrace the conclusion described in this article, one that is consistent with the current theoretical structure of the tax code.

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26. *See infra* text accompanying notes 63-66.
27. *See infra* text accompanying notes 67-69.
28. *See infra* text accompanying note 66.
29. *See infra* text accompanying notes 81-133.

II. The Facts and Opinions in *United States Steel*

In 1901, United States Steel issued its $100 par value preferred stock receiving $100 cash in exchange.[30] In 1966, it recapitalized and exchanged newly-issued debentures with a face value of $175 for the outstanding preferred stock.[31] Both the stock and the debt (on a when-issued basis) were trading on the New York Stock Exchange for approximately $165 when the exchange took place.[32] The transaction was tax-free to the company,[33] but United States Steel advised its shareholders that they would realize a taxable gain upon redemption of their stock to the extent that the $165 value of the debt exceeded their basis in the stock.[34]

Six years later, when the debentures had significantly declined in value, United States Steel was able to repurchase them on the open

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30. *See United States Steel,* 848 F.2d at 1233. The actual amount received by United States Steel in exchange for the preferred stock was in dispute, with the corporation claiming that it had received only $96.375 per share. *See* United States Steel v. United States, 11 Cl. Ct. 375, 377 n.7 (1986), *opinion on reconsideration,* 11 Cl. Ct. 541 (1987). The government claimed that more proof was necessary to determine the exact amount of cash paid for the stock. *Id.* However, for ease of reference, the parties assumed during the case that the company had received an amount equal to the $100 par value of the shares. *See* Appellant's Brief at 5 n.2, United States Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988) (No. 87-1611). The Federal Circuit Court of Appeals made that same assumption in its opinion. *United States Steel,* 848 F.2d at 1233. The exact amount received for the preferred stock was irrelevant to the taxpayer's argument, since, under its argument, no income would be realized as long as that amount was less than the amount paid to repurchase the debt. *See* Appellant's Reply Brief at 24, United States Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988) (No. 87-1611). The exact amount was also irrelevant to the government's argument, under which the face amount of the debt was the figure with which to compare the repurchase price. *See United States Steel,* 11 Cl. Ct. at 377-78.

31. *United States Steel,* 848 F.2d at 1233. The debentures, which bore interest at the rate of four and five-eighths percent, were to be issued only in denominations or multiples of $100, with cash paid to holders of fractional shares. Shareholders who held five shares or less could elect to receive all cash for their shares, at the rate of $175 per share. The debentures were nonredeemable for 10 years and were due in 1996. *United States Steel,* 11 Cl. Ct. at 376 n.3.

The purpose of the recapitalization, which was effected by a merger of United States Steel into a subsidiary, was to change the place of incorporation in addition to restructuring capital. *See id.* at 376.

32. *United States Steel,* 848 F.2d at 1233. On the effective date of the merger, the preferred stock was trading at $165, while the debentures (which had been actively traded for over a month on a when-issued basis) were trading at an amount that correlated to approximately $165 1/8 per each $175 face amount debenture. *See* Appellee's Brief at 4-5, United States Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988) (No. 87-1611).

33. *See United States Steel,* 848 F.2d at 1233. No dispute arose concerning the tax-free nature of the exchange to the company. *United States Steel,* 11 Cl. Ct. at 377.

34. *United States Steel,* 11 Cl. Ct. at 377.

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market for cash equal to approximately $118 for each $175 debenture.[35] The question in the case was whether United States Steel realized any income from its repurchase of the debt — whether the repurchase price of $118 was less than the "issue price."[36] Under the regulations (then and now), that difference is taxable to the debtor.[37]

United States Steel argued that the $100 cash received on the original issue of the stock should be regarded as the "issue price" of the debt.[38] According to the taxpayer, gain from cancellation of a debt should depend upon an increase in assets resulting from the borrowing transaction. In this case, the taxpayer had received no new assets when it had issued the debt in exchange for the preferred stock; the only asset ever received by United States Steel in the entire transaction was the cash paid in for the stock. A net asset increase, or economic gain as defined by the taxpayer, thus could be computed only by comparing that amount to the repurchase price.[39]

In *United States Steel*, the taxpayer had paid more to repurchase the debt than it originally had received for the stock. United States Steel argued that the transaction taken as a whole (considering the transaction from the cash receipt on the issuance of the stock in 1901 until the cash payment on the repurchase of the debt in 1972) really constituted a loss to the corporation since it had suffered a net reduction in assets.[40] Under these circumstances, according to the taxpayer,

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35. *United States Steel*, 848 F.2d at 1233. The taxpayer originally reported the difference between the face amount of the bonds and the repurchase price as income, but subsequently filed a timely claim for refund. *See id.*

36. *United States Steel*, 11 Cl. Ct. at 378.

37. The Treasury Regulations in effect when United States Steel acquired the debentures in 1972 provided:

> If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue price plus any amount of discount already deducted, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium already returned as income, the amount of such excess is income for the taxable year.

Treas. Reg. § 1.61-12(c)(3) (1972). The current regulation is in substance the same. *See* Treas. Reg. § 1.61-12(c)(3) (CCH 1990).

38. *United States Steel*, 11 Cl. Ct. at 378.

39. *See* Appellant's Reply Brief at 3-10, *United States Steel*, 848 F.2d at 1232.

40. *See United States Steel*, 11 Cl. Ct. at 378 n.12. The taxpayer cited the Supreme Court case of Bowers v. Kerbaugh Empire Co., 271 U.S. 170 (1926), to support its claim that the transaction as a whole must be examined to see if an economic gain had been realized. *See United States Steel*, 11 Cl. Ct. at 378 n.12; Appellant's Brief at 15 n.7, *United States Steel*, 848 F.2d at 1232.

the corporation could not be deemed to have realized an economic gain.[41]

The Claims Court disagreed with the taxpayer. It also rejected the government's view that United States Steel should have income to the extent the $175 face amount of the debt (which was greater than its value when issued) exceeded the $118 repurchase price.[42] Instead, the court held that the value of the consideration received upon issuance of the debt should be regarded as the "issue price" under the regulations. In this case, that consideration was the preferred stock, valued at $165 at the time of the exchange. According to the Claims Court, the difference between the deemed issue price of $165 and the repurchase price of $118 constituted taxable income to United States Steel.[43]

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41. *United States Steel*, 11 Cl. Ct. at 378. The taxpayer relied heavily on the case of Fashion Park, Inc. v. Commissioner, 21 T.C. 600 (1954). The corporation in that case had issued $50 par value preferred stock for $5 a share. *Fashion Park*, 21 T.C. at 601. Subsequently, the preferred stock was redeemed for bonds with a $50 face amount. *Id.* The corporation later repurchased the bonds for an amount less than $50 but more than $5. *Id.*

In *Fashion Park*, the government did not dispute the contention that the issue price of the bonds was $5, the amount initially paid in for the stock. *Id.* at 603. Instead, the government argued that the issue price was irrelevant, and that gain should be realized to the extent that the face amount of the bonds exceeded the repurchase price. *Id.* at 603-04. The Tax Court rejected the government's argument. *Id.* at 604. The court relied on United States v. Kirby Lumber Co., 284 U.S. 1 (1931), as holding that cancellation of indebtedness depends upon an increase in assets, so that the issue price (representing consideration received for the debt) rather than the face amount would be the relevant figure with which to compare the repurchase price. *See Fashion Park*, 21 T.C. at 606-07.

The Claims Court in *United States Steel* found that *Fashion Park* was not relevant to its decision since the government in that case had conceded the issue price as being the amount paid in for the preferred stock, while in the instant case, the government had made no such concession. *See United States Steel*, 11 Cl. Ct. at 381. The Federal Circuit, however, concluded that the government's concession in *Fashion Park* implied an acceptance of the conceded issue price as the correct figure. *See United States Steel*, 848 F.2d at 1235.

42. *See United States Steel*, 11 Cl. Ct. at 542. In its first opinion, the United States Claims Court interpreted the government's position as being that United States Steel should realize income only to the extent that the repurchase price was less than the value of the preferred stock received on issuance of the debt. *See id.* at 378. After the court's decision, the government moved for reconsideration, contending that it had argued consistently that gain should be realized to the extent the repurchase price was less than the face amount of the bonds. *See id.* at 541. While the court granted the government's motion, it did not change its decision upon reconsideration. *See id.* at 542. The government did not challenge the court's ruling on appeal. *See United States Steel*, 848 F.2d at 1234.

43. *United States Steel*, 11 Cl. Ct. at 385. The court noted that, under the applicable regulations, any previously deducted original issue discount would be added to the issue price for the computation of taxable income. *Id.* Apparently, United States Steel originally had claimed the difference between the $175 face of the debt and its initial $165 value as original issue

The Claims Court based its decision[44] on the Supreme Court opinion in *United States v. Kirby Lumber Co.*,[45] in which a corporate debtor realized gain when it repurchased its bonds at a discount from face value.[46] In applying *Kirby Lumber*, the Claims Court relied on an article, written more than forty years after the decision, which revealed that the taxpayer in *Kirby Lumber* actually had received preferred stock for its debt instead of cash, a fact that previously had been unrecognized by either courts or commentators.[47] The Claims Court in *United States Steel* saw it as relevant that the Supreme Court had not considered the amount originally paid in for the preferred stock but had looked only at the value of the consideration received on issuance of the debt.[48]

In *Kirby Lumber*, the parties had stipulated that the bonds "were issued at par," so that the consideration received for the debt was assumed to be equal to the face value of the debt. Under these facts, the Supreme Court found that the taxpayer realized a gain to the extent that the face value of the debt exceeded the repurchase price.[49] The Claims Court cited *Kirby Lumber* for the rule that the cancellation of a debt results in a gain because assets previously offset by the obligation become available to the taxpayer. The court went on to hold, however, that when the consideration received upon the issuance of the debt is *less* than the face amount (as in *United States Steel*),

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discount and had taken deductions based on that amount over the period the debt was outstanding. These deductions were disallowed by the Internal Revenue Service on audit. *See* Appellant's Brief at 9, *United States Steel*, 848 F.2d at 1232.

In reaching its decision in *United States Steel*, the United States Claims Court discussed the government's argument that cases determining the "issue price" of debt for purposes of original issue discount should be relevant in determining the "issue price" of debt for cancellation-of-indebtedness purposes. *See United States Steel*, 11 Cl. Ct. at 384. According to the government, these cases established that the amount paid in for the preferred stock would set a "floor" for the "issue price" but that if the value of the stock at the time of the exchange of stock for debt had increased to more than that, the higher figure would control. *See id.* at 384. While the Claims Court stated that these cases provided collateral support for its conclusion, it did not find it necessary to adopt the government's argument on this point in order to reach its decision. *See id.* at 384-85.

44. *Id.* at 385.

45. 284 U.S. 1 (1931).

46. *Id.* at 3.

47. *See United States Steel*, 11 Cl. Ct. at 381-83 (relying on Bittker, *Income From the Cancellation of Indebtedness: A Historical Footnote to the* Kirby Lumber Co. *Case*, 4 J. CORP. TAX'N 124 (1977)).

48. *United States Steel*, 11 Cl. Ct. at 378.

49. *Kirby Lumber*, 284 U.S. at 3.

the gain would be limited to the difference between the consideration actually received and the repurchase price.[50]

On appeal, the Federal Circuit Court of Appeals reversed the Claims Court in *United States Steel* and accepted the taxpayer's argument that it had not realized a gain on the cancellation of the debt.[51] The court cited *Kirby Lumber* and other lower court decisions for the principle that an increase in a taxpayer's assets is the critical determinant of whether cancellation of a debt results in gain.[52] According to the court, the term "issue price" had to be interpreted in light of that standard.[53]

In *United States Steel*, the Federal Circuit Court of Appeals found that the "issue price" of the debt was the amount originally received for the preferred stock.[54] Since the corporation had received "no new capital" on the issuance of the debt, the $100 cash paid in for the preferred stock was the only asset increase that resulted from the transaction.[55] Comparing that amount to the $118 cash paid to retire the debt showed that the overall effect was a reduction in the assets of the corporation.[56] Without an overall asset increase, the court concluded that no gain could result.[57]

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50. *United States Steel*, 11 Cl. Ct. at 380.

51. *United States Steel*, 848 F.2d at 1238.

52. *Id.* at 1235-36. In addition to *Kirby Lumber*, the major cases relied upon by the Federal Circuit were St. Louis Ry. v. United States, 444 F.2d 1102 (Ct. Cl.), *cert. denied*, 404 U.S. 1017 (1971); Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932); Fashion Park, Inc. v. Commissioner, 21 T.C. 600 (1954). *United States Steel*, 848 F.2d at 1235-36.

53. *Id.* at 1236.

54. *Id.*

55. *See id.*

56. *See id.*

57. *Id.* The Federal Circuit also referred to cases which considered the issue price of debt that was exchanged for stock in determining the existence of original issue discount. According to the government, cases in this context had held that the issue price of the debt would be the fair market value of the stock. *Id.* at 1237.

Because the court in *United States Steel* concluded that the focus of the inquiry was different in bond discount and cancellation-of-indebtedness cases, it did not regard these cases as controlling authority. *Id.* at 1237-38. Nevertheless, the court did consider the Supreme Court's decision in the context of original issue discount as "helpful." *Id.* at 1238. In Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974), the Supreme Court refused to allow the corporation a deduction for original issue discount on debt that had been issued in exchange for preferred stock. *Id.* at 155. The corporation claimed that the value of the stock was significantly below the face value of the debt. *Id.* at 140. The Court disallowed the deduction on the theory that the firm had not incurred "any additional cost for the use of capital" by exchanging stock for debt, but simply had replaced one form of capital with another. *Id.* at 151. The Supreme Court went on to state that the exchange of stock for debt had neither increased nor decreased

Under the decision of the Federal Circuit Court of Appeals in *United States Steel*, a corporation will not realize gain on the repurchase of debt that was issued to shareholders in exchange for their stock unless the cash paid on repurchase is less than the cash previously received by the corporation on the original issuance of the stock, so that the corporation realizes a net increase in its assets.[58] Further, under the court's decision, a corporation that issued debt to its shareholders as a dividend, receiving no assets in exchange, will not realize gain on either a repurchase or a cancellation of the debt.[59]

III. ANALYSIS

A. *Corporate Income and the Corporate Tax Base*

Traditionally, the realization of income on the cancellation of debt is justified on the theory that otherwise the debtor receives an untaxed economic benefit. Under this explanation, the debtor received the economic benefit, typically cash or property, upon incurring the debt, but was not taxed because of the obligation to invest an equivalent amount of after-tax capital on repayment. If the debtor ultimately repays less than promised (*i.e.*, the debt is cancelled or repurchased at a discount), the previous treatment of the cash or property received in the year of the borrowing was unjustified. Requiring realization of gain on the cancellation of the debt reverses the prior exclusion and assures that the debtor does not receive an economic benefit free from tax.[60]

In *United States Steel*, the Federal Circuit Court of Appeals applied this analysis, focusing on prior economic benefit to the debtor as the justification for cancellation-of-debt income.[61] In the context of a corporate debtor, the court defined economic benefit solely in terms of an increase in the debtor's assets.[62] That narrow definition, however,

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corporate assets. *Id.* at 152. It was that statement that the court in *United States Steel* found "helpful" in reaching its conclusion on the cancellation-of-indebtedness issue. *See United States Steel*, 848 F.2d at 1238.

58. *See id.* at 1234-36.

59. *See id.* at 1236. In this case, under the Federal Circuit's decision in *United States Steel*, the issue price for cancellation-of-indebtedness purposes would be zero. *See id.* (citing and relying upon Rail Joint Co. v. Commissioner, 22 B.T.A. 1277 (1931), *aff'd*, 61 F.2d 751 (2d Cir. 1932). For a discussion of the *Rail Joint* decision, see *infra* text accompanying notes 81-104.

60. *See, e.g.*, Commissioner v. Tufts, 461 U.S. 300, 309-10 (1983); M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 3.02 (5th ed. 1988); Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CALIF. L. REV. 1159, 1159-60 (1978).

61. *See United States Steel*, 848 F.2d at 1236.

62. *Id.*

is inconsistent with both the corporate tax base and the underlying formulation of corporate income.

The current structure of taxation on corporations and their shareholders is one of double tax. Gain accruing to shareholders through their interest in the entity is taxed twice: once when it is realized by the shareholders, either through distributions or stock sales, and once when it is realized by the corporate entity.[63]

Under this system, corporate income (which forms the basis of the current corporate tax) is defined with reference to the shareholders: corporate income is gain accruing to the corporate entity over and above the after-tax investments of its shareholders.[64] This definition is based upon the exclusion from corporate tax of shareholder contributions to the extent of their capital investments and on the nondeductibility of distributions to shareholders.[65] Corporate income reflects and is matched by gain to the shareholders, and it is the essence of the double tax system to tax that gain at both the shareholder and the corporate level.

Since corporate income is measured by shareholder gain during any specific period, two major components must be included in the corporate income formula: corporate distributions to shareholders during the period and changes in corporate net worth, or amounts accumulated for future distributions to shareholders. Advances from shareholders, or additional capital investments by them, are subtracted from the computation. Corporate income is then defined as (1) net distributions to shareholders (distributions minus advances), plus (or minus), (2) changes in corporate net worth.[66] Under this formula,

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63. The double tax system has been criticized, and proposals to integrate the individual and corporate tax structures have gained strong support. *See, e.g.*, McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 549-74 (1975); Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 769-72 (1981).

64. *See* Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89, 114-20 (1984); *see also* Crane, *Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders*, 44 TAX L. REV. 113, 143 (1988) (endorsing the concept that "the corporate tax base include only values that can be made available to shareholders above and beyond their contributions"); McLure, *supra* note 57, at 535 (stating that "so far as the earning of income for tax purposes is concerned, the corporation is simply the aggregate of its owners"). *But cf.* Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1593 (1974) (arguing that defining corporate gain with reference to the gain of the shareholders is not mandated conceptually by traditional notions of "income").

65. *See* Bryan, *supra* note 64, at 107-20 (discussing the statutory bases for this definition).

66. Gabinet & Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 915 (1977); Warren, *supra*

corporate income during a specific period measures the increase in value or economic gain to the shareholders that accrues through the entity during that period, whether the increase is distributed to them or remains inherent in their equity interest.

Defining corporate income in these terms illustrates that distributions to shareholders are analogous, for a corporate taxpayer, to an individual taxpayer's expenditures for consumption.[67] Under the most widely-accepted definition, personal income is defined as the sum of amounts spent on consumption plus changes in net worth, *i.e.*, amounts accumulated for future consumption.[68] The income formulation must

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note 64, at 1592 (accepting this formula if corporate income is defined with reference to shareholder gain); *see also* P. HANSEN, THE ACCOUNTING CONCEPT OF PROFIT 39 (2d ed. 1972); Sorter, *Accounting Income and Economic Income*, in 2 AICPA, OBJECTIVES OF FINANCIAL STATEMENTS 104-05 (1973).

Since a deduction is denied for federal taxes under Internal Revenue Code § 275, the federal tax rates are imposed on a "tax inclusive" base. Accordingly, the formula for the corporate income tax base must include an amount for federal taxes. Such a payment or liability does not represent a distribution to shareholders, nor is it a decrease in net worth that is recognized as a loss for tax purposes. Corporate income on which the tax is imposed is therefore actually equal to (1) net distributions to shareholders (distributions minus advances); plus (or minus) (2) changes in corporate net worth (amounts accumulated for future distributions); plus (3) the amount of nondeductible federal taxes.

For example, if a corporation earns $25 profit in one year and accrues federal taxes at a 40% rate, it will owe $10 tax and have $15 remaining after-tax to distribute to shareholders or to accumulate for future distribution. Under the formula expressed in the text, the corporation would appear to have only $15 income if it distributed the $15 to shareholders ($15 distribution plus 0 change in net worth); it would also appear to have only $15 income if it accumulated the $15 for future distributions (0 distributions plus $15 increase in net worth). The addition of the $10 nondeductible tax payment gives the correct result that the firm's income for purposes of the tax base is actually $25.

67. *See* Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 396 (1983) (analogizing between consumption for an individual taxpayer and distributions to shareholders for a corporate taxpayer in the context of the tax benefit rule). Discussing whether nonrecognition should override the tax benefit rule for a liquidating corporation, the Court stated, "[I]f a corporation turns expensed assets to the analog of personal consumption, as [the taxpayer] did here — distribution to shareholders — it would seem that it should take into income the amount of the earlier deduction." *Id.* (citing Williamson v. United States, 292 F.2d 524 (Cl. Ct. 1961)). In *Williamson*, the Claims Court held that a cash basis corporation should recognize gain on a liquidating distribution of accounts receivable. *Williamson*, 292 F.2d at 530. The *Williamson* court stated that "[p]aying the dividend was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way." *Id.*

See also Warren, *supra* note 64, at 1591-92 (analyzing consumption and accumulation in the corporate context); Note, *Tax Treatment of Previously Expensed Assets in Corporate Liquidations*, 80 MICH. L. REV. 1636, 1645-46 (1982) (corporate distribution represents a form of consumption that benefits the corporation).

68. *See* Haig, *The Concept of Income*, in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921). In 1921 Professor Haig defined income as "the *money value of the net accretion of one's*

include amounts spent on consumption; those expenditures evidence the taxpayer's economic gain despite the fact that the individual is left with fewer assets after the expenditure than before. Consumption expenses may not be deductible or the concept of economic gain would be defeated and the personal tax base could be eliminated altogether. Similarly, corporate distributions to shareholders are evidence of gain to the shareholders and consequently gain to the corporate entity. Just as individual consumption expenses, distributions to shareholders must be included in the corporate income formulation, and, just as consumption expenses, they are nondeductible and are intended to be made out of after-tax dollars.[69]

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economic power between two points of time." *Id.* (emphasis in original). Professor Simons rearticulated Haig's definition, adding to it the element of consumption (an idea that he attributed to Haig). H. SIMONS, PERSONAL INCOME TAXATION 61-62 (1938). As Simons defined it, personal income is the "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." *Id.* at 50. For discussions of the Haig-Simons definition as the base of personal income, see B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE 8 (1968); Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 320-25 (1972); Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703, 1705 (1986).

The federal personal tax rates are imposed on a "tax inclusive" basis, given the nondeductibility of federal taxes under I.R.C. § 275. Accordingly, federal taxes are included in the computation of personal income for tax purposes, just as they are included in the computation of corporate income for tax purposes. *See supra* note 66. In the case of personal income, federal taxes might be included as consumption, although the private benefit derived from the expenditure does not correlate with the amount owed. *See* Turnier, *Evaluating Personal Deductions in an Income Tax — The Ideal*, 66 CORNELL L. REV. 262, 272-75 (1981).

In any case, whether federal taxes are or are not deductible is a matter of the rate of tax, and the rate on a "tax-inclusive" base may be converted into the rate needed to raise the same amount of revenue on a "tax-exclusive" base. *See* M. GRAETZ, FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES 114-15 (2d ed. 1988); Turnier, *supra*, at 267.

69. Despite the inclusion of distributions to shareholders in corporate income, such distributions are not always taxable to the corporation in the year they are made. Just as an individual's consumption may be purchased out of previously-taxed savings, so distributions to shareholders may be made out of funds previously taxed at the corporate level. Distributions also may be made out of previous shareholder contributions, which are treated as corporate after-tax capital. *See* Bryan, *supra* note 64, at 110. In either case, the distribution will be matched by an equivalent reduction in corporate net worth, preventing taxation in the year of the distribution.

To illustrate, assume that a corporation receives $100 in initial shareholder contributions. Under the formula (distributions to shareholders minus advances from them plus (or minus) changes in corporate net worth), the $100 increase in corporate net worth will be offset by the $100 in advances from shareholders, and the firm would have no income. This conclusion makes sense since the shareholders have not enjoyed a gain, but simply have transferred funds from direct ownership to entity ownership.

If, in the next year, the corporation has no profit but makes a $50 distribution to its shareholders, that distribution would be deemed to be out of after-tax capital and so would not

B. *Distributions of Notes to Shareholders*

If a corporation borrows cash to finance a distribution to its shareholders, the proceeds of the loan are not subject to tax. Therefore, until repayment of the loan, the corporation achieves a distribution to its shareholders out of pre-tax resources, a result that is inconsistent with the corporate tax base. The inconsistency is corrected, of course, when the corporation repays the loan. Since the repayment is nondeductible and consequently out of after-tax dollars, it is the same (aside from timing) as if the original distribution had come from after-tax funds.

If the corporation borrows to finance a distribution to its shareholders and the debt is later cancelled, consistency requires that corporate income include the debt at the time of cancellation. Otherwise, without repayment, the prior tax-free borrowing becomes permanently exempt from corporate tax. Likewise, the prior distribution to shareholders becomes, in effect, a deductible outlay for the corporation. Either result is inconsistent with the corporate tax base. Taxing the debt upon cancellation, or the discount upon a repurchase of the debt, assures the same goal as repayment of the debt: the corporation achieves a distribution to shareholders only by paying tax on that amount, thus preserving the system of double tax on shareholder gain.

This analysis should not be affected if a corporation finances a distribution by borrowing from its shareholders rather than from a third party, distributing notes rather than loan proceeds. Under current tax provisions, the notes will be treated as accomplishing a distribution to shareholders just as if the corporation instead had distributed cash in an amount equal to the value of the notes.

If the distribution is characterized as a dividend, the shareholders will treat the value of the notes as dividend income on receipt.[70] If

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be taxed in the year of the distribution. The $50 distribution would be included in corporate income but would be offset by an equivalent $50 reduction in the firm's net worth. Unless distributions are viewed as analogous to consumption, the firm appears to have a loss. The result of no corporate income is, however, consistent with the lack of actual gain (or loss) to the shareholders.

The same result holds if the corporation has no profit but makes a $50 distribution out of accumulated earnings or amounts taxed in a prior year. In this case, as in the example above, the $50 distribution is offset by the $50 decrease in net worth, and the corporation has no income. Again, unless distributions to shareholders are included in corporate income, the corporation appears to have a loss. The conclusion that the corporation has no loss is, of course, consistent with the policy that dividends to shareholders are not deductible for tax purposes.

70. *See, e.g.*, Doerschuck v. United States, 274 F. 739, 740 (E.D.N.Y. 1921) (where the court distinguished a dividend in bonds, taxable on receipt, from a nontaxable stock dividend

the corporation distributes the notes in redemption of stock and the redemption is treated as a payment for the stock, the shareholders will compute gain or loss by comparing their basis in the stock to the value of the notes.[71] In either case, the shareholders will take a basis in the notes equal to the amount they included in income and will use that basis to compute future gain or loss on the debt.[72] The shareholders may sell the notes to third parties for cash or they may choose to retain the notes as nonequity investments in the corporation. Any gains or losses realized by them or by subsequent transferees on disposition, satisfaction or cancellation of the notes will be realized in the holder's role as a corporate creditor, a third party vis-à-vis the corporation.[73]

The corporation is also treated as if it had distributed cash equal to the value of the note. Earnings and profits, measuring the corporate gain available for distribution to shareholders, are reduced by that amount if the distribution is a dividend or by a pro rata portion if the distribution is a redemption treated as a sale of stock.[74]

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on the grounds that with the former the shareholders receive an actual payment of property "entirely severed or distinguished from their control of the property as stockholders"). For the statutory authority, see I.R.C. §§ 301(b), (c) and 316, governing the tax treatment of distributions of "property" to shareholders. Section 317 defines property for purposes of the distribution rules to include "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." I.R.C. § 317. Section 312(a), governing the reduction in earnings and profits on distributions of property, makes it clear that "property" includes obligations of the distributing corporation. I.R.C. § 312(a); *see also* Treas. Reg. § 1.301-1(d)(1)(ii) (CCH 1990).

71. *See* I.R.C. §§ 301-302. Amounts distributed in redemption of stock will be treated as payments only if one of the tests under I.R.C. § 302 is met. Otherwise, the distribution will be governed by I.R.C. § 301 and will be treated as a dividend assuming sufficient corporate earnings and profits.

72. *See* I.R.C. §§ 301(d), 1012.

73. It is possible that a shareholder who is also a creditor holding corporate notes might cancel those notes as a contribution to capital. If, for example, a shareholder cancelled corporate debt in order to protect her equity investment, the holder's action would be related to her role as shareholder. The shareholder-creditor would not realize a loss on the cancellation, but would increase her stock basis by her basis in the cancelled debt. The consequences to the corporation would also change. For further discussion on this point, see *infra* note 80.

74. I.R.C. § 312(a)(2). This section provides that a corporation that distributes notes shall reduce earnings and profits by the principal amount or, if the notes are issued with original issue discount, by the aggregate issue price of the notes. *Id.* Under I.R.C. § 312(o), the terms "issue price" and "original issue discount" are to be defined for earnings and profits purposes as they are under I.R.C. §§ 1273-1275, which control the computation of original issue discount. I.R.C. § 312(o). If the issue price of notes distributed to shareholders is less than the face amount, so that the issue price controls the charge to earnings and profits, the difference between the face amount and the issue price will reduce earnings and profits ratably over the term of the notes as the corporation deducts the original issue discount.

In addition, if the face amount of the notes is greater than their value on distribution, the corporation may deduct the difference ratably over the term of the notes as interest.[75] Under this tax provision, the corporation is treated exactly as if it borrowed the cash from a third party and then distributed the cash to its shareholders. When a corporation borrows from a third party, the excess of the face amount of the notes over the cash received, typically equal to the value of the notes on issuance, is deemed original issue discount and is deductible as a corporate expense for the use of money.[76] By according the

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If the note is issued in redemption of stock and is treated as a sale, only a portion of the note's face amount (or issue price, if less) would reduce earnings and profits, with that portion not to exceed a ratable share of earnings and profits. *See* I.R.C. § 312(n)(7); B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 9.35.

The fact that the face amount of the note (or the issue price, if less) governs the reduction in earnings and profits for notes that are issued to shareholders provides support for the rule that a corporation should recognize gain on a repurchase of the note for less than the face amount (or issue price). *See* B. BITTKER & L. LOKKEN, *supra* note 20, ¶ 6.4.2 n.28:

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

Id.

75. If the notes are issued as dividends, the issue price for original issue discount purposes will be determined under § 1275(a)(5) as if the notes were issued for property. Accordingly, if the notes are publicly traded, their fair market value will be the issue price. *See* I.R.C. § 1273(b)(3). If the notes are not publicly traded, the issue price will be determined under the rules of § 1274, which utilize the interest rates on federal debt.

If the notes are issued in redemption of stock, § 1273(b)(3) will set the issue price as the fair market value of the stock or debt if either one is publicly traded. Otherwise, the rules under § 1274 will control. *See generally* B. BITTKER & J. EUSTICE, *supra* note 23, ¶ 4.42.

Once the issue price is determined, original issue discount (defined under § 1273(a) as the excess of the stated redemption price at maturity over the issue price) is deductible to the issuer under § 163(e). I.R.C. § 163(e).

76. If a note is issued for cash, its issue price for purposes of original issue discount is determined under § 1273(b)(1) or (2). Unless the note is publicly offered, its issue price will be the amount of cash paid by the first buyer. If the note is publicly offered, the issue price will be the initial offering price at which a substantial amount of the debt was sold. *See* B. BITTKER & J. EUSTICE, *supra* note 23, ¶¶ 4.41, 4-59. If the exchange is arm's length, the amount received for the debt typically will be equal to the value of the debt. *See* United States v. Davis, 370 U.S. 65, *reh'g denied*, 371 U.S. 854 (1962).

The difference between the issue price and the stated value on maturity is defined as original issue discount under § 1273(a) and is deductible to the issuer under § 163(e).

same treatment to a corporation that finances shareholder distributions by borrowing directly from its shareholders as is accorded transactions between the corporation and third party creditors, the tax code makes it clear that the distribution of notes to shareholders closes the distribution transaction at that point. Any future payments to holders of the notes are considered to be payments to third party creditors.

Once it is clear that the transaction between the corporation and its shareholders closes at the time the corporation distributes the notes, the analysis of whether the corporation recognizes gain on a cancellation or a repurchase of the debt presents few problems. Just as when borrowed cash is distributed to shareholders, the corporation distributing notes has achieved a distribution to shareholders without an equivalent investment of its own. The distribution is effectively deductible to the corporation, an inconsistency with the corporate tax base that is corrected when the corporation pays the notes out of after-tax funds. If such payment does not occur, because the debt is either cancelled or repurchased at a discount, inclusion at that point is the only way to preserve the nondeductibility of shareholder distributions and to maintain consistency with the double tax.

The same analysis applies to an individual taxpayer who borrows to finance consumption, an expense that is nondeductible from the individual tax base. If, for example, an individual purchases $100 of consumption on credit, she is not taxed on the value of the consumption because of her repayment obligation. If, subsequently, she satisfies the debt for less than $100, she should be taxed on the discount.[77] She has enjoyed $100 consumption without an equivalent investment of her own, a result that is inconsistent with the personal tax base. The difference between the obligation and the amount repaid is taxed as gain in order to preserve the nondeductibility of consumption.

The problem in *United States Steel* arose from defining economic income only as an increase in accumulations. Relying on *Kirby Lumber*, the Federal Circuit Court of Appeals determined that an "increase in assets" was the critical determinant of gain from the cancellation of

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77. *See, e.g.*, M. CHIRELSTEIN, *supra* note 60, at 53 n.30; Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 244 (1959); Gunn, *Reconciling*, *supra* note 14, at 854 n.20.

Exclusion of gain from cancellation of a debt incurred for consumption might be justified if the cancellation is viewed as a retroactive adjustment in the purchase price. In that case, if the taxpayer is deemed not to have originally received consumption benefits in the full amount of the debt, the taxpayer will not have realized an economic benefit when the debt is cancelled for less than the original amount owed. As an analogy, see I.R.C. § 108(e)(5) (treating the reduction of debt owed by the purchaser to the seller of property as a price reduction, reducing the basis in the property, instead of taxing the debtor on gain from the cancellation of the debt).

debt.[78] That conclusion makes sense when the borrowing is for cash or other property, but is incorrect when the borrowing is for consumption (in the case of an individual) or for a distribution to shareholders (in the case of a corporation). Neither use increases the assets of the taxpayer and yet both are components of the tax base. If an individual taxpayer consumes, the consumption is included in the tax base and is to be accomplished out of after-tax funds; if a corporate taxpayer distributes to shareholders, the distribution is included in the tax base and is to be accomplished out of after-tax funds. Enjoying consumption or achieving a distribution without an equivalent outlay of funds is an economic benefit — to the individual in one case and to the corporation in the other — and should result in taxable gain.

This conclusion in the case of a corporate taxpayer may be illustrated further by considering the principle that corporate income is defined with reference to shareholder gain. When a corporation issues a note with a fixed rate of interest, whether to its shareholders or to a third party lender, the note may be viewed as an asset with a fluctuating value. If market interest rates rise, the value of the debt increases to the corporate debtor, who would be forced to pay higher interest rates were it not for the contractual commitment. The appreciation increases the corporate net worth, and the gain accrues to the shareholders through their stock interests.

As the corporate debtor enjoys a gain with rising market interest rates, the creditors suffer a loss. The fixed interest rate in the note no longer compensates the creditors adequately for the use of their money, and the present value of the principal payment on maturity and the periodic interest payments falls below the value of the debt when issued. The loss suffered by the third party creditors is equivalent to the gain enjoyed by the corporate entity and so by its shareholders.[79]

The gain accruing to the shareholders as the debt increases in value to the corporate debtor is realized by the shareholders if they sell their stock. To be consistent with the double tax, the corporate tax base should include that same gain as corporate income. If the corporation repurchases the debt at a discount from its initial value, realization to the corporation will occur at that point, and the gain, represented by the difference between the initial value and the repurchase price, should be taxed at the corporate level.

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78. *See United States Steel*, 848 F.2d at 1236.

79. *See* Bryan, *supra* note 64, at 121-23.

The gain realized upon the repurchase of a debt should not depend upon whether the debt was initially issued to shareholders or to third party lenders. In either case, the holders of the debt are third party creditors, unrelated to the corporate entity. The loss the creditors suffer as the debt declines in value represents a gain to the corporation and to its shareholder group, and it is that gain which is the subject of the double tax.[80]

C. Rail Joint — *A Faulty Precedent*

One of the main cases cited by United States Steel in its favor and relied upon by the Federal Circuit Court of Appeals in its opinion was *Commissioner v. Rail Joint Co.*[81] *Rail Joint* was decided by the Second Circuit Court of Appeals shortly after the Supreme Court

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80. It is crucial to this analysis that the loss realized on a repurchase or cancellation of the debt by the corporation is suffered by a third party creditor. If, for example, the debt were cancelled by a creditor who was also a shareholder and the cancellation occurred in order to protect the creditor-shareholder's equity investment, the analysis would change. In that case, the creditor-shareholder would be deemed to have made a capital contribution to the corporation to the extent of her basis in the cancelled debt and would increase her basis in the stock by that amount. Under I.R.C. § 108(e)(6), the corporation would be treated as satisfying the debt with an amount of money equal to the shareholder's adjusted basis in the indebtedness. Thus, the corporation would realize income only to the extent that the face amount (or the issue price) exceeded that basis.

This rule is consistent with the formula for corporate income described in the text, since the additional shareholder investment in the corporation would offset cancellation of indebtedness income that would otherwise be realized. *See* Bryan, *supra* note 64, at 124-25 (If the shareholder has an inherent loss in the debt — *i.e.*, her basis is greater than the fair market value of the debt — the loss of that shareholder will be offset by gain to the rest of the shareholders. This conclusion justifies the result of no gain to the corporation as an entity.).

Difficulties will arise in some cases in determining whether the cancellation of a debt was related to a shareholder-creditor's status as a shareholder or as a creditor. The Senate Finance Committee recognized that the corporation would have to face this issue under I.R.C. § 108(e)(6) and, in its committee report on that section, stated:

> Whether a cancellation of indebtedness by a shareholder-creditor is a contribution to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. *If the shareholder-creditor acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule.*

S. REP. No. 1035, 96th Cong., 2d Sess. 19 n.22 (1980) (emphasis added).

81. 61 F.2d 751 (2d Cir. 1932).

decided *Kirby Lumber*, the case in which the Court established that the repurchase of a debt at a discount would result in taxable gain.[82]

In *Rail Joint*, the corporate taxpayer had declared and paid a dividend in its own bonds. Almost ten years later, the taxpayer repurchased the bonds for less than their face amount.[83] The government relied on *Kirby Lumber*, arguing that the difference between the decrease in the taxpayer's liabilities and the decrease in its assets should be taxable as gain.[84] The Second Circuit, however, concluded that *Kirby Lumber* was not controlling.[85]

The distinguishing factor, according to the Second Circuit, was the lack of consideration received by the debtor upon incurring the debt.[86] In *Kirby Lumber*, according to the Second Circuit, the debtor had received cash upon issuing the debt.[87] When the debtor subsequently retired the bonds by paying less cash than it had received, it "obtained a net gain in assets from the transaction."[88] In contrast, the debtor in *Rail Joint* "never received any increment to its assets, either at the time the bonds were delivered [to the shareholders] or at the time they were retired."[89] When it repurchased the bonds at a discount, it simply paid those shareholders less than it had promised to pay them. Without a net gain in assets, considering the transactions in the aggregate, the court could not justify taxing the debtor.[90]

While the Federal Circuit Court of Appeals cited *Rail Joint* as authority in *United States Steel*, the *Rail Joint* opinion has been criticized by commentators[91] and should not be followed. The Second

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82. The Supreme Court decided *Kirby Lumber*, 284 U.S. 1 (1931), after the Board of Tax Appeals issued its opinion in *Rail Joint*. The Second Circuit was asked to reverse the Board's holding on the basis of the new authority, which it declined to do. *Rail Joint*, 61 F.2d at 751-52.

83. *See Rail Joint*, 61 F.2d at 751.

84. *See id.* at 752.

85. *Id.*

86. *Id.*

87. *Id.* at 751. Actually, the debtor in *Kirby Lumber* had issued the debt in exchange for its own preferred stock rather than, as the Second Circuit erroneously assumed, for cash. *See* Bittker, *supra* note 46, at 126.

88. *Rail Joint*, 61 F.2d at 751.

89. *Id.* at 752.

90. *Id.* The court recognized that cancellation of a liability might result in tax without a net gain in assets if the liability previously had been deductible, as some liabilities would be for an accrual basis taxpayer. The court concluded, however, that that principle was not applicable to the case at bar since the dividend obligation was not a deductible liability. *See id.*

91. *See, e.g.*, R. MAGILL, TAXABLE INCOME 257-59 (rev. ed. 1945); Bittker & Thompson, *supra* note 60, at 1167; Warren & Sugarman, *Cancellation of Indebtedness and Its Tax Consequences: I*, 40 COLUM. L. REV. 1326, 1332-33 (1940); Note, *Book Profits as Taxable Income*, 82 U. PA. L. REV. 641, 645 (1934). Some authors have stated that the transaction in *Rail Joint*

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Circuit was clearly wrong when it stated that a receipt of assets upon incurring a debt is a necessary finding in order to charge the debtor with gain upon the cancellation of the debt, and subsequent court decisions and commentators have rejected that view.[92] When a debtor incurs a debt, she may receive assets or other types of economic benefits in return. If, for instance, a debtor incurs a $100 debt for consumption and that debt is later cancelled, the debtor should be taxed on $100 gain in order to assure that consumption benefits are obtained out of after-tax dollars. Without that tax, the debtor will have received $100 consumption without any investment of her own, a result that is inconsistent with the personal tax base.[93] This result is correct despite the lack of an increase in the debtor's assets as a result of the overall transaction.

As discussed previously, consumption in the computation of personal income is analogous to distributions to shareholders in the computation of corporate income.[94] Accordingly, the individual debtor's situation above is analogous to a corporate debtor that distributed $100 in notes to its shareholders. If those notes are cancelled, the corporate debtor must be taxed on $100 in order to assure that the previous distribution is effectively made with after-tax funds. Without such a tax, the corporation achieves a $100 distribution with pre-tax funds, a result that is inconsistent with the corporate tax base. If the corporate debtor repurchases the notes at a discount, the debtor should be taxed to the extent of that discount. Again, this result is correct despite the lack of any increase in the corporate debtor's assets.

The decision in *Rail Joint* perhaps can be explained by the court's disregard of the distribution of the bonds as a true distribution to shareholders. Rather, the court seemed to regard the bond distribution as a transitory step, preliminary to the distribution of cash to the shareholders either on repayment or repurchase of the bonds.[95] Thus,

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should be analogized to an issuance of the bonds for cash, followed by a distribution of the cash as a dividend and a subsequent repurchase of the bonds at a discount. If these steps had been followed, the repurchase unquestionably would have resulted in taxable gain to the corporation. *See, e.g.*, Bittker & Thompson, *supra* note 60, at 1167; Note, *supra*, at 645. *But see* Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977, 982-93 (1940) (for the view that such a recharacterization should not control).

92. *See, e.g.*, Darrell, *supra* note 91, at 981; Eustice, *supra* note 77, at 244; Warren & Sugarman, *supra* note 91, at 1331-33.

93. *See supra* text accompanying notes 68-69.

94. *See supra* text accompanying notes 67-69.

95. *See Rail Joint*, 61 F.2d at 752. However, the Board of Tax Appeals in *Rail Joint* recognized that the shareholders would be taxed on the receipt of the bonds. *See Rail Joint*, 22 B.T.A. at 1278.

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the court stated that on repurchase of the bonds "all that happened was that the corporation . . . paid those shareholders whose bonds were redeemed at a discount, less than it had promised to pay them."[96] The court clearly did not view the shareholders as creditors to the extent of their holdings of the corporate debt; instead it viewed them as retaining shareholder status, holding the promise that the corporation would distribute a cash dividend to them in the future.[97]

In effect, the Second Circuit in *Rail Joint* held the dividend distribution open for tax purposes until cash was finally distributed.[98] Such treatment of a distribution of notes is inconsistent, however, with other provisions of the Code previously described.[99] Shareholders who receive a distribution of notes, whether as a dividend or in redemption of stock, must take the notes into account upon receipt. The shareholders must include the value of the notes in income or, in redemption transactions, subtract their stock basis from the value of the notes to determine gain.[100] The shareholders take a basis in the notes equal to their value in order to determine subsequent gain or loss to be realized in their new role as creditors.[101] If the notes are transferable (or traded on an established securities market, as they were in *United States Steel*[102]), the shareholders may choose to exchange the notes for cash, with the new buyers taking their place as corporate creditors.

On the corporate side, the corporation must treat the distribution of the notes the same as a distribution of cash, reducing earnings and profits by the full value if the distribution constitutes a dividend and by a proportionate amount if the distribution is a redemption treated as a sale of the stock.[103] Subsequent payments on the notes are treated as payments made to creditors, and original issue discount based on the difference between the face amount of the notes and their value is deducted ratably over the term.[104]

Given these provisions, the Second Circuit's treatment of the distribution of notes as a transitory step on the way to the eventual distribution of cash is inconsistent with current law. Under current law, the distribution of notes, whether as a dividend or in redemption

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96. *Rail Joint*, 61 F.2d at 752.
97. *See id.*
98. *See id.*
99. *See supra* notes 70-76 and accompanying text.
100. *See* authorities cited *supra* notes 70-71.
101. *See* authorities cited *supra* note 72.
102. Appellant's Brief at 4-5, *United States Steel*, 848 F.2d at 1232.
103. *See* authorities cited *supra* note 74.
104. *See* authorities cited *supra* note 75.

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of stock, is treated as a cash distribution both by the shareholders and by the corporation. Future transactions between the corporation and the holders are treated as occurring between the corporation and any other third party creditors. Under this analysis, appreciation in the value of the notes to the corporation with an equivalent depreciation to the creditors represents the shifting of wealth from third parties to the corporate entity. That appreciation clearly represents gain to the shareholder group and, as such, must be taxed when it is realized by the corporation upon a repurchase of the notes at a discount.

D. *The Argument Against Inclusion Based Upon an Overall Loss*

In addition to citing *Rail Joint* as authority for its position, United States Steel argued against realization of gain on its repurchase of the bonds by stressing that overall it had, in fact, paid out more assets than it had received.[105] United States Steel received $100 when it issued the stock and no additional cash when it issued debt worth $165 in exchange for each share of outstanding stock.[106] Under this analysis, incurring the liability without receipt of equivalent consideration appears to represent a loss to the corporation since the corporation's net asset value actually declined. When the taxpayer repurchased the debt by paying $118, a figure less than it promised to pay but more than the $100 received for the stock, the taxpayer reduced the overall loss. Under these circumstances, when the entire transaction resulted in a reduction of assets by $18 per share, the taxpayer argued that it could not be deemed to have realized a gain.[107]

This argument, accepted by the Federal Circuit Court of Appeals, has a superficial appeal under the facts of *United States Steel.* Authority does exist for the proposition that, despite the rule of annual accounting, gain in one year that is actually a recovery of a loss suffered in a prior year may be excluded from tax. Courts have justified this exclusion on the grounds that the apparent gain actually represents a recovery of capital.[108] Commentators and a few cases have extended this theory to the cancellation-of-debt area.[109] This

105. *See* Appellant's Brief at 11-12, 25, *United States Steel,* 848 F.2d at 1232.

106. *Id.* at 11-12. United States Steel had claimed the difference between the $165 value of the debt and its $175 face amount as original issue discount and had deducted it ratably over the term of the debt. *Id.* at 9.

107. *See id.* at 23; *United States Steel,* 11 Cl. Ct. at 378-79 n.12.

108. *See infra* text accompanying notes 110-23.

109. *See infra* text accompanying notes 126-28.

theory is not, however, relevant to a corporation that repurchases debt which was originally issued to shareholders and should be rejected in cases such as *United States Steel.*

The tax-free recovery of capital stands as a basic premise of the tax law, assuring that the taxpayer is taxed only on net gain. In many cases, the recovery of capital is implemented by the mechanism of basis, so that a taxpayer selling property is allowed to recover her investment from the amount realized, with only the excess subject to tax.[110] In other cases, taxation of net gain is assured by allowing the taxpayer to deduct costs incurred in earning income, with the deduction of the costs representing the recovery of capital.[111]

The concept of recovery of capital has been extended to justify the exclusion of gain in cases in which the taxpayer suffered a prior loss that either was not recognized for tax purposes or from which the taxpayer did not obtain any tax benefit. In *Dobson v. United States,*[112] for example, the Supreme Court considered a taxpayer who purchased several hundred shares of stock which he subsequently sold at a loss.[113] Although he had claimed the loss as a deduction, he had not obtained any tax benefit.[114] In the year at issue, the taxpayer received a recovery for his loss from the original seller, whom he had sued for fraud, but the recovery did not equal the taxpayer's entire investment in the stock.[115]

The taxpayer in *Dobson* successfully argued to the Supreme Court that the recovery in the later year (resulting in a clear increase in his net worth in that year) could not be taxed since it represented, in effect, a return of his capital. Looking at the overall transaction, and considering both the prior loss and the recovery, he enjoyed neither a net gain nor a tax benefit.[116] In agreeing with the taxpayer, the Supreme Court stressed that its holding did not allow courts to reopen the returns of prior years, but only allowed courts to look to prior events in determining the nature of the recovery, whether return of capital or income.[117] While a deduction of the loss normally would have allowed the taxpayer to recover his investment, a deduction with no

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110. *See* I.R.C. § 1001(a).

111. *See, e.g.,* I.R.C. §§ 162, 212. *See generally* B. BITTKER & L. LOKKEN, *supra* note 20, ¶ 5.4.

112. 320 U.S. 489 (1943).

113. *Id.* at 491.

114. *Id.* at 492.

115. *Id.* at 491-92.

116. *Id.* at 492.

117. *See id.* at 493.

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tax effect did not do so.[118] Exclusion of the subsequent recovery was the only way to assure that the taxpayer was not overtaxed.[119]

Dobson involved a case where the loss was deductible, but the taxpayer obtained no tax benefit from the deduction. Its rationale has been extended to exclude recoveries of prior losses that were not deductible although they represented a clear reduction in the taxpayer's net worth. *Clark v. Commissioner*[120] exemplifies such a case, with the court again justifying an exclusion on the grounds of recovery of capital.[121] In *Clark*, a taxpayer paid federal taxes that had been computed improperly by an accountant. The accountant, upon discovering the mistake in a subsequent year, paid the taxpayer cash in the amount of the increase in taxes which his negligence caused.[122] The Board of Tax Appeals concluded that the payment did not constitute income to the taxpayer but instead merely represented compensation for an earlier loss. Because that loss had not been recognized for tax purposes, the recovery was excluded as a return of capital.[123]

In *Dobson*, *Clark*, and other similar cases, courts have adopted a transactional approach in preference to annual accounting.[124] The courts have concluded that gain in one year should be excluded from income if it is characterized as a return of capital. That characterization is

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118. *Id.* at 491-92.

119. The principle articulated in *Dobson* sometimes is referred to as the exclusionary aspect of the tax benefit rule and is now codified in I.R.C. § 111. *See generally* Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486 (1983); Note, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1395 (1958) [hereinafter Note, *Loss Carryover Provisions*]. Although the predecessor to I.R.C. § 111 had been enacted at the time *Dobson* was decided, it applied only to recoveries of bad debts, prior taxes, and delinquency amounts. *See* Internal Revenue Code of 1939, § 22(b)(2) Stat. (now I.R.C. § 111). After *Dobson*, the Treasury Regulations under that section were expanded to cover "all other losses, expenditures, and accruals made the basis of deductions from gross income." T.D. 5454, 1945-1 C.B. 68. Subsequent court decisions continued the broad application of the rule approved by the Supreme Court in *Dobson*. *See* authorities cited in Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995, 1001 (1968) [hereinafter Note, *Claim of Right Restorations*]. The current version of I.R.C. § 111 excludes "income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."

120. 40 B.T.A. 333 (1939), *acq.* 1957-1 C.B. 4, *nonacq.* 1939-2 C.B. 45 *withdrawn.*

121. *Id.* at 335.

122. *Id.* at 334.

123. *Id.* at 335.

124. *See* Bittker & Kanner, *supra* note 119, at 270; Note, *Claim of Right Restorations*, *supra* note 119, at 1005-06; Note, *Loss Carryover Provisions*, *supra* note 119, at 1394-95.

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made if, considering the events of prior years, the court finds that the taxpayer has not enjoyed a net economic gain. Although the taxpayer enjoys an increase in net worth in the year of the recovery, looked at in isolation, the increase is offset by an earlier decline in net worth that was not recognized for tax purposes. The exclusion of the subsequent recovery balances the nonrecognition of the earlier loss so that the taxpayer is taxed only on net gain.[125]

A few courts have extended this analysis to the cancellation-of-debt area,[126] and some commentators have viewed the cases as establishing an exception to the normal rule that the cancellation of debt results in a gain to the debtor.[127] These cases seem to depend on a finding that the debtor received no readily ascertainable economic benefit upon incurring the debt. Incurring the liability decreased the taxpayer's net worth, representing a loss, but it was not recognized as such through a deduction for the taxpayer. If the debt is subsequently cancelled, the taxpayer has not enjoyed an overall gain, considering the years in the aggregate. Any increase in the taxpayer's net worth from the cancellation of the debt simply reduces the prior decrease in net worth. Exclusion of the gain from cancellation of the debt balances the prior nonrecognition of the loss.[128]

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125. It is certainly arguable whether the exclusion described in the text represents the most effective way to achieve transactional equity. If a taxpayer suffers a loss that reduces the amount she has available to consume, it would make most sense to allow her a deduction at that point. If the deduction cannot be utilized in that year, it could be added to a loss carryover (unlimited in time) for offsetting income in a subsequent year. As a result, the taxpayer would not be taxed on gain (looking at the years in the aggregate) until the loss had been deducted. If such deductions or additions to loss carryovers were allowed, then recoveries clearly would be taxable. Theoretically, it is the loss that should be deductible rather than the recovery that should be excludable. *See* Note, *Loss Carryover Provisions*, *supra* note 119, at 1419-20.

By excluding recoveries on the basis of a prior nondeductible loss, the system discriminates against taxpayers who suffer the loss but do not enjoy the recovery. Clearly they have less ability to consume than those who suffer the loss but then recover some amount, even though both groups of taxpayers are taxed in the same manner. Equity is, however, achieved between those groups of taxpayers who suffer the loss and recover and those who never suffered the loss at all. If the recovery were taxed, those who suffered the loss and recovered would be in a *worse* position than if they had never suffered the loss at all.

126. *See, e.g.*, Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956); Ruben v. Commissioner, 97 F.2d 926 (8th Cir. 1938).

127. *See, e.g.*, Darrell, *supra* note 91, at 981; Eustice, *supra* note 77, at 244; Gunn, *The Functional Approach*, *supra* note 14, at 213-14; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153, 1173-75 (1940). *But see* Warren & Sugarman, *supra* note 91, at 1329-33 (discharging indebtedness for amount less than that owed clearly saves money and therefore is gain to the debtor).

128. *See* authorities cited *supra* notes 125-26; *see also* Vukasovich, Inc. v. Commissioner, 790 F.2d 1409 (9th Cir. 1986).

While the judicial authority for this argument is limited, commentators have given examples of debts that could be cancelled without giving rise to gain. Most often cited are obligations to make charitable contributions or to pay a tort liability that are later cancelled or settled at a discount. In these cases, some commentators have stated that the cancellation should not give rise to taxable gain, but should simply be viewed as reducing the previous nondeductible loss.[129]

Although not fully explained, the recovery of capital theory appears to be the basis of the argument made by United States Steel. United States Steel argued that it received no economic benefit when it issued the debt to its shareholders in redemption of their stock. The only asset United States Steel received in connection with the entire transaction was the cash, $100 per share, originally paid in by its shareholders on the issuance of the preferred stock. Thus, the reduction in United States Steel's net worth upon incurring the debt, at least to the extent the debt exceeded $100 per share, was a loss, although the debt was not deductible when incurred and would not be deductible when paid. Under these circumstances, paying less than promised (although more than $100) simply reduced the overall loss rather than creating any overall gain. Excluding gain in the year of repurchase was the only way to assure that the taxpayer was not overtaxed since the taxpayer realized no net economic gain looking at the years in the aggregate.[130]

The problem with this argument in *United States Steel* is that the argument is based upon viewing the debt to the shareholders as a corporate loss, albeit a nondeductible one. That view of the debt, however, is not consistent with the structure of the double tax. As previously described, corporate income consists of two major components: distributions to shareholders and changes in net worth.[131] While the distribution of a note to shareholders reduces the firm's net asset value, it is not a corporate loss.[132] Instead, it is fully includable in

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129. *See* authorities cited *supra* note 126.

If the liability that is cancelled would have been deductible when paid (such as most debts to charities), the exclusion of any gain from cancellation of the debt is justified on accounting principles. Thus, the cancellation benefits the debtor by removing her payment obligation but it also deprives her of the deduction to the same extent. Any gain from the cancellation would have to be offset by the deduction she would have obtained, so that she would realize no tax consequences. This result is codified in I.R.C. § 108(e)(2).

130. *See* the argument as put forth by United States Steel in Appellant's Brief at 19-27 and as summarized by the Claims Court. United States Steel Corp. v. United States, 11 Cl. Ct. 375, 378 n.12 (1986).

131. *See supra* text accompanying notes 63-66.

132. Under the theory that corporate income is defined with reference to gain to its shareholders as described at the text accompanying notes 63-65, *supra*, a loss to the corporation

corporate income, and the corporation must be deemed to have realized economic benefit to the full extent of the value of the note distributed. Accordingly, a subsequent recovery of a portion of that debt results in the taxpayer paying less than full value for the economic benefit previously received. The difference between the economic benefit and the amount paid must be taxed as a gain.

Again, the analogy between an individual's expenses for consumption and a corporation's distributions to shareholders serves as an illustration.[133] An expense for consumption reduces an individual taxpayer's net assets and yet, since it is fully includable in the income computation, is not regarded as a loss. A subsequent recovery of that amount should be taxed as an economic gain, assuming that the taxpayer received full value from the original amounts spent. The theory of recovery of capital, or the exclusion of gain as a reduction of a prior loss, would be rejected in this case, just as it should be rejected under facts such as those in *United States Steel.*

IV. CONCLUSION

The court in *United States Steel* was misled by the taxpayer's emphasis on an increase in assets as the sole determinant of gain from the cancellation of debt. That conclusion is incorrect for corporate taxpayers who may borrow to make distributions to shareholders, whether the borrowing is from third party creditors or from the shareholders themselves. In either case, the repurchase of a debt at a discount from its initial value should result in taxable gain. Otherwise, gain to the shareholders, represented by the appreciation in the value of the debt, will remain untaxed at the corporate level, and the prior distribution to shareholders effectively will be deductible to the corporation. Both results are clearly inconsistent with the structure of double taxation.

With the current prices of junk bonds encouraging issuer repurchases, the decision in *United States Steel* will have an increasing impact on tax revenue. Under the holding of that case, corporate debtors will not recognize gain on the repurchase of notes issued to shareholders in redemption of their stock except in the unusual case where the cash paid on repurchase is less than the amount originally received for the stock. Corporate debtors will never recognize gain on the repurchase of notes originally distributed as dividends.

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should represent a reduction in the amounts available for future distribution to the shareholders. Clearly, a distribution to shareholders cannot qualify as a corporate loss under this definition.

133. *See supra* text accompanying notes 67-69.

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Not only are these results inconsistent with the theoretical framework of the Code, but they produce unnecessary distinctions between corporations that choose to borrow from third parties to achieve redemptions or dividends and those that borrow from shareholders to achieve the same result. The next court faced with the question should reject the Federal Circuit Court of Appeals' decision in *United States Steel*. Hopefully, that court will recognize that the revenue loss produced by that decision is unwarranted. Both theoretical consistency in the tax laws and a coherent definition of the corporate tax base argue in favor of a different conclusion: that a corporation that repurchases its own bonds at a discount should realize gain to the extent of the discount, regardless of whether the bonds were issued to third party creditors or directly to shareholders.

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