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CANCELLATION OF DEBT AND OTHER INCIDENTAL ITEMS OF INCOME: PURITAN TAX RULES IN THE U.S.

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I. INTRODUCTION

We are all either Platonists or Aristotelians, as the saying goes, but it would be difficult to find any Aristotelian tax professors in the United States. Our received doctrines regarding income are purely Platonist. Income is one single idea, and this idea is termed comprehensive taxation or the (Schantz-) Haig-Simons definition of income as the algebraic sum of the taxpayer's consumption and savings for the year.[1] All taxpayers who enjoy income conferring equal economic power must be taxed equally, because a dollar is a dollar, however acquired. To leave any dollar untaxed, or taxed at a favorable rate, would violate the principle of equality termed "horizontal equity."

This article examines some miscellaneous and incidental forms of income from a comparative point of view. It appears that U.S. law includes as income more types of incidental items than most other countries. The items considered here are (in no particular order) found money and property, gambling gains, gains from a personal hobby, isolated criminal profits, prizes and awards, damages, and gains from sale of personal-use property, especially personal residences. The article concludes with an in-depth examination of income from the cancellation or forgiveness of debts ("COD" income). These items have in common, for the most part, the fact that they are not usually associated with recurrent business and investment, which are at the heart of the income tax, but rather with transactions of private life.

Other examples of questionable taxes might be adduced, but the general picture seems clear enough: in the United States, in contrast to the tax systems of most other countries that seem more

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1. *See generally* HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938).

practical and realistic, all economic benefit of any kind is taxable at least in principle, even if enforcement is impractical or even impossible. In some cases the U.S. rules overshoot the mark altogether, and result in taxation even where there is no gain at all.

Americans are often stereotyped as idealistic (or more negatively, as moralistic), and it is true that we often idolize principle over practicality. Attempts to legislate morality form a significant part of our legal tradition, and laws that are purely aspirational in nature still reflect a continuing legacy of our Puritan past. Such legislation runs the gamut from the laughable, like our many state laws that forbid deviant sex even between husband and wife, to the disastrous, like our constitutional prohibition of alcohol in the 1920's.

No part of our legal system is completely free of these Puritan tendencies, and this includes tax law. One might almost say that just as the government has a "zero tolerance" for illegal drugs, it also has zero tolerance for untaxed income, and with a similar degree of success. In most of the examples of incidental income I have chosen, there is little or no revenue at stake, and it is precisely because so little is at stake that these examples can be so instructive about our legal culture.

II. Sources of Law

Congress itself seems to have embraced the unitary or global approach to income. The Internal Revenue Code ("IRC" or "Code") section 61(a) defines "gross income" with breathtaking circularity: it is "all income from whatever source derived." The provision goes on to provide fifteen examples, such as compensation for services, gross income from business, gains from dealings in property, interest, rents, and so forth, but the Code is careful to point out that these are only examples, and that the circular definition is not limited to the categories enumerated. Income is both global and open-textured.

The courts have occasionally attempted to clarify the statutory definition of income. The most recent attempt by the Supreme Court is widely admired and quoted for its comprehensiveness: income is "any accession to wealth, clearly realized, over which the taxpayer has dominion."[2] The *Glenshaw Glass* Court devised this ringing phrase to replace an earlier Supreme Court definition of income as the "gain from labor, or capital, or both combined,"[3] which it erroneously thought was not broad enough to encompass as taxable income a "windfall" gain of punitive damages. The older definition was perfectly adequate, however, because to obtain the reward of treble damages under the antitrust law the taxpayer must risk time and money — *viz.* labor and capital — to *earn* it in a lawsuit. These risks include not only the actual expenses of bringing and pursuing legal action, but also the possibility of ruinous retaliation by powerful competitors. Thus, the treble damages *sub judice* did not fall from heaven without action by the taxpayer, and can hardly be likened to finding money in the back seat of a taxicab. The Supreme Court's ringing definition in *Glenshaw Glass* is no more than dictum, but it has been widely cited and approved as supporting the widest possible conception of taxable income, as for example in the very first case to be examined here, that of found money or property.

III. Incidental Items of Income

A. *Found Money or Property*

On the somewhat dubious authority of *Glenshaw Glass* that "windfalls" are taxable, the U.S. Treasury Department ("Treasury") promulgated regulations that require taxpayers to include as income the fair market value of "treasure trove," meaning found property or money.[4] The rule is impeccable from the point of view of Haig-Simons; however, it suffers several disadvantages in the practical world, which is probably why no other country I know of has such a rule. In the first place, there is no practical method of enforcement. Withholding is of course impossible, and so is information reporting. In addition, even if the found property does come to the IRS's attention, there may be difficult problems of valu-

2. *See* Glenshaw Glass Co. v. Commissioner, 348 U.S. 426 (1955) (holding that treble or punitive damages awarded under antitrust law are taxable).

3. *See* Eisner v. Macomber, 252 U.S. 189 (1920) (holding stock dividend nontaxable; income includes only realized gains from capital, from labor, or from both combined).

4. *See* Treas. Reg. § 1.61-14 (as amended in 1993).

ation. The government has never actually attempted to apply the treasure-trove rule in the many situations that inevitably do come to its attention (although these are probably all in a *business* context), such as successful prospecting for gold or oil, or sunken Spanish galleons, and instead has always waited until the found property has been sold for cash before imposing any tax.[5]

In most cases taxpayers will not report a windfall find even of spendable cash, and therefore the desired goal of horizontal equality with other forms of taxable gain cannot be met. A second, deeper problem lies in the fact that a taxpayer who loses property or money is of course not permitted a deduction, which would be an open invitation to fraud. Our tax theorists seem to respect the dollar-is-a-dollar-regardless-of-source principle only on the upside. Diversity is the rule for losses, and in this venue, all our theorists are Aristotelians. Thus, if the taxpayer loses $10 of his own money and finds $10 interleaved in the pages of an old book, he is (in principle) taxed notwithstanding the fact that his economic position is unchanged. Equal tax treatment of earners and finders is impossible to achieve, but equality between finders and losers is both possible and fair. In my view, the tax system should probably ignore found property altogether.

B. Gambling

Most countries seem to remove gambling gains and losses from the tax system, but not the United States. All gambling gains are taxable in the United States; gambling losses, however, are deductible only as an offset to gambling gains for the same taxable year under IRC section 165(d), so that excess gambling losses may not be deducted to shelter any other kind of income. This treatment of gambling gains and losses suffers from several of the problems

5. This fact has been noted by the authors of a recent article, who point out that the treasure-trove rule has been applied only in one reported case that involved outdated currency found in a piano. With respect to found property, they correctly argue that it should not be taxed, even in principle, because it is similar to a bargain purchase. If a taxpayer is fortunate enough to buy property for less than its value, he is not taxed until his gain is realized by sale. The authors conclude that the rule should be limited to found money. I am not sure that even this limited conclusion is reasonable. *See* Lawrence A. Zelenak & Martin J. McMahon Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299 (1999).

noted above in connection with found (and lost) property. Gains from private gambling will generally not be reported, nor will most small gains even at public gambling establishments. Only a few reporting requirements are imposed on casinos and racetracks for very large winnings from a single bet, but reporting is generally not required and is not feasible for the vast majority of gains and losses.

It might be argued that, except in rare and unusual circumstances, the United States taxes gambling gains only in appearance. It seems fair to say most gamblers lose, and because net gambling losses are not deductible for tax purposes, they are in effect outside the tax system. For this reason, most winnings in the United States are not taxable, whether *de facto* because they are not reported, or *de jure* because the losses of most taxpayers will outweigh their gains, or some combination of the two. The rare enforcement is of course unfair to those few who must pay tax on a reportable gain and have insufficient losses for the year to offset the gain. But still more unfair is the fact that if these unlucky few gamble over a period of years, they are probably paying taxes on losses rather than gains. This is because the deduction for gambling losses may not be carried forward to future years. Over long periods of time it is very probable that taxpayers who gamble frequently lose more than they gain, and over a lifetime gamblers will nearly always suffer losses. This is especially true for gambling against commercial institutions such as casinos where over time, the odds in favor of the house guarantee gains to the casino, and doom the taxpayer to unavoidable losses.

The problem is still worse with government lotteries. Most lotteries give little chance to the ticket buyer because they pay out as winnings hardly more than 60% of what they receive in ticket sales. State lotteries are therefore already in effect very high taxes on the poor who can least afford it, and so taxing lottery winnings again as "income" seems excessive. At the very least, a taxpayer ought to be able to use his lifetime store of losing tickets and other bets to offset the one-time "lucky" gain, but this is not permitted.

It would be simpler and fairer to ignore gambling gains and losses altogether, as most other countries do. The logical and effective way to tax gambling is to tax the business profits of commercial casinos.

C. Hobby Gains

Hobbies that are not managed primarily as a business for profit do occasionally produce gains, and such gains are fully taxable in the United States at least in principle, but are ignored for tax purposes in many other countries, for example in France,[6] Germany,[7] and the United Kingdom.[8] Collectors of coins, stamps, antique cars, or racehorses may occasionally sell some item at a profit or win something at a race, and amateur chess or card players may win money or prizes in competition, and so forth. All such gains are taxable in the United States.

Here again, however, the U.S. system of comprehensive taxation is something less than it might appear at first look. Deductions are allowed for the cost of earning hobby gains from a particular activity, but not in excess of gains from that same activity under IRC section 183(b), in almost exactly the same fashion as gambling losses are deductible.[9] The costs of earning hobby gains from a given activity each year are almost by necessity greater than the profits from that activity, because if profits exceed losses on a regular basis, the activity will usually be treated as a business rather than as a hobby. Thus, unless a hobby gain is both extraordinary in amount as well as non-periodic in nature, it will probably not be taxed because of the offsetting associated costs. Finally, it may be noted that here too, as for treasure-trove and for gambling, the administrative impossibility of imposing third-party reporting makes actual tax collection a matter almost entirely dependent upon taxpayer honesty and goodwill. German law, no doubt for these reasons, treats hobby gains as generally tax-exempt, and (realistically, in my view) treats gambling winnings as a form of tax-exempt hobby gain.

6. *See* C. David et al., Les Grands Arrêts de la Jurisprudence Fiscale 210-11 (3rd ed. 2000).

7. Interview with Professor Manfred Moessner (Osnabrueck).

8. Interview with Professor David Southern.

9. Except that gambling gains and losses from all sources are lumped together, whereas hobby gains and losses are kept separate for each hobby.

D. Criminal Profits

As in most other countries, the profits from illegal activities are taxable in the United States, whether the activity is a regular and ongoing business, or merely an incidental or one-time event. There is money in crime, of course, but most criminals are unlikely to report their gains for fear of apprehension and punishment. The standard rationale for taxability is that it would be unfair to impose taxes on honest and law-abiding businessmen while exempting criminals. This is reasonable enough, but it could be countered simply by increasing criminal fines and penalties.

One problem with the taxation of stolen or embezzled money is that it can often result in taxation without gain. If the apprehended embezzler does not have enough money both to repay the rightful owner and to pay the IRS, who should win? Sometimes the IRS wins, if the money in the embezzler's possession cannot be traced directly back to the crime. If the embezzler does pay both, he is in principle entitled to an offsetting deduction for taxes paid on money he did not keep. If the repayment is in a later year, however, the deduction may be inadequate or even worthless if the embezzler does not have enough income to take full advantage of the deduction. In such situations the result is taxable income without gain.

Perhaps the most serious problem in taxing criminal enterprise is the political risk that the revenue administration will be pressured into enlistment in the War against Drugs and lose track of its primary function of collecting revenue. Already more than 60% of the criminal investigation division of the IRS now works in the area of drug enforcement, despite estimates that less than 10% of the revenue lost from criminal tax evasion is due to illegal business, and more than 90% is tax cheating in legitimate legal businesses. The tax authorities are of course not really trying to enforce the tax laws against drug traffickers and to collect revenue from them; that is only a pretext to put them out of business. If the government really wanted tax revenues from drugs, it would legalize them and collect taxes as it does from alcohol and tobacco.

E. Prizes and Awards

Until the 1986 Tax Reform Act, the United States, like most other countries, excluded from income tax prizes awarded for achievement in the arts and sciences, such as the Nobel Prize. Such prizes are fully taxable now, as if their former exclusion was a sort of loophole, rather than an additional reward for services benefiting the public. This stands in curious contrast with the doctrine of public policy that forbids deduction of otherwise legitimate business expenses under IRC section 162(f) if they are also fines, such as a trucking company's payment of speeding tickets.[10] The received rationale for disallowing the deduction is that it takes some of the sting out of the punishment. This is true, but it is equally true that taxing a prize for merit takes some of the pleasure out of the honor.

F. Damages for Personal Injury

Damages for personal injuries have always been exempt from tax on the theory that they are not gains, they are merely a monetary substitute for some loss, such as lost health or reputation or peace of mind, and so akin to a return of capital. Congress amended the Code in 1986 to narrow this exemption. Under current law, only damages awarded for physical injuries are exempt. Damages are now taxable for all non-physical injuries, including emotional distress, defamation, sexual harassment, and sex or age discrimination. This was a step in the wrong direction. The justification for allowing awards of compensatory damages for moral injury is just the same for physical injury, namely a replacement of what has been lost. A replacement of what has been lost is by its nature not a gain, but an attempt to return the victim to his *status quo ante*. Thus, all such indemnities should be tax exempt, as they are for example in France,[11] except where the loss has already been deducted, or where what has been lost would itself have been taxable (e.g., an award of back pay).

10. *See* Commissioner v. Tellier, 383 U.S. 687 (1966).
11. Interview with Professor Daniel Gutmann.

G. Personal-Use Property and Residential Housing

In the United States, gains from the sale of personal-use property are in principle all taxable, but losses are completely forbidden. This is therefore not a system of quarantining losses so that they are only deductible against income of the same category, like our restrictions on capital losses, or on the gambling and hobby losses discussed above, but rather an absolute and one-sided prohibition like that for lost and found property. On the other hand, except in the case of personal residences, there is little likelihood of any profit in the first place. It would be rare to make a gain from the sale of a used car, books, or clothes. It is only in the case of collectible items such as antique furniture that taxpayers stand any chance of making gains, and if a taxpayer does so more than occasionally, he is likely to be regarded as engaged in a taxable business. Moreover, there is no way for the IRS to monitor the occasional private sale of personal-use property. Thus, the tax is more theoretical than real.

By contrast, large gains are possible in the case of sales of a personal residence, even if such sales are relatively infrequent in the life of any given taxpayer. As with other kinds of personal-use property, a deduction for losses is prohibited. Gains are taxable in principle, but exceptions nearly swallow up the rule. Like most countries, the United States has rules that limit or eliminate taxes on capital gains from the sale of a taxpayer's principal residence. In 1997 these rules were significantly narrowed to limit the exclusion to a maximum of $500,000 of gain for a married couple and to $250,000 for an individual. In addition, some bright-line time requirements were added under the new IRC section 121: the taxpayer must not use the exclusion more than once in a two-year period, and he must have both owned the residence and lived in it as his principal residence for two years out of the five years preceding the sale. Failure to meet any of the two-year requirements results in the complete loss of the tax exemption, unless the taxpayer can show that the failure was due to health or employment reasons, or to unforeseen circumstances. In the event the taxpayer can show one of these exculpatory reasons, his exemption limit is nevertheless reduced proportionately.[12] The exemption applies only to one principal residence and not to secondary residences, as in France.

The dollar limits create some geographic injustice. Housing is far more expensive on the East and West coasts than in less urban areas of the United States, and this unfortunately works to the disadvantage of taxpayers who live in the more expensive areas.[13] It would be far more desirable to have a simple rule, as most countries do, that exempts gain from the sale of a private residence altogether.

Finally, it should be pointed out that any taxation of housing gains seems inherently unfair because housing losses are strictly nondeductible. The rationale for disallowing such losses is that housing is a personal expense or "consumption." This classification seems doubtful, however, because no one would buy a home if he expected to consume its value or to suffer a loss. He would rent instead. The purchase of a home is for most taxpayers their largest single investment. Considered as an investment, a deduction for losses on sale of a home should probably be allowed, at least where the loss is due to market forces and not to failure to maintain the property. Any loss from the sale of land under the house, as opposed to the house itself, is always due to market forces, and therefore should be allowed as a deduction like any other capital loss. As long as a deduction for losses is disallowed, fairness suggests that the exemption for gains should be unlimited. Under current law, if a taxpayer suffers a loss from the sale of one residence, and enjoys a gain on the sale of the next, he may be taxed on the gain, but ob-

12. For example, if a taxpayer's employment forces him to move after owning his residence only one year, which is half the required period of time, his $250,000 exclusion limit is also reduced by half, to $125,000. This seems to me unjustified. If the purpose of the two-year rules is to establish (i) that the residence in question really does serve as the taxpayer's home, and (ii) that the taxpayer is not engaged in a recurrent business of fixing up and reselling houses, it should follow that a showing of health or work necessity ought to preserve the exemption in its entirety, as it would, for example, in France. The current rules seem to elevate what are after all mere indicia of eligibility into ends in themselves.

13. This is part, but an unnecessary part, of a pervasive pattern of geographic unfairness in a progressive tax system. Generally, where prices and wages are high, taxpayers must pay a higher proportion of tax on income of the same purchasing power.

tains no offsetting relief from the loss. Taken together, the system produces taxable income without economic gain.

IV. Cancellation of Indebtedness

A. General

An American tax lawyer would be very surprised to see income from cancellation or discharge of indebtedness ("COD" income) classified as a form of incidental gain, and even more surprised to learn that most other countries do not tax COD income at all, at least for individuals. In American jurisprudence, COD income is regarded as a fundamental form of gain, and in U.S. casebooks and reference works the subject generally occupies a large and very complex chapter of its own.

The general rule is stated with disarming simplicity at IRC section 61(a)(12), which since 1954 simply adds to the list of examples of gross income "discharge of indebtedness." The item is not otherwise defined. The government had maintained that COD was taxable income as early as its 1918 regulations, but it was not upheld in the courts until the 1931 Supreme Court decision in *U.S. v. Kirby Lumber*,[14] where the taxpayer made a profit from repurchase of its own bonds on the open market at a discount. Before *Kirby Lumber*, the courts had consistently held that COD was not taxable, because under the doctrine of *Eisner v. Macomber*,[15] it provided no realized gain in the form of money or property. The taxpayer merely obtained a reduced cost in its assets, without any additional liquidity with which to pay tax. There is much to say in favor of this early doctrine of no-realization, both from the point of view of theory and of practice.

Oddly enough, *Kirby Lumber*, which is always cited as the foundation of COD income, said not a single word about cancellation of debts, and imposed tax only because the taxpayer had realized a "clear gain." Indeed it had, but its gain had nothing to do with cancellation of debt. All the gain was due solely to the fact that it made a profit in the securities market from a transaction resembling a short sale. That Kirby Lumber's bonds were cancelled after-

14. 284 U.S. 1 (1931).
15. 252 U.S. 189 (1920).

wards was purely incidental to its gain, and due solely to a rule of corporate law that does not permit a corporation to owe itself money. If the taxpayer could have kept its bonds alive for later resale like treasury stock, it would have enjoyed exactly the same gain. Despite the fact that cancellation of the bonds was not the cause of the gain in *Kirby Lumber*, the tax bar seems to have accepted without murmur the government's exaggerated if not unwarranted interpretation of the decision: that the cancellation of a debt produces taxable income.

B. Problems with Treating COD as Income

1. Theoretical

The standard explanation today for taxing COD income is based upon the fact that the proceeds of a loan are tax exempt because of the assumption that the loan will be repaid; if the assumption proves false when a debt is cancelled, the exemption should no longer apply, and the loan proceeds should be taxed *nunc pro tunc* to reflect the taxpayer's increase in net worth. The theory is open to attack, as we will see, but it is at the practical level that the tax suffers from its most serious defects. First, most COD creates no liquidity with which to pay tax. And second, so many exceptions are necessary that the rules produce more confusion than revenue.

This "loan proceeds" explanation is not entirely persuasive as a theoretical matter either, because our tax system does not normally tax appreciation in wealth until it is realized by sale or exchange. Also, the loan proceeds theory can at best justify taxing cancellation of loans of money, but not debts of other kinds. Unfortunately, nothing in the Code or regulations limits COD income to loans of money.

For example, Congress clearly intended the cancellation of at least some purchase-money debts to be taxable, because it enacted a provision that treats the reduction of purchase-money debt as a non-taxable (downward) adjustment to the purchase price of property, but only provided that (i) the lender is the same person as the seller, (ii) the property still remains in the hands of the borrower-purchaser, and (iii) the debt still remains in the hands of the seller-lender.[16] These rules seem designed to limit relief to renegotiations regarding the property rather than the debt, but they do not do so effectively, and they are far too restrictive. There are no such restrictions upon a *cash* refund of part of the purchase price, which would always be treated as a tax-free return of capital, and yet a cash refund seems economically indistinguishable. These rules can lead to absurdities. Suppose, for example, that a taxpayer purchases property for $100 using a bank credit card, finds the purchase unsatisfactory, and negotiates a reduction of the debt to $50 with the issuing bank. This $50 reduction would apparently be taxable because the bank is not the seller. And yet if the credit card issuer were a department store that is itself the seller, the identical transaction would be tax-free. Even stranger, if the taxpayer paid the issuing bank the $100 in full, and then made a complaint afterwards and received a $50 refund in cash, the refund would be tax-free.

Neither the Code nor the regulations address the question whether COD is taxable if the debt was incurred for the purchase of services rather than property, and there is apparently no reported case law on the question. In my opinion, all reductions of purchase money debt should be tax-free because the result is a bargain purchase or the creation of unrealized appreciation, neither of which is normally taxable.

There is also an exception for "disputed debts" in the case law. Obviously, if there is doubt whether money was ever borrowed in the first place, or the amount is in question, so is the amount of COD income. But very confusingly, the leading case in this area, *N. Sobel, Inc. v. Commissioner*,[17] had nothing to with a dispute over the amount of the debt. It was actually a case of purchase-price adjustment.[18]

16. *See* I.R.C. § 108(e)(5) (2000).

17. 40 B.T.A. 1263 (1939).

18. The taxpayer had bought stock from the issuer on credit, and when the stock became worthless, the taxpayer demanded rescission of the sale because the stock had not been properly registered. The parties settled by the taxpayer paying half the promised purchase price. The government claimed income tax from the debt reduction, and lost on the ground that the debt was "disputed." Actually the taxpayer had suffered a loss for the amount paid in settlement, not a gain from the cancelled portion of the debt.

The most important statutory exception by far is an exemption for taxpayers whose debts are discharged in bankruptcy or who are insolvent. This is of course the most common reason why creditors forgive debts. Obviously, one cannot squeeze blood from a turnip, and even the government allowed for the insolvency exception as early as its 1918 regulations.[19]

The insolvency exception under IRC section 108(a) does not provide an absolute immunity, however. The insolvent taxpayer must pay a price for his exemption from COD income, *viz.* he must surrender under IRC section 108(b) dollar-for-dollar any tax attributes that might reduce taxes in the future, such as net operating (business) loss carryforwards ("NOLs"), capital loss carryforwards, and basis in assets. This rule applies only to taxpayers who have such tax attributes.

These IRC section 108(b) attribute reduction rules are clearly justified, because a taxpayer who loses borrowed money in a business does not suffer a genuine loss if the debt is cancelled afterwards. The net effect is that the taxpayer has lost the creditor's money rather than his own, and therefore no deduction should be allowed. There is, however, no need to make the appropriate adjustments through the rules for COD income.

In such situations it would be much simpler just to disallow the loss carryforwards to the extent of the debt cancellation, that is to say, to the extent the taxpayer has not actually suffered a loss. Using such a rule, it would be irrelevant whether or not the taxpayer is solvent. In the case of a taxpayer who is solvent, there is no reason to create COD income, but then leave the taxpayer's losses intact — that seems backwards. It would make more sense simply to disallow the related losses instead. Such a rule should only apply in the case of a business or investment debt. There is no cogent reason for individuals to incur COD income or any other adjustments where the cancelled loan is personal in nature and no deductions are at stake.

19. Purists have attacked even this exception, however, on the ground that no other forms of income become tax exempt due to insolvency.

2. Practical Problems

Most debt cancellation is undoubtedly due to insolvency, which produces no revenue. The Treasury evidently became dissatisfied that it collected very little revenue from COD income, at least from individuals. Instead of considering repeal of the rules for taxing COD as essentially fruitless, however, the Treasury decided that the remedy was more enforcement. Since 1996, the Treasury regulations require all lending institutions to report COD of $600 or more. Banks in particular protested that such reporting would cause huge expense for little or no revenue, because most COD is not taxable. The banks won a partial victory. All COD outside of bankruptcy must still be reported, whether taxable or not. If debts are discharged in bankruptcy, however, reporting is required only if the bank is aware that the debts were incurred for business or investment purposes.[20] The new reporting requirement was a giant step in the wrong direction, as will be seen in the *Anderson* case described in the next section. Because most COD is not taxable even outside of bankruptcy, the new reporting rules are likely to cause immense friction for little or no revenue.

The most troublesome of all the exceptions from the point of view of pure confusion has proved to be the cancellation of debts for which the taxpayer received no consideration. One early decision correctly held that cancellation of such a debt should not be taxable.[21] The facts were much like those in *Kirby Lumber,* except the taxpayer's bonds had originally been issued as a dividend rather than in exchange for cash. Nothing was borrowed, and so the repurchase at a price below par did not generate any gain.

Examples of other such situations are abundant, although there is little or no case law on the subject. If a taxpayer incurs a judgment debt for causing a traffic accident he has borrowed nothing, and reduction or cancellation of such a debt should not result in taxable income. The result is avoidance of a threatened loss, rather than a gain. Avoidance of a threatened loss does not increase the taxpayer's capacity to pay tax, and is not within the scope

20. *See* Treas. Reg. § 1.6050P-1(d) (1996).
21. *See* Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932) (holding that repurchase of bonds for less than par not taxable where bonds had been issued as a dividend and without value received).

even of the most comprehensive idea of taxable income. Compromises of debts for child support or alimony should also be exempt because neither is based upon a borrowing of any kind, but there is no reported law on the question, and some commentators apparently disagree.[22] The reduction of tax debts because of the taxpayer's inability to pay should also be exempt because the taxpayer borrowed nothing from the government, but somewhat amazingly, the IRS has asserted in several reported decisions that taxpayers incur taxable income through such a compromise with the government.[23]

Taxing cancellation of debts where the taxpayer has borrowed nothing and bought nothing produces the miracle of taxable income without gain. And yet this miracle has come to pass more than once in the courts because the rules are badly drafted and poorly understood. I will close this paper with a sampling of the reported litigation.

C. *Confusion in the Courts: Three Wrong Decisions*

1. *Zarin v. Commissioner*

The litigation in *Zarin v. Commissioner*[24] provides a fascinating spectacle of law gone off the rails. The scholarly commentary on this decision is enormous.[25] The commentators were (and remain)

22. *See* William A. Klein, *Tax Effects of Nonpayment of Child Support*, 45 TAX L. REV. 259 (1990), and Richard C.E. Beck, *Tax Treatment of Defaulted Child Support: The Better Approach*, 89 TAX NOTES 1073 (2000).

23. The government has never gone so far as to assert that cancellation of a tax debt by reason of a statute of limitations is taxable, but it appears that nothing is impossible in this area. *See generally* Richard C.E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation*, 14 VA. TAX REV. 153 (1994).

24. 916 F.2d 110 (3d Cir. 1990), *rev'g.* 92 T.C. 1084 (1992).

25. The commentaries at the time include Lee A. Sheppard, *A Gambling Exception to Cancellation of Indebtedness of Income*, 49 TAX NOTES 1516 (1990); Calvin H. Johnson, Zarin *and the Tax Benefit Rule: Tax Models for Gambling Losses and the Forgiveness of Gambling Debts*, 45 TAX L. REV. 697 (1990); Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 TAX L. REV. 707 (1990); Susan Clark Taylor, *Income Taxation –* Zarin v. Commissioner*: The Viability of the Transactional Approach to Discharge of Indebtedness Income*, 20 MEMPHIS ST. U. L. REV. 235 (1991); Joel S. Newman, *Five Will Get You Ten: You Haven't Heard the Last About* 'Zarin', 50 TAX NOTES 667 (1991); Alan Gunn, *Another Look at the* Zarin *Case*, 50 TAX NOTES 893 (1991); William R. Culp Jr. & Richard E. Marsh Jr., *Avoiding Cancellation of Debt Income Where the Liability is Disputed*, 74 J. TAX'N 288 (1991); Douglas E. Kulper, *Taxpayer Rolls the Dice and the IRS Craps Out; Forgiveness of Gambling Debts is not Income in* Zarin v. Commissioner, 1991 UTAH L. REV.

about equally divided as to whether Zarin should have been taxed. And very interestingly, the litigation also involved at least two other forms of "incidental" income already discussed above, namely income from larceny and from gambling.

When the first legal gambling casino, Resorts International, opened its doors in Atlantic City, Zarin became a compulsive gambler and played dice for 16 hours a day, seven days a week. He gambled on credit, signing IOUs in exchange for chips, and ran up a casino debt of $3.4 million for losses at craps before Resorts cut off further credit. Resorts sued Zarin to collect its debt, and Zarin resisted payment, claiming the debt was unenforceable under New Jersey law that forbade the casino from extending excessive credit (Zarin's credit limit was $200,000, and the New Jersey authorities had already cited and fined Resorts on some 50 occasions for illegally extending Zarin excessive amounts of credit). Zarin settled out of court and paid Resorts $500,000 in full satisfaction of the debt.

At this point the tax authorities stepped in and assessed Zarin for income tax on gains from larceny or trickery. Apparently some of Zarin's checks written to Resorts were dishonored for insufficient funds. The IRS then dropped this theory without explanation, changed its theory of assessment to COD income, and together with interest and penalties, demanded much more money from Zarin — $5.2 million — than the $3.4 million the casino had claimed. The IRS apparently saw no irony in ruining gamblers with tax debts due to unenforceable gambling debts, even though the New Jersey law making unreasonable credit unenforceable was obviously intended to protect compulsive gamblers from ruin at the hands of casinos.

In the Tax Court, Zarin lost in an *en banc* decision, eight judges to five, in which there were several dissenting opinions. The majority refused to accept the taxpayer's argument that he received noth-

617 (1991); Gregory M. Giangiordano, *Taxation – Discharge of Indebtedness –* Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990), 64 TEMPLE L. REV. 1189 (1991); Babette B. Barton, *Legal and Tax Incidents of Compulsive Behavior*, 45 TAX LWYR 749 (1992); Jay Katz, *Did* Zarin *Have a Tufts Day at a Casino Made out of* Kirby Lumber?, 26 UC DAVIS L. REV. 261 (1992); Jon D. Rigney, Note, Zarin v. Commissioner*: The Continuing Validity of Case Law Exceptions to Discharge of Indebtedness Income*, 28 SAN DIEGO L. REV. 981 (1991); and Deborah A. Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115 (1992).

ing but an opportunity to gamble, and dismissed his persuasive plea that the IRS's reasoning was perverse because the more he lost, the more taxes he would owe.

On appeal, the Third Circuit reversed and offered two somewhat different and equally confused arguments. First, the court found the "disputed debt" doctrine applicable, citing *Sobel*, despite the fact that *Sobel* was actually a purchase-money debt case, and despite the fact that in neither *Sobel* nor *Zarin* was the amount of the debt uncertain or disputed. Second, the court concluded that because the debt was probably unenforceable under New Jersey law, it was not within the statutory meaning of "debt" for purposes of creating COD income. Commentators were quick to point out the shortcomings of both lines of reasoning. Whether or not the debt was unenforceable, Zarin had received whatever benefits he had obligated himself to pay for, and was relieved of that obligation. A dissenting judge would have upheld the Tax Court on just this ground that Zarin had enjoyed in the casino the pleasures for which others would have had to pay $3.4 million.

Some commentators argued that Zarin should have been taxed because he received value for his debts in the form of "consumption" or "services." Even assuming that cancellation of a debt for services is taxable, and I think it is not, this reasoning is erroneous. Resorts performed no services for Zarin that Zarin did not also perform for Resorts in return: each promised to pay the other if the dice came up a certain way. If there were a sale of services of some kind, the transaction would not be gambling at all — gambling is the pure creation of risk, and not the sale of anything. Nor is anything consumed in gambling; money simply changes hands. Confusion of gambling with consumption seems to have been caused by the marketing strategy of casinos that try to present gambling as if it were some sort of family entertainment like going to the movies or to a football game. But the economics of gambling are the same whether it is conducted in a stately pleasure dome, or on a folding table in a busy sidewalk.

Thus, Zarin received neither money nor goods nor services, and because he received no consideration in exchange for his debt, he was left with nothing of value when the debt was canceled, and he should not be taxed.

The purpose and effect of the New Jersey law that made Zarin's debt unenforceable was to undo the gambling transactions themselves. The casino should never have provided the credit, and so the losses should never have occurred, and the parties should be put back into the positions they were in before the transactions were entered into. In short, the gambling losses were rescinded. This is very similar to the situation in *Sobel*, in which the purchaser on credit of securities that were improperly registered was allowed a right of rescission of the purchase.

The result is a tax-free return of capital. If Sobel's stock purchase had been for cash and the effect of rescission were a return of Sobel's cash, it would be obvious that the reimbursement was simply a tax-free return of capital. The same is true for Zarin. Zarin simply got his money back, he gained nothing, and the casino lost nothing (except its hoped-for gain).

One lingering doubt lies in the fact that Zarin did (inadvertently) receive a sort of option: if he won, he could keep his winnings and was under no obligation to rescind the contract.[26] The same is true under the securities law, however. If Sobel's stock had gone up rather than down, Sobel would never have demanded rescission of his stock purchase. But the law has never taken account of such hypothetical gains, and rightly so. There is no tax on the receipt of valuable business opportunities such as a good job or a lucrative business contract. Taxes are only imposed when and if the opportunity is translated into realized gains.

2. *Rood v. Commissioner*

In a subsequent case involving forgiveness of a gambling debt, *Rood v. Commissioner*,[27] the taxpayer (a former President of the Association of Trial Lawyers of America) succeeded in negotiating a reduced settlement in full of $255,000 for a casino debt of $435,000 to Caesar's Palace in Las Vegas, apparently because the casino de-

26. Incidentally, the value of this option can be calculated, but only by an expert in statistics. A free line of credit of $3.4 million, where the maximum bet is $15,000 as it was at Resorts, is worth about $197,000. And rather surprisingly, with the same $15,000 betting limit, a free line of credit of $1 million and of $1 billion is worth exactly the same, $197,000. *See* Michael Orkin & Richard Kakigi, *What is the Worth of Free Casino Credit?*, AM. MATHEMATICAL MONTHLY, Jan. 1995, at 3-4.

27. 71 T.C.M. (CCH) 3125 (1996).

sired to avoid the time and effort of collection proceedings. Rood was forced to pay tax on the $180,000 of debt discharged despite the fact that he made no gain by the reduction of debt, he merely reduced his loss. In *Rood*, the debt was apparently enforceable under Nevada law, and so the exception for unenforceability created by the Third Circuit in *Zarin* did not apply. This erroneous decision in *Rood* only confirms the incorrectness of the Third Circuit's analysis in *Zarin*. The mistake would have been impossible if the Third Circuit had decided for Zarin on the correct ground that he borrowed no money, rather than on the irrelevant ground that the debt was unenforceable

3. *Anderson v. Commissioner*

In *Anderson v. Commissioner*,[28] which is a very recent unpublished summary decision from the Tax Court, the taxpayer was held taxable on the compromise of a credit card debt. The taxpayer had permitted a friend to use his credit card to make purchases under an agreement that she would reimburse him for her purchases. She refused to honor her agreement, leaving the taxpayer to pay her bills of about $4,500. Anderson was under a clear written obligation to pay the issuing bank, but he did manage to persuade the bank to reduce the bill by some 30% ($1,372), and paid the remaining 70%.

The taxpayer did not intend to make his friend a gift, and he did not enjoy the benefit of his friend's purchases. In this situation it is obvious that the taxpayer suffered a loss, and that the doctrine of COD income should not apply. In fact, it is reasonably well understood that cancellation of a guarantor's obligation to pay the debt of a principal borrower is not COD income for just that reason: the principal debtor, not the guarantor, is the person who received the benefit of the loan.[29] Once again, the source of the error is that the statute does not limit COD income to loans for value received.

There appears to be a second source of error in *Anderson* as well. The taxpayer seems to have held a worthless debt from his friend. Creditors may deduct worthless debts if the right conditions

28. T.C. Summ. Op. 2003-169.
29. *See* Merkel v. Commissioner, 109 T.C. 463, 479 (1997).

are met, and in Anderson's case it appears that if he had paid the bank the $1,372, he would have been entitled to the bad debt deduction. And in turn the COD rules at IRC section 108(e)(2) specify that COD is tax exempt if payment of the debt would have given rise to a deduction. That seems to be precisely the situation in *Anderson*, and thus no COD income should arise for this reason as well.

The taxpayer appeared without a lawyer, however, undoubtedly because there was only $420 in taxes at stake, and his only argument appears to have been that he never received the information report Form 1099-C that the bank sent to the IRS.

V. Conclusion

The Puritan spirit of U.S. tax law has led to an overly idealistic conception of income, which often translates into impractical attempts to tax miscellaneous items that would be better simply to ignore, as many other more practical governments do. Sometimes, as in the case of COD income, this *jusqu'au-boutisme* has the perverse effect of taxing losses rather than gains. Taxation is at bottom a practical business of administration in which ideology should take second place. Congress should repeal taxes on found property, gambling, prizes for merit, damages awards for non-physical injury, and most especially COD income, where the game is simply not worth the candle.