Federal Taxation: Tax Problems in Debt Cancellation

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The income tax problems arising from debt cancellation will confront every lawyer who is called on to aid in the reorganization of businesses in poor financial circumstances. If past history is any criterion, it is most likely that in the next five to ten years a considerable number of small business enterprises will find themselves in need of financial reorganization. The purpose of this comment is to point to some of the tax problems involved in debt cancellation and to some of the methods of avoiding tax liability for forgiveness of debts. It is the thought of the writer that in nine instances out of ten, a debt cancellation program, properly planned, can be carried into effect without incurring income tax liability. The major problem in this field is the very practical one of securing the consent of creditors to cancel one's debts.

The law of debt cancellation is largely decisional and has been developed in the cases interpreting Sec. 22(a), Internal Revenue Code. The statutes dealing directly with the problem affect a limited number of taxpayers only and for the most part merely postpone tax liability through an adjustment on basis.²

The principle that cancellation of indebtedness results in income to the debtor was established in United States v. Kirby Lumber Co.³ That case held that when liabilities are reduced without a corresponding reduction in assets, income is realized, the theory being that the assets of the debtor are freed from liabilities to the extent of the reduction and that this is equivalent to a receipt of cash or property. Under this theory if A corporation with outstanding interest bearing bonds purchased its bonds on the open market for less than par, income would be realized to the extent of the difference between par and the redemption price.⁴

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¹ On this subject generally see: Sec. 11.9 through Sec. 11.28 and Sec. 6.10, Mertens, Law of Federal Income Taxation (1942); Chap. 7, McGill, Taxable Income, Rev. Ed., (1945); Annotation, 87 L. Ed. 792 (1943); 53 Harv. L. Rev. 977 (1940); 49 Yale L. J. 1153 (1940); 40 Col. L. Rev. 1326 (1940); 41 Col. L. Rev. 61 (1941); 13 Ford. L. Rev. 145 (1944); and 24 Tax Magazine 875 (1946).
² Sec. 22 (b) (9) and 22 (b) (10), Int. Rev. Code (1939) as amended; Sec. 29.22 (b) (9) (1), 29.22 (b) (9) (2) and 29.22 (b) (10) (1), Reg. 111, Int. Rev. Code (1939) as amended; Chap. X, XI, XII, and XIII of the Bankruptcy Act, Title 11 U. S. C. (1943) as amended.
³ 284 U. S. 1, 76 L. Ed. 131 (1931).
⁴ This theory, however, does not include cases where the debtor is insolvent after his debts are cancelled nor where the liability is not the personal liability of the debtor, nor where the debt is only contingent, nor cases of a mere promise to cancel debts—the cancellation must be a present one. An interesting point brought up by way of dicta in D. Bruce Forrester, 4 T. C. 907 (1945), is that no income is realized when a non-interest bearing obligation due in the future is settled for its present discount value. The statement seems to be quite sound, but no cases passing directly on this point have been found.
The cases indicate at least three distinct theories or doctrines that have developed as exceptions to the Kirby doctrine. They can be best illustrated by examples.6

(1) Kerbaugh theory: Money or property is acquired and in consideration therefor a debt is incurred. The money or property is lost in a business operation, and the debt is later settled for less than its nominal value. No income is realized when the loss that resulted from the disposition of the property or money originally received is greater than the gain resulting from the settlement of the debt, the reason being that the transaction viewed as a whole resulted in a loss.6 The essential element of this theory is a completed transaction in which the money or property originally received is disposed of at a loss that is greater than the amount of gain realized from the debt settlement.7 The application of this theory involves the practical problem of proving that the money or property originally received has actually been lost or dissipated. The problem is similar to that involved in tracing the res in constructive trust cases.

(2) Hirsch theory: Property is purchased and part of the purchase price is represented by a debt as is the case when property is purchased and a note and mortgage is given for part of the purchase price. The property subsequently depreciates to a value below the amount of the outstanding debt. While the property is still held, the debt is settled for less than its face amount. No income is realized from such a transaction, the reduction of the debt being regarded as a reduction in the purchase price of the property. The important ele-

6 The theories will be referred to by the names of the cases from which they were developed. The Kerbaugh theory was developed from Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 70 L. Ed. 886 (1926); the Hirsch theory from Hirsch v. Commissioner, 115 F. (2d) 656 (1940); and the Dental Co. theory from Helvering v. American Dental Co., 318 U. S. 322, 87 L. Ed. 785 (1943).

6 This theory has been criticized severely. One ground of criticism is that the transaction "viewed as a whole" actually consisted of several transactions. The Kerbaugh case has never been expressly overruled, but some writers argue that the Kirby case and Burnett v. Sanford and Brooks Co., 282 U. S. 359, 75 L. Ed. 383 (1931) have impliedly overruled the case. The argument is that the Kirby case held that income may be realized when debts are settled for less than face value and the Sanford case held that losses incurred in prior tax years could not be used to offset income received in a later year. In the Sanford case the income or gain resulted from actual receipt of cash while in the Kerbaugh case the gain and alleged income resulted from a cancellation of indebtedness. It is the opinion of the writer that the difference in the nature of the gains in the two cases justifies an exception to the taxable year concept in the case of gain realized from debt cancellation. No case has been discovered by the writer wherein the Kerbaugh doctrine was rejected, and as late as 1945 the Kerbaugh doctrine was applied, Wm. H. Coverdale, T. C. Memo. Op., Dkt. 3981 (June 28, 1945).

7 Commissioner v. Coastwise Transportation Co., 71 F. (2d) 104 (1944); Frank v. U. S., 44 F. Supp. 729 (1942). These cases point out that if the transaction is not completed (as if the property originally received were still held), a subsequent sale of the property might result in a gain rather than a loss.
ments are that 1. the debtor and creditor deal personally, 2. in reference to purchase money obligations, 3. on property still held by the debtor, and 4. the property at the time of the cancellation has depreciated to a value less than the amount of the outstanding debt.

The fourth element of the Hirsch doctrine is the one most likely to be the subject of controversy. One line of cases holds that the cancellation of the debt will result in income when the value of the property at the time of the cancellation is greater than the amount of the outstanding debt even though the property originally purchased has depreciated in value more than the amount of gain realized from the cancellation. The Tax Court has stated that the Hirsch case is applicable only when the amount of the debt after cancellation is equal to or greater than the value of the property. It would seem the test should be to compare the amount of the debt and the value of the property before the cancellation takes place. When the value of the property at that time is less than the amount of the debt, the Hirsch rule should be applicable but only if and to the extent that the loss resulting from the depreciation of the property exceeds the gain realized from the reduction of the debt.

(3) Dental Co. theory: The debtor by personal negotiations with his creditors succeeds in obtaining a reduction of his debts; the creditors in forgiving the debts act freely and voluntarily and receive no consideration for the cancellation. No income is realized—the debt cancellation being regarded as a gift from the creditor to the debtor. The fact that the creditor may have acted for selfish reasons (such as hopes of future business with the debtor) does not prevent the cancellation from being a gift. The selfish interest of the creditor will be

8 Fifth Avenue-14th Street Corp. v. Commissioner, 147 F. (2d) 453 (1944).
9 In Frank v. U. S., 44 F. Supp. 729 (1942), the Hirsch doctrine was said not to be applicable when the cancelled indebtedness was not one incurred in the purchase of the property. The cases, however, have been quite liberal in interpreting the purchase money concept needed to apply the Hirsch doctrine. See Hirsch v. Commissioner, 115 F. (2d) 656 (1940); Allen v. Courts, 127 F. (2d) 127 (1942).
10 If the property is not held by the debtor, the case clearly falls within the Kerbaugh doctrine.
13 As pointed out in 13 Ford. L. Rev. 145 (1944).
14 This conclusion was reached after comparing the relation between the value of the debt and the property in the Coastwise, Hirsch and later cases. It may be illustrated as follows: A buys real estate for $20,000, giving a note and mortgage for $18,000 and paying $2,000 in cash. The property depreciates until it is worth $17,000. A then effects a settlement of his note and mortgage with a cash payment of $14,000. A realizes $1,000 in taxable income. The gain from the settlement was $4,000, while the loss suffered from depreciation was only $3,000. The Hirsch rule applies because the debt was greater than the value of the property at the time of the settlement, but the rule is only applicable to the extent of the loss resulting from the depreciation.
considered as the creditor's motive for cancelling the debt rather than an indication of the absence of a donative intent. The important elements are: 1. Non-arms length or personal dealing between debtor and creditor,\textsuperscript{15} 2. a voluntary act on the part of the creditor in forgiving the debt,\textsuperscript{16} and 3. an absence of consideration for the cancellation. When these elements are found the donative intent needed for a gift will also be found.

The case of \textit{Reliable Incubator and Brooder Co.},\textsuperscript{17} indicates that the third element considered above means the common law concept of consideration. However, in several cases where consideration sufficient to support a simple contract moved from the debtor to the creditor, the \textit{Dental Co.} doctrine was held applicable.\textsuperscript{18} In \textit{McConway and Torley Corp.},\textsuperscript{19} it was held the consideration must move from the debtor to the creditor in order to prevent application of the \textit{Dental Co.} doctrine.\textsuperscript{20} This case taken together with those cited in footnote \textsuperscript{18} suggests a possibility that a debtor may secure a composition agreement among his creditors that will give him an enforceable contract for the cancellation of part or all of his debts without giving rise to income tax liability because of the cancellation. The debtor would in such instance urge that the consideration for the contract moved from one creditor to the other and not from the debtor.\textsuperscript{21} The \textit{McConway} case clearly holds

\textsuperscript{15} In Lewis F. Jacobson, 6 T. C. 1048 (1946), the debtor retired bonds at less than par. Some of the bonds were purchased from creditors after personal negotiation between the debtor and the creditor, and some were purchased through security dealers. The \textit{Dental Co.} doctrine was held to apply to the first class of purchases and no income was realized, while it was held income was realized in the second type of purchase because the debtor and creditor did not deal personally.

\textsuperscript{16} In F. W. Leadbetter, T. C. Memo. Op., Dkt. 110, 258-9 (Aug. 13, 1943), the \textit{Dental Co.} case was held not applicable because the debtor owned all the stock in and controlled the creditor corporation, hence the forgiveness was not voluntary.

\textsuperscript{17} 6 T. C. 919 (1946), where income was held to have been realized when the debtor received a $1,200 credit on his debt by paying $600 before the due date for payment. The \textit{Dental Co.} doctrine was said to be inapplicable because there was consideration for the cancellation, the debt was paid before the due date.

\textsuperscript{18} Shellabarger Grain Products Co., 2 T. C. 75 (1943), where a note was settled for less than its face value in a transaction in which the creditor required the debtor as part of the agreement to pay another note owed to another bank. In \textit{National Ice and Cold Storage Co.}, of Calif., T. C. Memo. Op., Dkt. 7318 (Jan. 31, 1947), the debt was forgiven in a transaction wherein the debtor purchased some additional property from the creditor.

\textsuperscript{19} 2 T. C. 593 (1943).

\textsuperscript{20} Contrary to the common law concept of consideration. See Restatement of Contracts, Sec. 75 (2).

\textsuperscript{21} In 1. Williston on Contracts, Sec. 126, page 433 (1936), it is stated that the consideration usually bargained for in composition agreements is the promise of each creditor to forego a portion of his claim and the forbearance (or promise thereof) by the debtor to pay the assenting creditors more than equal portions. In view of the holdings of the two decisions cited in footnote (18) it is possible that the courts might not consider the promise of the debtor to forbear payment to the other assenting creditors to be such consideration moving from him as would prevent application of the \textit{Dental Co.} doctrine.
that when debts are cancelled as a result of a contract between the creditor and a third party wherein the debtor is a donee beneficiary, the element of consideration which prevents application of the Dental Co. doctrine will not be found.\textsuperscript{22}

When a debt is settled by transferring property or other consideration of uncertain value to the creditor, it is difficult to determine whether the transaction is one involving nothing more than a sale or other disposition of property\textsuperscript{23} or whether there is a cancellation of the debt. There is no problem when part of a debt is paid in cash and part is forgiven. The part of the debt that is forgiven will be treated as income or not depending on whether the transaction falls within one of the theories outlined above. The problem arises when property or other consideration transferred to the creditor is of such a nature that it is difficult to place a value on it. The cases suggest that if the parties deal with the property as having a particular value and the value is a reasonable one, the excess of the cancelled debt over the agreed value of the property will be treated like other debt cancellations.\textsuperscript{24}

In outlining a business reorganization, it is well to keep in mind the rule that the burden of proof lies with the taxpayer to overcome the presumption of correctness given to the Commissioner's assessment of a deficiency. At least one Tax Court memorandum opinion\textsuperscript{25} has held for the Commissioner when the taxpayer failed to produce evidence to prove that the cancellation of his debt came within the Dental Co. doctrine.

In summary, the three main theories that will be of aid in planning financial reorganizations are, as pointed out above: the Dental Co. theory which requires, (1) non-arms' length negotiation, (2) a voluntary act of cancellation by the creditor, and (3) the absence of consideration moving from the debtor to the creditor; the Hirsch doctrine which requires (1) that there be non-arms' length dealings between debtor and creditor, (2) in reference to purchase money obligation, (3) on property still held by the debtor and (4) that the property at the time of the cancellation have depreciated to a value less than the amount of the existing indebtedness; and the Kerbaugh doctrine which requires a completed transaction wherein the property or money acquired by

\textsuperscript{22} Another important feature of Helvering v. American Dental Co., 318 U. S. 322, 87 L. Ed. 785 (1943), is its rejection of the tax benefit theory as far as debt cancellation is concerned. Under this theory where a deduction had been taken in respect of a debt, income was realized, to the extent of the deduction formerly taken, when the debt was cancelled.

\textsuperscript{23} In which instance the debtor would be charged with income even though he be insolvent.

\textsuperscript{24} See Commissioner v. Sherman, 135 F. (2d) 68 (1943); Nutter v. Commissioner, 7 T. C. 480 (1946). For cases holding a sale or exchange took place, see R. O'Dell and Sons v. Commissioner 8 T. C. 1165 (1947), and cases cited therein.

\textsuperscript{25} Elizabeth Operating Corp., T. C. Memo. Op., Dkt. 112, 709 (Sept. 23, 1943).
virtue of the incurrence of the debt is disposed of. This transaction
must result in a loss that exceeds the gain from the debt cancellation.
The doctrine of the Dental Co. case will cover most instances where a
debt cancellation takes place, but the Hirsch doctrine\textsuperscript{26} may be useful
when the cancelled debt is a purchase money obligation and cancella-
tion is not the voluntary act of the creditor or there is consideration for
the cancellation. The Kerbaugh doctrine will continue to be applicable
in instances of completed transactions—whether the parties deal at
arms length or not.

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\textsuperscript{26} The Hirsch doctrine does not carry the dignity of having arisen out of a case
decided by the Supreme Court. It has been commented on with disfavor in
some U. S. Circuit Courts, but the theory received the tacit approval of the
Supreme Court in Helvering v. American Dental Co., 318 U. S. 322, 87 L. Ed.
785 (1943).